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CONFRONTING THE FISCAL FIRESTORM

AN UPDATE ON THE STATE BUDGET DEFICIT FOR FY 2011

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Illinois is in the midst of a burgeoning fiscal firestorm. Governor Quinn has presented the General Assembly with two budget options for FY 2011 — a formal proposal that relies on spending cuts and borrowing and an alternative plan that includes an income tax increase. Despite anticipated savings from recently enacted changes in state-funded retirement systems, the General Funds (GF) budget faces a *$13 billion* deficit in the coming fiscal year.[1] Meanwhile, public discussion of Illinois' fiscal crisis continues to be distorted by misleading claims that the state's enormous budget shortfall can be eliminated by spending cuts alone.

This special report begins with an analysis of the cyclical and structural components of the looming budget gap. The next section examines the Governor's two budget proposals, both of which would reduce the GF deficit for the coming fiscal year but would also leave the state with a massive backlog of unpaid bills, as well as deep cuts in vital programs and services. The report then turns to a discussion of some misconceptions about the growth of state spending and the feasibility of a "no-tax-hike" solution to the fiscal crisis. The stark reality is that a responsible budget will require a substantial amount of new revenue — even more than has been proposed by the Governor. A balanced and viable solution is not remotely possible without some combination of revenue increases, spending restraints, and other measures.

UNDERSTANDING THE STATE FISCAL CRISIS

The state fiscal crisis is a product of both short-term and long-term factors. The short-term *cyclical deficit* reflects the impact of the nationwide recession on state revenues. In addition, the state has a chronic *structural deficit* because the revenue generated by its tax system does not keep pace with underlying economic growth and cannot support established levels of services and other ongoing commitments over the long term. The convergence of the structural deficit and the recession has created a fiscal crisis of unprecedented magnitude.[2]

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[1] The General Funds — which include the General Revenue Fund, the Common School Fund, and the Education Assistance Fund — support the regular operating and program expenses of most state agencies. An earlier projection of the FY 2011 deficit ($12.8 billion) as a proportion of the state budget gave Illinois the dubious distinction of having the second largest budget gap among all states, exceeded only by Nevada. See Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery" (Center on Budget and Policy Priorities, February 2010).

[2] For a more extensive discussion, see "Roots of the State Fiscal Crisis" (Voices for Illinois Children, May 2009).

Revenue Trends

The long and deep recession has battered state budgets across the nation. The decline in state tax receipts has been the steepest in more than five decades of recorded data.[3] In Illinois, GF revenue from state sources plummeted by $2 billion in FY 2009. The Commission on Government Forecasting and Accountability (CGFA) expects state revenue to fall another $1.8 billion by the end of FY 2010. CGFA projects a modest increase (about $400 million) in FY 2011, but state revenue would still be $1 billion lower than it was five years earlier. Using FY 2008 as the baseline, the cumulative three-year revenue loss from the recession will exceed $9 billion (see Table 1).

Aside from the effects of the recession, the state's inheritance tax, which is tied to the federal estate tax, expired on January 1, 2010. Because of delays in estate settlements, state revenues will not be significantly affected for about nine months. In the absence of legislation to reinstate the inheritance tax, CGFA estimates that the revenue loss in FY 2011 will be about $200 million.

Table 1: General Funds Revenue from State Sources (in $ millions)

	FY 2008	FY 2009	Estimated FY 2010	Projected FY 2011	
Individual income tax	10,320	9,223	8,574	8,709	
Sales taxes	7,215	6,773	6,200	6,300	
Corporate income tax	1,860	1,710	1,279	1,407	
All other (excluding transfers)	3,549	3,278	3,093	3,141 *	
Total	22,944	20,984	19,146	19,557	
Change from prior year	1,253	-1,960	-1,838	411	
Pct. change	5.8%	-8.5%	-8.8%	2.1%	
					Total
Change from FY 2008	-------	-1,960	-3,798	-3,387	-9,145

* Expiration of inheritance tax not included.

