

*Report of the
State Budget Crisis Task Force*

ILLINOIS REPORT





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Paul A. Volcker and Richard Ravitch introduced the July 2012 Full Report of the State Budget Crisis Task Force with the following statement:



A Statement From the Task Force Co-Chairs

July 17, 2012

CHAIRS:

Richard Ravitch
Paul A. Volcker

MEMBERS:

Nicholas F. Brady
Joseph A. Califano, Jr.
Phillip L. Clay
David Crane
Peter Goldmark
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George P. Shultz

Our purpose in assembling the State Budget Crisis Task Force has been to understand the extent of the fiscal problems faced by the states of this nation in the aftermath of the global financial crisis. While the extent of the challenge varies significantly state by state, there can be no doubt that the magnitude of the problem is great and extends beyond the impact of the financial crisis and the lingering recession. The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened.

The United States Constitution leaves to states the responsibility for most domestic governmental functions: states and their localities largely finance and build public infrastructure, educate our children, maintain public safety, and implement the social safety net. State and local governments spend \$2.5 trillion annually and employ over 19 million workers—15 percent of the national total and 6 times as many workers as the federal government. State governments are coping with unprecedented challenges in attempting to provide established levels of service with uncertain and constrained resources.

Within the limits of time and resources, we have examined the financial condition of six heavily populated states—California, Illinois, New Jersey, New York, Texas and Virginia. While each state varies in detail, a common thread runs through the analysis, supported by information available for states generally.

What we found will not be surprising to many knowledgeable observers, but the facts have never been assembled in a way that reflects the totality of the problems.

Certain large expenditures are growing at rates that exceed reasonable expectations for revenues:

- Medicaid programs are growing rapidly because of increasing enrollments, escalating health care costs and difficulty in implementing cost reduction proposals. At recent rates of growth, state Medicaid costs will outstrip revenue growth by a wide margin, and the gap will continue to expand.
- Pension funds for state and local government workers are underfunded by approximately a trillion dollars according to their actuaries and by as much as \$3 trillion or more if more conservative investment assumptions are used.

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- Unfunded liabilities for health care benefits for state and local government retirees amount to more than \$1 trillion.

The capacity to raise revenues is increasingly impaired:

- Untaxed transactions are eroding the sales tax base. Gasoline taxes are eroding as well, making it more difficult for states to finance roads, highways, and bridges.
- Income taxes have become increasingly volatile, particularly during and after the recent economic crisis.

The federal budget crisis will have serious spillover effects on state and local governments, and state actions will have spillover effects on local governments:

- Cuts in federal grant dollars, lower spending on federal installations, procurement, and infrastructure, and potential changes to the federal tax code all threaten states' fiscal stability.
- Pressures on local governments, caused by the weak economy and cuts in state aid, are constraining education spending, law enforcement, aid to the needy, and the institutions that make up the culture of our cities. Local government cuts pose a significant risk to the overall economic and social fabric of states.

State budget practices make achieving fiscal stability and sustainability difficult:

- While almost all states have constitutional or statutory balanced budget requirements, "revenue" and "expenditure" are not defined terms. The use of borrowed funds, off-budget agencies, and the proceeds of asset sales are not uncommon practices, often rendering balanced budgets illusory.
- The lack of financial transparency makes it more difficult for the public to understand the critical nature of problems such as pensions and other payment obligations. Temporary "one-shot" measures to avoid or delay hard fiscal decisions mask these underlying problems.
- Opaque and untimely reporting, coupled with nonexistent multiyear planning, severely hampers efforts to address these problems in a serious manner.

The Task Force is not in a position to propose changes in programmatic priorities, tax rates or structures to deal with budgetary problems. Such decisions are properly subject to the values and politics of a democratic society. Our essential goal is to inform the public of the gravity of the issues and the consequences of continuing to postpone actions to achieve structural balance. We do, however, believe that certain basic procedural approaches should be introduced and followed by all states and urge that prompt attention be given to financial relationships among all levels of government.

- The public needs transparent, accountable government. Individual states, existing associations of states, and advisory and standard-setting bodies should develop and adopt best practices to improve the quality and utility of financial reporting.

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- Multiyear planning and budgeting approaches should be a normal part of fiscal planning.
- States need better tools for managing over the business cycle. A priority for states should be better use of their existing counter-cyclical tools, including "rainy day" funds and repayment of debts in prosperous periods.
- Pension plans need to account clearly for the obligations they assume and disclose the potential shortfalls and risks they face. Legislators, administrators, and beneficiaries alike need to develop and adopt rules for the responsible management of pension plans and mechanisms to ensure that required contributions are paid. States should recognize and account for post-employment benefits, such as healthcare, that they intend to continue.
- Prompt attention is needed to the effects that federal deficit reduction and major changes in the federal tax system will have on states and localities.
- States that do not have suitable mechanisms to monitor and assist local governments experiencing fiscal distress should develop them.
- Looking ahead more broadly, the recurrent problems of state finances and the growing state fiscal imbalance suggest that more fundamental approaches require attention. Tax reform at the state level may be needed to achieve revenue systems that are adequate and predictable and that minimize volatility.
- The apparent growing gap between states' spending obligations and their available financial resources points toward a need to reexamine the relationship between the federal government and the states.

The threats and risks vary considerably from state to state, but the storm warnings are very serious. Only an informed public can demand that the political systems, federal, state and local, recognize these problems and take effective action. The costs, whether in service reductions or higher revenues, will be large. Deferring action can only make the ultimate costs even greater.

The conclusion of the Task Force is unambiguous. The existing trajectory of state spending, taxation, and administrative practices cannot be sustained. The basic problem is not cyclical. It is structural. The time to act is now.

Respectfully submitted,

Richard Ravitch

Paul Volcker

Chairmen

 ***Foreword***

Former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Board Chair Paul Volcker created the State Budget Crisis Task Force because of their growing concern about the long-term fiscal sustainability of the states and the persistent structural imbalance in state budgets, which was accelerated by the financial collapse of 2008.

After extensive planning and fundraising in 2010 and early 2011, Messrs. Ravitch and Volcker recruited a board of individuals with extensive and varied careers in public service and public policy. The Task Force was officially launched in April 2011.

In addition to the co-chairs, the board of the State Budget Crisis Task Force includes these members:

Nicholas F. Brady	Joseph A. Califano, Jr.
Phillip L. Clay	David Crane
Peter Goldmark	Richard P. Nathan
Alice M. Rivlin	Marc V. Shaw
George P. Shultz	

The executive director of the Task Force is Donald Boyd, on leave from his responsibilities as senior fellow at the Rockefeller Institute of Government. Ravitch and Boyd worked together to assemble a core team of experts with budget and financial planning experience at the national, state, and local levels and practical experience derived from the management of previous fiscal crises. The names of the full project team can be found on the Acknowledgements page at the end of this report.

The Task Force decided to focus on the major threats to states' fiscal sustainability. Since it was not feasible to study each of the fifty states in depth, we decided to target six states — California, Illinois, New Jersey, New York, Texas, and Virginia — for in-depth, onsite analysis. In each state, the core team worked closely with experts who were deeply familiar with the substance, structure, procedures, documents, and politics of the state's budget. The names of budget experts consulted in each state can be found on the Acknowledgements page at the end of this report. The core team and state experts conducted detailed inquiries into major issue areas including Medicaid, pensions, tax revenues, debt, the fiscal problems of local governments, and state budgeting and planning procedures. In doing so, the core team and state experts reviewed budget documents and data from the respective states and interviewed key budget officials.

The Task Force released its main report in July 2012, focusing on issues that cut across the six states. The Task Force also is preparing reports on individual states, including this report on Illinois.



Summary

Illinois' budget is not fiscally sustainable. Despite recent progress and difficult choices, it is still in a deep hole. It cannot simultaneously continue current services, keep taxes at current levels, provide all promised benefits, and make needed investments in education and infrastructure. All of the major threats identified by the Task Force in its July 2012 report have contributed to Illinois' current problems and will contribute to future budget-balancing struggles.

Illinois has the worst unfunded pension liability of any state, an estimated \$85 billion. It has underfunded its pension systems since the early 1980s. Contributions now must escalate rapidly if Illinois is to honor promised benefits; by fiscal year 2015, pension costs (and related debt service) could take up one-fourth of the state's resources. Illinois will not be able to fund other priorities unless it adopts serious pension reform.

Medicaid enrollment and expenditures in Illinois doubled between 2000 and 2011, growing far more rapidly than tax revenue. In June 2012 the state made major changes that reduce spending, but rising health care costs and the aging population will continue to drive costs upward. Without further reform, unsustainable Medicaid growth will crowd out other essential areas of the budget.

Illinois' debt is also crowding out the budget. In 2003 Illinois sold a record-breaking \$10 billion in pension obligation bonds, and again in fiscal years 2010 and 2011, the state sold bonds to cover its required contributions. The result of pension borrowing is that Illinois' debt per capita is one of the highest of any state. Over 60 percent of Illinois' total outstanding debt is due to pension bonds.

Illinois has compounded its challenges with poor fiscal management and opaque budgeting. At the onset of the 2008 financial crisis, Illinois was essentially insolvent. In the years leading up to the crisis, Illinois borrowed and shifted money across years and funds to "balance" the budget, without providing sustainable resources to pay for ongoing commitments. Budget gimmicks became a standard practice. The state has perennially pushed its bills off to the future; at the start of fiscal year 2013, unpaid obligations from prior years were approximately \$8 billion. Illinois did all this without any sort of long-term financial plan to restore balance, and without reserves. Illinois has been doing backflips on a high wire, without a net.

Narrow, eroding tax bases have contributed to Illinois' fiscal difficulties. State tax revenues were stagnant for at least a decade before the recent recession. Illinois enacted a major, temporary, income tax increase in 2011, but the additional revenues are being offset by reductions in federal American Recovery and Reinvestment Act of 2009 (ARRA) monies. Income tax revenues will not keep up with growth in the aging population because Illinois exempts retirement income. Other tax bases — on corporate income, cigarettes, and motor fuel — have been eroding and failing to keep up with economic growth. Illinois' sales tax rates are high, but its base is narrow and the state taxes relatively few services. Illinois tax revenues are not likely to grow enough to meet future needs.

Federal deficit reduction threatens Illinois, as other states. Federal dollars account for approximately a quarter of the state's all-funds budget and, after the expiration of federal stimulus spending, currently are \$14.8 billion. Federal aid matches about 50 percent of Illinois' Medicaid spending, and constitutes about 35 percent of the budget of the Department of

Human Services, 30 percent of transportation, 20 percent of K-12 education, and 20 percent of spending for environment and natural resources. Federal spending cuts will put these programs at risk.

Illinois' aging and deteriorating infrastructure is in urgent need of immediate repairs to meet basic standards of public safety. Beyond that, it needs expansion and modernization to accommodate future growth. Over the next several decades, Illinois' infrastructure needs will likely exceed \$300 billion, yet the state does not have a comprehensive plan to address this critical need. There are real costs associated with underfunding of infrastructure: shipping and travel delays, congestion, pollution, and diminished economic growth.

The state's fiscal problems affect local governments in Illinois by shrinking revenue transfers at a time when these monies are most needed. The state has also proposed shifting funding responsibility for teachers' pensions from the state to local school districts. This would eliminate some incentives that can drive pension costs upward, but would put considerable pressure on local finances. Local governments struggle with their own revenue problems, unfunded pension liabilities, and bond rating downgrades. The state does minimal monitoring of local government finances, and budget cuts could further reduce this oversight.

Illinois' past fiscal choices and future threats challenge the state's ability to meet its population's basic needs, let alone accommodate future growth. Infrastructure is deteriorating. Education is threatened. Public safety, public health, and care for the needy all are at risk. Taxpayers and the state's competitiveness are also at risk.

Illinois needs to make tough choices — now. Both spending cuts and revenue increases probably will be needed. Pension reform is necessary to salvage the benefits of future retirees. Illinois should work with the federal government to control Medicaid costs. "Optional" treatments such as medications and preventive care can be cost-effective alternatives to hospitalization, but under the current federal rules these are the first services to be cut. And the state needs to think seriously about revenue: Tax reform may be needed to achieve an adequate, sustainable, and predictable revenue system.

Illinois should revamp its fiscal toolkit. It should adopt multi-year planning; develop and fund a meaningful rainy day fund; create a more-transparent budget that examines all funds, not just the General Fund; adopt a nonpolitical revenue forecasting process; monitor the fiscal condition of local governments; and consider other reforms detailed in this report.

Finally, the state needs to change how it does business. The culture of budget gimmickry and short-sightedness pushes costs off to the future, but eventually that will be impossible — retirees may lose their pensions as the funds dwindle; low-income and disabled people may lose their healthcare as costs escalate; and citizens and businesses seeking a stable environment may face steep and sudden tax increases. It would be better for Illinois to start on a long-run path to a sustainable budget than to live beyond its means for several more years and then face a sudden, painful reckoning.

Introduction

Illinois faces a number of daunting budgetary challenges, and is among the worst states in the nation with regard to its fiscal condition. Its bond rating is the lowest of all fifty states according to Moody's Investors Service, its unfunded pension liabilities are the worst in the country, and the state has approximately \$8 billion in unpaid bills, according to the Illinois comptroller.¹ Significant positive steps have been taken toward fiscal stability in recent years, but much work remains to be done.

How did it get so bad? Illinois is, after all, a wealthy state with a diverse economy and the third-largest metropolitan area in the country. Illinois has corporate headquarters, an international transportation hub, a sizeable manufacturing base, and a number of tourist attractions. How did this happen?

In 2008, the perfect storm hit Illinois. Like other states, when the financial markets collapsed, Illinois saw its revenues plummet and demands for government services skyrocket. But unlike other states, Illinois was effectively insolvent. Illinois had no reserves and had used fiscal gimmicks and borrowing to balance the budget for the previous six or seven years. Illinois had shortchanged its pension systems for decades and, in 1994, had set a schedule of increased payments each year. At the same time the revenue recession hit, the schedule mandated sharply higher payments to the retirement systems.

Illinois was also in political meltdown. The state legislature was locked in a stalemate as a long federal investigation of Governor Blagojevich ended with his impeachment and removal from office in January 2009. (Later, Blagojevich became the second consecutive Illinois governor to be sent to prison on corruption charges.) Even with a new governor and with Illinois' Democratic legislators holding a majority in both houses, the stalemate did not end.

The new governor, former Lieutenant Governor Pat Quinn, was a political outsider with a reputation as a reformer. One of his first actions was to propose a tax increase. The proposal was unsuccessful — a revenue bill was passed by the Senate but was never called for a vote in the House. Although it was becoming clear to many that a combination of tax increases, spending cuts, and transitional borrowing would be necessary to bring the state's massive deficits under control, there was no political consensus about how to proceed.

The major threats to U.S. states' fiscal sustainability all apply to Illinois. These include the big problems of unfunded pension liabilities and Medicaid costs, both of which are growing faster than the state's revenues. The lack of transparency and the use borrowing and gimmicks — such as putting off bills until next year — contributed to the confusion about pensions and Medicaid, and allowed leaders to portray the budget as "balanced" without raising taxes or cutting services.

Illinois faces serious threats from future federal budget cuts and diminishing economic growth. Its revenues were stagnant for a decade before the onset of the Great Recession and have eroded over time. It is likely that state revenues will not be able to offset predicted cuts in federal funds.

Illinois has already made large cuts to human services and education. Unless balanced and carefully considered changes are made to a number of spending programs and revenue sources, further cuts in these "discretionary" areas of spending will become the default budget policy. Moreover, failure to engage in long-term budget planning and failure to make tough budget choices will lead to even greater payment delays and the attendant distress for service providers.

In telling the story of Illinois' fiscal troubles, several themes will emerge. One is the lack of transparency: The way the budget is presented and decided is muddled and confusing. Second, chronic short-sightedness and avoidance of tough choices have pushed problems into future years and made things worse. A third theme is progress – while Illinois still struggles, problems are being recognized and tough decisions are being made. That is a big step in the right direction. The final theme is that, unfortunately, Illinois started out in such a deep hole that it still has a very long way to go.

