

Summary of the Recent Lottery/Pension Funding Proposal July, 2007

1. Proposal Summary:

A long term lease or sale of the Illinois lottery to generate \$10 billion in total revenue, which will be used toward paying down the state's \$40.7 billion unfunded pension liability.

2. Concerns:

A. Fiscal Policy Concerns

Operation of a lottery is not a core function of government, so it would be appropriate for the state to consider whether a long term lease or sale of the lottery would be beneficial to taxpayers. However, core function or not, the lottery does generate revenue to fund essential services, most notably education. In that sense, it represents a capital, revenue generating asset of the state. So, any transaction involving the disposition of a long term capital asset ought to include two fundamental components:

i) First, all the revenue generated from the disposition of this asset should be used for the sole purposes of either acquiring a new long term, revenue generating asset (e.g. a tollway) or to pay off a long term, higher priced debt of the state (e.g. the unfunded pension liability). None of the proceeds from the disposition of the lottery should be used to cover any current operating expenses of the state.

Sale of a long term revenue generating asset to cover an increase in operating expenditures is questionable fiscal policy. Once the asset is sold, and the proceeds spent the state loses the asset's ongoing revenue generation, creating pressure on remaining revenue sources to increase at rates sufficient to cover the lost revenue source. Illinois' revenue generation from its current tax system does not even keep pace with inflation, and in fact, no current revenue source can grow at levels sufficient to continue paying for the services they currently fund, plus generate hundreds of millions more.

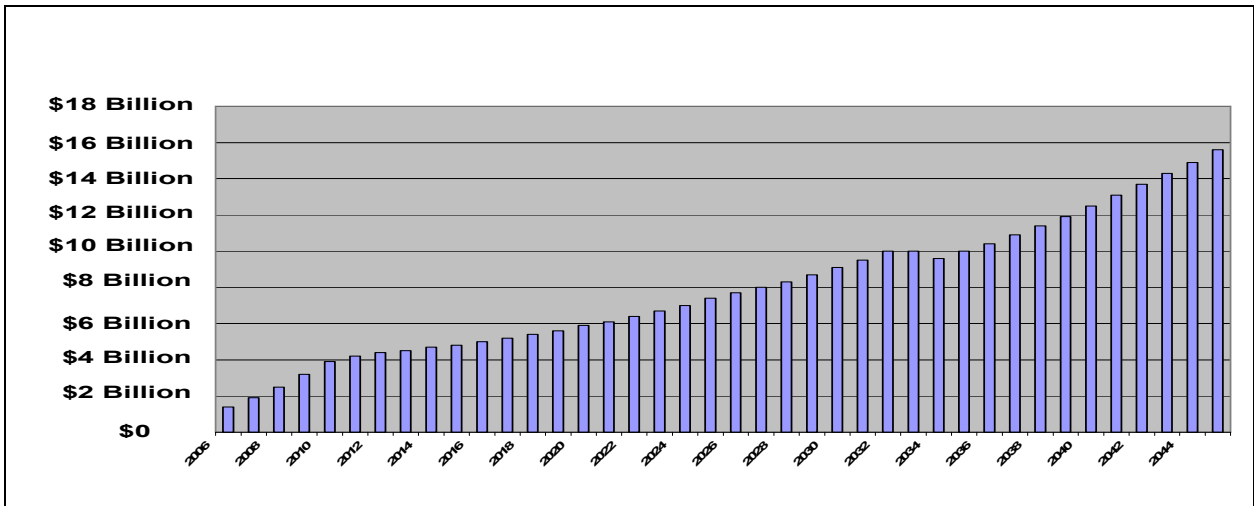
ii) Second, the annual revenue the assets (in this case the lottery) formerly generated must be replaced with a new, ongoing revenue stream, which grows at least as quickly as the revenue from the asset (i.e. the lottery) grew.

Moreover, unlike the Pension Obligation Bonds issued in 2003, when the state only used a portion of the bonds to pay the unfunded liability, the state must use all of the lottery proceeds to pay the unfunded pension liability. This would make sense for taxpayers, because it would generate a greater return.

If the lottery is worth \$10 billion and it currently generates \$650 million in annual revenue, the state's effective return on the lottery is 6.5%. Unfunded pension obligations bear compound interest at 8 to 8.5% per year. Hence, taxpayers would realize the benefit of a greater return on the lottery asset, if all proceeds for its disposition were used to eliminate pension debt.

Any major refinancing of the state's unfunded pension liability ought to include elimination of the current pension ramp, which irresponsibly backloads costs.

