CTBA | Center for Tax and Budget Accountability

Analysis of the Governor's Fiscal Year 2010 Illinois General Fund Budget Proposal

March 2009

Center for Tax and Budget Accountability

CTBA | Center for Tax and Budget Accountability

About CTBA

Founded in 2000, the Center for Tax and Budget Accountability is a non-profit, bi-partisan research and advocacy think tank committed to ensuring that tax, spending and economic policies are fair and just, and promote opportunities for everyone, regardless of economic or social status.

CTBA uses a data-focused, bipartisan approach to work in partnership with legislators, community groups and other organizations to help change both public policy and perceptions.

For More Information Contact:
Chrissy Mancini
Associate Executive Director &
Director of Budget and Policy Analysis
cmancini@ctbaonline.org
773-330-1141

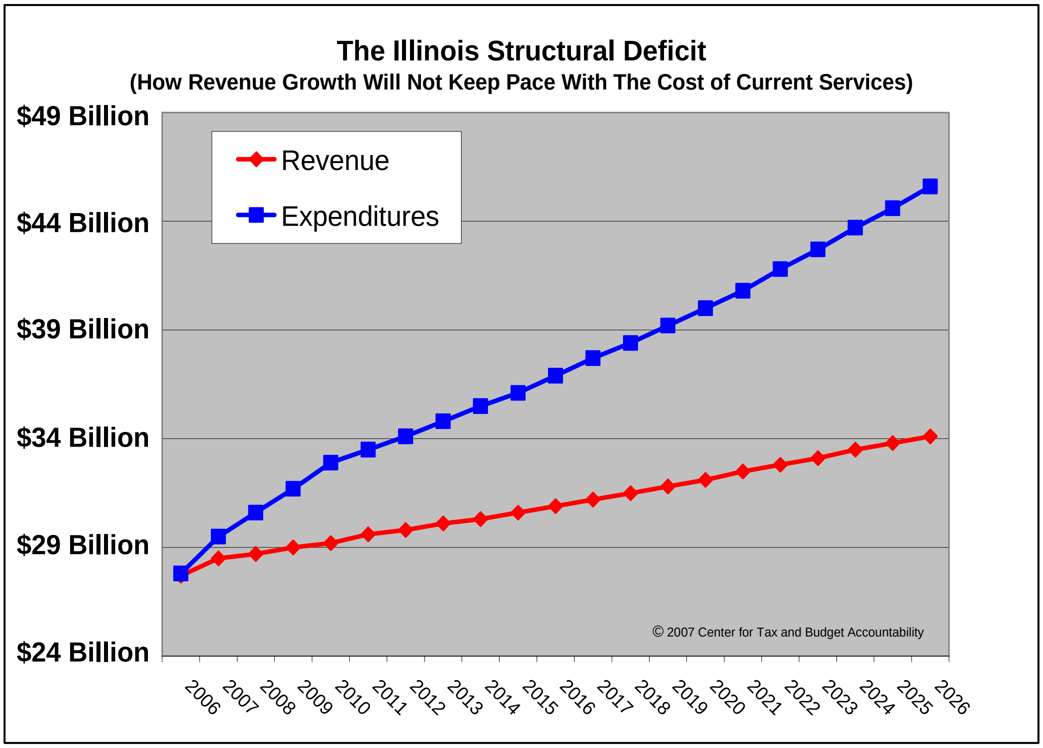
Center for Tax and Budget Accountability
70 E. Lake St, Suite 1700
Chicago, IL 60601
Phone: (312) 322-1041
Fax: (312) 578-9258
Www.ctbaonline.org

Analysis of the Governor's Fiscal Year 2010 General Fund Budget Proposal

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Figure 1



Illinois is in the middle of one of the worst economic downturns in history. The state's unemployment rate, which hit 8.6 percent this month, is at a 15 year high and is expected to climb.[1] The housing market has weakened, with permits for new construction down 50 percent from last year, and major job losses are expected to continue in manufacturing, construction and retail.[2]

When unemployment is high and businesses are struggling, even well designed state fiscal systems generate less tax revenue, especially from those revenue streams most directly tied to the economy, like income and sales taxes. The problem for Illinois state government is that it has a poorly designed fiscal system that struggles to generate adequate revenue—even during normal economic growth cycles. As Figure 1 demonstrates, Illinois has a "structural deficit." This simply means yearly revenue growth is inadequate to cover the annual increase in public service costs caused by inflation alone. Put another way, the state's revenue structure cannot provide sufficient funding to maintain existing service levels over time, much less support new or expanded programs. The failing economy, combined with the state's ongoing structural deficit, has created an aggregate budget deficit of $11.6 billion for Fiscal Years (FY) 2009 and 2010.[3]

Due to the recession and the state's ongoing structural deficit, Governor Quinn faced budgetary challenges unlike ever before when preparing his Fiscal Year (FY) 2010 budget proposal, including:

- A structural long standing deficit;[4]
- One of the worst economic downturns in history;
- Final FY 2009 revenues that are projected to be $2.35 billion less than FY 2008 revenues;
- FY 2010 revenue that is projected to be almost $200 million less than FY 2009;
- A $4.3 billion budget deficit for the current FY 2009;[5]
- A projected $7.3 billion budget deficit for FY 2010;[6]
- A combined $11.6 billion deficit for FY 2009 and FY 2010; and
- A $73.4 billion unfunded pension liability for the five state retirement systems.[7]

Sound economic theory and data demonstrate that the best approach state government could take to resolve a budget deficit during a recession is to maintain spending on essential public services by raising taxes progressively.[8] (For more information see CTBA's report, "Moving Forward," available online at http://www.ctbaonline.org). A "progressive" tax increase would shift tax burden from middle and low income earners to more affluent individuals, when tax burden is measured as a percentage of income. Implementing progressive tax reform is particularly important in Illinois, which currently ranks as the sixth most regressive taxing state in the nation.[9]

Governor Quinn has supported implementing a progressive tax increase to address a portion of the budgetary challenges facing Illinois. The Governor's progressive approach and willingness to level with voters about the need for revenue increases are laudable, and comport with sound economic theory. That said, his full proposal incorporates a combination of spending cuts, revenue increases, debt restructuring, pension underfunding and reductions in public employee pension benefits, all of which require a close analysis.

Governor Quinn will also receive some, one-time, non-recurring financial help from the Federal Government. President Obama signed the stimulus package, known as the "American Recovery and Reinvestment Act" (ARRA) of 2009, this February. ARRA will infuse over $6 billion to Illinois state government in funding for education, human services, health care, economic development and other programs over the next two years.

FY 2010 Governor's Proposed General Fund Budget Highlights

- Overall spending on public services in FY2010 is scheduled to increase in nominal terms by $693 million from FY2009 General Fund expenditures. After adjusting for inflation, real spending under the proposed FY2010 budget will increase by 2.4percent, or $665 million.[10]

- FY2010 base revenue growth, however, is projected to decrease by $198 million over FY2009 base revenues (this projection excludes federal funds from the ARRA).[11] This comes on the heels of FY2009, during which revenues are now projected to come in at $2.35 billion less than FY2008.[12]

- In FY2009, the General Assembly appropriated and Governor Quinn signed off on a $31.5 billion General Fund budget. The General Fund budget includes projected spending on public services appropriated under the General Revenue Fund (**GRF**), like education, health care and human services, as well as the state's special purpose funds, like the Illinois Wildlife Preservation Fund. As such, the General Fund budget provides a more complete basis for analyzing state revenue and spending trends than the GRF alone.

