The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

# STATE OF ILLINOIS FY2018 BUDGET ROADMAP:

## *State of Illinois Budget Overview, Projections and Recommendations for the Governor and the Illinois General Assembly*

**February 10, 2017**

The Civic Federation • 10 N. Dearborn Street • Chicago, IL 60602 • civicfed.org

*The Civic Federation is an independent, non-partisan government research organization working to maximize the quality and cost-effectiveness of government services in the Chicago region and State of Illinois.*

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## EXECUTIVE SUMMARY

This report describes the State of Illinois' fiscal condition and presents the Civic Federation's proposed five-year plan to stabilize the State's finances. The report is published before the Governor's annual budget address for consideration by the Governor and General Assembly during upcoming budget deliberations.[1]

For over 19 months Illinois has continued to operate without a full-year, comprehensive budget. This prolonged delay— unprecedented in recent history—is the result of a political struggle between Democratic legislators who control the General Assembly and a Republican Governor who took office in January 2015. As of the publication date of this report, there is no clear end in sight to the standoff.

Illinois' current financial predicament stems from a continuing failure to deal with the fiscal cliff caused by the partial rollback of income tax rates in January 2015. Instead of increasing revenues or significantly cutting spending, State officials closed the budget gap in FY2015 mainly by using budgetary gimmicks and one-time revenue sources. An Illinois Supreme Court ruling in May 2015 sharply limited options for reducing the State's overwhelming pension costs.[2]

The absence of full-year budgets in FY2016 and FY2017 has done nothing to alleviate the resulting structural imbalance, and unpaid bills have continued to accumulate. Even without a complete general operating budget, Illinois government has continued to function because of court orders, consent decrees and statutory requirements. State employees have been paid due to a court ruling in July 2015. Public schools have remained open because the only full-year spending bills that have been enacted are for elementary and secondary education.

A stopgap appropriations package—signed on June 30, 2016 and expiring on December 31, 2016—provided partial relief for most areas of government that had received little or no State funding: higher education, human services and agency operations. But it did not cover employee group health insurance, which has not obtained general operating funds since the deadlock began.

With the State continuing to accrue expenses that exceed revenues, the total backlog of unpaid bills rose to $10.9 billion at the end of December 2016.[3] State group health insurance bills accounted for about $3.9 billion of the total, with some of the claims nearly two years overdue.[4] If Illinois authorized enough additional spending to cover FY2017 services at close to historical levels, more than 40% of projected FY2018 revenues would need to be used just to pay

[1] Governor Bruce Rauner is scheduled to present his budget proposal for FY2018 on February 15, 2017. The State of Illinois' fiscal year begins on July 1 and ends on June 30.

[2] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015. A prior Illinois Supreme Court opinion, Kanerva v. Weems (2014 IL 115811, July 3, 2014), blocked the State from reducing retiree health insurance benefits.

[3] State of Illinois Governor's Office of Management and Budget, *Bills Outstanding – Summary*, https://www.illinois.gov/gov/budget/Documents/Bill_Backlog_Presentation_%201.15.17.pdf (last visited on February 9, 2017).

[4] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Monthly Briefing for the Month Ended: January 2017*, p. 16, http://cgfa.ilga.gov/Upload/0117revenue.pdf (last visited on February 9, 2017).

outstanding bills and other commitments.[5] Balancing the FY2018 budget through cuts alone would require a more than 26% reduction in net agency expenditure from projected FY2017 maintenance levels, and more than 18% from FY2015 levels.

The delay in acting on the State's fiscal problems means that the measures taken now need to be more dramatic and the resolution of the crisis will take longer. The Civic Federation's comprehensive plan would substantially reduce, but not eliminate, the FY2017 operating deficit. However, beginning in FY2018 the State would have budget surpluses that would cover debt service for bonds issued to pay off the backlog of bills. After debt service is complete in five years, Illinois could build reserves at a level sufficient to weather the next economic recession.

Spending controls are at the center of the Federation's plan, but more revenue is also needed to close the FY2018 operating deficit and pay off the State's accumulated bills. It is not responsible to assume that net agency spending could be cut from historic levels by over 18% in one year. It is also imprudent to continue carrying over billions of dollars in unpaid bills from one year to the next, using revenues from the current year to pay off the previous year's bills and limiting the State's ability to cover unexpected shortfalls.

**Civic Federation Recommendations**

The Civic Federation offers the following recommendations to begin stabilizing the State of Illinois' financial position:

### *Issue 1: Spending Controls*

The State should limit spending growth to 1.7% per year through FY2024, using the Governor's estimated maintenance spending level in FY2017 as the base.

### *Issue 2: Increasing Income Tax Rates*

The State should increase the individual income tax to 5.25% from 3.75% and to 7.0% from 5.25% for corporations. The State should be in a position to lower the individual tax rate to 5% on January 1, 2022. The burden of the increase on low-income residents should be alleviated by expanding the earned income tax credit by 50%.

### *Issue 3: Retirement Income Exclusion*

The State should broaden its income tax base by eliminating the tax exemption for retirement income, excluding only federally tax-exempt Social Security income. The State can no longer afford to provide this generous exemption, which is out of line with most other states.

[5] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016, https://www.illinois.gov/gov/budget/Documents/Economic%20and%20Fiscal%20Policy%20Reports/FY%202016/Five%20Year%20Forecast%202018-2022%2011.15.16.pdf (last visited on February 9, 2017). According to the Civic Federation's adjustments to the Governor's estimates, projected year-end payables of $14.5 billion would be roughly 43% of projected FY2018 revenues of $33.5 billion.

### *Issue 4: Expanding the Sales Tax Base and Lowering the Rate*

In order to avoid tax pyramiding while accessing a larger and growing sales tax base, the State should enact a new service tax including a broad-based definition of consumer services and a firm business-to-business transaction exemption. The State should also exclude medical services. In conjunction with this change, the State should lower the general sales tax rate for goods and services from 6.25% to 5.5%. This should be accomplished by lowering the state portion from 5% to 4.25%, without lowering the 1.25% share for local governments.

### *Issue 5: Business Tax Changes*

The State should limit business tax expenditures that it can no longer afford and that do not provide sufficient public value to justify their cost. The State should cap the retailer's discount for sales taxes at $200 per month per retailer, eliminate the E-10 ethanol incentive, decouple from the federal domestic production activities deduction from corporate income tax and eliminate the continental shelf exemption from taxable income.

### *Issue 6: Merging the Chicago and State Teachers' Pension Funds*

The Chicago Teachers' Pension Fund (CTPF) should be consolidated with the downstate and suburban Teachers' Retirement System (TRS). There is no good public policy reason for Illinois to maintain two separate funds for public school teachers' pensions. Chicago Public Schools (CPS) should continue to be responsible for paying the normal cost of its plan, while responsibility for paying all of the normal cost of the TRS system should be shifted over three years to school districts outside of Chicago. Consolidation would provide more equitable pension funding for all teachers and help stabilize CPS finances.

### *Issue 7: Consolidating and Streamlining Government Units in Illinois*

The State of Illinois has by far the highest number of local governments in any state, at 6,963, according to the United States Census Bureau.[6] The multiplicity of local units of government, many of which are funded predominantly by property taxes, is often cited as a reason for high property tax rates in Illinois.[7] In addition to recommending the merger of the Chicago and State Teachers' Pension Funds, the Civic Federation supports the following: consolidating local pension funds, merging the offices of the Illinois Comptroller and Treasurer, authorizing townships to be dissolved by referendum, consolidating property tax administration roles in Cook County and dissolving the Illinois International Port District.

### *Issue 8: Borrowing to Clear the Unpaid Bill Backlog*

In order to eliminate the backlog of unpaid bills, save on interest penalties and restore confidence in the State's finances, the Civic Federation recommends borrowing to pay off the accumulated bill backlog during FY2018. If the other recommendations in this Roadmap are adopted, the Civic Federation estimates that $8.96 billion in proceeds will be necessary to bring the backlog

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[6] United States Census Bureau 2012 Census of Governments, *Government Organization Summary Report: 2012*, September 26, 2013, p. 1, http://www2.census.gov/govs/cog/g12_org.pdf (last visited on February 9, 2017).

[7] Illinois ranked seventh among the states in per capita property taxes collected in 2013 and was the highest ranking states in the Midwest. For more information, see Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois' National Rankings – 2016 Update*, November 2016, p. 30.

to zero by the end of FY2018. The bonds should amortize as quickly as possible, ideally within five years. This recommendation is contingent upon a balanced budget, a credible plan to maintain fiscal sustainability, restriction of the bond proceeds to eliminating the bill backlog and the payment of debt service with revenues not otherwise needed to balance the budget.

### *Issue 9: Supplemental Pension Payments*

The State should make supplemental payments corresponding to the debt service savings associated with retiring pension obligation bonds beginning after backlog bond debt service ends in FY2024 and continuing until returns are sufficient to bring all five State retirement systems to 100% funded status by FY2045.

### *Issue 10: Rainy Day Fund*

The State should work toward building a rainy day fund equal to 10.0% of General Funds revenues to cushion the budget from the next economic downturn. Legislation must explicitly indicate when deposits will be made and in what amount and the circumstances under which withdrawals will be allowed.

### *Future Changes*

Once the State pays off its unpaid bill backlog and begins to make progress toward building a rainy day fund, it should consider some of the following measures that would give the State's finances more long-term sustainability:

- A constitutional amendment limiting the pension protection clause to accrued benefits;
- A constitutional amendment allowing a graduated individual income tax;
- A reduction in the interest the State pays on overdue bills;
- A return of the lapse period to two months from six; and
- A phase-out of Section 25 liabilities and other practices that allow current years' costs to be paid from future years' appropriations.

## Civic Federation Findings

- For many areas of State government not covered by court orders or existing statutory requirements, the stopgap spending plan paid FY2016 bills with little or nothing left over for FY2017:
    - Higher education received a total of $1.6 billion in the 18 months ended December 31, 2016—on an annualized basis, approximately 56% of the FY2015 funding level.
    - Monetary Award Program (MAP) grants for low income college students were funded at $320.8 million for the 18-month period, compared with $364.1 million in FY2015.
    - Human services activities received about 65% of the full 18-month funding.
    - No general operating funds have been appropriated for State group health insurance since FY2015.
- The backlog of unpaid bills is expected to reach $14.5 billion by the end of FY2017, including as yet unappropriated amounts for historical costs that have not been covered.

- Due to the ongoing budget impasse and associated bond rating downgrades, the State will pay an additional $61 million in debt service on the $480 million in general obligation bonds issued in November 2016.
- In the past ten years, delayed payment of bills cost the State more than $1.0 billion in interest penalties; another $700 million would be owed if the bills expected to be on hand at end of FY2017 were paid off, according to an estimate by the Illinois Comptroller's Office.
- Pension contributions from General Funds more than quadrupled to $6.9 billion in FY2017 from $1.6 billion in FY2008 and are expected to increase to $7.9 billion in FY2018.
- Income tax deposits into General Funds declined by $4.0 billion, or 20.7%, to $15.8 billion in FY2016 from $19.8 billion in FY2014 due to the rollback in income tax rates as of January 1, 2015.

## ILLINOIS BUDGET IMPASSE

The State of Illinois has not had a complete budget since fiscal year 2015, which ended on June 30, 2015. The unprecedented delay has significantly worsened the financial condition of the nation's fifth largest state, which never fully recovered from the Great Recession.

Even without a comprehensive budget, Illinois government has continued to function because of court orders, consent decrees and statutory requirements. State employees have been paid due to a court ruling in July 2015. Public schools have remained open because the only full-year spending bills that have been enacted are for elementary and secondary education.

A stopgap budget—signed on June 30, 2016 and expiring on December 31, 2016—provided partial relief for most areas of government that had received little or no State funding: higher education, human services and agency operations. But it did not cover state employee group health insurance, which has not obtained general operating funds since the deadlock began.

With State spending exceeding revenues, the total backlog of unpaid bills rose to $10.9 billion at the end of December 2016.[8] State group health insurance bills accounted for about $3.9 billion of the total, with some of the claims nearly two years overdue.[9] If Illinois authorized enough additional spending to cover FY2017 services at close to historical levels, the State would need to use more than 40% of projected FY2018 revenues just to pay outstanding bills and other commitments.[10]

The 19-month budget impasse is the result of a political dispute between Democrats who control the General Assembly and a Republican Governor who has made pro-business reforms a condition for approving additional revenues. Efforts to end the standoff accelerated in January 2017, following the expiration of the stopgap budget.

Recent initiatives include a bipartisan attempt by Illinois Senate leaders to pass a sweeping budget package[11] and a move by Illinois' Attorney General to stop payments to State workers in the absence of appropriations.[12] In a State court filing, Attorney General Lisa Madigan argued that the payments are unconstitutional and have alleviated pressure on State officials to resolve the budget deadlock. Governor Bruce Rauner said he would take legal action to make sure workers continue to be paid.[13]

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[8] State of Illinois Governor's Office of Management and Budget, *Bills Outstanding – Summary,*.
[9] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Monthly Briefing for the Month Ended: January 2017,* p. 16.
[10] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016. According to the Civic Federation's adjustment of the Governor's estimates, projected year-end payables of $14.5 billion would be roughly 43% of projected FY2018 revenues of $33.5 billion.
[11] Doug Finke, "New sales, employer taxes in state budget deal," *The State Journal-Register*, January 24, 2017.
[12] Monique Garcia, "AG Madigan asks judge to lift order to pay state workers during impasse," *Chicago Tribune*, January 27, 2017.
[13] Tina Sfondeles, "Gov Vows to Keep Cash Flowing," *Chicago Sun-Times*, January 28, 2017.

Credit rating agencies, which have given Illinois the lowest rating of any state, have signaled growing impatience with its fiscal mismanagement. In issuing the latest downgrade on February 1, 2017, Fitch Ratings cited the failure to enact a budget for two years and warned that another rating reduction could come in the next six months if the impasse is not resolved.[14]

**Path to Financial Crisis**

Illinois' overriding fiscal issue in FY2015 was how to deal with reduced revenues caused by the phaseout of temporary income tax rate increases. Income tax rates were raised in January 2011 to offset a steep decline in economically sensitive State revenues related to the Great Recession.[15] Income taxes are the State's main source of General Funds revenue, followed by sales taxes.[16]

Individual income tax rates were increased to 5.0% from 3.0% and corporate tax rates were raised to 7.0% from 4.8%.[17] The rate increases were scheduled to roll back to 3.75% for individuals and 5.25% for corporations on January 1, 2015 and to 3.25% for individuals and 4.8% for corporations on January 1, 2025.

After the rate increases, income tax revenues had more than doubled to $19.8 billion by FY2014 from $9.8 billion in FY2010.[18] Largely as a result of the rate decreases halfway through the year in January 2015, income tax revenues declined by $1.2 billion to $18.6 billion in FY2015. Beginning on February 1, 2015, the law that raised income tax rates also required that a specific share of income tax revenues be diverted from General Funds to provide additional funding for human services and education.[19]

[14] Fitch Ratings, "Fitch Downgrades Illinois Ratings to 'BBB'; Negative Rating Watch Maintained," *news release*, February 1, 2017.

[15] The recession began in December 2007 and ended in June 2009, according to the National Bureau of Economic Research.

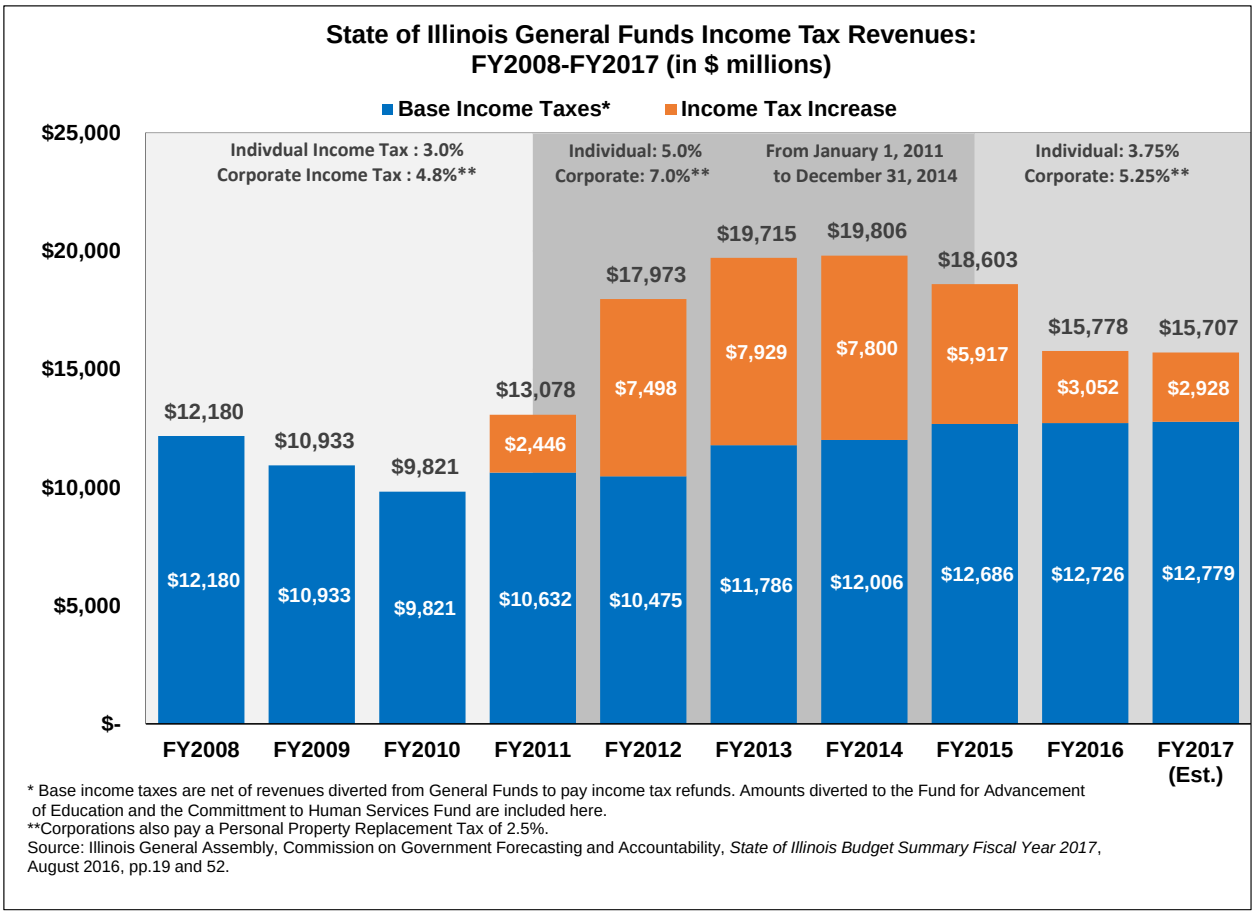
[16] General Funds support the regular operating and administrative expenses of most agencies and are the funds over which the State has the most control. The General Funds consist of the General Revenue Fund, the Education Assistance Fund, the Common School Fund and the General Revenue-Common School Special Account Fund.

[17] Public Act 96-1496, signed on January 13, 2011. In addition to these rates, corporations pay a Personal Property Replacement Tax (PPRT) of 2.5%, which was not affected by the income tax rate changes. The PPRT, which was created by the Illinois General Assembly in 1970 to replace a tax on the personal property of businesses that was abolished pursuant to the 1970 Illinois Constitution, is mainly a revenue source for local governments.

[18] Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary FY2017*, August 2016, p. 19. The law that temporarily increased tax rates also temporarily eliminated the ability of businesses filing as C corporations to deduct net operating losses from their taxable State income, but was amended on December 12, 2011 to allow for up to $100,000 of losses to be deducted.

[19] 35 ILCS 5/901 (f) and (g). The Commitment to Human Services Fund and Fund for the Advancement of Education each receive 1/30 of net income tax revenues from individuals, trusts and estates annually through FY2024; in February 2025 the share increases to 1/26. This requirement diverted $486 million from General Funds in FY2015 and $916 million in FY2016 and is expected to divert $922 million in FY2017.

The following chart, based on an analysis by the General Assembly's Commission on Government Forecasting and Accountability (COGFA), shows the estimated impact of the tax rate increases on General Funds income tax revenues. The chart uses FY2008 as a starting point because it was the first full fiscal year before revenues declined due to the economic downturn.




* Base income taxes are net of revenues diverted from General Funds to pay income tax refunds. Amounts diverted to the Fund for Advancement of Education and the Committment to Human Services Fund are included here.
**Corporations also pay a Personal Property Replacement Tax of 2.5%.
Source: Illinois General Assembly, Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2017*, August 2016, pp.19 and 52.

In FY2016, the first full fiscal year of reduced income tax rates, income tax revenues were $15.8 billion, a decrease of $4.0 billion, or 20.3%, from FY2014. Income tax revenues are expected to remain virtually flat at $15.7 billion in FY2017.

