Alternatives to the Proposed Illinois Budget Cuts

A White Paper on Options to Address the Current Crisis

December, 2001

In the midst of the worst economic recession in over a decade, the state of Illinois is facing a significant budgetary shortfall. Estimates indicate that it will be at least $500 million in the current fiscal year, but it may be more. To eliminate the shortfall, Governor Ryan has proposed approximately $485 million in budget cuts.

While this will help close the revenue gap, the Center for Tax and Budget Accountability * (the **"Center"**) opposes the proposed cuts for two reasons. First, the proposed cuts may actually worsen the impact of the recession in Illinois. Second, and more importantly, there are better alternatives available to the state to balance it books.

Because the current recession is due in large part to excess industrial capacity that has resulted from decreased consumer purchasing, concerns that the proposed cuts will worsen the recession are valid. For example, the proposed budget cuts that eliminate pay raises, reduce payments for healthcare benefits, cut jobs by closing healthcare and prison facilities, reduce payments to healthcare providers and take financial benefits away from the elderly, disabled and low-income families, especially those with children, all take money out of the economy. This has significant potential to reduce consumer demand further, exacerbate the capacity problem, and worsen the recession.

In addition to worsening the recession, the proposed cuts do not appear to be necessary for the state to balance its budget. The Center, together with a coalition of more than 30 other organizations, have identified the following alternatives to Governor Ryan's proposed budget cuts. While not exhaustive, the alternatives identified in this white paper would allow the state to balance the budget and maintain an array of healthcare and other essential services, without taking money out of the economy during a recession.

1. Prescription Drug Purchasing Reform

Rising drug costs are a major contributor to the state's budget woes. In FY2002, Illinois will spend an estimated $1.5 billion on prescription drug purchases for state employee benefits, Medicaid, the Pharmaceutical Assistance Program and other agencies. This is a 16.2% increase over FY2001, costing Illinois an additional $200 million. Whether the economic times are good or bad, it makes sense for the state to implement cost savings in this significant budget line item.

The good news is, a simple method for generating meaningful savings exists – prescription drug purchasing pools.

* The Center is a bipartisan 501(c)(3) not-for-profit think tank committed to ensuring the Illinois tax system is both fair and sound.

Chain pharmacies, HMOs and governmental units like the U.S. Department of Veterans Affairs currently realize significant savings by pooling their purchases and bargaining for volume discounts. For example:

- Per item drug costs for the U.S. Department of Veterans Affairs average 35-40% less than the state's Medicaid costs and 50% less than retail costs; and
- Other states have recently developed purchasing pools to save on state drug expenditures, including Maine, the New England Tri-State Coalition, and Florida.

Illinois, however, is not taking advantage of any such program to generate substantial volume discounts on drug purchases. In fact, the state's prescription drug purchases are decentralized across agencies and even among programs within agencies. Compare that to Florida, which has a centralized drug purchasing plan that will save it $214 million in taxpayer money annually.

Adopted earlier this year, the Florida Medicaid Drug Rebate law allows that state to negotiate its own discounts on prescription drugs for Medicaid beneficiaries. The Florida plan has been approved by the Bush White House. Acting quickly to save tax revenue, the state already has negotiated discount agreements with Pfizer and Bristol-Myers Squibb. (Bristol-Myers agreed to discount $16.3 million of its $60 million in sales.)

HB2236, which passed the Illinois House of Representatives last spring and is now pending in the Illinois Senate, is designed to create similar budgetary savings in Illinois, while assisting senior citizens with their drug purchases. This legislation would create a Prescription Drug Purchasing Policy Office within Central Management Services that could pool the state's drug purchases and bargain for discounts similar to those provided to the federal government, large HMOs and other states.

If implemented this year, HB2236 could save the state an estimated $158 million on its annual drug expenditures. In other words, this simple reform would add $158 million to the state's General Revenue fund, eliminating the need for one-third of Governor Ryan's proposed cuts. It would transfer taxpayer money the state currently is overspending on drugs, to fund providing essential service programs that would otherwise be cut. A win-win situation.

2. Eliminate Significant Revenue Loss Illinois Stands to Realize from the Federal Repeal of the Estate Tax

Part of President Bush's tax package that Congress passed into law this spring repealed the federal estate tax. This repeal will be phased in over the next ten years. In addition to reducing the amount of revenue available to the federal government, the repeal of the federal estate tax will significantly reduce revenues in the state of Illinois.

That is because the Illinois Estate and Generations Skipping Transfer Tax - also known as the "Pick-Up" tax, is directly tied into the federal estate tax. As the federal estate tax phases out to zero, the state will realize a concomitant reduction in revenues from the "Pick-Up tax".

