The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

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

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.

The Civic Federation
would like to express its gratitude
to the John D. and Catherine T. MacArthur Foundation,
whose generous grant to fund
the Institute for Illinois' Fiscal Sustainability at the Civic Federation
made the research and writing of this report possible.

ACKNOWLEDGMENTS

The Institute for Illinois' Fiscal Sustainability at the Civic Federation would like to express its appreciation to the Governor's Office of Management and Budget, the Illinois Department of Revenue and the Illinois Office of the Comptroller for their assistance with this report.

TABLE OF CONTENTS

EXECUTIVE SUMMARY **2**

CIVIC FEDERATION RECOMMENDATIONS 3
CIVIC FEDERATION FINDINGS 4

ILLINOIS' BUDGET IMPASSE **5**

PATH TO FINANCIAL CRISIS 5
OPERATING WITHOUT A FULL FY2016 BUDGET 12
COST OF THE BUDGET IMPASSE 16
Debt Costs ***16***
Interest Penalties ***20***
Loss of Services ***22***

GOVERNOR'S THREE-YEAR BUDGET PROJECTION **23**

CIVIC FEDERATION RECOMMENDATIONS **29**

COMPREHENSIVE PLAN 29
RECOMMENDATIONS 32
Issue 1: Year-End Backlog of Unpaid Bills ***32***
Issue 2: Rainy Day Fund ***35***
Issue 3: Revenue Loss from Income Tax Rate Rollback ***37***
Issue 4: Retirement Income Exemption ***38***
Issue 5: The Earned Income Tax Credit ***39***
Issue 6: Expanding the Sales Tax Base ***39***
Issue 7: Chicago and State Teachers' Pension Funding Reform ***42***
Issue 8: Constitutional Amendment Limiting the Pension Protection Clause ***44***
Issue 9: Supplemental Pension Payments ***45***
Issue 10: Retailer's Discount ***47***
Issue 11: Tax and Budget Reforms ***48***

APPENDIX A: DEBT COMPARISION **50**

APPENDIX B: INCOME TAX RATES IN ILLINOIS AND NEIGHBORING STATES **53**

APPENDIX C: SALES TAX EXPANSION **55**

EXECUTIVE SUMMARY

This report describes the State of Illinois' fiscal condition and presents the Civic Federation's proposed three-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]

More than seven months after the start of the current fiscal year on July 1, 2015, Illinois continues to operate without a 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.

Even without a complete general operating budget for FY2016, virtually all of the State's projected annual revenues will be spent due to statutory requirements, consent decrees, court orders and an appropriation bill for elementary and secondary education signed by Governor Bruce Rauner. That leaves nothing for the areas of government that have gone unfunded, including the entire field of higher education and major human services programs.

Funding these areas even at a reduced level would create an operating deficit of $4.6 billion, according to a recent estimate by the Governor's Office.[2] That shortfall would increase the State's accumulated backlog of unpaid bills to $10.0 billion at the end of FY2016.

Illinois' current financial predicament stems from a failure to deal with the fiscal cliff in January 2015 caused by the partial rollback of income tax rates. 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.[3]

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 FY2016 operating deficit. However, beginning in FY2017 the State would have budget surpluses that would pay off the backlog of bills by FY2019. At that point, Illinois could start building reserves to prepare for the next economic recession.

Spending controls are at the center of the Federation's plan, but more revenue is also needed to close the FY2016 operating deficit and pay off the State's accumulated bills. It is not responsible to assume that agency spending could be cut by $4.6 billion, or nearly 20%, in less than five months.[4] 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.

---

[1] Governor Bruce Rauner is scheduled to present his budget proposal for FY2017 on February 17, 2016. The State of Illinois' fiscal year begins on July 1 and ends on June 30.
[2] Illinois Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY17-FY19*, January 6, 2016.
[3] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015.
[4] Agency spending is defined in this report as General Funds expenditures excluding pension contributions, debt service, group health insurance payments and legislatively required transfers.

Civic Federation Recommendations

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

Issue 1: Backlog of Unpaid Bills

The State should pay off its unpaid bill backlog by FY2019 by **limiting spending in FY2016 and establishing spending controls that limit the growth in agency spending over the next three years** in order to generate annual operating surpluses that will fund bill backlog payments.

Issue 2: Rainy Day Fund

After the backlog of unpaid bills is eliminated, 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.

Issue 3: Revenue Instability from Income Tax Rate Rollback

The State should moderate the revenue cliff in FY2016 by retroactively increasing the individual income tax back to 5.0% from 3.75% and to 7.0% from 5.25% for corporations. The delay in taking action to address its fall in revenues has worsened the State's crisis to point where it is not possible to contemplate rolling back the income tax rates as proposed in previous roadmaps until after the bill backlog is paid off in FY2019.

Issue 4: Retirement Income Exemption

The State should broaden its income tax base by eliminating the tax exemption for retirement income, excluding Social Security income and all retirement income from individuals with taxable income of less than $50,000. The State can no longer afford to provide this generous exemption, which is out of line with most other states.

Issue 5: Earned Income Tax Credit

To offset some of the impact of higher tax rates on low income residents, the State should increase its Earned Income Tax Credit by 50% to 15% of the federal amount.

Issue 6: Sales Tax Base

In order to expand the sales tax base and access a growing area of economic activity, the State should enact a new service tax including a broad-based definition of consumer services. A strict exemption for business-to-business transactions should be included to avoid tax pyramiding. Due to the depth of the financial crisis, the State should also temporarily suspend its sales tax exemption for food and over-the-counter drugs until its backlog of bills has been significantly reduced and the tax on services is fully implemented.

Issue 7: Comprehensive Teacher Pension Funding Reform

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 each school district outside of Chicago should be shifted over three years to that school district. Consolidation would provide more equitable and uniform pension funding for all teachers, improve accountability and help stabilize CPS finances.

Issue 8: Constitutional Amendment Limiting the Pension Protection Clause
In order to protect the future solvency of the State's pension funds and help stabilize the State's finances over the long term, the Civic Federation urges legislators to draft and approve a proposed amendment to the Illinois Constitution for the November 2016 statewide ballot. The amendment should specify that the clause in the Illinois Constitution that protects public pension benefits applies only to accrued benefits. Such a change, if approved, would give the legislature the discretion to make adjustments to non-accrued future benefits for existing employees.

Issue 9: Supplemental Pension Payments
The State should make supplemental payments corresponding to the reduced debt service obligations associated with retiring Pension Obligation bonds beginning in FY2019 until all five State retirement systems are 100% funded.

Issue 10: Reduce the Retailer's Discount
The State should cap the retailer's discount, which is currently the third highest in the United States, at $200 per month per retailer to save $85 million per year.

Issue 11: Comprehensive Tax Reform
Once the State pays off its unpaid bill backlog and begins to make progress toward building a rainy day fund, it should consider starting to reverse some of the tax policy changes that were necessary to end the crisis as part of a comprehensive evaluation of the adequacy, efficacy and sustainability of the State's tax policy.

Civic Federation Findings

- More than seven months after the start of the current fiscal year on July 1, 2015, the State of Illinois continues to operate without a comprehensive budget.
- The FY2016 and FY2017 General Funds budget shortfalls are projected at $4.6 billion and $5.6 billion, respectively.
- The State still has not addressed its fiscal cliff, which means that if current trends in revenues and expenditures continue, the State's backlog of unpaid bills could grow to $25.9 billion in FY2019.
- Due to the ongoing budget impasse and associated bond rating downgrades, the State paid an additional $43 million in interest charges for the $250 million bond issuance in January 2016.
- The State paid $126.1 million in interest penalties in FY2015 and $106.4 million, or 84.4%, were related to the group health insurance program. Group health bills totaled $2.5 billion at the end of December 2015, compared with $1.4 billion a year earlier.
- Total General Funds pension-related payments—including pension contributions and debt service on pension bonds—more than tripled to $7.5 billion in FY2015 from $2.0 billion in FY2008.
- General Funds spending not related to pensions decreased by $533 million, or 1.9%, to $27.8 billion in FY2015 from $28.3 billion in FY2008. However, after accounting for spending shifted to FY2014 or to other funds, General Funds expenditures not related to pensions increased by $467 million, or 1.6%.
- Income tax deposits into General Funds are expected to decline by $5.3 billion, or 26.6%, to $14.5 billion in FY2016 from $19.8 billion in FY2014 due largely to the rollback in income tax rates as of January 1, 2015.
- Two of the three major rating agencies reduced the State of Illinois' bond ratings in October 2015, directly citing the State's budget impasse for the ratings actions. These downgrades made Illinois the only state credit currently rated below the 'A' category.

