



CTBA | Center for Tax and
Budget Accountability

ANALYSIS OF THE FISCAL YEAR 2008 ILLINOIS GENERAL FUND BUDGET PROPOSAL

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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.

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Analysis of the Fiscal Year 2008 General Fund Budget Proposal

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EXECUTIVE SUMMARY

Following is an analysis of the proposed Fiscal Year (FY) 2008 General Fund Operating 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 General Fund budget proposed for FY 2008 demonstrates the continuation of two significant flaws in the state's overall fiscal system. First, revenue growth will again fail to keep pace with the economy, falling short of inflation. This pattern of revenue underperformance is long standing,¹ and has contributed substantially to Illinois' structural deficit.² A "structural deficit" is the term used to describe an ongoing shortfall between the revenues that a tax system generates and the inflationary cost of continuing the same level of public services from one year to the next, without expanding or adding programs.

If the FY 2008 budget passes as proposed, almost 7% of spending on current public services will be paid for with debt rather than recurring revenue.

The state's historic revenue underperformance also has contributed to the second significant flaw demonstrated in the FY 2008 General Fund budget proposal – an over reliance on debt to fund current services. If the FY 2008 budget passes as proposed, almost 7% of spending on current public services will be paid for with debt rather than recurring revenue. Generally speaking, current public services should be paid for with recurring revenue. Debt should be reserved for covering capital projects that have long-term useful lives, much like a family incurring a mortgage to finance the purchase of a home.

For FY 2008, the state is proposing the passage of a new tax on business called the Gross Receipts Tax or "GRT". A GRT is a tax imposed on *all income received by a business* without any deductions for costs of doing business, such as wages. GRTs are not based on a company's profit or loss for a given tax year; rather, they are imposed on gross income.

The proposed GRT would impose a tax rate of 1.0% on the gross receipts from the sale of all manufacturing goods, and 2.0% on the gross receipts from the sale of all service industry items. According to the Office of Management and Budget ("OMB"), the GRT would raise an estimated \$2.626 billion in FY 2008, and around \$6 billion annually thereafter.³ Additionally, the Governor has proposed a 3.0% payroll tax that employers would pay on Illinois employee wages. This payroll tax would be reduced by a credit based upon an employer's contribution to cover health insurance cost for its employees.⁴ This proposed healthcare/payroll tax is expected to generate \$1.1 billion.⁵

FY 2008

GENERAL FUND BUDGET HIGHLIGHTS

- Overall spending on public services is scheduled to increase in nominal terms by \$3.2 billion, or 11.3%, from FY 2007 General Fund expenditures. After adjusting for inflation, real spending under the proposed FY 2008 budget will increase by 8.1%, or \$2.3 billion.⁶
- Current revenue growth, however, is projected to increase by only \$805 million. This is not sufficient to cover the cost of continuing the public services Illinois provided in FY 2007, adjusting solely for inflation.⁷ The inflation-adjusted cost of just maintaining FY 2007 service levels in FY 2008 is \$907 million. Therefore, projected revenues fall short of projected cost increases for existing programs by at least \$102 million, based on the CPI. The shortfall is even greater, increasing to \$357 million, when inflationary service costs are adjusted by the more appropriate Employment Cost Index or ECI.
- In addition to the projected cost of maintaining current services, the FY 2007 budget proposal includes at least \$2 billion of spending on new initiatives. These initiatives primarily include items an increase of \$1.5 billion in K-12 education funding, and the Governor's Illinois Covered Health Insurance Plan initiative.
- To cover the cost of these new initiatives, the FY 2008 budget proposal includes various revenue enhancement proposals, which OMB estimates will generate \$2.186 billion. These initiatives include items such as a change in business taxes from the current Corporate Income Tax to a Gross Receipts Tax, a payroll tax on wages, and additional gaming taxes.
- To the extent any of the Governor's proposed revenue initiatives do not pass the legislature, there will be revenue shortfalls that necessitate either passage of other revenue initiatives like HB/SB750 {for a summary of that legislation see the CTBA fact sheets available online at www.ctbaonline.org}, incurring more debt or cutting existing or newly proposed programs.

Projected revenues fall short of projected cost increases for existing programs by at least \$102 million, based on the CPI. The shortfall is even greater, increasing to \$357 million, when inflationary service costs are adjusted by the more appropriate Employment Cost Index or ECI.

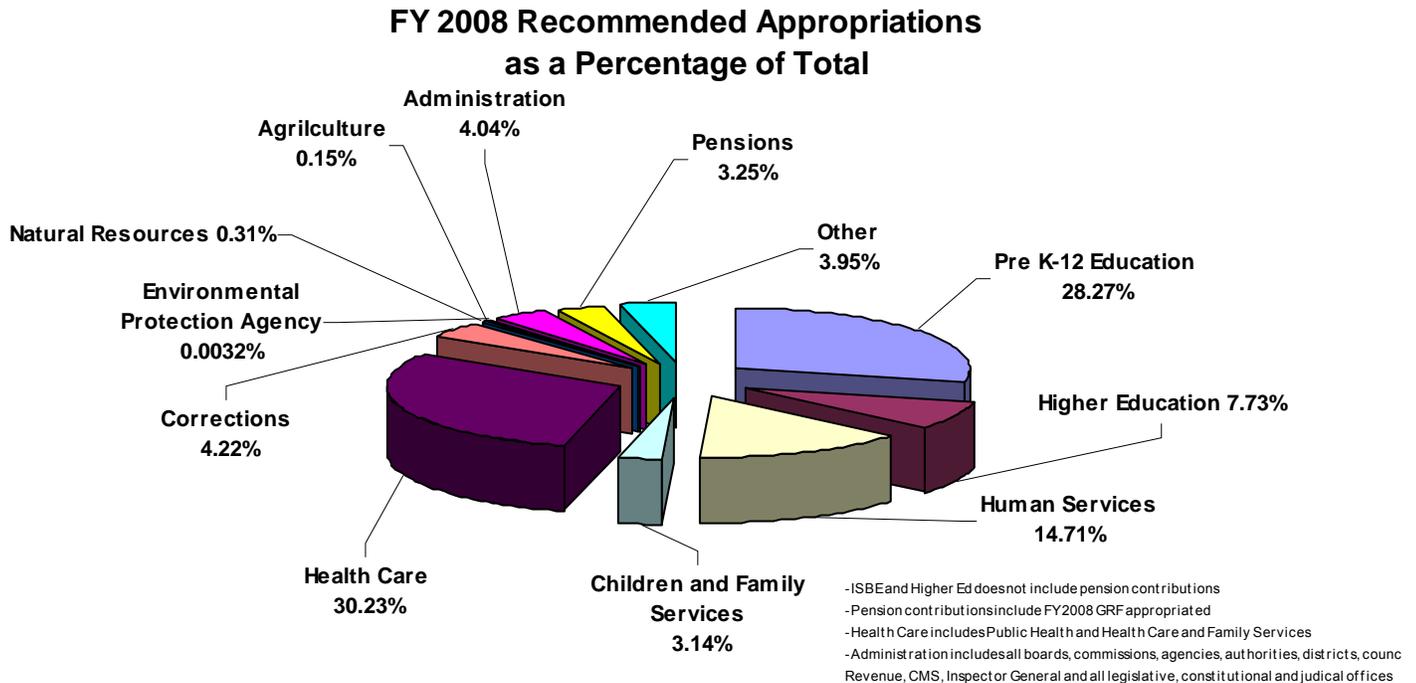
FISCAL NOTE: WHY ADJUST FOR INFLATION?