Source: Commission on Government Forecasting and Accountability

Pension Costs

Illinois has five separate state-funded retirement systems for public school teachers, state government employees, state university employees, judges, and members of the General Assembly. The largest of these is the Teachers' Retirement System, which accounts for more than half of annual contributions.[4] Decades of chronic underfunding of pension obligations constitute a significant part of the structural deficit. According to a recent report from the Pew Center on the States, the ratio of assets to liabilities in the state's retirement systems declined from 73 percent in 1999 to 54 percent in 2008, which placed Illinois last among all states.[5]

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[3] See, e.g., Donald J. Boyd, "Recession, Recovery, and State-Local Finances" (Nelson A. Rockefeller Institute of Government, January 2010); McNichol and Johnson, "Recession Continues to Batter State Budgets."

[4] The Teachers' Retirement System of Illinois is separate from the Chicago Teachers' Pension Fund, which receives a relatively small amount of state revenue.

[5] Pew Center on the States, "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform" (February 2010).

In FY 2008, pension costs for the General Funds totaled about $2 billion, including $470 million in debt service for pension obligation bonds issued in 2003. In FY 2010, mandated pension costs were scheduled to jump to $3.9 billion, with most of the increase reflecting statutory mandates to reduce unfunded liabilities. As part of the FY 2010 budget, the General Assembly authorized $3.47 billion in intermediate-term borrowing (five-year pension notes) to cover required state contributions to the retirement systems (see Table 2).

The Governor's budget proposed both long-term and short-term budget savings through changes in the state retirement systems. On March 24th (several weeks after the Governor's budget address), the General Assembly approved pension legislation (Senate Bill 1946) that will raise the retirement age and reduce benefits for new employees hired after January 1, 2011. The bill was signed into law on April 14th. CGFA estimates that the legislation will reduce pension costs by $500 million in FY 2011. Nonetheless, total projected GF pension costs for FY 2011 will be $2.9 billion higher than they were in FY 2008 (see Table 2).

Table 2: General Funds Pension Costs (in $ millions)

	FY 2008	FY 2009	Estimated FY 2010	Projected FY 2011
Pension contributions	1,559	2,486	3,466 *	3,657 **
Debt service: pension obligation bonds	470	467	465	464
Debt service: pension obligation notes	------	------	------	803
Total	2,029	2,953	3,931	4,924
Change from FY 2008	------	924	1,902	2,895

* Financed with five-year pension notes

** Includes estimated effects of SB1946.

Sources: Illinois Office of the Comptroller; Commission on Government Forecasting and Accountability.

Federal Recovery Funds

The American Recovery and Reinvestment Act (ARRA) provided two sources of federal funds that were specifically designed for deficit reduction (see Table 3). The State Fiscal Stabilization Fund, administered by the U.S. Department of Education, allocated more than $2 billion to Illinois. Under the ARRA statute, the "first use" of these funds had to be the restoration of state formula aid to public schools to the FY 2008 or FY 2009 level, whichever was greater. In FY 2009 and FY 2010, Illinois designated all of its allocation for PK-12 education and higher education.

The other source of fiscal relief has been a temporary increase in federal Medicaid matching funds, This provision of ARRA was designed to protect and maintain state Medicaid programs during the recession. For Illinois, the federal share of Medicaid costs was raised from 50 percent to more than 60 percent, retroactive to October 2008.[6] The General Funds will receive about $1.4 billion in federal fiscal relief for FY 2009 and FY 2010. Enhanced Medicaid matching funds will expire at the end of December 2010 (halfway through FY 2011), although the Governor's budget assumes that Congress will enact a six-month extension.

[6] To qualify for the enhanced federal match, states cannot make Medicaid eligibility standards or enrollment procedures more restrictive, and they must assure prompt payments to hospitals, nursing homes, and medical practitioners (in most cases, within 30 days). This latter requirement compelled Illinois to reduce its backlog of unpaid Medicaid bills, which stood at $2 billion at the end of FY 2008.

In February, the U.S. Department of Health and Human Services announced that federal ARRA funds will be used to reduce the state share of the cost of the Medicare prescription drug coverage for individuals who are eligible for both Medicare and Medicaid. This reduction in Medicare "clawback payments" will apply to the period from October 2008 through December 2010. The estimated savings for Illinois will be about $200 million.[7]

Table 3: Federal ARRA Revenue for General Funds Deficit Reduction in Illinois (in $ millions)

	FY 2009	FY 2010	FY 2011
State Fiscal Stabilization Fund			
State Board of Education	1,039	922	0
State universities	0	94	0
Subtotal	1,039	1,016	0
Increase in Medicaid matching funds	527	839	454
Reduction in Medicare clawback payments*	-----	-----	200
Total	1,566	1,855	654

* Applicable to period from October 2008 to December 2010.

