CENTER FOR TAX AND BUDGET ACCOUNTABILITY
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Analysis of the Fiscal Year 2007 Illinois General Fund Budget Proposal

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Executive Summary

Following is a brief analysis of the proposed Fiscal Year (**FY**) 2007 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 2007 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, and has contributed substantially to Illinois' structural deficit. A "structural deficit" is the term used to describe an ongoing shortfall between the revenues that a tax system will generate and the inflationary cost of continuing current levels of public services, without expanding or adding programs.

The state's historic revenue underperformance has also contributed to the second significant flaw demonstrated in the FY 2007 General Fund budget proposal – an over reliance on debt to fund current services. If the FY 2007 budget passes as proposed, almost 11% of spending on current public services will be paid for with debt rather than recurring revenue. Generally speaking, current public services should predominantly be paid for with recurring revenue. Debt should be reserved for covering the construction of capital projects that have long-term useful lives, much like a family incurring a mortgage to finance the purchase of a home. 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.

FY 2007 General Fund Budget Highlights

- Overall spending on public services is scheduled to increase in nominal terms by $1.32 billion, or 4.9%, from FY 2006 General Fund expenditures. After adjusting for inflation, real spending under the proposed FY 2007 budget will increase by 1.49%, or $402 million.[1] If the budget passes, it will be the first time real spending by the state will increase on public services since FY 2004.

- Revenue growth, however, is projected to increase by $860 million. This is not sufficient to cover the cost of continuing the public services Illinois provided in FY 2006, adjusting solely for inflation.[2] The inflation-adjusted cost of just maintaining FY 2006 service levels in FY 2007 is $918 million. Therefore, projected revenues fall short of projected increases by $58 million.

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[1] Inflation based on Consumer Price Index, Bureau of Labor Statistics.

[2] 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.

- Over 10% of projected spending in the FY 2007 budget proposal is being paid for with either debt or one-time revenues (primarily in the form of transfers from special purpose funds), rather than recurring tax revenue. The two most significant components of the projected debt being used to pay for operating costs are: borrowing $1.13 billion from the employer contributions Illinois owes to the five state pension systems; [3] and borrowing $1.8 billion from private providers of Medicaid services, through the use of Section 25 Medicaid liability deferrals.[4] Fund sweeps account for another $159 million. Hence, at least $3.09 billion of the cost of public services in the proposed FY 2007 budget will be paid for with debt, or one-time revenue.

- In addition to the projected cost of maintaining current services, the FY 2007 budget proposal includes at least $213 million of spending on new initiatives. These initiatives include items such as preschool for all children, a $1,000 tax credit for college students who maintain a "B" average, and extending additional health coverage to low-income veterans.

- To cover the cost of these new initiatives, the FY 2007 budget proposal includes various revenue enhancement initiatives, which collectively total $306 million. These initiatives include items such as an increased tax on the price of tobacco products other than cigarettes, taxing certain business software purchases, and selling the Illinois Student Assistance Commission student loan program.

- Obviously, to the extent any of the proposed revenue initiatives do not pass the legislature, there will be revenue shortfalls that necessitate either passage of other revenue initiatives, incurring more debt or cutting existing or newly proposed programs.

Spending

Figure 1 shows the FY 2006 enacted General Fund budget , the inflationary cost of maintaining FY 2006 services levels in FY 2007, the proposed FY 2007 budget and the difference between the budget as proposed and the inflationary cost of maintaining FY 2006 services in FY 2007.

Figure 1: General Fund Spending: Proposed FY 2007 Compared to FY 2006 Inflation Adjusted

General Fund FY 2006	General Fund FY 2006 Inflation Adjusted to FY 2007	General Fund FY 2007	Difference	% Change
$27,000.00	$27,918.00	$28,320.00	$402.00	1.49%

[3] The five Illinois Retirement Systems are the State Employees Retirement System, the Teachers Retirement System, the State Universities Retirement System, the General Assemblies Retirement System and the Judges Retirement System.

[4] Illinois Office of the Comptroller, *Comptroller Quarterly*, January 2006.