Figure 1¹
Illinois Required Yearly State Pension Payments



This effectively defers the problem to future generations, and constrains the state’s ongoing ability to fund services. Illinois should replace its existing pension ramp with a flat, annual payment amount amortizing the unfunded liability in equal, annual installments over a period of 40-45 years. This will make the obligation far less constrictive of state finances, as the real value of the flat annual payment will decrease over time, after inflation.

B. Loss of Education Funding:

If the lottery is leased or sold, then a new revenue stream that is targeted to education must replace the annual revenue stream from the lottery that currently funds education. For FY 2008, education is forecasted to receive \$650 million from the lottery. In addition to funding education, the lottery provides revenue for other ‘specialty causes.’ The FY 2008 transfer to those ‘specialty causes’ like breast cancer funding, is \$4 million. If the lottery is leased, the state will have to replace that shortfall in the General Revenue Fund or cut other programs.

Over the last five years, lottery revenue has grown by an average of \$27 million per year.² If that rate of growth would have continued over the next four years, it would generate a total of \$108 million of new education funding over that period, in addition to the \$650 million annual base for education the lottery currently provides.

This last note is of concern given the state’s existing fiscal system. Since existing revenue sources cannot makeup the loss of revenue from the lottery, three options come into play. First, the state could replace the lottery revenue stream by either raising taxes or cutting spending on other public services such as health care, housing, human services and public safety, to maintain education funding. Second, the state could cut school funding. Third, the state could resort to unsound fiscal practices like incurring debt or under funding state employee pensions to maintain school funding.

If history is any guide, the state will resort to a combination of poor fiscal practices and spending cuts on other public services to maintain education spending levels. Over the last decade, on an inflation-adjusted basis, Illinois has cut spending on every public service other than education and healthcare, because of ongoing revenue shortfalls. Moreover, the state has raided the pension funds and increased indebtedness to levels deemed "unmanageable" under the standards of the National State Budget Officers Association³, primarily to pay current operating expenses.

¹ Illinois Commission on Government Forecasting and Accountability, Monthly Briefing, November 2006.

² CTBA Analysis of FY 2003 – FY 2007 State of Illinois lottery revenues.

³ National Association of State Budget Officers, *Budget Analyst Training Program*.

Figure 2
Actual General Revenue Fund Spending on Services Versus Inflation
(adjusted for CPI), From FY 1995—FY 2006 (\$ in billions):

Budget Category	FY 1995 Actual	FY 1995 Inflation Adjusted to FY2006 (CPI)	FY 2006 Enacted	\$ Difference Between 1995 Adj'd for Inflation (CPI) & 2006 Enacted
GRF	\$17,302.0	\$22,613.7	\$24,406.4	\$1,792.7
Education	\$3,656.0	\$4,778.4	\$6,093.0	\$1,314.6
Health Care	\$4,319.0	\$5,644.9	\$7,034.0	\$1,389.1
Pension	\$519.0	\$678.3	\$938.4	\$260.1
GRF without Health Care, Pensions & Education	\$8,808.0	\$11,512.1	\$10,341.0	-\$1,171.1

C. Complications from Private Ownership of the Lottery:

Once the lottery is transferred to a private sector owner, that owner will be compelled—appropriately— to maximize profits. This could result in some negative public policy consequences. For instance, since most individuals who play the lottery are low to middle income minorities and senior citizens, marketing efforts designed to increase lottery sales and hence profitability will in all likelihood be targeted those individuals, who can least afford it. A private sector owner also would be likely to try and use other methods to increase lottery sales, like expanding the number of outlets where the lottery is sold, gaining approval for internet versions of the game, or possibly seeking expansions of the lottery into related gambling endeavors, such as keno.

When Connecticut analyzed lottery privatization, it found privatizing a portion of the lottery raised a number of federal tax and regulatory issues.⁴ For example, would existing regulatory restrictions on private lottery advertising prohibit a private firm from advertising its games, and would private ownership of the lottery subject it to paying federal corporate income taxes? Ultimately, Connecticut chose not to privatize its lottery fully. Instead, it created a self-supported non-profit entity run by 13 state appointed board members. All lottery revenues still go to the Connecticut General Fund to fund public services.⁵

D. Value of Transaction:

Until the Goldman Sachs report identifying how the \$10 billion value was determined for the proposed disposition of the Lottery is released, it is impossible to determine whether said valuation is accurate.

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⁴ State of Connecticut, Office of the Comptroller, January 1996.

⁵ Connecticut Lottery Corporation, Comprehensive Annual Financial Report, June 2005.