Sources: Illinois Office of the Comptroller; Illinois State Board of Education; Governor's Office of Management and Budget; U.S. Department of Health and Human Services.

The Cumulative Deficit

At the end of FY 2009, the cumulative GF budget deficit was $3.7 billion, even with a substantial amount of fiscal relief from the federal government. This carryover deficit meant that $3.7 billion in FY 2009 expenditures had to be covered with FY 2010 revenues. The State Comptroller has reported that the current backlog (about $4.5 billion) includes unpaid bills that are more than six months old. Moreover, cash flow problems will intensify during the final three months of the fiscal year, as the state must complete repayment of $2.25 billion in short-term borrowing.[8] The deficit is expected to reach *$6 billion* by the end of FY 2010.

For the coming fiscal year, the gap between anticipated revenue and spending is about $7 billion. Much of the one-year deficit reflects $4.2 billion in higher pension costs, including state contributions covered by borrowing in FY 2010, an increase in mandated contributions for FY 2011, and the first year of debt service for the five-year pension notes. Another important factor is the net loss of $1.2 billion in federal ARRA funds. By the end of FY 2011, the cumulative deficit will reach *$13 billion* (see Table 4 and Appendix). This figure is equivalent to combined FY 2010 funding for the State Board of Education, the Department of Human Services, the Department of Children and Family Services, the Department on Aging, and the Department of Public Health.

[7] "Clawback" refers to monthly payments made by states to the federal Medicare program. These payments are meant to reflect a portion of the prescription drug expenditures a state would have made for dual eligibles under Medicaid. See Andy Schneider, "The 'Clawback': State Financing of Medicare Drug Coverage" (Kaiser Family Foundation, June 2004).

[8] Illinois Office of the Comptroller, "Cash Position Deteriorates as State Begins to Repay Short-Term Borrowing," *Comptroller's Quarterly*, April 2010.

Table 4: Simplified Estimate of General Funds Budget Deficit for FY 2011 (in $ millions)	
Carryover deficit from FY 2009 and FY 2010	**$6,020**
One-year deficit for FY 2011	
Baseline deficit (gap between FY 2010 revenue and spending)	1,250
Increased pension costs relative to FY 2010	
Regular state contributions	4,160
Pension legislation (SB1946)	-500
Debt service for pension obligation notes	800
Subtotal	4,460
Net loss of federal ARRA funds	1,200
Net loss of state revenue	90
Total	**7,000**
Cumulative three-year deficit	**13,020**

Note: For detailed estimate, see Appendix.

THE GOVERNOR'S BUDGET PROPOSALS

Budget without a Tax Increase

The Governor's proposed budget for FY 2011 includes more than $2 billion in GF spending reductions relative to FY 2010. The largest portion of these spending cuts — $1.2 billion — would occur in the State Board of Education budget. Other substantial reductions would come from state employee group insurance ($325 million), the Department of Human Services ($150 million), state universities ($87 million), and the Department on Aging ($42 million). Some areas of the GF budget would get increased or level appropriations. As a result, the net reduction in operating expenditures would be about $1.6 billion.[9]

The Governor has also proposed cutting about $300 million in transfers to the Local Government Distributive Fund (LGDF). Under current law, one-tenth of state revenue from individual and corporate income taxes is transferred to LGDF and allocated to municipalities and counties on the basis of population.[10] As a result of the recession, the LGDF share of income tax revenue in FY 2010 will be about $230 million lower than in FY 2008 — a 19 percent drop. The Governor would reduce LGDF transfers by another 30 percent. Not surprisingly, local government officials are strongly opposed to this change.

Finally, the Governor's deficit reduction plan includes $4.7 billion in "strategic borrowing" to ensure timely payments to service providers. This borrowing would take the form of a series of "voucher payment notes" to cover specific expenditures during the fiscal year. Documents from the Governor's Office of Management and Budget (GOMB) refer to an unspecified combination of short-term, intermediate-term, and long-term borrowing, but GOMB does not provide details about anticipated sources of borrowing or about debt service and repayment schedules.