The amount the state stands to lose is significant. Without addressing the situation, Illinois will lose $100 million in revenue next year alone, and at least $365 million annually after the federal estate tax repeal is fully phased in. There is simply no reason why the state has to accept this significant revenue loss.

Fortunately, the remedy to the problem is a simple one. All Illinois has to do is decouple its Pick-Up tax from the phase-out of the federal tax, and predicate the Pick-Up tax on the old federal estate tax definitions existing as of January 1, 2001. Other states like Rhode Island have already taken this step.

The repeal of the federal estate tax was not debated in the Illinois legislature. There is no excuse for the Illinois legislature to allow the federal government to reduce the state's revenue stream unilaterally, especially when Illinois is facing significant shortfalls.

3. Use Unspent Member Initiative Funds to Close the Budget Gap

The current year's budget (FY 2002) included $209,122,788 in "reappropriations" for the Fund for Illinois' Future, commonly known as the "member initiative" fund. This is not new (FY 2002) General Funds revenue, but rather unspent appropriations previously authorized for this fund and carried forward from prior fiscal years.

According to the Comptroller's web site, which is updated daily, as of November 29, 2001, only $79 million of these funds have been spent or encumbered. This leaves a balance of over $130 million that is neither spent, nor "encumbered." "Encumbered" funds simply means money identified to a specific project. Most (if not all) of the projects that would be funded from this balance can be deferred until the state's fiscal situation improves.

Moreover, the programs Governor Ryan proposes to cut have been approved by the full General Assembly, while projects under consideration for Member Initiative funding have not been and never will be approved by the full legislature. It is difficult to justify spending taxpayer money on new, pet-projects hand picked by legislative leaders without any public debate, when we are cutting essential services that have already been approved by the full Assembly.

By delaying or reconsidering these projects, the state could save up to $130 million for its current year budget, and eliminate the need to make 26% of Governor Ryan's proposed cuts. While this is a one-time source of revenue, it could help tide the state over until the economy recovers.

4. Closing Unnecessary Corporate Tax Loopholes

The Illinois tax code contains numerous special tax exemptions for specific corporations and types of business. Many of these have been on the books for years and have long outlived their purported purpose; others simply advantage specific companies over others. **Together they drain over $500 million each year from Illinois corporate income and sales tax receipts.** It is time to revisit these taxpayer subsidies of private enterprise, to ensure we are getting a real bang for our investment.

The Single Sales Factor Method of Computing Illinois Corporate Income Tax. Illinois recently changed its method for determining the corporate income tax, from a three-part formula to the single sales factor. Under the single sales factor, corporate income taxable in Illinois is determined solely on the basis of that company's in-state sales. Under the prior method, in addition to sales, the value of a corporation's property and payroll in Illinois were weighed in determining how much of that company's income was subject to Illinois Corporate Income Tax and Corporate Personal Property Replacement Tax.

Under the single sales factor method, large, multinational companies who already have a strong presence (facilities and employees) in Illinois, and are therefore the largest beneficiaries of state services, receive major corporate income tax cuts. Compare that to small mom and pop shops, who principally make all their sales in the state, and therefore receive no benefit from the tax law change.

Illinois companies reported in local news coverage to have gained multi-million dollar tax windfalls from the single sales factor included Motorola, Archer Daniels Midland, Caterpillar, R.R. Donnelly, John Deere, Abbot Labs, SBC/Ameritech, and BP/Amoco. According to a report issued by then Illinois Comptroller Loleta A. Didrickson, 32 companies were projected to gain at least $1 million per year in tax savings. Overall, 7,014 corporations were estimated to have their state tax burden reduced by $217 million per year, while 7,586 "losers" would pay $122 million more. **This resulted in a net tax revenue loss to the state treasury of $95 million in the first year the single sales factor was law. Simply going back to the prior method of determining the Illinois income tax for corporations will eliminate the need to make 20% of the cuts Governor Ryan proposes.**

Single Sales Factor was "sold" as an economic development policy. However, there is no compelling evidence that the change in how Illinois apportions the income of multi-state corporations for tax purposes resulted in any economic growth. In fact, many of the companies benefiting have laid-off thousands of Illinois workers and/or have been purchased by out-of-state or foreign-owned companies.

The only study supporting the measure was paid for by the Illinois Manufacturer's Association and has not been subjected to peer review. University of Illinois Economics Professor J. Fred Giertz -- a longtime observer of state fiscal policy -- has analyzed the

IMA's paper and concluded that "the estimates (for job creation) are simply not credible...I do not believe that their statistical model is capable of isolating the impact of apportionment formula changes with the precision they report."

