



To the Members of the 95th General Assembly,

February, 2008

The accompanying special report provides a comprehensive view of Illinois' finances over the past five years and represents a "fiscal state of the state" for legislators and state policy makers to consider as they begin the process of enacting a new budget for fiscal year 2009. It illustrates the enormous financial challenges confronting the state as we yet again attempt to address long-standing budgetary issues and begin to face an increasingly uncertain economic future.

The contents of this report demonstrate that since the low point of fiscal year 2003, the year Illinois officially declared a "failures in revenue" and suffered from a payment backlog that reached \$2.4 billion, the state's economic revenues have enjoyed an impressive resurgence in tandem with the performance of the U.S. economy. The \$28.6 billion in General Funds revenues collected in fiscal year 2007 totaled \$5.6 billion more than in fiscal year 2003, reflecting a 35% growth in income taxes and an 18% increase in sales taxes.

Expenditures from the General Funds also grew significantly, however, as current year General Funds appropriations represent an increase of 23%, or \$5.2 billion more than in fiscal year 2003. A net \$2 billion increase in Department of Healthcare and Family Services budget levels occurred, while Human Services grew \$561 million. The State Board of Education experienced appropriation growth of \$1.9 billion during the same period, but notably, higher education received a smaller allocation this year than in fiscal year 2003.

During this period of national economic growth, most other states took advantage of their increased revenues to stabilize their financial positions. Illinois, when measured on the more comprehensive GAAP (Generally Accepted Accounting Principles) basis, still sustains a deficit, ending fiscal year 2007 nearly \$3.6 billion in the red based on preliminary unaudited estimates. While this is an improvement from the record \$4.166 billion GAAP deficit recorded in fiscal year 2003, it provides Illinois the dubious opportunity to retain its status of having the worst deficit in the nation for the fourth year in a row. The state's deficit is driven largely by Section 25 liabilities (prior year's bills deferred to future years), which stood at over \$1.8 billion in fiscal year 2003 and grew to \$3.371 billion at the end of fiscal year 2007, again based on preliminary unaudited estimates.

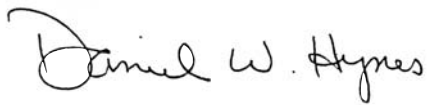
Meanwhile, as the report details, issues of critical importance have gone largely unaddressed, as revenue growth was directed primarily toward new spending. The state's total unfunded pension liability places Illinois' five public pension systems as among the worst funded in the nation. Despite spending more than \$2 billion more a year on healthcare and ostensibly expanding enrollment thru All Kids and other programs, the number of uninsured Illinoisans has remained at comparable levels to 2003 and by some estimates has increased. Recommended K-12 education funding goals have gone unmet, again despite large funding increases.

While these problems create significant challenges for the state, they are made more difficult by the prospect of a slowing economy and deteriorating revenues.

It is my hope that this sobering look at state finances is not only instructive, but will also serve as an impetus for cooperation and determined action as the state enters an extraordinarily challenging period. It is imperative that policy makers recognize the gravity of the situation that Illinois is facing in the immediate future.

I look forward to working with you in the weeks and months ahead. My staff and I would be happy to meet with you either individually or with your respective caucuses in order to further discuss the contents of this report and the critical issues facing our state.

Sincerely,

A handwritten signature in black ink that reads "Daniel W. Hynes". The signature is written in a cursive style with a large initial 'D'.

Daniel W. Hynes
Illinois State Comptroller

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Illinois' Fiscal Condition

FIVE-YEAR HISTORY

Overview. Since the end of the last recession in 2001, Illinois has been unable to regain its fiscal footing despite impressive and consistent revenue performance.

The state's fiscal position bottomed out in fiscal year 2003 as General Funds revenues from individual and corporate income taxes fell when compared to the prior year and sales taxes were flat. The backlog of General Funds bills awaiting payment in the Comptroller's Office that spring peaked at \$2.4 billion and the payment delays after bills were filed with the office reached 51 days. The state was forced to short-term borrow \$1.5 billion in May 2003.

At the end of fiscal year 2003, even in spite of the short-term borrowing, Illinois was holding \$874 million in bills, plus delaying income tax refund payments and holding bills at state agencies. The state's GAAP (Generally Accepted Accounting Principles) deficit reached an all-time high of \$4.166 billion.

However, a rebounding economy provided Illinois with strong revenue growth. General Funds revenues in fiscal year 2007 totaled \$28.6 billion, nearly \$5.6 billion higher than the amount collected in fiscal year 2003. This reflects a trend increase of \$1.4 billion a year, or over 5.5% annually.