The Fiscal State of the State of Illinois

Understanding the severity of Illinois' fiscal problems — and possible solutions — requires a careful baseline analysis of trends in revenues and spending. The following section presents a brief synopsis of Illinois' consolidated budget situation for the past few years (fiscal years 2011, 2012, and 2013) based on the University of Illinois Institute of Government and Public Affairs (IGPA) Fiscal Futures Project research briefs and reports.²

Fiscal Year 2011

At the beginning of fiscal year (FY) 2011 (July 1, 2010), the State of Illinois had so many unpaid bills that the average delay in payment was over seven months.³ In the middle of FY 2011, the Fiscal Futures Project team at IGPA issued a report characterizing Illinois' fiscal situation as “Titanic and Sinking.”⁴ Using a “Consolidated Funds” budget (which is much broader and consistently defined than the more commonly reported General Funds budget), IGPA's Fiscal Futures Model estimated that the FY 2011 budget had an \$11 billion cash deficit.⁵ This was in addition to the \$6 billion in unpaid bills carried over from prior years.

The IGPA Fiscal Futures model projected that, absent policy changes, the consolidated funds cash deficit could reach \$27 billion (in real 2011 dollars) in ten years. The study dramatized the magnitude of the budget gap with a number of “what would it take” calculations. For example:⁶

- If the projected deficits were paid for by borrowing, debt service costs would grow to consume *all* sales tax and income tax collections in just five years.
- To close the gap with an income tax increase would require the individual tax rate to rise to 7.1 percent from the then-existing 3.0 percent and a proportional rise in the corporate rate.
- To close the gap with a sales tax increase would require the rate to jump from 6.25 percent to 13.5 percent.
- To close the gap with spending cuts alone would require over 25 percent across the board reductions in all spending (other than for pensions, debt service, and transportation).

In January 2011, a political majority was found to enact income tax increases, as well as caps on spending growth, and additional authority to borrow. The income tax increases were large, but mostly temporary:⁷

- Personal income tax rates went from 3.0 percent in 2010, to 5.0 percent in 2011-2014, to 3.75 percent in 2014-2023, and 3.25 percent thereafter.
- Corporate income tax rates went from 4.8 percent in 2010, to 7.0 percent in 2011-2014, to 5.25 percent in 2014-2023, and back down to 4.8 percent thereafter.

As a result of the tax increases, personal and corporate income tax collections were \$7.6 billion, or 72.6 percent higher than they would have been without the rate increase.⁸

Also in January 2011, a spending cap was enacted that limits General Fund spending growth to 2 percent annually between FY 2012 and FY 2015.⁹ The final element of the January 2011 budget package was authority to borrow \$3.7 billion to pay the scheduled FY 2011 pension payment and pay off that debt over eight years.

Fiscal Year 2012

In the middle of FY 2012, IGPA recalculated their estimates of the current and future gaps in the consolidated funds budget factoring in the temporary increases in the income tax, the General Fund growth caps for FY 2012-2015, and other changes implemented for FY 2012.¹⁰ Figure 1

shows projections for three scenarios. The baseline estimate for all three scenarios is a consolidated budget gap of \$2.9 billion in FY 2012, which is down from \$5.6 billion in FY 2011.

Scenario (a) shows existing law, with income tax rates lowered after calendar year 2014 and the General Fund spending growth cap expiring after FY 2015. Figure 1 shows a sharp jump in the budget gap – to \$9.4 billion in FY 2016 – when these temporary measures expire. Because the IGPA model projects spending growth rates in excess of revenue growth rates, the gap continues to grow and reaches a projected \$13.0 billion in FY 2022.

Scenario (b) in Figure 1 shows the projected budget gap assuming that income tax rates remain at the higher levels and do not go down as scheduled after 2014. In this case, the projected gaps are much smaller. But the shortfall still grows over time and reaches \$6.6 billion in 2022.

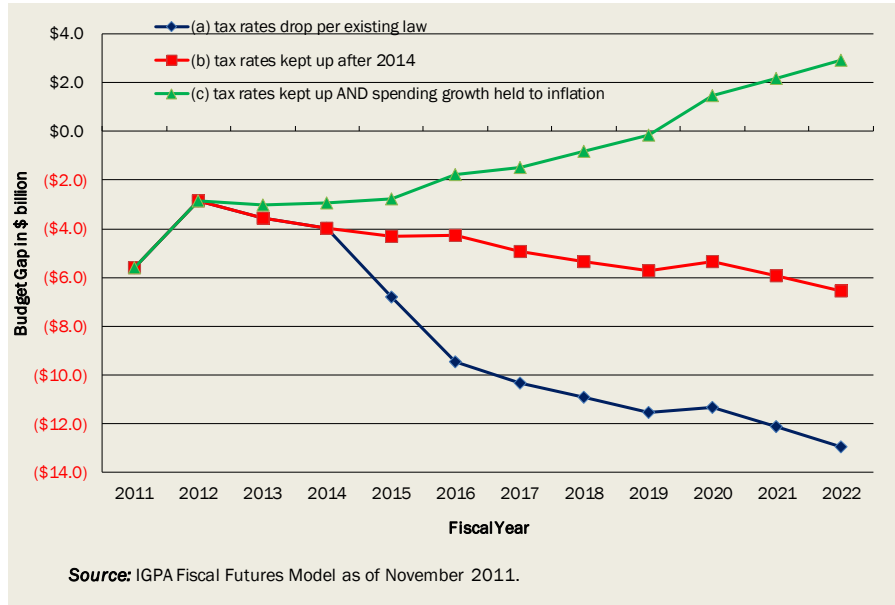
Scenario (c) assumes that the income tax rates remain at the 2011 higher rates **and also** that growth in all spending except for pensions and debt can be held to the inflation rate starting in FY 2013. Especially with rising health care costs, this would represent substantial cuts in many areas and would be very difficult to achieve. In this case of very tough decisions and actions on both taxes and spending, a balanced budget is projected by 2019.

Fiscal Year 2013: Encouraging Budget Actions, But Much to be Done

Illinois' FY 2013 budget process has been a marked improvement over previous years, in that lawmakers made a number of difficult decisions regarding education, human services, and Medicaid in a year when every State House and Senate seat is up for reelection. The governor and lawmakers were involved in crafting a spending plan that was based on realistic projections of sustainable revenues. This was a big step in the direction of fiscal stability. But unfortunately, more cuts will be needed in the years ahead. And Illinois has likely pushed off its biggest challenge – pension reform – until next year.

In total, the FY 2013 General Funds budget is \$33.7 billion, an increase from the \$33.2 billion budget of FY 2012. However, the 2013 budget made a \$700 million reduction in discretionary spending. The 2013 General Funds budget

Figure 1 | Projected Gap in Illinois Consolidated Budget under Existing Law, with Higher Taxes, and with Inflation-only Growth in Spending



includes a projected surplus of \$1.3 billion, which is to be directed toward paying down the \$8 billion backlog of unpaid bills from FY 2012.

There is, of course, nothing “encouraging” about cuts in education, medical care, and human services from the point of view of recipients or advocates. One of the most controversial budget appropriations was \$6.5 billion for K-12 education, which was a cut of 3 percent from FY 2012. Governor Quinn’s 2013 Operating Budget had allocated approximately the same amount for K-12 Education in FY 2013 as FY 2012, but legislators cut this amount.¹¹

Illinois made meaningful strides toward Medicaid reform with a number of changes to the program enacted in June 2012. These changes (detailed in a later section) include \$1.6 billion in Medicaid programs cuts and savings and gain the state roughly \$1 billion in new cigarette taxes, provider assessments, and federal matching funds.¹²

FY 2013 budget legislation will close or consolidate a total of fifty-seven state facilities including six for corrections, two youth centers, four centers for the mentally ill and the developmentally disabled, and a number of smaller facilities like parking garages. This is projected to save \$82 million in FY 2013 and \$136 million in FY 2014. An example of the difficulties associated with making changes is the huge pushback from constituencies of the correctional and human service facilities to be closed. Governor Quinn ordered the closure of the Tamms Correctional Center, a high security prison in southern Illinois. Lawmakers concerned with local jobs opposed its closing, and a review commission voted to keep it open.¹³ In July 2012, the union representing the correctional officers sued to stop the closure, and the outcome is currently in mediation.¹⁴

Gambling expansion legislation, which would allow a new casino in Chicago plus four additional riverboat casinos and slot machines at horse tracks, passed the legislature but was vetoed by Governor Quinn. Supporters claim the gambling bill could generate \$1 billion per year and create 100,000 jobs. Governor Quinn cited ethical issues and the regulatory autonomy that would be given the Chicago casino.¹⁵

Of Illinois’ three biggest fiscal problems — pension costs that are crowding out the rest of the budget, Medicaid cost increases that have grown faster than the state’s resources and will be unsustainable as the federal ARRA funds expire, and a murky budget process that neglects long-term planning — only Medicaid saw significant reform in the last year.

Despite greater recognition that the growth in pension costs cannot be sustained, different views of how to cut or shift the costs have led to a stalemate. No action on pension reform is expected until after the November 2012 elections at the earliest. Legislation was recently enacted which significantly alters state support of retiree healthcare.¹⁶

A baby step toward long-term budget planning was taken with a new requirement for a three-year budget forecast, but this forecast is of limited value because it only projects the General Funds budget. Illinois leaders continue to focus on the General Funds budget, which ignores over half of the state budget picture.¹⁷ Illinois still maintains a short-term focus for its total (all funds) operating budget and has no long-term capital plan.

Before examining each of the big three problems in turn — pensions, Medicaid, and budget process — we examine Illinois’ economic and political environment.

Economic Forces Affecting Illinois' Budget

Illinois is a wealthy state with an economy whose industrial diversity is quite similar to the nation as whole. However, Illinois' economic fate is closely tied to the Midwest region because much of Illinois' economic activity is linked with manufacturing sectors in its neighboring Midwest states.¹⁸ Illinois' high wage jobs are clustered primarily in the Chicago metropolitan area, in businesses and industries that are subject to vigorous interstate competition. Illinois' Democratic political tilt sometimes leads to political/ideological battles with more Republican-leaning neighboring states. These political and economic forces may limit Illinois' ability to raise business taxes.

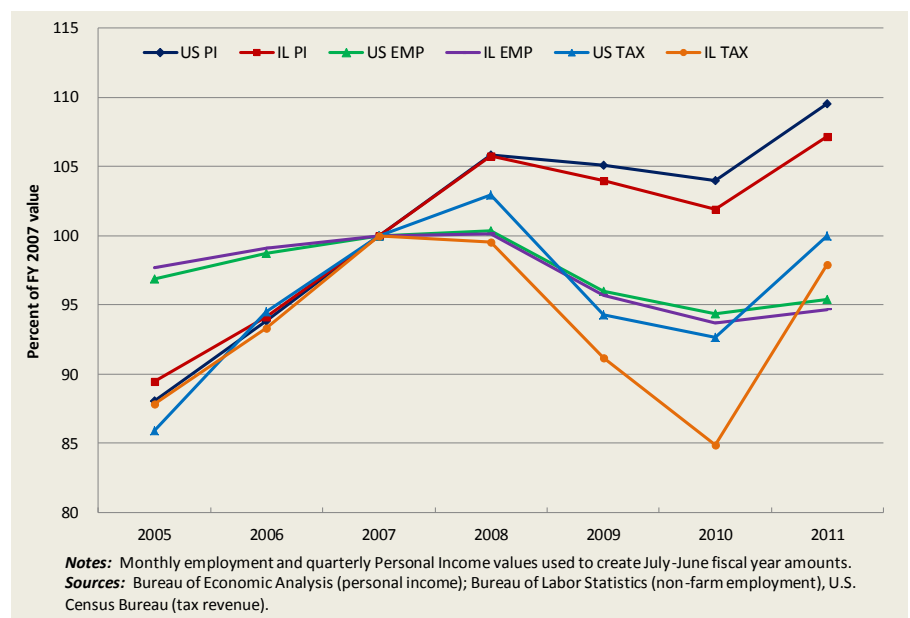
Illinois has a relatively educated populace and some higher education institutions that are nationally and internationally renowned. However, there is generally believed to be a shortage of skilled labor in many sectors of Illinois due in part to troubled school districts, the Chicago Public School system in particular. This makes it harder to attract and retain some manufacturing firms.¹⁹

Illinois' demographics show an aging population with a trend toward fewer workers and more retirees, which will pose daunting fiscal challenges in the years ahead. Illinois is also a diverse state with a variety of competing interests, which makes it difficult for political leaders to reach consensus on key issues.

Although Illinois' income remains relatively high, its position has deteriorated over time. In 2011 personal income per capita in Illinois was \$44,140, which was 106 percent of the national average.²⁰ The gap was larger in earlier decades – 121 percent in 1951 and 108 percent in 1981 – and has been declining over time. Being a relatively rich state “has made it easier to provide decent schools and good public universities than has been the case for poorer states, even if poorer states tax their citizens more heavily than does Illinois.”²¹

As the narrowing income gap implies, Illinois' economic growth has been slowing relative to the United States since World War II. In addition to lagging in personal income growth, Illinois lags in gross domestic product (GDP, formerly called gross state product) growth and employment growth. Between 1991 and 2011 job growth in the U.S. averaged 1.0 percent per year, but only 0.4 percent per year in Illinois.²²

Figure 2 | Illinois v. U.S.: Personal Income (PI), Nonfarm Employment (EMP), & Tax Revenue (TAX) (relative to 2007 value)



Illinois was hit particularly hard by the recession that followed the burst of the housing bubble in 2007 and the 2008 financial collapse. Figure 2 shows the trajectories of three key indicators – personal income, employment, and state tax revenue – for Illinois compared to the nation as a whole. By FY 2010, Illinois’ total personal income fell 2 percent more and employment fell 1 percent more than in the U.S. as a whole. The impact of the recession on Illinois’ tax collections was much, much larger. In FY 2010, total state taxes in the U.S. were 93 percent of the amount in FY 2007, but Illinois’ tax revenues had fallen to 85 percent of the FY 2007 amount.

Illinois has lagged in economic growth in recent decades and fallen farther in recent recessions, and these trends are expected to continue. Economists at the University of Illinois find that as Illinois has begun to rebound from the 2007-09 recession, it has done so more slowly than after the previous three recessions using a weighted average of growth rates in corporate earnings, consumer spending, and personal income.²³

Looking to the future, the University of Illinois’ Regional Economics Applications Laboratory (REAL) projects a slow recovery until at least 2019. Moody’s Analytics (MA) offers a more optimistic scenario; however, both describe a relatively gloomy picture for Illinois for the foreseeable future. These projections are shown in Table 1.

Table 1 | Economic Forecasts For Illinois, 2013-2019
Moody’s Analytics (MA) vs. University of Illinois Regional Economics Applications Laboratory (REAL)

Calendar Year	Employment (% change)		Unemployment Rate (%)		Personal Income (% change, nom.)	
	MA	REAL	MA	REAL	MA	REAL
2013	1.8%	0.3%	7.1%	8.1%	7.3%	2.5%
2014	2.1%	0.3%	5.4%	7.7%	5.8%	2.9%
2015	1.4%	0.6%	4.9%	7.4%	5.2%	3.3%
2016	0.0%	0.7%	5.1%	7.1%	4.1%	3.9%
2017	-0.2%	0.7%	5.2%	6.8%	3.9%	3.6%
2018	-0.1%	0.8%	5.3%	6.4%	3.7%	4.0%
2019	0.0%	0.7%	5.3%	6.0%	3.7%	3.9%

Sources: REAL projections from Illinois Regional Economic Model, July 2011. MA forecasts from Moody’s Analytics, State of Illinois Forecast Report, Prepared for State of Illinois Commission on Government Forecasting & Accountability, February 2011.

Ultimately, even using the most optimistic projections, an economic recovery in Illinois will take considerable time. The only factor keeping Illinois’ revenues from falling far below the national average are the large income tax increases implemented in the middle of FY 2011 – and those are set to expire in two years.