The answer is simple. It's the only way to determine whether spending on public services and/or revenue growth is increasing in real terms, is just keeping pace with cost increases generated by the economy over time, or is falling behind cost increases generated by the economy. The most common inflation metric is the "Consumer Price Index" or "CPI". 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% of total cost. Hence the CPI is not the best inflationary metric to use for determining the increased costs of public services annually. The preferred inflation metric is the "Employment Cost Index" or "ECI", which is tied directly to changes in labor market costs.

SPENDING

Figure 1 illustrates proposed FY2008 General Fund spending by major purpose. In total, health care, education and human services make up over 84 percent of the General Fund budget.

Figure 1



Source: Illinois FY 2008 Proposed Budget

Figure 2 shows: (i) the FY 2007 enacted General Fund budgets {Note, the state frequently spends a different amount than what is authorized by the budget. Since FY2007 is not yet complete, the budgeted appropriations are currently the best dates available in spending.}; (ii) the inflationary cost of just maintaining FY 2007 services levels in FY 2008, using the CPI and ECI; (iii) the proposed FY 2008 budget; and (iv) the difference between the budget as proposed and the inflationary cost of maintaining FY 2007 services in FY 2008.

Figure 2:
General Fund Spending: Proposed FY 2008 Compared to FY 2007 Inflation Adjusted (CPI) (\$ in millions)

General Fund FY 2007	General Fund FY 2007 Inflation Adjusted to FY 2008 (CPI)	General Fund FY 2008	Difference	% Change
\$28,350	\$29,257	\$31,562	\$2,305	8.13%

Source: Illinois FY 2008 Proposed Budget

Figure 3 shows the same categories as Figure 2, except the inflation adjustment is based on the more accurate ECI.

Figure 3:
General Fund Spending: Proposed FY 2008 Compared to FY 2007 Inflation Adjusted (ECI) (\$ in millions)

General Fund FY 2007	General Fund FY 2007 Inflation Adjusted to FY 2008 (ECI)	General Fund FY 2008	Difference	% Change
\$28,350	\$29,512	\$31,562	\$2,050	7.23%

Source: Illinois FY 2008 Proposed Budget

Figure 4 compares the estimated GRF FY 2007 spending levels to the proposed FY 2008 proposed spending levels by government department. It also includes the inflation-adjusted cost (CPI based) of maintaining FY 2007 services in FY 2008. After adjusting for CPI, the Illinois State Board of Education is scheduled to receive a real increase of \$1,315 billion. The Departments of Human Services and Corrections are also scheduled to receive increases. Again, after adjusting for CPI, Higher Education, Environmental Protection and Agriculture are scheduled to be cut in FY 2008.

Figure 4:

Comparison of GRF Spending by Department Inflation Adjusted(CPI): FY 2007 & FY 2008

Agency	FY 2007 Estimated	2007 Inflation Adjusted CPI	FY 2008 Recommended	Diff FY 2007 CPI Inflation Adjusted and FY 2008 Recommended
General Revenue Fund Total	\$25,675,837	\$26,497,464	\$28,394,988	\$1,897,524
Illinois State Board of Education	\$6,504,371	\$6,712,511	\$8,027,695	\$1,315,184
Higher Education	\$2,151,873	\$2,220,733	\$2,194,761	-\$25,972
Human Services	\$3,985,204	\$4,112,731	\$4,175,878	\$63,147
Children and Family Services	\$775,892	\$800,721	\$890,442	\$89,721
Health Care	\$7,884,006	\$8,136,294	\$8,584,696	\$448,402
Corrections	\$1,125,218	\$1,161,225	\$1,197,026	\$35,801
Natural Resources	\$84,544	\$87,249	\$88,997	\$1,748
Agriculture	\$48,779	\$50,340	\$42,481	-\$7,859
Environmental Protect Agency	\$1,229	\$1,268	\$906	-\$362

Source: Illinois FY 2008 Proposed Budget

Figure 5 compares GRF FY2007 spending levels to FY2008 proposed spending levels by government department, this time adjusting for inflation based on the more accurate ECI.

Figure 5:

Comparison of GRF Spending by Department Inflation Adjusted (ECI): FY 2007 & FY 2008

Agency	FY 2007 Estimated	2007 Inflation Adjusted ECI	FY 2008 Rec- ommended	Diff FY 2007 ECI Infla- tion Adjusted and FY 2008 Recommended
General Revenue Fund Total	\$25,675,837	\$26,728,546	\$28,394,988	\$1,666,442
Illinois State Board of Education	\$6,504,371	\$6,771,050	\$8,027,695	\$1,256,645
Higher Education	\$2,151,873	\$2,240,100	\$2,194,761	-\$45,339
Human Services	\$3,985,204	\$4,148,597	\$4,175,878	\$27,281
Children and Family Services	\$775,892	\$807,704	\$890,442	\$82,738
Health Care	\$7,884,006	\$8,207,250	\$8,584,696	\$377,446
Corrections	\$1,125,218	\$1,171,352	\$1,197,026	\$25,674
Natural Resources	\$84,544	\$88,010	\$88,997	\$987
Agriculture	\$48,779	\$50,779	\$42,481	-\$8,298
Environmental Protection Agency	\$1,229	\$1,279	\$906	-\$373

Source: Illinois FY 2008 Proposed Budget

NEW SPENDING INITIATIVES

The FY 2008 budget proposal outlines numerous new spending initiatives including: (i) \$1.5 billion for PreK-12 Education; and (ii) \$374 million for the Illinois Covered health insurance program. Figure 6 outlines the proposed new initiatives.

