CENTER FOR TAX AND BUDGET ACCOUNTABILITY
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Issue Brief on the Recent Lottery/School Funding Proposal

June 2006

1. Proposal Summary:

- Sell or lease the Illinois lottery to accomplish two goals: (i) generate $10 billion in total revenue, $4 billion of which will be used towards the commitment to infuse $6 billion of new funding into specific, current education operating programs over the next four years only – there is no enhanced school funding after four years; and (ii) create an annuity fund with the $6 billion balance of the proceeds, generating a sufficient return to maintain a $650 million annual revenue stream for education through fiscal year 2025, that will replace the annual revenue education is targeted to receive from the lottery in FY2007, but without replacing any growth in the annual lottery revenue over time. After the year 2025, the state would no longer receive any lottery funding.

- The targeted programs that would receive $6 billion over the next four years are primarily designed to: improve performance of struggling students, enhance special education funding from the state, assist in the purchase of textbooks, encourage parental involvement, create additional accountability measures, enhance teacher mentoring, fund some school construction projects, encourage school district consolidation and create a merit pay for teachers template.

2. Revenue Sources:

- The primary revenue source identified in the proposal is the contemplated sale (through an initial public offering) or lease (over a long, unspecified term) of the Illinois State Lottery, for an estimated $10 billion.

- Of the $10 billion in proceeds from the sale or lease of the lottery, $4 billion would go towards funding the $6 billion commitment to identified programs over the next four years. The remaining balance of the lottery sale proceeds would be deposited in an unidentified annuity investment account, to generate the promised $650 million annually that replaces current lottery funding for education until fiscal year 2025, when the fund would be depleted.

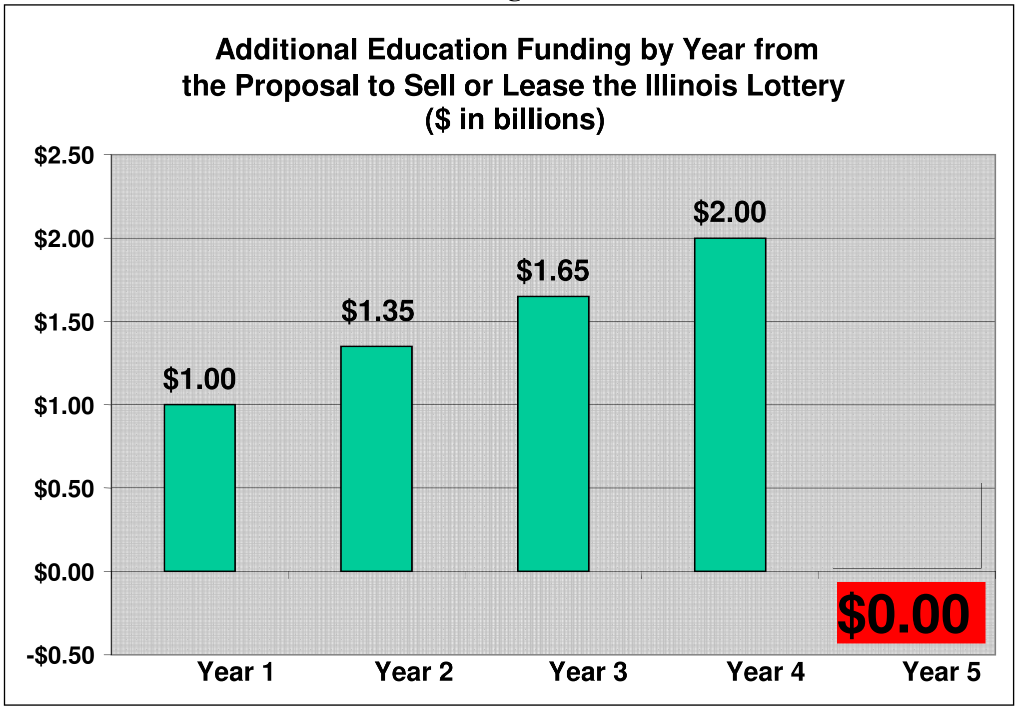
- The proposal relies on a combination of the following sources to generate the additional $2 billion needed to fund the $6 billion commitment to education over the next four years: income taxes paid by the new, private owner of the lottery, transfers from as of yet unidentified special funds, natural revenue growth, and interest generated from the short-term account holding the $4 billion in lottery proceeds targeted for immediate education spending over the next four years.

