FISCAL POLICY CENTER
AT VOICES FOR ILLINOIS CHILDREN

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New Budget Will Take State Backwards If Current Tax Rates Not Maintained

By David Lloyd and Larry Joseph

The failure of the General Assembly to extend current income tax rates resulted in an irresponsible budget that stops the improvement of Illinois' finances in its tracks. Rather than confront reality and over $4 billion in unpaid bills, lawmakers cobbled together a budget for fiscal year 2015, which began July 1, by borrowing and by underfunding existing obligations, which will further add to the state's backlog of unpaid bills. The General Assembly's actions merely papered over the projected $2 billion revenue collapse that will occur if the tax rates are not extended beyond December 31.

Since the tax rates are not set to expire until January, lawmakers used various budget maneuvers to largely avoid deep cuts to services. But that just means that service cuts will deepen and unpaid bills will quickly pile up when revenue starts to plummet in January. In FY 2016, which begins in less than a year, Illinois' fiscal dam will truly break when the revenue loss reaches nearly $5 billion — forcing deep cuts to essential services and investments in our future such as education. Additionally, Illinois' already worst-in-the-nation credit rating will almost certainly be pushed even lower, increasing the cost of issuing bonds for investments in roads and other transportation infrastructure, school facilities, and economic development. The way out is for lawmakers to extend the current tax rates beyond December 31.

Failure to Adopt Responsible Budget Worsens State's Finances

Lawmakers in Illinois unfortunately have a history of making shortsighted decisions that end up costing the state much more later on. By not extending current income tax rates prior to passing the FY 2015 budget, the General Assembly created yet another scenario that will harm the state's finances as well as essential services.

After rightly rejecting a plan with enormous cuts to nearly every area of the state budget,[1] the General Assembly failed to take the next obvious step: maintain revenue to support essential services and investments such as education, early childhood programs, and public safety. Instead, lawmakers came up with a budget that masked the $2 billion revenue loss from the midyear expiration of current income tax rates. Even then, some areas of the budget were still hit by significant cuts.

[1] The House of Representatives voted 107 to 5 against House Bill 3792, House Amendment 1.

Several maneuvers have created the illusion of a balanced budget for FY 2015. A transfer of $600 million to the Healthcare Provider Relief Fund, which is used primarily to pay outstanding Medicaid bills, was shifted from FY 2015 to FY 2014. In addition, the General Assembly authorized $650 million in interfund borrowing from dedicated accounts outside the General Funds to continue to fund services and obligations despite the projected revenue collapse. This borrowing creates a liability that the state must repay (with interest) within 18 months of the time of borrowing. Thus, if the revenue collapse is not prevented, it will simply shift cuts to programs and services into future years.

The new budget also underfunds existing obligations for human services programs, state payroll expenses, and various other purposes by about $750 million, according to the Governor's Office of Management and Budget (GOMB). The state must ultimately pay for these obligations, which will reduce available resources in future years to fund priorities such as education, transportation, and public safety.

Prior Underfunding and the Halt to Recent Progress

Illinois has a woeful history over several decades of failing to meet its financial obligations. Such underfunding is largely hidden from immediate public view and only becomes apparent once the state does not have the money to pay obligations that come due. These shortsighted practices have cost Illinois dearly. Areas of underfunding have included:

- **Grossly inadequate pension contributions.** The repeated failure to make annual pension contributions has undermined the retirement security of public workers. To compensate for inadequate contributions and the loss of investment returns, the state must now pay billions more each year.
- **Insufficient Medicaid funding.** In the past, lawmakers knowingly funded Medicaid below actual program costs, which produced a backlog that exceeded $2 billion at its height. As a result, some health care providers stopped accepting Medicaid patients, who might then need more expensive care in emergency rooms, which are required to accept Medicaid.[2]
- **Failure to pay contractual wages for state employees.** The General Assembly has passed budgets that do not provide enough funding to pay contractual wages for state employees. To force the state to honor its contractual obligations, employees owed back wages have obtained court judgments against the state in an attempt to compel payment.[3]
- **Inadequate payments to group health insurance.** The state still owes over $1 billion to the State Group Health Insurance Program, which provides health insurance to state employees, retirees, and their dependents. This inadequate funding has led some providers, who insist on timely payment, to deny patients care or require that patients pay out-of-pocket and file for reimbursement themselves.

[2] Jamey Dunn, "Unpaid Bills: The state's inability — or unwillingness -— to meet its commitments is simply unfair, some say," *Illinois Issues* (University of Illinois Springfield, March 2010).

[3] "Judge orders Quinn to honor state employee raises" (State Journal-Register, December 7, 2012).

Additionally, even where appropriations were sufficient to meet program costs, the revenue collapse due to the Great Recession forced the state to delay payments to community-based service providers, local governments, school districts, and others. Such delays have disrupted annual budgeting, curtailed service delivery, and caused some community-based providers to shut their doors.