While State tax collections were shrinking due to the recession, statutorily required State pension contributions were increasing. Since FY1996, State contributions to Illinois' five pension funds have been based on a 50-year funding plan.[20] After a 15-year phase-in period, the law requires the State to contribute a level percentage of payroll sufficient to bring the retirement systems' funded ratios to 90% by FY2045.[21]

[20] Public Act 88-0593, signed on August 22, 1994. The five retirement systems are the Teachers' Retirement System, the State Employees' Retirement System, the Universities Retirement System, the Judges' Retirement System and the General Assembly Retirement System.
[21] A funded ratio shows the percentage of accrued pension liability covered by pension assets and is a commonly used measure of the financial health of a retirement system.

When the funding plan began, the total unfunded liability of the five systems stood at approximately $19.5 billion.[22] By the end of FY2016, the unfunded liability had grown to $129.8 billion, based on the market value of assets, and the funded ratio stood at 37.6%.[23] In recent years, Illinois has consistently ranked among the states with the worst funded retirement systems.[24]

The growth in the unfunded liability is largely attributable to inadequate State contributions. The funding plan and subsequently enacted changes deferred a large portion of the required State contributions to later years. Under existing law, the State is not required to make adequate contributions to keep the unfunded liability from growing until approximately FY2029.[25]

These problems were exacerbated in FY2006 and FY2007, when the funding law was modified in order to pay less than the statutorily required amounts. As a result, contributions had to ramp up from a lower base in the following three years to complete the 15-year phase-in period.[26]

The State issued a total of $7.2 billion in Pension Obligation bonds to make its General Funds pension contributions in FY2010 and FY2011. Illinois had previously sold $10 billion in pension bonds in 2003 to reduce the unfunded liability and cover the full required contributions in FY2003 and a portion of the required contributions in FY2004.[27]

To reduce pension costs, the State in April 2010 created a two-tier benefits system with a lower Tier 2 level of benefits for workers hired on or after January 1, 2011.[28] These benefit reductions will increasingly reduce the State's required pension contributions in future years but have not had a significant impact in the short term because they do not apply to retirees or current employees hired before 2011.

In December 2013 the State enacted a new pension law that significantly lowered its pension obligations by reducing annual benefit increases to retirees and Tier 1 employees upon

[22] Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, January 2006, p. i. This figure is based on the purchase price (or book value) of assets. Unfunded liability is the actuarial value of accrued pension benefits that are not covered by pension assets. A pension fund is considered 100% funded when its asset level equals the actuarial accrued liability.
[23] Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2016, p. 2.
[24] Martin Z. Braun, "New Jersey Tops Illinois as State with Worst-Off Pension Systems," *Bloomberg.com*, November 2, 2016.
[25] Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2016, p. 10. The contribution amount that is adequate to keep the unfunded liability from growing consists of the normal cost (the amount needed to cover the present value of benefits earned by system members in each fiscal year) plus interest on the unfunded liability. This contribution, while adequate to prevent growth in the unfunded liability, is not enough to pay down the unfunded liability.
[26] Public Act 94-0004, signed on June 1, 2005. For more information, see State of Illinois, Office of the Auditor General, *Supplemental Digest of Retirement Systems' Audits for the years ending June 30, 2016 and June 30, 2015*, January 26, 2017.
[27] State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016, p. E-14.
[28] Public Act 96-0889, signed on April 14, 2010.

retirement.[29] The law was scheduled to take effect on June 1, 2014 but was not implemented pending legal challenges by labor unions.

The Illinois Supreme Court struck down the law on May 8, 2015, ruling that it violated the Illinois Constitution's pension protection clause.[30] That provision establishes membership in a State retirement system as "an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[31] According to the high court's opinion, the constitutional protection begins when a worker is hired, and any subsequent changes to pension law that diminish benefits may not be applied to that employee.

Under existing law, statutorily required General Funds pension contributions grew to $6.9 billion in FY2017 from $1.6 billion in FY2008. Debt service on previously issued bonds increased to $1.6 billion from $467 million during the same period, bringing total pension-related payments to $8.5 billion from $2.1 billion.

Since FY2011, the State has made its pension contributions without borrowing. However, other expenditures not related to pensions remained approximately flat overall through FY2015.

Spending not related to pensions was $28.2 billion in FY2015, compared with $28.3 billion in FY2008.[32] However, FY2015 expenditures were artificially low. To manage the budget in light of the January 2015 income tax rate reductions, FY2014 revenues were used to pay for a portion of FY2015 Medicaid expenses. Instead of transferring $600 million out of General Funds in FY2015 to pay for those costs, the State did the transfer in FY2014.[33] After adjusting for the advance funding of Medicaid, spending not related to pensions increased by $424 million, or 1.5%, from FY2008 to FY2015. The Consumer Price Index rose 9.1% during the same period.[34]

Due to the budget impasse in FY2016, spending not related to pensions declined to $23.6 billion, not including about $3.8 billion in unappropriated costs.[35] Without a complete budget in FY2017, the State is expected to spend $26.6 billion on costs other than pensions, but this does not include about $3.9 billion of as yet unappropriated costs.[36] Expenditures in FY2016 and FY2017 are discussed in more detail below.

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[29] Public Act 98-0599, signed on December 5, 2013. Retirees and Tier 1 employees upon retirement currently receive annual compounded benefit increases of 3%, while Tier 2 employees receive 3% or one-half of the increase in the Consumer Price Index on a simple-interest basis, whichever is less. The law also raised retirement ages for younger workers and capped the salary on which pension benefits are based.

[30] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015.

[31] Ill. Const. art. XIII, sec. 5.

[32] The $28.2 billion in FY2015 includes spending from General Funds, the Fund for the Advancement of Education and the Commitment to Human Services Fund.

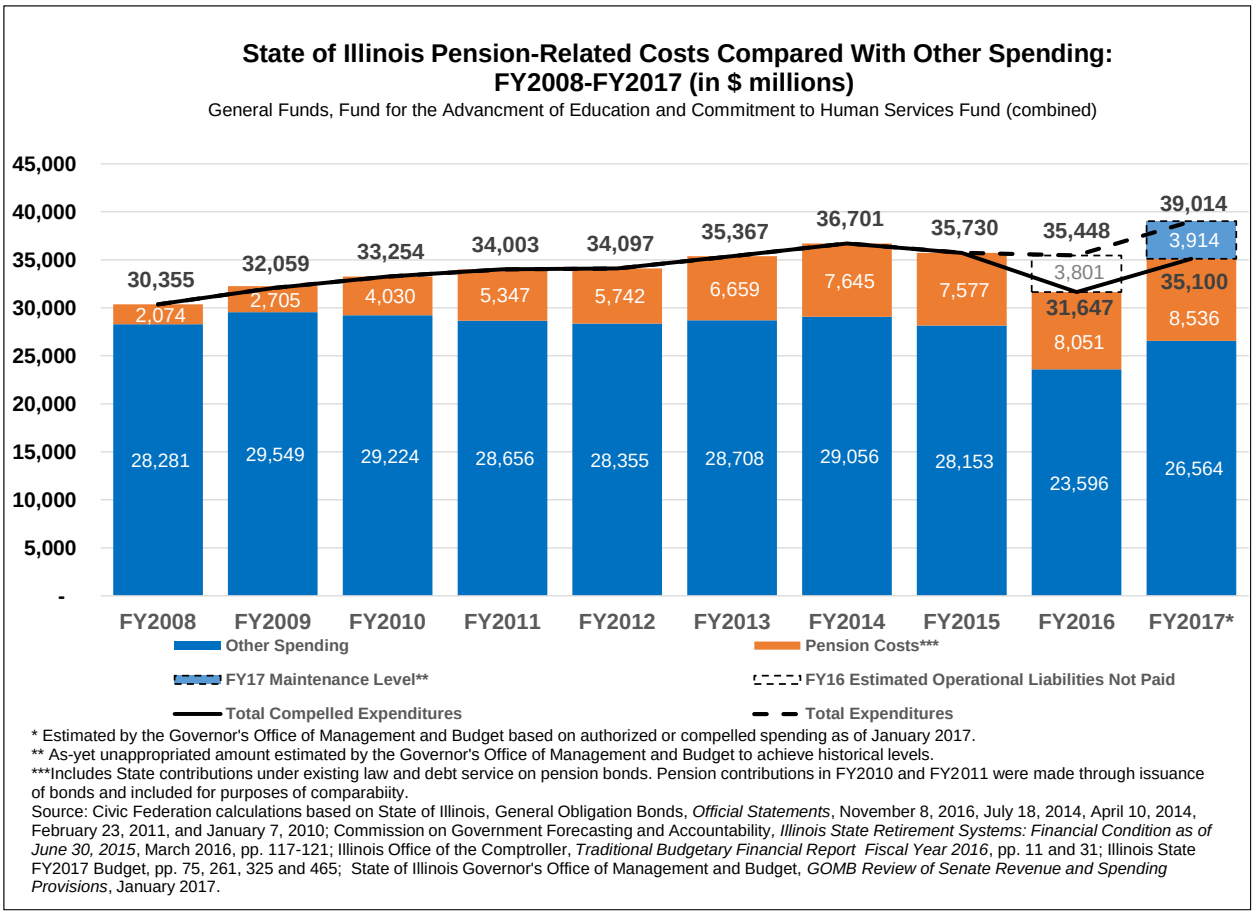
[33] Public Act 98-0642, signed on June 9, 2014.

[34] U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Detailed Report: Data for December 2016*, p. 73.

[35] State of Illinois Comptroller, *Traditional Budgetary Financial Report Fiscal Year 2016*, p. 11. The Comptroller's General Funds spending figure of $31.2 billion is increased by $446 million to account for spending from the Fund for the Advancement of Education.

[36] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016.

The next chart shows spending from FY2008 through FY2017 in two categories: spending related to pensions, including contributions and debt service, and spending not related to pensions. Non-pension spending increased in FY2009 and FY2010 due to federal stimulus funds from the American Recovery and Reinvestment Act of 2009.[37]




* Estimated by the Governor's Office of Management and Budget based on authorized or compelled spending as of January 2017.
** As-yet unappropriated amount estimated by the Governor's Office of Management and Budget to achieve historical levels.
***Includes State contributions under existing law and debt service on pension bonds. Pension contributions in FY2010 and FY2011 were made through issuance of bonds and included for purposes of comparabiity.
Source: Civic Federation calculations based on State of Illinois, General Obligation Bonds, *Official Statements*, November 8, 2016, July 18, 2014, April 10, 2014, February 23, 2011, and January 7, 2010; Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems: Financial Condition as of June 30, 2015*, March 2016, pp. 117-121; Illinois Office of the Comptroller, *Traditional Budgetary Financial Report Fiscal Year 2016*, pp. 11 and 31; Illinois State FY2017 Budget, pp. 75, 261, 325 and 465; State of Illinois Governor's Office of Management and Budget, *GOMB Review of Senate Revenue and Spending Provisions*, January 2017.

## Operating Without a Budget

To close the FY2015 budget gap, the State transferred about $1.3 billion from other State funds to General Funds (a practice known as fund sweeps) and reduced most agencies' spending by 2.25%. As FY2015 ended without a complete budget in place for the next fiscal year, the administration borrowed $454 million from other State funds to increase cash reserves.

The FY2016 budget was more challenging than FY2015's because it covered the first complete fiscal year with lower income tax rates. Although the Illinois Constitution requires that the Governor propose and the General Assembly pass a balanced budget,[38] neither the executive nor

[37] This analysis does not account for growth in Medicaid spending outside of General Funds, primarily resulting from expansion of eligibility under the Affordable Care Act beginning on January 1, 2014. These costs were entirely funded by the federal government through calendar year 2016. Federal reimbursement declined to 95% in calendar year 2017 and will be further reduced to 94% in 2018, 93% in 2019 and 90% in 2020 and thereafter.
[38] Ill. Const. art. VIII, sec. 2(a) and sec. 2(b).

legislative branches advanced General Funds budget plans that matched revenues and expenditures.[39]

Just before the end of FY2015, Governor Rauner vetoed virtually all of the General Assembly's spending plan, citing a duty to "protect taxpayers from an unbalanced and therefore unconstitutional budget."[40] The Governor had previously signed the appropriation bill for elementary and secondary education, which ensured that public schools could open on time despite the budget impasse.[41]

The vast majority of other State spending also continued, even in the absence of a full budget.[42] The State spent $31.6 billion in FY2016 from General Funds and the two funds that received income tax diversions, according to the Comptroller's records. That represented approximately 89% of the $35.7 billion in spending from those funds in FY2015.

The appropriation bill for elementary and secondary education included contributions to the State's largest pension fund, the Teachers' Retirement System, which covers public school teachers outside Chicago. Contributions to the State's four other retirement systems were made pursuant to continuing appropriations, the statutory authority to make payments in the absence of appropriations by the legislature.

Funding for higher education was authorized in April 2015 from a General Funds account specifically designated for education, where money was accumulating but not being spent.[43] The amount represented less than one-third of FY2015 spending of $1.9 billion and was designed to help public universities keep operating through the summer.

Debt service payments and operations of the legislative and judicial branches were also funded due to continuing appropriations. Certain statutory transfers from General Funds, such as the distribution of income tax revenues to local governments, were made based on existing statutes.

The State made payments pursuant to court orders related to about a dozen prior federal consent decrees. These court orders cover payments to Medicaid providers, the operations of the Departments of Children and Family Services and Juvenile Justice and certain human services programs.

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[39] For more information on the Governor's budget proposal and General Assembly legislation, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2016 Recommended Operating and Capital Budgets: Analysis and Recommendations*, May 7, 2015, http://civicfed.org/iifs/publications/FY16_ILRecommendedBudget (last visited on February 9, 2017) and *State of Illinois FY2017 Budget Roadmap: State of Illinois Budget Overview, Projections and Recommendations for the Governor and the Illinois General Assembly*, February 11, 2016, http://civicfed.org/iifs/publications/FY2017IllinoisRoadmap (last visited on February 9, 2017).

[40] The spending plan consisted of approximately 20 appropriation bills and related budget implementation legislation. A representative veto message can be found on the General Assembly's website at http://www.ilga.gov/legislation/fulltext.asp?DocName=09900HB4165gms&GA=99&SessionId=88&DocTypeId=HB&LegID=90394&DocNum=4165&GAID=13&Session= (last visited on February 9, 2017).

[41] Public Act 99-0005, signed on June 24, 2015.

[42] The General Assembly passed and the Governor signed legislation authorizing spending of federal funds and certain other State funds.

[43] Public Act 99-0502, signed on April 25, 2015.

State workers received paychecks based on a ruling in July 2015 by a judge in St. Clair County Circuit Court.[44] The Rauner administration had pushed for full payment of all employees, but the Illinois Attorney General's Office argued that such payment without a budget violated the Illinois Constitution. The Illinois Supreme Court declined the Attorney General's request to consider the issue immediately.[45]

The main areas of State government not being fully paid were universities, community colleges, Monetary Award Program (MAP) scholarships for low income college students, group health insurance for employees and retirees, social service programs not covered by Medicaid and operational costs of certain agencies. In the case of group health insurance, the State is obligated to make the payments eventually due to State law and union contracts.

In May 2016 a group of 82 social service providers sued the State for breach of contract, alleging they were owed more than $100 million for work that had been performed but not paid for on contracts dating back to July 1, 2015.[46] The agencies provided services even though their contracts were contingent on State appropriations, which had not been enacted. Many of the organizations reduced staff and programs due to the lack of funding and some faced the threat of closing down entirely.

Despite the hardships imposed on unfunded programs and services, there was no progress on a budget until the last day of FY2016. On June 30, 2016, a stopgap funding bill and related legislation was rushed through the legislature and signed by the Governor.[47]

The package included full-year funding for elementary and secondary education and for spending from federal and other State funds outside of General Funds.[48] The K-12 education appropriation for FY2017 of $7.5 billion was up by $523.6 million, or 7.5%, from $6.9 billion in FY2016.[49]

The stopgap bill included partial funding for areas not previously required by statute or court order (except group health insurance). The spending authority could be used for costs in FY2016 or FY2017, but the bills had to be incurred by December 31, 2016.[50]

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[44] Kim Geiger, "Illinois state workers' paychecks to go out as court fight continues," *Chicago Tribune*, July 14, 2015.
[45] Kim Geiger, "High court denies Lisa Madigan bid for ruling on state worker paychecks," *Chicago Tribune*, July 17, 2015.
[46] Pay Now Illinois, "Gov. Rauner and State Agencies Sued for Breach of Contract by Coalition of Human and Social Service Agencies, *news release*, May 4, 2016. The lawsuit was dismissed in August 2016 and the organizations are appealing the decision.
[47] Public Act 99-0524, signed on June 30, 2016.
[48] For more detailed information about the stopgap legislative package, see State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016, pp. 23-24.
[49] Illinois State Board of Education, *FY16, FY16/17, FY17 Budget*, https://www.isbe.net/Documents/fy17-budget.pdf (last visited on February 9, 2017).
[50] The legislative package also included Senate Bill 2822, which provided $215 million for normal pension costs of the Chicago Teachers' Pension Fund. The bill was vetoed by the Governor on December 1, 2016.

To help pay for the stopgap spending, the State forgave all but $15 million of the $454 million interfund borrowing from FY2015; used up the entire $275 million balance in the Budget Stabilization Fund, the State's only rainy day fund; and negotiated a new $150 million assessment on hospitals in exchange for increased federal Medicaid funding. The State also refinanced some of its outstanding bonds to save money on interest payments.

Authorized or compelled spending in FY2017 totals about $35.1 billion, according to a recent estimate by the Governor's Office.[51] That is approximately $3.9 billion short of the Governor's estimate of historical funding levels of $39.0 billion in FY2017.[52] The State's FY2017 operating deficit—the difference between estimated resources of $33.7 billion and spending of $39.0 billion—would be $5.3 billion if the $3.9 billion were appropriated to cover remaining FY2017 costs.

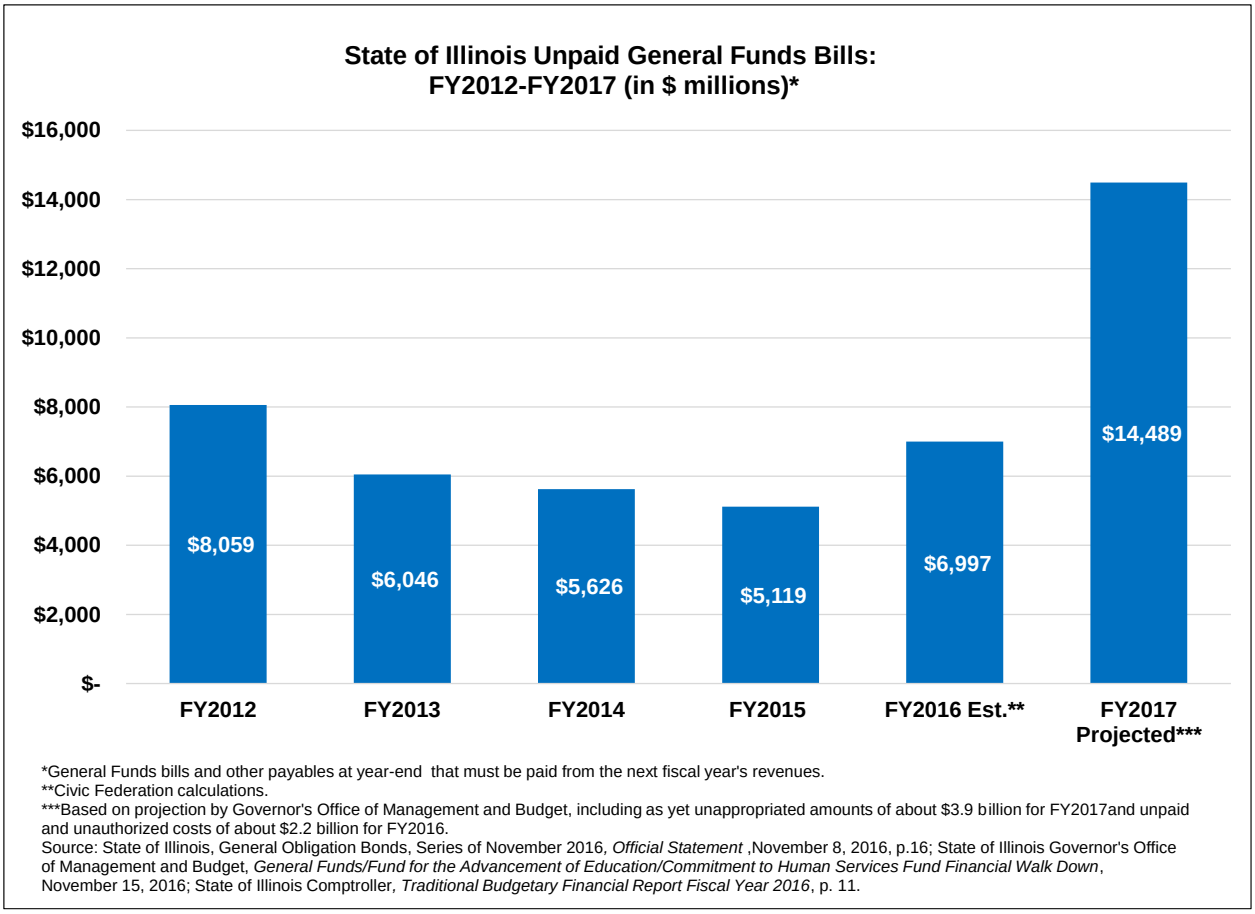
An additional $3.0 billion would be needed to cover costs from FY2016 that remain unpaid, according to the Governor's Office.[53] The $3.0 billion includes $1.6 billion in group health insurance costs and $1.4 billion in costs related to human services, corrections and other agencies.