Politics and the Budget Process in Illinois

Understanding how Illinois' fiscal condition has become such a mess requires some understanding of Illinois' politics. Illinois' fiscal condition has deteriorated for two principal reasons. First, going back decades, Illinois has “balanced” its annual cash budget by not putting aside sufficient funds to cover the increase in future pension benefits associated with the current year's payroll. As a result, unfunded pension liabilities have continued to grow.

Second, during the good economic times of the late 1990s to mid-2000s, Illinois expanded government services, but did not raise taxes and did not put away cash reserves. The state paid for its new spending by making even smaller payments to the pension systems, borrowing heavily, sweeping special funds, and putting off paying Medicaid and employee healthcare bills until the following budget year. This chronic shortsightedness and avoidance of tough choices has accumulated to a significant structural deficit for Illinois. When the revenue recession hit in 2009, Illinois had no cushion. Time-shifting budgeting tricks used persistently in the good years were of much less value for temporary use in a downturn.

The Politics of Spend, but Don't Tax

These things happened for political reasons. While in Illinois, as elsewhere, the desire to please constituents by expanding government services without increasing taxes is a given, the origins of the structural gap between spending growth and sustainable revenues can be traced to the 1990s. Governor Rod Blagojevich (Illinois' first Democratic governor since 1976) was elected in 2002 with an agenda to expand programs for children, seniors, and the poor. However, conflict between Blagojevich and Speaker of the House Michael Madigan (both Democrats) meant that tax increases became virtually impossible as the two “checkmated one another.... The governor declared he would veto any general tax increase.... Madigan blocked all the revenue initiatives proposed by the governor.”²⁴

During Blagojevich's two terms as governor, new programs were created and expanded, including health insurance coverage and preschool for Illinois children and free public transportation and prescription drugs for Illinois seniors. But with an existing structural deficit, and without new sources of revenue, the state did not have sufficient resources to meet all of its obligations. For these reasons Illinois' fiscal condition was poor going into the Great Recession, which had a devastating effect on the state's revenues and increased demand for services. And while the recession took a toll on the state's resources, Illinois' government became essentially dysfunctional, with the federal investigation of Governor Blagojevich and his removal from office.

When Governor Quinn (the former lieutenant governor) took office in January 2009, he inherited a state government that was insolvent. Quinn immediately proposed a tax increase and borrowing to pay down a backlog of bills, but many believed that spending programs should be cut before taxes were increased. Still, Blagojevich's programs were popular with many people, and no one really wanted to see the draconian cuts in education or human services that would be necessary to balance the budget. An income tax increase was unavoidable, but did not happen until the last half of fiscal 2011. By that time the state budget was in a very deep hole.²⁵

Although some blame former Governor Blagojevich for Illinois' current fiscal mess,²⁶ there are broader reasons for the state's fiscal and political dysfunction. Although Illinois is considered a “blue state” because of the heavily Democratic City

of Chicago, the City accounted for only 21 percent of Illinois' population in 2010. Nearly half of Illinois' population is in the Chicago suburbs, and nearly a third is "downstate," and people in these areas are more likely to vote Republican.²⁷

In 2007 a national poll found that 50.1 percent of Illinois voters considered themselves Democrats, suggesting a "purple state."²⁸ This means that Illinois' population tends to be liberal or moderate on social issues, desiring generous social services for seniors, children, and the poor. On the other hand, people in Illinois are fiscally conservative and — after two consecutive governors have been sent to prison on corruption charges — very reluctant to "throw good money after bad." Illinois' climate of political corruption — a "constant companion of Illinois and Chicago governments throughout their history" — has taken a toll.²⁹

In Illinois, as elsewhere, lawmakers have strong political incentives to provide benefits to their constituents, and equally strong incentives to avoid raising taxes. But Illinois is a very diverse mix of competing interests. Often, interest groups are strong enough to cancel out the influence of the opposition, or concessions must be made to appease multiple stakeholders. This is why changes are very difficult to make. Unions are strong, but so are downtown business groups. Advocates for the social safety net are strong, and so are those who want to limit the size of government. Chicago benefits from public transit subsidies; downstate benefits from keeping prisons and mental institutions open.³⁰ When Illinois' fiscal condition was fairly good, its competing interests were able to be relatively balanced in the budget process. But during the Great Recession and the state's fiscal and gubernatorial meltdown, Illinois' budget process became completely dysfunctional.

The Budget Process

Illinois' fiscal year runs from July 1 through June 30. The state budget is initially formulated by the Governor's Office of Management and Budget (GOMB). Revenue estimates for the current fiscal year and preliminary estimates for the upcoming fiscal year are developed by the GOMB and a legislative agency, the Commission on Government Forecasting and Accountability (COGFA).³¹ The governor establishes basic budgetary objectives and directives to state agencies early in the budgetary cycle. State agencies respond to the GOMB, developing a proposed budget in an iterative process. Illinois' budgets are typically crafted by the GOMB, legislative leaders, and a few lawmakers who specialize in the state budget. "Rank-and-file legislators are basically left out of the process, except when they vote on a final budget, which is presented to them without much time for analysis."³²

The governor must present his or her budget to the General Assembly by the third Wednesday in February. For the budget to pass the General Assembly before the end of May requires a simple majority vote. After that, a three-fifths supermajority vote is required.

Illinois' Squishy Balanced Budget Requirement

It would appear that Illinois' budget is required to be balanced. The *Illinois Constitution* states that "Proposed expenditures **shall not exceed funds estimated to be available** for the fiscal year shown in the budget" (emphasis added).³³ However, Illinois' balanced budget requirement has some serious limitations.

First, it refers to *anticipated* revenues, and there is no requirement that the state adjust its spending if the anticipated revenues are not realized. There is nothing to stop a governor or General Assembly from using an unrealistically high estimate when crafting the budget. This is well known and has been acknowledged by political leaders.^{34, 35} In addition,

“funds available” can include existing fund balances, even if these are intended to meet future obligations; and borrowing, even to pay operating expenses.

Illinois’ balanced budget requirement is also a cash concept, referring only to the current fiscal year. This means that the balanced budget requirement does not refer to future pension liabilities or unpaid bills from the previous year. Each fiscal year from 2009 to 2012 ended with a larger stack of unpaid bills — \$8 billion at the end of fiscal year 2012 — and each year these bills were ignored when projecting balance for the next year’s budget.

The Run-Up to the Current Fiscal Crisis

By 2007 it was obvious to most policy makers that a major tax increase would be needed to offset Illinois’ continual budgetary deficits, and several serious plans were offered. But Governor Blagojevich had pledged not to raise income or sales taxes, and instead proposed a gross receipts tax on business transactions.³⁶ There was no tax increase at that time.

Under Governor Quinn, in the depths of the Great Recession, revenue estimates for FY 2010 and 2011 were so far below the amounts needed for agencies’ budgets that the legislature, in a political maneuver, appropriated “lump sum” amounts for many agency budgets. The lump sum amounts appropriated were “well in excess of expected revenues” so that the Governor — not the legislators — was forced to specify the cuts.³⁷

Big Strides, But a Long Way to Go

For a number of years prior to FY 2012, legislative leaders developed the budget. In FY 2012, the “normal” budget process was again in place and “for the first time in decades, rank-and-file appropriations committees actually went through Governor Pat Quinn’s proposed budget, line item by line item, to keep agency spending within the predetermined amounts.”³⁸ The income tax increase in February 2011 was a difficult choice. Spending growth in FY 2012 was constrained — albeit more by revenue scarcity and realism than by the legislated cap on increases in the General Funds budget.

In 2012, in another first for Illinois, the governor’s office released three-year budget projections of the General Funds for 2013-2015. The fact that the state is now planning its budget more than a single year ahead is very good news. However, Illinois’ fiscal crisis has been decades in the making and it will take many more years to get the situation under control. Even without contentious politics, the situation will be very difficult to resolve. Illinois faces some very tough choices in the years to come. The toughest of these choices centers on Illinois’ most daunting challenge — pension reform — a very contentious issue that must be resolved to keep escalating pension costs from crowding out other areas of the budget.

Underfunded Retirement Promises Are Crowding Out Other Needs

It is widely recognized that Illinois has the worst unfunded pension liability of any state. Its five retirement systems had a total of \$85 billion in unfunded liability in 2011 (Table 2), and the figure has increased since then. Dealing with some of the lowest funded ratios of public pensions in the nation has contributed to the state's ongoing fiscal crisis. Illinois' pension problems were cited by Moody's Investors Service when it downgraded the state's bond ratings in January 2012, making Illinois' credit rating the lowest of all fifty states. However, Illinois has done nothing to reform state employee pensions since that time and it is doubtful that anything will happen before 2013.

Table 2 describes the five retirement systems the State of Illinois is responsible for funding: Teachers Retirement System (TRS), State University Employees Retirement System (SURS), State Employees Retirement System (SERS), General Assembly Retirement System (GARS), and Judicial Retirement System (JRS). It also shows the Illinois Municipal Retirement Fund (IMRF), which the state administers but the local government entities are responsible for funding. Most of the state's \$85 billion in unfunded liabilities are in the three largest funds, TRS, SURS, and SERS. All five state funds have funding ratios below 41 percent. The IMRF has a much higher funding ratio because of a state law that obliges local governments to make "annual required contributions" (ARC).

Table 2 | Descriptive Statistics For Six Major Public Employee Pension Funds in Illinois

FY 2011	TRS	SURS	SERS	GARS	JRS	IMRF
Active Members	133,920	71,888	66,363	180	968	175,844
Current Annuitants	90,967	42,682	47,002	291	720	99,684
Assets (market value) (\$ billions)	\$37.50	\$14.30	\$11.00	\$0.06	\$0.60	\$24.80
Unfunded Liabilities (\$ billions)	\$43.80	\$17.20	\$20.40	\$0.20	\$1.30	\$6.10
Funded Ratio (w/o smoothing)	46.1%	45.3%	34.9%	20.2%	31.0%	80.2%
State Contribution (\$ billions)	\$2.20	\$0.80	\$1.10	\$0.01	\$0.06	NA
Sources: TRS, SURS, SERS, GARS, JRS: Commission on Government Forecasting and Accountability. A Report on the Financial Condition of the Illinois State Retirement Systems as of June 30, 2011. (March 2012). IMRF: 2011 Illinois Municipal Retirement Fund Comprehensive Annual Financial Report, December 31, 2011.						

The primary cause of the state pension systems' underfunding is that the state does not impose the same obligation on itself that it imposes on local governments, and for decades its employer contributions have been below annually required amounts. Illinois has planned so poorly that it had to borrow to make its scheduled pension contributions for FY 2010 and 2011, which were below the ARC amount.

State leaders vowed to make the entire FY 2012 pension payment without issuing bonds, but as of the development of this report it is unclear whether Illinois has made its complete pension contributions to all the systems for the fiscal year that just ended or whether part of the FY 2012 pension contributions are among the \$7.5 to 8.0 billion in unpaid bills that are being carried into FY 2013.³⁹

The Way Pension Costs Are Reported Can Obscure the Problem

Illinois' pension systems are likely in a more dire fiscal condition than they seem. Illinois' three largest pension systems discount future pension liabilities using an assumed rate of return on investments of around 8 percent.⁴⁰ Since the financial crisis, ongoing economic instability in Europe, and worries of a double-dip recession, many believe that this assumed rate of return is overly optimistic. Most state pension systems have exceeded an 8 percent rate of return over the past several decades, but the rates have been much lower in recent years.

Lower discount rates will soon be required in Illinois and other states. Under new rules approved by the Governmental Accounting Standards Board (GASB) in June 2012, Illinois will be required to report liabilities using "market rates," which are typically closer to 5 percent.⁴¹ Although this change will no doubt have a positive impact by more accurately estimating the level of state liabilities, it reveals an even more precarious financial position. For example, "[u]nder the new rules, the Illinois Teachers' Pension System [TRS], one of the country's worst funded, would have shown just an 18 percent funding ratio as of July 2010."⁴²

Finally, some state obligations were not reported at all until recently. Since liabilities for retiree healthcare ("other post-employment benefits" or OPEB) were only reported after GASB Statement 45 was implemented in FY 2008,⁴³ long-term trend data are not available. However, even using only recent reports, it is clear that Illinois' OPEB liability is large and increasing more than a billion per year. Illinois' Unfunded Actuarial Accrued Liability (UAAL) for other post-employment benefits was \$33.3 billion as of June 2011.⁴⁴

Background and History

Table 2 shows FY 2010 membership, assets, and unfunded liabilities for the five state pension plans and the state-administered, local-liability IMRF plan. All of Illinois' pension systems are defined benefit plans, but they differ as to particulars, e.g., minimum retirement age, required years of service, employee contribution rate, and the formula for calculating benefits.⁴⁵

Illinois' pension systems date to the 1940s, and since 1970 the state constitution has protected employees' benefits. Nearly 80 percent of workers covered by Illinois' state pension plans are not eligible for Social Security.⁴⁶ In the 1990s national surveys found that Illinois' pension benefits were not generous compared to other states.⁴⁷ Offsetting the relatively low benefits, Illinois has historically provided greater financial support for healthcare benefits to retirees than most other states, and has been one of the few states that provides and funds disability benefits.^{48, 49}

Underfunding of the Illinois pensions systems dates to the early 1980s. Until that time, the policy was that the state made sufficient contributions to cover annuitants' benefits, while the employees' contributions and investment income were used to build future reserves. There was no actuarial basis for this system, but it did sustain the pensions. Fiscal stress in 1981 led Illinois to abandon this policy. State contributions plummeted in 1982 and 1983 and increased very modestly for the next decade, although annuitants' benefits payments grew dramatically. Between 1981 and 1995, the state's pension contributions increased 28 percent, but benefits expenditures increased by a factor of almost 4.5, and unfunded liabilities escalated. In 1995, the funded ratio for the five systems combined was only 53 percent.⁵⁰

Recognizing the Problem but Putting Off the Painful Solution for Years

In 1994, Illinois established a plan to bring the pension systems to 90 percent funding by 2045. This “fifty year plan” has guided the funding of the pensions up to the present. However, the scheduled contributions are less than the ARC — also known as “normal cost plus interest” — meaning that even if the state makes payments as scheduled in the 1995 plan, unfunded liabilities continue to grow.

This is another reason why it is hard to see the true picture of Illinois’ pension problem. Much of the budgetary discussion of pensions in the state is the “scheduled” payments and few understand the more important concept of the ARC.

The financial condition of the pension systems improved during the late 1990s, as the booming economy helped increase the five systems’ combined funded ratio to about 70 percent. But during this time, benefits were expanded as well.⁵¹

In 2000 the pension systems were relatively sound, but the economic recession of 2000-2003 was disastrous for the systems’ asset values. The funded ratio for the five systems combined plummeted to 49 percent in 2003. In response, pension benefits were reduced, the state issued \$10 billion in bonds (of which \$7.3 billion went to the pension systems), and legislation was enacted allowing a “partial pension holiday” for FYs 2006 and 2007. Although the intent of borrowing was to reduce unfunded liabilities, the statute was written such that the required contributions going forward included the amount of debt service on these bonds, which reduced the amount actually contributed to the pensions and worsened the chronic underfunding. The 2006 and 2007 contributions made during the pension holidays were only about half the amount required based on actuarial calculations. So the financial condition of the pensions continued to deteriorate.

In fiscal years 2008 to 2010, Illinois was required to make larger contributions to its pension systems to make up for the pension holidays of 2006 and 2007. Unfortunately, these ramped-up payments coincided with the Great Recession when the state’s fiscal condition was already poor. During the relatively good economic times of the late 1990s and mid-2000s, Illinois had not raised taxes. Rather, the state had relied heavily on borrowing and temporary measures (like the pension holiday), so it was not well-prepared to weather the recession. Illinois made its required contribution to the pension systems through FY 2009 but issued pension obligation bonds to cover the payments for FYs 2010 and 2011.

Changing Pensions in Illinois: Small Strides

Although Illinois has made significant strides in some areas of its finances, pension reform has been difficult to achieve. In 2010, Illinois established a two-tier pension system with reduced benefits for employees hired after January 1, 2011.⁵² This will generate substantial long-term savings, but did nothing to reduce the preexisting unfunded liability. Legislation that would create a third tier in the form of a defined contribution 401(k)-style plan — and requiring larger employee contributions if workers opted to keep their traditional pension plans — did not pass the 2011 legislative session.