Figure 6:
New Spending Initiatives for FY 2008 (\$ in millions)

New Program Proposals	
Increase P-12 Education Funding	\$1,500
Illinois Covered-Health Insurance	\$374
Increased Medical Provider Rates	\$90
Capital	\$12
Healthcare System Improvement	\$16
Total Sources	\$1,992

Source: Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast and Updated FY 2007 Revenue Estimate, March 2007.

EDUCATION

For FY 2008, the state proposes increasing PreK-12 education by almost \$1.5 billion over FY 2007 in nominal dollars, or \$1.3 billion after adjusting for inflation. This increase however, is dependent on the passage of the proposed GRT. To the extent that the GRT does not pass the General Assembly, it is uncertain how much of the proposed increases for education will become law.

Major Proposed Education Funding Increases for FY 2008 include:

- An increase in the K-12 Foundation Level OF \$686, to \$6,020 per pupil.
 - The Foundation Level does not represent total school expenditures per child. It in fact 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 have 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 created a recommended FY 2008 foundation level of \$6,974 that ties the per pupil expense to the actual cost of an academic curriculum 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.⁹
 - The proposed Foundation Level increase is still \$954 short of the FY 2008 Education Funding Advisory Board recommendation of \$6,974.
- An increase in the reimbursement rate for certified Special Education Teachers from \$8,000 per teacher (initially set in 1985) to \$10,750 per teacher.
 - On an inflation-adjusted basis, however, the personnel reimbursement rate for these items would increase to \$18,714 for a certified special educator.¹⁰
- An additional \$69 million for Pre-School for All.
- \$10 million for one year grants to schools to help fund Full-Day Kindergarten.
- Fully funding the state's share of mandated categoricals such as transportation and orphanage education.

*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>

HEALTH CARE

For FY 2008, the Governor is proposing expanding two current state sponsored health care programs that provide health care access for low income children and families—"All Kids" and "Family Care"—to include all the uninsured in Illinois under the newly proposed Illinois Covered plan. Under this proposal, Illinois would enter into a public-private partnership with private insurance carriers to provide insurance to (i) individuals whose employers do not offer coverage and (ii) employees of by small businesses.

The plan would be phased in over the next few years at a total cost estimated by OMB to be between \$2.0 and \$2.5 billion funded through revenue from the Gross Receipts Tax and the Payroll Tax. In FY 2008, the first phase of the plan, \$374 million is proposed to be spent.¹¹

Figure 7 illustrates the difference between current law and the proposed Illinois Covered Plan. To the extent that the Gross Receipts Tax does not pass the General Assembly, it is uncertain how much of the proposed health care expansion will become law.

Figure 7:

Illinois Covered Proposal Compared to Current State Health Care Program

Note: For 2007, the Federal Poverty Level for individuals is \$10,210 and for an adult with two children is \$17,170.

Program	Currently	Proposed "Illinois Covered"
Individuals	None	Individuals whose employers do not provide group health insurance and whose incomes are at or below 400% of the federal poverty level (for the first year). Must work at least 15 hours per week.
Childless Adults	Medicaid coverage only to the aged, blind and disabled up to 100% of the federal poverty level.	Persons between 19 and 64 who do not have access to employer provided insurance and are at or below 100% of the federal poverty level would be eligible.
FamilyCare – Parents living with children 18 years old or younger	Healthcare coverage to parents living with their children 18 years or older up to 185% of the federal poverty level.	Expands to parents and caretaker relatives who have incomes at or below 400% of the federal poverty level. <ul style="list-style-type: none"> For a family of 3, 400% of the federal poverty level is \$68,680.
Blind and Disabled	Currently, seniors, disabled and the blind, up to 100% of the federal poverty level.	Assistance for seniors, blind and disabled up to 300% of the federal poverty level. <ul style="list-style-type: none"> For an individual, 300% of the federal poverty level is \$30,630.
Workers with Disabilities	Provides health benefits for workers with disabilities up to 200% of the federal poverty level.	Subject to federal approval, workers eligible for the Health Benefits Workers with Disabilities program will be eligible for this new program if their income is equal to or less than 350% of the federal poverty level. <ul style="list-style-type: none"> For an individual, 350% of the federal poverty level is \$35,735.
Small Businesses	None	Illinois based businesses employing not more the 25 people may buy into program. For the 1st year, at least 2/3 of employees must earn less than 400% of the federal poverty level. Beginning in the 2 nd year, all employers may participate.

Source: Presentation to the House Democratic Caucus, March 20, 2007

HEALTH CARE-CONTINUED

As the number of uninsured in Illinois increases, increasing access to health care is needed. That said, Illinois' chronic fiscal problems make it increasingly difficult for the state to keep up with soaring health care costs, which are growing three times faster than general inflation, making health care funding one of the state's greatest challenges.¹² For instance, Illinois' Medicaid program grew at an average annual rate of nine percent between fiscal years 2000 and 2004, while state tax revenue grew at an average annual rate of only 2.5 percent over the same period.¹³ Skyrocketing Medicaid costs only compound Illinois' annual revenue shortfalls, resulting in cuts to other vital human services and the financing of a greater portion of government operations with debt rather than tax revenue.

While many states have elected to cut Medicaid benefits or restrict eligibility as a way to curtail program costs, Illinois should be applauded for not taking that approach, recognizing that providing basic health care to low-income, uninsured families is an essential public service. Rather, the state has dealt with the predicament another way: by delaying payment of Medicaid bills owed to health care professionals, in many cases for months. By deferring these "Medicaid liabilities," the state essentially pushes costs from one fiscal year to the next, making the state budget appear balanced each year when in fact it is not. This results in long payment delays to hospitals, doctors and pharmacists that treat the most vulnerable in our society.

By deferring these "Medicaid liabilities," the state essentially pushes costs from one fiscal year to the next, making the state budget appear balanced each year when in fact it is not.