Only $155 million for remaining FY2016 higher education costs are included in the total $3.0 billion, although spending in FY2016 of about $623 million was $970 million below the Governor's recommended level of $1.6 billion.[54] The Civic Federation increased the estimate of FY2016 remaining costs to $3.8 billion to account for the difference between the $970 shortfall and the Governor's allocation of $155 million. The Governor's recommended FY2016 funding level of $1.6 billion was $348 million below FY2015 spending of $1.9 billion.

Including costs from FY2016 that have not been covered, the accumulated backlog of unpaid bills would increase to about $14.5 billion at the end of FY2017.[55]

[51] State of Illinois Governor's Office of Management and Budget, *GOMB Review of Senate Revenue and Spending Provisions*, January 2017.
[52] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016.
[53] State of Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, November 15, 2016, pp. 6-7.
[54] Illinois State FY2016 Budget, p. 2-23.
[55] The estimate of $14.5 billion reflects the Civic Federation's adjustment of GOMB's projection on November 15, 2016 to account for a $268 million increase in General Funds accounts payable in FY2016.

The following chart shows the State's year-end backlog of unpaid bills from the previous peak in FY2012, through FY2015, the Civic Federation's estimate of FY2016 unpaid bills and the projected backlog at the end of FY2017 based on the spending described above. The backlog declined from $8.1 billion in FY2012 to $5.1 billion in FY2015, mainly due to revenue from the income tax increase and the fund sweeps described above. In FY2016 the amount of unpaid bills increased to an estimated $7.0 billion, including the $1.6 billion in unappropriated FY2016 health insurance costs, which must be paid eventually under State law and union contracts. Other remaining FY2016 costs that were carried over into FY2017 may be paid if funds are appropriated by the legislature and are shown as part of that year's backlog.




*General Funds bills and other payables at year-end that must be paid from the next fiscal year's revenues.
**Civic Federation calculations.
***Based on projection by Governor's Office of Management and Budget, including as yet unappropriated amounts of about $3.9 billion for FY2017and unpaid and unauthorized costs of about $2.2 billion for FY2016.
Source: State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement* ,November 8, 2016, p.16; State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016; State of Illinois Comptroller, *Traditional Budgetary Financial Report Fiscal Year 2016*, p. 11.

The backlog estimates presented above are on a budgetary basis and are intended to show accounts payable and other liabilities at the end of one year that will have to be paid from the next year's revenues. The numbers include fiscal year-end General Funds payables—bills owed to vendors and payments and transfers owed to State agencies and local governments—that will be paid during the lapse period, as well as estimated Section 25 liabilities.

The lapse period is the time during which this year's bills may be paid with next year's revenues. Most bills are due to the Comptroller by two months after the end of the fiscal year, but the

Comptroller has until December 31 to pay them.[56] State vendors still owed money after the end of the lapse period based on unpaid appropriations may seek compensation in the Illinois Court of Claims.[57]

Under State law, most bills must be paid based on the current year's spending authority.[58] However, exceptions to Section 25 of the State Finance Act permit the payment of certain bills based on future years' appropriations. These bills are known as Section 25 liabilities. The exceptions have allowed the State to hide deficits by budgeting an insufficient amount to cover costs in one year knowing that the remainder will be paid from the next year's appropriations.[59] The authority to defer Medicaid bills was sharply restricted beginning in FY2013; group health insurance bills currently represent the major Section 25 liability.[60]

## Cost of the Budget Impasse

Faced with reduced revenues and rising pension costs, the State was not able to create financial plans for FY2016 or FY2017 that aligned resources and expenditures. The result has been cash flow problems, growth in the backlog of unpaid bills and lower credit ratings.

Although most State functions have continued without a budget, several major areas of government were paid little or nothing in FY2016. The stopgap spending bill passed at the end of FY2016 essentially provided partial funding for that year's shortfall with little or nothing left over for FY2017. As noted previously, no general operating funds were made available in either year for group health insurance.

This section examines the financial and social costs of the budget standoff. While some effects can be quantified, others are difficult to measure and may only be fully known in the long run. For example, university officials have said the budget problems have made it difficult to recruit faculty and students due to concerns about the State's fiscal stability.[61] Advocates for the poor and disabled maintain that services eliminated due to the budget impasse will not be easy to replace.[62]

### *Debt Costs*

In the second year of the impasse, all three ratings companies further downgraded Illinois' general obligation rating. In June 2016, Moody's Investors Service lowered its rating from Baa1 to Baa2, and Standard & Poor's lowered its rating from A- to BBB+.

[56] 30 ILCS 105/25(b) and (m). The Department of Healthcare and Family Services may submit bills through December 31 [30 ILCS 105/25(k) (3)].
[57] 705 ILCS 505/24.
[58] 30 ILCS 105/25(a).
[59] State of Illinois Comptroller, "The Section 25 Budget 'Loophole'," *Fiscal Focus*, July 2008, p. 7.
[60] 30 ILCS 105/25.
[61] Steven R. Strahler, "Why are so many professors moving out of Illinois," *Crain's Chicago Business*, July 30, 2016; Julie Wurth, "UI faculty departures up 59% over last August," *The News-Gazette*, August 30, 2016.
[62] Monique Garcia, "Stopgap budget failing to erase damage of state impasse," *Chicago Tribune*, July 18, 2016.

In its report, Moody's noted that continuing gridlock has prevented the State from dealing with a structural imbalance caused by the expiration of the temporary tax increases.[63] Moody's also cited the growing unfunded pension liability. This downgrade was the second by the company in eight months. The new rating was the lowest ever assigned to a State by Moody's, tied only with Massachusetts from 1990 to 1992.[64]

S&P said that its downgrade was due to the State's delay in addressing fiscal strain, resulting in structural imbalance and a large backlog.[65] The company stated that the rating could improve if State leaders were able to negotiate a compromise that restored fiscal balance.

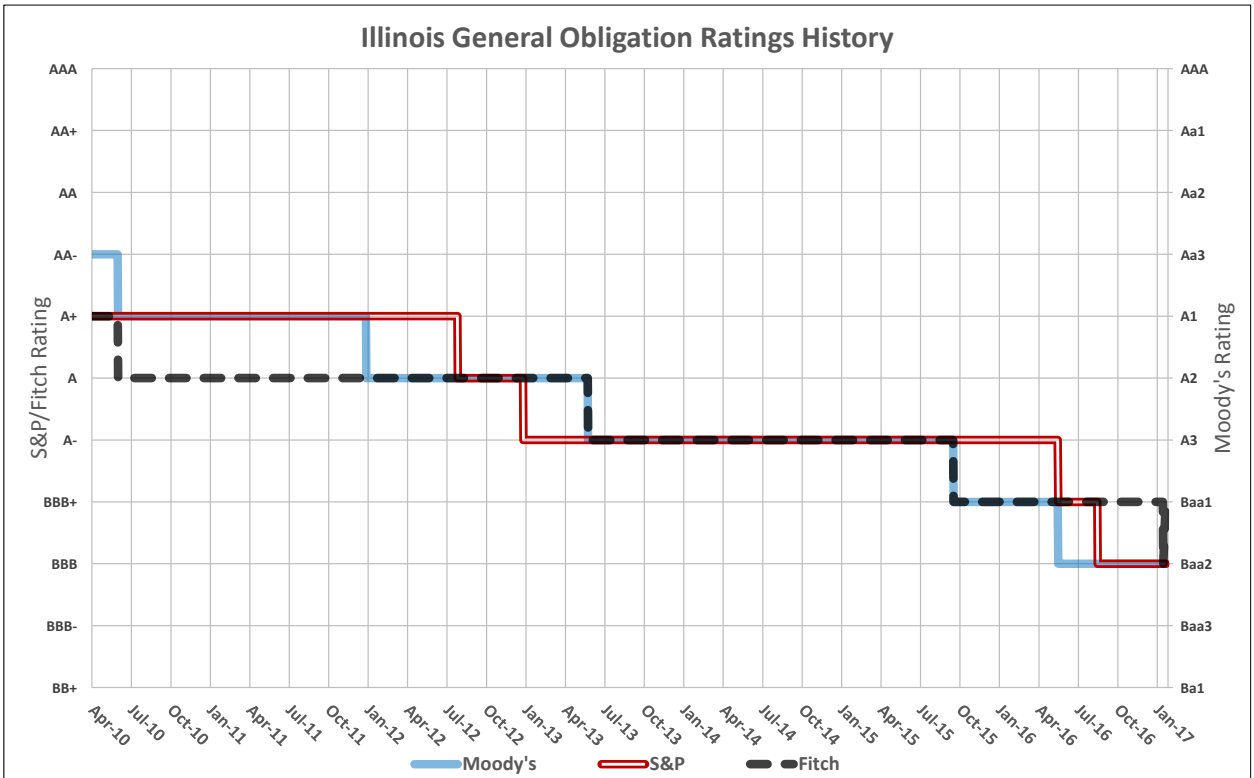
Four months later, on September 30, S&P downgraded Illinois another notch, to BBB, in advance of the State's October 2016 refunding transaction.[66] The report cited weak financial management and rising short- and long-term pressures as a result of the impasse. The downgrade came with a warning of further downgrades if the State was not willing or able to address these issues.

Fitch Ratings downgraded the state to BBB on February 1, 2017, citing the "unprecedented failure" to pass a budget for two consecutive years, which had "fundamentally weakened" the State's finances even if the impasse is resolved.[67] The report maintained a negative watch on the credit.

Illinois currently has the lowest rating of any state by all three ratings agencies. At the time of this report, all three ratings companies place the State's general obligation credit at the BBB/Baa2 level, two notches above junk, with a negative outlook.

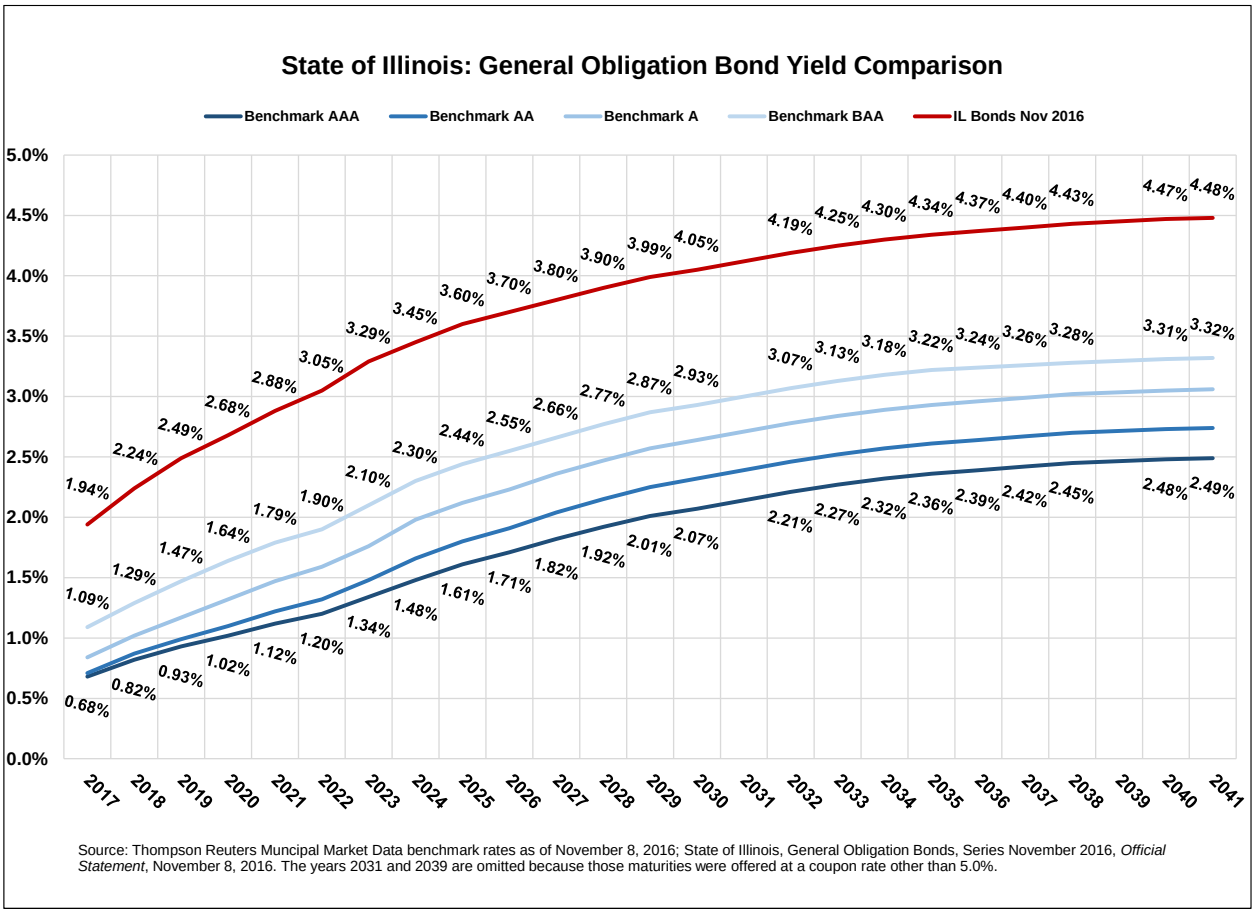
[63] Moody's Investors Service, "Moody's downgrades Illinois GOs to Baa2 from Baa1; related ratings also downgraded," *news release*, June 8, 2016.
[64] Yvette Shields, "Illinois Ratings Punished For Impasse," *The Bond Buyer*, Jun 9, 2016.
[65] Yvette Shields, "Illinois Ratings Punished For Impasse, "*The Bond Buyer*, Jun 9, 2016.
[66] "S&P cuts Illinois' credit rating on state's 'weak' management," *Reuters*, September 30, 2016.
[67] Fitch Ratings, "Fitch Downgrades Illinois Ratings to 'BBB'; Negative Rating Watch Maintained," *news release*, February 1, 2017.

The following table shows the State of Illinois' general obligation debt rating at the end of each fiscal year from 2010 through the Fitch downgrade on February 1, 2017.




Source: Commission on Government Forecasting and Accountability, State of Illinois Budget Summary Fiscal Year 2017, August 2016, pp. 208; Reuters, "S&P cuts Illinois' credit rating on state's 'weak' management" September 30, 2016; Fitch Ratings, "Fitch Downgrades Illinois Ratings to 'BBB'; Negative Rating Watch Maintained," February 1, 2017.

The downgrades have increased the cost of Illinois' borrowing. On November 8, the state issued $480 million in general obligation bonds for capital improvements.[68] The following chart compares the yields received by the State to the benchmark yields for better rated municipal credits reported for the date of the sale.[69] Yields represent the interest rates on bonds after accounting for any premiums or discounts paid or received by investors at the time of a bond sale.




Source: Thompson Reuters Muncipal Market Data benchmark rates as of November 8, 2016; State of Illinois, General Obligation Bonds, Series November 2016, *Official Statement*, November 8, 2016. The years 2031 and 2039 are omitted because those maturities were offered at a coupon rate other than 5.0%.

Various market factors may affect the yields that investors are willing to pay for new bond issuances at any given time, including but not limited to the bond ratings attributed to the issuer. Internal analysis by investors, market supply, demand for various yields at specific maturities, other portfolio standards and current events can affect the outcome of a bond sale.

However, not only did Illinois pay yields averaging 1.88 percentage points higher than the AAA-rated benchmark, it also paid an average of 1.11 percentage points over the BAA-rated benchmark, the level of ratings that Illinois possesses. This suggests that, for a number of reasons, investors may have demanded an additional penalty due to factors specific to Illinois.

[68] State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016.
[69] Thompson Reuters, *Municipal Market Data Index*, November 8, 2016. Both the daily index and the sale were completed before the result of the U.S. Presidential election was known and do not reflect the resulting instability in markets.

As a result of the high yield penalties, Illinois will pay substantially more in debt service than it would have otherwise. The total cost of the November 2016 bonds will be $786 million over the 25-year life of the series. This is $61 million higher than the State would have paid if it had issued bonds producing the same total proceeds at the BAA-rated benchmark levels, and $103 million higher than it would have paid at the AAA-rated levels.[70]

Not only does Illinois' higher cost of borrowing impose a burden on Illinois taxpayers, but the State's low ratings also affect the borrowing costs of local governments. Despite recent outlook changes from negative to stable in two of the City of Chicago's ratings, the market demanded steep yield penalties on a January 2017 general obligation issuance, in part due to the continued instability of State finances.[71]

### *Interest Penalties*

The State is required to pay interest penalties at steep rates on certain overdue bills. As the budget impasse has continued, the backlog of unpaid bills has grown, payment delays have increased and penalties owed to vendors have climbed.

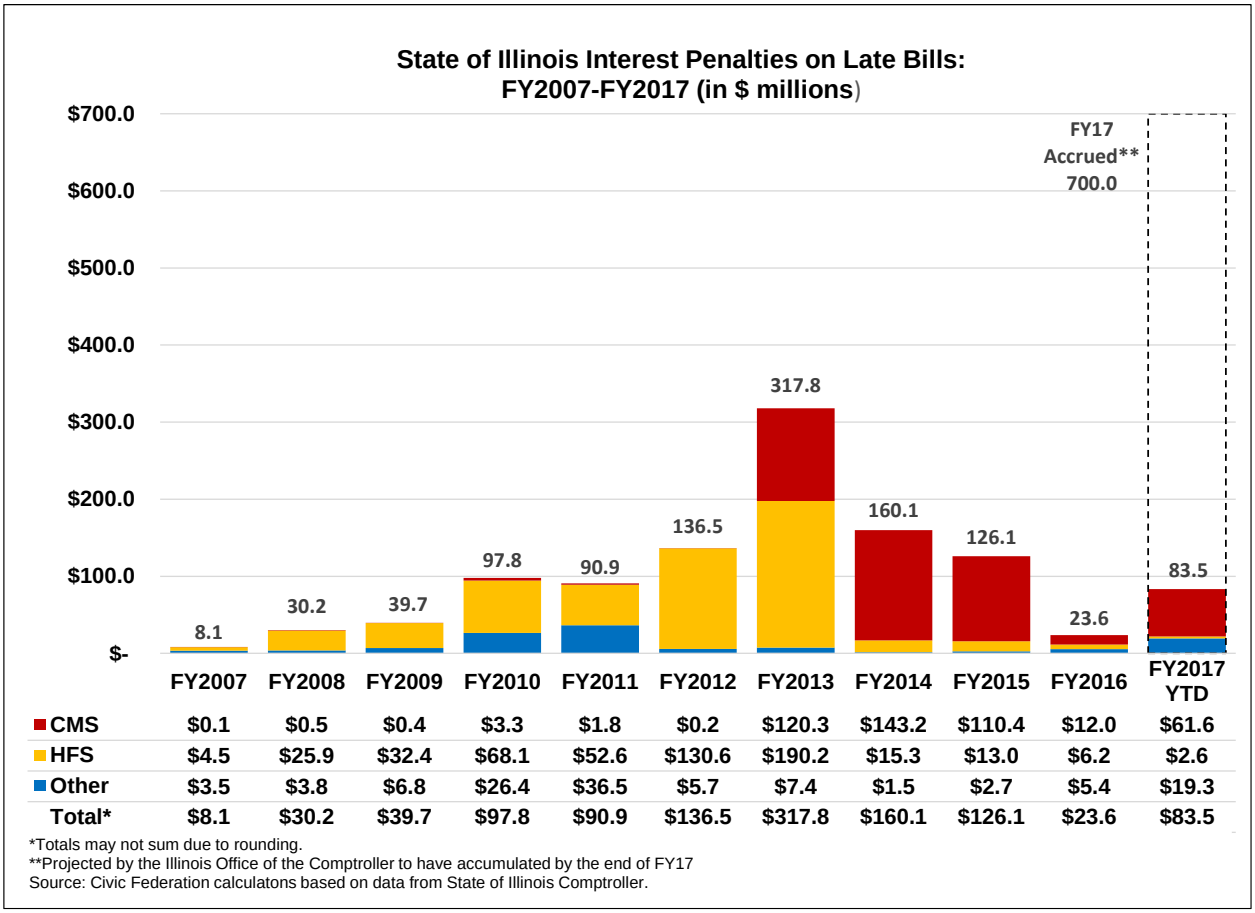
In the past ten years, delayed payment of bills cost the State more than $1.0 billion in interest penalties.[72] If overdue bills on hand were paid at the end of FY2017, the State would have to spend another $700 million, according to an estimate by the Illinois Comptroller's Office.[73]

Interest penalties are not paid until the State pays the underlying bills, which means that the amount of interest penalties paid depends on the timing of bill payments. It should also be noted that many types of State payables included in the total bill backlog, including grants and transfers to local governments and State agencies, are not eligible for interest when payment is delayed.