ILLINOIS' BUDGET IMPASSE

More than seven months after the start of the current fiscal year on July 1, 2015, the State of Illinois continues to operate without a 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.[5] As of the publication date of this report, there is no clear end in sight to the standoff.[6]

Even without a complete general operating budget for FY2016, the State is on course to spend approximately $31.5 billion.[7] Spending from General Funds is authorized or compelled by statutory requirements, consent decrees, court orders and an appropriation bill for elementary and secondary education signed by Governor Bruce Rauner.[8] However, the State is not currently paying at least $5.1 billion in costs of other areas of government that have historically received financial support, including public universities, college scholarships for low income students and certain human services programs.[9]

The budget delay has diverted attention from the State's underlying problem: the continuing mismatch between revenues and expenditures due to required contributions to its dramatically underfunded pension funds and the rollback of income tax rates midway through FY2015. With General Funds revenues projected at $31.9 billion, the State is expected to significantly expand its multi-billion dollar backlog of unpaid bills in FY2016.

This section provides an overview of events leading to the budget impasse, an analysis of the State's current fiscal condition and an examination of the financial impact of the standoff.

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.[10] Income taxes are the State's main source of General Funds revenue, followed by sales taxes. Individual income tax rates were increased to 5.0% from 3.0% and corporate tax rates were raised to 7.0% from 4.8%.[11] The rate increases were scheduled to roll back to 3.75% for

---

[5] Phil Ciciora, "How long could Illinois' budget impasse last?" *Illinois News Bureau*, December 10, 2015, https://news.illinois.edu/blog/view/1612/291489 (last visited on January 17, 2016).
[6] Associated Press, "Radogno: Budget standoff could last for years," *The State Journal-Register*, January 11, 2016.
[7] State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, p. 24.
[8] Public Act 99-0005, signed on June 24, 2015. The State has also enacted Public Act 99-0409, which appropriated federal funds received by the State, and Public Act 99-0491, which appropriated other State funds and an additional $28 million in General Funds.
[9] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report,* January 6, 2016, p. 3.
[10] The recession began in December 2007 and ended in June 2009, according to the National Bureau of Economic Research.
[11] 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.

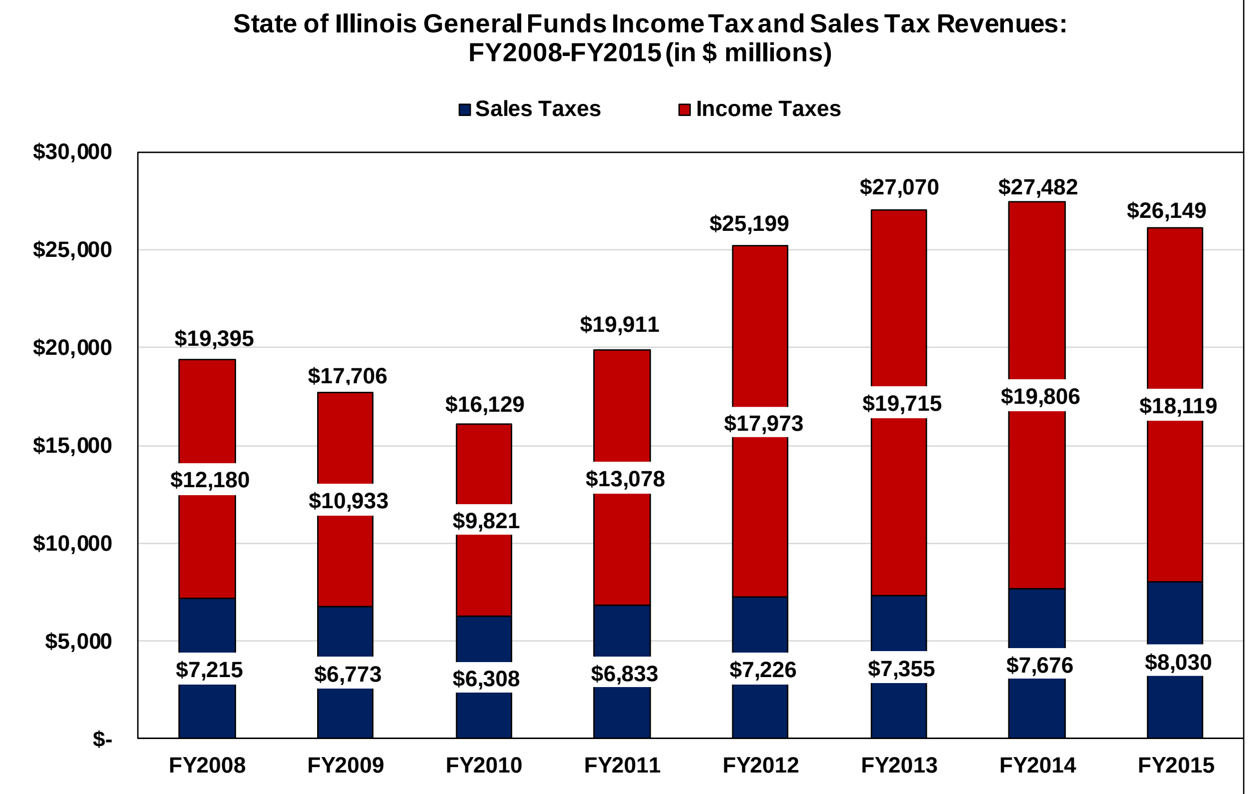
individuals and 5.25% for corporations on January 1, 2015 and to 3.25% for individuals and 4.8% for corporations on January 1, 2025.

After the rate increases, income tax revenues more than doubled to $19.8 billion in FY2014 from $9.8 billion in FY2010.[12] Largely as a result of the rate decreases in January 2015, income tax revenues declined by $1.7 billion to $18.1 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 elementary and secondary education.[13]

[12] Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary FY2016*, August 2015, updated September 9, 2015, p. 40. The law that temporarily increased tax rates also 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.

[13] 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 $484 million from General Funds in FY2015.

The following chart shows General Funds income tax and sales tax revenues from FY2008 through FY2015. The chart uses FY2008 as a starting point because it was the first full fiscal year before revenues declined due to the economic downturn.



Source: Illinois General Assembly, Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2016*, August 2015, Updated September 9, 2015, p. 40.

While State tax collections were shrinking due to the recession, statutorily required State pension contributions were accelerating. Since FY1996, State contributions to Illinois' five pension funds have been based on a 50-year funding plan.[14] 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.[15]

When the funding plan began, the total unfunded liability of the five systems stood at approximately $19.5 billion.[16] By the end of FY2015, the unfunded liability had grown to $111.0

---

[14] 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.

[15] 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.

[16] 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

billion, based on the market value of assets, and the combined funded ratio stood at 41.9%.[17] In recent years, Illinois has consistently ranked as the state with the worst funded retirement systems[18] and the largest pension burden relative to revenues.[19]

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 FY2030.[20]

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, higher contributions were needed in the following three years to complete the 15-year phase-in ramp.[21]

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.[22]

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.[23] These benefit reductions will increasingly reduce the State's required pension contributions in future years, but they did not have a significant impact in the short term because they did not apply to retirees or current employees.

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 retirement.[24] The law was scheduled to take effect on June 1, 2014 but was not implemented pending legal challenges by labor unions.

---

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.

[17] Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2015, p. 2.

[18] Bloomberg, "State pension funding levels rise across U.S.—except you-know-where," *Crain's Chicago Business*, October 13, 2015.

[19] Matt Dietrich, "Fitch Issues Credit Downgrade; Moody's May Follow; Budget Deadlock, Illinois Pension Debt Cited," *rebootillinois.com*, October 19, 2015.

[20] Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2015, p. 9. 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.

[21] 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, 2014 and June 30, 2015*, January 12, 2016.

[22] State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, p. E-15.

[23] Public Act 96-0889, signed on April 14, 2010.

[24] 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 the lesser of 3% or one-half of the increase in the Consumer Price Index on a simple-interest basis. The law also raised retirement ages for younger workers and capped the salary on which pension benefits are based.

The Illinois Supreme Court struck down the law on May 8, 2015, ruling that it violated the Illinois Constitution's sweeping pension protection clause.[25] That provision establishes membership in a State retirement system as "an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[26] According to the 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.