3. Education Funding Falls Off a Cliff - Twice

- The proceeds that will be generated from the sale of the lottery are not renewable. Once they are spent, they are gone—with no replacement identified. The structure of how the proposal will fund education creates two distinct, steep drop-offs in education funding.

- Given that the state's current revenue structure cannot make up the school funding shortages that create these cliffs, the enhanced education programs funded in the first four years of the proposal will in all likelihood not be sustainable thereafter. As Figure 1 demonstrates, the most dramatic cliff occurs at the end of year four of the funding plan, when the state is left with no revenue to continue the education programs enhanced in years one through four of the proposal.

Figure 1



- Note that Figure 1 represents a best case scenario. Over the last five years, lottery revenue has grown by an average of $27 million per year.[1] 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. The proposed annuity, however, will replace only the $650 million per year base of school funding from the lottery, not the $27 million in average annual lottery revenue growth. So, while the proposed annuity will make up for the base level of school funding the lottery generates in FY2007, it will not make up for the annul growth in lottery proceeds that goes to schools thereafter. Hence, in all probability in year five of the proposal, education funding could drop to a level below where it would have been if the lottery was not sold.

- The second cliff occurs in FY2025, when the investment annuity from the sale/lease of the lottery is exhausted. At that point, the state will have to find a new revenue stream worth in excess of $650 million annually to replace the annuity, or cut education funding or other services by $650 million.

4. Education Programs Targeted to Receive the Initial $1 Billion in Funding:

• Increase the Foundation Level:	$250 million
• Increase Special Education Funding:	$200 million
• School Construction:	$50 million (debt service)
• Preschool Expansion:	$60 million
• Programs for underperforming students:	$200 million
• Textbook replacement:	$40 million
• Other reforms:	$200 million

[1] Analysis of FY 2003 – FY 2007 State of Illinois lottery revenues.

YEAR ONE TOTAL $1 Billion

5. Other Concerns:

A. Pressure to Employ Poor Fiscal Practices and Cut Other Programs

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.

Since existing revenue sources cannot makeup the difference, three options come into play. First, the state could replace the lost lottery revenue stream by either raising taxes or cutting spending on other public services such as heath care, housing, human services, and public safety, to maintain the enhanced education funding. Second, the state could cut school funding back to levels that existed before the lottery was sold. 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 Association[2], primarily to pay current operating expenses.

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 (CPI) to FY2006	FY 2006 as Enacted	$ Difference Between 1995 Adj'd for Inflation (CPI) & 2006 Enacted
GRF-Total	$17,302.0	$22,613.7	$24,406.4	$1,792.7[3]
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
All other public service expenditures-combined	$8,808.0	$11,512.1	$10,341.0	**-$1,171.1**

[2] National Association of State Budget Officers, *Budget Analyst Training Program.*
[3] Note, this column does not add up because it does not include the $260.1 million, inflation adjusted increase in expenditures on state pension contributions during this period that were mandated by the Pension Ramp. This increased pension expenditure was not for current public services, and so was not included in the chart.

B. Current Deficit Spending Indicates Lottery Proposal Will Not Reach Its Target of Infusing $6 Billion into Education over the Next Four Years:

The proposal relies on more than proceeds from the sale/lease of the lottery to meet its enhanced education funding target of $6 billion over the next four years. Fully one-third of that amount—$2 billion—is supposed to come from natural revenue growth and other sources. The state's current deficit spending for the coming fiscal year makes it highly unlikely that the needed $2 billion will materialize.

The FY2007 GRF budget calls for spending $27 billion on public services. Of that amount, at least $3.092 billion is being paid for with either one-time revenues or debt. This means that over 11% of the proposed General Revenue Fund budget for 2007 is not sustainable as it is.

Figure 3 shows the minimum amount of deficit spending included in the FY2007 budget.

Figure 3

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

Underfunding the Pension	$1.133
Special Fund Sweeps	$ .159
Deferred Medicaid Liabilities	$1.800
TOTAL Deficit Spending in Current Budget	**$3.092**

Amounts expressed in billions of dollars

As Figure 3 shows, the state will not make $1.13 billion of scheduled pension contributions,[4] effectively borrowing that amount from the state pension systems to fund proposed spending on services. The Illinois Comptroller estimates the state will fund another $1.8 billion of services in FY 2007 by deferring its obligation to pay—that is, borrowing against—what it owes to providers of Medicaid health care services, from FY 2007 to FY 2008.[5]

The significant amount of borrowing and utilization of other one-time revenue sources like fund sweeps to pay for current operations make it highly unlikely that any amount of natural revenue growth—even if such growth breaks with historic trends and actually exceeds inflation—will be available to fund the education increases contemplated in the proposal. It is far more likely that such growth, if it materializes, will be used to replace borrowing and one-time revenues used to pay for current services.