Yet, financial stability has remained out of reach. Illinois' spending in many programmatic areas has grown, but several key areas of governmental activity have not been addressed, leaving the state poorly prepared for the next economic downturn, a phenomenon that may already be underway.

Revenue Performance. Economic growth has provided Illinois with impressive revenue growth. Driven by strong income tax and sales tax receipts, Illinois' General Funds revenues in fiscal year

2007 were nearly \$5.6 billion, or 24% higher than in fiscal year 2003. This reflects a trend growth of \$1.4 billion a year, or 5.5% annually.

Fiscal year 2007 income tax collections exceeded fiscal year 2003 collections by 35%, while sales tax collections were 18% higher.

Fiscal year 2008 revenues initially were projected to total approximately \$30.2 billion, according to unofficial budget estimates. Although this estimate now appears unlikely, the state still stands to collect at least \$6 billion more in fiscal year 2008 than was received in fiscal year 2003.

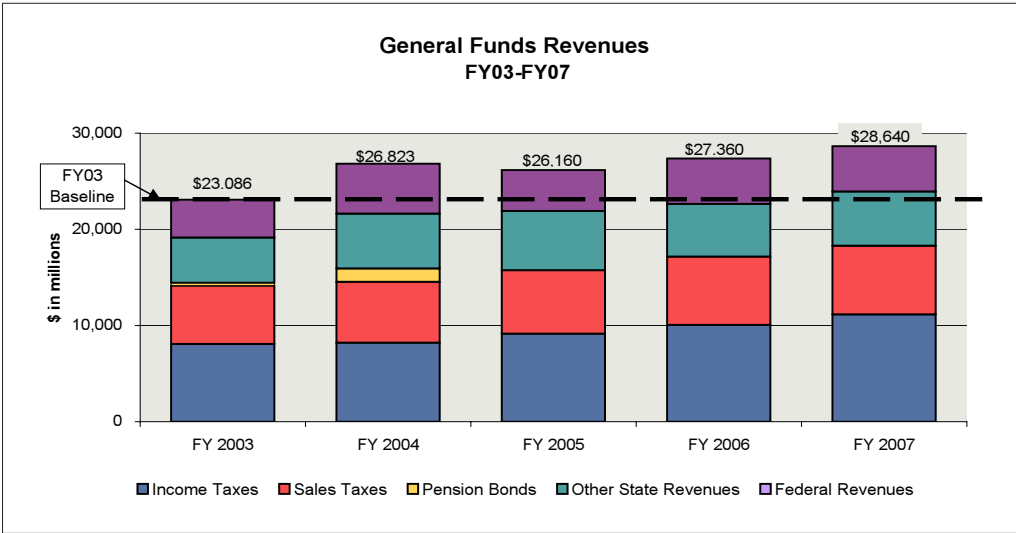
Appropriation Growth. As revenues grew, General Funds appropriations also have grown. The programmatic areas of elementary and secondary education and health care were the prime beneficiaries. Fiscal year 2008 appropriations from the General Funds total approximately \$27.5 billion, approximately \$5.2 billion higher than in fiscal year 2003, an increase of 23%.

The Department of Healthcare and Family Services' General Funds appropriations are up \$3.0 billion, or 59%. This increase is tied primarily to the state's Medicaid and other government subsidized health care programs, but is also partially due to the transfer of state employee health insurance costs to the department (totaling around \$1.06 billion of this total) from another agency.

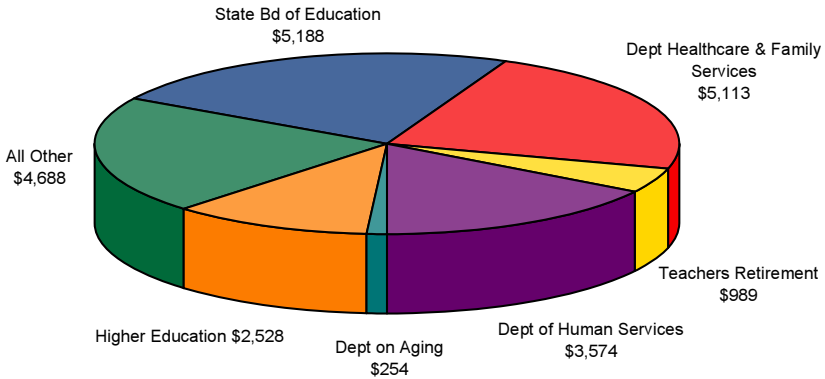
General Funds appropriations to the State Board of Education are up \$1.9 billion, or 37%, primarily to fund increases in the General State Aid foundation level and reimbursements for transportation and special education costs.