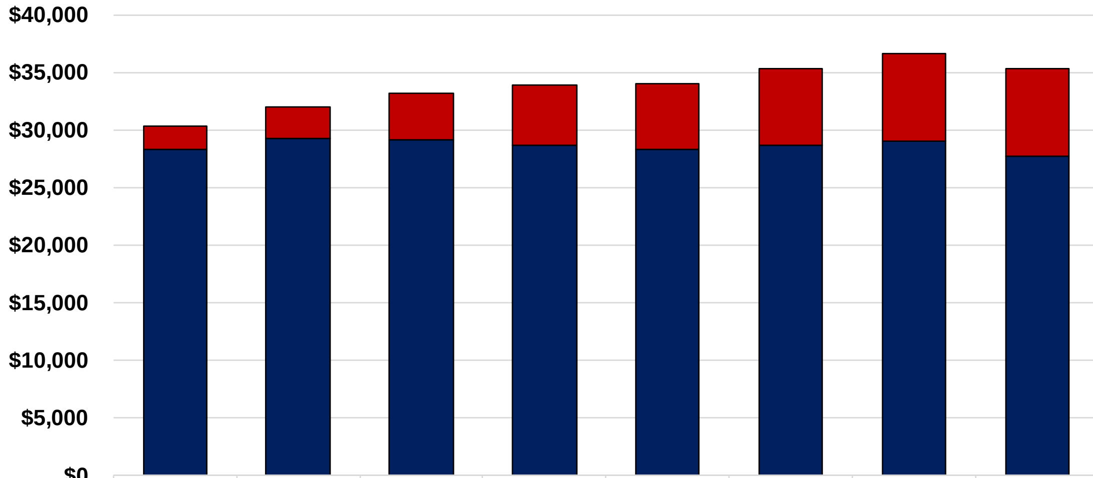
Under existing law, statutorily required contributions grew to $6.0 billion in FY2015 from $1.56 billion in FY2008. Debt service on previously issued bonds increased to $1.5 billion from $467 million during the same period, bringing total pension-related payments to $7.5 billion from $2.0 billion.

Due to the income tax rate increases, the State has made its pension contributions without borrowing since FY2011. However, other General Funds expenditures not related to pensions have remained approximately flat overall.

[25] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015.
[26] Illinois Constitution, Article XIII, Section 5.

The next chart shows General Funds spending from FY2008 through FY2015 in two categories: spending related to pensions, including contributions and debt service, and spending not related to pensions. Spending not related to pensions was $27.8 billion in FY2015, a decrease of $533 million, or 1.9%, from $28.3 billion in FY2008.[27]

State of Illinois General Funds Expenditures: Pension-Related Costs Compared With Other Spending FY2008-FY2015 (in $ millions)



	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
Total Expenditures	**$30,355**	**$32,059**	**$33,254**	**$34,003**	**$34,097**	**$35,367**	**$36,701**	**$35,346**
Pension Costs*	**$2,026**	**$2,757**	**$4,030**	**$5,347**	**$5,742**	**$6,659**	**$7,645**	**$7,550**
Other Spending**	**$28,329**	**$29,302**	**$29,224**	**$28,656**	**$28,355**	**$28,708**	**$29,056**	**$27,796**

* Includes State contributions under existing law and debt service on Pension Obligation Bonds. Pension contributions in FY20 10 and FY2011 were made through issuance of bonds and included for purposes of comparabiity.
**FY2015 expenditures reflect a Comptroller budgetary basis reduction of approximately $11 million.
Source: State of Illinois, General Obligation Bonds, *Official Statements*, January 16, 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, 2014*, February 2015, pp. 117-121.

However, it should be noted that 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 some 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.[28] In addition, the revenue diversions discussed above resulted in total appropriations of $400 million for education and human services from two other State funds.[29]

---

[27] Increased spending in FY2009 and FY2010 was supported by federal stimulus funds from the American Recovery and Reinvestment Act of 2009.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 are entirely funded by the federal government through calendar year 2016. Federal reimbursement declines to 95% in calendar year 2017, 94% in 2018, 93% in 2019 and 90% in 2020 and thereafter.
[28] Public Act 98-0642, signed on June 9, 2014.
[29] Public Acts 98-0677 and 98-0680, signed on June 30, 2014.

After adjusting for the advance funding of Medicaid and the spending shift to other funds, General Funds spending not related to pensions increased by $467 million, or 1.6%, from FY2008 to FY2015. The Consumer Price Index rose 9.1% during the same period.[30]

Despite the Medicaid funding shift, the FY2015 General Funds budget was still significantly out of balance when the new administration took over in January 2016. Governor Rauner's predecessor, Pat Quinn, had proposed that the higher income tax rates not be rolled back in his recommended budget for FY2015.[31] Rather than retaining the higher tax rates or cutting spending, the FY2015 budget passed by the General Assembly underfunded hundreds of millions of dollars in known expenses. It also authorized $650 million in interfund borrowing from accounts outside of General Funds, which had to be repaid in 18 months.[32]

Governor Rauner's proposed budget for FY2016, issued on February 18, 2015, showed that the FY2015 budget was unbalanced by $1.6 billion.[33] The operating deficit was partly due to the new administration's decision not to proceed with interfund borrowing that had been previously authorized.[34] It also reflected a shortfall in projected revenues and the need for supplemental appropriations to cover known costs that were not appropriated in the enacted FY2015 budget.

To close the FY2015 budget gap, the Governor and General Assembly agreed to approximately $1.3 billion in transfers from other State funds.[35] These transfers, known as fund sweeps, are different from interfund borrowing because they do not have to be repaid unless the affected accounts run out of needed resources. Balances in these funds accumulate over time, so the amount of surplus resources available in the near future is considerably reduced by fund sweeps. In addition, the General Funds appropriations of most agencies were cut by 2.25%.[36]

---

[30] U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Price Index Detailed Report: Data for December 2015*, p. 73.

[31] For more information on Governor Quinn's FY2015 budget proposal, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2015 Recommended Operating Budget: Analysis and Recommendations*, May 13, 2014, https://www.civicfed.org/sites/default/files/Illinois%20Recommended%20FY2015%20Budget.pdf (last visited on January 24, 2016). For FY2015 Governor Quinn proposed both a recommended budget, retaining the higher income tax rates, and a not recommended budget, which allowed the rates to be reduced.

[32] For more information on the enacted FY2015 budget, see the 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 9, 2014, https://www.civicfed.org/sites/default/files/REPORT_StateofIllinoisEnactedBudgetFY2015.pdf (last visited on January 24, 2016).

[33] Illinois State FY2016 Budget, p. 3-6. For more information on Governor Rauner's FY2016 budget proposal, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois Recommended Operating and Capital Budgets: Analysis and Recommendations*, May 7, 2015, https://www.civicfed.org/sites/default/files/REPORT-FY2016RecommendedBudget.pdf (last visited on January 24, 2016).

[34] Illinois State FY2016 Budget, pp. 2-2 and 3-3.

[35] Public Act 99-0002, signed on March 26, 2015.

[36] Public Act 99-0001, signed on March 26, 2015.

Largely because of the fund sweeps, the General Funds budget had an operating surplus of $1.0 billion at the end of FY2015.[37] The positive results also reflected the decision to do $454 million of interfund borrowing at the end of the fiscal year. As FY2015 ended without a complete budget in place for the next fiscal year, the administration borrowed from other State funds to increase cash reserves despite initial opposition to the practice.[38]

Operating Without a Full FY2016 Budget

The FY2016 budget was even more challenging than FY2015's because it covered the first complete fiscal year with lower income tax rates. Income tax deposits into General Funds are expected to decline by $5.3 billion, or 26.6%, to $14.5 billion in FY2016 from $19.8 billion in FY2014.[39] The decrease also reflects the first full fiscal year of revenue diversions to two other State funds for education and human services, which are expected to total $887 million.[40]

The Illinois Constitution requires the Governor to present a budget in which proposed expenditures do not exceed funds estimated to be available for the fiscal year.[41] Since the FY2012 budget, State law has also required that the Governor's budget proposal be based only on existing revenue sources.[42]

Governor Rauner's FY2016 budget proposal identified spending needs of $38.2 billion based on existing programs and services, compared with available revenue of $32.0 billion.[43] The Governor proposed closing the projected $6.2 billion gap through pension changes and steep spending cuts to most areas of government. The $31.5 billion budget also allocated $500 million to pay down the State's accumulated backlog of unpaid bills.

To achieve the projected savings, the FY2016 budget recommendation relied on a new pension proposal intended to cut the State's required FY2016 General Funds contribution by $2.2 billion.[44] The proposal would not have affected retirees but would have frozen Tier 1 benefits as of June 30, 2015, with benefits thereafter based on the less generous Tier 2 plan. The new proposal was not introduced as legislation and appeared to face very significant legal obstacles after the May 2015 ruling by the Illinois Supreme Court, striking down a previous 2013 reform law.[45]

---

[37] Illinois Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY17-FY19*, January 6, 2016.
[38] State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, p. 21.
[39] Illinois Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY17-FY19*, January 6, 2016.
[40] Communication between the Civic Federation and the Illinois Department of Revenue, January 29, 2016.
[41] Illinois Constitution, Article VIII, Section 2(a). The constitutional requirement does not prohibit carrying over a deficit from one year to the next.
[42] 15 ILCS 20/50-5(a). Governor Quinn's budget proposal for FY2015, presented in March 2014, included a recommended budget, with income tax rates at existing levels, and a not recommended budget, with income tax rates reduced in January 2015 as required by law.
[43] Illinois State FY2016 Budget, p. 3-6.
[44] Illinois State FY2016 Budget, p. 2-15.
[45] Associated Press, "Illinois Gov. Bruce Rauner says no 'clear roadmap' on pension reform," *Northwest Herald*, May 14, 2015.