[9] A subsequent report will present a comprehensive analysis of the Governor's budget proposals at the agency and program levels.

[10] The county portion is allocated on the basis of population in unincorporated areas.

Under this plan, the total amount of deficit reduction would be about $7 billion, including $4.7 billion in borrowing, which would have to be repaid sometime in the future, and $500 million from recently enacted pension change. In effect, the spending cuts and borrowing would cover the one-year budget gap for FY 2011 but would leave a $6.4 billion carryover deficit (see Table 5).[11]

Budget with a Tax Increase

As an alternative to the formal budget proposal, the Governor has advocated an income tax "surcharge" for education. The individual income tax would be raised from 3 percent to 4 percent and the corporate income tax from 4.8 percent to 5.8 percent. According to GOMB, the income tax increase would generate about $2.8 billion in new revenue — with $1.3 billion earmarked to maintain education funding at FY 2010 levels. The remainder would be used to reduce the backlog of more than $1.5 billion in delayed payments for school districts, state universities, and community colleges. There would be no additional revenue for human services or any other programs in the GF budget.

Under the Governor's alternative budget plan — with an income tax increase — total deficit reduction in FY 2011 would be about $8.6 billion, which would be more than enough to close the one-year budget gap. However, the remaining backlog of unpaid bills – mostly for human service providers – would be close to $5 billion (see Table 5).

Table 5: Estimated Deficit Reduction in Governor's Budget Plans (in $ millions)

	Without tax increase	With tax increase
Baseline deficit (not including pension changes)	**13,520**	**13,520**
Net reductions in agency spending	1,628	312
Local Government Distributive Fund	308	308
Pension changes	500	500
Borrowing	4,672	4,672
New revenue	0	2,800
Total deficit reduction	**7,108**	**8,592**
Remaining deficit	**6,412**	**4,928**

MISCONCEPTIONS ABOUT THE DEFICIT

Some policymakers, newspaper editorial boards, and other opinion leaders continue to propagate the idea that the state fiscal crisis was created by runaway spending. This claim is not supported by the relevant data, however. The rate of GF spending growth was substantially higher during the 1990s than in more recent years. Between FY 1989 and FY 1999, GF expenditures increased at an average annual rate of 6.1 percent — higher than the growth rate for aggregate personal income in Illinois and much higher than the rate of inflation. Between FY 1999 and FY 2008 (before the discernible impact of the recession), the rate of spending growth was only 3.9 percent — lower than growth of personal income and not much higher than the rate of inflation (see Table 6).

[11] These figures do not include any revenue from a possible extension of federal ARRA funds for Medicaid.

Table 6: Average Annual Growth of General Funds Expenditures, FY 2000 to FY 2009

	FY 1989 to FY 1999	FY 1999 to FY 2008
General Funds base expenditures*	6.1%	3.9%
Personal income in Illinois**	5.6%	4.3%
Consumer price index**	3.3%	2.7%

* Base expenditures exclude short-term borrowing and cash flow transfers.

** Calendar years 1999-2007

A related misconception is that the state's budget problems can be readily fixed by cutting expenditures for wasteful programs. A prominent example is the contention by the editorial board of the *Chicago Tribune* that the state's budget problems can be solved with $6.4 billion in spending cuts. This would "negate a need for tax increases" and "pay off the state's shortfall in two years."[12] Their proposed spending cuts include $3.2 billion from state agency appropriations and $2.1 billion from pension changes that would affect both current and future employees. Putting aside the merits of the specific cuts, this no-tax-hike plan would leave a one-year shortfall of $600 million for FY 2011. Moreover, the spending cuts would do nothing to reduce the backlog of unpaid bills. At the end of two years, the cumulative budget deficit would still be more than $6 billion.

What would it actually take to solve the state fiscal crisis with spending reductions alone? Baseline GF spending for FY 2011 (with agency appropriations at FY 2010 levels) is about $33.8 billion, including $6.4 billion for mandated pension contributions and debt service (see Table 7). In order to eliminate the deficit, the remainder of the budget ($27.9 billion) would have to be cut by *more than 45 percent*. Another factor to consider is that federal grants, together with various federal mandates, amount to about $10 billion. If this part of the GF budget were protected, closing a $13 billion gap would require spending cuts of *more than 70 percent*.

