The Potential Impact of COVID-19 on School Funding in Illinois

Robert G. Grossi, Ed.D.

April 9, 2020

The following report contains the expressed opinions, projections and recommended actions of Robert G. Grossi. Dr. Grossi does not have any inside information on any matters pertaining to potential legislative action or potential actions of ISBE or any other authoritative entity.

A Cause for Concern

The State of Illinois' fiscal vulnerability to the COVID-19 pandemic compares to the health vulnerability of an elderly person with multiple preexisting conditions. Days prior to the crisis, the Illinois General Assembly's Commission on Government Forecasting and Accountability (COGFAS) reported a backlog of outstanding bills in the State's General Fund of $7.6 billion, interest and penalties for late payments in the 2019 calendar year of $470 million and cited that the State of Illinois was one of the few states in the country with a shrinking tax base.

Additionally, the December 2019 Report of the State Actuary noted that the State pension systems were grossly underfunded. It stated that "continuing the practice of underfunding the systems increases the risks of needing even larger contributions in the future that make the systems unsustainable" and that the inadequate funding of the pension systems will continue to crowd out other funding needs until the situation is rectified. As of June 30, 2019, the unfunded liabilities of the State retirement systems totaled $137 billion, led by TRS, whose unfunded liability was about $78 billion.

In assessing the impact of the potential recession from the virus, the COGFAS reports that general operating revenues could decrease almost $2 billion and more than $8 billion over several years, depending on the severity and length of the virus-triggered recession. This estimate is based on data from prior recessions.

On April 3, 2020, S&P Global Ratings cut its outlook for the State's general-obligation bonds to negative, citing at least a one-in-three chance that economic conditions will worsen enough to affect Illinois' ability to stay in line with the investment-grade rating level. In other words, Illinois' credit rating may possibly move to junk status. At the time of this report, Illinois municipal bonds values are plummeting. Illinois has suffered over 21 downgrades since 2009 and has the lowest credit rating of any state in our country. The State must and will do whatever it takes to avoid this crippling embarrassment. To assume that the solution will not dramatically impact school funding is ill-advised.

Without a substantial bailout from the federal government, the State could be in an immediate fiscal crisis. Even with a substantial bailout, the long-term impact of lower income and sales tax revenues into the State's already depleted treasury would require a proportionate reduction in expenditures out of the State's treasury to maintain a structural balance.

Potential Impact of the COVID-19 Crisis on the Financial Condition of School Districts

Fiscal Year 2020

The short-term financial impact of the COVID-19 crisis will likely be positive for school districts. More than likely, expenditures will be under budget as the operational costs of running a school without student and staff attendance is lower than if fully operational. In addition, it is likely that school districts will receive funds from the Coronavirus Aid, Relief, and Economic Security Act (CARES) during this fiscal year. The following is a link of the estimated payments school districts will receive from this program:

https://www.isbe.net/_layouts/Download.aspx?SourceUrl=/Documents/Est-Prelim-CARES-Act-Emergency-Relief-LEA-Allocations-3-31-20.xlsx

In terms of state revenues, ISBE has committed to make all Evidence Based Funding (EBF) payments to school districts in a timely manner through the remainder of the fiscal year. It is uncertain as to when the State will release its categorical payments. As of the date of this report, the State of Illinois has made one of four categorical grant payments from the 2020 project year. In the prior fiscal year, Illinois school districts received the second categorical payment in mid-April and the third payment in mid-May. I have no information on the status of these payments, but it is certainly possible that payments will not be made prior to the end of this fiscal year.

Fiscal Year 2021

Expect the State of Illinois to adopt a six-month budget that will fund EBF for the first half of the fiscal year at levels similar to those paid during fiscal year 2020. Then, based on an assessment of the financial impact of the COVID-19 crisis and the result of the progressive income tax question on the November 2020 state-wide ballot, the State will adopt a budget for the second half of the year. As of this moment, I would budget EBF dollars to be flat for FY 2021. In terms of State categorical payments, I would budget receiving whatever was due from the 2020 project year and maybe one payment from the 2021 project year.