In addition to pension savings, the Governor's FY2016 budget proposal assumed a reduction of $655 million, or more than a third, in the cost of State group health insurance through collective bargaining. Other budgeted savings depended on changes in State law, required federal approval or were likely to face federal court scrutiny.[46]

Although the budget proposal did not include new revenue, Governor Rauner has said repeatedly that he would consider tax increases if the legislature approved key elements of his Turnaround Agenda for the State.[47] The agenda includes changes in workers' compensation; limits on damages in civil lawsuits; constitutional amendments on term limits and redrawing legislative districts; and a freeze on local property taxes, combined with measures to cut costs for local governments by limiting the scope of collective bargaining and eliminating prevailing wage requirements.[48] The General Assembly has not considered the Governor's legislation, although it has acted on bills involving some of the same issues.[49]

The Illinois Constitution requires that the legislature make appropriations for all expenditures of public funds by the State and that appropriations for a fiscal year not exceed funds estimated by the General Assembly to be available during that year.[50] After the end of May of one calendar year, a three-fifths vote of each chamber, rather than a simple majority, is required for legislation to be effective before June 1 of the next calendar year.[51]

At the end of May 2015, during the final days of the regular spring session, the General Assembly approved a $36.3 billion spending plan for FY2016 with an acknowledged operating deficit of at least $3 billion.[52] The actual gap was closer to $4 billion because Medicaid costs were underfunded by $600 million and the legislative budget relied on the same low number for group health insurance that was in the Governor's budget proposal.[53] Democratic leaders said they were willing to work with the Governor to pass additional revenues.[54]

---

[46] For more information on Governor Rauner's FY2016 budget proposal, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois Recommended Operating and Capital Budgets: Analysis and Recommendations*, May 7, 2015, https://www.civicfed.org/sites/default/files/REPORT-FY2016RecommendedBudget.pdf (last visited on January 24, 2016).

[47] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, January 6, 2016, p. 8.

[48] Doug Finke, "Rauner agenda surfaces at Capitol," *The State Journal-Register*, May 22, 2015.

[49] Tina Sfondeles, "House Democrats approve workers' comp changes; Rauner cries politics," *Chicago Sun-Times*, June 4, 2015.

[50] Illinois Constitution, Article VIII, Section 2(b).

[51] Illinois Constitution, Articles IV, Section 10.

[52] Monique Garcia and Kim Geiger, "Illinois Democrats push ahead with budget that's $3 billion short," *Chicago Tribune*, May 26, 2015. The General Assembly projected total General Funds revenues at $33 billion, rather than at $32 billion as in the Governor's recommended budget, because of assumptions about federal revenues related to Medicaid spending. In both the Governor's proposal and the General Assembly's spending plan, total General Funds revenues included revenues required to be diverted for education and human services.

[53] For a summary of the General Assembly's spending plan, see Illinois Senator Heather A. Steans, "I'm disappointed, but there's a better plan," *e-newsletters*, June 2, 2015, http://www.senatorsteans.com/index.php/news/e-newsletters/149-budget-update-im-disappointed-but-theres-a-better-path (last visited on January 31, 2016).

[54] Doug Finke, "Madigan: Democrats will pass their own budget; needs $3 billion in more revenue," *The State Journal-Register*, May 25, 2015.

On June 25, 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."[55] A day earlier he had signed the appropriation bill for elementary and secondary education, which ensured that public schools could open on time despite the budget impasse.[56]

The legislature continued to meet after the regular session ended, but there was virtually no progress on the General Funds budget. The Senate voted to override a handful of the Governor's appropriation vetoes, but no action was taken by the House.[57]

In August 2015 the legislature passed, and the Governor signed, a bill that allowed the State to spend about $5.2 billion in federal funds for a wide variety of programs.[58] Legislation signed in December authorized the spending of about $3.1 billion in State funds outside of General Funds, including lottery ticket sale proceeds owed to lottery winners and motor fuel taxes due to local governments.[59] Illinois attracted international attention for its decision not to pay lottery participants who won more than $600 until after the State passed a budget.[60]

With no budget in place, the Governor's Office announced a series of administrative actions to control costs.[61] The steps included suspending funding for certain violence prevention and job training programs and delaying the purchase of new forensic equipment by the State Police. The administration also tightened income limits for the State's subsidized child care program for working parents and requested federal permission to raise eligibility requirements for Medicaid-funded community care for the elderly and disabled. However, these actions were subsequently modified or halted after protests from advocates.[62]

Meanwhile, the vast majority of expected FY2016 spending from General Funds has continued, even in the absence of a full budget. The State is authorized or compelled to pay about $31.5 billion from General Funds during the fiscal year, according to documents issued in connection

---

[55] 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 January 31, 2016).
[56] Public Act 99-0005, signed on June 24, 2015.
[57] Three-fifths of the members in each chamber are required to override a veto. Democrats have a super majority in both chambers, but the margin is wider in the Senate, which has 39 Democrats and 20 Republicans, compared with 71 Democrats and 47 Republicans in the House. The Senate voted to override five of the Governor's vetoes of appropriation bills, but the House did not take action on any of the vetoed appropriation bills.
[58] Public Act 99-0409, signed on August 20, 2015. The law also included $166.5 million in State funds outside of General Funds to help the Metropolitan Pier and Exposition Authority make a bond payment.
[59] Public Act 99-0491, signed on December 7, 2015. The legislation also included General Funds appropriations totaling $28 million for domestic violence shelters and operations of the Illinois Secretary of State.
[60] Harriet Alexander, "Illinois hands IOUs to lottery winners instead of cash," *The Telegraph*, October 16, 2015.
[61] Illinois Office of the Governor, "Administration Initiates Management Steps to Prepare for Madigan-Cullerton Budget, *news release*, June 2, 2015; Illinois Office of the Governor, "Administration Initiates Additional Management Steps to Prepare for Madigan-Cullerton Budget," *news release*, June 12, 2015.
[62] Kim Geiger, "Rauner reverses course on cuts to child care, disability services," *Chicago Tribune*, November 9, 2015.

with the State's recent bond sale.[63] That represents approximately 86% of the $36.6 billion that is expected to be spent to complete the year, according to the Governor's Office.[64]

The State is paying for elementary and secondary education due to the $6.5 billion appropriation bill signed by the Governor.[65] That bill also includes authority to pay the $3.7 billion statutorily required FY2016 contribution to the Teachers' Retirement System, the pension fund for public school teachers outside of Chicago.

Pension contributions to the other four retirement systems are covered by continuing appropriations, the statutory authority to make payments in the absence of appropriations by the legislature. Debt service payments and operations of the legislative and judicial branches have also been funded pursuant to continuing appropriations. Certain statutory transfers from General Funds, such as the distribution of income tax revenues to local governments, must be made due to existing statutes.

The State is making 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.

State workers are receiving paychecks based on a ruling in July by a judge in St. Clair County Circuit Court.[66] 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.[67]

The main areas of State government not being paid are universities, community colleges, 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.

On January 28, 2016, the General Assembly passed an appropriations bill authorizing $721 million in General Funds spending for college scholarships under the Monetary Awards Program (MAP) and community college operations.[68] The Governor said he would veto the bill because it was not supported by funding.[69]

---

[63] State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, p. 24.
[64] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, January 6, 2016, p. 3.
[65] Public Act 99-0005, signed on June 24, 2015.
[66] Kim Geiger, "Illinois state workers' paychecks to go out as court fight continues," *Chicago Tribune*, July 14, 2015.
[67] Kim Geiger, "High court denies Lisa Madigan bid for ruling on state worker paychecks," *Chicago Tribune*, July 17, 2015.
[68] 99th Illinois General Assembly, Senate Bill 2043, passed by House and Senate on January 28, 2016.
[69] Doug Finke, "Rauner threatens veto after Democrats pass higher education spending bill," *State-Journal Register*, January 28, 2016.

Although State spending has dropped off in the absence of a budget, the backlog of unpaid bills has increased due to the decline in revenues.[70] In October the Comptroller's Office announced that November pension contributions of $560 million would be delayed because the State would not have enough cash on hand to make all payments required by State law and court orders.[71] Pension contributions are expected to be paid in full by the end of FY2016.

Cost of the Budget Impasse

A budget is a plan that indicates objectives and shows how to obtain and use resources to achieve those objectives.[72] Faced with sharply reduced revenues and rising pension costs, the State has not been able to create a financial plan for FY2016 to align 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 areas of government that have historically been funded are not being paid and have relied on reserves and lines of credit to stay afloat. In the past few months, with no sign of a resolution to the budget impasse, more of these traditional recipients of State funds have taken steps to cut staff, reduce services or discontinue operations entirely.