Despite the shortcomings of this particular third-tier proposal, some type of equitable pension reform is urgently needed. Between FY 2012 and FY 2013, Illinois’ required contributions to the five pension systems increased nearly \$1 billion, and that amount does not completely cover the liabilities incurred during the year. In addition, Illinois is required to pay debt service for the pension bonds it issued to cover payments to the systems in FYs 2003, 2010, and 2011. “In FY 2008, total pension costs, including regular state contributions and pension-related debt service, took up only 8 percent of General Funds revenue from state sources, but by FY 2012 these costs had grown to almost 20 percent of state revenue. By FY 2015, pension costs are projected to take up one-fourth of the state’s resources.”⁵³

Small strides have also been made with respect to OPEB. Last spring, Governor Quinn proposed that if employees were to keep their free retirement healthcare, their annual cost-of-living adjustments (COLAs) would be reduced from 3 percent compounded annually to the lesser of 3 percent or one-half of the consumer price index, not compounded. Alternatively, those who wanted to retain their 3 percent annually compounded COLA would be required to pay a fee (or higher employee contributions) for their post-employment health insurance.⁵⁴ This proposal did not pass, but the General Assembly did enact limits on state subsidies for retiree healthcare. Under the new law, employees will contribute to their healthcare premiums based on their ability to pay.⁵⁵

Serious Problems Remain

Pension reform is one of the most pressing issues facing Illinois. Without reform, huge costs loom for future taxpayers or would-be beneficiaries of state programs that will be crowded-out. But the magnitude of the problem also means any solution will include big benefit reductions or cost shifts, so political interests differ sharply on how to act. The lack of legislative action on pensions has not been for lack of ideas. In fact, several proposals have been put forth.

Governor Quinn proposed ambitious pension reforms in April 2012. Under this proposal, Illinois' pension systems would be 100 percent funded by 2042. The proposed reforms included reductions in the COLA, increases in the retirement age, and increases in employee contribution rates.⁵⁶ In addition, the normal cost of pensions of teachers⁵⁷ and state university employees would become the responsibility of the universities and school districts, rather than the state. Proponents of the shift argue that currently school districts can raise teacher salaries but bear no responsibility for the resulting pension cost increases. Opponents raise the specter of large property tax increases they argued would be needed to support teachers' pensions.

IGPA released a plan to reform SURS in early 2012; its principles also could be applied to the state's other pension systems.⁵⁸ The IGPA proposal would create a hybrid defined benefit/defined contribution system for new employees. Hybrid systems help balance the pros and cons of defined benefit and defined contribution plans, allowing retirees to have a guaranteed income since, in Illinois, most are not eligible for Social Security.

Despite a variety of ideas and proposals to fix Illinois' ailing pension systems, political logjams have halted proposed reforms. The latest legislative session ended in May without any changes being made to the state employee pension systems. Governor Quinn called a special legislative session in August to address the issue, but this session also ended without results. A possible post-election session may be more fruitful. The November 2012 ballot includes a proposal that would amend the Illinois Constitution to require a three-fifths majority to increase benefits under any state or local retirement system.

Because the state's resources are limited, some type of reduction in pension benefits appears inevitable, despite the difficulties in making any type of change. Illinois' future pension payments are scheduled to grow at rates exceeding the anticipated growth rates of the state's revenue sources. Assuming that total spending is kept within the limits of the state's revenues, if Illinois makes the required contributions to its pension systems, serious cuts in other areas of the budget will be necessary.⁵⁹ Pension obligations will continue to crowd out other spending.

Second to pensions, Illinois' most challenging fiscal problem is the growth in the Medicaid program, in which enrollment and expenditures doubled between 2000 and 2011. Medicaid's growth is unsustainable and, without reform, will crowd out other essential areas of Illinois' budget.

Medicaid Spending Growth Is Crowding Out Other Needs

For years Illinois' Medicaid program has contributed to the state's growing budget crisis. Medicaid expenditures and enrollment have approximately doubled between 2000 and 2011, as the growth in healthcare costs has far exceeded the rate of inflation⁶⁰ and the program was expanded to provide more coverage.⁶¹ In June 2012, Illinois made major changes to its Medicaid program that are projected to reduce spending by billions of dollars, but many issues remain.

Illinois Medicaid: High Coverage and Costs, Low Expenditures per Enrollee

Illinois' Medicaid program has grown to be relatively generous compared to other states in its coverage and optional services. For example, its FamilyCare program, initiated in 2002, provided health insurance to parents of children under age 18 in families with incomes of up to 185 percent⁶² of the federal poverty level (FPL),⁶³ which was lowered to 133 percent in 2012. Optional services covered under Medicaid in Illinois included "supportive living facilities (a step below nursing home care), inpatient hospital psychiatric services, home care, medical equipment and mental health rehabilitation services."⁶⁴ While Illinois was not unique in the level of optional services it provided, during the Great Recession Illinois was less likely than other states to reduce those services.

In contrast, Illinois' Medicaid spending per enrollee is not generous. According to National Center for Health Statistics (NCHS) data, average Medicaid spending per enrollee in Illinois was \$5,773 in 2009 which was the second lowest among Midwest states and below the U.S. average (\$6,826).⁶⁵ Provider reimbursement rates for physicians, nursing homes, and dentists have also been low relative to other states and the nation.⁶⁶ Recent reforms will further reduce these rates.

Illinois' Medicaid spending represents a considerable and growing amount of the state budget. Medicaid plus CHIP expenditures comprised about 23 percent of the state's

total expenditures from all funds in FY 2010.⁶⁷ Medicaid spending growth over time is illustrated in Table 3. Total FY 2010 Medicaid spending, as measured by the Kaiser Family Foundation, was approximately \$15.3 billion, of which \$5.9 billion came from the state's resources and \$9.4 billion came from the federal government.⁶⁸

Illinois' Medicaid spending by enrollment group for FY 2009 is shown in Table 4. The vast majority of Medicaid payments are for aged and disabled patients; children are usually relatively inexpensive to cover.

Table 3 | Average Medicaid Spending Growth, 1990-2009

Federal Fiscal Years	Illinois Average Annual Growth	Federal Average Annual Growth
1990-2001	11.1%	10.9%
2001-2004	8.7%	9.4%
2004-2007	7.6%	3.6%
2007-2010	6.6%	6.8%
Source: Kaiser Family Foundation.		

Table 4 | Distribution of Medicaid Enrollees and Payments By Enrollment Group
Illinois vs. United States, FY 2009

Enrollees	Illinois		United States	
	Percent of Enrollees	Percent of Payments	Percent of Enrollees	Percent of Payments
Aged	8%	17%	10%	23%
Disabled	12%	40%	15%	43%
Adults	26%	17%	26%	14%
Children	54%	26%	49%	21%
Total	100%	100%	100%	100%

Source: Kaiser Family Foundation.

Budget Presentation Makes Medicaid Hard to See

Although the Medicaid program is a huge and rapidly growing part of Illinois' budget, the cost of Medicaid is not explicitly quantified anywhere in the Illinois state budget documents such as the Comprehensive Annual Financial Report (CAFR) or Detailed Annual Report (DAR). Typically, presentations of the Illinois budget use "medical assistance payments" made by the Department of Healthcare and Family Services (DHFS) as a proxy for Medicaid expenditures.⁶⁹ However, DHFS medical assistance payments include state-funded medical programs that are technically not part of Medicaid and some Medicaid expenditures are made by agencies other than DHFS.

Because medical assistance payments from DHFS are not the same as "Medicaid," Illinois budget documents do not exactly align with the Medicaid expenditure numbers disseminated by national data sources.⁷⁰ Medicaid expenditures are an aggregation of medical treatment costs for qualifying patients in a variety of programs. For this reason, it is difficult to quantify the total costs of the program.⁷¹

Another problem with quantifying Medicaid expenditures is that because appropriations have often been insufficient to cover projected liabilities, Illinois pays many of its Medicaid bills the year after they are incurred.⁷² The practice is permitted by the Section 25 of the State Finance Act (30 ILCS 105), although recent changes will phase this out. Lawmakers have used Section 25 to balance the budget — cuts and tax increases could be avoided if next year's revenues could be used to pay this year's expenses. From FY 2000 through 2010, deferred Medicaid payments under Section 25 totaled about \$18 billion. Section 25 amounts are not reported until years after the fact, making it very difficult to see what is happening.

Medicaid in Illinois is a very complex program and there are no easy fixes. Provision of optional services such as preventive care and medications is cost effective to a certain degree because it reduces the need for emergency room visits and hospitalization, but hospital care is mandated by federal program requirements, while optional services can be cut. Further complicating the issue, the bulk of Illinois' Medicaid spending is for acute care. In 2010, 73 percent of Illinois' Medicaid dollars went to acute care, compared to the national average of 64 percent.⁷³ Nearly half of Illinois' spending on acute care (48 percent) went to inpatient hospital expenses, while the U.S. average was 21 percent.⁷⁴

Big Strides: 2012 Medicaid Changes

Recognizing the dire straits of the Illinois Medicaid program, Governor Quinn proposed and the legislature largely enacted in June 2012 a “saving Medicaid plan” for FY 2013 totaling \$2.7 billion in cost reductions, significant new revenues, and other changes.⁷⁵

The majority of the 2012 changes to Illinois’ Medicaid program were cuts and efficiencies — elimination of some programs for which there is no federal match, more means testing, lower income ceilings for eligibility, greater enforcement of eligibility rules, elimination of optional services, and service utilization controls (such as limits on the number of prescriptions per month).⁷⁶ Illinois Cares Rx, a prescription assistance program for seniors, was eliminated completely. Hospitals and nursing homes will see their Medicaid reimbursement rates cut.⁷⁷

In addition to program changes, Illinois’ cigarette tax rate increased from \$0.98 per pack to \$1.98 (along with taxes on other tobacco products). The increased revenue from the tax increase, along with matching federal funds for Medicaid, is expected to total approximately \$675 million.⁷⁸

The June Medicaid changes will also largely put an end to a process of paying bills out of future revenues, known in Illinois as “Section 25.” As the Civic Federation explains it: “This provision ... has repeatedly been used to budget an insufficient amount of Medicaid appropriations to cover costs for a given fiscal year, knowing that the bills will be paid from the next year’s appropriations.”⁷⁹

Prior to the June 2012 changes, the gap under Section 25 had been expected to grow. The Illinois Department of Healthcare and Family Services (HFS) projected that:

[T]he unfunded budget gap for HFS Medical Assistance Programs will be \$1.4 billion in FY 12 ... [causing] the payment cycle to expand to about 120 days ..., and the ending FY 12 bills on hand will be \$2.1 billion. This continued pattern of deferring payment of bills means that the FY 13 GRF appropriation for Medicaid will need to increase by almost \$2.8 billion just to maintain the payment cycle.⁸⁰

The June 2012 legislation capped unpaid bills under Section 25 at a maximum of \$700 million in FY 2013, and \$100 million in FY 2014 and thereafter.⁸¹

The Affordable Care Act and Future Medicaid Spending in Illinois

Both the Institute of Government and Public Affairs (IGPA) of the University of Illinois and the Kaiser Family Foundation offer analyses of future Medicaid spending and the effects of the Patient Protection and Affordable Care Act (PPACA) on Medicaid. Both studies were completed before the extensive changes enacted in June 2012.

The Kaiser Family Foundation study points out that the vast majority of additional spending for additional Medicaid enrollments is projected to be at the federal level, at least in the near term. For example, as shown in Table 5, although enrollment increases of nearly 40 percent are projected under certain scenarios, state spending would not increase nearly as much between 2014 and 2019.⁸² This is because the federal government would pick up a very large share of the cost of increased enrollment.

Table 5 | Kaiser Family Foundation Medicaid Projections for Illinois (2010)

Participation Level	Enrollment Change by 2019	State Spending 2014-2019 (\$ millions)	Spending Change from Baseline
Standard Participation Scenario	25.8%	\$1,202	1.6%
Enhanced Outreach Scenario	37.2%	\$2,468	3.3%
Source: Kaiser Family Foundation.			

The IGPA study predicted smaller enrollment increases under PPACA, primarily federally funded. Given the extensive coverage provided by Illinois' Medicaid and State Children's Health Insurance (SCHIP) programs in 2011, the authors concluded, "the PPACA will have less impact on enrollment in Illinois than in most other states."⁸³ Authors Kaestner and Kazee estimated, "[S]omewhere between 640,000 and 962,500 additional persons in Illinois will be covered by Medicaid as a result of the PPACA" and, as a result, "Medicaid expenditures are expected to increase by 5 percent to 9 percent by 2020."⁸⁴

They go on to warn that these estimates may be too low "because the more generous federal matching rate will not apply to Medicaid recipients who were eligible but not enrolled before reform" and the requirement of the PPACA that all persons have health insurance will encourage additional enrollment.⁸⁵ The lack of federal funding for this group could dramatically increase Illinois' Medicaid expenditures: "If we assume that 25 percent of the increase in Medicaid enrollment in response to the PPACA consists of those previously eligible, then the State's Medicaid expenditures may grow by between 10 percent and 20 percent by 2020."⁸⁶

Kaestner and Kazee argue that, despite the vast majority of new Medicaid expenditures being covered by the federal government, an already struggling State of Illinois may find its increased Medicaid share to be a burden. "[A] 5 percent to 9 percent increase as a result of the PPACA implies an increase of between \$400 million and \$720 million."⁸⁷ And if their warning regarding previously eligible persons holds true, the figure could be twice as high. However large the increase, it will continue the long trend of Medicaid expenditures taking a growing share of the state's budget and crowding out other spending.

In summary, although Illinois has recently enacted some significant reforms to the Medicaid program, for many years, lawmakers and voters were led to believe that the rapid growth in state healthcare spending could be sustained by the use of budgetary gimmicks, including putting off bills until next year, and one-time "fixes," such as short-term borrowing and raids of special funds. Over the years these gimmicks have become a standard part of the Illinois budget, allowing state leaders to portray it as "balanced."

Illinois Budget Laws and Practices Hinder Fiscal Stability and Mask Imbalances

There are a number of things that budget makers in Illinois do — or don't do — that disguise the true budget situation and facilitate short-sighted actions. These can be grouped in three broad categories:

- Time-shifting budget practices;
- Fund-shifting budget practices; and
- Lack of information on, or planning for, long-term fiscal stability.

Time shifting practices include accelerating revenues, delaying payments, and borrowing from the future to pay for today. Fund-shifting (and other accounting tricks) can create the impression of “cuts” or “increases” without any substantive change from year to year. Other budget gimmicks include counting on revenues or savings that are unlikely to materialize and using temporary, one-time resources for recurring expenditures.⁸⁸

Time-Shift Budgeting: Pension Obligation Borrowing and Nonrecurring Resources

We have already seen that Illinois' squishy balanced budget requirement allows a number of time shifting practices: optimistic revenue projections; counting borrowing for operations as revenue; ignoring the accrual of long-term pension liabilities; and ignoring short-term liabilities in the form of unpaid bills.

The largest example of time-shift budgeting is Illinois' June 2003 record-breaking sale of \$10 billion in pension obligation bonds. Proceeds were to be used to pay Illinois' obligations to the state pension systems.⁸⁹ The bond sale was portrayed as a new and creative way to support the state pension systems, because the state would borrow the money at low interest rates and invest it in state employee pension funds and earn higher (estimated at 8 percent) returns. However, the plan failed because the rate of return on the pension investments has been much less than 8 percent⁹⁰ and the interest rate the state paid was higher, about 5 percent.⁹¹ In addition to the \$10 billion in bond sales, the statute included a provision requiring that the state's contributions to the retirement systems would be reduced by the amount of the debt service on the bonds. This is one reason why the unfunded liabilities of the pension system have grown significantly since 2003.⁹²

Notwithstanding the problems with the 2003 pension obligation bond sale, Illinois has gone back to this well twice. The state borrowed to meet its scheduled payments to the pension funds in FY 2010 and again in FY 2011.