- The FY2009 General Fund budget was based on projected revenues of $31.5 billion.[13] However, the FY2009 revenue forecast was recently reduced and now stands at $27.2 billion, a result of the economy weakening throughout the fiscal year. This leaves a projected $4.3 billion shortfall between FY2009 appropriations and FY2009 revenues.

- Declining revenues and expected cost increases in mandatory expenditures such as Medicaid and employee benefits, leave a projected FY2010 budget deficit of $7.3 billion.[14]

- To reduce the budget deficit, the Governor proposes several initiatives, the most substantial of which are:

  - Increasing the individual and corporate income tax rates from 3 percent to 4.5 percent and 4.8 percent to 7.2 percent, respectively;
  - Eliminating certain tax expenditures that benefit businesses;
  - Reducing benefits under the state's five retirement systems;
  - Restructuring state debt to save an estimated $530 million;
  - Using federal stimulus funding received under ARRA to replace, dollar-for-dollar, state revenue that would have funded K-12 and higher education;
  - Underfunding the state retirement systems by $2.296 billion in FY2010;
  - Underfunding the state retirement systems by $550 million in FY 2009;
  - Cutting or flat funding various services.
- The FY2010 budget proposal includes increasing the per pupil education foundation level from $5,959 to $6,089.

- The FY2010 budget proposal includes: an 80 bed expansion at LaSalle Veterans' Home and a new 200 bed Chicago veterans home; $1 million to fund food banks across the state; creating 2,000 slots for the Illinois Summer Jobs programs for teens; and keeping state parks open.

- The Governor has also proposed a $26 billion capital program, funded partially through an increase in vehicle license fees and a portion of the new revenue from his proposed income tax increase.

- To the extent any of the Governor's proposed revenue initiatives do not pass, there will be revenue shortfalls that necessitate either passage of other revenue initiatives, incurring more debt or cutting existing or newly proposed programs. This is because Illinois, unlike the federal government, operates under a balanced budget requisite.[15]

FISCAL NOTE: WHY ADJUST FOR INFLATION?

The answer is simple. Adjusting for inflation is the only way to determine whether spending on public services and/or revenue growth: (a) is increasing in real terms, (b) is just keeping pace with cost increases generated by the economy over time, (c) is falling behind cost increases generated by the economy. The most common inflation metric is the "Consumer Price Index" or "CPI", published by the Bureau of Labor Statistics. The CPI is the rate of inflation based on the change in the cost of all goods and services that collectively constitute the U.S. consumer economy. However, public services, whether education, police protection, healthcare or human service related, are labor intensive endeavors, with labor costs generally comprising over 80 percent of total cost. Hence the CPI is not the most accurate inflationary metric to use for determining the increased costs of public services annually. The more accurate inflation metric is the "Employment Cost Index" or "ECI" (also published by the Bureau of Labor Statistics), which is tied directly to changes in labor market costs.

OVERALL SPENDING

Figure 2 illustrates the Governor's proposed FY2010 General Fund spending by major purpose.

Figure 2

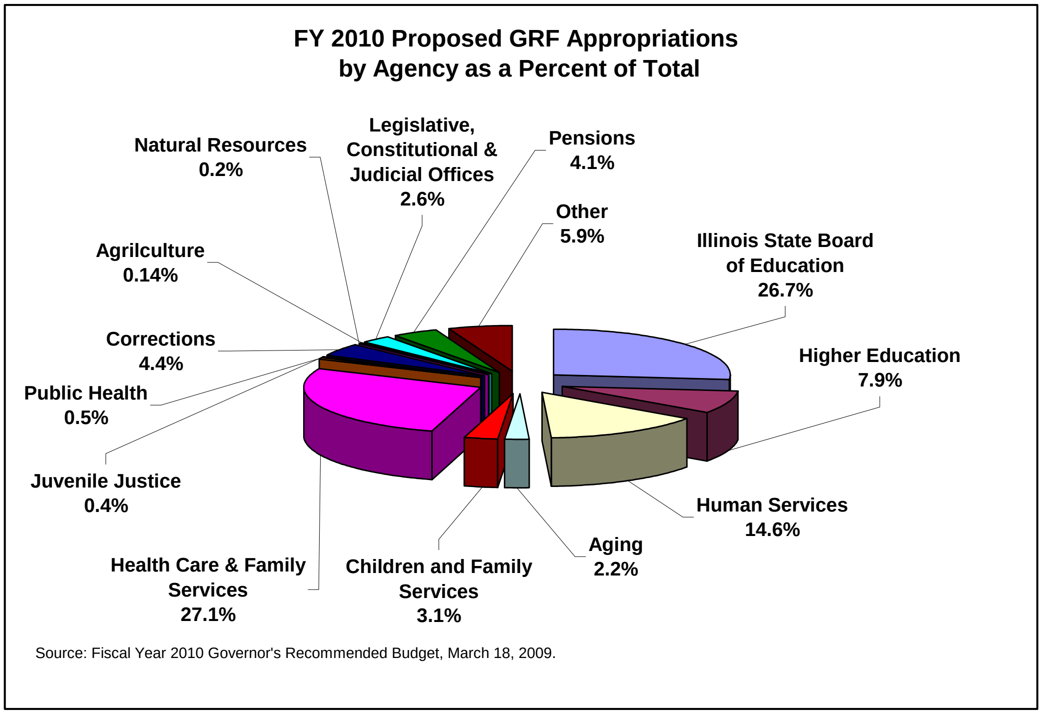


Figure 3 shows: (i) the FY2009 estimated General Revenue Fund budget; (ii) the inflationary cost of maintaining FY2009 service levels in FY2010, using the CPI; (iii) the proposed FY2010 budget; and (iv) the difference between the budget as proposed and the inflationary cost using the CPI of maintaining FY2009 services in FY2010.

Figure 3
General Fund Spending: Proposed FY2010
Compared to FY2009 Inflation Adjusted (CPI) ($ in millions)

Category	FY2009 Estimated	FY2009 Inflation Adjusted (CPI)	FY2010 Proposed	Difference FY2009 Inflation Adjusted and FY2010 Proposed	Percent Change FY2009 Inflation Adjusted and FY2010 Proposed
General Revenue Fund Total	$27,854	$27,881.9	$28,547	$665.1	2.4%

Source: Illinois FY 2010 Proposed State Budget

Figure 4 shows the same categories as Figure 3, except the inflation adjustment is based on the more accurate Employment Cost Index (ECI).

Figure 4
General Fund Spending: Proposed FY2010
Compared to FY2009 Inflation Adjusted (ECI) ($ in millions)

Category	FY2009 Estimated	FY2009 Inflation Adjusted (ECI)	FY2010 Proposed	Difference FY2009 Inflation Adjusted and F 2010 Proposed	Percent Change FY2009 Inflation Adjusted and FY2010 Proposed
General Revenue Fund Total	$27,854	$28,689.6	$28,547	-$142.6	-0.5%

Source: Illinois FY 2010 Proposed State Budget

Figure 5 compares estimated FY2009 GRF spending to the proposed FY2010 GRF spending, itemized by major government department. It also includes the inflation-adjusted cost (CPI based) of maintaining FY2009 services in FY2010.