Figure 2 compares the enacted GRF FY 2006 spending levels to the proposed FY 2007 spending levels, by government department. It also includes the inflation-adjusted cost of maintaining FY 2006 services in FY 2007. After adjusting for inflation, the Illinois State Board of Education is scheduled to receive a real increase of $222 million. The Departments of Human Services and Corrections are also scheduled to receive increases, after being cut by 1.5% and 7% respectively from FY 2005 to FY 2006. Again, after adjusting for inflation, Higher Education, Environmental Protection and Agriculture are scheduled to be cut in FY 2007.

Figure 2: Comparison of GRF Spending by Department Inflation Adjusted: FY 2006 & FY 2007

	FY 06 Enacted	FY 06 Inflation Adjusted (ia)	FY 07 Proposal	Diff FY 06 (ia) to FY 07	% Change FY 06 (ia) to FY 07
GRF Total	24.300	$25.126	$25.710	$0.584	2.3%
IL State Bd of Edu	$6.094	$6.301	$6.523	$0.222	3.5%
Higher Education	$2.196	$2.271	$2.215	-$0.056	-2.5%
Human Services	$3.842	$3.973	$4.018	$0.045	1.1%
Child & Family Serv	$0.810	$0.838	$0.770	-$0.068	-8.1%
Health Care	$7.542	$7.798	$7.979	$0.181	2.3%
Corrections	$1.047	$1.083	$1.120	$0.037	3.5%
Natural Resources	$0.084	$0.087	$0.084	-$0.003	-3.3%
Agriculture	$0.044	$0.045	$0.043	-$0.002	-5.5%
Envir Protect Agcy	$1.196	$1.237	$0.849	-$0.388	-31.3%

New Spending Initiatives:

The FY 2007 budget proposal outlines numerous new spending initiatives including; (i) $15 million for Stem Cell Research; (ii) $2.3 million for DNA testing. Figure 3 outlines the proposed new initiatives.

Figure 3: New Initiatives for FY 2007 ($ in millions)

Pre School for All	$45.0
Tuition Tax Credit	$90.0
Sales Tax Rebate for the Purchase of Fuel Efficient Vehicles	$7.5
Stem Cell Research	$15.0
DNA Testing	$2.3
Health Care for Veterans	$10.0
Increase Nursing Faculty	$3.3
Film Tax Credit	N/A
Riverfront Redevelopment	$20.0
Expediting the Process of Business Licenses	$1.6
Thompson Correctional Center	$6.5
Methamphetamine Unit	$1.9
Reduced K-12 Class Size	$10.0
Estimated Total (excluding the Film Tax Credit)	**$213.1**

Revenues

As Figure 4 shows, the Governor's Office of Management and Budget (GOMB) estimates the state will realize $936 million in revenue growth from state and federal sources in FY 2007.

Figure 4: GOMB Estimated Revenue Growth

From Existing State Sources	$878
Transfers In	-$65
Federal	$123
Total	**$936**

GOMB also estimates $306 million of projected revenue the state will receive if the new initiatives outlined in Figure 5 below become law. These new initiatives combined with GOMB's other FY 2007 revenue projections total $1,242 billion in projected revenue for FY 2007.

Figure 5: GOMB New Revenue Initiatives
(Must be passed by the legislature)

Governor's New Revenue Initiatives	
Special Purpose Fund Sweeps	$159
Software Tax	$48
Reform Retail Rate Law	$25
Treat U.S. Territories same as the U.S. so they are subject to income tax.	$10
Gas Tax on Out of State Fuel	$44
Increase on Tobacco (Cigar)	$10
Sale of ISAC Student Loans	$100
Permit Audit to Verify Losses Older than 3 Years	$10
Revenue Lost from Proposed Tax Cuts	-$100
TOTAL NEW REVENUE INITIATIVES	**$306**
Grand Total (New Initiatives + Revenue Growth)	**$1,242**

Figure 6 displays the difference in the revenue forecasts by GOMB and COGFA. COGFA forecasts revenue will grow in FY 2007 in an amount that fails to keep pace with the inflation adjusted increases in the costs of simply maintaining FY 2006 services levels in FY 2007, by $58 million. GOMB's forecast for FY 2007, however, is quite different, projecting that revenue growth will exceed the inflationary cost of maintaining FY 2006 service levels by $18 million. That, however, has not happened in Illinois since the dot-com boom in the late 1990's. For at least the last ten years, COGFA's revenue estimates have been more accurate than the revenue estimates of either GOMB, or its predecessor, the Bureau of the Budget.