Recently, the state has been moving in the right direction thanks to the additional revenue from the 2011 increase in income tax rates. Every year since FY 2012, the state has made its annual pension contributions without borrowing. And, in the last two years, the state has reduced its backlog of unpaid bills by more than $3 billion, including nearly eliminating the backlog of Medicaid payments. Just this May, the state was able to pay $50 million in back wages to state employees, though it still owes another $62 million.

However, that progress has now come to an abrupt halt due to the General Assembly's failure to extend current income tax rates. The enacted FY 2015 budget, with its $2 billion reduction in revenue, once again takes Illinois' finances in the wrong direction by underfunding obligations and increasing the backlog of unpaid bills. Various human services programs are underfunded by $300 million, threatening service providers' finances and the strength of the service delivery system (for more details, see next section). The state is also once again not funding about $250 million in contractually obligated wages to state employees.

As with the borrowing from dedicated funds, most of the pain inflicted by the FY 2015 budget could be avoided if lawmakers maintained existing income tax rates. However, if current rates expire, the backlog will sharply increase, once again digging a deeper fiscal hole for the state.

Budget Still Contains Significant Cuts

While most areas of the new budget were held to FY 2014 funding levels, there were significant cuts to important human services. Funding to help low-income working families afford child care will be cut by $84 million. Though it is not yet clear how the Department of Human Services (DHS) will implement these cuts, an estimated 17,000 children could lose access to services, and a plan to lower family copayments, which were increased substantially in both 2010 and 2011, will likely be shelved.

In the Department on Aging, $38.5 million will be cut from the Community Care Program, which provides services for seniors who might otherwise need nursing home care. Funding will be $132 million below the level proposed by the Governor. A similar program in DHS — the Home Services Program for individuals with physical disabilities — will be cut by a relatively small amount (about $8 million), but funding will be $47 million below the estimated cost of maintaining current service levels. Both programs are funded largely through Medicaid, and those who meet program eligibility criteria are guaranteed services under federal court orders that eliminated waiting lists for services and required timely determination of eligibility and provision of benefits.[4] Consequently, underfunding these two programs below actual costs will also result in a growing backlog of unpaid bills to service providers.

The budget also significantly underfunds community-based services for individuals with developmental disabilities, which are primarily funded through Medicaid. The funding provided will be about $65 million below the costs to support current service levels. Once again, the shortfall will result in delayed payments to service providers.

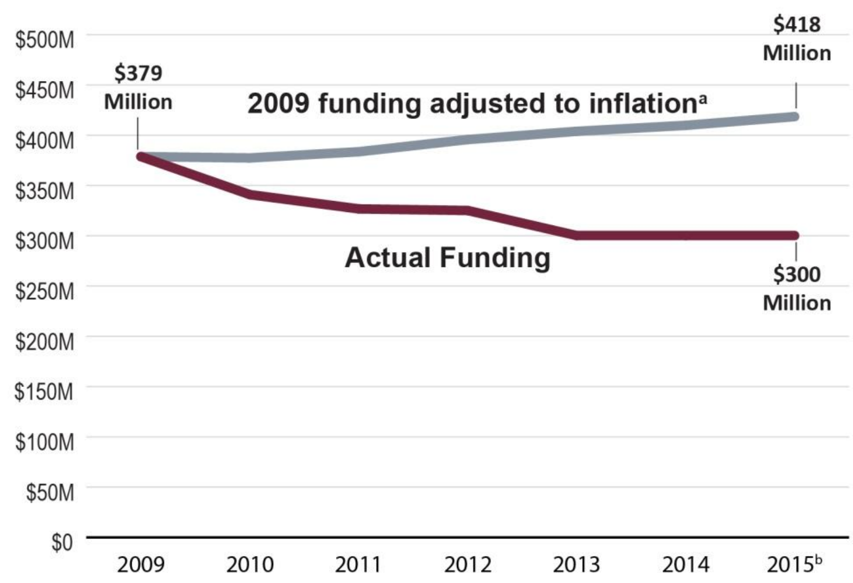
Investments in Education Fail to Keep Pace

Many other services, which were deeply cut due to the Great Recession, are being further eroded by even modest levels of inflation. For example, the Early Childhood Block Grant, which funds preschool for three- and four-year-olds, as well as developmental services for younger children, has been stuck at $300 million for the past three years, down from about $380 million in FY 2009. Funding is now about $120 million (39%) below the level that would now be needed to have maintained the 2009 level of services (Exhibit 1).

EXHIBIT 1

Preschool Funding Continues to Erode

Even after deep cuts were halted in 2014, preschool and birth-to-three funding through the Early Childhood Block Grant continues to be eroded due to inflation. In inflation-adjusted dollars, 2015 funding will be 39% below the 2009 level.