Figure 5
Comparison of GRF Spending by Department Inflation Adjusted (CPI): FY2009 & FY2010 Proposed

Category	FY2009 Estimated	FY2009 Inflation Adjusted (CPI)	FY2010 Proposed	Difference FY2009 Inflation Adjusted and FY2010 Proposed	Percent Change FY2009 Inflation Adjusted and FY2010 Proposed
Illinois State Board of Education	$7,383	$7,390.4	$7,627	$236.6	3.2%
Higher Education	$2,164	$2,166.2	$2,248	$81.8	3.8%
Human Services	$4,118	$4,122.1	$4,164	$41.9	1.0%
Aging	$611	$611.6	$620	$8.4	1.4%
Children and Family Services	$863	$863.9	$899	$35.1	4.1%
Health Care & Family Services	$6,876	$6,882.9	$7,734	$851.1	12.4%
Public Health	$154	$154.2	$150	-$4.2	-2.7%
Juvenile Justice	$123	$123.1	$125	$1.9	1.5%
Corrections	$1,310	$1,311.3	$1,244	-$67.3	-5.1%
Natural Resources	$63	$63.1	$69	$5.9	9.4%
Agriculture	$41	$41.0	$39	-$2.0	-5.0%
Legislative & Judicial Offices, Elected Officials & Elections	$792	$792.8	$766	-$26.8	-3.4%

Source: Illinois FY 2010 Proposed State Budget

Figure 6 also compares GRF FY2009 spending levels to FY2010 proposed spending levels itemized by government department, this time adjusting for inflation based on the more accurate ECI.

Figure 6:
Comparison of GRF Spending by Department Inflation Adjusted (ECI): FY2009 & FY2010 Proposed

Category	FY2009 Estimated	FY2009 Inflation Adjusted (ECI)	FY2010 Proposed	Difference FY2009 Inflation Adjusted and FY2010 Proposed	Percent Change FY2009 Inflation Adjusted and FY2010 Proposed
Illinois State Board of Education	$7,383	$7,604.5	$7,627	$22.5	0.3%
Higher Education	$2,164	$2,228.9	$2,248	$19.1	0.9%
Human Services	$4,118	$4,241.5	$4,164	-$77.5	-1.8%
Aging	$611	$629.3	$620	-$9.3	-1.5%
Children and Family Services	$863	$888.9	$899	$10.1	1.1%
Health Care & Family Services	$6,876	$7,082.3	$7,734	$651.7	9.2%
Public Health	$154	$158.6	$150	-$8.6	-5.4%
Juvenile Justice	$123	$126.7	$125	-$1.7	-1.3%
Corrections	$1,310	$1,349.3	$1,244	-$105.3	-7.8%
Natural Resources	$63	$64.9	$69	$4.1	6.3%
Agriculture	$41	$42.2	$39	-$3.2	-7.6%
Legislative & Judicial Offices, Elected Officials & Elections	$792	$815.8	$766	-$49.8	-6.1%

Source: Illinois FY 2010 Proposed State Budget

K-12 EDUCATION

For FY2010, the state proposes increasing PreK-12 education by $244 million over FY2009 in nominal dollars, or $236.6 million after adjusting for inflation using the CPI. The proposed FY2010 increase in education spending, however, falls to a meager $22.5 million, using the more accurate ECI.

Major Proposed Education Funding Increases for FY2010 include:

- An increase in the K-12 Foundation Level of $130, from $5,959 per pupil to $6,089 per pupil.
- Note the Foundation Level does not represent total school expenditures per child, because it does not include many basic costs, like transportation and special education. Instead, the Foundation Level is just the minimum amount that all school districts are supposed to spend per pupil, through a combination of state and local property tax revenue, to cover the cost of core academic programs.
- The current Foundation Level is not based on any objective, measurable standard. It simply represents what the state believes it can afford. The nonpartisan Education Funding Advisory Board or "EFAB", has recommended that the FY2010 Foundation Level be $7,388[17] per child, based on its determination of the minimum amount per pupil needed to cover the actual cost of academic curriculum and teachers of sufficient quality to permit an efficiently operated school district to obtain the result of having two-thirds of its non-at-risk children pass the Illinois standardized tests.

The current Foundation Level is not based on any objective, measurable standard. It simply represents what the state believes it can afford.

- The Governor's proposed Foundation Level increase is still $1,299 short of the FY2010 Education Funding Advisory Board recommendation of $7,388 per pupil. Attaining the EFAB level of funding should generate better academic performance. For more information on why, see the CTBA report, "Money Matters", available online at http://www.ctbaonline.org.
- Fully funding the state's share of mandated categoricals, including special education, transportation and school breakfast and lunch.
- Allocating $1.5 million to improve low performing high schools.
- A $12.5 million increase for early childhood education.
- An $8.0 million increase in bilingual education.
- Funding for a Longitudinal Data System to integrate student data across educational careers from preschool through post-graduate studies.
- From the federal stimulus funding targeted to Illinois under the ARRA, K-12 education will receive a total of $2.8 billion over the next two and one-half years. This funding will be used in the following areas:

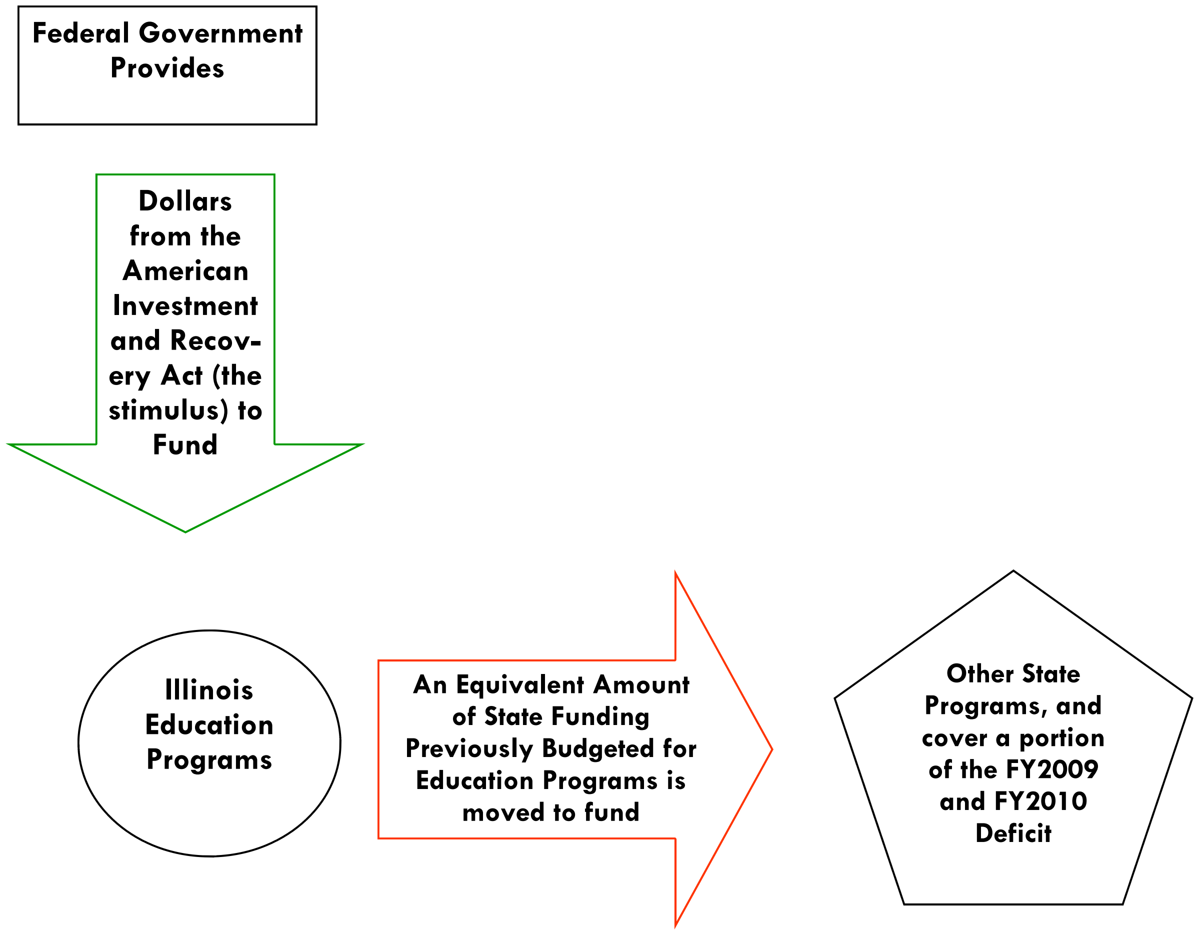
  - Title I - $335 million in Title I formula grants in FY2010, with an additional $545 million being disbursed directly to local school districts to help support programs for children at risk of academic failure. (Title I of the Elementary and Secondary Education Act of 1965 provides federal funding for improving the academic achievement of disadvantaged students).
  - IDEA, or the Individuals with Disabilities Education Act – An additional $262 million in FY 2010 and $524 million overall will go directly to school districts to help ensure that all children with disabilities receive a quality public education.
  - Education Technology – Over $26.5 million will go toward integration of technology resources, teacher training and curriculum development.
  - An undetermined amount of the stimulus money will be used for: expanded support for National Board Certified Teachers to teach in hard to staff schools; teacher and principal mentor support; and strengthening Illinois K-12 learning standards.

For more on EFAB and school funding, see the CTBA issue brief, The Illinois School Funding Formula and the Distribution of General State Aid, available online at: http://www.ctbaonline.org/Education.htm

Unfortunately, this federal money will not effectively increase funding for education. Instead, the federal funds received under the stimulus package will be used to replace state-based revenue that otherwise would have funded education programs. This in turn allows Illinois to implement a minimal increase for education with the federal stimulus funds. State revenue that otherwise would have gone to education will instead fund other state programs.

For example, funding from state-based revenue that previously was targeted to programs like bilingual education, mentoring, transportation and special education, was reduced and replaced in part or entirely by the new federal funds for education under the stimulus bill. How this process works is outlined in Figure 7.

Figure 7



HIGHER EDUCATION

For FY2010, the state proposes increasing higher education funding by $84 million in nominal terms, or $81.8 million after adjusting for inflation using the CPI, a 3.8 percent increase. Using the more accurate ECI, higher education funding increases by $19.5 million in real terms, or 0.9 percent. Higher education programs will realize additional federal stimulus funding under the ARRA, including the following:

- Beginning July 1, 2009, the U.S. Department of Education will provide an additional $500 to each eligible PELL grant student in Illinois, increasing the grant from its current level of $4,850 per student, to $5,350. Moreover, funding will be provided to award PELL grants to an additional 10,000 Illinois students.
- Community colleges will receive an additional $9.6 million targeted to reducing their reliance on student tuition and local property taxes.
- A $21 million increase in the Monetary Award Program (MAP) to help low and middle income students attend colleges and universities.

Health Care

For FY2010, the State proposes a nominal dollar increase of $858 million for the Department of Healthcare and Family Services (DHFS) over FY2009 estimated spending. After adjusting for inflation using the CPI, DHFS will see a real increase of $851.1 million or 12.4 percent. Using the more accurate ECI, the real increase for DHFS is $651.7 million, or 9.2 percent.

- The stimulus package implemented under the ARRA increased the federal matching rate for Illinois' Medicaid program from 50.32 percent to 60.48 percent for the 27 months starting October 1, 2008. The estimated benefit to Illinois is $2.9 billion across all Medicaid spending and funds. The state is required to maintain payment times for healthcare providers at 30 days and reduce payment times for hospitals and nursing homes to 30 days by June 1, 2009, in order to take full advantage of the funding.

Revenue

As Figure 8 shows, the Governor's Office of Management and Budget (GOMB) estimate that in FY2010, state revenues will be $198 million less than FY2009 from state-based sources, in nominal dollars.

Figure 8: GOMB Estimated Revenue Growth

FY 2010 Forecasted Revenue Growth from Existing Sources			
Revenue Source	**FY 2009**	**FY 2010**	**Difference**
State Sources	$20,886	$19,699	-$1,187
Federal Sources	$4,699	$5,594	$895
Transfers In	$1,585	$1,679	$94
Total	**$27,170**	**$26,972**	**-$198**

Source: Illinois FY 2010 Proposed Budget

Budget Deficit

For FY2009 and FY2010, the state forecasts an aggregate budget deficit of $11.6 billion.

Figure 9: Forecasted Budget Deficit

$ in millions	FY 2009	FY 2010	Two Year Total
Revenue	$27,170	$26,972	$54,142
Spending (includes increases in required costs such as labor and Medicaid)	$31,487	$34,261	$65,748
Deficit	**-$4,317**	**-$7,289**	**-$11,606**

Source: Illinois FY 2010 Proposed Budget

The State of Illinois has a forecasted budget deficit of $11.6 Billion for Fiscal Years 2009 and 2010.

NEW REVENUE INITIATIVES

To close the budget deficit in FY2009 and FY2010, the Governor has proposed some revenue enhancements. These include:

(a) Tax Increases and Reforms

- Increase the Individual Income Tax Rate from 3.0 percent to 4.5 percent;
- Increase the Corporate Income Tax Rate from 4.8 percent to 7.2 percent;
- Increase the State Cigarette and Other Tobacco Products Tax by $1.00 per pack; and
- Increase the dependent exemption. Coupled with raising the individual income tax rate, the Governor has proposed increasing the dependent exemption from $2,000 to $6,000. Everyone, regardless of wealth would receive the tax benefit. CTBA estimates a $4,000 increase in the exemption will cost $1.4 billion.

  Increasing the exemption to $6,000 means single taxpayers earning $14,000 and a family of four earning $56,000 would pay no additional income tax under the proposed rate increase. Singles earning less than $14,000 and a family of four earning less than $56,000 would realize a decrease in the amount of income taxes paid.