The Department of Human Services is up \$561 million, or 16%, for grants to service providers and for the costs of running the state's mental health facilities.

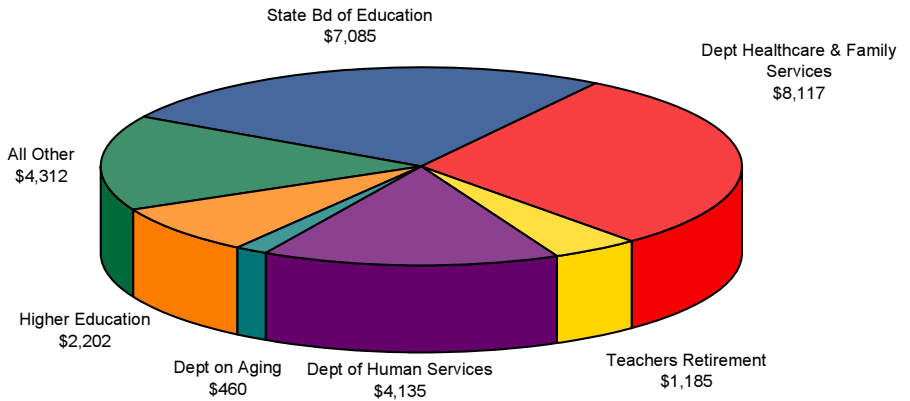
Appropriations to the Department on Aging are up \$205 million, or 81%, primarily for the Commu-



**Fiscal Year 2003 Appropriations
(\$ in millions)**



**Fiscal Year 2008 Appropriations
(\$ in millions)**



nity Care Provider program which provides assistance to seniors wishing to remain in their homes instead of going to a nursing home.

Notably, higher education is receiving less in fiscal year 2008 than in fiscal year 2003. Not surprisingly, tuition costs at public universities have risen steeply since then.

ILLINOIS TODAY

Fiscal Problems Persist. Even with the large growth in spending, several key areas have not been addressed.

- The state's five retirement systems remain among the most poorly funded in the country, while Illinois has done nothing to address the looming specter of retiree health care benefits.
- Health care costs have gone up without addressing the underlying problem of insurance coverage.
- At the same time, the state continues to abuse the loophole that allows Medicaid bills to be carried over into the next fiscal year – contributing to persistent structural deficits and payment delays.
- Although education has received significant funding increases, investment in education is still below recommended levels and the state's educational finance system has not been revamped.
- Tuition costs are rising – affecting college affordability – as the state's share of higher education funding has fallen.

Pensions. The funding level of the state's five retirement systems remains among the nation's lowest. The five state systems -- the State Employees' Retirement System (SERS), the State Universities Retirement System (SURS), the Teachers' Retirement System (for teachers outside of Chicago –