In projecting the impact of the virus-induced recession on real estate tax revenues received during fiscal year 2021 and beyond, I see four areas of impact on school districts:

1. Tax bill due dates may be pushed back as a form of relief to residents and businesses. For most school districts, the impact of this delay will merely be a loss of interest earnings. However, those school districts without healthy fund balance reserves may need to issue tax anticipation warrants or other forms of debt to cover payroll and accounts payable. An important point: This will affect more school districts if tax bills are due after the due date of principal and interest payments on the district's outstanding debt.

2. Tax collection percentages may decline, especially for school districts with populations of low-income residents or vulnerable businesses which may not survive the crisis. School districts should factor in this possibility when developing real estate tax revenue budgets for FY2021 and within their long-term projections.

3. Expect an increase in tax appeals, which would have the greatest impact on school districts with large commercial/industrial tax bases. It appears that Cook County will now be reassessing the entire county rather than just the South Triad and is also planning on expediting the appeals process. This can greatly impact appeals in all three triads of Cook County. Note that reassessments and tax appeals that are processed prior to the calculation of the tax bill will not impact tax revenues if a school district is in a tax-capped county and the district levies appropriately.

4. The crisis will significantly raise the probability of a state-wide property tax freeze as legislators will be hard pressed to not support relief to their voters who are unemployed or suffering otherwise. If I was preparing a long-term financial projection today, I would include a property tax freeze in my "most likely" scenario.

Impact to School Districts Beyond FY 2021

Prior to the COVID-19 pandemic I was concerned about the future of school funding in Illinois. I am now deeply concerned about the long-term ability of the State of Illinois to fund approximately 850 school districts at an appropriate level. There are many positive attributes of the EBF formula, primarily the fact that new dollars entering the formula go first to those school districts defined as "most in need." This has resulted in many struggling school districts now having significantly more resources to address the needs of their students.

The challenge of the EBF formula is that there is a huge gap in the amount of funds needed to achieve "adequate funding" as compared to how much funding the State of Illinois can afford. Attempts to significantly close this gap have created a financial stress on the State that has and will manifest into dramatic and systematic changes to Illinois fiscal policy. Since 2017, the State of Illinois has increased its annual funding level for school districts by over one billion dollars. Additionally, the EBF formula reflects that many more billions of dollars are needed to get schools to an adequately funded level.

The State was never in a financial position to provide this level of funding increase, even in $300 million annual increments. Partially due to this stress, the State was forced to legalize marijuana, legalize gambling, consider a progressive income tax and place a heightened emphasis on consolidating school districts.

A substantial downturn of the State's economy will expand the gap between EBF funding needs and the State's ability to fund those needs. Not only will sales tax and income tax revenues fall, but an extended crisis will likely generate an expansion of government supported health care and social services, further squeezing budgetary dollars from education. In addition, pension costs can increase dramatically if investment returns within the pension portfolios drop.

Without a substantial increase in the State's tax base via economic growth, which seems unlikely now, the following are some options that most likely will be considered by the State to resolve its crisis. I have added my probability of each option's implementation:

1. **A tax increase at the State level.** If a progressive income tax passes, State revenues are projected to increase (assuming same size tax base). A progressive income tax system would make it easier to approve future tax increases as those increases can be targeted to higher or middle-income taxpayers. The State must be cautious about raising taxes, as this action could further shrink the State's fragile tax base. **Probability:** The passage of the progressive income is uncertain. If the State strategically pairs the vote

with property tax freeze legislation, the probability rises. Other tax increases are highly unlikely given the current economic climate.

2. **Consolidate school districts**. It is not accurate to make a blanket statement that consolidation would not lower the cost of providing education to the almost two million students attending Illinois Public Schools. The design of the consolidation plan will determine its efficiencies and the State is looking hard at this option. **Probability:** The likelihood of forced consolidation or a plan with significant incentives for voluntary consolidation as a result of this crisis is higher than its been in my 30+ years of working in public education.