  Two issues with raising the exemption are (a) the cost, $1.4 billion, is a significant amount of the revenue received from the proposed individual income tax rate increase and (b) it is not adequately targeted. Illinois places a significantly greater tax burden on low and middle income families than on affluent families when tax burden is measured as a percentage of income. In Illinois, the poorest one-fifth of households pay about 13 percent of their incomes in state and local taxes, while the wealthiest 1 percent of earners spend less than 5 percent of theirs on such taxes.[18] A better approach to creating a fairer tax system in Illinois is a targeted tax credit for only low and middle income earners. A targeted tax credit would go to those who need it most while costing significantly less than $1.4 billion.

(b) Eliminating Corporate Tax Expenditures

Among the corporate tax expenditures modified or eliminated in the Governor's proposal are the following:

- Including the "Outer Continental Shelf" and "U.S. Territories" in the definition of the "United States", thereby rendering corporations organized in those territories subject to Illinois' corporate income tax;
- Repealing the Research and Development Exemption;
- Making prewritten software that is acquired via a licensing agreement subject to the same tax as software purchased off the shelf;
- Revising a provision in the Insurance Tax Law that allows large entities to purchase insurance directly from an underwriter who is not licensed in Illinois, and thus avoid the state's insurance tax;
- Allowing the Manufacturers' Purchase Credit to expire. A manufacturer may earn the Manufacturer's Purchase Credit when purchasing exempt manufacturing machinery and equipment. The credit may be used to satisfy Use Tax or Service Use Tax liability;
- Reducing the retailer's discount rate for FY2010 to 0.75 percent from 1.75 percent (the Governor estimates this will finance his proposed Sales Tax Holiday). The retailer's discount currently allows businesses that charge and collect the sales tax for the state to keep 1.75 percent of the sales tax they collect;
- Limiting credits that a corporation can take to 50 percent of the state income tax they owe;
- Taxing all grooming and hygiene products at the same rate. Some grooming and hygiene products like shampoo and soaps claiming medicinal qualities are taxed at the qualifying food and drug sales tax rate of 1 percent while other products on the shelf are taxed at the full 6.25 percent state sales tax rate. Under Governor Quinn's plan, the medicated products would no longer be exempt from the regular sales tax based solely on what the labels say. (Athletes' foot creams and other antifungal salves are still considered medicinal, and would sill be taxed at the lower rate);
- Limiting the Graphic Arts Machinery and Equipment Exemption to only Graphic Arts firms; and
- Decoupling from the following provisions of the American Recovery and Reinvestment Act.
  - -Deferral of gain recognition from reacquisition of business debt security, and
  - -The Net Operating Loss Deduction.

(c) Other Initiatives

- Debt Restructuring - The Governor proposes restructuring the state's outstanding debt to save money by taking advantage of historically low interest rates. Other state and local governments have recently done the same.[19] The Governor estimates his proposed debt restructuring plan should save the state **$530 million** in fiscal year 2010.
- Sales Tax Holiday – The Governor proposes a ten day sales tax holiday in August, 2009. A "sales tax holiday" simply means the state won't charge its sales tax on specific items it normally would. Qualifying items in the Governor's sales tax holiday include clothing and footwear with a price of $100 or less (per item) and school supplies. The Governor estimates that the reduction he has proposed in the retailer's discount, from 1.75 percent to 0.75 percent will cover the cost of the sales tax holiday.

(d) Underfunding the State Retirement Systems
The Governor proposes underfunding the state retirement systems by $2.846 billion over Fiscal Years 2009 and 2010.

(e) Budget Cuts in FY 2010
The Governor also projects savings from cutting expenditures on the following services:

- Cut spending on workers' salaries by requiring state employees to take four, unpaid furlough days (excluding workers who provide direct patient care or public safety), generating **$36 million** in savings;
- Implement an across-the-board two percent reduction in grant programs, excluding health care and education programs, for a savings of **$80 million**;
- Implement cuts and efficiencies throughout various state agencies, for a savings of **$390 million**;
    - Examples include consolidating the Historic Preservation Agency into the Department of Natural Resources, and combining two labor boards, and
    - Consolidating state leases.

The Governor proposes underfunding the state retirement systems by $2.846 billion over Fiscal Years 2009 and 2010.

(f) Flat Funding Programs
The Governor projects decreasing spending pressure in the FY2010 budget by holding appropriations for the following programs at the FY2009 levels:

- Services for seniors and persons with disabilities, saving $44 million,
- Mental health grants, saving $12 million,
- After school programs, saving $6 million, and
- Developmental disability grants, saving $26 million.

(g) Cost Shifting
The Governor projects saving the state $200 million by shifting more of the cost for retiree pension and healthcare benefits to current state employees and retirees.

Figure 10: Proposed Revenue and Spending Changes to Reduce the Budget Deficit

$ in millions	FY 2009	FY 2010	Two Year Total
Revenue	$27,170	$26,972	$54,142
Spending	$31,487	$34,261	$65,748
Deficit	**-$4,317**	**-$7,289**	**-$11,606**
Deficit Closing Proposals			
Revenue Actions			
Federal Stimulus	$2,155	$1,843	$3,998
Individual and Corporate Income Tax Rate Increase	$0	$3,207	$3,207
Loopholes, Fees, Fund Sweeps	$199	$1,054	$1,253
Subtotal Revenue Actions	**$2,354**	**$6,104**	$8,458
Spending Actions			
Underfund Retirement Systems	$550	$2,296	$2,846
Medicaid Payments (to pay down current backlog)	**-$1,491**	$0	**-$1,491**
All Other Spending Cuts	$155	$1,303	$1,458
Subtotal Spending Actions	**-$786**	**$3,599**	$2,813
Total Deficit Closing Proposals	**$1,568**	**$9,703**	**$11,271**
Deficit After Budgetary Actions	**-$2,749**	**$2,414**	**-$335**

Source: Illinois FY 2010 Proposed Budget

State Retirement Systems

(a) The Current System.

The state of Illinois maintains five separate retirement systems for public employees: the State Employees Retirement System; the Teachers Retirement System; the State Universities Retirement System; the General Assembly Retirement System; and the Judges' Retirement System.

After decades of underfunding its employer contribution to each of these five systems, Illinois now has the greatest total unfunded pension liability in the nation, an astounding $73.4 billion.[20] The debt affects everything from the revenue available to fund public services like education and healthcare, to the state's bond rating and ability to pursue capital improvement projects.

Funding the five state retirement systems for public employees has challenged Illinois state government for decades. In fact, the main reason Illinois has such a large retirement system unfunded liability does not stem from generous benefits, the benefits are about average,[21] or high basic costs (the weighted average normal cost across all five systems is 9.3 %, which is 26% less than the national average).[22] Instead, the main reason Illinois has run up a large unfunded liability is simple—the state's revenue system has historically underperformed over time, creating the structural deficit described previously in this report. As state decision makers continually found themselves short of the revenue needed to cover both maintaining essential services from one year to the next, and making the full, actuarially determined employer contribution required to fund the pension systems, they consistently opted to skip full funding of the retirement systems to maintain spending on services.