Table 7: Major Components of Baseline General Funds Spending, FY 2011

	$ millions	Pct. distribution
Pension contributions	3,657	12.1%
Debt service for pension obligations	1,611	4.7%
Debt service for capital projects	638	1.9%
Local Government Distributive Fund	1,027	3.0%
Other statutory transfers	977	2.8%
Operating expenditures (FY 2010 level)	25,909	75.5%
Total	33,819	100.0%

Source: Governor's Office of Management and Budget

[12] "A No-Tax-Hike Option," Editorial, *Chicago Tribune*, February 28, 2010.

CONFRONTING FISCAL REALITY

Illinois policymakers must come to terms with the scope, magnitude, and urgency of the fiscal firestorm, which will not dissipate on its own. The cumulative budget deficit will reach $6 billion by the end of the current fiscal year and will grow to $13 billion during FY 2011. Ignoring fiscal reality and avoiding difficult decisions will only add fuel to the fire. The state's continuing inability to pay its bills will have devastating effects on public schools, state universities, community colleges, public transportation, early childhood programs, and a wide range of services for vulnerable populations across Illinois.

Addressing both the cyclical and structural components of the state fiscal crisis will require a significant amount of new revenue — even more than the Governor has proposed. The starting point should be the framework contained in House Bill 174, which would raise the individual income tax to 5 percent and expand the base of the state sales tax to cover more consumer services. This bill, which passed the State Senate last May, would generate about $5 billion annually. If HB174 or similar legislation had been effective beginning July 1, 2009, the cumulative deficit for FY 2011 would have been reduced by $10 billion.

A recent report from the Civic Federation declared that "the scope of the state's fiscal crisis requires a combination of remedies. The problem is too large to be solved solely by budget cuts or tax increases."[13] While Voices for Illinois Children does not agree with all aspects of the Civic Federation's "fiscal rehabilitation plan," we strongly concur that a responsible solution requires a balanced approach. New revenue, appropriate spending restraints, and fiscal reforms must all be part of that balance.

[13] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "A Fiscal Rehabilitation Plan for the State of Illinois" (February 22, 2010).

Appendix: Detailed Estimate of General Funds Budget Deficit for FY 2011 (in $ millions)

Baseline FY 2011 deficit (assumes no changes in FY10 revenue or spending)		**-$1,251**
FY 2011 changes in revenue		
State sources		
Estimated revenue growth (including transfers)	462	
Expiration of inheritance tax*	-200	
Special transfers (fund sweeps)**	-352	
Federal ARRA funds	-1,401	
Reduction in Medicare clawback payments	200	
Net changes in revenue		**-1,291**
FY 2011 changes in pension costs		
Contributions covered by borrowing in FY 2010**	3,466	
Increase in required contribution in FY 2011 (excluding effects of SB1946) **	691	
Pension legislation (SB1946)*	-500	
Debt service for pension obligation notes*	803	
Net increase in pension costs		**4,460**
One-year deficit = (baseline deficit) + (changes in revenue) – (changes in spending)		**-7,002**
Carryover deficit from FY 2009 and FY 2010		**-6,018**
Cumulative deficit		**-13,020**

* Estimate by Commission on Government Forecasting and Accountability

** Estimate by Governor's Office of Management and Budget

About Voices for Illinois Children

Voices for Illinois Children works across issue areas to improve the lives of children of all ages throughout our state so they grow up healthy, nurtured, safe, and well-educated. For more than 20 years, Voices has been helping opinion leaders and policymakers understand the issues facing children and families. The Voices network weaves through the state, engaging community leaders and people who care passionately about children.

About the Budget & Tax Policy Initiative

The Budget & Tax Policy Initiative (BTPI) provides information and analysis to advocates and policymakers on a wide range of spending and revenue topics that affect the lives of children and families in Illinois. BTPI is part of the State Fiscal Analysis Initiative, a network of organizations coordinated by the Center on Budget and Policy Priorities in Washington, D.C.

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