Under the State Prompt Payment Act, interest accrues at 1% a month, or more than 12% annually, on "proper bills" that are not paid within 90 days.[74] Proper bills are defined as those that include the information needed to process the payment. Other claims, including those from healthcare providers, accrue interest at 9% a year after 30 days under the Illinois Insurance Code.[75]

[70] For data and comparison calculations, see Appendix A on p. 54.
[71] Yvette Shields, "Chicago Yield Penalties Steepen," *The Bond Buyer*, January 19, 2017.
[72] Civic Federation calculations based on data from the State of Illinois Comptroller.
[73] Communication between the Civic Federation and the State of Illinois Comptroller, February 2, 2017.
[74] 30 ILCS 540.
[75] 215 ILCS 5/368(a).

As indicated in the following chart, interest penalties from FY2007 through January FY2017 totaled $1.1 billion. The vast majority of penalties in the past ten years have been paid by the Departments of Healthcare and Family Services (HFS) and Central Management Services (CMS). HFS administers the Medicaid program and was in charge of employee and retiree group health insurance before FY2013, when the responsibility was shifted to CMS.




State spending on interest penalties began to climb in FY2008, as unpaid bills accumulated during the Great Recession. Interest penalties peaked in FY2013 at $317.8 million, largely due to a pay down of Medicaid bills.

In the last few years, late payment of group health insurance bills has accounted for most of the interest penalties paid by the State. As explained above, health insurance bills can be held indefinitely by the State because they may be paid from future years' appropriations. As of the end of December 2016, State group health insurance claims totaled about $3.9 billion and had been held as long as 675 days.[76]

Despite mounting bills, interest payments were relatively low at $23.6 billion in FY2016 due to the lack of health insurance appropriations to pay down the claims. As of early February 2017,

[76] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Monthly Briefing for the Month Ended: January 2017*, p. 16.

the State had paid $83.5 million in interest penalties in FY2017, of which $59.4 million was related to State group health insurance.[77] Although there have been no General Funds appropriations for group health insurance since FY2015, the stopgap spending bill authorized the use of other funding sources, such as employee contributions, to pay bills.

According to the Comptroller's estimate, the State could pay an additional $700 million in interest penalties if unpaid bills at the end of FY2017 were paid off.[78] The total consists of about $600 million in health insurance-related interest penalties and $100 million in penalties related to other kinds of bills.

A portion of the accrued penalties are not owed to vendors but to third parties who participate in the State's Vendor Support Initiative.[79] This program allows vendors to assign bills to authorized third party collectors, who pay the vendors 90% of the bills up front and the remaining 10% when the bills are paid by the State. In return, the collectors get to keep any interest penalties.

### *Loss of Services*

The lack of a complete State budget has had the most impact on areas of government that were not compelled to be paid by court orders or statutes or, like K-12 education, covered by full-year appropriations. The largest area is higher education, which includes nine public universities, 48 community colleges and MAP, the college scholarship program for low income students.

Higher education received $1.9 billion in General Funds in FY2015 but only about $623 million in the following year.[80] With little State funding in FY2016, public colleges and universities dipped into reserves, laid off administrators and credited students' tuition bills for their MAP grants, expecting to be reimbursed when a budget was enacted.

Among the hardest hit was Chicago State University, which receives about one-third of its funding from the State. The school's trustees declared a financial emergency in February 2016, laid off about 40% of its employees, reduced library hours and cut spending on travel and supplies.[81]

The stopgap spending plan enacted in June 2016 provided about $1 billion in additional funds, bringing total funding to approximately $1.6 billion over the 18 month period.[82] On an annualized basis, that represents approximately 56% of the FY2015 funding level.[83]

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[77] This amount is the portion of the penalties paid by CMS out of the Health Insurance Reserve Fund, the account that funds payments for State group health insurance.
[78] Communication between the Civic Federation and the State of Illinois Comptroller, February 2, 2017.
[79] Illinois Department of Central Management Services, Vendor Support Initiative, https://www.illinois.gov/cms/business/VendorPayment/Pages/VSI.aspx (last visited on February 9, 2017).
[80] Higher education also includes the Board of Higher Education, Math and Science Academy and State Universities Civil Service System. Higher education budget numbers presented here do not include State contributions to the State Universities Retirement System.
[81] Peter Matuszak, "Chicago State University faces year-end deficit, needs to slash expenses," *Chicago Tribune*, December 27, 2016.
[82] In addition to General Funds, the stopgap funding included money from the Fund for the Advancement Education, the Personal Property Tax Replacement Fund and the Budget Stabilization Fund.
[83] The calculation is: $1.620 billion x (12/18) = $1.080 billion / $1.940 billion = 56%.

The stopgap plan included MAP grant funding for the 2015-2016 school year but no remaining funds for the current academic year.[84] A recent survey by the Illinois Student Assistance Commission found that nearly all public universities covered MAP grants in the fall of 2016, but only two-thirds were committed to covering them in the spring.[85]

Chicago State lifted the emergency designation in December 2016 but still faces a cash crunch in the coming months.[86] Enrollment dropped this fall to under 3,600 students, less than half of what it was six years ago. There were fewer than 90 new full-time freshmen when school started in September.

Overall undergraduate enrollment at Illinois' public universities dropped by 2% in the fall of 2016 from a year earlier, with only the University of Illinois and Illinois State University reporting increases, according to the State's Board of Higher Education.[87] School leaders could not say for sure that the declines were caused by the budget uncertainty, but some officials pointed to decreases in the size of the freshmen class as evidence of a connection.[88]

Although many healthcare and social services programs were funded due to federal consent decrees, there were notable exceptions. Lutheran Social Services, one of the State's largest social service agencies, said in January 2016 that it was laying off 750 employees, or about 43% of its staff, cutting its annual budget by 21.9% and ending more than 30 programs for about 4,700 people.[89]

Many of the programs eliminated by Lutheran Social Services, such as in-home care and adult daycare for seniors, were part of the State's Community Care Program, which is designed to keep seniors out of nursing homes. A large portion of the Community Care Program does not fall under Medicaid and was not being funded by the State. Other social service programs that were not funded in FY2016 served immigrants, teens, the mentally ill and individuals with autism and epilepsy.

A survey in June 2016 by the United Way of Illinois found that about two-thirds of the 429 social services agencies that responded had made cuts to programs or operations due to the budget impasse.[90] More than one-third said they would have to close their doors in six months if the deadlock continued.

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[84] Illinois Student Assistance Commission, *Student and Parent FAQs: Impact of State Budget Delay on ISAC Gift Assistance Programs*, https://www.isac.org/students/during-college/budget-faqs.html (last visited on February 9, 2017).

[85] Dan Petrella, "Illinois colleges face MAP grant decision again," *The Southern Illinois*, December 14, 2016.

[86] Peter Matuszak, "Chicago State University faces year-end deficit, needs to slash expenses," *Chicago Tribune*, December 27, 2016.

[87] Illinois State Board of Higher Education, *Fall 2016 Enrollment Snapshot for Public Universities*, http://www.ibhe.org/DataPoints/Fall2016Enrollment.pdf (last visited on February 9, 2017).

[88] Dawn Rhodes and Kate Thayer, "Illinois public universities have fluctuating enrollment after difficult year," *Chicago Tribune*, September 8, 2016.

[89] Shia Kapos, "Big Lutheran social agency cuts 750 jobs amid budget impasse," *Crain's Chicago Business*, January 22, 2016.

[90] United Way of Illinois, "After a Year with No State Budget, Fourth United Way of Illinois Survey Shows Accelerating Damage to Those in Need of Services, Sector Viability," *news release*, June 22, 2016.

The United Way survey was conducted before the passage of the stopgap spending plan. The stopgap measure provided about 65% of the human services funding needed to cover activities in FY2016 and the first half of FY2017—or less than 12 months of funds for an 18-month period.[91]

Under the stopgap plan, social service agencies have received little or no money for services provided in FY2017, according to a new complaint by organizations that initially sued the State for breach of contract in 2016.[92] The Department of Corrections has not fully paid for FY2016 services nor made any payments for FY2017, while the Department of Human Services and Department on Aging are paid up for FY2016 but have made only limited payments for FY2017.[93]

Even if additional funding for FY2017 is forthcoming, rebuilding efforts may be slow due to difficulties in rehiring staff and resuming contacts with clients. Nearly 60 percent of the 37 social service agencies involved in the new lawsuit have reduced services and about 76 percent have taken steps to cut personnel costs.[94]

The budget standoff affected crime prevention programs such as Adult Redeploy Illinois, which is aimed at diverting non-violent offenders from prison into community programs. Adult Redeploy was singled out for praise in Governor Rauner's first State of the State address. Adult Redeploy was not funded in FY2016, resulting in reduced staff, unfilled positions, a decrease in service and treatment availability and reduced or suspended enrollments.[95] Three counties—Kane, Kankakee and McLean—dismantled their Adult Redeploy programs due to the budget problems.[96] Officials have said that the stopgap funding will cover FY2016 expenses and costs for continuing program sites.[97]

Continued lack of funding is also having an impact on State employees who need to see the doctor. Because of record delays in payments of State health insurance claims, some doctors and hospitals are demanding payment up front or are declining to accept new State-insured patients. A medical center in Springfield, for example, reportedly requires patients insured by the State to pay half of their expected bills for elective surgery in advance. [98] A professor at Southern Illinois University recently told the Illinois Comptroller that his specialist in St. Louis is no longer

[91] Illinois State Senator Daniel Biss, *Update from Springfield: Budget deal shows progress is possible*, June 30, 2016.
[92] Caritas Family Solutions v. Dimas et al., 17-CH-___, Cir. Ct. of St. Clair Co.(Compl. para. 4), filed February 9, 2017.
[93] Caritas Family Solutions v. Dimas et al., 17-CH-___, Cir. Ct. of St. Clair Co.(Compl. para. 50,51,52), filed February 9, 2017.
[94] Pay Now Illinois, "Gov. Rauner and State Agencies Sued in St. Clair County for Nonpayment of Fiscal Year 2017 Contracts," *news release*, February 9. 2017.
[95] Adult Redeploy Illinois Oversight Board, Performance Measurement Committee, Minutes of the October 26, 2015 meeting.
[96] Adult Redeploy Illinois, Letter to Will County Board, August 22, 2016.
[97] Adult Redeploy Illinois, Letter to Will County Board, August 22, 2016
[98] Dean Olsen, "Orthopedic Center requiring up-front payments from state workers," *The State-Journal Register*, January 17, 2017.

treating patients covered by the State of Illinois' health insurance plans because of payment delays.[99]

[99] Jordan Abudayyeh, "The 'State' of Illinois: Comptroller Mendoza Discusses the Costs of the Gridlock," *WICS News Channel 20*, February 1, 2017.

## ALTERNATIVES TO THE ROADMAP

In this Roadmap, the Civic Federation proposes a balanced strategy to address the State's financial challenges, including spending restraint, governmental reforms and enhanced revenues. However, the consequences of two alternative scenarios must also be explored. The first is the possibility that no action will be taken by the Governor or General Assembly, and the status quo would be maintained. The second is to show the effects of achieving balance using only spending cuts.

### Status Quo

With the budget impasse having lasted for nearly two years, it is worth exploring the likely results for the State if the current path is left unaltered. The Governor's Office of Management and Budget (GOMB) has made such a projection, assuming a maintenance level of expenditures and no new revenue sources for five years.[100]

In the forecast, GOMB blends two sets of assumptions about economic performance, a baseline and a pessimistic scenario.[101] The table below summarizes the projection with only the adjustments to the starting backlog amount discussed in the last section.

The already significant difficulty in balancing budgets from FY2018 forward is exacerbated by the nearly $900 million increase in General Funds pension contribution requirements from $7.0 billion in FY2017 to $7.9 billion in FY2018. In August 2016, the Teachers' Retirement System (TRS) Board of Trustees voted to reduce its assumed rate of investment return from 7.5% to 7.0%. [102] The State Employees' Retirement System (SERS) both reduced its rate of return assumption from 7.25% to 7.0% and revised its assumptions about life expectancy.[103] The result of these changes is a dramatic increase in the contribution requirement under state law.

[100] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016.
[101] State of Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, November 15, 2016, p. 2.
[102] Teachers' Retirement System of the State of Illinois, "TRS Assumed Long-Term Rate of Return Reduced to 7 Percent," *news release*, August 26, 2016.
[103] State Employees' Retirement System of Illinois, "FY2015 Financials," *The SERS-O-Gram*, August 2016.

As the chart shows, if nothing is done and the impasse continues, the backlog of unpaid bills would increase to an estimated $21.8 billion by the end of FY2018 on June 30, 2018 and $48.3 billion by the end of FY2022 on June 30, 2022.

**State of Illinois: Governor's Five-Year Budget Projection**
**with Civic Federation Adjustment to Backlog Total**
General Funds, Fund for the Advancement of Education, and Commitment to Human Services Fund (combined)

| | Estimated FY 2017 | Projected FY 2018 | Projected FY 2019 | Projected FY 2020 | Projected FY 2021 | Projected FY 2022 |
|---|---|---|---|---|---|---|
| **Revenues** | | | | | | |
| State Source Revenues | $ 29,048 | $ 29,543 | $ 30,086 | $ 30,970 | $ 31,838 | $ 32,715 |
| Federal Revenues | $ 3,809 | $ 3,847 | $ 3,886 | $ 3,924 | $ 3,964 | $ 4,003 |
| Other Resources | $ 856 | $ 70 | $ - | $ - | $ - | $ - |
| **Total Revenues** | **$ 33,713** | **$ 33,461** | **$ 33,972** | **$ 34,894** | **$ 35,802** | **$ 36,718** |
| **Expenditures** | | | | | | |
| Net Agency Expenditure | $ 25,336 | $ 25,800 | $ 26,273 | $ 26,724 | $ 27,185 | $ 27,653 |
| Pension Contributions | $ 6,971 | $ 7,889 | $ 8,088 | $ 8,330 | $ 8,659 | $ 8,949 |
| Group Insurance Payments | $ 1,810 | $ 1,873 | $ 1,939 | $ 2,007 | $ 2,077 | $ 2,150 |
| Statutory Transfers[1] | $ 2,547 | $ 2,575 | $ 2,634 | $ 2,707 | $ 2,786 | $ 2,867 |
| Debt Service | $ 2,350 | $ 2,418 | $ 2,091 | $ 1,536 | $ 1,585 | $ 1,628 |
| **Total Expenditures[2]** | **$ 39,014** | **$ 40,556** | **$ 41,025** | **$ 41,304** | **$ 42,292** | **$ 43,247** |
| **Operating Surplus (Deficit)** | **$ (5,301)** | **$ (7,096)** | **$ (7,054)** | **$ (6,410)** | **$ (6,490)** | **$ (6,528)** |
| **Bill Backlog[3]** | **$ (14,489)** | **$ (21,585)** | **$ (28,639)** | **$ (35,049)** | **$ (41,539)** | **$ (48,067)** |

[1] Includes repayment of $15 million of interfund borrowing in FY2017.

[2] Includes approximately $3.9 billion of as-yet-unauthorized expenditures in FY2017 to maintain services at existing levels.

[3] The Civic Federation has made adjustments to the starting backlog for FY2017 of $131 million, reflecting actual FY2016 results in the Traditional Budgetary Financial Report. Additionally, $815 million in accumulated FY16 higher education bills that GOMB excluded from its analysis are included here.

Source: State of Illinois, Governor's Office of Management and Budget, *Five Year Forecast* , *FY18-FY22* , November 15, 2016; Civic Federation calculations.

Backlogs of this magnitude are obviously unsustainable and would quickly limit the State's ability to operate. Credit ratings would be downgraded further, likely to junk levels. Long-term borrowing would become prohibitively expensive. Some vendors would not be willing to continue to do business with the State. At some point, maintaining liquidity would become challenging, as the State exhausts reserves in other funds, and because the Illinois Constitution sharply restricts the State's ability to do short-term borrowing for liquidity purposes. Clearly, this is not a path worth pursuing.

## Spending Cuts

Without new revenue, the only path to stabilizing the State's finances and eliminating the backlog of bills is through spending cuts. However, many areas of spending lack the flexibility to make meaningful cuts. Debt service is mostly fixed and can only be meaningfully adjusted through costly scoop-and-toss transactions. The Illinois Supreme Court has severely limited the State's ability to alter pension benefits.[104] Employee group health expenditures are dependent upon the outcome of negotiations with state employee unions[105] and reductions to retiree health

[104] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015.
[105] Amanda Vinicky, "What's Behind State Workers' Potential Strike?," *Chicago Tonight*, January 16, 2017.

insurance benefits were blocked by an Illinois Supreme Court ruling in 2014.[106] Finally, although statutory transfers, the largest of which is to the Local Government Distributive Fund, are in need of reform and could conceivably be reduced somewhat,[107] the magnitude of reduction would not alone be sufficient to address the crisis. Therefore, a significant portion of the cuts would need to be focused on net agency expenditures.

The following chart shows the level of cuts to net agency appropriations necessary to eliminate the structural deficit in FY2018 and eliminate the bill backlog by FY2022.

**State of Illinois: Governor's Five-Year Budget Projection**
**with Expenditure Reductions**
General Funds, Fund for the Advancement of Education, and Commitment to Human Services Fund (combined)

| | Estimated FY 2017 | Projected FY 2018 | Projected FY 2019 | Projected FY 2020 | Projected FY 2021 | Projected FY 2022 |
|---|---|---|---|---|---|---|
| **Revenues** | | | | | | |
| State Source Revenues | $ 29,048 | $ 29,543 | $ 30,086 | $ 30,970 | $ 31,838 | $ 32,715 |
| Federal Revenues | $ 3,809 | $ 3,847 | $ 3,886 | $ 3,924 | $ 3,964 | $ 4,003 |
| Other Resources | $ 856 | $ 70 | $ - | $ - | $ - | $ - |
| **Total Revenues** | **$ 33,713** | **$ 33,461** | **$ 33,972** | **$ 34,894** | **$ 35,802** | **$ 36,718** |
| **Expenditures** | | | | | | |
| **Net Agency Expenditure** | **$ 25,335** | **$ 25,800** | **$ 26,273** | **$ 26,724** | **$ 27,185** | **$ 27,653** |
| **Annual Reductions** | **$ -** | **$ (6,629)** | **$ (832)** | **$ (795)** | **$ (760)** | **$ (726)** |
| Percentage Reduction from Prior Year | | -26.17% | -4.45% | -4.45% | -4.45% | -4.45% |
| Cumulative Reductions | | -26.17% | -29.45% | -32.59% | -35.59% | -38.46% |
| **Total Reduced Net Agency Expenditures** | **$ 25,336** | **$ 18,706** | **$ 17,874** | **$ 17,079** | **$ 16,319** | **$ 15,593** |
| Pension Contributions | $ 6,971 | $ 7,889 | $ 8,088 | $ 8,330 | $ 8,659 | $ 8,949 |
| Group Insurance Payments | $ 1,810 | $ 1,873 | $ 1,939 | $ 2,007 | $ 2,077 | $ 2,150 |
| Statutory Transfers[1] | $ 2,547 | $ 2,575 | $ 2,634 | $ 2,707 | $ 2,786 | $ 2,867 |
| Debt Service | $ 2,350 | $ 2,418 | $ 2,091 | $ 1,536 | $ 1,585 | $ 1,628 |
| **Total Expenditures[2]** | **$ 39,014** | **$ 33,461** | **$ 32,626** | **$ 31,659** | **$ 31,426** | **$ 31,187** |
| **Operating Surplus (Deficit)** | **$ (5,301)** | **$ 0** | **$ 1,346** | **$ 3,235** | **$ 4,376** | **$ 5,531** |
| **Bill Backlog[3]** | **$ (14,489)** | **$ (14,489)** | **$ (13,142)** | **$ (9,907)** | **$ (5,531)** | **$ 0** |
| **Reserves** | **$ -** | **$ -** | **$ -** | **$ -** | **$ -** | **$ 0** |

[1] Includes repayment of $15 million of interfund borrowing in FY2017.

[2] Includes approximately $3.9 billion of as-yet-unauthorized expenditures in FY2017 to maintain services at existing levels.

[3] The Civic Federation has made adjustments to the starting backlog for FY2017 of $131 million, reflecting actual FY2016 results in the Traditional Budgetary Financial Report. Additionally, $815 million in accumulated FY16 higher education bills that GOMB excluded from its analysis are included here.

Source: State of Illinois, Governor's Office of Management and Budget, *Five Year Forecast* , *FY18-FY22* , November 15, 2016; Civic Federation calculations.

If GOMB's revenue projections and maintenance-level FY2017 expenditures are assumed, a one-year cut of over 26% is necessary to eliminate the FY2018 structural deficit. This would represent a cut of 18.5% from FY2015 spending levels. If implemented across the board, this would mean cutting K-12 education from $7.4 billion to $5.5 billion in one year. It would also represent a cut of approximately $1.2 billion from FY2015 levels.

[106] Kanerva v. Weems (2014 IL 115811, July 3, 2014.

[107] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2014 Budget Roadmap*, February 25, 2013, p. 57, https://www.civicfed.org/iifs/publications/IllinoisRoadmapFY2014 (last visited on February 9, 2017).