Figure 6: FY 2007 Revenue Estimate Comparison: GOMB & COGFA

	GOMB	**COGFA**
Projected Increases from State Sources Without New Revenue Initiatives for FY 2007	$936	$860
Amount Needed to Keep Pace with Inflation Cost Increases	$918	$918
Difference FY 2006 Revenue Inflation Adjusted and FY 2007	$18	-$58

Debt and One-Time Revenues

Figure 7 shows Illinois will continue to rely on significant infusions of debt and one-time revenue sources to fund services in FY 2007. For example, the state will not make $1.13 billion of its scheduled pension contribution,[5] effectively borrowing that amount from the state pension system to fund proposed spending on services, and the Illinois Comptroller estimates the state will fund another $1.8 billion of services in FY 2007 by deferring its obligation to pay $1.8 billion it owes to providers of Medicaid health care services, from FY 2007 to FY 2008.[6] 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 state costs.[7]

Figure 7: FY 2007 Budget Spending Covered by Debt & One-Time Revenues

Pension Holiday	$1,133
Special Fund Sweeps	$159
Deferred Medicaid Liabilities	$1,800
TOTAL	**$3,092**

In fact, as Figure 8 shows, Illinois' flawed revenue system has forced state government to use $15 billion in a combination of debt and non-recurring, one-time revenues since FY 2003 to maintain current spending on public services.

Figure 8: Debt and One-Time Revenues FY 2003 – FY 2007

Category	**FY2003**	**FY2004**	**FY2005**	**FY2006**	**FY 2007**
Fund Sweeps	$165	$154	$260	$160	$159
Tax Amnesty		$290	$100		
Pension Bond Sale	$300	$1,395			
Cigarette Tax Adjustment			$50		
Federal Fiscal Relief		$750			
Sale of State Assets		$233			
Sub-Total	**$465**	**$2,822**	**$410**	**$160**	**$159**
Appropriation Adjustments					
Accelerated/Deferred Medical Payments			$1,100	$1,250	$1,800
Restructure of ERI Pension Payment			$200		
Increase in State Pension Fund Approps			$80		
Increase in non-IDOT Road Fund Approps	$95	$145	$145		
Borrowing Against in State Pension Fund				$1,178	$1,133
Total	**$1,025**	**$5,789**	**$2,345**	**$2,748**	**$3,092**

[5] Commission on Government Forecasting and Accountability, August 2005.
[6] Illinois Office of the Comptroller, *Comptroller Quarterly*, January 2006.
[7] Center for Tax and Budget Accountability, *Revenue Performance is the Primary Cause of Illinois Chronic Budget Deficits* available at www.ctbaonline.org

Figure 9 shows why Illinois balances the budget through debt and one-time revenues sources. It shows that revenue increases in FY 2007 will not keep up with projected public service costs, even if the $306 million in FY 2007 revenue enhancement initiatives become law. This is why the state swept $159 million from special purpose funds and will defer Medicaid bills by $1.8 billion. The failure to make the required $1.133 billion payment to the pension system was already written into the budget, as it was approved by the legislature in FY 2006.[8]

Figure 9: Comparison of Revenue & Spending Increases COGFA and GOMB

Estimated Revenue Increase GOMB	$936
Projected Spending Increase	$1,320
Difference Revenue Compared to Spending Increase GOMB	**-$384**
Difference if $306 million in FY 2007 revenue enhancement initiatives become law	**-$78**

Estimated Revenue Increase COGFA	$860
Projected Spending Increase	$1,320
Difference Revenue Compared to Spending Increase COGFA	**-$460**
Difference if $306 million in FY 2007 revenue enhancement initiatives become law	**-$154**

Pension

In FY 2006, elected officials knew revenues would be insufficient to cover the costs of public services scheduled to be provided in both FY 2006 and FY 2007. To cover the anticipated revenue shortfall, state government opted to borrow against the pension in both fiscal years. The effect, the required pension payment for FY 2007 was decreased by $1.13 billion.