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 known in the long run. For example, university officials have said the budget problems might make it difficult to recruit faculty and students due to concerns about the State's fiscal stability.[73] Advocates for the poor and disabled maintain that services eliminated due to the budget impasse will not be easy to replace.[74]

Debt Costs

Two of the three major rating agencies reduced the State of Illinois' bond ratings in October 2015, directly citing the State's budget impasse for the ratings actions. These downgrades made Illinois the only state credit currently rated below the 'A' category and signal a weakened capacity for the government to meet its financial obligations.

The lower ratings also led to higher borrowing costs for the State when it entered the bond market in January 2016 than if it had received interest rates in line with municipal bonds in the 'A' categories.

---

[70] Illinois Office of the Comptroller, "Expenditures, Revenues Down as Backlog Grows," *Comptroller's Quarterly*, January 2016. The backlog was reduced at the end of FY2015 due to fund sweeps and interfund borrowing.
[71] Illinois Comptroller Leslie Geissler Munger, "Munger: Cash Shortage Requires State to Delay Pension Payment," *news release*, October 14, 2015.
[72] Steven A. Finkler et al., *Financial Management for Public, Health, and Not-for-Profit Organizations*, 4th ed. Upper Saddle River, NJ: Pearson Education Inc., 2013, p. 29.
[73] Lolly Bowean, "State budget impasse leads to cost cutting at U of I," *Chicago Tribune*, October 19, 2015.
[74] Kim Geiger, "Social service groups sound alarm on Illinois budget impasse," *Chicago Tribune*, September 15, 2015.

The downgrades took place shortly after Illinois Comptroller Leslie Geissler Munger announced that due to year-end spending pressures and lower revenues, contributions to the State's pension funds in would be delayed in November.[75]

Fitch Ratings was the first agency to take action, downgrading Illinois to BBB+ from A- on October 19, 2015.[76] This marked the seventh downgrade of Illinois' General Obligation bond rating by Fitch in the last five years. The press release accompanying the downgrade from Fitch attributed the action directly to the State's budget impasse and liquidity issues despite a growing economy in the State.

Moody's Investors Service also lowered its rating on Illinois' General Obligation bonds to Baa1 from A3 on October 22, 2015.[77] Using a rationale similar to Fitch's, Moody's attributed the ratings action to the State's lack of a budget and deteriorating finances. This was the sixth downgrade of Illinois by Moody's over the last five years. Illinois' outlook from Moody's remains negative, indicating the possibility of further downgrades if nothing is done to address the budget crisis.

Although the rating is now below the 'A' level, Illinois' General Obligation bonds are still considered investment grade and three levels above speculative, or junk status. The outlook on Illinois' credit from Fitch is listed as stable, indicating that another downgrade is not likely in the near term.

At the time of the downgrades, Illinois had $26.8 billion in outstanding General Obligation bonds with related interest payments totaling $13.9 billion in interest due on the debt as it is repaid through 2039.[78]

---

[75] Illinois Comptroller Leslie Geissler Munger, "Munger: Cash Shortage Requires State to Delay Pension Payment," n*ews release*, October 14, 2015.
[76] Fitch Ratings, "Fitch Downgrades Illinois' GO Rating to 'BBB+'; Outlook Revised to Stable," *news release*, October 19, 2015.
[77] Moody's Investors Service, "Moody's downgrades Illinois' outstanding $27B of GO bonds to Baa1; outlook negative," *news release*, October 22, 2015.
[78] Moody's Investors Service, "Moody's downgrades Illinois' outstanding $27B of GO bonds to Baa1; outlook negative," *news release*, October 22, 2015.

The following table shows the State of Illinois' General Obligation debt rating at the end of each fiscal year from FY2008 through the current ratings in FY2016.

State of Illinois General Obligation Bond Ratings FY2008-FY2016			
	Moody's Investors Service	**Standard & Poor's**	**Fitch Ratings**
FY2008	Aa3	AA	AA
FY2009	A1	AA-	A
FY2010	Aa3*	A+	A+*
FY2011	A1	A+	A
FY2012	A2	A+	A
FY2013	A2	A	A
FY2014	A3	A-	A-
FY2015	A3	A-	A-
FY2016	Baa1	A-	BBB+

*Moody's and Fitch increased Illinois' bond ratings in March 2010 due to recalibrations of their entire rating scales but this was not considered an upgrade.

Source: Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2016* , August 2013, pp. 184; Moody's Investors Service, "Moody's downgrades Illinois' outstanding $27B of GO bonds to Baa1; outlook negative," n*ews release,* October 22, 2015; Fitch Ratings, "Fitch Downgrades Illinois' GO Rating to 'BBB+'; Outlook Revised to Stable," *news release,* October 19, 2015.

Both of the downgrades from Moody's and Fitch also affect several other types of bonds issued by the State.

Moody's lowered its ratings to Baa1 from A3 on the State's Build Illinois bonds, which are backed by a portion of sales tax receipts. It also cut the State's ratings to Baa2 from Baa1for debt associated with the Metropolitan Pier and Exposition Authority and the Civic Center program, which are subject to appropriation each fiscal year. The outlook for all of these credits was held at negative.

Fitch downgraded the Illinois Sports Facilities Authority and Metropolitan Pier & Exposition Authority McCormick Place to BBB from BBB+, also due to the need for State appropriations to pay for debt service, but gave the rating a stable outlook. It also downgraded the City of Chicago's motor fuel tax bonds to BBB from BBB+. Earlier this fall, the Metropolitan Pier & Exposition Authority received a quadruple downgrade from Fitch from AA- to BBB+ when the State failed to appropriate the funds needed to make its debt service payments.[79]

The third prominent ratings agency, Standard and Poor's, continues to rate Illinois A- with a negative outlook.

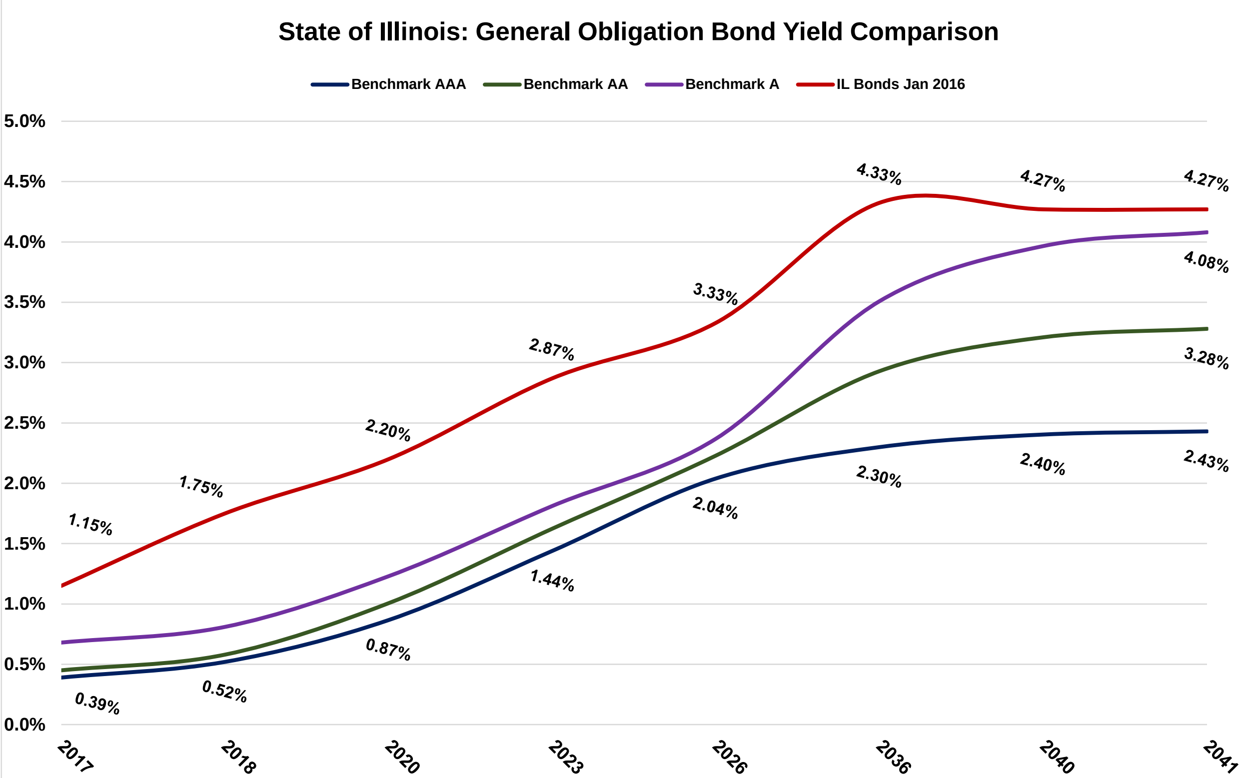
Lower bond ratings increase the State's cost of borrowing above other better-rated governments. Illinois has not issued General Obligation bonds since April 2014. Although the Governor's proposed FY2016 budget projected a sale of $250 million of capital purpose bonds in FY2015 and proposed the sale of an additional $1.1 billion in bonds in FY2016, the State remained out of the municipal securities market until early in 2016.[80]

[79] Fitch Ratings, "Fitch Rates $223MM Metropolitan Pier and Exposition Auth., IL Bonds 'BBB+'; Outlook Negative," *news release*, September 11, 2015.
[80] Illinois State FY2016 Budget, p. 7-9.