The state's unpaid Medicaid liabilities nearly tripled between fiscal year 2000 and 2005, increasing from \$977 million in 2000, to \$2.7 billion in 2005.¹⁴ Currently, the past due payments are approximately \$2 billion.¹⁵

REVENUES

As Figure 8 shows, the Governor's Office of Management and Budget (GOMB) estimates the state will realize \$900 million in revenue growth from state and federal sources in FY 2008. The Illinois Commission on Government Forecasting and Accountability estimates revenue growth at \$805 million

Figure 8:
GOMB and COGFA Estimated Revenue Growth (\$ in millions)

Estimated Revenue Growth	GOMB	COGFA
From Existing Sources	\$614	\$519
Federal	\$286	\$286
Total Growth	\$900	\$805

Source: Illinois FY 2008 Proposed Budget and Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast and Updated FY 2007 Revenue Estimate, March 2007

GOMB also estimates \$2.186 billion of projected revenue the state will receive if the new initiatives outlined in Figure 9 below become law. These new initiatives combined with GOMB's forecasted FY 2008 revenue projections total \$3,086 billion in projected new revenue for FY 2008.

Figure 7:
GOMB New Revenue Initiatives (Must be passed by the legislature)

New Revenue Proposals	\$ in millions
Gross Receipts Tax Plan	\$2,626
Enhanced Federal Matching Revenue	\$63
ITP	\$32
Riverboat tax and fee changes	\$115
Proposed Increase to Base Revenue	\$2,836
Offset of Lottery Revenue	-\$650
Total Growth from Proposed Changes	\$2,186

Source: Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast and Updated FY 2007 Revenue Estimate, March 2007.

Figure 10 displays the difference in the current revenue forecasts by GOMB and Illinois Commission on Government Forecasting and Accountability. COGFA forecasts revenue (without the new revenue initiatives outlined above) will not grow sufficiently in FY 2008 to keep pace with the CPI inflation adjusted increases in the costs of simply maintaining FY 2007. The CPI inflation adjusted shortfall in revenues versus costs for FY 2008 projected by COGFA is \$102 million. When adjusting for the more appropriate ECI, the revenue shortfall is worse, increasing to \$357 million. GOMB's forecast for FY 2008, however, is quite different, projecting that revenue growth will fall short of maintaining existing services levels by \$7 million.

Figure 10:
FY 2008 Revenue Estimate Comparison (CPI): GOMB & COGFA

\$ in millions	GOMB	COGFA
Projected Increase From State Sources without Gross Receipts Tax Plan	\$614	\$519
Projected Increase From Federal Sources	\$286	\$286
Total Increase	\$900	\$805
Amount Needed to Keep Pace with FY 2007 Inflationary Cost Increases (CPI)	\$907	\$907
Difference	-\$7	-\$102

Source: Illinois FY 2008 Proposed Budget and Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast and Updated FY 2007 Revenue Estimate, March 2007.

Figure 10:
FY 2008 Revenue Estimate Comparison (ECI): GOMB & COGFA

\$ in millions	GOMB	COGFA
Projected Increase From State Sources without Gross Receipts Tax Plan	\$614	\$519
Projected Increase From Federal Sources	\$286	\$286
Total Increase	\$900	\$805
Amount Needed to Keep Pace with FY 2007 Inflationary Cost Increases (ECI)	\$1,162	\$1,162
Difference	-\$262	-\$357

Source: Illinois FY 2008 Proposed Budget and Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast and Updated FY 2007 Revenue Estimate, March 2007.

DEBT AND ONE-TIME REVENUES

Figure 11 shows Illinois will continue to rely on significant infusions of debt and one-time revenue sources to fund services in FY 2008. For example, the Illinois Comptroller estimates the state will artificially balance its FY 2007 budget by deferring its obligation to pay \$2.0 billion it owes to providers of Medicaid health care services in FY 2008.¹⁶ Borrowing and utilization of other one-time revenue sources like fund sweeps to pay for current operations has become common practice because the Illinois revenue system cannot cover current public service costs.¹⁷

Figure 11:
FY 2008 Budget Spending Covered by Debt & One-Time Revenues
(\$ in millions)

Deferred Medicaid Bills	\$2,000
Fund Sweeps	\$117
Charge Backs	\$76
Total	\$2,193

Source: Illinois Office of the Comptroller, 3/21/2007 and Illinois Commission on Government Forecasting and Accountability

DEBT AND ONE-TIME REVENUES-CON'T

In fact, as Figure 12 shows, Illinois' flawed revenue system has forced state government to use almost \$13 billion in a combination of debt and non-recurring, one-time revenues since FY 2003 to maintain current spending on public services.

Figure 12: Debt and One-Time Revenues FY 2003 – FY 2008

\$ in millions	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Revenue Adjustments						
Fund Sweeps	\$165.0	\$158.5	\$259.8	\$129.0	\$200	\$117.0
Chargebacks		\$269.4	\$208.2	\$140.3		\$76.0
Executive Order 10		\$5.5				
Increased Fee Transfers		\$88.8	\$37.6	\$35.3		
Tax Amnesty		\$290.0	\$100.0			
Pension Bond Sale	\$300.0	\$1,395.0				
Cigarette Tax Adjustment			\$50.0			
Federal Fiscal Relief		\$750.0				
Sale of State Assets		\$233.0				
Sub Total	\$465.0	\$3,190.2	\$655.6	\$304.6	\$200	
Appropriation Adjustments						
Accelerated/Deferred Medical Payments			\$1,100.0		\$2,900	\$2,000.0
Restructure of ERI Pension Payment			\$200.0			
Increase in State Pension Fund Ap-props			\$80.0			
Increase in non-IDOT Road Fund Ap-props	\$95.0	\$145.0	\$145.0			
Decrease in State Pension Fund				\$1,178	\$1,133	
Sub Total	\$95.0	\$145.0	\$1,525.0	\$1,178	\$4,033	
Grand Total	\$560.0	\$3,335.2	\$2,180.6	\$1,482.6	\$4,233.0	\$2,193.0

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). Borrowing to pay for public services is problematic, however, if used to cover ongoing revenue shortfalls caused by structural inadequacies in a fiscal system. In such cases, natural revenue growth will never catch-up with both the cost of repaying the debt, plus interest, and the inflationary cost of maintaining public services over time. This is exactly what is happening in Illinois. Over the past six years, the state has short term borrowed over \$6 billion, mostly to pay Medicaid bills. Prior to FY 2002, the state had not practiced short term borrowing in over five years, since it borrowed \$500 million in FY 1996.¹⁸

Figure 13: Short Term Borrowing FY 2002 – FY 2007

Fiscal Year Short Term Borrowing	\$ Amount in Millions	Reason
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	\$6.015	

Source: Illinois Commission on Government Forecasting and Accountability Bonded Indebtedness Reports

NEW REVENUE INITIATIVES— PROPOSED GROSS RECEIPTS TAX

For FY 2008, the Governor is proposing a new tax on business called the Gross Receipts Tax or GRT. A GRT is a tax imposed on *all income received by a business* without any deductions for costs of doing business, such as wages. GRTs are not based on a company's profit or loss for a given tax year like the current Illinois Corporate Income Tax. Rather, GRTs are imposed on all income, regardless of profitability. This makes the GRT a stable revenue source because all firms, even unprofitable ones, pay tax, which results in revenue for the state.