Similarly, higher education would experience a cut of $482 million in one year. This would follow two years of underfunding from the FY2015 level that totals $1.4 billion. Finally, human services would also experience a one-year cut of more than $1.5 billion, also following two years of underfunding without full-year budgets.

Some efforts, including debt restructuring and statutory transfer reform, could mitigate these cuts. However, existing consent decrees and further litigation resulting in court-ordered spending would reduce the flexibility of the state to implement cuts in a cost-effective manner. As a result, cuts would have be concentrated in areas with less legal protection.

Even after the severe cuts needed to balance the FY2018 budget, further reductions would be needed to eliminate the backlog of bills. Additional spending cuts of 4.45% per year would eliminate the backlog by FY2022. The cuts total more than a 38% reduction in spending over five years. Cuts of this magnitude would almost certainly result in a decline in the quality of life in Illinois, and would represent a drastic departure from the current understanding of the relationship between the government of Illinois and its people.

## CIVIC FEDERATION RECOMMENDATIONS

The Governor's five-year projection illustrates the fiscal reality that the State of Illinois' current revenue and spending structures do not provide a sustainable basis for funding essential government services and will lead to unmanageable growth in liabilities through FY2022. Moreover, cuts alone cannot resolve the crisis unless they are so drastic as to severely impair the quality of life in Illinois.

The Civic Federation presents the following comprehensive plan and recommendations to stabilize the State's operating budget and establish a balanced financial path out of its ongoing fiscal crisis.

### Comprehensive Plan

In order to achieve stability in the State's long-term finances, the Civic Federation proposes that the comprehensive financial plan should meet the following goals:

- Ensure future annual operating budgets are balanced;
- Eliminate the backlog of unpaid bills;
- Provide achievable spending limits;
- Avoid drastic revenue cliffs;
- Broaden the tax base to provide sustainable revenue sources;
- Include additional assistance for local governments; and
- Set aside reserves for an adequate rainy day fund.

It is important to recognize that the State is in an exceedingly difficult position due to the 19-month budget impasse and the lack of action taken to address the revenue cliff from the rollback of income tax rates as of January 1, 2015. With less than six months remaining in the current fiscal year to address an estimated operating shortfall of $5.3 billion, there are no practical measures that would completely balance the FY2017 budget and prevent an increase in the backlog of unpaid bills by the end of FY2017. Only difficult choices remain for the State.

Given the projected FY2018 operating shortfall of $7.1 billion, fixing the State's finances will require stricter spending restraints and more painful revenue increases to balance the budget and pay down the backlog of bills than the Civic Federation has previously proposed. The Federation's plan is based on limiting agency spending (excluding pension contributions, debt service, employee health insurance and legislatively required transfers) to 1.7% a year, which is below the Federal Reserve's target inflation rate of 2.0%.[108] Annual spending must be capped at these levels so the State can use additional revenues to pay for new borrowing costs, as discussed below, and to build financial reserves.

Illinois must also pursue tax policy changes that will reduce the FY2017 operating deficit, balance the FY2018 budget and generate surpluses. Many of these tax changes are politically unappealing and painful for both individuals and businesses in the State, but they are of the

[108] Federal Open Market Committee of the Board of Governors of the Federal Reserve Bank, *news release*, February 1, 2017, https://www.federalreserve.gov/newsevents/press/monetary/20170201a.htm (last visited on February 9, 2017).

magnitude necessary to solve the State's financial crisis. Income tax rate increases in the plan are accompanied by a proposed decrease in the State's sales tax rate for goods.

The Civic Federation's comprehensive plan proposes the following tax policy changes to address the State's fiscal crisis:

1. Raise the income tax rate for individuals to 5.25% from 3.75% as of January 1, 2017 and return the rate to 7.0% from 5.25% for corporations. The individual income tax rate is reduced to 5.0% as of January 1, 2022;
2. Extend Illinois' income tax to cover all federally taxable retirement income; currently the State does not tax any retirement income;
3. Broaden the sales tax base to include services, which will capture a growing area of the State economy;
4. Reduce the State's portion of the sales tax rate to 4.25% from 5%; currently the State receives 5% and local governments receive 1.25%;
5. Restore local governments' share of income tax proceeds to 10% in FY2020; local governments did not benefit from the 2011 income tax rate increases;
6. Reduce or eliminate certain business tax benefits that do not promote economic efficiency; and
7. Increase the earned income tax credit from 10% of the federal amount to 15% to provide additional relief for low income residents.

The Civic Federation also recommends that the State eliminate the backlog of unpaid bills by selling $8.96 billion of five-year bonds. Although the Civic Federation generally opposes borrowing for operating expenses, it has become clear that Illinois cannot achieve fiscal stability without addressing the bill backlog. Bond proceeds must be restricted to paying off the bills.

The Federation's plan includes a more equitable proposal for teacher pension funding, which is critical for the Chicago Public Schools' long-term sustainability. The Chicago Teachers' Pension Fund (CTPF) would be consolidated with the Teachers' Retirement System of the State of Illinois, and the State would assume responsibility for the unfunded liability of Chicago teachers' pensions. Chicago Public Schools would continue to pay normal costs (the annual cost of pension plan benefits) for its teachers, while school districts outside Chicago would gradually take over from the State the responsibility for their teachers' normal costs.

By the end of FY2018, the Civic Federation's comprehensive plan would generate an operating surplus and clear out the backlog of bills. Budget surpluses in the following years would allow the State to build a rainy day fund that would reach $2.7 billion, or almost 6% of projected revenues, by the end of FY2022.

A caveat is in order about the financial projections underlying these recommendations. The projections should be regarded as rough estimates due to data limitations and significant uncertainty about major factors that will affect the State's budget. For example, the new administration in Washington is considering fundamental changes to the Medicaid program that

could sharply reduce the amount of federal funding available to Illinois.[109] After two years, the outcome of labor negotiations with the State's largest union is still uncertain, with members of the American Federation of State, County and Municipal Employees (AFSCME) in the midst of a vote on whether to authorize their first strike against Illinois.[110] Another example is the transportation lockbox amendment[111] approved by Illinois voters at the November 2016 general election. The amendment restricts some transportation-related revenues, such as vehicle licensing fees, to various transportation-related expenses. Although proponents of the amendment claimed that its purpose was primarily to prevent sweeps from transportation funds,[112] the full effect of this amendment on the General Funds is still unknown.

[109] Robert Pear, "Trump's Health Plan Would Convert Medicaid to Block Grants, Aide Says," *The New York Times*, January 22, 2017.
[110] Doug Finke, "AFSCME starts vote on authorizing state employee strike," *The State Journal-Register*, January 30, 2017.
[111] Ill. Const. art. IX, sec. 11.
[112] *See* Institute for Illinois' Fiscal Sustainability at the Civic Federation, "State of Illinois Diversions of Transportation Funds," blog post, October 7, 2016, http://civicfed.org/iifs/blog/state-illinois-diversions-transportation-funds, (last visited on February 9, 2017).

The following table presents the Civic Federation's comprehensive plan for the State of Illinois.

**State of Illinois: Adjusted Governor's Five-Year Budget Projection and Civic Federation Comprehensive Plan FY2017-FY2022 (in $ millions) with Backlog Bonds**
General Funds, Fund for the Advancement of Education and Commitment to Human Services Fund (combined)

| | Governor's FY2017 | Estimated FY 2017 | Projected FY 2018 | Projected FY 2019 | Projected FY 2020 | Projected FY 2021 | Projected FY 2022 |
|---|---|---|---|---|---|---|---|
| **Revenues** | | | | | | | |
| State Source Revenues | $ 29,048 | $ 29,048 | $ 29,543 | $ 30,086 | $ 30,970 | $ 31,838 | $ 32,715 |
| Federal Revenues | $ 3,809 | $ 3,809 | $ 3,847 | $ 3,886 | $ 3,924 | $ 3,964 | $ 4,003 |
| Other Resources | $ 856 | $ 856 | $ 70 | $ - | $ - | $ - | $ - |
| **Civic Federation Tax Changes** | | | | | | | |
| Increase Individual Income Tax (5.25% through 12/31/2021, then 5%) | $ - | $ 2,782 | $ 5,776 | $ 5,905 | $ 6,137 | $ 6,387 | $ 6,091 |
| Increase Corporate Income Tax (7.0%) | $ - | $ 325 | $ 642 | $ 657 | $ 703 | $ 729 | $ 747 |
| Increase Local Share of Income Tax to 10% | | | | | $ (1,009) | $ (1,050) | $ (1,035) |
| Retirement Income[1] | $ - | $ 1,319 | $ 2,745 | $ 2,890 | $ 3,043 | $ 3,203 | $ 3,292 |
| Local Government Share of Retirement Income Tax[2] | $ - | $ (75) | $ (157) | $ (289) | $ (304) | $ (320) | $ (329) |
| Business Tax Changes | $ - | $ - | $ 265 | $ 265 | $ 265 | $ 265 | $ 265 |
| Sales Tax on Services at 5.5%[3] | $ - | $ - | $ - | $ 705 | $ 1,438 | $ 1,467 | $ 1,497 |
| Reduce State General Sales Tax to 5.5%[4] | $ - | $ - | $ - | $ (641) | $ (1,305) | $ (1,330) | $ (1,355) |
| **Net New Revenues** | **$ -** | **$ 4,351** | **$ 9,271** | **$ 9,492** | **$ 8,969** | **$ 9,352** | **$ 9,173** |
| **Total Revenues** | **$ 33,713** | **$ 38,064** | **$ 42,731** | **$ 43,464** | **$ 43,863** | **$ 45,154** | **$ 45,891** |
| **Expenditures** | | | | | | | |
| Net Agency Expenditure | $ 25,336 | $ 25,336 | $ 25,800 | $ 26,273 | $ 26,724 | $ 27,185 | $ 27,653 |
| Pension Contributions | $ 6,971 | $ 6,971 | $ 7,889 | $ 8,088 | $ 8,330 | $ 8,659 | $ 8,949 |
| Group Insurance Payments | $ 1,810 | $ 1,810 | $ 1,873 | $ 1,939 | $ 2,007 | $ 2,077 | $ 2,150 |
| Statutory Transfers[5] | $ 2,547 | $ 2,547 | $ 2,575 | $ 2,634 | $ 2,707 | $ 2,786 | $ 2,867 |
| Debt Service | $ 2,350 | $ 2,350 | $ 2,418 | $ 2,091 | $ 1,536 | $ 1,585 | $ 1,628 |
| **Civic Federation Expenditure Changes** | | | | | | | |
| CTPF Unfunded Liability | $ - | $ 487 | $ 477 | $ 531 | $ 571 | $ 596 | $ 621 |
| TRS Normal Cost Shift | $ - | $ - | $ (322) | $ (631) | $ (924) | $ (899) | $ (876) |
| EITC Increase 10%-15% | $ - | $ - | $ 131 | $ 134 | $ 139 | $ 145 | $ 151 |
| Supplemental Pension Payment (Postponed to Pay Debt Service on Backlog Bonds) | | | | | | | |
| Debt Service on Backlog Bonds | $ - | $ - | $ 226 | $ 2,070 | $ 2,064 | $ 2,058 | $ 2,053 |
| **Total Civic Federation Expenditure Changes** | **$ -** | **$ 487** | **$ 511** | **$ 2,104** | **$ 1,850** | **$ 1,900** | **$ 1,949** |
| **Total Expenditures[6]** | **$ 39,014** | **$ 39,501** | **$ 41,067** | **$ 43,129** | **$ 43,154** | **$ 44,192** | **$ 45,196** |
| **Operating Surplus (Deficit)[7]** | **$ (5,301)** | **$ (1,437)** | **$ 1,662** | **$ 335** | **$ 709** | **$ 963** | **$ 696** |
| **Proceeds from Backlog Bonds** | **$ -** | **$ -** | **$ 8,963** | **$ -** | **$ -** | **$ -** | **$ -** |
| **Bill Backlog** | **$ (14,489)** | **$ (10,625)** | **$ -** | **$ -** | **$ -** | **$ -** | **$ -** |
| **Reserves** | **$ -** | **$ -** | **$ -** | **$ 335** | **$ 1,043** | **$ 2,006** | **$ 2,702** |

[1] Revenue estimates for taxing of retirement income include all income taxable at the federal level.

[2] Local governments begin to get full 10% share of retirement income tax in FY2019.

[3] Excludes business-to-business transactions and medical services, but includes financial and legal services. The 5.5% rate reflects a 4.25% State rate and 1.25% rate for local governments. Implemented in January, 2019.

[4] The 5.5% sales tax rate reflects a 4.25% State rate and 1.25% rate for local governments. The State rate is reduced from the existing 5.0% and the total rate is reduced from 6.25%. Implemented in January, 2019.

[5] Includes repayment of $15 million of interfund borrowing in FY2017.

[6] Includes approximately $3.9 billion of as-yet-unauthorized expenditures in FY2017 to maintain services at existing levels.

[7] The Civic Federation has made adjustments to the starting backlog for FY2017 of $131 million, reflecting actual FY2016 results in the Traditional Budgetary Financial Report. Additionally, $815 million in accumulated FY16 higher education bills that GOMB excluded from its analysis are included here.

Source: State of Illinois, Governor's Office of Management and Budget, *Five Year Forecast* , *FY18-FY22* , November 15, 2016; Civic Federation calculations.

In addition to the assistance provided to the Chicago Public Schools through the proposed change in pension funding, the Federation's plan provides new revenues for local governments through the proposed tax changes. The plan also increases costs for school districts outside of Chicago because of the proposed shift in normal pension costs from the State to local districts.

The main source of new funds for local governments is an increased share of income tax revenue at the higher proposed rates. Before tax rates were increased in 2011, local governments received 10% of total net income tax collections (after amounts were deducted to pay for tax refunds). The rate increases brought in more revenue for the State, but the share paid to local governments was still based on the revenues collected at the old rates. The Civic Federation's plan restores the

local share to 10% of total net collections in FY2020, which generates more than $1 billion. Although the State needs all of the new revenues from taxation of retirement income to balance its FY2018 budget, local governments begin to receive the full 10% share beginning in FY2019.

Once fully implemented, the sales tax on services provides an estimated $412 million to local governments in FY2022. This represents the 1.25% distributed to local governments based on their share of the State sales tax rate. The tax on services could bring in significantly more if municipal sales tax rates are applied to the new tax base.

As shown in the next table, the net effect on local governments is an additional $562 million in FY2017. The net additional assistance increases to $1.5 billion in FY2022.

| Civic Federation Comprehensive Plan FY2017-FY2022 (in $ millions)<br>Net Effect on Local Governments* | Estimated FY 2017 | Projected FY 2018 | Projected FY 2019 | Projected FY 2020 | Projected FY 2021 | Projected FY 2022 | Projected FY 2023 | Projected FY 2024 |
|---|---|---|---|---|---|---|---|---|
| Increase Local Share of (Increased) Income Tax to 10% | $ - | $ - | $ - | $ 1,009 | $ 1,050 | $ 1,035 | $ 1,018 | $ 1,057 |
| Local Government Share of Retirement Income Tax | $ 75 | $ 157 | $ 289 | $ 304 | $ 320 | $ 329 | $ 338 | $ 356 |
| Local Share of Service Sales Tax | $ - | $ - | $ 194 | $ 396 | $ 404 | $ 412 | $ 420 | $ 428 |
| CTPF Unfunded Liability | $ 487 | $ 477 | $ 531 | $ 571 | $ 596 | $ 621 | $ 700 | $ 728 |
| TRS Normal Cost Shift | $ - | $ (322) | $ (631) | $ (924) | $ (899) | $ (876) | $ (851) | $ (823) |
| **Total Assistance to Local Government** | **$ 562** | **$ 312** | **$ 383** | **$ 1,356** | **$ 1,470** | **$ 1,522** | **$ 1,625** | **$ 1,745** |

*Does not include local benefit from proposed reduction of retailer's discount.

Source: Civic Federation calculations based on data sources in table on p. 33.

### *Issue 1: Spending Controls*

The Illinois Constitution states that neither the Governor's proposed budget, nor the appropriations adopted by the General Assembly, can exceed estimated revenues.[113] Nevertheless, every year since 2001, expenses in the General Funds have exceeded the revenues available to pay for them.[114] During those years, the State has relied on a number of measures to get from one year to the next, using one-time measures such as sweeps from other funds[115] and borrowing for operations.[116]

As part of this Roadmap, the Civic Federation proposes a number of new sources of revenue to eliminate deficits, eliminate the large backlog of unpaid bills and enhance the stability of the pension funds. However, if new revenues are instead redirected to new spending, progress toward fiscal sustainability will be imperiled. Therefore, it is imperative that spending be

[113] Ill. Const. art. VIII, sec. 2.
[114] State of Illinois Comptroller, "General Funds Budgetary Balance," *The Ledger*, http://ledger.illinoiscomptroller.gov/fiscal-condition/ (last visited on February 9, 2017). Deficits are measured as gross outstanding expenditures in excess of fund balance at the end of the fiscal year.
[115] Illinois General Assembly, Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary, Fiscal Year 2017*, August 10, 2016, 222-224.
[116] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois Enacted FY2015 Budget: A Review of the Operating and Capital Budgets for the Current Fiscal Year*, October 19, 2014, p. 54, https://www.civicfed.org/iifs/publications/FY15_EnactedBudget (last visited on February 9, 2017).

controlled, and the Civic Federation only endorses revenue increases in the context of a comprehensive multi-year plan that includes limits on spending.

In its five year projection, the Governor's maintenance budget grows net agency expenditures by only 1.7% per year.[117] This is lower than the Federal Reserve's longstanding inflation target of 2.0%.[118] The Civic Federation endorses this constrained level of spending growth until the State's fiscal condition can be substantially improved.

***Civic Federation Recommendation on Spending***

**The Civic Federation recommends that the State of Illinois limit net agency spending growth to 1.7% annually through at least FY2022.**

### *Issue 2: Increasing Income Tax Rates*

The 25% reduction in the income tax rates for individuals and corporations on January 1, 2015 created a significant revenue cliff for the State of Illinois beginning in FY2015 and continuing through the present.

The partial rollback of the FY2011 temporary income tax increase reduced the individual rate from 5.25% to 3.75% and the corporate rate from 7.0% to 5.25%. This reduction caused total income tax revenues to decline by $1.7 billion in FY2015 to $18.1 billion and by an additional $3.3 billion in FY2016 to $14.9 billion.[119] This amounts to an aggregate two-year decline of $4.9 billion, or 13.3% of the FY2014 total revenue of $36.8 billion.

While the FY2015 budget was balanced with one-time measures including $1.3 billion of fund sweeps and $454 million of interfund borrowing, FY2016 expenditures exceeded revenues by $643 million dollars,[120] in addition to the more than $3 billion in accumulated, unpaid operational liabilities.[121]

The Governor's five-year projection shows that even after several years of underlying growth, General Funds revenues are projected to total only $36.8 billion in FY2022, which is still $100 million below the peak eight years earlier.[122]

In light of the potential accumulated backlog of unpaid bills in excess of $14 billion at the end of FY2017, the State is not in a position to prolong the reduction in tax rates without a plan to balance its operating budget and pay down its bills. Due to the lack of action taken to address the revenue in the last two years, the State must now make up for lost time to stabilize the State's finances.

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[117] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016

[118] Federal Open Market Committee of the Board of Governors of the Federal Reserve Bank, *news release*, February 1, 2017.

[119] State of Illinois Comptroller, *Traditional Budgetary Financial Report Fiscal Year 2016*, p. 5.

[120] State of Illinois Comptroller, *Traditional Budgetary Financial Report Fiscal Year 2016*, p. 11.

[121] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016.

[122] State of Illinois Governor's Office of Management and Budget, *General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down*, November 15, 2016.

The Civic Federation calculates that the state needs to raise the individual income tax to 5.25% and restore the corporate income tax to 7.0%. Moreover, local governments would not be given a share of the increased rate until FY2020. However, if the other recommendations in this Roadmap are followed, and if Illinois economic growth meets or exceeds the Governor's conservative projections, then the Civic Federation projects that the State would be in a position to lower the individual income tax rate to 5.0% beginning in calendar year 2022.

To offset some of the impact of the higher taxes included in the Civic Federation's comprehensive plan, the State should provide an offsetting benefit to lessen the impact on low income residents.

The federal earned income tax credit (EITC) is a benefit provided to working individuals with low and moderate incomes. The credit reduces tax liabilities based on income level and household size and can be claimed as a refund if the credit exceeds tax liabilities.

As of 2017 single individuals claiming no dependents and income less than $15,010 could claim a maximum federal credit of $510 and married individuals without children could claim the same credit if their income was below $20,600. For a married couple with three or more children and an income of $53,930 or less the maximum credit that could be claimed was $6,318. Single individuals with three or more children may also claim that amount with an income of $48,340 or less.[123]

Illinois currently matches 10% of the federal credit, which cost the State an estimated $234 million in FY2015.[124] If the credit was increased by 50%, payments would increase by $315 for the highest level of benefits available to married individuals with three or more dependents.