Prior to the downgrades, Illinois stood alone with New Jersey as the only single 'A' rated state credits. More than half of the remaining states are rated 'Aa' and 15 states have the highest level of 'Aaa' rating from Moody's.[81]

On January 16, 2016 the State sold $480 million of General Obligation bonds to fund ongoing capital projects.

The following chart compares the yields received by the State to the benchmark yields for better-rated municipal credits reported for the month of January.[82] 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: Yahoo Finance, Composite Bond Rates for January 2016, http://finance.yahoo.com/bonds/composite_bond_rates (last visited February 2, 2016). State of Illinois, General Obligation Bonds, Series January 2016, *Official Statement*, January 16, 2016.

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 and other portfolio standards can affect the outcome of a bond sale.

---

[81] Moody's Investors Service, *Annual State Debt Medians 2015*, June 24, 2015.

[82] For more details on the calculations and yield comparisons, including background data, see Appendix A on p. 50.

However, based on the available data, Illinois paid much more than a better rated government would have been charged for the $480 million of bonds issued in January, which will cost a total of $238.3 million in interest through FY2041.

For the same bond issuance, a government with an ‘A’ bond rating receiving the composite yields in the chart above would have paid 18.0% less than Illinois, leading to a total of $43 million in interest savings.

Using the same methodology, a government rated ‘AA’ would have paid $72.8 million less, or 30.5%, and a government rated ‘AAA’ would have paid $105.0 million less, or 44.1%, for the same bond issuance.[83]

Although these additional interest charges are paid over 25 years, the higher yields lead to a significantly greater cost to provide essential infrastructure investments for the State of Illinois due to its low credit ratings and ongoing budget crisis.

Interest Penalties

The State is required to pay interest penalties on certain overdue bills. As the budget impasse continues, the backlog of unpaid bills is expected to grow, payment delays will increase and penalties owed to vendors will climb.

However, interest penalties are not paid until the State pays the underlying bills, which means that the amount of interest penalties paid in FY2016 will depend on the timing of bill payments. Some vendors with State contracts may not be paid at all unless appropriation bills are enacted. It should also be noted that many type of payments owed by the State, including grants and transfers to local governments, are not eligible for interest when payment is delayed.

Late payment of group health insurance bills has accounted for most of the recent interest penalties paid by the State. In FY2015 the State paid a total of $126.1 million in interest penalties, according to the Illinois Comptroller’s Office. Of that amount, $106.4 million, or 84.4%, was related to the group health insurance program.

The group health insurance program is one of the major areas of State government for which there appears to be no legal authority to pay bills.[84] Nevertheless, the program’s costs must be paid eventually because of State law and union contracts. According to the Governor’s Office, the backlog of health insurance claims stood at $2.5 billion at the end of December 2015, compared with $1.4 billion a year earlier.[85]

---

[83] For data and comparison calculations see Appendix A on p. 50.

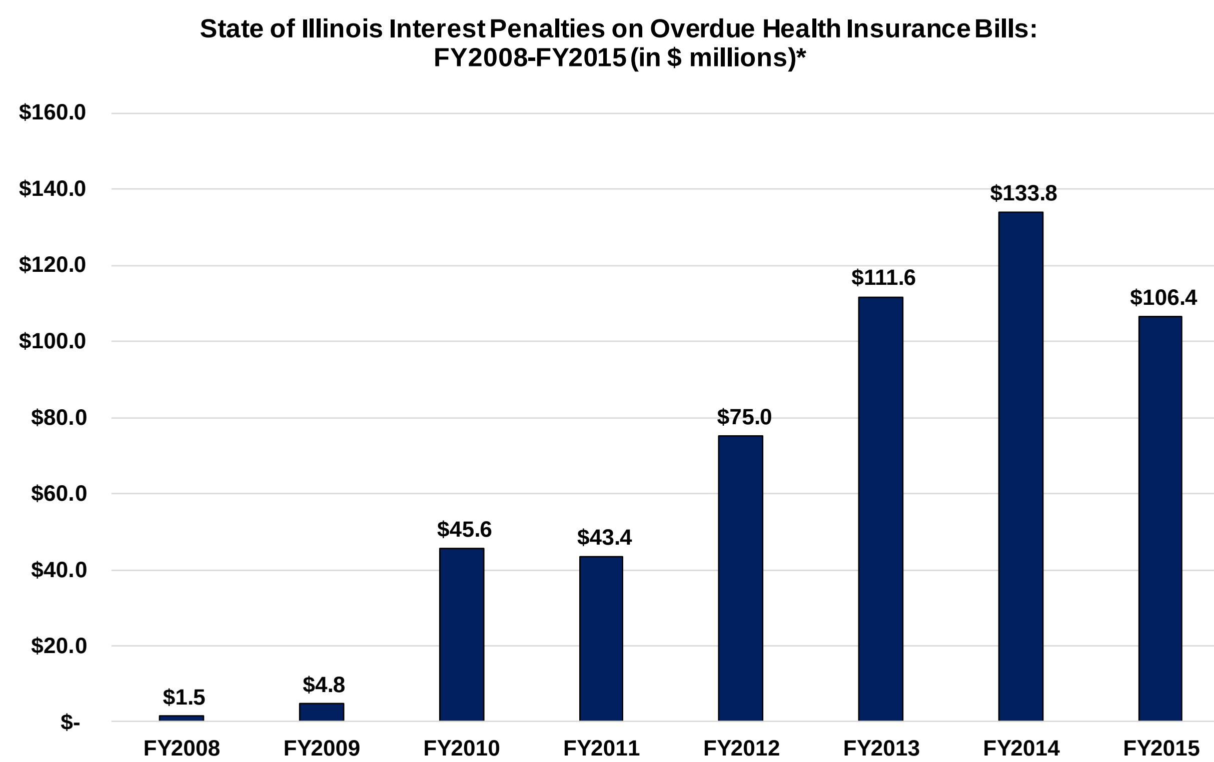
[84] Illinois Department of Central Management Services, *Group Insurance Budget Impasse FAQs*, September 25, 2015, http://www.illinois.gov/cms/Employees/benefits/StateEmployee/Documents/Budget_Impasse_FAQs_092415.pdf (last visited on February 2, 2016).

[85] Illinois Governor’s Office of Management and Budget, *Bills Outstanding – Summary*, December 2015, http://www.illinois.gov/gov/budget/Documents/Bill_Backlog_Presentation_1.20.16.pdf (last visited on February 2, 2016).

Unlike most other State bills, group health insurance claims may be paid from future years' appropriations under an exception to Section 25 of the State Finance Act.[86] The State used the provision to mask budget deficits in the past by appropriating an insufficient amount to cover group health insurance costs in one year, knowing that remaining bills could be paid from the next year's budget. The deferred bills are known as Section 25 liabilities.

Under the State Prompt Payment Act, which applies to managed care companies, interest accrues at 1% a month on complete claims that are not paid within 90 days.[87] Claims from healthcare providers accrue interest at 9% a year after 30 days under the Illinois Insurance Code.[88]

The following chart shows interest penalties related to the State group health insurance program from FY2008 through FY2015. The State has paid $522.1 million in such penalties during that period, according to the Comptroller's Office. Interest penalties spiked in FY2014 because of a supplemental appropriation that permitted the State to pay off bills.



*Includes penalties paid under the State Prompt Payment Act and the Illinois Insurance Code for claims to the State Employees Group Insurance Program.
Source: Illinois Office of the Comptroller.

[86] 30 ILCS 105/25(b-4).
[87] 30 ILCS 540.
[88] 215 ILCS 5.

With a backlog of $2.5 billion at the end of December, claims from managed care companies and healthcare providers are currently held as long as 420 days before being paid.[89] Payment delays are expected to increase if the budget impasse continues.

Loss of Services

The lack of an FY2016 budget has had the most impact on areas of State government that traditionally have been funded but are not currently authorized to be paid. The largest is higher education, which covers nine public universities, community colleges and MAP, the college scholarship program for about 128,000 low income students. Higher education received $1.9 billion in General Funds in FY2015.[90]

Without State funding, public universities initially dipped into reserves, laid off administrators and credited students' tuition bills for their MAP grants, expecting to be reimbursed when a budget was enacted. More recently financially weaker institutions have said they are running out of cash and are having trouble paying bills.