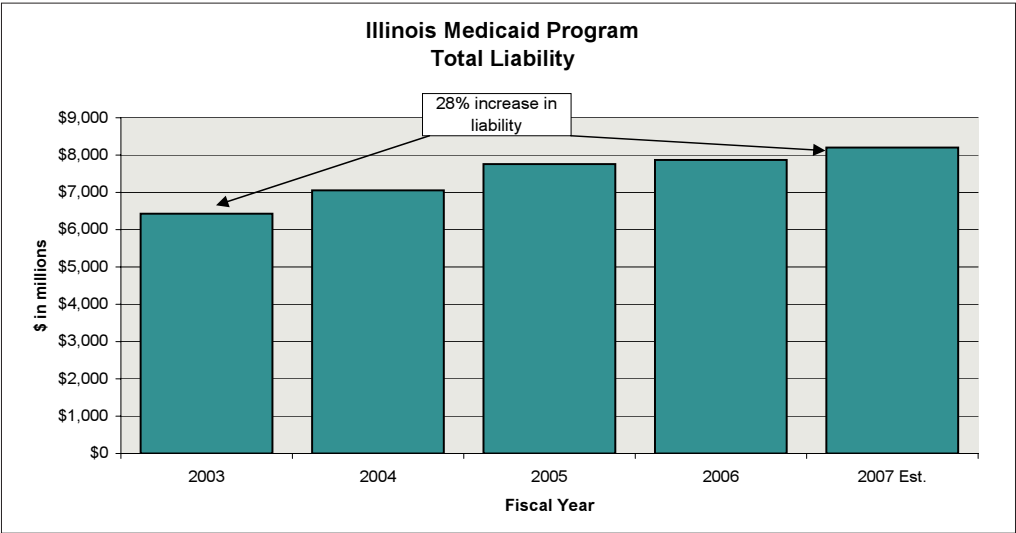
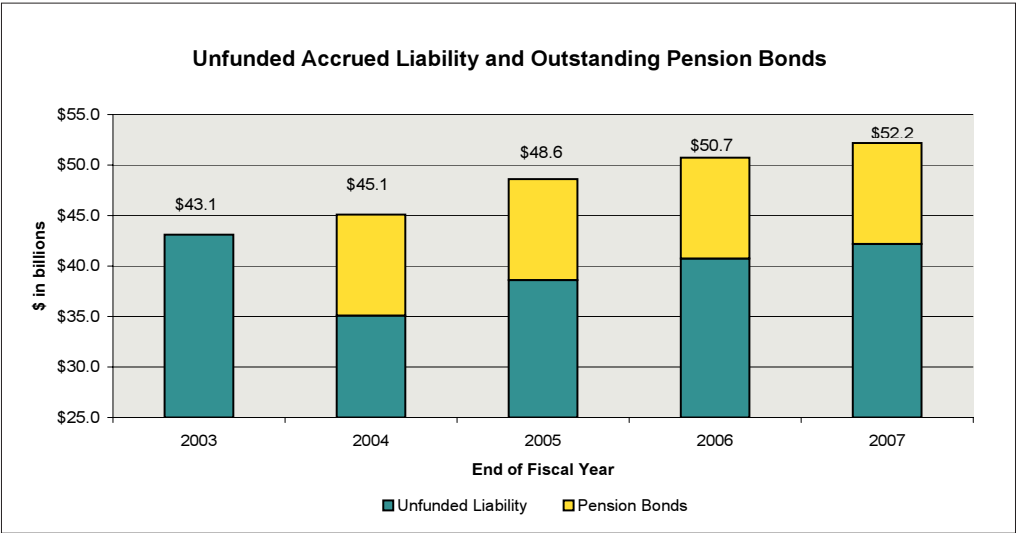
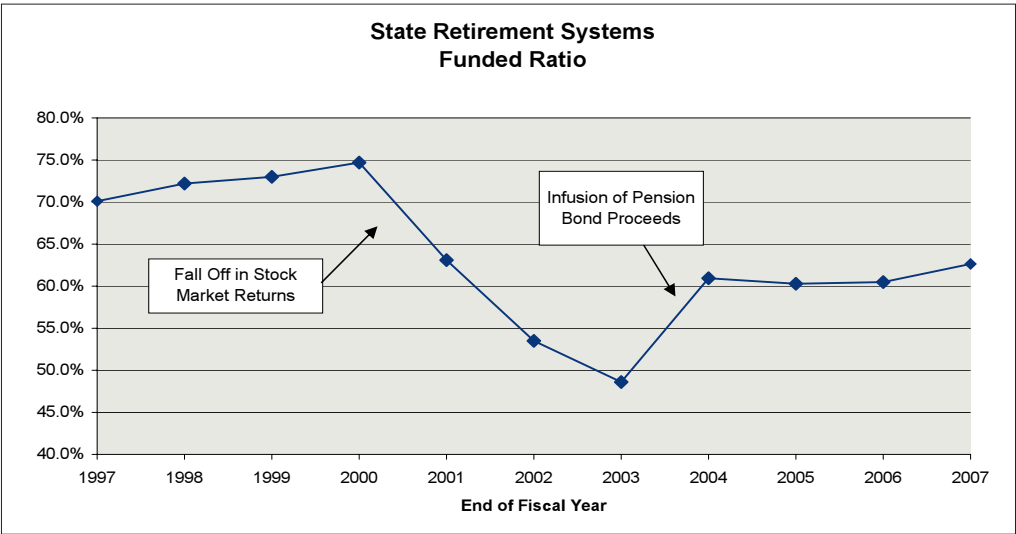
TRS), Judges' Retirement System (JRS), and General Assembly Retirement System (GARS) – were funded at a 62.6% ratio at the end of fiscal year 2007 (assets vs. liabilities). Even with the infusion of the \$10 billion pension funding bond proceeds into the system in July 2003, the funded ratio has failed to reach the highs seen prior to the last recession, where the systems' funded ratio reached 74.7%.