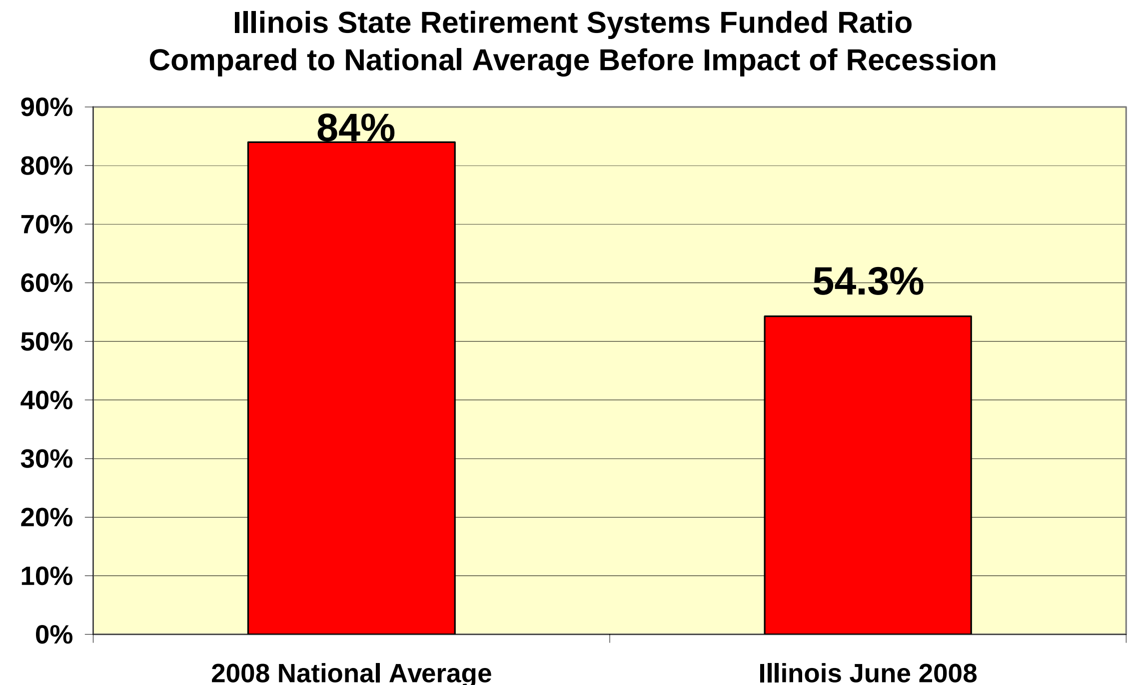
Effectively, this meant Illinois was diverting payments it owed to the retirement systems to cover the cost of providing current public services. Essentially, the pension systems were used as a credit card. When the state fails to pay its required pension contributions, the amount it ultimately must contribute grows substantially over time. That is because under state law, any funding shortfall must be paid back with interest, compounded at each retirement system's target rate of return, currently pegged at 8.0% to 8.5% per year, depending on the retirement fund.[23]

The deadly combination of years of systemic state underfunding of its employer contribution to the pension systems, followed by the cataclysmic decline in asset values caused by the national meltdown in financial markets over the last year, have led to an all-time high in the state's unfunded pension liability. This unfunded liability, or the difference between the systems' accrued liabilities and net assets, reached $73.4 billion in December, 2008. That was an increase of almost $20 billion in only a few months.[24] The ongoing struggles in financial and capital markets continue to have a negative impact on investment returns for the state's five retirement systems. So much so that in the current fiscal year 2009, investment returns of the Teachers Retirement System are down 25.5 percent, and those of the State Universities Retirement System have declined 26.7 percent. The remaining three systems' investment returns have dropped by 20.9 percent.

For more on the Illinois State Pension Systems contact Bukola Bello,
Director of the Illinois Retirement Security Initiative
at bbello@ctbaonline.org or visit:
http://www.ctbaonline.org/Pensions.htm

The huge increase in the aggregate unfunded pension liability has led to a corresponding decrease in the funded ratio of the five state retirement systems. The "funded ratio" of a retirement system is simply the percentage of what is required to be funded versus what has actually been funded. Illinois has one of the worst funded ratios in the nation.[25] In June 2008, Illinois' funded ratio was 54.3 percent, far below the 2008 national average funded ratio of 84 percent found by Wilshire Associates.[26]

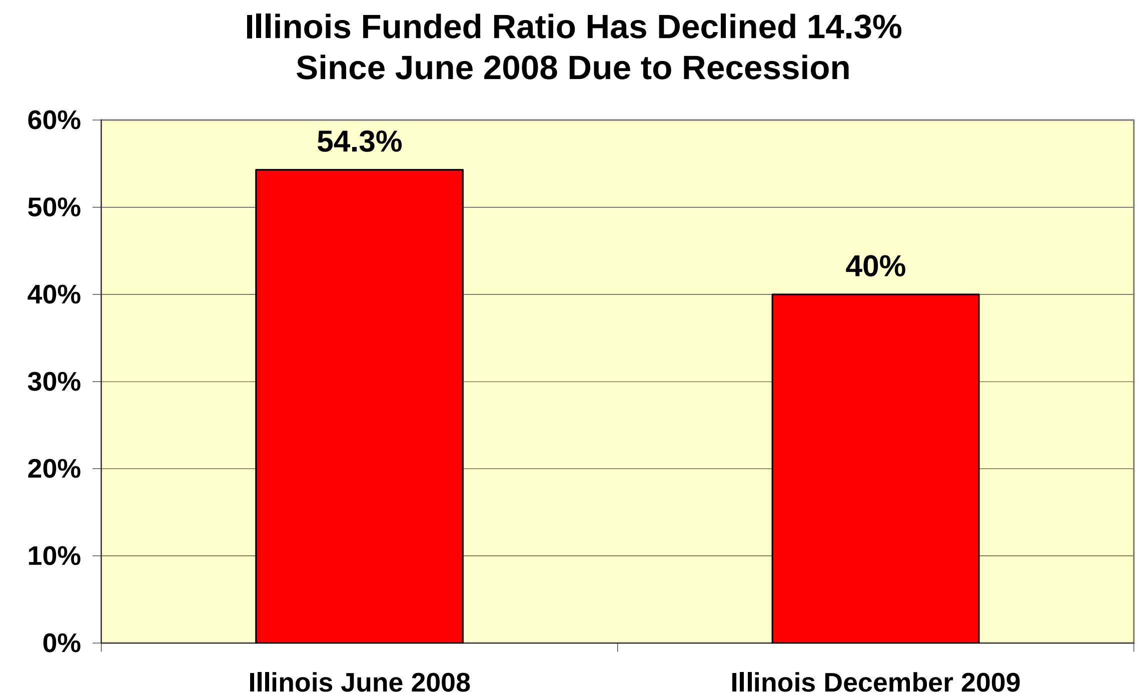
Figure 11



Source: Illinois Commission on Government Forecasting and Accountability, February Monthly Revenue Update, February 2009 and 2009 Willshire Report on State Retirement Systems: Funding Levels and Asset Allocation

Due to the meltdown of the financial markets, from June 2008 to December 2009, the Illinois funded ratio declined 14.3 percent and to date stands at 40 percent, less than half of the national average.