On February 4, the Board of Trustees of Chicago State University declared a financial crisis, which reportedly makes it easier to lay off employees, including tenured professors.[91] The institution had previously said that it would not be able to cover its payroll by March.

Chicago State and many other schools have also stopped covering MAP scholarships. As a result, more than 1,000 students reportedly failed to return to school for the second semester.[92]

State financial support is more important to some public universities than others. Chicago State received 31.6% of its revenue from State appropriations in FY2015, compared with an average of 17.5% for all public universities and 14.9% for the University of Illinois, the State's flagship university.[93] The U of I has also made cutbacks, postponing upgrades to its information technology operating system and delaying building improvements.[94]

Although most healthcare and social services programs are being funded due to federal consent decrees, there are notable exceptions. Lutheran Social Services, one of the State's largest social service agencies, said on January 22 that it was laying off 750 employees, or about 43% of its staff, and cutting its annual budget by 21.9% from $96 million to $75 million.[95] More than 90% of the program cuts were a result of not being paid by the State, which owes the organization more than $6 million.

---

[89] Commission on Government Forecasting and Accountability, *Monthly Briefing for the Month Ended: January 2016*, p.8.

[90] State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, p. 17. This figure does not include pension contributions of $1.4 billion to the State Universities Retirement System.

[91] Jodi S. Cohen, "Chicago State University declares financial crisis due to state budget mess," *Chicago Tribune*, February 4, 2016.

[92] Douglas Belkin, "Illinois Budget Deadlock Hits College Enrollments," *The Wall Street Journal*, January 18, 2016.

[93] Illinois State Board of Higher Education, *Annual Report on Public University Revenues and Expenditures: Fiscal Year 2015*, October 2015, Appendix A.

[94] Lolly Bowean, "State budget impasses leads to cost cutting at U of I," *Chicago Tribune*, October 19, 2015.

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

Lutheran Social Services said it was ending more than 30 programs for about 4,700 people. Many of the programs that are being eliminated, such as in-home care and adult daycare for seniors, are 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 is not being paid by the State.

Other social service programs that are not being funded serve immigrants, teens, the mentally ill and individuals with autism and epilepsy. A recent survey by the United Way of Illinois found that nearly half of the 444 human services agencies that responded had reduced services, programs or staff since July 2015 due to the budget impasse.[96]

The budget standoff has also affected crime prevention programs such as Adult Redeploy Illinois, which is aimed at diverting non-violent offenders from prison into community programs and was singled out for praise in Governor Rauner's first State of the State address. Adult Redeploy has not been funded in FY2016, resulting in reduced staff, unfilled positions, a decrease in service and treatment availability and reduced or suspended enrollments.[97] The Governor's three-year projection assumes that the program will eventually receive funding during the current year and that it will continue to be supported in subsequent years.[98]

GOVERNOR'S THREE-YEAR BUDGET PROJECTION

Since 2011 the Governor's Office of Management and Budget (GOMB) has issued a three-year budget forecast in early January as part of a statutorily required economic and fiscal policy report.[99] This year's report is the first under Governor Rauner, who took office on January 12, 2015, after the publication of the 2015 report issued by former Governor Pat Quinn's administration.

The three-year forecast, issued on January 6, 2016, covers FY2017 through FY2019. It also includes actual budget results for FY2015, which ended on June 30, 2015, and estimated results for FY2016, which began on July 1, 2015.

Because the State has not enacted a full General Funds budget for FY2016, the three-year projection provides the most complete information available on the current year's finances.[100] More details will emerge on February 17, 2016 when the Governor is scheduled to present his FY2017 budget. Due to the lack of other data, the Civic Federation is using the numbers in the

---

[96] United Way of Illinois, "Seven Months into State Budget Impasse, United Way of Illinois Survey Shows Extensive Cuts to Human Service Programs and Harm to Sector," *news release*, January 26, 2016.
[97] Adult Redeploy Illinois Oversight Board, Performance Measurement Committee, Minutes of the October 26, 2015 meeting.
[98] Communication between the Civic Federation and the Governor's Office of Management and Budget, February 5, 2016.
[99] 20 ILCS 3005/7.3.
[100] A narrative discussion of the FY2016 budget is also included in documents filed in connection with the State's recent bond offering. For more information, see State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, pp. 22-24.

three-year projection as the basis of its recommendations for solving the State's financial problems.

The projection shows the State's backlog of unpaid bills growing to $25.0 billion in FY2019 from $4.4 billion in FY2015 based on current tax and spending policies, with certain exceptions noted below. The following table summarizes the information in the projection.

State of Illinois Governor's Three-Year General Funds Budget Projection (in $ millions)	FY2015 Actual	FY2016 Estimated	FY2017 Forecast	FY2018 Forecast	FY2019 Forecast
State Sources					
Individual Income Tax	$ 15,433	$ 12,301	$ 12,618	$ 13,091	$ 13,613
Corporate Income Tax	$ 2,686	$ 2,242	$ 2,341	$ 2,425	$ 2,503
Sales Taxes	$ 8,030	$ 8,205	$ 8,390	$ 8,620	$ 8,840
Other State Taxes and Fees	$ 3,427	$ 3,110	$ 3,093	$ 3,077	$ 3,061
Transfers In	$ 1,697	$ 1,661	$ 1,678	$ 1,694	$ 1,712
Fund Sweeps	$ 1,284	$ -	$ -	$ -	$ -
Total State Sources	**$ 32,557**	**$ 27,519**	**$ 28,120**	**$ 28,907**	**$ 29,729**
Federal Sources	**$ 3,331**	**$ 4,408**	**$ 4,452**	**$ 4,497**	**$ 4,542**
Total Revenues	**$ 35,888**	**$ 31,927**	**$ 32,572**	**$ 33,405**	**$ 34,270**
Agency Appropriations*	$ 24,188	$ 24,038	$ 24,584	$ 25,253	$ 25,969
Less Unspent Appropriations	$ (1,024)	$ (251)	$ (255)	$ (260)	$ (265)
Net Agency Appropriations	$ 23,164	$ 23,787	$ 24,329	$ 24,993	$ 25,704
Pension Contributions	$ 6,046	$ 6,631	$ 6,930	$ 7,103	$ 7,233
Group Insurance Payments	$ 1,565	$ 1,650	$ 1,708	$ 1,768	$ 1,829
Total Appropriations	**$ 30,775**	**$ 32,068**	**$ 32,967**	**$ 33,864**	**$ 34,766**
Transfers Out					
Statutory Transfers Out	$ 2,489	$ 2,405	$ 2,460	$ 2,531	$ 2,605
Debt Service**	$ 2,094	$ 2,080	$ 2,746	$ 2,309	$ 1,923
Total Transfers Out	**$ 4,583**	**$ 4,485**	**$ 5,206**	**$ 4,840**	**$ 4,528**
Total Expenditures	**$ 35,358**	**$ 36,553**	**$ 38,173**	**$ 38,704**	**$ 39,294**
Budgetary Basis Adjustments	$ 47	$ -	$ -	$ -	$ -
Operating Surplus (Deficit)	**$ 577**	**$ (4,626)**	**$ (5,601)**	**$ (5,300)**	**$ (5,024)**
Borrowing for Operations* **	**$ 454**	**$ -**	**$ -**	**$ -**	**$ -**
Operating Surplus (Deficit) After Borrowing for Operations	**$ 1,031**	**$ (4,626)**	**$ (5,601)**	**$ (5,300)**	**$ (5,024)**
Gross Bill Backlog at Year End	**$ 4,403**	**$ 9,029**	**$ 14,630**	**$ 19,930**	**$ 24,954**

*Includes FY2016 appropriations not yet enacted.

**Includes $454 million in FY2017 for repayment of FY2015 interfund borrowing.

***Interfund borrowing of $454 million in FY2015.

Source; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY17-FY19*, January 6, 2016.

As previously discussed in this report, the projected growth in unpaid bills is not surprising in light of the decrease in income tax rates that took effect midway through FY2015 and the State's large and growing contributions to its underfunded retirement systems. State officials closed the budget gap in FY2015 mainly by using budgetary gimmicks and one-time revenue sources.

Revenues in FY2015 were boosted by $1.3 billion in transfers of surplus balances from other state funds to General Funds—a practice known as fund sweeps. In FY2015 the State also borrowed $454 million from other state funds; this interfund borrowing must be repaid in 18 months.

Fiscal year 2016 is the first full budget year since the partial phaseout of temporary income tax rate increases enacted in 2011. As of January 1, 2015, individual income tax rates, which had been raised to 5.0% from 3.0%, declined to 3.75%; corporate income tax rates, which had increased to 7.0% from 4.8%, declined to 5.25%.[101]

According to GOMB's estimates, total General Funds revenues decline by 11.0% from $35.9 billion in FY2015 to $31.9 billion in FY2016, mainly because of the income tax rate reductions, and then rise moderately through FY2019 due to natural economic growth. Income tax revenues fall 19.7% from $18.1 billion in FY2015 to $14.5 billion in FY2016 before growing to $16.1 billion in FY2019.