So, to maintain the FY2007 level of public services in FY2008, the state will have to identify new revenue and incur additional debt in an amount needed to cover: (i) the $3.092 billion in debt and one-time revenue used to finance the FY2007 deficit spending, plus interest on the debt portion of that financing; plus (ii) at least another $105 million, which is the inflation adjusted increase in the cost of the $3.092 billion in services funded with debt or one-time revenue in FY2007; plus (iii) almost $2 billion to cover the pension contribution which is scheduled to come back on-line in FY 2008.

[4] Commission on Government Forecasting and Accountability, August 2005.
[5] Illinois Office of the Comptroller, *Comptroller Quarterly*, January 2006.

The net result, Illinois must identify over $5 billion in new revenue for FY 2008 to both maintain the FY 2007 level of services and cover the scheduled pension payment.

C. Inadequate Revenue Growth:

Since 2000, Illinois' General Fund Revenue growth has fallen short of inflation by $4 billion in the aggregate.[6] Given this, there is no reason to anticipate there will be any net natural revenue growth available to cover the $2 billion in revenue from sources other than the sale of the lottery, that the proposal is relying on to reach the $6 billion commitment to education promised over the next four years.

D. Fund Transfers:

Because revenue historically underperforms inflation, Illinois frequently uses one-time revenue sources to cover the annual increases in the cost of public services caused just by inflation.[7] Since FY 2003, ongoing revenue shortfalls have caused Illinois to sweep $848 million from special funds as one-time revenue sources to maintain service levels. Fund sweeps are controversial and require legislative approval. Further, until the specific funds to be swept are identified, it is impossible to determine precisely how much revenue would be generated from the sweeps to cover education funding, whether the targeted funds should be tapped for other than their dedicated purposes, or whether the legislature is likely to approve the proposed sweeps.

Figure 4

Fund Sweeps FY 2003 – FY 2007

Fiscal Year	FY2003	FY2004	FY2005	FY2006	FY2007
Amount of Fund Sweeps	$165	$154	$260	$160	$159

Amounts expressed in millions of dollars

E. 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.[8] 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

[6] Center for Tax and Budget Accountability analysis of the General Revenue Fund FY 2000 – FY 2006.
[7] Center for Tax and Budget Accountability, *Revenue Performance is the Primary Cause of Illinois Chronic Budget Deficits* available at www.ctbaonline.org
[8] State of Connecticut, Office of the Comptroller, January 1996.

board members. All lottery revenues still go to the Connecticut General Fund to fund public services.[9]

F. Loss of Other Funding:

In addition to funding education, the lottery currently provides revenue for other "specialty causes."[10] The FY 2007 transfer to these "specialty causes" is $8 million. If the lottery is sold/leased, the General Revenue Fund (GRF) will have to replace that shortfall, or cut other programs.

G. 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.

5. Conclusions:

- It is widely acknowledged that the education programs the proposal would fund are good, will help students achieve, and need the additional funding. But the proposal does not create a sustainable way to fund those programs. Instead, it creates, at a minimum, a $2 billion education funding shortage in year four, that will compel the state to take one of two actions concerning the proposal's widely acknowledged, good investments in educational programs - Either raise the taxes needed to continue funding these needed programs—or cut them back to the levels existing before the proposal was implemented.

- Implementing comprehensive fiscal reform that modernizes the Illinois tax system while keeping the state economically competitive 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 education programs that would be funded in the proposal.

- If in fact the targeted education programs represent wise and needed investments, then why sell a state asset today and create the need to raise taxes tomorrow. If the investment is needed today, Illinois should take the fiscally responsible strategy of raising the tax revenue necessary to fund these programs today.

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[9] Connecticut Lottery Corporation, Comprehensive Annual Financial Report, June 2005.
[10] The Fiscal Year (FY) 2007 does not define the "specialty causes". The $8 million revenue for "specialty causes" in FY 2007 is above the $650 million for education.