[a] Calculated using Consumer Price Index data from the Bureau of Labor Statistics
[b] Appropriation approved by General Assembly
Note: All years are state fiscal years (July 1 - June 30)
Source: Illinois State Board of Education

[4] See "A CRS Review of 10 States: Home and Community-Based Services — States Seek to Change the Face of Long-Term Care: Illinois (Congressional Research Service, June 2003).

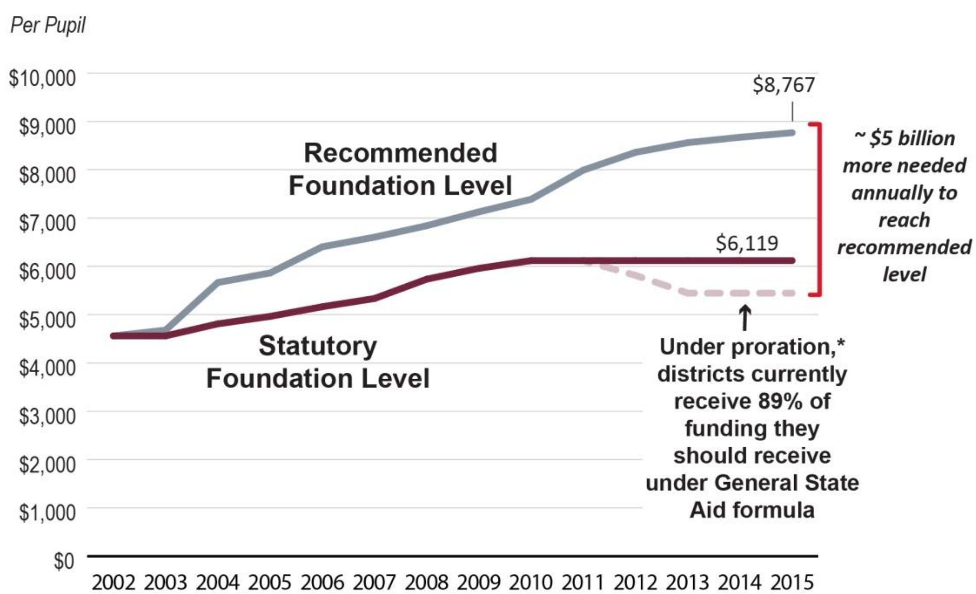
The state's primary funding stream for elementary and secondary education, General State Aid (GSA) received a slight increase in the new budget, but that merely allows school districts to tread water. Funding is still $85 million below six years ago. Simply to have kept up with inflation, GSA would now need to be $550 million higher.

Even an increase of $550 million to GSA would be far from enough. Every year since 2003, the General Assembly has failed to provide the level of per-pupil funding recommended by the Education Funding Advisory Board (EFAB). Instead, the "foundation level" for GSA — the minimum amount of funding per pupil from state and local resources combined — set by lawmakers continues to fall further behind the EFAB recommendation. The new budget sets the foundation level at $6,119 for the sixth consecutive year, far below EFAB's recommendation of $8,767 (Exhibit 2).

EXHIBIT 2

Grossly Inadequate State K-12 Funding

The $80 million increase to General State Aid merely treads water — preventing deeper per pupil cuts in 2015. An additional $550 million is required to meet the statutory "foundation level," and about $5 billion more would be required to meet recommended levels.



*Dashed line for illustrative purposes. Proration operates by first calculating the amount that districts should receive in General State Aid (given the funding formulas and statutory foundation level) and then multiplying by the current proration percentage of 89 percent.

Note: All years are state fiscal years (July 1 - June 30)

Moreover, the General Assembly has once again failed to fully fund even the inadequate foundation level that it has set. In the FY 2015 budget, GSA will again be prorated, with each school district receiving 89 percent of its allocation under current funding formulas. Proration is most harmful to school districts that rely most on state funding — those with meager amounts of property wealth and large concentrations of low-income students. To come close to meeting the recommended funding levels, Illinois would need to add about $5 billion *each year* to General State Aid.[5] Such grossly inadequate funding for something as basic as K-12 education harms children and undermines our economy by weakening our future workforce and making Illinois a less attractive place to live and do business.

Where Illinois Is Today

The 2011 income tax increase has made the state's financial situation substantially better than it would otherwise be. The additional revenue allowed Illinois to fulfill its mandated pension obligations, which were covered by borrowing in FY 2010 and FY 2011. The additional revenue also helped fill an enormous hole in the state budget caused by the Great Recession. Before the increase, the state faced a projected deficit of $15 billion for fiscal year 2012. With the increased revenue from the increase in rates, the backlog of unpaid bills instead stood at about $8.7 billion at the end of FY 2012. Since then, the backlog has been reduced by more than $3 billion.[6] Unless the General Assembly prevents the coming revenue collapse, progress in reducing the backlog will come to a halt — and almost certainly be reversed. Longer delays in payments from the state will affect health care providers, school districts, public universities, community colleges, and businesses, as well as community non-profit agencies that provide services for children, families, people with disabilities, and seniors.