***Civic Federation Recommendation on the Income Tax Rate Rollback***

**The Civic Federation recommends retroactively increasing the income tax rates as of January 1, 2017 to 5.25% for individuals and 7.0% for corporations to mitigate a large portion of the current financial crisis. Local governments would receive a 10% share of the proceeds, but not until FY2020. Halfway through FY2022, if the budget has stabilized in accordance with projections, the State should lower the individual income tax rate to 5.0%.**

**The Civic Federation recommends mitigating some of the impact of the tax measures included in the comprehensive plan on lower income residents through an immediate 50% increase to the amount of the federal EITC match by the State of Illinois.**

[123] Internal Revenue Service, *2017 EITC Income Limits, Maximum Credit Amounts and Tax Law Updates*, https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eitc-income-limits-maximum-credit-amounts-next-year (last visited on February 9, 2017).
[124] State of Illinois Comptroller, *Tax Expenditure Report Illinois Fiscal Year 2015*, April 2016, p. B-1.

### *Issue 3: Retirement Income Exclusion*

Unlike the federal government, which taxes certain levels of Social Security benefits and other retirement income, Illinois excludes all retirement income from the State's income tax base.[125] Out of the 41 states that impose an income tax, Illinois is one of three that exclude all pension income and one of 27 that exclude all federally taxable Social Security income.[126]

The Illinois Comptroller reports that this exclusion of federally taxable retirement income reduced individual income tax revenues by $2.3 billion in FY2015.[127] This exclusion is the most expensive of all of the State's tax breaks and the cost is expected to increase rapidly over time as the population ages.[128]

Historically, retirement income has grown at a much higher annual rate than regular income. Between 2007 and 2014, retirement income in Illinois (excluding federally taxable Social Security benefits) grew at an average annual rate of about 5.3%, while other individual income increased on average by less than 1% per year.[129]

Including this high-growth component in the income tax base would provide for a more sustainable revenue source for the State. At the Civic Federation's proposed individual income tax rate of 5.25%, the additional State revenue from taxing the federally taxable portion of retirement income is estimated to be $2.7 billion in FY2018. After the income tax rate is lowered to 5.0% on January 1, 2022, the new tax would bring in $3.8 billion in FY2023. The proposal would also provide local governments with an estimated $153 million in FY2018 and $338 million in FY2023.[130]

Illinois is an outlier regionally among bordering states in excluding all retirement income. Although Michigan, Indiana, Wisconsin, Iowa and Missouri all exempt Social Security income, they also tax other retirement income. Indiana has the lowest rate of 3.3%, which is a flat income tax rate applied to non-Social Security retirement income.[131] Iowa charges the highest rate, which is the top rate on its graduated income tax scale of 8.98% applied to earners above $69,930, but also exempts specified amounts of retirement income for taxpayers aged 55 or older.

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[125] 35 ILCS 5/203(F).

[126] National Conference of State Legislatures, *State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2014*, April 3, 2015. At the federal level, between 15% and 100% of Social Security benefits are excluded from taxation. Generally, Social Security benefits are not taxable if they represent a taxpayer's only income. If base income is up to $25,000 for an individual or $32,000 for joint filers, then no tax is owed. Base income is the sum of half of Social Security benefits plus all other income.

[127] State of Illinois Comptroller, *Tax Expenditure Report Fiscal Year 2015*, April 2016, p. 4.

[128] State of Illinois Comptroller, *Tax Expenditure Report Fiscal Year 2013*, April 2014, p. 7.

[129] Civic Federation calculations based on Internal Revenue Service, *SOI Tax Stats-Historic Table 2*, https://www.irs.gov/uac/soi-tax-stats-historic-table-2 (last visited on February 9, 2017).

[130] Civic Federation calculations based on Illinois Department of Revenue, *Illinois Individual Income Tax Returns with Retirement Income Subtraction: Tax Year-2014-Preliminary*, January 2016, http://www.revenue.state.il.us/AboutIdor/TaxStats/2014/2014-IIT-AGI-Retirement-Prelim.pdf (last visited on February 9, 2017).

[131] Indiana's tax rate declines to 3.23% in tax year 2017. Many Indiana counties charge an additional income tax.

***Civic Federation Recommendation on Taxing Retirement Income***

**The Civic Federation recommends that the State of Illinois broaden its income tax base by eliminating the tax exclusion for all federally taxable retirement income. This will enhance the State's fiscal stability by providing access to a faster growing portion of the income tax base.**

### *Issue 4: Expanding the Sales Tax Base and Lowering the Rate*

The scope of Illinois' fiscal crisis is so large that raising income taxes alone would not be enough to stabilize the State's finances. The second largest State revenue source is the sales tax but sales tax rates across Illinois are already too high to allow for an increase in the State rate. For example, the combined sales tax rate in the City of Chicago is highest of any major municipality in the Unites States at 10.25%.[132] The State charges 6.25 percentage points, and the remaining 4.0 percentage points are charged by local taxing authorities. Of the State's 6.25 percentage points, 1.25 percentage points are distributed to local governments, counties, and mass transit districts.[133]

While a sales tax rate increase is not prudent, the State could examine broadening the sales tax base to generate additional revenue. According to a revenue study issued by the Commission on Government Forecasting and Accountability, Illinois' sales tax base is much narrower than those in other states leading to greater volatility and higher rates.[134]

One cause of this narrowness is that Illinois excludes services from its sales tax base, with the exception of several public utility taxes.[135] In addition to narrowing the tax base, this exposes Illinois to negative long-term revenue trends. Nationwide sales tax revenues have grown more slowly than other state revenues in recent years, in part because of online sales.[136] Moreover, goods have declined relative to services as a proportion of total consumer spending.[137] As part of a path to sustainable state finances, Illinois should contemplate expanding its sales tax to cover services.

During the 2014 gubernatorial campaign, Governor Bruce Rauner proposed broadening the sales tax base in Illinois to include 32 services that are currently untaxed, which was estimated to

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[132] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois' National Rankings – 2016 Update*, November 2016, p. 10.
[133] Illinois General Assembly Legislative Research Unit, *Illinois Tax Handbook for Legislators*, 32nd Ed., March 2016, p. 119.
[134] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 66.
[135] Illinois General Assembly Legislative Research Unit, *Illinois Tax Handbook for Legislators*, 32nd Ed., March 2016, p. 86.
[136] Jackson Brainerd, "Taxed and Spent: Does the Sales Tax Have a Future?" *State Legislatures Magazine*, June 1, 2016.
[137] Fred Nicely and Liz Malm, National Conference of State Legislators, *Broadening the Sales Tax Base Do's and Don'ts*, http://www.ncsl.org/documents/statefed/Sales_Tax_Base_Expansion_Practices.pdf (last visited on February 9, 2017).

generate an additional $600 million in General Funds revenue.[138] However, this proposal has not been pursued by the Governor's administration.

In the meantime, the State's financial condition has worsened and it is necessary to look at a broader sales tax on services as part of a comprehensive plan to adequately address the State's financial crisis. Any taxation of services is expected to be controversial and draw intense opposition and legal challenges from a variety of special interest groups.

In the past attempts to add individual services to the current sales tax laws, which are made up of the Retailers' Occupation Tax, Service Occupation Tax, Service Use Tax and Use Tax, have been challenged in court. According to a policy analysis by the Illinois Department of Revenue,[139] the Illinois Supreme Court's ruling in at least one case would likely prevent individual services from being added to the current sales tax laws incrementally due to the Illinois Constitution's uniformity clause.[140]

If lawmakers intend to tax services in Illinois, according to the Revenue Department analysis, the State would need to tax them comprehensively under a new general consumer services sales tax or as individual excise taxes. To effectively broaden the base of the sales tax to address volatility and higher rates in Illinois, the process of enacting, implementing and administrating each individual service area as its own excise tax would likely require a far too cumbersome and expansive bureaucracy.

By enacting a general consumer services sales tax the State could more efficiently broaden its tax base while avoiding business-to-business services taxation, which could lead to tax pyramiding. A broader law focused on consumer services could also exempt services that are not typically subject to sales taxes such as medical and strictly business services. These items could be broadly protected from taxation while adhering to the Illinois Constitution's uniformity clause[141] that requires real and substantial difference between those objects taxed and those objects not taxed, and that the classification serve some reasonable relationship to the object of the legislation or to public policy.

If enacted, it should be expected that the new State revenues from the additional categories would be delayed for 18 to 24 months to allow for implementation.[142] Even after legislative action is taken to authorize taxing services, the complexity of collecting the tax may require new rules for sourcing and other administrative guidelines. Some of the new procedures may require review and approval by the legislature's Joint Committee on Administrative Rules. Other delays due to technology acquisition for businesses that do not currently collect sales taxes and connectivity with the Illinois Department of Revenue's existing systems should also be assumed. Finally, there is a one-month lag between collecting sales taxes and remission to the State.

A variety of revenue estimates have been produced to illustrate the range of revenue the State could receive if it were to broadly apply the sales tax to all service transactions or more narrowly tailor a list of specific services to be taxed. The most recent estimates show that the broadest

[138] Paul Merrion, "Rauner, the anti-tax candidate, finds a tax he likes: on services," *Crain's Chicago Business*, July 26, 2014.
[139] Communication between the Civic Federation and Illinois Department of Revenue, December 9, 2017.
[140] Fiorito v. Jones, 39 Ill.2d 531, 236, N.E. 2d 698 (Ill. 1968).
[141] Ill. Const. art. IX, sec. 2.
[142] Communication between the Civic Federation and Illinois Department of Revenue, December 9, 2017.

taxation of all service purchases including personal and business-to-business transactions could produce revenues totaling $9.3 billion, or $4.1 billion if business-to-business transactions are excluded.[143] A narrower application of the sales tax on services that excludes all business-to-business transactions and medical services could increase annual General Funds revenue by an estimated $1.86 billion per year at the current 6.25% rate, once fully implemented.[144]

However, once the sales tax is broadened to include services, the Civic Federation recommends lowering the State portion of the sales tax rate (on goods as well as services) by 0.75 percentage points to 4.25%. With the local share at 1.25%, the total state sales tax would stand at 5.50%, providing some relief to retailers and consumers across the state.

The Civic Federation estimates that the lower rate would cost the General Funds approximately $1.3 billion in existing sales tax revenue, but the loss would be more than offset by General Funds revenue from taxing services. While the total revenue from taxing services would be lowered by about $400 million to $1.44 billion, the net effect of both the extension to services and the lowering of the general rate on the General Funds, once fully implemented, is about $130 million in additional revenue per year. Moreover, since the base of Illinois' sales tax will be much broader, the shift should lead to increased revenue stability and lessen the gradual erosion of one of the "Big Three" revenues for the State.[145]

***The Civic Federation Recommendation on Expanding the Sales Tax Base***

**The Civic Federation recommends that the State of Illinois expand the sales tax base to include a new general consumer services tax while strictly excluding all business-to-business services and medical services. Once implemented, the State should lower the sales tax rate on both goods and services from 6.25% to 5.50% by subtracting 0.75 percentage points from the State's share of the tax.**

### *Issue 5: Business Tax Expenditures*

The Civic Federation believes as a matter of principle that tax exemptions and benefits should sunset and that their renewals be debated and discussed, not continued indefinitely. There should be evidence that tax credits or reductions granted actually produce the benefits promised and that analysis should be conducted and published in a report by the Department of Revenue for existing as well as new tax incentives and credits.

The Federation recommends the following changes to business taxes, which are designed to reduce or eliminate outdated and economically inefficient tax policies:[146]

- Reduce the retailer's discount: Illinois is one of 28 states that offer a retailer's discount, also known as a vendor discount or vendor collection allowance.[147] The retailer's

[143] Communication between the Civic Federation and Illinois Department of Revenue, January 19, 2016.
[144] The Civic Federation projections assume the first revenues will be available in January 2019, and that FY2020 will be the first full year of revenue under the expansion.
[145] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study*, December 31, 2014, p. 65.
[146] Savings estimates below were provided by the Illinois Department of Revenue.

discount is the percentage of sales tax due on a transaction that retailers are allowed to retain as reimbursement for collecting sales taxes and remitting them to the state.[148] Illinois' retailer's discount of 1.75%, with no monthly limit, is the third highest in the U.S., behind Colorado at 3.3% and Missouri at 2.0%.[149] The retailer's discount was expected to cost the State about $125 million in lost revenue in FY2016. If the amount of sales tax kept by each retailer were capped at $200 per month, the State would save about $85 million over 12 months.[150] This action is expected to affect only the largest 5% of retailers.

- Eliminate the E-10 (ethanol) incentive: The E-10 incentive is a 20 percent per gallon sales tax break on E-10, which is scheduled to expire in 2018. E-10 is 10% ethanol and 90% gasoline. The incentive was enacted when ethanol was not universally available as a way to encourage gas stations to start carrying ethanol. Now that almost all fuel sold is E-10, it is no longer needed. The change is expected to generate $100 million per year.
- Decouple from the domestic production activities deduction: This rule allows companies involved in certain production activities to reduce their taxable income related to those activities by 9%. In addition to manufacturing, the deduction covers a broad range of activities including food processing, filmmaking and utilities. In Illinois and other states that offer the deduction, the incentive also applies to activities that take place outside the state. Twenty-one states (including Indiana, Wisconsin and Minnesota) have disallowed the deduction.[151] Decoupling in Illinois is expected to generate $65 million per year.
- Eliminate the continental shelf exemption: The definition of United States would be changed to include the outer continental shelf, thus requiring Illinois companies that drill offshore to pay a share of State corporate income taxes. The change is expected to generate $15 million per year.

***Civic Federation Recommendation on Business Tax Expenditures***

**The Civic Federation recommends that the retailer's discount from sales tax receipts be capped at $200 per month per retailer. The E-10 ethanol incentive should be eliminated. Illinois should decouple from the federal domestic production activities deduction from corporate income tax. Finally, the State should eliminate the continental shelf exemption from total corporate income.**

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[147] Federation of Tax Administrators, *State Sales Tax Rates and Vendor Discounts*, January 1, 2017, http://www.taxadmin.org/assets/docs/Research/Rates/vendors.pdf (last visited on February 9, 2017).

[148] For example, for a purchase of $100 with a state sales tax rate of 6.25%, sales taxes are $6.25 and the retailer is allowed to keep 11 cents ($6.25 x 1.75%).

[149] Illinois General Assembly, Tax Policy Subcommittees, Joint Revenue & Finance and State Government Administration Committees, *Report on Findings*, May 28, 2014, p. 13.

[150] This estimate has not been revised to account for the reduction in the sales tax rate proposed by the Civic Federation.

[151] Michael Mazerov and Chris Mai, Center on Budget and Policy Priorities, *States Can Opt Out of the Costly and Ineffective "Domestic Production Deduction" Corporate Tax Break*, January 31, 2013, p.1.

### *Issue 6: Merging the Chicago and State Teachers' Pension Funds*

The Civic Federation recommends that the Chicago Public Schools (CPS) work with the General Assembly and the Teachers' Retirement System (TRS) to consolidate the Chicago Teachers' Pension Fund (CTPF) with TRS.

In conjunction with this change, CPS should continue to be responsible for paying the normal cost of its plan, while responsibility for paying all of the normal cost of each school district outside of Chicago should be shifted over three years to that school district.

Consolidating CTPF and TRS would eliminate the current inequitable funding structure under which Chicago taxpayers pay for both nearly the entire cost of Chicago teachers' pensions and downstate and suburban teachers' pension costs. It would achieve some cost efficiencies as duplicative functions were eliminated.

Under a consolidation plan, the CTPF and TRS systems would be managed by a single pension board that would have proportional representation for both teachers' pension funds. However, the current member plans would be maintained as separate accounts. The State of Illinois would assume responsibility for the unfunded liability of CTPF, while CPS would continue to fund the pension fund's normal cost (the annual cost of the pension plan's benefits).

Adjusted for the fact that CPS makes its contribution at the end of the fiscal year, the employer normal cost for FY2017 is $136.8 million. State assumption of the CTPF unfunded liability would reduce its FY2017 required contribution by approximately $531.4 million, helping to stabilize the district's finances.

The current situation in which local school districts outside Chicago have the power to incur expenses while the State of Illinois must pay those expenses is unsustainable and fiscally reckless. State taxpayers should not be required to pay the operating cost of local governments. Instead, all school districts in Illinois should assume funding the full normal cost of their employee pensions. The responsibility for contributing to a worker's pension should rest with the employer who determines the worker's salary. The shift would help inject greater fiscal accountability into school district operations and budgeting and would eventually offset the additional cost of the State taking on the unfunded liability of Chicago teachers' pensions.

In FY2018 the State's statutorily required contribution to TRS is $4.6 billion, with $3.6 billion going toward the unfunded liability and $968 million for normal cost.[152] The shift of the State's share of normal cost to school districts could be achieved gradually, over a period of three years, to allow school districts sufficient time to adjust to the change. To help pay for the normal cost of teachers' pensions, school districts could end the practice of paying or "picking up" all or a share of the annual 9.4% employee pension contribution.

It is reasonable for the State of Illinois to continue to assume financial responsibility for the unfunded liability of all school districts because:

[152] Teachers' Retirement System of the State of Illinois, *Actuarial Valuation and Review of Benefits as of June 30, 2016*, January 5, 2017, pp. 4 and 78. School districts currently cover about $85 million of normal cost, including administrative expenses.

- The State created the current expensive and unsustainable situation that has led to $71.4 billion in unfunded liability and a funded ratio of 39.8% for TRS as of June 30, 2016[153] and $9.6 billion in unfunded liability and a funded ratio of 52.4% for CTPF;[154] and
- Paying these enormous costs is beyond the capability of local school districts to readily absorb. This is particularly the case because they rely heavily on property taxes to fund their operations and many are under the property tax extension limitation law (PTELL), which limits levy increases to 5% or the rate of inflation, whichever is less.

CPS' budget for FY2017 relied on $215.2 million in additional State funding to pay for that year's normal pension costs. Governor Rauner vetoed the State funding on December 1, 2016,[155] and CPS has begun to announce spending cuts to fill the budget hole.[156] To achieve both equity and accountability, the State should assume responsibility for CTPF's unfunded liability rather than paying for the district's normal costs.

***Civic Federation Recommendation on CPS and State Teachers' Pension Funding Reform***

**The Civic Federation recommends that the Chicago Teachers' Pension Fund be consolidated with the Teachers' Retirement System and that the State assume responsibility for the unfunded liability of CTPF. The Federation also recommends that the Chicago Public Schools continue to pay for the normal cost of Chicago teachers' pensions and that responsibility for the normal cost of pensions for teachers outside of Chicago be shifted from the State to local school districts over three years.**

### *Issue 7: Consolidating and Streamlining Government Units in Illinois*

The State of Illinois has by far the highest number of local governments in any state, at 6,963, according to the United States Census Bureau.[157] The multiplicity of local units of government, many of which are funded predominantly by property taxes, is often cited as a reason for high property tax rates in Illinois.[158]

In addition to recommending the merger of the Chicago Teachers' Pension Fund with the Teachers' Retirement System, the Civic Federation supports the following government consolidation initiatives:[159]

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[153] Teachers' Retirement System of the State of Illinois, *Actuarial Valuation and Review of Pension Benefits as of June 30, 2016*, January 5, 2017, *p. 4.* These figures are based on asset smoothing.
[154] Public School Teachers' Pension and Retirement Fund of Chicago, *Actuarial Valuation and Review as of June 30, 2016*, October 27, 2016, p. v.
[155] 99th Illinois General Assembly, Senate Bill 2822, vetoed on December 1, 2016. Senate Bill 5, introduced in the 100th General Assembly on January 11, 2017, would require the State to pay CTPF normal costs permanently.
[156] Greg Hinz, "CPS hits schools with new cuts, blames Rauner," *Crain's Chicago Business*, February 6, 2017.
[157] United States Census Bureau 2012 Census of Governments, "Government Organization Summary Report: 2012," September 26, 2013, p. 1.
[158] Illinois ranked seventh among the states in per capita property taxes collected in 2013 and was the highest ranking states in the Midwest. For more information, see Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois' National Rankings – 2016 Update*, November 2016, p. 30.
[159] For more information on these proposals, see Civic Federation, *The Civic Federation 2017 Legislative Priorities 100th General Assembly of the State of Illinois*, November 10, 2016,

- Consolidate local pension funds: There are over 600 local pension funds in the state, each with its own governing board, most of which are police and fire funds for individual municipalities. While these funds may enjoy local control over investing and disability decisions, the Federation believes that overall investment performance and administrative efficiency generated by economies of scale would greatly improve if funds were consolidated into the Illinois Municipal Retirement Fund.

- Merge the offices of the Illinois Comptroller and Treasurer: The Illinois Constitution currently divides the State's main fiscal operations between two offices: the Illinois Treasurer is responsible for collecting and investing state revenue while the Illinois Comptroller is responsible for paying bills from those accounts.[160] Several states have already combined those operations for greater efficiency including Wisconsin, Michigan and Minnesota. The Civic Federation supports an amendment to the Illinois Constitution to merge the offices of the Illinois Comptroller and Treasurer.