The proposed Illinois GRT rate is 1.0% on all receipts from manufacturing sales and 2.0% on all receipts from the sale of services. Business with receipts under \$2 million would be exempt from the GRT. The OMB estimates the GRT will raise \$2.626 billion in FY 2008, and \$6 billion annually thereafter.¹⁹ Additionally, the Governor has proposed a 3.0% payroll tax that all employers with ten or more workers would pay on Illinois employee wages. This payroll tax would be reduced by a credit based upon the employer's contribution to cover health insurance cost for its employees. OMB estimates this payroll tax will generate \$1.1 billion annually.

On Wednesday, May 9, 2004, the Illinois House of Representatives held a hearing on the Governor's Gross Receipts Tax (GRT) proposal. During the House hearing, opponents and supporters for the Governor's GRT proposal made their cases. At the end of the day, House members voted on Resolution 402 to support or oppose the Governor's proposal.

In total, 107 House members voted to oppose the Governor's GRT proposal; not a single Representative voted in favor of the proposal. Seven members voted "present".

While last Thursday's vote sent a clear message that Illinois Representatives are *not* in favor of the Governor's gross receipts tax proposal as the best revenue solution for Illinois, it is significant to note that legislators, business groups, elected officials, Ph.D. economists, and advocates around Illinois recognize and are committed to addressing the state's dire need to raise new state revenue in order to fund important priorities this year, like education, healthcare and transit and pay the state's pension debt. These diverse interest groups are speaking in a common voice, agreeing on the need to increase taxes so as to put the state's fiscal house back in order and to generate some much-needed revenue.

Diverse interest groups are speaking in a common voice, agreeing on the need to increase taxes so as to put the state's fiscal house back in order and to generate some much-needed revenue.

Why the GRT is Not the Answer

While a GRT can be expected to generate stable revenue, the tax also creates a number of significant problems, which on balance outweigh the benefits. The problems with a GRT include the following:

*Research shows that new firms pay a much higher effective tax rate than established firms, no matter what the industry.*²⁰

- While tax scholars typically advocate low rate, broad-based income and sales taxes, experts also acknowledge that GRTs do not treat all taxpayers equally.

GRTs are regressive taxes for both businesses and consumers.

- GRTs are regressive for business. While proponents argue a broad-based, low rate tax imposed on the gross income of all business taxpayers would require all businesses to pay their "fair share," in actuality, low-profit margin businesses and start up businesses would pay higher effective tax rates than established high-profit margin businesses.
- GRTs are also regressive for consumers. A GRT, because it is based on a gross sales rather than profits, is a

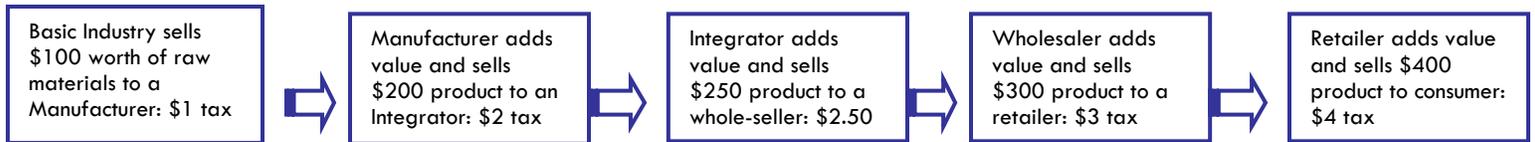
Because the GRT becomes part of the price of a product or service, it affects more of the take home pay of low and middle income families than an affluent family, making the tax highly regressive.

fixed cost for business, likely be passed in whole or substantial party, to consumers, in the form of higher prices for products or services. This is especially the case for low profit margin businesses. So, while businesses will be writing the GRT check received by the Illinois Department of Revenue, consumers will be actually paying most of the GRT. Because the GRT becomes part of the price of a product or service, it affects more of the take home pay of low and middle income families than an affluent family, making the tax highly regressive.

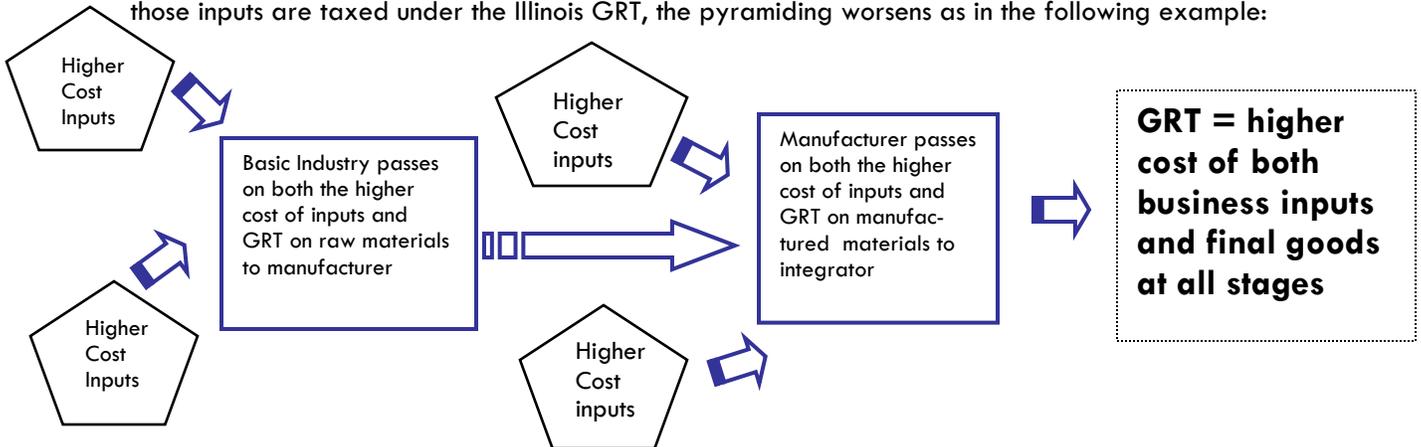
- The proof of how regressive a GRT can be comes from the state of Washington, which currently has both the largest GRT by rate and longest standing GRT in the nation. Washington also happens to be the most regressive taxing state in the country.²¹ The GRT proposed for Illinois would be greater than Washington's. Given that Illinois is already the sixth most regressive taxing state,²² enacting the proposed GRT can be expected to make the Illinois tax system even more regressive, and hence unfair for low and middle income families.
- Further, GRTs are “pyramided” as a product moves through the economy. This pyramiding effect would also pass additional costs on to the consumer.