In recognition that increasing rates was a critical step for the state, the credit rating agencies stabilized Illinois' credit rating — which plays a big role in determining how much interest the state has to pay when it borrows — immediately following the increase. Standard & Poor's removed Illinois from its watch list for a potential rating downgrade. Fitch Ratings changed its outlook for Illinois from "negative" to "stable." And Moody's affirmed the state's existing rating, saying that the new revenue was a "major step toward beginning to address Illinois' chronic budget imbalances."[7]

In April of this year, Standard & Poor's said the pending reduction in income tax rates meant Illinois was approaching a critical juncture regarding its credit rating. The state's creditworthiness "will largely hinge on the willingness of policy makers to decisively address chronic budget issues." Fitch Ratings stressed the need for "timely action on a more permanent budget solution to the structural mismatch between spending and revenues in advance of the expiration of temporary tax increases." According to Moody's, maintaining higher revenues from current income tax rates would help Illinois stabilize its credit standing,

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[5] "Illinois Education Funding Recommendations" (Education Funding Advisory Board, January 2013).

[6] The backlog has two major components — (1) the cumulative General Funds deficit, which reflects the gap between appropriations and available revenue, including the carryover deficit from previous fiscal years, and (2) deferred liabilities resulting from insufficient appropriations, primarily for Medicaid, other medical assistance programs, and state employee group insurance.

[7] The state's credit rating was subsequently downgraded several times due to legislative inaction on unfunded pension liabilities. While the major bond rating agencies viewed the pension legislation enacted in 2013 as a positive sign, they also warned that the state's credit rating could be downgraded again if it failed to make progress improving its finances.

while losing this revenue "would exacerbate the state's credit challenges."[8] Most recently, Moody's and Fitch warned of the consequences of the FY 2015 budget passed by the General Assembly. The state's credit rating — already the worst among the 50 states — could be downgraded to a record-low level.[9]

The Only Responsible Choice: Maintain Stable Revenue

With over $4 billion in unpaid bills, worst-in-the-nation credit ratings, and eroding investments in essential services that create a stronger economy, Illinois cannot afford to go backwards by allowing the current income tax rates to expire. If that occurs, the enacted FY 2015 budget will sharply increase the backlog of unpaid bills and ensure deeper cuts in FY 2016, when revenue would be nearly $5 billion below FY 2014 levels.

The looming revenue collapse would also harm Illinois' economy by drastically increasing uncertainty about the state's financial future. Contrary to claims made by critics of the income tax rates enacted in 2011, tax cuts will not "pay for themselves" by spurring economic growth. In fact, the connection between state tax rates and economic growth is extraordinarily weak with study after study showing little, if any, connection between the two.[10] In contrast, a growing body of economic evidence connects policy uncertainty with poor economic growth.[11] Lawmakers' failure to maintain current income tax rates has created a new round of heightened policy uncertainty about Illinois' willingness to make the choices necessary to put the state on a better financial path.

Illinois needs to pay down its bills while strengthening its investments in public schools, early childhood programs, higher education, children's health, public safety, and services for vulnerable populations. Lawmakers should reject the irresponsible, shortsighted practices of the past and do what needs to be done: maintain stable revenue by making current income tax rates permanent.

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[8] "Developing Story: Illinois Is Facing Crucial Decisions as It Determines its Credit Path" (Standard & Poor's Rating Services, April 9, 2014); "Fitch Rates $750MM Illinois GO Bonds 'A-'; Outlook Remains Negative (Business Wire, April 17, 2014); "Illinois Tax-Rate Extension, Pension Reforms Would Reduce Fiscal Stress (Moody's Investor Service, April 17, 2014).

[9] "Budget Plan Could Impair Illinois' Credit Standing" (Reuters, May 30, 2014).

[10] Michael Mazerov, "Academic Research Lacks Consensus on the Impact of State Tax Cuts on Economic Growth" (Center on Budget and Policy Priorities, June 17, 2013).

[11] Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty" (Economic Policy Uncertainty, June 4, 2012).

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The Fiscal Policy Center at Voices for Illinois Children provides timely, credible, and accessible information and analysis on fiscal issues that affect children, families, and communities in Illinois. The FPC is a member of the State Fiscal Analysis Initiative (SFAI), a network of nonprofit organizations in more than 40 states. SFAI is coordinated by the Center on Budget and Policy Priorities, a Washington, D.C.-based research organization and strategic policy institute that works on a range of federal and state issues.

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