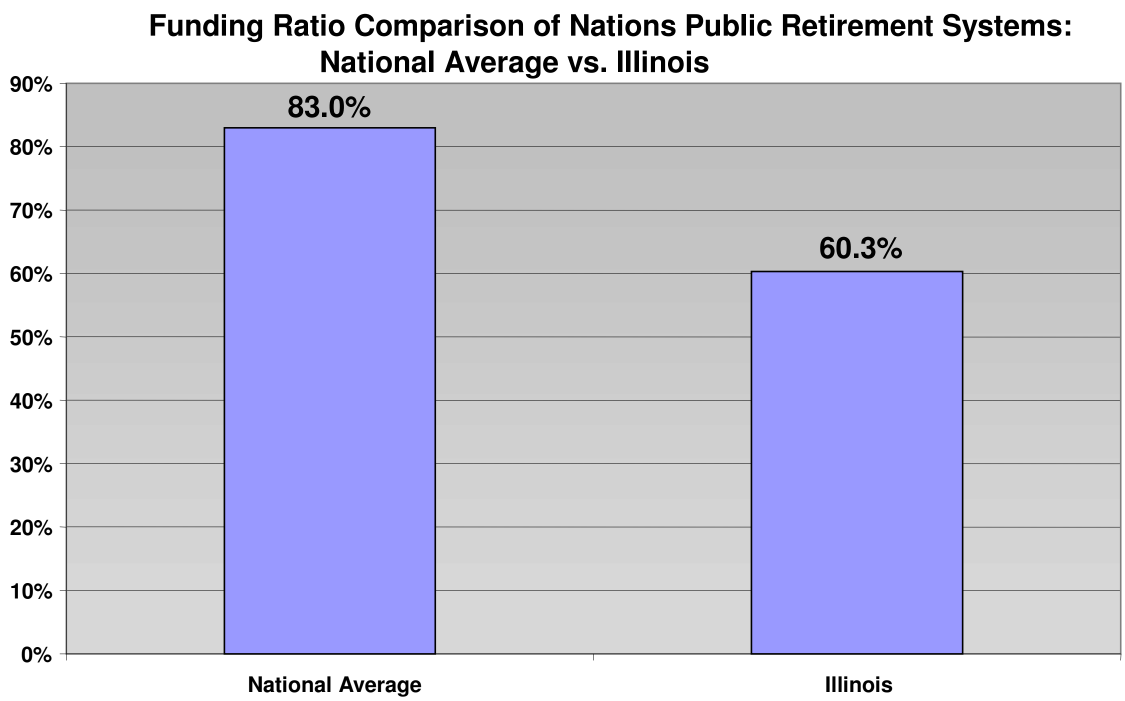
Figure 10: Borrowing Against the Pension to Balance the Budget

Required Yearly Pension Payments to the Five State Retirement Systems: FY 2006 & FY 2007 Pre vs. Post FY 2006 Pension Holiday ($ in billions)			
Fiscal Year	**Amount Owed**	**Amount Paid**	**Amount Borrowed**
2006	$2,117.2	$938.4	-$1,178.7
2007	$2,507.8	$1,374.7	-$1,133.2

[8] Commission on Government Forecasting and Accountability, August 2005

Illinois already has the largest unfunded pension liability, in the country totaling $40.9 billion.[9] Illinois' Pension Funded Ratio, that is, the percentage of what it is required to fund that it has actually funded, is also one of the worst in the nation. In 2005, Wilshire Associates reported on 64 state pension systems and found that the average national Funded Ratio for a state pension system was 83%.[10] As Figure 11 shows, Illinois' Funded Ratio of only 60.3% is significantly below the national average.[11]

Figure 11



Source: Illinois Commission on Government Forecasting and Accountability. Illinois funding ratio is the FY 2006 reported number. The national Average is based on the 2005 Wilshire Report on State Retirement Agencies, the latest national data available.