- Authorize townships to be dissolved by referendum: The Illinois Constitution appears to permit dissolution of townships by referendum (Illinois Constitution, Section 5: Townships). However, township laws only provide for the dissolution of all the townships in a county, not the dissolution of individual townships (60 ILCS 1/25-5 Discontinuance of Township Organization). Illinois statute states that 10% of registered voters in each township must petition for a referendum on continuance of township government. Elimination of township government then requires approval "with a majority of the votes in at least three-fourths of the townships that contain at least a majority of the population in the county." The Civic Federation sees no good public policy reason why the intent of the Illinois Constitution that township residents be able to dissolve township government should not be reflected in Illinois law. As such, the Federation encourages the Illinois General Assembly to pass legislation to clarify township dissolution procedures and allow dissolution via referendum.

- Consolidate property tax administration roles in Cook County: Administration of the Cook County property tax function is primarily handled by three different elected county officials (Assessor, Clerk and Treasurer), leading to taxpayer confusion about whom to contact with questions or complaints about the tax. The lines of responsibility are nearly impossible for ordinary taxpayers to discern and politicians exploit this fact to their political advantage. Building on the consolidation of the offices of the Cook County Recorder of Deeds and the Cook County Clerk approved by Cook County voters in a binding referendum in November 2016,[161] the Civic Federation recommends that a unified property tax administration office be created. The new office would merge the Treasurer's office; the County Clerk's tax extension, tax redemption and map divisions; the part of the Recorder's office dealing with property records; and the Auditor's

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https://www.civicfed.org/sites/default/files/2017civicfederationlegislativeagenda.pdf (last visited on February 9, 2017).

[160] Ill. Const. art. V, sec. 1-18.

[161] Alexandra Silets and Eddie Aruza, "Cook County Voters Choose to Merge Clerk, Recorder of Deeds Offices," *Chicago Tonight*, November 9, 2016.

property functions. It would be an appointed rather than an elected office. According to an opinion of the Cook County State's Attorney's Office, creating a unified Office of Property Tax Administration would require legislation be passed by the General Assembly and could not be done solely via County referendum or administratively.[162]

- Dissolve the Illinois International Port District: The Illinois International Port District should be dissolved because the District is failing to fulfill its principal mission of promoting shipping and port operations and is instead focused on its Harborside International Golf Center. In July 2013, Mayor Emanuel announced plans to privatize the Port District; following the announcement, the only potential bidder withdrew from negotiations in October 2013. In July 2015, the Port District sought investment and operating proposals for its maritime/industrial property. No additional public updates were available following the announcement. In July 2016, the Port District issued a request for proposals for Industrial Real Estate Broker Services and or Consulting Services. In late August 2016, the District reported it was in talks with several firms, none of which has been chosen to provide the services.[163] Due to ongoing serious concerns, the Civic Federation continues to call for the dissolution of the Illinois International Port District. After the District has been dissolved, the City of Chicago should consider transferring the District's open lands to the Forest Preserve District of Cook County and its golf courses to the Chicago Park District.

### *Issue 8: Borrowing to Pay the Bill Backlog*

That governments should not borrow to pay for operating expenses is a core principle of the Civic Federation, and to do so is a hallmark of fiscal irresponsibility. In fact, the Civic Federation, in its analysis of the proposed FY2012 budget, opposed Governor Quinn's plan to borrow to pay off a previous backlog of bills.[164]

However, after nearly two years without a budget and a bill backlog that could exceed $14 billion by the end of FY2017, extreme measures are now necessary to end the State's fiscal crisis.

The first and most compelling reason for borrowing is that for a considerable portion of the backlog the State could save on interest cost. The State's most recent general obligation bond issuance in November 2016 priced with a five-year yield of 2.88%.[165] This includes a spread to the AAA-rated benchmark of 1.76%.[166] Prevailing interest rates have risen since that issuance and are expected to continue to rise, the State is likely to face increased spreads on future deals

[162] Office of Tax Administration Report, Prepared by Representatives of the County Board President, Cook County Assessor, Cook County Clerk, Cook County Treasurer and State's Attorney.
[163] Eddie Arruza, "Port of Chicago Privatization Plan Draws Critics," *Chicago Tonight*, August 29, 2016.
[164] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2012 Recommended Operating and Capital Budgets: Analysis and Recommendations*, May 9, 2011, p. 5, https://www.civicfed.org/iifs/publications/state-illinois-fy2012-recommended-operating-and-capital-budgets-analysis-and-recom (last visited on February 9, 2017).
[165] State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016.
[166] Thompson Reuters, Municipal Market Data, November 8, 2016.

and the new issuance would not be tax-exempt because it covers operating costs. Nevertheless, even if there is a substantial increase in interest rates, the total borrowing cost of the bonds would still be lower than the 9% to 12% the state currently pays under the Prompt Payment Act.[167]

A second argument in favor of borrowing is that proceeds of the bonds could be restricted to paying existing bills. This restriction is vital if borrowing is to achieve its narrow focus: to repay the bill backlog quickly without adding to the State's financial distress. New revenues not tied to expenditures will be needed for debt service, and restricting the proceeds could help avoid political pressure to divert new revenues to new spending.

A final argument in favor of borrowing is that vendors would be paid immediately. Many vendors have had to wait for payment, which has resulted in some vendors cutting off service to the State and in social service providers reducing support for the most vulnerable citizens.[168] Eliminating the bill backlog immediately could help stabilize vendor finances and help restore confidence in Illinois.

Despite these advantages, borrowing is still a costly proposition. The Civic Federation estimates level debt service payments at over $2 billion per year over five years.[169] The following table contains an estimate of the debt service on such a large borrowing.

**Bill Backlog Bonds - Estimated Debt Service Schedule**
**Taxable Issuance Dated November 1, 2018**

| Date | Fiscal Year | Principal | Yield/ Coupon* | Price | Interest | Total Debt Service | Fiscal Year Total |
|---|---|---|---|---|---|---|---|
| 5/1/2018 | FY18 | | | | $ 225,509,783 | $ 225,509,783 | $ 225,509,783 |
| 11/1/2018 | FY19 | $ 1,652,595,000 | 4.10% | 100.000 | $ 225,509,783 | $ 1,878,104,783 | $ 2,069,736,369 |
| 5/1/2019 | | | | | $ 191,631,586 | $ 191,631,586 | |
| 11/1/2019 | FY20 | $ 1,720,350,000 | 4.61% | 100.000 | $ 191,631,586 | $ 1,911,981,586 | $ 2,063,959,104 |
| 5/1/2020 | | | | | $ 151,977,518 | $ 151,977,518 | |
| 11/1/2020 | FY21 | $ 1,799,655,000 | 5.02% | 100.000 | $ 151,977,518 | $ 1,951,632,518 | $ 2,058,438,696 |
| 5/1/2021 | | | | | $ 106,806,178 | $ 106,806,178 | |
| 11/1/2021 | FY22 | $ 1,890,000,000 | 5.34% | 100.000 | $ 106,806,178 | $ 1,996,806,178 | $ 2,053,149,355 |
| 5/1/2022 | | | | | $ 56,343,178 | $ 56,343,178 | |
| 11/1/2022 | FY23 | $ 1,990,925,000 | 5.66% | 100.000 | $ 56,343,178 | $ 2,047,268,178 | $ 2,047,268,178 |
| **Total Principal:** | | **$ 9,053,525,000** | | | **$ 1,239,026,700** | **$ 10,292,551,700** | |
| **Total Proceeds:** | | **$ 8,963,000,000** | | | | | |

* The Civic Federation assumes U.S. Treasury yields as of January 31, 2017, plus the spreads from the State of Illinois' general obligation series of November 2016, plus 200 basis points.

The large size of the issue could result in higher borrowing costs for capital projects if it exhausts the market's appetite for Illinois' credit. Moreover, it remains unclear whether the market would absorb such a large issuance from the lowest-rated state in the absence of a comprehensive plan to get the budget back into balance. At a minimum, the State should adopt the following principles to guide any plan for borrowing to pay off the backlog:

[167] 30 ILCS 540.
[168] See the section of this Roadmap entitled "Cost of the Budget Impasse," on p. 17, above.
[169] The Civic Federation assumes taxable U.S. Treasury yields as of January 31, 2017, plus the spreads from the State of Illinois, General Obligation Bonds, Series of November 2016, plus 200 basis points. The State could potentially reduce debt service by issuing a portion of these bonds tax-exempt through a deficit financing.

- The borrowing must be paired with a comprehensive, credible plan to balance the budget in FY2018 and match expenditures to revenues for the foreseeable future;
- The borrowing should be as short as possible in duration to minimize the burden on future fiscal years;
- The proceeds should be strictly limited to repaying existing, overdue bills; and
- The State should identify revenues for debt service not otherwise needed to balance the budget.

***Civic Federation Recommendation on Addressing the Bill Backlog***

***In order to eliminate the backlog, save on interest penalties and restore confidence in the State's finances, the Civic Federation recommends borrowing to pay off the accumulated backlog during FY2018. If the other recommendations in this Roadmap are adopted, the Civic Federation estimates that $8.96 billion in proceeds will be necessary to bring the backlog to zero by the end of FY2018. The bonds should amortize as quickly as possible, ideally within five years. This recommendation is contingent upon a balanced budget, a credible plan to maintain fiscal sustainability, restriction of the bond proceeds to eliminating the bill backlog and the payment of debt service with revenues not otherwise needed to balance the budget.***

### *Issue 9: Supplemental Pension Payments*

For many years, the State of Illinois has maintained the official position that a 90% funded ratio for its pensions is an adequate target.[170] Public Act 88-593 enacted a 50-year contribution schedule that would achieve 90% funding by 2045. As part of the act, the Commission on Government Forecasting and Accountability is required by law to revisit the adequacy of the 90% target every five years,[171] and it affirmed this view most recently in 2006[172] and 2011[173]. As part of its 2016 review, however, COGFA presented the view of its actuary, Segal, that the 90% target is insufficient.[174] The Civic Federation endorses the view that an actuarially sound pension payment plan calculates annual contributions to achieve a target of 100% funding within, at most, 30 years.

Under the pension reform law that was passed in 2013, the State would have moved to an actuarially based 30-year funding plan and made supplemental contributions to achieve 100% funding even sooner.[175] However, these provisions were overturned when the pension reform law was ruled unconstitutional in its entirety by the Illinois Supreme Court.[176] The State now remains on its original inadequate 50-year funding plan. The reduced funding levels built into the State's 50-year plan to achieve 90% funding mean that even after making its full statutory contribution,

[170] 40 ILCS 1-103.3(b).
[171] 40 ILCS 1-103.3(c).
[172] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, January 2006.
[173] Illinois General Assembly, Commission on Government Forecasting and Accountability, *A Report on the Appropriateness of the 90% Funding Target of Public Act 88-593*, June 2011.
[174] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Monthly Briefing*, November 2016, p. 12.
[175] Public Act 98-0599, signed on August 22, 1994.
[176] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015.

pension liabilities are expected to continue to grow annually, not beginning to drop until FY2029.[177]

In the current fiscal crisis the State cannot possibly generate the funding necessary to improve its pension funding plan until its operating budget is stabilized and the bill backlog is cleared. However, once the debt service on the backlog bonds is complete, a supplemental payment plan similar to the one included in the 2013 pension reform law could still be affordable and would put the State on track to reach 100% funding within the next 30 years.

Under Public Act 98-0599, the State would have been required to make supplemental payments totaling $364 million in FY2019 and $1.0 billion annually thereafter to the Pension Stabilization Fund until FY2045 or when the systems are all 100% funded. The payments would be transferred to the Pension Stabilization Fund and distributed among the five State retirement systems. Under the law, the additional assets from the supplemental payments could be used when calculating the funding ratios of the various pension funds but not when determining the annual contributions. The State was also prohibited from using any of the funds transferred into the Pension Stabilization Fund to offset or replace its actuarially based contribution. These restrictions were intended to make the supplemental payments a pure add-on to its required annual contributions.

Based on current actuarial estimates,[178] if the State made eleven annual supplemental payments of $1 billion, starting in FY2024 and continuing through FY2034, the State's retirement systems would experience a decline in unfunded liabilities beginning in FY2026 and would be 100% funded by FY2045. Assuming a long-term rate of return equal to the current 7.0% used by the Teachers' Retirement System, the $11 billion in supplemental payments would increase the assets of the retirement systems by $33.2 billion by FY2045.

[177] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2016, p. 10.
[178] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2016, p. 10.

The following table shows the application of the supplemental payments and the effect on the funded status of the retirement systems:

| State of Illinois Pension Funding Projections: Supplemental Annual Contribution FY2019 to FY2045 (in $ million) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Fiscal Year** | **Accrued Liabilities** | **Actuarial Value of Assets** | **Unfunded Liabilities** | **Funded Ratio** | **Supplemental Contribution Value*** | **Total Asssets with Supp. Value** | **Reduced Unfunded Liabilities** | **Increased Funded Ratio** |
| **2019** | $ 228,454 | $ 92,078 | $ (136,376) | 40% | $ - | $ 92,078 | $ (136,376) | 40% |
| **2020** | $ 235,141 | $ 95,422 | $ (139,719) | 41% | $ - | $ 95,422 | $ (139,719) | 41% |
| **2021** | $ 241,722 | $ 100,128 | $ (141,593) | 41% | $ - | $ 100,128 | $ (141,593) | 41% |
| **2022** | $ 248,183 | $ 104,951 | $ (143,232) | 42% | $ - | $ 104,951 | $ (143,232) | 42% |
| **2023** | $ 254,504 | $ 109,810 | $ (144,694) | 43% | $ - | $ 109,810 | $ (144,694) | 43% |
| **2024** | $ 260,667 | $ 114,690 | $ (145,977) | 44% | $ 1,000 | $ 115,690 | $ (144,977) | 44% |
| **2025** | $ 266,645 | $ 119,596 | $ (147,049) | 45% | $ 2,070 | $ 121,666 | $ (144,979) | 46% |
| **2026** | $ 272,416 | $ 124,563 | $ (147,853) | 46% | $ 3,215 | $ 127,777 | $ (144,639) | 47% |
| **2027** | $ 277,964 | $ 129,612 | $ (148,352) | 47% | $ 4,440 | $ 134,052 | $ (143,912) | 48% |
| **2028** | $ 283,273 | $ 134,733 | $ (148,540) | 48% | $ 5,751 | $ 140,484 | $ (142,789) | 50% |
| **2029** | $ 288,328 | $ 139,955 | $ (148,373) | 49% | $ 7,153 | $ 147,108 | $ (141,220) | 51% |
| **2030** | $ 293,111 | $ 145,278 | $ (147,833) | 50% | $ 8,654 | $ 153,932 | $ (139,179) | 53% |
| **2031** | $ 297,597 | $ 150,726 | $ (146,871) | 51% | $ 10,260 | $ 160,985 | $ (136,612) | 54% |
| **2032** | $ 301,827 | $ 156,414 | $ (145,413) | 52% | $ 11,978 | $ 168,392 | $ (133,435) | 56% |
| **2033** | $ 305,735 | $ 162,355 | $ (143,380) | 53% | $ 13,816 | $ 176,171 | $ (129,563) | 58% |
| **2034** | $ 309,318 | $ 169,641 | $ (139,677) | 55% | $ 15,784 | $ 185,424 | $ (123,893) | 60% |
| **2035** | $ 312,560 | $ 177,341 | $ (135,219) | 57% | $ 16,888 | $ 194,229 | $ (118,331) | 62% |
| **2036** | $ 315,462 | $ 185,519 | $ (129,944) | 59% | $ 18,071 | $ 203,589 | $ (111,873) | 65% |
| **2037** | $ 318,041 | $ 194,263 | $ (123,778) | 61% | $ 19,336 | $ 213,598 | $ (104,443) | 67% |
| **2038** | $ 320,271 | $ 203,624 | $ (116,647) | 64% | $ 20,689 | $ 224,313 | $ (95,958) | 70% |
| **2039** | $ 322,170 | $ 213,696 | $ (108,474) | 66% | $ 22,137 | $ 235,834 | $ (86,337) | 73% |
| **2040** | $ 323,752 | $ 224,581 | $ (99,171) | 69% | $ 23,687 | $ 248,267 | $ (75,484) | 77% |
| **2041** | $ 325,056 | $ 236,390 | $ (88,666) | 73% | $ 25,345 | $ 261,735 | $ (63,321) | 81% |
| **2042** | $ 326,128 | $ 249,256 | $ (76,872) | 76% | $ 27,119 | $ 276,375 | $ (49,753) | 85% |
| **2043** | $ 327,037 | $ 263,334 | $ (63,703) | 81% | $ 29,018 | $ 292,352 | $ (34,685) | 89% |
| **2044** | $ 327,866 | $ 278,804 | $ (49,062) | 85% | $ 31,049 | $ 309,852 | $ (18,013) | 95% |
| **2045** | $ 328,678 | $ 295,811 | $ (32,867) | 90% | $ 33,222 | $ 329,033 | $ 355 | 100% |

*Assumes $1.0 billion annually from FY2024 through FY2034. Earnings on these contributions, with a 7.0% long-term rate of return, will be sufficient to lower the unfunded liabilities of the funds to zero by FY2045.

Source: Commission on Government Forecasting and Accountibility, *"Special Pension Briefing* ," November 2016, p. 10; Civic Federation calculations.

It should be noted that the calculations above only include the existing State pension systems and do not account for merging the Chicago Teachers' Pension Fund with the Teachers' Retirement System as also recommended in this report.[179] However, due to the relatively small size of CTPF's liabilities compared to the State's existing five systems, their inclusion would not dramatically change the funding ratio.

[179] For more details on this proposal see *Issue 6: Merging the Chicago and State Teachers' Pension Funds* on p. 42 of this report.

The growth in the State of Illinois' already large unfunded public pension liability is often cited by the three major bond agencies as a contributing factor to the State's low bond ratings.[180] Reinstating the supplemental payment plan would more quickly start to decrease unfunded liabilities and act as a spending control that prioritizes pension costs until the systems are fully funded.

It should be noted that the State also sold Pension Obligation Bonds in FY2003 that are repaid through FY2033. The debt service for these bonds is heavily back-loaded, with principal payments ballooning from $674 million in FY2020 to nearly $1.2 billion in FY2032 and FY2033.[181] However, the debt service cost of the 2003 bonds is offset in the statutory calculation of the State's annual pension contributions.[182] So the cost of these bonds should not impede the State from making supplemental pension payments.

***Civic Federation Recommendation on Supplemental Pension Payments***
***In order to mitigate the additional cost of the State's inadequate statutory pension payments, the Civic Federation recommends requiring annual supplemental payments of $1 billion from FY2024 through FY 2034.***

### *Issue 10: Rainy Day Fund*

Building a financial cushion to deal with future economic downturns is a key element in restoring the State to fiscal stability. Although Illinois has not fully recovered from the Great Recession, the risk of the next economic decline is already being factored into State revenue projections.[183]

According to public finance experts, all governments should place a portion of their general operating revenues in a general fund reserve or "rainy day" fund.[184] Rainy day funds are savings accounts that governments can use to address revenue shortfalls or unanticipated expenditures and to help stabilize tax rates.

Governments that maintain adequate reserves are better positioned to deal with funding issues in bad times. Putting money into reserves is a more fiscally prudent action than spending surplus funds on new or expanded programs. The median rainy day fund balance among states in FY2016 was 5.1% of general funds expenditures, according to a survey by the National Association of State Budget Officers.[185]

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[180] For more details on the State's bond ratings and debt costs see p. 17 of this report.
[181] State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016, p. 28.
[182] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2016, p. 10.
[183] State of Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, November 15, 2017, p. 6.
[184] Government Finance Officers Association, *Best Practice: Appropriate Level of Unrestricted Fund Balance in the General Fund*, September 2015.
[185] National Association of State Budget Officers, *The Fiscal Survey of States Fall 2016*, p. 60.

Illinois has not maintained a functional rainy day fund, although a law was enacted in 2004 to build such a fund. [186] The law established a goal of maintaining 5% of General Funds revenues in an existing account called the Budget Stabilization Fund. According to the law, the fund would be used to reduce the need for future tax increases or short-term borrowing, maintain high credit ratings and address budgetary shortfalls. In authorizing withdrawals from the fund, priority was to be given to services for children. Deposits into the fund would be triggered by projected revenue growth of more than 4% from the prior year.

The fund has never received significant resources, however, apparently because annual revenue projections have not met the threshold requirement to trigger deposits into the fund.[187] The balance of about $275 million at the end of FY2015 represented less than 1% of General Funds revenues of $36.4 million.