Net Operating Loss Deduction, Illinois Corporate Income Tax. **This loophole, which cost $126 million in FY 2000, was added to the Illinois tax code in 1986.** It allows companies with Illinois Income Tax liability to carry net operating losses back 2 years or forward 20 years, against positive base income allocable to Illinois in other tax years. This loophole tracks federal tax policy, but many states have different provisions. For example, about half of the states (24) do not allow corporations to carry backward losses for any amount of time. Sixteen states allow losses to be carried forward much less than the 20 years allowed in Illinois.

It is time the state considered whether this corporate income tax loophole is serving any legitimate purpose, or simply costs the state revenue with no corresponding benefit.

Sales Tax Exemption on Manufacturing Equipment and Machinery. **This tax break went into effect in 1979, and cost over $143 million in FY 2000.** States that made the same move did so fearing that they would not be "competitive" in attracting manufacturing. However, most studies show that state tax policies are a negligible factor in business location decisions -- far more important is the quality of a state's public education, workforce, and infrastructure. Illinois should focus on ensuring it has the revenue to provide the type of state infrastructure that is actually attractive to businesses, rather than engaging in dubious public subsidies of private enterprise.

Retailer's Discount. The Retailer's Discount was enacted in 1959, to reimburse businesses for the burden of computing and collecting the amount of state sales tax that applied to their sales. Under the statute, retailers keep 1.75% of the sales tax they collect. **In 2000, over $102 million of tax revenue was retained by retailers to offset the cost of collecting sales taxes.**

While this discount served a legitimate purpose when it was enacted, its value is questionable today. Before the advent of automated record-keeping, Illinois sales tax collection, accounting, and remitting was a laborious process. But with computerized collection and accounting systems prevalent today, the cost of collecting sales taxes, especially for large retailers, is built into standard accounting systems and is therefore negligible. In fact, many businesses actually make money on "the float" -- sales taxes are deposited in interest-bearing accounts before being remitted to the state.

Twenty-four states currently do not provide any discounts for the collection of sales taxes. Of the 26 that still have these outmoded discounts, 10 have caps on the amount of discount to assure that large businesses do not benefit beyond reasonably expected costs.

Restructuring the discount to better reflect actual collection costs is easy. Simply cap the discount at 1.75% of the first $1 million in sales taxes collected by retailers ($17,500 per year).   This will preserve the discount for small businesses while greatly reducing the cost of this tax expenditure to Illinois taxpayers.

Subsidizing the Racetrack Industry. The state of Illinois is currently using taxpayer money to subsidize the horse track racing industry. This use of public money comes in a combination of tax breaks and direct subsidies. According to both the Economic and Fiscal Commission and the Illinois Racing Board, the value of this subsidy is $38 million annually.

It is unclear how state government can justify continuing to subsidize gambling in Illinois while closing prisons and healthcare facilities. These tax expenditures and subsidies should be eliminated.

5. Pending Assistance from Federal Economic Stimulus Legislation

Congress is currently debating the final shape of economic stimulus legislation designed to jump-start the national economy as well as assist individuals and states hard hit by the economic downturn. The Economic Recovery and Assistance for American Workers Act of 2001, sponsored by Senator Max Baucus and supported by a majority in the U.S. Senate, would increase federal assistance to the Illinois Medicaid program. **According to Federal Funds Information for States – 2001, under this proposal, Illinois would receive an additional $250 million towards its current Medicaid obligations.** Our political leaders should rally behind this important effort – and generate a quarter of a billion dollars for the state.

6. Other Emergency Measures

The current budget shortfall is due in large part to a temporary crisis caused by the national economic slowdown. Most mainstream economists are predicting a recovery by the beginning of the next state fiscal year. While it is better, and more responsible, to enact long-term revenue enhancements, short-term measures like those outlined in this White Paper are preferable to closing state facilities and implementing other long-term service reductions. Put another way, a temporary measure ends when the crisis ends, a permanent service cut or facility closure is gone forever.

Other emergency measures the state could consider include short-term borrowing (especially in a period of a extremely low-interest rates), temporary fee hikes or other limited revenue enhancements, drawing down the year-end balance, or implementing a tax amnesty to increase the rate at which the state collects its unpaid tax receivables.

Alternatives to the Proposed State of Illinois Budget Cuts
(estimated annual savings)

1. Prescription Drug Purchasing Reform	$158,000,000
2. Corporate Tax Loopholes	
Single Sales Factor	$ 95,000,000
Illinois Net Operating Loss Deduction	$126,096,000
Manufacturing Equipment and Machinery	$143,600,000
Retailer's Discount	$102,950,000
3. Fund For Illinois' Future (one time)	$130,000,000
4. Federal Economic Stimulus Assistance	$250,000,000
5. Other Emergency Measures:	?
TOTAL	**$1.006 billion**