There are several smaller examples of reliance on one-time revenue sources in Illinois. In FY 2011, the state securitized its tobacco settlement receipts for \$1.5 billion. Two periods of tax amnesty have been granted, in FYs 2004 and 2011, with net receipts collected of about \$300 million for both. However, these amounts are relatively small: Illinois' total state budget is over \$60 billion.

Time-Shift Budgeting: Payment Delays

Illinois' mountain of unpaid bills has become epic, as are the stories of small businesses, nonprofits, and social service providers that have been unable to remain solvent as they await reimbursement from the state. As FY 2012 ended in June, Illinois' comptroller wrote that “the state moved into fiscal year 2013 ... with an estimated \$7.5 to \$8 billion in unpaid obligations, slightly lower than the \$8.5 billion total of the last two fiscal years.”⁹³

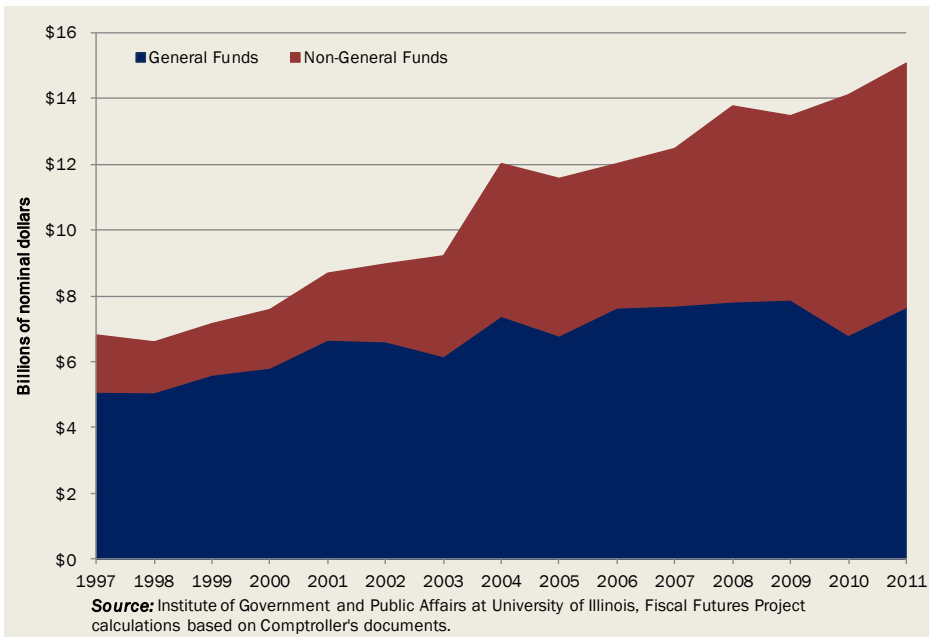
State leaders have not formulated any financial management plan to pay down Illinois' overdue bills. Twice last year Governor Quinn unsuccessfully proposed issuing bonds to cover the backlog.⁹⁴ Illinois' strategy instead has been to enact legislation allowing more time to pay bills: extending the fiscal lapse period from two months to six months, and allowing carry-over of Medicaid and state employee healthcare bills into the next fiscal year — a practice codified in Section 25 of the State Finance Act.⁹⁵

Fund-Shift Budgeting: Narrow Focus on General Funds Budget Obscures True Picture

One of the biggest impediments to budget transparency in Illinois is the emphasis on reporting the General Funds Budget while increasingly using resources from 600-plus non-General Funds (including special funds, state trust funds, and federal trust funds). The General Funds Budget represents less than half of Illinois' total spending and some major expenditure categories — such as transportation — are not part of the General Funds budget at all.

This is a problem because it can be confusing — or a deliberate source of obfuscation — when expenditure items are moved out of, or receipts are moved into, the General Funds from one of the many special funds.⁹⁶ This practice occurs frequently in Illinois and makes it difficult to tell what is real and what is a mere accounting change when comparing the budget from year to year.⁹⁷ For example, the budget may appear “balanced” because an expenditure item that used to come from the General Funds has been shifted to a special fund. In order to consistently track revenues and spending over time, the IGPA Fiscal Futures Project team developed a Consolidated Funds Budget, which could significantly increase transparency as it accounts for all of the state's resources and expenditure activities.⁹⁸

Figure 3 | Estimated Medicaid & CHIP Expenditures, General Fund vs. Non-General Funds, FYs 1997-2011



Non-General Funds represent an increasing share of the total state budget. Illinois has more than 600 funds, a 33 percent increase since 1997. Non-General Funds make up a significant share — in some cases, the majority — of major expenditure categories, and in some instances the share of non-General Funds expenditures has increased dramatically over time (Figure 3).⁹⁹ Budget transparency is diminished when the state increasingly uses special funds while widely reporting only General Funds to the public. In a fifty-state study, the Fiscal Futures Project team found that Illinois has one of the highest rates of year-to-year variation in the share of the budget that comes from General Funds.¹⁰⁰

Fund Sweeps and Related Special Fund Transfers

Special state funds are often funded by dedicated revenue sources or prior appropriations from the General Revenue Funds for a specified purpose. Special funds often carry a balance across fiscal years. When a special fund carries a balance in excess of expected obligations for its specified purpose, transferring balances into the General Funds can be an appropriate — but nonrecurring — use of state resources. When fund balances are transferred that will be needed for expected obligations, this is a form of short-term borrowing for general operations.

There are several different types of special to General Fund transfers in Illinois. “Chargebacks” are transfers from special funds to general operations at the discretion of the chief executive. From FY 2004 until FY 2007 (when the General Assembly took away the power to do so), Governor Blagojevich authorized chargebacks totaling over \$700 million.¹⁰¹ “Fund sweeps,” legislative authorization for specific transfers in a given year, totaled \$1.2 billion from FY 2003 to 2010.¹⁰² Several other types of transfers bring the total for the FY 2003 to FY 2010 period to \$2.2 billion.¹⁰³

There was considerable resistance to the fund sweeps and chargebacks, including lawsuits by interest groups associated with particular funds, but in October 2011 the Illinois Supreme Court acknowledged the state’s power to make such transfers.¹⁰⁴

After a decade of sweeps, any obviously “excess” fund balances had been transferred — making further sweeps a form of short-term borrowing. Recognizing this, in FY 2011 the General Assembly authorized inter-fund borrowing to be paid back within 18 months, but no open-ended sweeps.¹⁰⁵

Threat to Fiscal Stability: Illinois Has No Realistic Long-Term Financial Plan

A major threat to Illinois’ fiscal health is a lack of planning. Multiyear planning in Illinois is only a very recent development, and lacks the depth necessary to steer the state toward fiscal stability.¹⁰⁶ Only since January 2012 has the Governor’s Office of Management and Budget presented a three-year budget forecast, and its projections are only for the General Funds Budget — less than half of Illinois’ total budget. A much more meaningful fiscal picture could be seen in projections of *total* revenues and spending (a Consolidated Funds Budget).¹⁰⁷ Without consolidation, transfers between Illinois’ hundreds of funds can obscure the true budget situation. If major budget items are shifted into and out of the General Funds from one year to the next, three-year or five-year projections of General Funds revenues and spending may not be very meaningful.

Threat to Fiscal Stability: Illinois Has No Real Rainy Day Fund

Illinois has never had a significant rainy day fund. Illinois does have a formal structure in place to provide a budget stabilization tool, but the fund was never large (about one percent of the budget) and has been repeatedly raided, even during relatively good economic times. The rainy day fund did not provide much fiscal cushion during the economic downturn that began in 2008.

Illinois’ Budget Stabilization Fund was established in 2000 “to assist the State in meeting cash flow deficits as needed.”¹⁰⁸ Prior to this, Illinois was the only major industrial state without such a fund.¹⁰⁹ The statutory goal for the fund was 5 percent of the General Fund’s revenues.¹¹⁰ The fund received its only major infusion from a payment of \$226 million from Illinois’ Tobacco Settlement Recovery Fund at the beginning of FY 2002.¹¹¹ The reserves were soon raided in what would become a consistent pattern of short-term borrowing. From 2002 to 2011, after the fund was repaid each year, Illinois has

maintained a year-ending fund balance of approximately 1 percent of General Fund revenues, far short of the 5 percent goal.¹¹²

Budget gimmickry is a serious threat to Illinois' fiscal stability, limiting its ability to deal with challenges as pensions and Medicaid continue to crowd out other areas of the budget. Over the past decade, Illinois has increasingly used borrowing as a means to avoid raising taxes and cutting spending. Like pensions and Medicaid, Illinois' escalating debt service is now crowding out other areas of the budget.

Uses and Misuses of State Borrowing

States issue debt for three fundamental reasons. The first is to finance capital improvements. The second is to manage cash flow problems within a fiscal year due to difference in the timing of spending obligations and receipts. The third is to plug budget gaps and borrow to finance current cash deficits. Financing deficits, particularly using debt as if it were an element of revenue, is bad financial and budgetary practice.

Illinois has traditionally used debt finance to fund its capital programs, but more recently has been borrowing for other purposes. Illinois' debt places it near the top of the rankings for U.S. states (Table 6). In 2008 Illinois ranked second among states in the amount of state outstanding debt per capita. Illinois also ranked sixth in local debt. Illinois' borrowing may accelerate in the future, as sizable capital programs (e.g., *Illinois Jobs Now!*) have been enacted.

Table 6 | Total State and Local Debt Outstanding, Selected States, Fiscal Year 2008

State	Total State and Local Debt			State Share of Total	Local Share of Total
	Per Capita Rank	Amount (Millions)	Per Capita Amount		
NY	1	269,742	13,840	42.4%	57.6%
IL	2	124,163	9,624	47.1%	52.9%
PA	3	118,611	9,529	33.8%	66.2%
CA	4	341,094	9,280	35.7%	64.3%
TX	5	215,877	8,874	15.4%	84.6%
FL	6	142,129	7,755	29.8%	70.2%
MI	7	75,247	7,522	38.6%	61.4%
OH	8	68,658	5,978	39.2%	60.8%
NC	9	51,202	5,552	38.3%	61.7%
GA	10	50,561	5,220	25.9%	74.1%
MEAN			8,317	34.6%	65.4%

Source: U.S. Census Bureau, State and Local Government Finances by Level of Government and State: 2007-2008, the most recent data available.

Illinois' debt use has accelerated over the last decade, as the state has issued more than \$17 billion in general obligation bonds to fund annual payments to the state retirement systems (called "pension obligation bonds"). Considering only "direct debt," or debt that the state is directly obligated to repay, pension obligation debt comprises over 60 percent of state indebtedness.¹¹³

The state's \$85 billion in unfunded pension liabilities was described in a previous section of this report. This form of off-the-books *implicit* debt exceeds the state's \$58 billion in *explicit* debt (Table 6). Indeed, when the state borrows to make a pension obligation payment, it is turning implicit debt into explicit debt. Total debt goes up, not because of the one-for-one

swap of bond promises for pensions promises, but because no *current* resources are put aside to pay for retirement costs. Since the Great Recession, Illinois has balanced its budget with another type of implicit debt, paying this year's bills with next year's revenues. The state has a huge pile of overdue bills, estimated to be \$7.5 to \$8.0 billion at the end of fiscal year 2012. The state must also pay late fees and interest related to these bills.

Illinois' heavy reliance on debt is unsustainable. Illinois now has the lowest bond rating of any U.S. state, according to Moody's Investors Service.

Special Obligation Debt: Hard to See

Illinois requires a three-fifths majority of each house of the legislature to authorize General Obligation (GO) debt, which is backed by the full faith and credit of the State of Illinois. This means that the state pledges to repay these bonds from all available resources before any other commitments.

Special obligation (SO) bonds are long-term debt that is backed by a dedicated revenue stream (e.g., sales taxes or gambling proceeds). SO bonds do not require a super majority to be authorized. In Illinois, there are two types: Build Illinois Bonds (for economic development and capital projects); and Civic Center Bonds.

Nationally, there has been an increase in the use of state-created authorities that are able to issue long-term bonds without the approval of voters or a super-majority of the legislature. In Illinois, there are several: Illinois Development Finance Authority, Metropolitan Pier and Exposition Authority, and the Illinois Sports Facilities Authority. The bonds issued by these agencies are "revenue bonds," repaid (at least in part — depending on the agency) by revenues generated by the various projects. The process for issuing these bonds is much less transparent than for GO bonds.

Downgrades: Illinois Is the Worst State in the Nation

Illinois' high levels of debt have contributed to its deteriorating bond rating. Illinois is rated in the single A category by all three rating agencies, Moody's, Standard and Poor's, and Fitch (Table 7). In January 2012, Moody's downgraded Illinois state debt to A2 from A1, the lowest among the 50 states.¹¹⁴ This means that it is more costly for Illinois to borrow.

Illinois' declining credit rating is nothing new. In 1979 the state's Standard and Poor's bond rating was AAA; today it is A, the lowest in history (Table 7). As it lowered Illinois' rating from A+ to A on August 29, 2012, Standard and Poor's noted, "The downgrade reflects the state's weak pension funding levels and lack of action on reform measures intended to improve funding levels and diminish cost pressures associated with annual contributions."¹¹⁵

When it downgraded Illinois' bond rating, Moody's stressed: (a) negative year-end fund balance reflecting systematic payment deferrals and structural imbalance, (b) very large unfunded pensions, and (c) growth in debt burden associated with deficit financings. Moody's recently warned that it might downgrade Illinois further, explaining, "[I]naction on the state's pension liabilities will further strain this lowest-rated state's finances."¹¹⁶

Table 7 | Illinois' General Obligation Bond Ratings Over Time

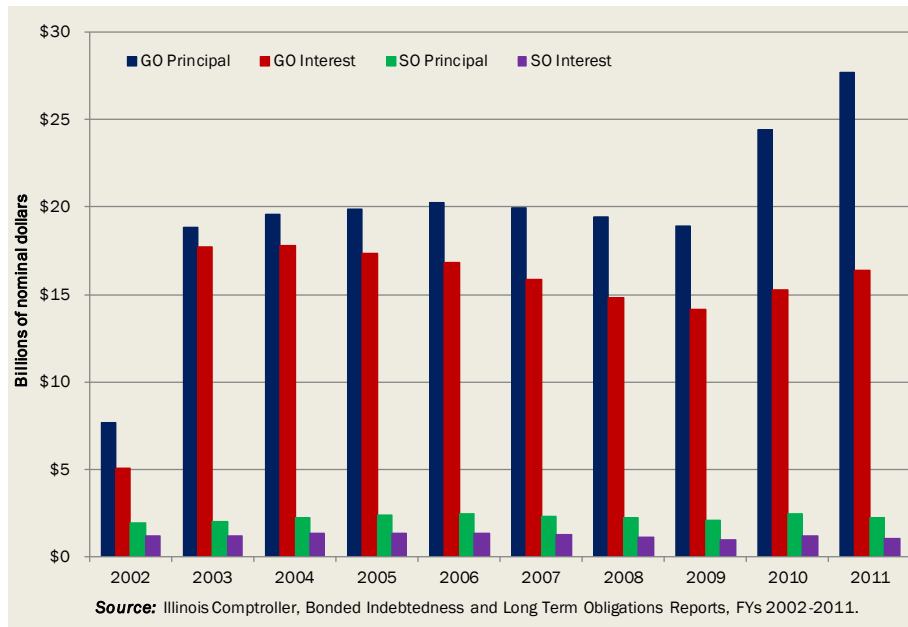
Year	S&P	Moody's	Fitch
1998	AA	Aa2	AA
1999	AA	Aa2	AA
2000	AA	Aa2	AA+
2001	AA	Aa2	AA+
2002	AA	Aa2	AA+
2003	AA	Aa3	AA
2004	AA	Aa3	AA
2005	AA	Aa3	AA
2006	AA	Aa3	AA-
2007	AA	Aa3	AA
2008	AA	Aa3	AA-
2009	A+	A2	A
2010	A+	A1	A
2011	A+	A1	A
2012	A (neg.)	A2 (stable)	A (stable)

Notes: The red highlights indicate downgrades, and the green highlights indicate upgrades.
Sources: Illinois Comptroller, Bond Ratings for 2012;
U.S. Census Bureau, Statistical Abstract of the United States, State & Local Government Finances & Employment for 1998-2011.