Instead of being used to withstand fiscal emergencies, the fund was used for cash flow problems resulting from timing variations between receipt and disbursement of funds in a given fiscal year.[188] By law, any cash flow borrowings transferred during a fiscal year from the Budget Stabilization Fund to the General Funds are to be reimbursed by a transfer back by the end of that fiscal year.[189]

Due to the State's financial crisis, this provision was changed to allow amounts in the Budget Stabilization Fund to be used to pay expenses and not repaid.[190] As part of the stopgap spending plan passed in June 2016, the Fund's entire balance was appropriated to pay for State operations in FY2017.[191]

In 2014 the Commission on Government Forecasting and Accountability (COGFA) concluded that raising the funding goal to 10% of General Funds revenues from 5% made sense in light of recent revenue volatility.[192] COGFA examined two funding strategies—making deposits into the fund only when revenues are growing rapidly or making regular deposits regardless of revenue growth—and determined that each presented challenges. While funding mechanisms that depend on excess revenues can have wide variations in annual funding, regular funding puts annual pressure on the budget.[193]

The Civic Federation supports COGFA's suggestion to establish a funding goal for a rainy day fund of 10% of General Funds revenues. The budget plan presented in this report begins to create

[186] Public Act 93-660, enacted on February 2, 2004.
[187] The law was amended to prohibit any deposits into the fund in FY2008.
[188] Commission on Government Forecasting and Accountability, *Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 88.
[189] 30 Illinois Combined Statutes 105/6z-51(b). The law was amended to defer cash repayment for FY2011 until July 15, 2011.
[190] Public Act 99-0523, signed on June 30, 2016.
[191] State of Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, November 15, 2017, p. 11.
[192] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 99.
[193] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 103.

a functional rainy day fund in FY2019, after the State's backlog of unpaid bills is paid off through borrowing. The fund ends FY2022 with a balance of $2.7 billion, or 5.9% of projected revenues.

***Civic Federation Recommendation on Rainy Day Fund***

**The State of Illinois should work toward building a rainy day fund equal to 10.0% of State-source General Funds revenues to cushion the budget from the next economic downtown. Legislation must explicitly indicate when deposits will be made and in what amount and the circumstances under which withdrawals will be allowed.**

## Future Tax and Budget Reforms

The Civic Federation's comprehensive plan will stabilize the State's finances by eliminating the backlog of bills and making progress toward building a rainy day fund to help prevent future fiscal crises. Achieving these goals must be the highest priority.

As Illinois gets its finances in order, the General Assembly and Governor should study and reach agreement on fundamental tax and budget reforms to ensure that State government operates efficiently and responsibly.

The Civic Federation recommends that the following reforms be considered:

- Constitutional Amendment Limiting the Pension Protection Clause: The State of Illinois has unfunded public employee pension liabilities of $126.5 billion[194] and many local governments are either straining under the cost of employee pensions or facing the possibility that the funds will run out of money to pay retirees. In May 2015, the Illinois Supreme Court ruled that a law passed by the General Assembly in 2013 that reduced pension benefits for some State employees and retirees violated the pension protection clause of the Illinois Constitution.[195] This opinion was reinforced in March 2016 when the high court struck down pension changes involving two City of Chicago pension funds.[196] The Court ruling makes it difficult to see how Illinois governments can reduce benefits in place when workers were hired – even if the obligations are unaffordable and jeopardize the solvency of the pension funds. The General Assembly should approve an amendment to the Illinois Constitution for the November 2018 statewide ballot that would specify that the pension protection clause applies only to accrued benefits, giving the State legislature the discretion to make adjustments to non-accrued future benefits for existing employees.

- Graduated individual income tax: The Civic Federation's comprehensive plan calls for increasing the individual income tax rate to 5.25% from 3.75% retroactive to January 1,

[194] Illinois Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2016, p. 2. This figure is based on the smoothed value of assets as of June 30, 2016. The total is $129.8 billion based on the market value of assets.
[195] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015.
[196] Jones v. Municipal Employees' Annuity & Benefit Fund, 2016 IL 119618, March 24, 2016.

2017 and then reducing it to 5.0% on January 1, 2022. A permanent income tax rate of 5.0% is burdensome for low income taxpayers, despite the proposed increase in the earned income tax credit. A modestly graduated rate structure that could lower rates for many taxpayers should be considered.[197] Moving from a flat tax rate to a graduated rate structure would require an amendment to the Illinois Constitution.[198]

- Interest penalties on overdue bills: The State pays penalties on late bills at steep interest rates: about 12% after 90 days on some bills and 9% after 30 days on others. Because of the State's practice of deferring bills to manage deficits, interest penalty payments totaled more than $1 billion since FY2007.[199] An estimated $700 million more would be owed if Illinois paid off its growing bill backlog by the end of FY2017, according to an estimate by the Illinois Comptroller's Office. The situation has turned into a business opportunity for lenders, who can pay State vendors upfront in exchange for the right to collect the interest penalties when the bills are finally paid. Although the Civic Federation hopes that the State of Illinois will, after implementing a comprehensive plan to stabilize its finances, never again allow its bill backlog to grow to such a level that the penalty rates become necessary, the rates should still be reduced to reflect lower economy-wide rates of return.[200]

- Lapse Period Spending: The lapse period is the period of time after the end of the fiscal year during which the next year's revenues can be used to pay for the current year's bills. Because of the large amount of payables outstanding at the end of the fiscal year, this period was extended to December 31 from August 31 beginning in FY2013.[201] The ability to roll bills over into the next year gives the State flexibility during times of financial crisis, but it also undermines responsible budgeting. Once the State pays off its bill backlog, the lapse period should be returned to two months, a reasonable period of time to process and pay late bills.

- Section 25 Liabilities: By FY2019 the State should phase out the use of Section 25 liabilities and other practices that allow prior year's costs to be paid from the current year's appropriations.[202] An annual budget should reflect that year's costs. The practice of moving costs from one year to the next has allowed the State to disguise budget deficits and avoid development of a structurally balanced budget.

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[197] For regional comparison of rates and tax structures to other states, see Appendix B on p. 53.

[198] Ill. Const. art. IX, sec. 3(a). Among nearby states, Indiana and Michigan have flat individual income tax rates; Iowa, Kentucky, Minnesota, Missouri and Wisconsin have graduated rate structures. For more information, see Federal Tax Administrators, *State Income Taxes Updated January 1, 2016*, February 2016, http://www.taxadmin.org/assets/docs/Research/Rates/ind_inc.pdf (last visited on February 9, 2017).

[199] For more information on interest penalties on overdue bills, see p. 21 of this report.

[200] Governor Rauner's FY2016 budget proposed that Prompt Payment interest be lowered from about 12% per year to the rate on five-year U.S. Treasury bonds plus one full percentage point. As of the February 1, 2017, that would have meant a new rate of about 2.93%. House Bill 4981 in the 99th Illinois General Assembly proposed a rate of 0.75% a month, or about 9% per year. No action was taken on either proposal.

[201] 30 ILCS 105/25(m).

[202] For more information on Section 25 liabilities, see p. 59 of this report.

## APPENDIX A: DEBT COMPARISON

The following table compares the debt service schedule for the November 2016 bonds with the debt service schedules that would have resulted if the State of Illinois had been able to borrow at the Thompson Reuters MMD Scale yields for AAA and BAA-rated credits. In all scenarios, the sale proceeds, purchaser's discount and costs of issuance are held constant.

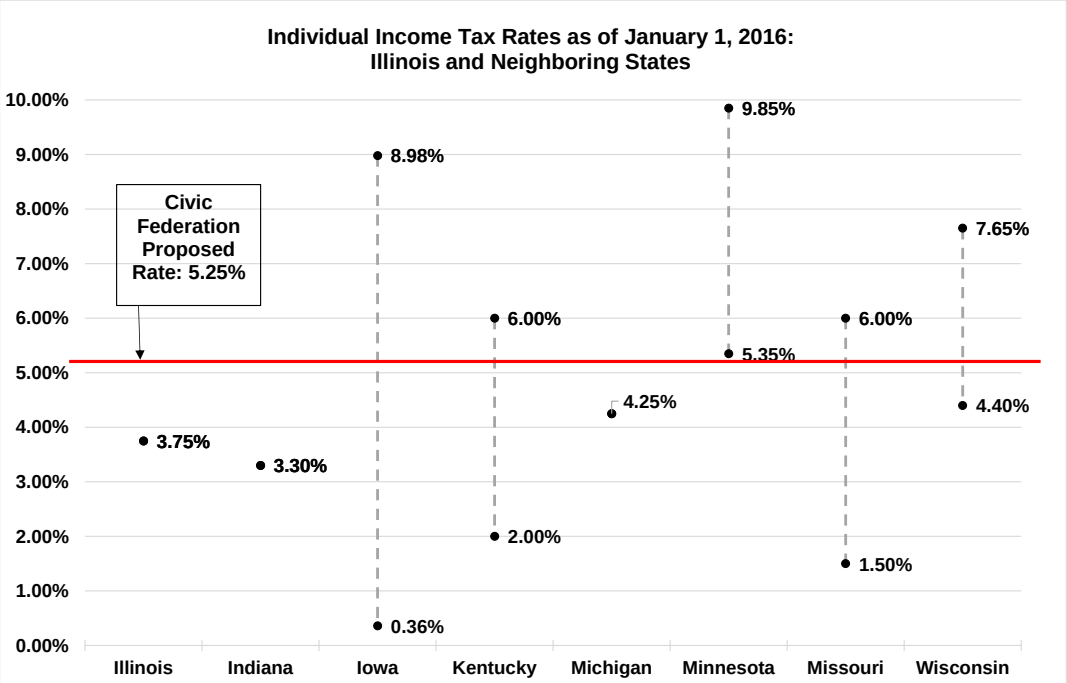
| State of Illinois Bond Cost Comparision ($ millions) | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Illinois, GO Bonds, Series November 2016 | | | | | Benchmark AAA Rated Bonds | | | | | Benchmark BAA Rated Bonds | | | | |
| Maturity | Yield | Principal | Interest | Debt Service | Yield | Principal | Interest | Debt Service | Increased Cost | Yield | Principal | Interest | Debt Service | Increased Cost |
| **2017** | 1.94 | $ 19.2 | $ 22.7 | $ 41.9 | 0.68 | $ 16.7 | $ 19.7 | $ 36.4 | $ 5.5 | 1.09 | $ 17.7 | $ 20.9 | $ 38.6 | $ 3.3 |
| **2018** | 2.24 | $ 19.2 | $ 22.8 | $ 42.0 | 0.82 | $ 16.7 | $ 19.8 | $ 36.5 | $ 5.5 | 1.29 | $ 17.7 | $ 21.0 | $ 38.7 | $ 3.3 |
| **2019** | 2.49 | $ 19.2 | $ 21.8 | $ 41.0 | 0.93 | $ 16.7 | $ 19.0 | $ 35.6 | $ 5.4 | 1.47 | $ 17.7 | $ 20.1 | $ 37.8 | $ 3.2 |
| **2020** | 2.68 | $ 19.2 | $ 20.9 | $ 40.1 | 1.02 | $ 16.7 | $ 18.1 | $ 34.8 | $ 5.3 | 1.64 | $ 17.7 | $ 19.2 | $ 36.9 | $ 3.1 |
| **2021** | 2.88 | $ 19.2 | $ 19.9 | $ 39.1 | 1.12 | $ 16.7 | $ 17.3 | $ 34.0 | $ 5.1 | 1.79 | $ 17.7 | $ 18.3 | $ 36.0 | $ 3.0 |
| **2022** | 3.05 | $ 19.2 | $ 18.9 | $ 38.1 | 1.20 | $ 16.7 | $ 16.5 | $ 33.1 | $ 5.0 | 1.90 | $ 17.7 | $ 17.5 | $ 35.2 | $ 3.0 |
| **2023** | 3.29 | $ 19.2 | $ 18.0 | $ 37.2 | 1.34 | $ 16.7 | $ 15.6 | $ 32.3 | $ 4.9 | 2.10 | $ 17.7 | $ 16.6 | $ 34.3 | $ 2.9 |
| **2024** | 3.45 | $ 19.2 | $ 17.0 | $ 36.2 | 1.48 | $ 16.7 | $ 14.8 | $ 31.5 | $ 4.7 | 2.30 | $ 17.7 | $ 15.7 | $ 33.4 | $ 2.8 |
| **2025** | 3.60 | $ 19.2 | $ 16.1 | $ 35.3 | 1.61 | $ 16.7 | $ 14.0 | $ 30.6 | $ 4.6 | 2.44 | $ 17.7 | $ 14.8 | $ 32.5 | $ 2.7 |
| **2026** | 3.70 | $ 19.2 | $ 15.1 | $ 34.3 | 1.71 | $ 16.7 | $ 13.1 | $ 29.8 | $ 4.5 | 2.55 | $ 17.7 | $ 13.9 | $ 31.6 | $ 2.7 |
| **2027** | 3.80 | $ 19.2 | $ 14.1 | $ 33.3 | 1.82 | $ 16.7 | $ 12.3 | $ 29.0 | $ 4.4 | 2.66 | $ 17.7 | $ 13.0 | $ 30.7 | $ 2.6 |
| **2028** | 3.90 | $ 19.2 | $ 13.2 | $ 32.4 | 1.92 | $ 16.7 | $ 11.4 | $ 28.1 | $ 4.2 | 2.77 | $ 17.7 | $ 12.1 | $ 29.9 | $ 2.5 |
| **2029** | 3.99 | $ 19.2 | $ 12.2 | $ 31.4 | 2.01 | $ 16.7 | $ 10.6 | $ 27.3 | $ 4.1 | 2.87 | $ 17.7 | $ 11.3 | $ 29.0 | $ 2.4 |
| **2030** | 4.05 | $ 19.2 | $ 11.3 | $ 30.5 | 2.07 | $ 16.7 | $ 9.8 | $ 26.5 | $ 4.0 | 2.93 | $ 17.7 | $ 10.4 | $ 28.1 | $ 2.4 |
| **2031** | 4.25 | $ 19.2 | $ 10.3 | $ 29.5 | 2.14 | $ 16.7 | $ 8.9 | $ 25.6 | $ 3.9 | 3.00 | $ 17.7 | $ 9.5 | $ 27.2 | $ 2.3 |
| **2032** | 4.19 | $ 19.2 | $ 9.5 | $ 28.7 | 2.21 | $ 16.7 | $ 8.3 | $ 24.9 | $ 3.8 | 3.07 | $ 17.7 | $ 8.8 | $ 26.5 | $ 2.2 |
| **2033** | 4.25 | $ 19.2 | $ 8.5 | $ 27.7 | 2.27 | $ 16.7 | $ 7.4 | $ 24.1 | $ 3.6 | 3.13 | $ 17.7 | $ 7.9 | $ 25.6 | $ 2.2 |
| **2034** | 4.30 | $ 19.2 | $ 7.6 | $ 26.8 | 2.32 | $ 16.7 | $ 6.6 | $ 23.3 | $ 3.5 | 3.18 | $ 17.7 | $ 7.0 | $ 24.7 | $ 2.1 |
| **2035** | 4.34 | $ 19.2 | $ 6.6 | $ 25.8 | 2.36 | $ 16.7 | $ 5.8 | $ 22.4 | $ 3.4 | 3.22 | $ 17.7 | $ 6.1 | $ 23.8 | $ 2.0 |
| **2036** | 4.37 | $ 19.2 | $ 5.7 | $ 24.9 | 2.39 | $ 16.7 | $ 4.9 | $ 21.6 | $ 3.3 | 3.24 | $ 17.7 | $ 5.2 | $ 22.9 | $ 1.9 |
| **2037** | 4.40 | $ 19.2 | $ 4.7 | $ 23.9 | 2.42 | $ 16.7 | $ 4.1 | $ 20.8 | $ 3.1 | 3.26 | $ 17.7 | $ 4.3 | $ 22.0 | $ 1.9 |
| **2038** | 4.43 | $ 19.2 | $ 3.7 | $ 22.9 | 2.45 | $ 16.7 | $ 3.3 | $ 19.9 | $ 3.0 | 3.28 | $ 17.7 | $ 3.5 | $ 21.2 | $ 1.8 |
| **2039** | 4.61 | $ 19.2 | $ 2.8 | $ 22.0 | 2.47 | $ 16.7 | $ 2.4 | $ 19.1 | $ 2.9 | 3.30 | $ 17.7 | $ 2.6 | $ 20.3 | $ 1.7 |
| **2040** | 4.47 | $ 19.2 | $ 1.9 | $ 21.1 | 2.48 | $ 16.7 | $ 1.7 | $ 18.4 | $ 2.8 | 3.31 | $ 17.7 | $ 1.8 | $ 19.5 | $ 1.6 |
| **2041** | 4.48 | $ 19.2 | $ 1.0 | $ 20.2 | 2.49 | $ 16.7 | $ 0.8 | $ 17.5 | $ 2.6 | 3.32 | $ 17.7 | $ 0.9 | $ 18.6 | $ 1.6 |
| **Total** | | **$ 480.0** | **$ 306.2** | **$ 786.2** | | **$ 417.0** | **$ 266.1** | **$ 683.1** | **$ 103.1** | | **$ 442.6** | **$ 282.4** | **$ 725.0** | **$ 61.3** |

Note: Principal amounts on benchmark bonds are calculated to achieve the same proceeds as the actual sale using the actual coupon rates and the benchmark yields as of November 8, 2016.

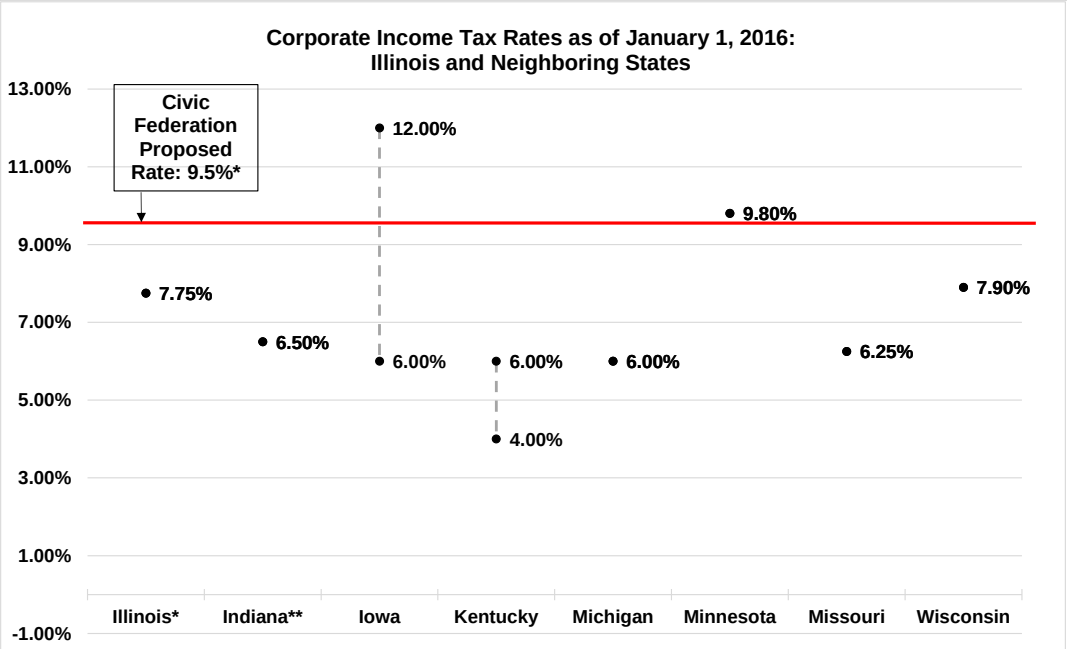
Source: Thompson Reuters Muncipal Market Data benchmark rates as of November 8, 2016; State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement* , November 8, 2016.

## APPENDIX B: STATE INCOME TAX COMPARISON

The following charts compare individual and corporate income tax rates in neighboring states.




**Note: Each state has different exemption levels and states with multiple tax rates have different numbers of tax brackets.**
**Source: Federation of Tax Administrators, *State Individual Income Taxes (Tax rates for tax year 2016 as of January 1, 2016)*, Updated June 2016.**




* Current and proposed Illinois corporate income tax rates include 2.5% personal property replacement tax.
**Indiana's corporate tax rate decreased to 6.25% on July 1, 2016.
Note: Each state has different exemptions and states with multiple tax rates have different numbers of tax brackets.
Source: Federation of Tax Administrators, *Range of State Corporate Income Tax Rates (For tax year 2016 as of January 1, 2016)*, February 2016.

## APPENDIX C: STATE SALES TAX COMPARISON

The following table compares sales tax rates and exemptions in neighboring states.

| Sales Tax Rates: Illinois and Neighboring States | | | | |
|---|---|---|---|---|
| | **Tax Rate** | **Food** | **Prescription Drugs** | **Non-Prescription Drugs** |
| **Illinois** | | | | |
| Current | 6.25% | Yes - 1.0% | Yes - 1.0% | Yes - 1.0% |
| Proposed | 5.50% | Yes - 1.0% | Yes - 1.0% | Yes - 1.0% |
| **Indiana** | 7.00% | No | No | Yes - 7.0% |
| **Iowa** | 6.00% | No | No | Yes - 6.0% |
| **Kentucky** | 6.00% | No | No | Yes - 6.0% |
| **Michigan** | 6.00% | No | No | Yes - 6.0% |
| **Minnesota** | 6.875% | No | No | No |
| **Missouri** | 4.225% | Yes - 1.225% | No | Yes - 4.225% |
| **Wisconsin** | 5.00% | No | No | Yes - 5.0% |

Source: Federation of Tax Administrators, *State Sales Tax Rates and Vendor Discounts*, January 1, 2017