What is the “Pyramiding Effect” of the GRT?

The “pyramiding effect” of the GRT refers to the compounding nature of the tax. Since the GRT is imposed on every transaction of the business cycle, a product or service is subjected to multiple levels of taxation. The chart below illustrates this pyramiding effect, using a 1% GRT as an example.



Of course, the GRT's impact on the economy is more complex, resulting in a greater degree of pyramiding than the previous graphic indicates. That is because each business in the cycle depicted above also has inputs—and to the extent those inputs are taxed under the Illinois GRT, the pyramiding worsens as in the following example:



- Research finds that tax pyramiding leads to tax evasion, since businesses use strategies to avoid the tax, such as conducting a portion of the manufacturing operation in another state or creating subsidiaries to receive part of their income in another state.²³

Which Businesses Win or Lose with a GRT?

- If a GRT were imposed in Illinois, winners would include those businesses that sell high-profit margin products or services. Losers would include businesses that sell low-profit margin products particularly those companies with high gross receipts compared to profit margin.

While it is legally the business' responsibility to pay the GRT, in most cases the economic burden of GRTs are passed on to consumers in the form of higher prices.

Transparency: Consumers Will Bear Some of the Burden

- A basic principle of good tax design is that taxes should be transparent to taxpayers. GRTs are commonly criticized for being non-transparent taxes.
- While it is legally the business' responsibility to pay the GRT, in most cases the economic burden of GRTs are passed on to consumers in the form of higher prices.
- Unlike the retail sales tax, GRTs cannot be printed on sales receipts given to consumers because it is not possible to know the final amount of the GRT that is pyramided into the final price of a good or service. Hence, consumers ultimately bear the burden of the GRT without any knowledge that they are paying it.

- Another way business may pass along the GRT is through offering lower wages to employees to offset the increased tax burden.

Other States

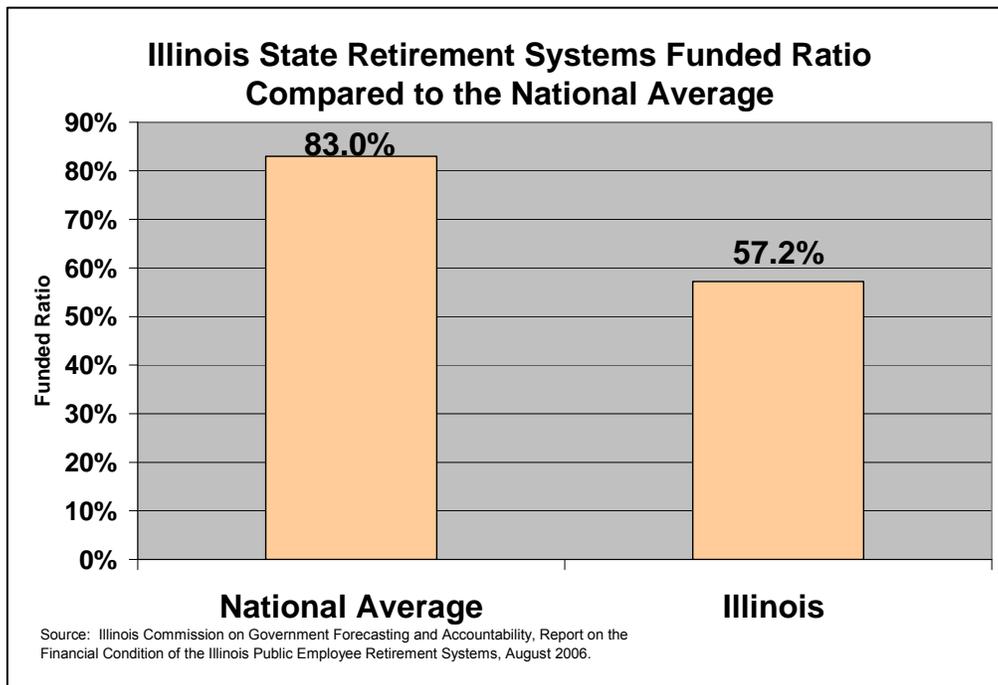
- Currently, seven states impose a GRT: Delaware, Kentucky, Michigan, New Mexico, Ohio, Texas and Washington. However, comparing the GRT proposed for Illinois to the other GRT states is an apples to oranges comparison. Unlike Illinois, Delaware has no state sales tax, while Texas and Washington have no state income tax; Ohio, which is new to the world of GRT, enacted a very small, 0.26% GRT rate, that both replaced all other corporate taxation in that state, and was designed to be, at most, revenue neutral, but the hope was it would reduce overall business tax burden in Ohio.