Growth of State Debt

Illinois' debt has grown dramatically over the past several decades. And as debt grows, future budgets are impacted because of debt service payments of principal and interest. In 2010, the future interest associated with Illinois' \$24.5 billion in outstanding GO debt was \$15.3 billion. The future interest associated with the \$2.4 billion in outstanding SO debt was \$1.15 billion (Figure 4). The increases in debt in FYs 2003 and 2010 reflect pension bonds – long term GO bonds issued to cover the state's pension payments.

Figure 4 | Illinois Direct Debt: General Obligation (GO) and Special Obligation (SO) Principal and Interest, FYs 2002-2011

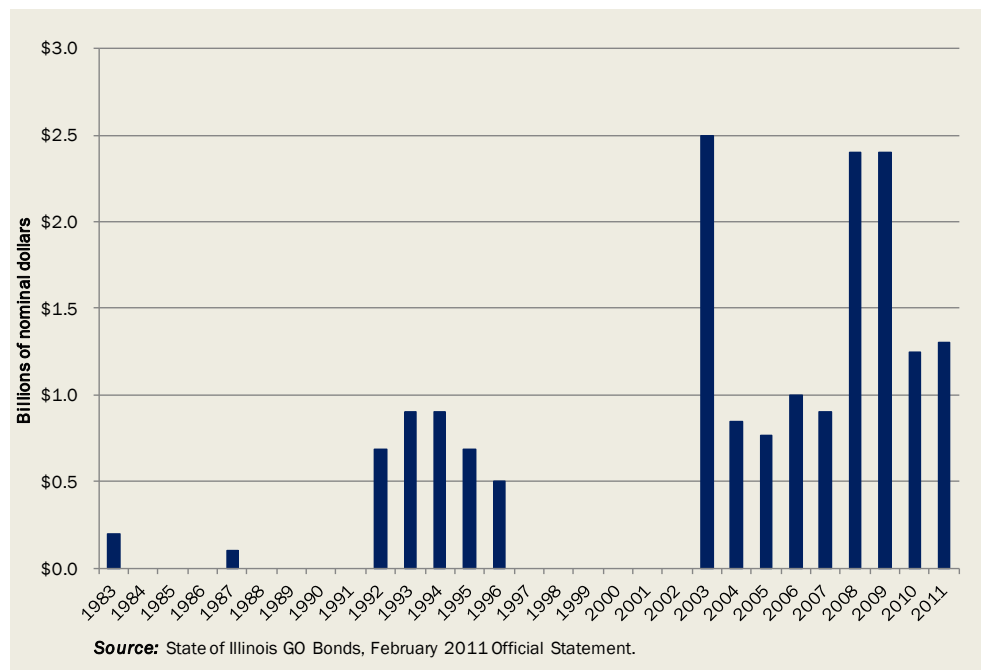


Reliance on Short-Term Cash Borrowing

Illinois can issue short-term debt pursuant to the Short Term Borrowing Act, which allows borrowing for “emergencies or failures of revenue” not to exceed 15 percent of the state’s appropriation for that fiscal year.¹¹⁷ Short-term borrowing must be repaid within one calendar year – not fiscal year – of the date it is incurred. This means that revenues from the next fiscal year can be used to pay off a current year’s loan.

Illinois used emergency short-term borrowing to deal with cash flow crises during the recessions in 1991 to 1992 and 2001 to 2002. But Illinois *continued* to use short-term borrowing even as the economy grew between 2003 and 2007. This illustrates the structural imbalance (and political issues) that existed even before the onset of the Great Recession (Figure 5). Illinois issued its most recent short-term certificates for \$1.3 billion in July 2010 (FY 2011) and used the proceeds to pay overdue FY

Figure 5 | State of Illinois Short-Term Borrowing Certificates Issued, FYs 1983-2011



2010 bills.

Along with growing costs for pensions and Medicaid, the cost of servicing a growing debt burden (most of it now for pension obligation bonds) is crowding out spending on essential state services and priorities. We turn next to two of those critical priorities, education and infrastructure, but it is important to note that all other areas of the state budget are threatened too — corrections, human services, non-Medicaid health care, transportation, revenue transfers to local government ... everything.

Educating Illinois for the Future in a Time of Fiscal Stress

The general consensus in Illinois is that education is a priority, and this view was reflected in Governor Quinn's annual budget address last spring. However, funding pensions, Medicaid, and debt service has diminished Illinois' ability to fund education. The governor's preliminary General Funds budget for 2013-2015 maintained the total amount allocated to education for all three years while other areas of the budget were cut.¹¹⁸ However, due to insufficient resources and the end of the stimulus program, the enacted 2013 General Funds budget cut PreK-12 education appropriations by 3 percent, and appropriations from all funds for preK-12 education were cut 8 percent.¹¹⁹ In August 2012, Governor Quinn's office released an analysis showing that if pensions were not reformed, by 2016 the state would spend more on pensions than education. Since Illinois legislators have made no progress on pension reform, deeper education cuts are likely on the horizon.¹²⁰

Background and History: PreK-12 Education

For the past decade, about two million pupils have been enrolled in Illinois public schools (Table 8). Enrollment peaked at almost 2.4 million in 1972 with the baby boom generation and declined through the late 1980s, when it began to increase again.¹²¹ Between 2000 and 2010, the total number of students in Illinois public schools has increased about only 0.4 percent per year and the number of school-age children is not expected to grow in the near future.¹²²

Table 8 | Illinois State PreK-12 Education Expenditures, FYs 2000-2012

Fiscal Year	Number of Pupils	Pre-K-12 Education Exp. (\$ millions)	Pre-K-12 Education Exp. Per Pupil
2000	2,027,600	\$6,049	\$2,983
2001	2,048,792	\$6,405	\$3,126
2002	2,071,391	\$6,633	\$3,202
2003	2,084,187	\$6,699	\$3,214
2004	2,100,961	\$7,128	\$3,393
2005	2,097,503	\$7,573	\$3,611
2006	2,111,706	\$7,877	\$3,730
2007	2,118,692	\$8,270	\$3,904
2008	2,113,435	\$8,878	\$4,201
2009	2,112,132	\$9,374	\$4,438
2010	2,105,779	\$9,847	\$4,676
2011	2,074,806	\$9,286	\$4,476
2012	2,087,628	\$8,506	\$4,075

Source: Illinois State Board of Education.

Table 8 shows spending for primary and secondary education for FY 2000 to FY 2012. In FY 2000, the state preK-12 budget was \$6.0 billion. (This does not include the Teachers Retirement System.) By FY 2010, with the aid of federal stimulus funds, total state preK-12 spending had increased to \$9.8 billion. In FY 2012, in the absence of federal stimulus funds, spending will likely drop even further.¹²³ The third column of Table 8 indicates that the state's expenditures per pupil have increased from \$2,983 in 2000 to \$4,676 in 2010. That is an increase of 2.0 percent per year after adjusting for inflation. If the total amount that Illinois spends on education is held constant for the next several years, deeper cuts in education will likely be required.

Most state aid to local school districts in Illinois is given through the General State Aid (GSA) formula, which has three components: a property wealth equalizing formula, payments for districts with a disproportionate number of students in poverty, and adjustments for districts subject to property tax limitations.

The equalizing grant is calculated from a "foundation level," the amount of aid that would go to a hypothetical district with no locally taxable resources. Aid then declines for districts with higher property tax base per pupil. The foundation level is set each year based on the total amount that the legislature appropriates for GSA. Education advocates argue that the foundation level should reflect the actual costs to provide an adequate education and sufficient funds should be appropriated to achieve that. Due to these concerns, the Illinois Education Funding Advisory Board (EFAB) was created to annually recommend an "adequate" foundation level to Illinois leaders. Table 9 shows the actual foundation level supported by state appropriations and the EFAB recommended levels for the last decade. Since FY 2002 when an adequate level was funded, the actual GSA foundation level has fallen farther and farther behind the EFAB recommendation.

Table 9 | Illinois General State Aid School Funding Formula Foundation Levels and EFAB Recommended Levels

Fiscal Year	Foundation Level (\$ per pupil)	EFAB Level (\$ per pupil)
2002	\$4,560	\$4,560
2003	\$4,560	\$4,680
2004	\$4,810	\$5,665
2005	\$4,964	\$5,863
2006	\$5,164	\$6,405
2007	\$5,334	\$6,404
2008	\$5,734	\$6,841
2009	\$5,959	\$7,128
2010	\$6,119	\$7,388
2011	\$6,119	\$7,992
2012	\$6,119	\$8,360

Source: Illinois Education Funding Advisory Board, Illinois Education Funding Recommendations, January 2011.

In Illinois, total preK-12 education spending per pupil slightly exceeds the national average, but the proportion that comes from the state's own resources is low in comparison to other states.¹²⁴ In the 2008-2009 academic year Illinois was ranked forty-eighth in per-pupil education revenues from state sources, but tenth in per pupil revenues from local sources.¹²⁵ Illinois' heavy reliance on local property taxes to fund education means that disparities between wealthy and poor communities are reflected in the quality of the schools. During the 2009-2010 academic year, Illinois' wealthiest elementary districts spent about \$24,000 per pupil while the poorest districts spent about \$6,000.¹²⁶ A 2010 national study found that Illinois has the second-highest disparity between high-poverty and low-poverty schools.¹²⁷

Since the late 1980s, civic, business, and advocacy organizations in Illinois have worked to gain consensus on statewide school funding reform, sponsoring numerous pieces of legislation that would change the system, including increased state funding, changes to the funding formula, and "tax swaps": higher state income taxes coupled with local property tax relief.¹²⁸ There have been lawsuits and a referendum to change the state constitution. However, the system of education funding remains unchanged because tax increases are extremely unpopular, and because suburban residents value the control of their local schools. Property tax redistribution would not be politically feasible.

Illinois' heavy reliance on the property tax to fund schools is also problematic because in 39 of Illinois' 102 counties, property tax caps limit increases in school districts' revenues.¹²⁹ The Property Tax Extension Law (PTELL) restricts the annual increase in a school district's property tax revenues from existing property to the rate of increase in the consumer price index or 5 percent, whichever is less.¹³⁰ Over time, an increasing share of the state's education dollars have gone to PTELL districts (where property tax caps limit revenues available to school districts) and to poverty grants.¹³¹

Illinois has the third highest number of school districts of all U.S. states. More than 200 of Illinois' 868 school districts have only one school. Last year Governor Quinn proposed consolidating the number of school districts to 300 and formed a commission to study the issue, estimating that Illinois could save \$100 million per year.¹³² However, implementation of the plan (and potential savings) are at least a year away.¹³³

Illinois does face a financial hurdle in school district consolidation. The commission studying consolidation estimated there would be a \$3.7 billion cost, due in part to financial incentives the state provides.¹³⁴ In April 2012 the commission recommended that school district consolidation be voluntary; many districts are proposing ways to save money that would keep them from having to consolidate.¹³⁵

Higher Education

There are nine public universities in Illinois with over 205,000 students and forty-eight public community colleges with nearly 380,000 students (in fall 2010).¹³⁶ From fall 1997 to fall 2010, enrollment at Illinois' public universities has increased 7 percent and increased 10 percent at public community colleges.¹³⁷

As shown in Table 10, Illinois' higher education spending in nominal terms has been virtually flat for the entire decade, 2000 to 2010. After adjusting for inflation, Illinois' higher education expenditures have declined an average of 3.3 percent per year from FY 2002 to FY 2012. (The numbers do not include the retirement systems.) Worse, a lack of pension reform will probably necessitate education cuts. Governor Quinn's office projects that without pension reform, by 2018, a cumulative \$284 million more will be cut from higher education FY 2013 spending levels.¹³⁸ State spending is but one

revenue source of the universities that also collect income from tuition, fees, grants, donations, contracts, and other sources.

Table 10 | Illinois State Expenditures for Higher Education, FYs 2000-2012

Fiscal Year	Higher Education Expenditures (\$ millions)
2000	\$2,260
2001	\$2,466
2002	\$2,671
2003	\$2,546
2004	\$2,367
2005	\$2,329
2006	\$2,355
2007	\$2,467
2008	\$2,504
2009	\$2,473
2010	\$2,532
2011	\$2,456
2012	\$2,445

Notes: State Higher Education Expenditures aggregated 9 public universities and several state agencies related to higher education, NET of pensions. Includes capital spending, which is not a significant share.

Sources: Illinois Comptroller, Detailed Annual Reports (FY 97-10); Comptroller's website (FY 11-12).

Overall, there are three main financial issues currently affecting Illinois state universities. First, pension benefit reductions affect university hiring. Higher education officials have argued that recent pension reforms that offer much less to new hires than preexisting employees put a burden on the hiring of professors because Illinois universities compete for new academic hires in a national market. University presidents have opposed recent pension reform proposals.¹³⁹ Second, the University of Illinois hospitals receive a large portion of their overall budgets from Medicaid reimbursements, which could be cut. Third, Illinois universities have steadily raised tuition over the past decade to compensate for diminishing state support. At this point, tuition rates at Illinois' state universities are comparable to out-of-state tuition rates at universities in other states, so they are competing for Illinois students. If the state budget crisis results in additional real declines in state aid to higher education, it will be more difficult to offset these declines by raising tuition than it has been in the past.

Underinvestment in Infrastructure

Crowding out has also become increasingly evident in the case of Illinois' aging infrastructure. In 2010, the American Society of Civil Engineers (ASCE) Infrastructure Report Card gave Illinois an overall grade of D+.¹⁴⁰ The state's infrastructure is in urgent need of immediate repairs to meet basic standards of public safety, and in need of expansion and modernization to accommodate future growth. However, as Illinois continues to struggle to pay its pension, Medicaid, and debt obligations, the state's infrastructure condition will only worsen. Illinois state agencies estimate that infrastructure needs over the next twenty to thirty years will exceed \$300 billion. But the state does not have a comprehensive capital improvement plan, and the information needed to make an accurate assessment of the condition of Illinois' infrastructure is incomplete.

Three entities are primarily responsible for the management and funding of infrastructure assets on a statewide or regional basis: the State of Illinois, the Illinois State Toll Highway Authority (ISTHA), and the Regional Transportation Authority (RTA). The State of Illinois has responsibility for surface transportation, bridges, facilities, state parks, aviation, and water infrastructure, and provides funding for elementary and secondary education infrastructure as well as higher education institutions. The ISTHA oversees the operations and capital management of the toll roads in northeastern Illinois. The RTA is charged with financial and budget oversight of the three mass transit service boards in the six-county region of northeastern Illinois: the Chicago Transit Authority or CTA (Chicago rail and bus transit); Metra (the suburban rail system); and Pace (the suburban bus system and provider of regional paratransit services).

Capital projects in Illinois are funded by federal monies, bonds, vehicle tolls, and rider fares. In addition, the state uses lottery receipts, sales taxes, and vehicle license fees. New capital projects (and new sources of revenue to fund them) are often proposed on an ad-hoc basis. Despite the size of its capital program and the challenges that it faces, the State of Illinois does not develop a formal capital improvement plan to explain the prioritization of projects in the capital budget or provide an overall needs assessment for all state-owned assets. For this reason, there is no centralized database or report providing comprehensive information about infrastructure condition or needs for state funded and managed capital assets.

Condition of Illinois' Infrastructure

The poor condition of Illinois' infrastructure — including highways, roads, bridges, trains, buses, dams, locks, and buildings — has become critical.