Meanwhile, the liabilities of the system (including the repayment of the bonds) have continued to grow. Illinois is also likely to face a multi-billion dollar liability for retiree health insurance benefits as those costs begin to be disclosed. This was estimated to total \$43 to \$53 billion in a report released in 2006 by the Civic Committee of the Commercial Club of Chicago. An official number is expected within the year.

Healthcare. Spending on state sponsored health coverage has grown significantly in the last few years. Liability of the state's Medicaid plan grew 28% between fiscal years 2003 and 2007. Services provided under the umbrella of state health insurance exceeded \$8 billion in fiscal year 2007. The spending would have grown even more rapidly had the federal government not begun providing drug coverage during this time frame.

While spending more on health care, the number of uninsured in Illinois has not changed significantly. According to the U.S. Census Bureau, approximately 1.76 million Illinoisans (13.9% of the population) were uninsured in 2003. In 2006, the estimate of uninsured was 1.78 million, or 14.0% of the state's population.

Continuing Deficits. The state's budget is persistently out of balance. At the end of fiscal year 2003, the state's GAAP deficit was \$4.166 billion. "Section 25 liabilities" (Medicaid and other health care bills carried over into the next year to be paid from that future year's appropriations) were over \$1.8 billion. At the end of fiscal year 2007, the GAAP deficit remained high– nearly \$3.6 billion,



according to preliminary unaudited estimates, with estimated Section 25 liabilities of \$3.371 billion. Unlike after the 1990s recession, there has been no significant reduction in these types of liabilities. Due to this condition, Illinois' GAAP deficit will likely retain its status as the worst in the nation and will fail to show the same level of improvement as seen in other states.

Additionally, Illinois' General Revenue Fund has had persistent payment delays since 2001 and has been on "cash management" status since then, meaning that on most days, there are insufficient funds available to pay pending bills at the Comptroller's Office. The General Revenue Fund cash balance has continued to remain far lower than the highs seen prior to the last recession.

K-12 Education. Elementary and secondary education funding levels have grown. Appropriations for General State Aid have increased on average 6.9% per year, and spending on other areas such as transportation reimbursements have also grown. However, even with the increases in elementary and secondary education funding, the state in fiscal year 2008 will still fall below the \$6,405 per-pupil foundation level recommended by the Education Funding Advisory Board for fiscal year 2006. Additionally, although there have been repeated legislative attempts to change the way that the state's schools are funded, the underlying system is unchanged, with persistent disparities in funding across the state's school districts.

Higher Education. Since fiscal year 2003, total state General Funds appropriations to public colleges and universities have dropped by \$326 million. While a portion of this decrease is due to pension cost reallocation, direct state support for four-year institutions has fallen at the same time that average tuition costs have increased well over 50%. This dynamic has significantly impacted the affordability and accessibility of a college education for Illinois students and their families.