Figure 12



Source: Illinois Commission on Government Forecasting Accountability February 2009 Report on the Fiscal Condition of the Illinois State Retirement Systems as of June 2008 and February 2009 Monthly Revenue Update.

Though negative investment returns caused the unfunded pension liability to increase dramatically over the past few months, historically it is not the main reason for the state's unfunded liability. The main reason is the state has often chosen to skip its required employer contribution, and Governor Quinn's FY2010 budget proposal repeats this unsound practice, as detailed in Section 10(d) below.

(b) The Pension Ramp.

The state attempted to address its unfunded pension liability in 1994, under P.A. 88-0593, which became commonly known as the "**Pension Ramp**". Intended to force increased payments to the retirement systems over time, the Pension Ramp established a timeframe during which Illinois was required to fund both: (i) the actuarially determined employer contribution the state owed for retirement benefits accruing to existing employees (the "**Normal Cost**"); plus (ii) make up a portion of previously unpaid employer contributions and the associated return thereon. The Pension Ramp amortized this payment schedule over 50 years, with a target of funding 90% of total actuarial liabilities by 2045. The Pension Ramp created a framework that established a 15 year ramp period, during which the newly mandated contributions Illinois had to make for current and past employees increased in annual increments. Since these makeup payments increased annually, they became known as the "**Pension Ramp**", that is, they "ramp-up" over time.

(c) The Pension Obligation Bonds.

In FY2003, then Governor Blagojevich decided the state's revenue system could not fund the required contributions under the Pension Ramp. He therefore had the General Assembly approve issuing $10 billion in pension obligation bonds (the **"Pension Obligation Bonds"**). The concept supporting the Pension Obligation Bonds was simple, interest rates on the bonds would be lower than the 8 - 8.5 percent compounding interest the state owed on its unfunded pension liability. Selling the Pension Obligation Bonds at the lower interest rate would save Illinois money long-term, over what it would have had to pay the systems in interest. This arbitrage play was quite risky to begin with, but would have worked out better if the state had contributed the full $10 billion it received from the bond sale directly into the pension funds. Then the only risks would be market based. Sadly, the state only contributed about $7.3 billion of the bond proceeds to the five retirement systems. It used 2.7 billion to cover basic budget operating costs in FY2003 and FY2004. Governor Blagojevich justified this action by taking the present value of the projected savings over time—a highly unsound fiscal practice, that looks disastrous in retrospect.

(d) Underfunding the Retirement Systems.

In FY2006 and FY2007, on a strictly partisan vote, the General Assembly elected not to make its full, scheduled pension contributions under the Pension Ramp. Collectively over those two fiscal years, the state underfunded its required employer contributions under the Pension Ramp by $2.3 billion. This was accomplished through legislation that created a two year, partial "**Pension Holiday"** under P.A. 094-0004 (Senate Bill 27). So, Illinois again repeated the unsound practice of borrowing against the retirement systems to cover the cost of providing public services.

For FY2010, Governor Quinn has proposed funding the current normal cost across the five systems of $1.517 billion, and the $544 million in debt service on the Pension Obligation Bonds the state floated in 2003-2004. But Governor Quinn also proposes skipping $550 million of the required Pension Ramp payment in FY 2009, and not making $2.296 billion in required employer contributions in 2010. This essentially skips the Pension Ramp payments over two years, pushing that liability onto future generations. Recall that each year that pension obligations are unpaid, the investment return the state must make up on the unpaid contribution ***compounds*** at 8.0 percent to 8.5 percent annually.

Governor Quinn also proposed several benefit cuts to the five Illinois state retirement systems, which he estimates will save $162 billion through 2045. These benefit cuts include:

Employee Contributions

- State employees would be required to increase the contribution they make to the pension systems by an additional two per cent of their state wages. Currently employee contributions to the systems for those **not covered** by Social Security range from 8.0 percent of pay to 11.5 percent and for those **covered** by Social Security from 4.0 percent of pay to 8.0 percent.[27]

Establishing a new lower tier of benefits for new hires, including:

- A reduction in the benefit formula from 2.2 percent to 2 percent for those not covered by Social Security, and from 1.67 percent to 1.5 percent for those who are covered.
- Raising the normal retirement age to 67 across the board. Currently the systems have varying retirement ages depending on years of service.
  - -For example currently teachers have the option to retire at age 62 with five years of service, at age 55 with 35 years of service or age 55 with 20 years of service at a discounted annuity.
  - -State employees retire at 60 with 8 years of service and 55 for early retirement with a minimum of 25 years of service.
- Capping annual cost of living adjustments (COLAs) to 50 percent of the CPI or 3 percent, whichever is less.
- Ending compounded COLAs.
- Determining final average salary by a participant's highest eight years of service instead of the current highest four years of service.

DEBT AND ONE TIME REVENUES

Governor Quinn has proposed several budgetary maneuvers to help close the FY2009 and FY2010 budget deficits. Figure 13 shows the Governor's budget proposal relies on one-time, non-recurring revenue of $2.7 billion in FY 2009 and $5.1 billion in FY2010, that will not be available again to fund current services. While some one time revenues such as debt restructuring make sense if the state can utilize historically low interest rates, skipping required employer pension payments to the state retirement systems is fiscally unsound and only pushes debt off to future years.

Figure 13
FY 2009 & FY 2010 Budget Spending Covered by Debt & One-Time Revenues

$ in millions	FY 2009	FY 2010
Revenue from 10th Casino License		$50
Federal Stimulus	$2,155	$1,843
Skipped Employer Contributions to the State Retirement Systems	$550	$2,296
Fund Sweeps		$450
Debt Restructuring		$530
Total	**$2,705**	**$5,169**

Source: FY 2010 Governor's Budget Proposal

SHORT TERM BORROWING

Short-term borrowing is sometimes appropriate to help with cash flow or to weather one-time revenue shortfalls caused by a recession or unique event (like significant flood damage). That said, in FY 2009 the state borrowed $3.6 billion in short-term debt, just so it could pay some of its current bills. This is akin to a family taking out a loan to pay for groceries, heat and utilities. The very next month, the family will incur those same costs, plus have to repay part of the loan. In the state's case, the $3.6 billion in short-term borrowing incurred earlier this year must be paid back by the end of FY 2009.

Borrowing to pay for public services is problematic if used to cover ongoing revenue shortfalls caused by structural inadequacies in a fiscal system, rather than one-time revenue shortfalls caused by a recession. Over the past eight years, the state has utilized short term borrowing almost every year, mostly to pay Medicaid bills. Prior to FY 2002, the state had not practiced short term borrowing in over five years.[28]

Figure 14
Short Term Borrowing FY 2002 – FY 2007

Fiscal Year Short Term Borrowing	$ Amount in Millions	Reason
FY 2009	$3,650	To relieve General Revenue Fund Cash Flow Pressures
FY 2008	$2,400	Medicaid Bills
FY 2007	$900	Medicaid Bills
FY 2006	$1,000	Medicaid Bills
FY 2005	$765	Medicaid Bills
FY 2004	$850	Medicaid Bills
FY 2003	$1,500	Medicaid Bills, K-12 State Aid Payments, Income Tax Refunds, Long Term Care Payments
FY 2002	$1,000	Medicaid Bills, Income Tax Refunds, Long Term Care Payments
Total	**$12,065**	

Source: Illinois Commission on Government Forecasting and Accountability

CAPITAL BILL

It has been ten years since the last capital construction program was signed into law in Illinois. For FY2010, Governor Quinn has proposed a capital plan - "Illinois Jobs Now!"—which calls for $26 billion in infrastructure projects and will create an estimated 340,000 jobs.