3. **An old-fashioned pension shift**. If the State does not have the funds to both address its pension crisis and fund EBF, something must fill the void. The State would save about $1 billion annually by shifting pensions to school districts. Would the optics of shifting the pension obligation versus cutting EBF dollars by $1 billion be more attractive to legislators? **Probability**: The likelihood of both a pension shift and a significant decrease in EBF dollars is unlikely. The likelihood of one of those actions occurring is absolutely possible.

4. **Decrease EBF dollars**. While politically challenging to approve a budget that lowers funding to education, the State has a history of decreasing funding when the funds are not available. Let's not forget that the State of Illinois prorated general State-aid every year between 2010 and 2016, with a low funding rate of 87.1% in fiscal year 2015. The ability to link the difficult decision to decrease educational funding to the COVOD-19 crisis rather than poor fiscal practices, makes the decision more politically viable. **Probability:** I believe that there is a higher probability that the solution package will include some combination of school consolidation, pension shift and EBF funding decrease versus a tax increase in the State's final plan to better align State revenues to expenditures.

Decreasing EBF Dollars and the Impact on School Districts – Methodology

While the legislative language on the process of allocating EBF dollars is confusing, the following is my interpretation of the allocation and reduction process of EBF dollars under various scenarios:

Increase in EBF by $300 million:

50% of new money ($150 million) goes into Tier 1
49% of new money ($147 million) goes into Tier 2 (Distributed to Tier 1 and Tier 2 schools)
.09% of new money ($2.7 million) goes into Tier 3
.01% of new money ($300,000) goes into Tier 4

Increase in EBF by $150 million:

$150 million goes into Tier 1
$0 goes into Tier 2
$0 goes into Tier 3
$0 goes into Tier 4

No New EBF Dollars: (Flat versus previous year)

All school districts receive the same level of funding that they received the previous year

EBF funding decreases - Methodology

Phase One: Tier 3 and Tier 4 school districts get reduced on a per pupil basis equivalent to the total number of the Average Student Enrollment (ASE) in Tier 3-funded and Tier 4-funded districts divided by the total reduction in State funding. The reductions in this phase may not result in a school district receiving less than the Base Funding Minimum established in the first year of EBF. Since Tier 3 and Tier 4 schools have received approximately $6 million since the base year of EBF, the first $6 million would be taken from Tier 3 and Tier 4 school districts. This equates to a reduction of about $47 per ASE per district for those districts in Tier 3 and $2.50 per ASE per district for those districts in Tier 4. I believe that if a school district in Tier 3 or Tier 4 received a boost in their EBF funding through the property tax relief grant, those funds would be taken from their EBF funding at this point as well.

Phase Two: Additional reductions will affect all school districts in all Tiers on a per pupil basis equivalent to the total number of the ASE in all Tiers divided by the total additional reduction in State funding. Since the total ASE State-wide is approximately 1,637,000, every $100 million in EBF reductions will decrease funding to all school districts by approximately $61 per ASE per district. In other words, if a district has an ASE of 1,000, it would see a reduction of approximately $61,000 for every $100 million of EBF reductions.

Recommendations

Development of Financial Projections

All school districts should consider running financial projections under three scenarios:

(1) Best-Case Scenario – No property tax freeze (2% CPI). EBF funding continues to grow at $300 million State-wide.
(2) Most Likely Scenario – Property tax freeze beginning with 2019 tax year. Tax collection percentages are down dependent on the district's exposure to defaults and appeals. EBF dollars are flat versus FY2020.
(3) Realistic Worst-Case Scenario - Property tax freeze beginning with 2019 tax year. Tax collection percentages are down based on the district's exposure to defaults and appeals. Either EBF dollars are decreasing beginning in FY2021 or a gradual pension shift. (To estimate pension shift impact, take the district's on-behalf payments from the audit and phase that amount into the district's expenses over a 5 to10-year period).