LOOKING FORWARD

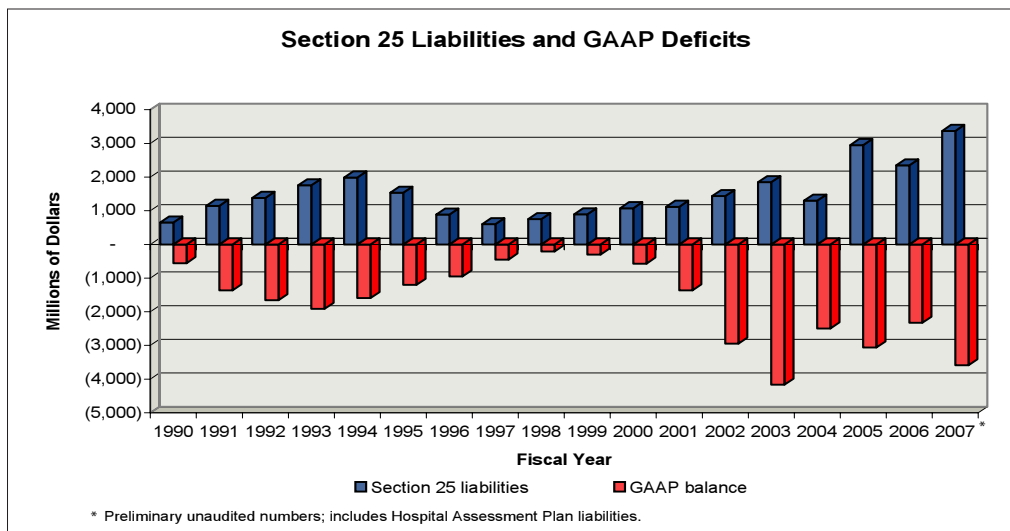
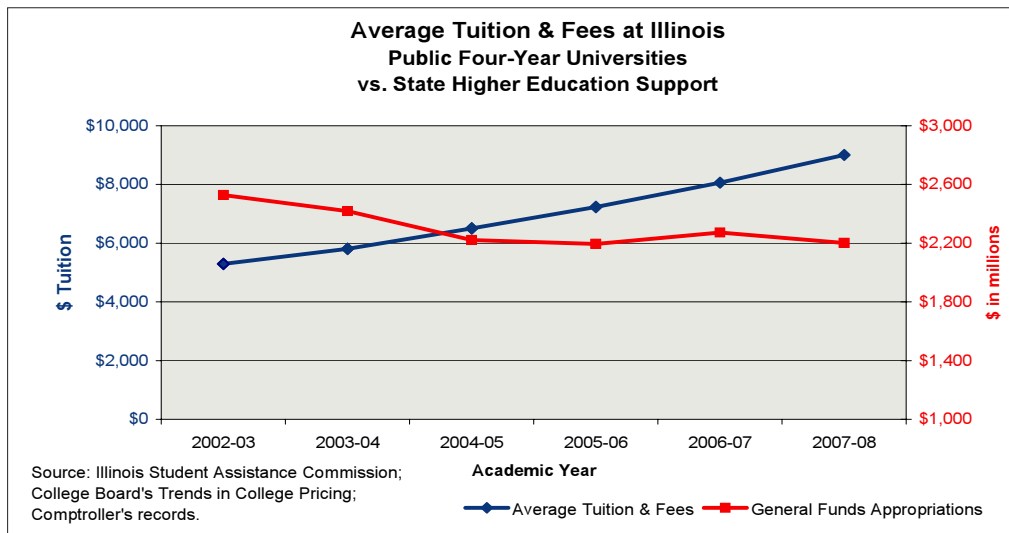
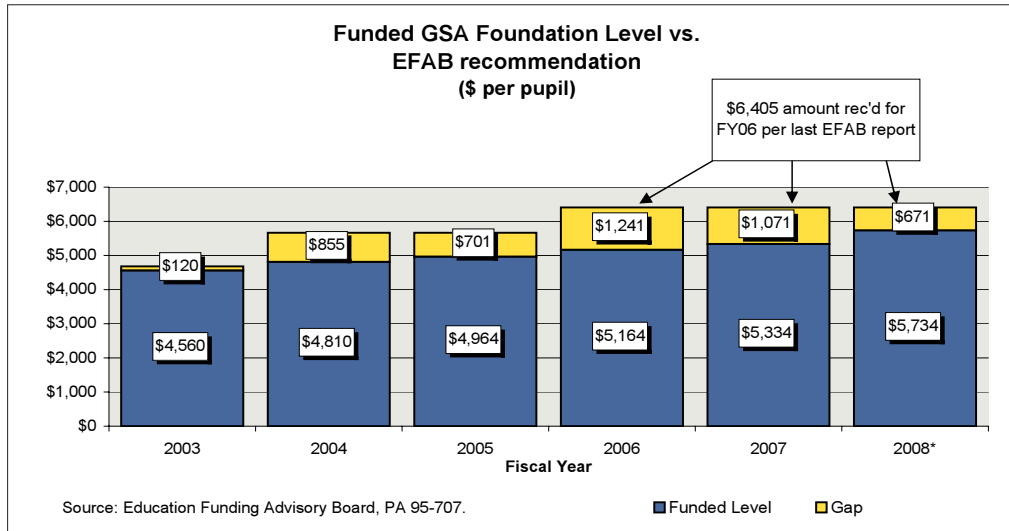
Looming Recession? Unfortunately, Illinois' era of relative prosperity appears to be ending. While other states have taken advantage of the "good times" to address problems, Illinois has not. Recent economic performance suggests that the time to act and address these problems may have already passed.

The legislature's Commission on Government Forecasting and Accountability (CoGFA) commissioned a study by Moody's Economy.com which predicts a 6 in 10 chance of recession this year. As reported in CoGFA's January 2008 monthly report, Moody's Economy.com also notes "97% of variations in the Illinois economy are related to variations in the national economy" and that the state's downswings are historically worse than the national averages.

At the end of January, the U.S. Commerce Department reports that the national Gross Domestic Product rate of growth in the fourth quarter of 2007 was substantially weaker than earlier in the year, with problems in the housing sector making a significant impact. Meanwhile, the Conference Board's measure of consumer confidence followed a downward trend during most of 2007. The Federal Reserve has resorted to major interest rate cuts in recent sessions.