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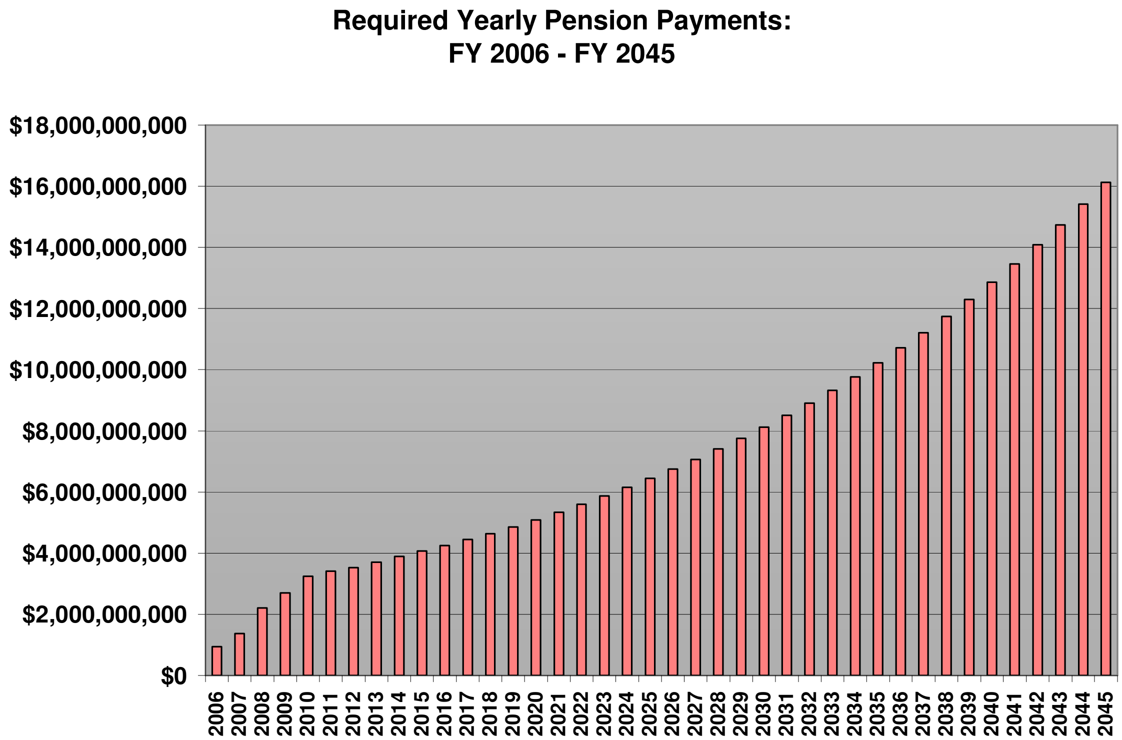
[9] Unfunded liability based on the Commission on Government Forecasting and Accountability, Report on the 90% Funding Target of Public Act 88-05932004 and the FY 2006 and FY 2007 Pension Holiday. Illinois national rank is based on the 2004 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation.

[10] 2005 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation.

[11] Commission on Government Forecasting and Accountability, Report on the 90% Funding Target of Public Act 88-0593.

Looking to the future, it is important to note that the state's required yearly pension payment is scheduled to increase significantly over the next ten years. Not paying the required pension contributions in FY 2006 and FY 2007 further defers the state's pension funding problem into the future, threatening the state's ability to continue funding current service levels overtime.

Figure 12



Conclusion

Overall, the FY 2007 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 tax reforms to allow the state to provide necessary public services including K-12 and Higher Education, the state has chosen again to balance the budget by footing pension bills to the future and using unstable one-time revenues. For more information on how the state can get on sound fiscal ground please visit www.ctbaonline.org