PENSIONS

The Current System

Illinois already has the largest unfunded pension liability in the country totaling \$40.7 billion.²⁴ The "Funded Ratio", for the Illinois Pension System, that is, the percentage of what is required to be funded that has actually been funded, is also one of the worst in the nation. In 2005, Wilshire Associates found that the average national Funded Ratio for a state pension system was 83 percent.²⁵ As Figure 14 shows, Illinois' Funded Ratio of only 57.2% is significantly below the national average.²⁶

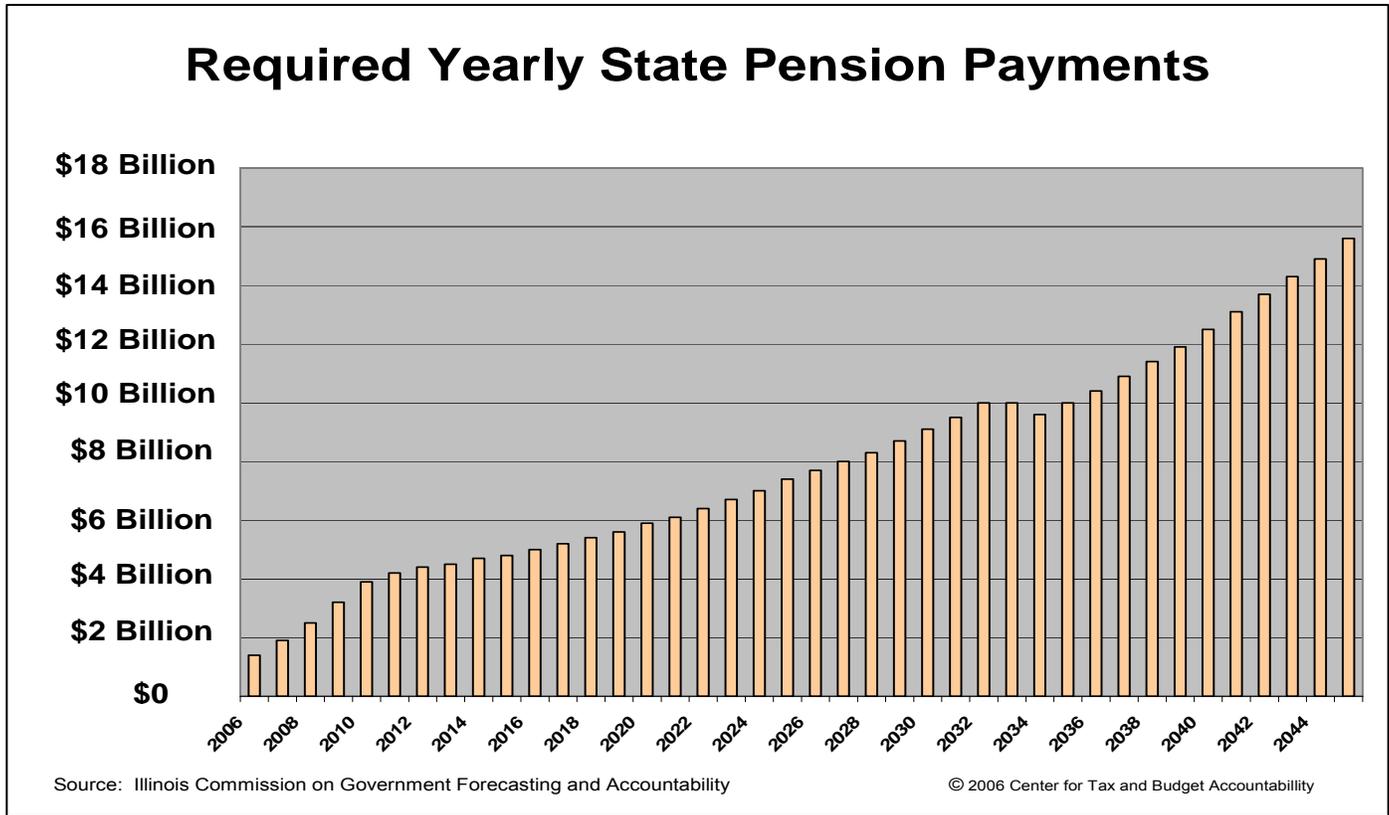
Figure 14



Looking ahead, it is important to note that the state's required yearly pension payment is scheduled to increase significantly over the next ten years, as shown in Figure 15. Skipping an aggregate of \$2.3 billion in required pension contributions over the past two fiscal years further deferred the state's pension funding problem into the future, threatening the state's ability to continue funding current service levels overtime.²⁷

*For more on the Illinois State Pension Systems visit
CTBA's special pension research project—The Illinois Retirement Security Initiative:
<http://www.ctbaonline.org/Pensions.htm>*

Figure 15



The FY 2008 Pension Proposal

Without modernizing current revenue streams, the state simply will not have the financial capacity to pay its unfunded pension liability plus maintain current services. That said, the Pension Ramp also is not realistic, so an alternative, long-term payment program makes sense, particularly one that eliminates the ramp and the irresponsible practice of back loading costs. Issuing pension obligation bonds could provide some relief, if: (i) the arbitrage realized by paying lower rates to bond holders than what is currently due in interest to the pension systems is material; (ii) all bond proceeds were used to refinance pension debt; (iii) the bond payment levels both saved the state money over the long term and were attainable; and (iv) the state had the recurring revenue to fund the debt service.

But, to be clear, the true savings for taxpayers comes from the value of the arbitrage on interest rates. This is risky, particularly if the market crashes shortly after the pension obligation bond proceeds are invested by the pension systems. Moreover, the state remains on the hook for the full \$40.7 billion in principal owed, whether to bond holders or the pension system.

For FY 2008, the state is proposing leasing the Illinois lottery at an estimated \$10 billion and selling \$16 billion in pension obligation bonds to infuse into the pension system and bring the unfunded liability down to \$14.7 billion and the funded ratio up to 83 percent.

Lease of the Illinois Lottery

Leasing the Illinois lottery would generate an estimate \$10 billion to use toward paying down the state retirement pension unfunded liability. However, if the lottery leased, a separate revenue stream must be introduced to replace the annual revenue stream that is targeted to education from lottery proceeds. For FY 2008, education is forecasted to receive \$650 million from the lottery. In addition to funding education, the lottery currently provides revenue for other “specialty causes.” The FY 2008 transfer to these “specialty causes” like breast cancer funding, is \$4 million. If the lottery is leased, the state will have to replace that shortfall in General Revenue Fund (GRF) or cut other programs.

If the lottery is leased, a separate revenue stream must be introduced to replace the annual revenue stream that is targeted to education from lottery proceeds. For FY 2008, education is forecasted to receive \$650 million from the lottery.

The Pension Obligation Bond Option

Admittedly, the state is already overextended when it comes to debt. But issuing a pension obligation bond will not, in reality, increase the aggregate liability of the state. Illinois owes the \$40.7 billion it has borrowed from the pensions and has the constitutional obligation to pay existing pension benefits without diminishment. Rather than increase what the state owes, issuing a bond to cover the unpaid pension liability could actually lessen the long-term costs of paying it, while creating the discipline that will force the liability to be paid, and establishing a long-term payment schedule that is feasible. Illinois could save money long-term by issuing pension obligation bonds to refinance existing pension debt for one simple reason, lower interest rates. The current interest rate of 8.0% to 8.5% on the unfunded pension liability is higher than interest rates available in the bond market. Similar to a homeowner refinancing a mortgage to take advantage of a lower interest rate, issuing a POB for some or all of the unfunded liability would allow the state to pay it off at a lower interest rate than the current 8.0% to 8.5% rate.