State measures of economic performance are also troubling. Illinois' housing market saw a slowdown in 2007 as home sales in the state fell by 16.9% compared to 2006. The unemployment rate in Illinois (seasonally adjusted) rose to 5.5% in December 2007, up from 5.2% in November 2007 and from 4.1% in December 2006. This could lead to weakening individual income tax receipts in fiscal year 2009 and beyond.

Other state revenues appear to have already felt the impact of this slowdown. Sales tax revenues grew by only 0.8% over last year. Corporate in-



come tax collections have also slowed down, falling by 5.5% versus the first half of last year.

Fiscal Year 2008 Budget Out of Balance. With the lackluster performance of some of the state's major revenue sources, questions have arisen about the state's ability to reach the revenue projections reportedly used to craft the fiscal year 2008 budget. CoGFA has recently reported that they expect the state to struggle to reach the \$1.6 billion in revenue growth anticipated in fiscal year 2008, and may even face difficulty reaching \$1 billion in growth by the end of June. If so, the fiscal year 2008 budget will be significantly out of balance.

Further contributing to a fiscal year 2008 budgetary imbalance, the Medicaid program appears to be underfunded by at least \$220 million when compared to the Governor's original budget projections. However, the one-time drawdown of the accumulated balance in the Education Assistance Fund (one of the four General Funds) – authority granted in recent legislation – by up to \$500 million during the second half of fiscal year 2008 will partially offset the poor revenue performance.

Outlook for the Rest of Fiscal Year 2008. Payment delays and backlogs reached record levels at the end of the first half of fiscal year 2008. General Revenue Fund bills on hand at the end of December totaled \$1.72 billion, \$300 million more than was held halfway through fiscal year 2003. General Revenue Fund bills were delayed by 34 business days, well above the average seen at this date over the last few fiscal years. In mid-January, the Department of Healthcare and Family Services (DHFS) was holding \$1.3 billion in Medicaid bills, approximately \$300 million more than at this point last year.

Although the spring usually brings the strongest revenue months, collections are unlikely to be sufficient to eliminate the bill backlog, particularly given underperforming revenues. At this writing,

the bill backlog is expected to be more than half a billion dollars higher than at the end of fiscal year 2007.