A FY 2011 survey of Illinois' highways and roads by the Illinois Department of Transportation indicated that approximately half of Illinois' highways and roads were in Fair or Poor condition.¹⁴¹ According to the Federal Highway Administration, in 2010 over 15 percent of Illinois' 26,000 bridges were structurally deficient or functionally obsolete.¹⁴²

Illinois' mass transit infrastructure is also lacking: in 2010 approximately one-third of mass transit bridges and structures; maintenance facilities; and buses were not in a state of good repair. Nearly two-thirds of Metra and CTA passenger rail cars were in a "marginal" state.¹⁴³ Nearly half of Metra and CTA train stations were past their useful life, and about one-third of CTA and Pace buses were in the last quarter (or less) of their useful life.¹⁴⁴ Little state funding is available to address these needs. ASCE noted, "The current five-year [transit] capital needs in Northeastern Illinois alone are \$10 billion, yet the recent Illinois Capital Bill provides only \$2.7 billion for the entire state."¹⁴⁵

Illinois' water infrastructure is also in dire condition: the locks and dams on Lake Michigan and the Mississippi, Illinois, and Ohio Rivers were given a grade of D- by the 2010 American Society of Civil Engineers Infrastructure Report Card. Roughly a third of Illinois' 1,500 dams are at least fifty years old. Two hundred and one Illinois dams received a high hazard rating from the United States Army Corps of Engineers in 2010.¹⁴⁶

Cuts to Illinois' agency budgets have led to deferred maintenance for many state-owned buildings, including those on university campuses. However, there is no single, publicly available report that details these costs.¹⁴⁷

Over the next twenty to thirty years, Illinois state agencies estimate that infrastructure needs will likely exceed \$340 billion. The greatest need is for maintenance, rehabilitation, and replacement of roads and bridges, which the Illinois Department of Transportation estimated would require \$171.4 billion between 2007 and 2036. Other needs assessments by different agencies, for different time periods, are summarized in Table 11. If these costs are not addressed, they will continue to grow as the infrastructure deteriorates over time.

Table 11 | Illinois' Infrastructure Needs, According to Various Agencies

	Needs (\$ billions)	Timeline (years)	Source
Roads and Bridges	\$171.4	30	IDOT
Freight Rail	\$1.7	30	IDOT
Mass Transit	\$64.7	30	IDOT
Mass Transit (RTA)	\$24.1	20	RTA
Mass Transit - CTA	\$14.5	20	RTA
Mass Transit - Metra	\$7.3	20	RTA
Mass Transit - Pace	\$2.2	20	RTA
Toll Highways	\$12.1	15	ITHA
School Facilities	\$9.9	2	ISBE/CDB
Drinking Water Infrastructure	\$15.0	20	US EPA
Wastewater Treatment	\$17.5	20	US EPA
Sources: Illinois Department of Transportation (IDOT), Illinois State Transportation Plan, Special Report: Transportation Funding, July 2007; Regional Transportation Authority (RTA), Capital Asset Condition Assessment; Illinois Toll Highway Authority (ITHA), Move Illinois - Capital Program Summary; United States Environmental Protection Agency (US EPA), Drinking Water Infrastructure Needs Survey and Assessment, February 2009; US EPA, Office of Wastewater Management, Clean Watersheds Needs Survey 2008, February 2009. CDB signifies "Capital Development Board."			

Capital Financing

Recent plans to finance new capital projects in Illinois have not been very successful. In July 2009, as part of the *Illinois Jobs Now!* capital plan, the state enacted the first comprehensive capital bill since 1999. The intent of *Illinois Jobs Now!* was to fund capital projects through approximately \$1 billion per year in new revenues, which would come from five sources: legalization of video gambling; private management of the lottery; sales tax expansion to candy, sweetened beverages, and some hygiene products; increased liquor tax; and increased motor vehicle fees.¹⁴⁸

However, in the two and a half years since *Illinois Jobs Now!* was enacted, only a fraction of the anticipated new revenues have been realized. The unpopularity of gambling led more than eighty municipalities, including the City of Chicago, to opt out of the legislation.¹⁴⁹ Regulatory issues delayed implementation of video gambling; reportedly, machines will begin operating in September 2012.¹⁵⁰ The private firm contracted to manage the lottery (and increase its earnings) did not begin work until FY 2012. Although the lottery has made record profits this year, the revenues have reportedly fallen about \$100 million short of the goal.¹⁵¹ Receipts from the liquor tax increase were held up by a lawsuit.¹⁵² It is still unknown whether increased receipts from the lottery, liquor taxes, and vehicle fees are being used for new capital projects.

Despite the size of its capital program, the State of Illinois does not develop a comprehensive multi-year capital improvement plan nor provide publicly available future year projections of total capital spending and revenues in other reports, and the state has never provided the public with projections of pay-as-you-go capital spending. The only publicly available estimates of future capital spending have been the five-year projections of bond-funded capital expenditures in the annual Capital Budget. But this year Illinois has not (yet) issued a FY 2013 Capital Budget.¹⁵³ The FY 2011 and 2012 Capital Budgets described the intended use of *Illinois Jobs Now!* Funds, but as discussed earlier, those revenues did not materialize as planned.¹⁵⁴

Several areas of risk could lead to the need for additional capital funds in the future. However, because of the lack of information on plans to address capital assets in poor condition, it is not possible to assess this probability.

Consequences of Underinvestment in Infrastructure

Illinois faces significant consequences as a result of underinvestment in infrastructure. ASCE explains,

Roads and rail, which both received a grade of D, are experiencing substantial congestion problems. Rail congestion costs millions of dollars in shipping delays and causes substantial noise and air pollution as trains idle for hours waiting for track clearances. Meanwhile, it is estimated that road congestion costs Illinois' economy tens of billions of dollars in lost productivity each year. The average cost of congestion per commuter in the Chicago area is \$921 per year.¹⁵⁵

Similarly, ASCE notes that underfunding in Illinois' waterways "[threatens] the future viability of the state's navigable waterway infrastructure."¹⁵⁶

As critical as the condition of Illinois' infrastructure is, it is unlikely that the state will be able to allocate additional resources to fix the problems in the foreseeable future. This is because the growth in spending for pensions, Medicaid, and debt service will out-pace the anticipated growth in Illinois' resources. Except for the 2011 increases in the personal and corporate income tax rates, Illinois' tax revenues have been stagnant for over a decade. The revenues from the tax increase have been offset by the decline in federal receipts as the stimulus program ended. And deeper cuts in federal funding are on the horizon, as the federal government works to reduce its own deficit.

Narrow, Eroding Tax Bases and Volatile Revenues Undermine Illinois' Finances

Underinvestment in funding priorities such as education and infrastructure did not come overnight. Over time, Illinois' revenues have eroded and are unlikely to grow enough to meet future needs. In addition, federal deficit reduction is likely to mean serious cuts for states.

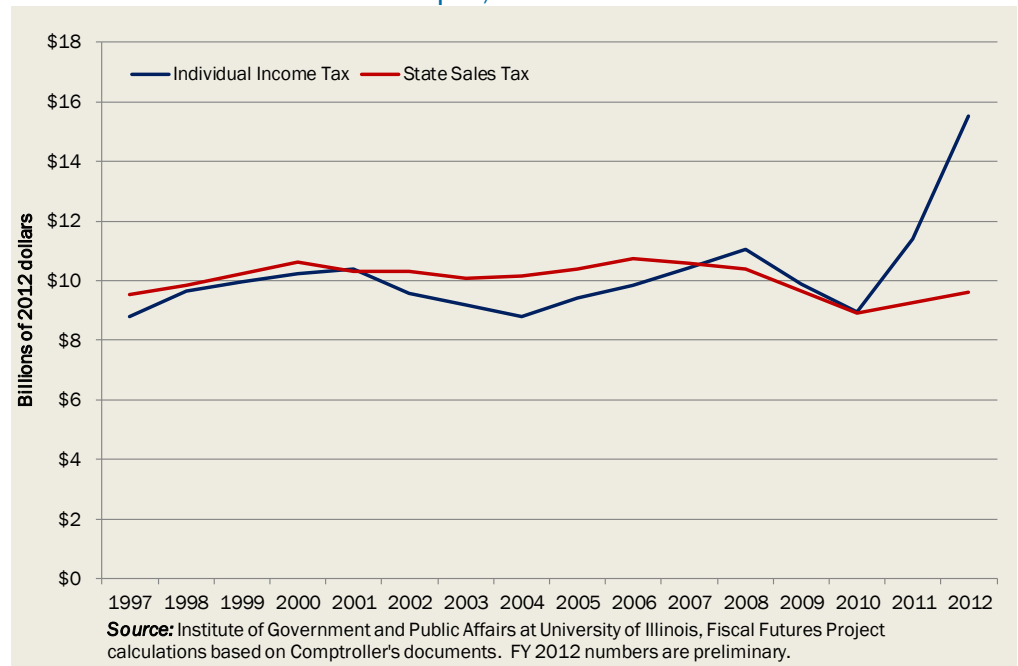
Illinois' tax revenues had been stagnant for at least a decade before the Great Recession. In January 2011, state lawmakers enacted the first income tax increase in over two decades, but structural problems remain. In addition, political expediency required that the tax increase be phased out beginning in FY 2015.

The State of Illinois gets more than 60 percent of its tax revenue from the general sales tax and the personal income tax. Selective sales taxes (tobacco and liquor taxes, motor fuel taxes, telecommunications taxes, etc.) are also significant and represent about 20 percent of tax revenue. Corporate income taxes account for about 5 percent of state tax revenue.

General Sales Tax

In real terms, Illinois' general sales tax revenues have been stagnant for over a decade (Figure 6). Inflation-adjusted sales tax receipts plummeted from \$10.4 billion in FY 2008 to \$8.9 billion in FY 2010, and still have not returned to pre-recession levels.¹⁵⁷ In Illinois, as in other states, stagnation of sales tax revenues is primarily due to two factors: the expansion of the service sector of the economy while few services are taxed; and the increase in Internet purchases which are not subject to the state sales tax.

Figure 6 | Illinois General State Sales Tax and Individual Income Tax Receipts, FYs 1997-2012



Illinois has a relatively high 6.25 percent general sales tax rate, with local home-rule sales taxes added that bring the total sales tax rate to over 9 percent in some locations.¹⁵⁸ Of the total 6.25 percent state sales tax rate, Illinois keeps the revenues from a 5 percent rate and distributes the revenues from a 1.25 percent rate to local governments. Food and drug purchases are taxed at 1 percent, which is all distributed to local governments.¹⁵⁹

Compared to other states, Illinois taxes very few services. A 2007 survey found that out of 168 potentially taxable services, Illinois taxed only seventeen, compared to a national average of fifty-six. Only four states taxed fewer services than Illinois.¹⁶⁰ At the same time, Illinois' economy is more dependent on services than many other states, primarily due to the importance of service industries such as finance and insurance, professional services, and information. In 2011, COGFA estimated that if Illinois were to implement taxation of services (excluding business to business transactions) this could generate \$4.0 to \$8.5 billion in new revenues per year,¹⁶¹ although the amount that is politically feasible could be much lower.

Internet taxation is an evolving issue in Illinois. In 2011, the Illinois Department of Revenue estimated that Illinois was losing about \$157 million per year in unpaid sales taxes for online purchases and this would grow to over \$200 million in 2013.¹⁶² Last year Illinois lawmakers passed the Main Street Fairness Act which expanded the meaning of a retailer's "physical presence" to include affiliated companies. In response, Amazon cut ties with thousands of Illinois affiliates, and these companies successfully sued the Illinois Department of Revenue.¹⁶³

Personal Income Tax

Figure 6 shows real personal income tax collections in Illinois for the last fifteen years. Though a bit more volatile, income taxes are similar to sales taxes in the \$10 billion per year order of magnitude and in the lack of a discernible growth trend. Personal income tax receipts increase sharply after FY 2012 with the increase in the tax rate from 3.0 to 5.0 percent.

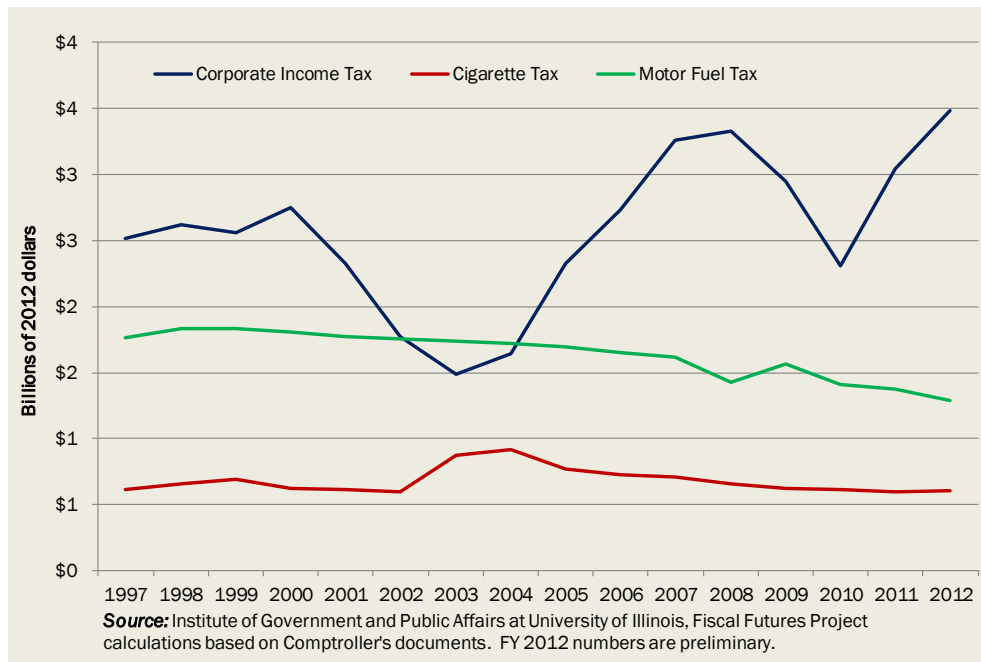
Illinois has a broad personal income tax base and a simple flat rate structure. Taxable income in Illinois is very similar to federal adjusted gross income (AGI) except that Illinois excludes all retirement income,¹⁶⁴ which could be a significant source of revenue: over \$1 billion in 2010.¹⁶⁵ Retirement income is rising as a share of all income, which means that Illinois' personal income tax base is gradually eroding.

Because Illinois has a flat rate tax with a personal exemption of only \$2,050 per capita, the system has a roughly proportional burden across different income groups.¹⁶⁶ This lack of progressivity in the personal income tax system, combined with the nationwide trend toward rapid growth of income among high-income individuals, has meant that income tax revenue has grown somewhat more slowly in Illinois than in states with a progressive tax system. However, Illinois' flat income tax rate also means that personal income tax revenues are less volatile than they would be under a more progressive rate structure.

Corporate Income Tax

Like other states, Illinois has seen long-term erosion in its corporate income tax base as businesses have developed effective tax avoidance strategies. Tax incentives for businesses totaled \$1.18 billion in FY 2008.¹⁶⁷ According to COGFA, Illinois is considered to be "average" compared to other states in terms of its business tax climate, although this was before the tax increase. Like other states, Illinois' corporate income tax revenues are volatile and vary with the business cycle (Figure 7). Corporate income taxes fell sharply in the recessions after FY 2000 and FY 2008. The increase from FY 2010 to 2012 is not from growth in corporate income, rather from the big increase in tax rates.

Figure 7 | Illinois Corporate Income, Cigarette, and Motor Fuel Tax Receipts, FYs 1997-2012



Selective Sales Taxes: Cigarette, Motor Fuel, Telecommunications

Cigarette tax revenues have stagnated in Illinois, declining about a third in real terms between 2004 and 2012 (Figure 7). This is probably due to the fact that the share of the population that smokes has declined and, also, tax avoidance has become more common. Very high local cigarette tax rates in Cook County and in Chicago encourage cross-state (or cross-county) cigarette purchases, resulting in a large share of tobacco consumers who do not pay the tax. In July

2012, in an effort to reduce planned cuts to the Medicaid program, the Illinois state cigarette tax was increased from 98 cents to \$1.98 per pack, which would increase cigarette tax revenues to an estimated \$950 million for FY 2013. The legislation also expanded the definition of a "cigarette" and increased a separate tax on other tobacco products.¹⁶⁸

There are two components of the motor fuel tax in Illinois: the state motor fuel tax (or "gallongage tax") and the state sales tax on motor fuel sales. The gallongage tax is \$0.19 per gallon on gasoline/gasohol (\$0.21 for diesel) plus \$0.011 per gallon in environmental fees. The sales tax is 6.25 percent of the price of motor fuel sales exclusive of the gallongage tax — with revenue from a 5 percent rate going to the state and the revenue from a 1.25 percent rate to local governments. In addition, there are federal taxes of 18.4 cents per gallon. Local home-rule municipalities may also levy additional sales taxes on motor fuels.¹⁶⁹

In real terms, Illinois' total motor fuel tax revenues (gallongage tax and sales tax combined) have declined from about \$1.8 billion in 1997 to \$1.3 billion in 2012 (Figure 7). Motor fuel tax revenues have eroded due to the increasing consumption of gasohol.¹⁷⁰ In Illinois, only 80 percent of the price of gasohol is subject to the state sales tax, so as gasohol has accounted for a greater share of fuel consumption, motor fuel tax revenues have declined. Increasingly fuel-efficient automobiles have also reduced revenue.