The $26 billion program will be funded through a combination of state funds, as well as federal and local matching funds. Figure 15 identifies the projects that would be included in the Governor's proposed capital bill.

Figure 15
FY 2010 Proposed Capital Construction Program Spending by Purpose

Purpose	State	Federal	Local	Stimulus	Total
Multiyear Road Program (FY10 -FY 15)	$1,898	$7,499	$725		$10,122
Road and Bridge Program	$3,000			$936	$3,936
Education	$2,546		$1,600	$25	$4,170
Environment/Energy/Technology	$506	$1,023	$50	$375	$1,954
Transportation	$1,520	$3,020		$564	$5,104
State Facilities	$251	$15			$266
Economic Development	$875			$96	$971
Total	**$10,596**	**$11,557**	**$2,375**	**$1,996**	**$26,523**

Source: Illinois FY 2010 Governor's Proposed Capital Plan

Highlights of the proposal include:

- **$14 billion** for the state's bridges, roads, highways and interstates;
- **$4.6 billion** for mass transit agencies;
- **$4.2 billion** for education, including $3 billion in school construction matching grants; and
- **$200 million** in school maintenance funds.
- **$920 million** for higher education capital projects including:
  -Over $662 million for public university capital projects.
  -Over $158 million in community college capital project funding.
  -$100 million in private universities and colleges capital funding.
- **$971 million** for economic development to help stimulate job growth, provide affordable housing, improve community healthcare centers, and improve infrastructures to attract new businesses to Illinois.

FEDERAL RECOVERY OVERVIEW

The federal stimulus money under the American Recovery and Reinvestment Act of 2009 contains funding for capital programs that would supplement the projects targeted in the Illinois Jobs Now! plan. This federal stimulus funding would flow through the Department of Commerce and Economic Opportunity, Illinois Department of Transportation, Illinois Environmental Protection Agency and Department of Natural Resources.

Governor Quinn proposes to raise the revenue to fund the Illinois Jobs Now! initiative by:

- Increasing driver's license fees from $10 to $20.
- Increasing license plate renewal fees from $79 to $99.
- Increasing motor vehicle transfer fees from $65 to $105.
- Diverting some current motor fuel taxes and vehicle registrations fees.
- Using 10 percent of the revenue from his proposed personal income tax rate increase and corporate income tax rate increase.

Conclusion

Governor Quinn should be applauded for honestly telling citizens what they need to hear, not what they want to hear. Simply put, Illinois cannot make investments in needed services and infrastructure without raising tax revenue. Moreover, any tax revenue increase in Illinois should be accomplished through comprehensive reforms that modernize and stabilize the fiscal system, while making it fairer. The Governor again should be applauded for insisting that any tax increase be accomplished in a progressive fashion. Governor Quinn has shown the strength of character to lead on this subject, which hopefully can spark a bi-partisan conversation to design a modern tax system that assesses tax burden fairly.

That said, while the Governor should be applauded and supported for his approach, honesty and vision, his specific budget proposal does not go far enough to solve the long term fiscal problems confronting Illinois. Moreover, repeating the poor fiscal practice of underfunding the state's five pension systems exacerbates the problem, and should be avoided.

CTBA promotes implementing comprehensive fiscal reform that modernizes the Illinois tax system while keeping the state economically competitive like that proposed in SB750 and HB855. By taking the economically sound steps of expanding the state sales tax base to include services that our neighboring states tax, increasing the income tax rate from 3 percent to 5 percent, providing property tax relief and implementing a refundable credit for low and middle-income families to offset any additional tax burden from the reforms, Illinois can effectively reform its tax system to comport with the modern economy, assess tax burden more fairly among taxpayers, maintain its status as a low tax state overall, pay its debts and generate the recurring revenue needed to fund essential public services.

End Notes

1. Governor's State of Illinois FY 2010 Recommended Budget.
2. Governor's State of Illinois FY 2010 Recommended Budget and Illinois Commission on Government Forecasting and Accountability testi mony presented to the Senate Deficit Reduction Committee, March 24, 2009.
3. Governor's State of Illinois FY 2010 Recommended Budget.
4. Illinois Commission on Government Forecasting and Accountability testimony presented to the Senate Deficit Reduction Committee, March 24, 2009.
5. Governor's State of Illinois FY 2010 Recommended Budget.
6. Ibid.
7. Illinois Commission on Government Forecasting and Accountability February Monthly Revenue Update.
8. Center for Tax and Budget Accountability, *Moving Forward, To Counter the Current Recession, Illinois State Government Should Main tain or Enhance Spending—Even if it Means Progressive Tax Increases—Rather Than Cut its Budget*, March, 2009 available at www.ctbaonline.org.
9. Institute on Taxation and Economic Policy, Balancing Act: Choice for Illinois Tax Reform, February, 2006.
10. Inflation based on Consumer Price Index, Bureau of Labor Statistics was just one-tenth of one percent last year.
11. Governor's State of Illinois FY 2010 Recommended Budget.
12. Illinois Commission on Government Forecasting and Accountability testimony presented to the Senate Deficit Reduction Committee, March 24, 2009.
13. Ibid.
14. Ibid.
15. IL Const. art. VIII, § 2. Note: 49 of the 50 states have balanced budget requirements.
16. As estimated by the Government Office of Management and the Budget ("GOMB"), in the Governor's State of Illinois FY 2010 Recom mended Budget.
17. The FY 2010 EFAB recommendation of $7,388 is based on the FY 2010 Illinois State Board of Education recommended budget avail able at http://www.isbe.net/budget/FY10_budget_book.pdf
18. Institute on Taxation and Economic Policy, Balancing Act: Choice for Illinois Tax Reform, February, 2006.
19. State of New Jersey Department of Treasury, Analysis Shows State Realized Net Savings of $41 Million in Bond Issues and Subsequent Restructuring, October 29, 2008.
20. Illinois Commission on Government Forecasting and Accountability February Monthly Revenue Update.
21. United States Census Bureau, Employee Retirement Systems of State and Local Governments. 2001-2002. (This is the latest available national data).
22. Weighted average based on data provided by each of the five retirement systems.
23. Each system's Comprehensive Annual Fiscal Report lists their actuarial interest rate in the Actuarial Section.
24. Unfunded liability based on the Illinois Commission on Government Forecasting and Accountability February 2009 Monthly Revenue Update.
25. 2009 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation and Center for Tax and Budget Accountability, The Illinois Pension Funding Problem, Why it Matters, November 2006 available at www.ctbaonline.org
26. 2009 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation.
27. February 2009 Illinois Commission on Government Forecasting and Accountability Financial Condition of the State of Illinois Retirement Sys tems as of June 30, 2008.
28. Illinois Commission on Government Forecasting and Accountability Bonded Indebtedness Reports.