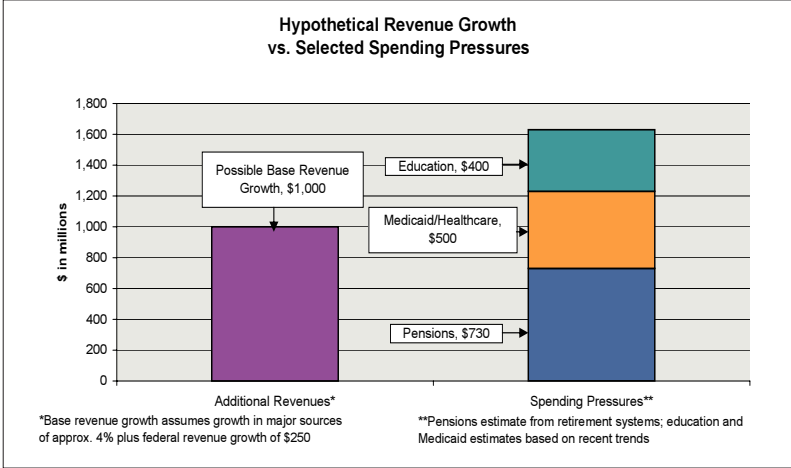
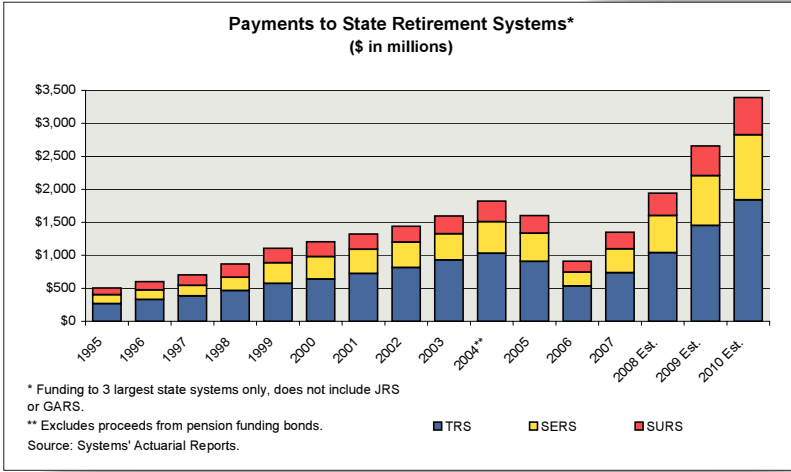
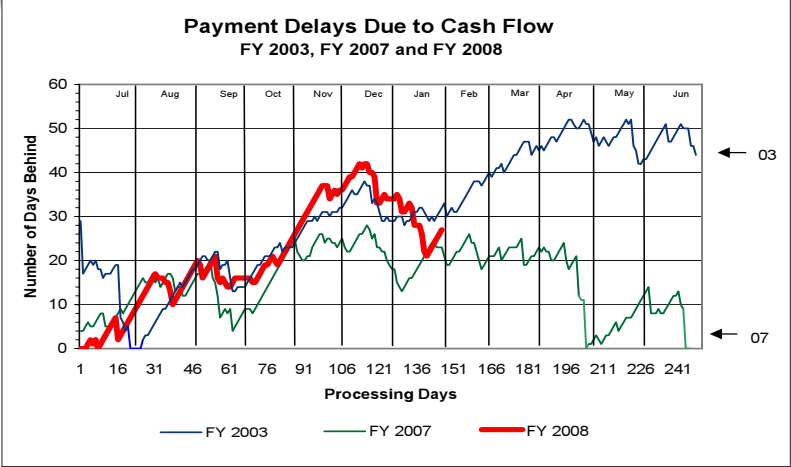
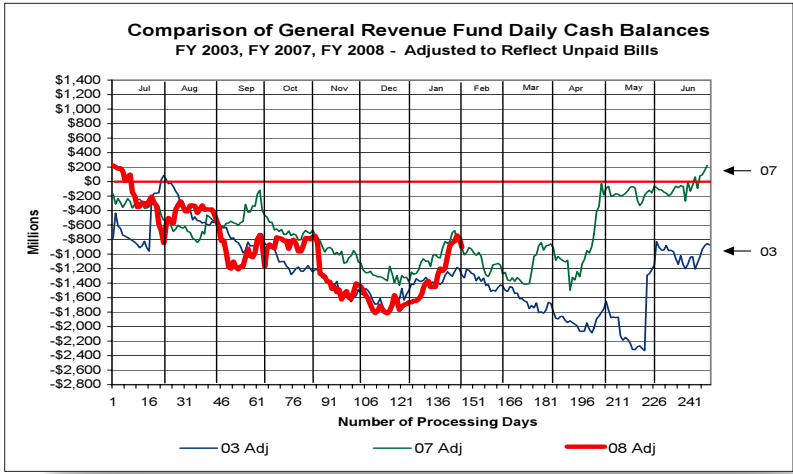
The projected amount of bills on hand at the Comptroller's Office does not include the expected Medicaid bills on hold at DHFS. Based on current expenditure trends, well over a billion dollars worth of bills are likely to be sitting at DHFS at the end of the year.

Fiscal Year 2009 Budget Development. The adoption of a fiscal year 2009 budget is likely to be difficult. Spending pressures for pensions, education and health care are expected to continue to consume all revenue growth. As shown in the accompanying graph, if fiscal year 2009 revenues were to grow \$1 billion, an optimistic amount given current economic trends, this amount would be insufficient to meet the spending pressures from pension costs, healthcare and education funding.

Pension payments are projected to continue to rise sharply under the requirements of the 1995 funding plan that was briefly sidestepped in fiscal year 2006 and 2007. Pension payments are certified to increase \$730 million for fiscal year 2009, an amount that exceeds the amount of the total contributions to the retirement systems in the mid-1990s.

If the state's Medicaid program grows at a rate around 6% as seen in recent years, then approximately \$500 million would be needed to cover the growth of liability projected for fiscal year 2009. Additionally, a spending increase of approximately \$400 million for elementary and secondary education is likely based on the trend in increases during the last few years.

Adding these three areas together, new revenues would need to total \$1.630 billion. It also does not include other common sources of spending pressure such as state employee health insurance, employee labor costs and higher education funding (to minimize tuition increases).



CONCLUSION

The fiscal outlook for Illinois is not optimistic. The state has failed to build up reserves or address the underlying structural problems of the state's budget – in particular, the pension and Medicaid liabilities. At the same time as the economy appears to be slowing, the Governor has promised expansions in health care without a permanent revenue source to pay for them. This lack of reserves – and the Medicaid and pension payments “albatrosses” – will be a drag on the state when it faces an inevitable economic downturn, likely already underway.