Telecommunications taxes — primarily on mobile phones — have provided a stable source of selective sales tax revenue and compensated to some extent for erosion in the general sales tax base.¹⁷¹

Illinois has a serious problem with stagnant tax base growth — or even decline — for all of its major and minor taxes. Only the large increases in income tax rates in 2011 increased tax collections, but tax rate increases are not a sustainable source of revenue growth.

Federal Deficit Reduction Threatens State Budget and Economy

To add to the threats from stagnation of its own-source revenues, Illinois faces large decreases in the revenue it gets directly and indirectly from the federal government. It is almost certain that massive cuts in the federal budget will be unavoidable in the years ahead. Assuming that the federal government's priorities are defense, Social Security, Medicare, and net interest, federal grants to state and local governments will become a primary target for budget cuts. Because federal monies account for a large share of state budgets, these cuts could cancel out the additional revenues that states have gained from tax increases since the financial collapse of 2008.

The main way that federal actions will probably impact Illinois (and other states) in the years ahead is that the federal government will have to cut spending to reduce its deficits. The Budget Control Act (BCA) of 2011 mandated \$917 billion in cuts over ten years. While grants to state and local governments account for about 16 percent of the total federal budget, they make up more than 40 percent of discretionary spending, so they are likely to be targeted for cuts.

At the same time total federal grants to states are expected to decline, Medicaid is set to be expanded under the Affordable Care Act. This will crowd out other spending priorities at the federal level, and the state share will crowd out other spending at the state level. Of course, this trajectory could be changed by policy actions.

Federal Funds in Illinois

Historically, federal dollars have comprised nearly a quarter of Illinois' total (all funds) budget from fiscal years 1997 through 2008. In fiscal years 2009 through 2012, the share increased to about 29 percent, due to the federal stimulus program, but dropped back to 23 percent in FY 2012. In FY 2008, prior to the stimulus program, Illinois received \$13.7 billion in federal funds.¹⁷² Under ARRA this amount increased to \$18.2 billion in FY 2010 and was nearly as much in FY 2011. In FY 2012, as the stimulus ended, Illinois' federal receipts dropped precipitously to \$14.8 billion and this amount is not expected to increase in FY 2013.¹⁷³

Federal dollars match about 50 percent of Illinois' Medicaid spending, and comprise roughly 35 percent of the budget of the Department of Human Services, 30 percent of Illinois' transportation spending (including capital projects), 20 percent of Illinois' spending on K-12 education, and about 15 to 20 percent of Illinois' spending for environment and natural resources. These are the areas of the budget that will be the most impacted by changes in federal policy.

Most federal grants that Illinois receives go into special funds or trust funds, not the General Funds. For this reason, the federal effect on the budget can be hard to see. For example, in FY 2012 Illinois received \$14.8 billion in federal dollars, but only \$3.6 billion of that went into the General Funds. Over time, the share of federal dollars that are deposited in funds outside the General Funds has increased, from 58 percent in FY 1997 to 76 percent in FY 2012. This practice masks the state's true budgetary situation.

As federal and state revenues decline, local governments will also be impacted. At the same time, local governments are experiencing their own fiscal problems, which will put additional pressure on the state.

Local Government Fiscal Stress Poses Challenges for Illinois and Vice Versa

Local government taxing jurisdictions weave a complex web in Illinois. According to the 2007 *Census of Governments*, Illinois has more units of government than any other state — nearly 7,000. This includes 102 counties, 1,400 townships, 1,300 municipalities, 868 school districts, and about 4,000 special taxing districts such as library, fire protection, forest preserve, and park districts.¹⁷⁴

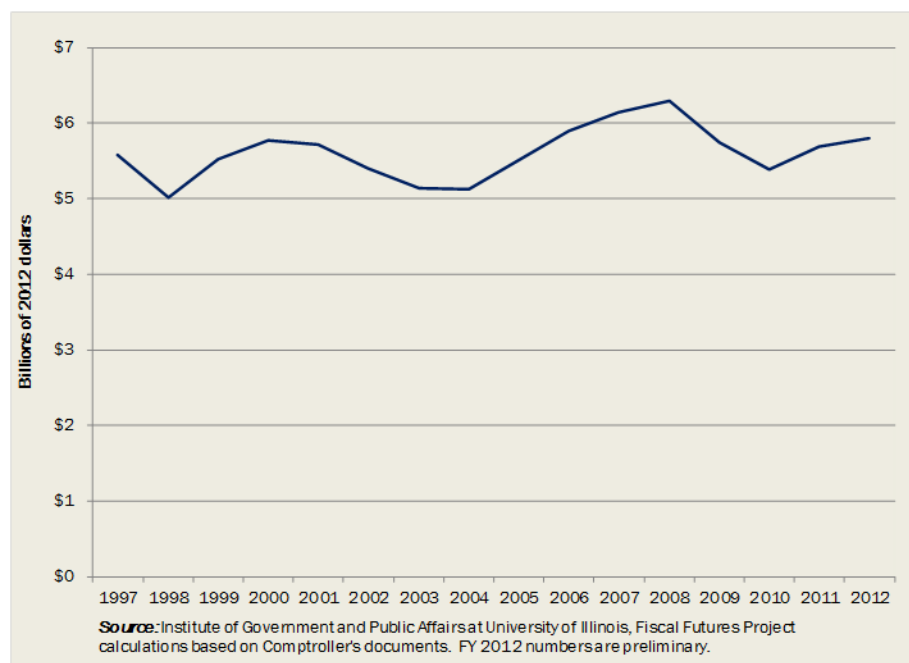
Although units of local government have the authority to levy property taxes, sales taxes, utility taxes, and fees to sustain their operations, they also rely on federal and state aid. According to the Census, in 2008 in Illinois, 66 percent of local governments' revenues came from their own sources (taxes, fees, and miscellaneous charges); 34 percent came from state and federal aid. Roughly 30 percent of local governments' revenues come from the State of Illinois. Local governments' tax revenues come from the property tax (82 percent) and sales taxes (15 percent).

In Illinois, the fiscal condition of thousands of local governments is intertwined with that of the state. At present, neither is in a position to help the other. The state's fiscal stresses have led to cutbacks in transfers of state revenues to local governments, exactly at the time that local governments are most in need of assistance. As the state's bond rating has been downgraded, bonds issued by local governments are affected. On the local side, a number of school districts' and municipalities' bond ratings (including the City of Chicago and Springfield, the state capitol) have recently been downgraded by Moody's Investors' Service, which certainly does not help Illinois.

Other state actions also threaten to significantly impact municipalities. In spring of 2012, Governor Quinn proposed that funding the pensions of teachers (and state university employees) would become the responsibility of local school districts (and state universities) rather than the State of Illinois. This proposal would be a massive shift of responsibility and fiscal pressure from the state to the local level, and has been widely criticized on the grounds that it would require significant property tax increases.

Local governments in Illinois rely heavily on revenue transfers from the state: shares of the personal income tax revenues, personal property tax replacement revenues, and sales tax. Motor fuel tax revenues are also transferred to localities, for the purpose of maintaining roads and

Figure 8 | State of Illinois Transfers to Local Governments, FYs 1997-2012



highways. When Illinois increased the personal and corporate income tax rates in January 2011, it was stipulated that the additional receipts from the higher rates would not be transferred to local governments. In other words, intergovernmental transfers from income tax receipts would be frozen at pre-tax increase levels. Since tax revenues from sales taxes and motor fuel taxes have remained stagnant or declined in real terms, Illinois' transfers to municipal governments have remained flat as well: in 2012 dollars somewhere in the range of \$5 to \$6 billion for more than a decade (see Figure 8).

Similar to the Medicaid program, "transfers to local governments" lack transparency: they are not a specific program or line item anywhere in Illinois budget documents. Different types of revenue transfers go through different funds and state agencies. For example, motor fuel tax receipts go into a special fund (not a General Fund) administered by the Illinois Department of Transportation (IDOT) for distribution to local governments. Transfers of the shares of personal and corporate income taxes and personal property replacement taxes are administered by the Department of Revenue. The share of the state sales tax receipts that is transferred to local governments goes into a special fund that does not appear in the state's appropriated funds budget and is thus off-limits for state legislators.

Crowding out of the state budget also threatens what meager fiscal oversight exists in Illinois. Local governments other than school districts are required to file financial reports with the comptroller, but that office does not have the necessary staff to review the reports, nor does it have the authority to force a local government to change its practices.¹⁷⁵ Illinois' school districts do have limited monitoring by the Illinois State Board of Education (ISBE). School districts must file detailed annual financial reports with ISBE, which uses the information to create a composite summary of financial health known as the District Financial Profile (DFP). As districts' financial condition deteriorates, ISBE begins to intervene with direct monitoring and technical assistance.¹⁷⁶

In addition, local governments face fiscal pressures due to unfunded pension liabilities, budgetary deficits, and bond ratings downgrades. In years ahead, as pensions, Medicaid, and debt increasingly crowd out other areas of the state budget, local governments will increasingly experience difficulties in meeting their obligations.

Although Illinois' fiscal future appears bleak, there are many things that can be done to improve the situation. In the next section we offer a number of recommendations.

Conclusions and Recommendations

The recent recession hit Illinois particularly hard. At the onset of the financial crisis, Illinois was essentially insolvent because it had no reserves; had used borrowing, time-shifting and fund-shifting devices to balance the budget for the previous six or seven years; and had shortchanged its pension systems for decades. Illinois also suffered a crisis of leadership at a time when a strong and effective governor was needed to make tough decisions to move the state forward. For these reasons, even at a time when all U.S. states were struggling, Illinois' fiscal crisis was one of the very worst.

Make the Tough Choices Sooner Rather than Later

Illinois starts with a large structural deficit, an imbalance between sustainable revenues and existing spending levels. Illinois faces major challenges going forward due to the aging of the population, rising health care costs, unfunded pension liabilities, stagnant and eroding revenues, and impending federal budget cuts. Some of the problems going forward are the consequence of time-shifting from unbalanced budgets in recent years — debt service costs for pension obligation bonds, pension payments that were less than the ARC, and billions in unpaid bills.

The state needs to recognize that large cuts in many areas of the budget as well as increases in revenues will be necessary. The default policy if policy makers do not make the tough choices soon will be two-fold. First, further time-shifting will make the situation in future years even worse — larger stacks of unpaid bills and more debt service payments to pay for past gaps. Second, without deliberate choices as to what to cut or who to tax, cuts will be concentrated in the “discretionary” areas of spending for human services and education — programs that have already seen large cuts. We do not offer specific recommendations for which spending to cut or which taxes to increase, only a few general observations.

Pension reform must be a priority. Illinois' pension systems are crowding out all other areas of the budget. Without some type of reform that reduces costs going forward, the systems appear destined for insolvency. Illinois needs to act now to salvage the benefits of future retirees. Illinois could learn from hybrid systems adopted in a number of other states.

Medicaid costs and reforms must be addressed. Illinois should work with the federal government to control Medicaid costs and implement reforms. “Optional” treatments such as medications and preventive care can be cost-effective alternatives to hospitalization, but under the current federal rules these are the first services to be cut.

Revamp the State's Fiscal Toolkit

There are a number of things that can be done to provide better information on the fiscal situation and improve the budgetary decision making process:

- **Timely reporting.** Illinois' budget is typically enacted at the end of May; the governor's office should issue a detailed report of the enacted budget within a month. The comptroller should release detailed reports of actual revenues and expenditures within six months of the fiscal year's end so that this information is available when the next year's budget is proposed. The private sector accomplishes this task regularly.
- **Accrual accounting.** Illinois should supplement cash-based budget reports with companion tables that use the accrual accounting concepts required of year-end CAFRs. This reporting should include changes in net liabilities for pensions and OPEB.¹⁷⁷ Reporting changes in assets and liabilities alongside current cash receipts and expenditures will expose budget shortfalls concealed by cash-based accounting.

- **Pension schedules.** Illinois should provide annually required contribution amounts (ARC or “normal cost plus interest”) in the same table as the pension contribution schedule so that lawmakers and the public can clearly see that even if the state makes its annual contribution to the systems, unfunded liabilities continue to grow. Even better would be to show “normal cost plus interest plus a 30-year amortization of unfunded liabilities” as the benchmark.
- **All funds, not General Funds.** Illinois should reduce its focus on General Funds-only budgeting and present the total funds budget so that major expenditure categories such as transportation and major revenue streams such as the sales tax are fully brought into the budget frame. This would also eliminate confusion that results when expenditure items are shifted into and out of the General Funds budget from one year to the next.
- **Transparent transfers.** Statutory transfers between General Funds and other funds (and between non-General Funds) should be itemized in the governor’s prospective budget and in reports on the enacted budget. Illinois’ comptroller should report statutory transfers to and from the General Funds (and between other funds) on its drilldown website. Currently, only aggregated amounts are available, making this information impossible to track.
- **Multi-year forecasting.** Illinois should build on the steps it made last year to generate multi-year forecasts and plans for the total budget (not just General Funds) that extend at least four years beyond the current budget year. This will improve the state’s ability to make decisions, which will lead to better fiscal outcomes. Illinois should make its forecasts available to the public and encourage outside review.
- **Long-term planning.** Responsible long-term fiscal planning is vital if Illinois is to put its house in order. Budget forecasts and legislative and public hearings should be used to develop spending priorities and a responsible long-term fiscal plan for Illinois. Rules and regulations will need to be put in place so that the plan is not just a recommendation but will be adhered to.
- **Fiscal notes.** Legislation that will have a significant fiscal impact on Illinois should be accompanied by a fiscal note so that lawmakers can see the price tag associated with a given policy. Illinois currently has very limited resources available to make estimates of these costs but this should be a priority for planning and budgeting.
- **Apolitical revenue estimates.** Illinois needs a nonpoliticized process for approving revenue estimates. The General Assembly should either adopt COGFA’s estimates or establish a consensus process as other states have done.
- **Omnibus spending bill.** Currently, Illinois’ budget is enacted as a series of appropriations bills rather than a single, coherent state budget. If the total state budget was enacted as a single omnibus bill, this would facilitate monitoring and increase transparency.

Illinois should establish a real **rainy day fund** and use it responsibly. During good times, the state should save automatically and allow time to replenish the reserve funds after a fiscal emergency ends. Illinois could learn from successful models of rainy day funds such as those in Virginia and Texas.

Other Issues

Tax reform at the state level may be needed to achieve revenue systems that are adequate and predictable and that minimize volatility. Illinois’ state sales tax is antiquated and has eroded over time. Illinois should reform its income and sales tax structures to make them broader-based, stable, and productive.

Illinois should establish procedures for monitoring the **fiscal condition of its local governments** and taking early action to help local governments resolve their fiscal problems. Illinois could learn from well-established monitoring and early-intervention procedures in North Carolina, New Jersey, Kentucky, Pennsylvania, and Michigan.

Illinois' **infrastructure** needs can no longer be ignored. Deferred maintenance is costly in the long run because problems continue to worsen. Especially problematic is Illinois' lack of a comprehensive capital improvement plan that identifies priorities and establishes repair and replacement schedules for five or ten years in the future. Infrastructure quality will have an impact on Illinois' long-term economic development.

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