Note that scenario three is a realistic worst-case scenario. It is possible that a scenario would unfold that would be worse, but at this moment, I view the described scenario as a realistic worst-case scenario.

Collective Bargaining Agreements

Unless a school district can settle on an agreement that ensures fiscal stability even under a realistic worst-case projection, the school district should consider rolling over the contract for a short period of time until the impact of the economic downturn on school funding is better known. If the school district enters into a multi-year contract, strong consideration should be given for a clause that readjusts increases or reopens negotiations based on a negative event such as a property tax freeze, a pension shift or a significant, defined decrease in EBF dollars.

Capital Projects

School districts should strongly consider either addressing only those capital projects deemed critical or paying for major capital projects through the issuance of bonds. Preservation of fund balances should be viewed as a critical goal to carry a school district through this crisis with minimal impact on student learning.

Increasing Staffing or Programs

School districts should maintain a commitment to improving student learning through best practices. Continue to allocate resources in the areas of staffing and programs as needed. If the district's financial condition erodes, it is easier to remove added staff or programs versus recapturing money lost in a collective bargaining agreement.

Cash Flow

There is a significant possibility that real estate tax collections could be delayed by 1-3 months. Perform a cash flow analysis to determine if the district may need to issue tax anticipation warrants to cover payroll, accounts payable and possibly bond payments. If vulnerable, begin conversations with your municipal advisor or bond counsel as soon as possible to gear up for the possibility of a swift issuance. This is prudent even if the district ends up not having to issue the warrants. Additionally, schools should immediately focus on ensuring the availability of liquid funds to cover expenses throughout the anticipated tax delay period. This may be the time to sacrifice higher interest earnings and keep funds in money market and short-term investments rather than illiquid, longer-term higher yielding securities.

Focus on "Return on Investment" When Making Budgetary Decisions

This is not the time to slash expenses which provide value to your students. It is the time, however, to consider slashing expenses that do not provide value. As the district makes major financial decisions, it must focus on "Return on Investment" measured as the amount of student learning value per dollar spent. Spend wisely.

Advocate for Solutions to This Crisis Within the Arena of Reality

Too often in my 30+ years of involvement with school finance I have witnessed school districts put all their energy on opposing a legislative proposal rather than being involved in improving the legislation. Consequently, when passed, the legislators have completely defined the terms of the new law. I recommend school districts stay ahead of issues and get involved in the solution. For example, if there must be consolidations, then districts should be involved in molding that legislation. If there must be a property tax freeze, they should do the same. Perhaps the strategy needs to be to oppose first, but if the train is moving downhill, it is prudent to jump onboard and guide its direction. School districts do not want anything dramatic to happen legislatively, but I contend that something dramatic will happen regardless of whether we oppose the measure or not. School districts should have their fingerprints on the final product.

Summary

Today is the most pessimistic I have ever been on the long-term future of school funding in Illinois. The State of Illinois is extremely vulnerable to this economic crisis created by the COVID-19 pandemic. In order to survive, the State may be forced to take dramatic action, likely in the form of a package that includes a combination of school district consolidations, pension shifts and decreases in EBF funding. Additionally, our taxpayers are currently out of work or out of business, increasing the likelihood of a property tax freeze, decreased tax collections and increased tax appeals. Without a massive bailout from the federal government, combined with a rapid and substantial economic recovery, something significant will happen which will impact the financial condition of all school districts in Illinois.

Fortunately, at this moment in history, school districts have generally been able to strengthen their financial condition by increasing fund balance reserves and balancing budgets over the past several years. This allows school districts some time to adapt to the crisis. However, school districts must begin to consider the possible long-term effects of the crisis and must ensure sufficient resources are available not only for the students they currently educate, but for those who will come after them. This crisis must be taken seriously, and school districts must redouble their efforts to spend every dollar wisely and be involved in the decisions coming out of Springfield which will impact their school district.