Of course, to make this option feasible, the state still must modernize its existing tax structure through both income and sales tax enhancements to raise enough ongoing revenue to cover both continuation of public services and the new pension bond debt service. However, in that context, appropriate refinancing of the pension debt could save billions.

How a POB Works

The state would issue a \$16 billion pension obligation bond at an interest rate lower than 8.0% and then deposit the proceeds immediately into the pension fund to pay off all or some of the current unfunded liability. If structured appropriately, the state would save money because the interest rate paid on the bond debt will be less than the interest rate on the unfunded liability. For example, the state is currently paying an 8.0% to 8.5% interest rate on the unfunded liability. If the POBs are issued at a 6.0% interest rate, the 2.0% to 2.5% differential is the savings to the state. The bonds will then be paid out of increased revenue generated for the General Revenue Fund from tax enhancements, over a set period, such as 30 years.

Of course, a POB reduces but **does not eliminate** the state's unfunded liability. There are also bond issuance costs, such as lenders fees, bond counsel fees and other miscellaneous fees. However, unlike current practices, once the state issues a POB it would have the fiscal discipline imposed on it to pay the bonds, because of the legal and contractual obligations owed to the bond holders. Further, unlike the 2003 issued POB when the state used \$2.1 billion of the bond proceeds to help eliminate the budget deficit, the state must use all of the bond proceeds to pay off unfunded pension liability and must adopt an equal annual payment level, rather than a gradually increasing payment schedule, to gain the long-term savings. Back loading the repayment of a POB is simply another way to avoid making the required payment, and effectively defers problem to the future. Finally, while issuing pension obligation bonds could both save money and create fiscal discipline, the option is not truly viable unless Illinois raises enough in new tax revenue to meet both its debt service obligation and maintain essential services.

The New Pension Payment Schedule Proposal – Concern

Currently, state actuaries determine pension funding requirements based on social, demographic and historical data. However, the FY 2008 pension proposal includes throwing out that actuarial estimate, and instead, proposes to increase pension payments by an estimated \$280 million per year. This is bad fiscal policy, as it does not base pension funding requirements on sound actuarial data and continues the trend of back loading payments off to the future.

Figure 14 shows the FY 2008 proposed funding level and the FY 2008 actuarial funding requirement. In essence, the state is proposing to skip \$1.3 billion in payments to the pension for FY 2008.

Figure 14: FY 2008 Proposed Pension Appropriation Compared to Actuarial Requirement

Total Appropriation	FY 2008
GARS	\$5,220
JARS	\$35,237
SURS	\$256,805
TRS	\$881,473
SERS	\$204
Total	\$1,178,939
FY 2008 Required Payment	\$2,527,000
Difference	-\$1,348,061

Source: Illinois FY 2008 Proposed Budget

CONCLUSION

Overall, the FY 2008 budget continues to show the state is not on sound fiscal footing. Budget stress stemming from increased health care costs and yearly required pension payments make it necessary to modernize how Illinois taxes to raise revenue. However, instead of implementing fair and modern reforms to allow the state to provide necessary public services, the state has proposed a gross receipts tax that will make the Illinois tax system more regressive, as the tax will be passed onto consumers. Additionally, the state has again chosen balance the budget by deferring Medicaid payments to providers and sweeping funds.

Implementing comprehensive fiscal reform that modernizes the Illinois tax system while keeping the state economically competitive like that proposed in HB 750 is the only way to provide the ongoing revenue necessary to sustain these important programs. By taking the economically sound steps of expanding the state sales tax base to include services, increasing the income tax rate, 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, and generate the recurring revenue needed to fund essential public services—like the new education and health care programs proposed in the FY 2008 budget proposal.

*For more information about HB/SB 750 please visit
www.ctbaonline.org*

ENDNOTES

1. Center for Tax and Budget Accountability analysis of historical revenue data compared to the Bureau of Labor Statistics, Consumer Price Index.
2. See Center for Tax and Budget Accountability, *Private Sector Job Trends and the Illinois Structural Deficit*, January 2007.
3. Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast, March 2007.
4. State of Illinois FY 2008 Recommended Budget.
5. Ibid.
6. Inflation based on Consumer Price Index, Bureau of Labor Statistics.
7. The Center for Tax and Budget Accountability (CTBA) uses revenue estimates from the Commission on Government Forecasting and Accountability (COGFA) because their revenue estimates over the past ten years have been more accurate than estimates by the Governor's Office of Management and Budget's (GOMB) and its predecessor, the Bureau of the Budget.
8. State of Illinois FY 2008 Recommended Budget.
9. The FY 2008 EFAB recommendation of \$6,974 is based on the FY 2006 recommendation adjusted for inflation based on the Employment Cost Index as EFAB recommends.
10. Inflation based on Bureau of Labor Statistics, Employment Cost Index.
11. State of Illinois FY 2008 Recommended Budget.
12. See The Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits 2005 Annual Survey*, September 2005.
13. See State of Illinois Comptroller, "Medicaid Continues to Challenge State Budgets," *Fiscal Focus*, May 2005 (Medicaid liability growth); See Illinois Commission on Forecasting and Accountability for revenue data.
14. Illinois State Comptroller, March 21, 2007.
15. Ibid.
16. Ibid.
17. See Center for Tax and Budget Accountability, *Revenue Performance is the Primary Cause of Illinois Chronic Budget Deficits* available at www.ctbaonline.org
18. Illinois Commission on Government Forecasting and Accountability Bonded Indebtedness Reports.
19. Illinois Commission on Government Forecasting and Accountability, FY 2008 Revenue Forecast, March 2007.
20. Washington State Tax Structure Study Committee Report, Vol. I and II, 2002-2003.
21. Institute on Taxation and Economic Policy, *Who Pays?*, 2003.
22. Ibid.
23. Ibid.
24. Unfunded liability based on the Commission on Government Forecasting and Accountability. Illinois national rank is based on the 2004 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation.
25. 2005 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation.
26. Commission on Government Forecasting and Accountability, Report on the 90% Funding Target of Public Act 88-0593.
27. Ibid.