GOMB's revenue forecast is based on conservative assumptions about economic growth in FY2016 and over the next three years.[102] The State's economic consulting firm, IHS Economics, provided two sets of metrics to assist with the three-year projection. The first was a baseline model that assumed continuation of the slow growth environment that has persisted in Illinois over the last several years. The second set was a pessimistic model that incorporated a 20.0% chance of economic downturn over the next three years.

The following chart shows the growth rates for the key economic factors considered by GOMB to produce the revenue estimates in the three-year projection.

State of Illinois Governor's Three-Year General Funds Budget Projection:
Key Revenue Forecasting Indicators and Assumed Growth Rates, Baseline (b) and Pessimistic (p)
FY2016-FY2019

Economic Indicator	FY2016 (b)	FY2016 (p)	FY2017 (b)	FY2017 (p)	FY2018 (b)	FY2018 (p)	FY2019 (b)	FY2019 (p)
Illinois Real Gross Domestic Product	1.5%	1.0%	2.5%	-0.2%	2.4%	1.8%	2.3%	1.9%
Illinois Non-Farm Employment	0.5%	0.4%	1.0%	-0.4%	1.0%	0.3%	1.0%	0.8%
Illinois Wages and Salaries	3.1%	2.7%	4.5%	2.1%	4.9%	3.6%	4.7%	4.6%
Domestic Corporate Profits	1.3%	-2.2%	7.7%	-3.2%	0.4%	-3.9%	0.1%	-2.7%
Illinois Retail Sales	2.2%	1.7%	5.6%	3.0%	5.0%	4.6%	4.2%	3.9%

State of Illinois, Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report* , January 6, 2016. Growth rates provided by IHS Economics.

[101] In addition to the corporate income tax rate, businesses in Illinois are also charged the Personal Property Replacement Tax at a rate of 2.5% for C corporations; partnerships, trusts, and S corporations pay a 1.5% tax on corporate income; and public utilities pay a 0.8% tax on invested capital.
[102] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, January 6, 2016, pp. 4-6.

The State used a blended rate between the baseline and pessimistic projection to produce its revenue estimates.[103]

Total General Funds expenditures are estimated to increase by 3.4% from $35.4 billion in FY2015 to $36.6 billion in FY2016 and by 4.4% from FY2016 to $38.2 billion in FY2017. Annual increases are projected at 1.4% and 1.5% in FY2018 and FY2019, respectively.

The relatively high spending increase in FY2016 reflects a jump in statutorily required pension contributions and artificially low General Funds Medicaid spending in FY2015, when the State used FY2014 revenues to pay for FY2015 Medicaid expenditures. Projected spending in FY2017 includes the repayment of the FY2016 interfund borrowing and an increase in debt payments owed on pension bonds issued in 2011.

The State has been paying a large portion of its expected FY2016 expenses even without a General Funds budget due to statutory requirements, consent decrees and court orders. In addition, although Governor Rauner and the General Assembly have not reached agreement on most of the FY2016 general operating budget, the Governor did sign an appropriation bill for elementary and secondary education.[104] In all, the State is authorized or compelled to spend approximately $31.5 billion out of General Funds in FY2016.[105]

The $31.5 billion does not include group health insurance, the cost of which must be paid eventually because of State law and union contracts. Other areas that have historically been funded but are not being financially supported currently are public universities and community colleges, scholarships for low income college students, human services programs not covered by Medicaid and operational expenses of certain agencies.

The new FY2016 General Funds spending estimate allocates $5.1 billion to currently unfunded areas, bringing total expected expenditures to $36.6 billion. The estimate assumes that the State will enact a supplementary appropriation covering the areas that are currently unfunded.

The spending estimates included in the three-year projection represent a considerable reduction from the spending presented as a maintenance budget in the Governor's FY2016 budget proposal. The autopilot or maintenance budget for FY2016 in the recommended budget was intended to show expenditure levels needed to support existing State programs and services.[106]

---

[103] Governor's Office of Management and Budget, *Economic and Fiscal Policy Report*, January 6, 2016, p. 6.
[104] Public Act 99-0005, signed on June 24, 2015.
[105] State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, p. 24.
[106] Illinois State FY2016 Budget, p. 2-23.

The following table compares FY2016 spending in the new three-year projection to the FY2016 autopilot budget included in Governor Rauner's recommended budget document issued in February 2015.

Comparison of State of Illinois FY2016 General Funds Autopilot and Estimated Expenditures (in $ millions)				
	FY2016 Autopilot[1]	FY2016 Estimated[2]	$ Change	% Change
Appropriations				
K-12 Education[3]	$ 6,401	$ 6,572	$ 171	2.7%
Higher Education	$ 2,024	$ 1,571	$ (453)	-22.4%
Economic Development	$ 97	$ 63	$ (34)	-35.1%
Public Safety	$ 1,714	$ 1,619	$ (95)	-5.5%
Human Services[4]	$ 5,456	$ 4,936	$ (520)	-9.5%
Healthcare	$ 7,795	$ 7,997	$ 202	2.6%
Environment and Culture	$ 64	$ 54	$ (10)	-15.6%
Government Services	$ 1,188	$ 1,226	$ 38	3.2%
Group Health Insurance	$ 1,850	$ 1,650	$ (200)	-10.8%
Pension Contributions	$ 6,821	$ 6,631	$ (190)	-2.8%
(Unspent Appropriations)	$ (251)	$ (251)	$ -	0.0%
Expenditures from Appropriations	**$ 33,159**	**$ 32,068**	**$ (1,091)**	**-3.3%**
Transfers Out				
Statutory Transfers Out	$ 2,482	$ 2,405	$ (77)	-3.1%
Debt Service	$ 2,129	$ 2,080	$ (49)	-2.3%
Total Transfers Out[5]	**$ 4,610**	**$ 4,485**	$ (125)	-2.7%
Total	**$ 37,769**	**$ 36,553**	**$ (1,216)**	**-3.2%**

[1]Maintenance expenditures as of February 2015.

[2]Expected expenditures as of January 2016.

[3]Original $6,621 million in autopilot budget reduced by $220 million to account for diversion to Fund for Advancement of Education.

[4]Original $5,676 million in autopilot budget reduced by $220 million to account for diversion to Commitment to Human Services Fund.

[5]Totals may not add due to rounding.

In the table above, FY2016 autopilot expenditures total $37.8 billion. This represents a decrease of $440 million from $38.2 billion autopilot spending in the recommended budget document. The original number did not properly account for the statutorily required diversion of $220 million to each of two separate funds to support education and human services, according to GOMB.[107]

[107] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 7, 2016.

The expected spending in FY2016 is $1.2 billion below the FY2016 autopilot budget. Certain reductions are related to revised estimates of FY2016 costs, according to GOMB. The major reductions include the following:

- Higher education: The $453 million decrease is in line with the Governor's FY2016 budget recommendation, which proposed that spending on public universities be cut by 31.9% to $849.1 million from $1.2 billion in the autopilot budget;
- Human services: The $520 million reduction reflects savings on programs that are not being funded because they are not covered by court orders or consent decrees, as well as administrative actions taken to reduce costs. For example, the Rauner administration said it saved $145 million in FY2016 by tightening eligibility requirements for the Child Care Assistance Program, which provides subsidized child care for low income working families.[108] The restrictions were partially rolled back in November 2015 after opposition from advocates.[109] An additional $120 million reduction reflects savings on programs that are not being funded in FY2016 due to the lack of appropriations or other spending authority.[110] However, the portion of the Community Care Program that is not covered by Medicaid and not currently being funded is assumed to receive an FY2016 appropriation. The Community Care Program provides home and community services for seniors to help them stay out of nursing homes;
- Group health insurance: The $200 million decrease is due to rate reductions negotiated with insurers and healthcare providers, savings from an audit of dependent eligibility and use of cash balance from the program's special account, according to GOMB; and
- Pension contributions: The reduction of $190 million reflects regular funding from the State Pensions Fund, which receives proceeds from the sale of unclaimed property. This funding was not accounted for in the autopilot budget but is deducted from General Funds spending in the new estimate.

Going forward, the projection assumes that eligibility requirements for Child Care Assistance Program are restored to their original level, according to GOMB. It also assumes that the entire Community Care Program will be funded.

However, other social service programs that are not being funded in FY2016 are not included in the following years' budgets. These programs include psychiatric leadership capacity grants, which help community mental health centers pay for psychiatrists, as well as programs that serve immigrants, teens, the mentally ill and those with autism and epilepsy.

The projection does not include salary increases. The State's contract with its largest union, Council 31 of the American Federation of State, County and Municipal Employees (AFSCME), expired on June 30, 2015, and negotiations on a new contract have been ongoing for the past year with no resolution.

On January 15, 2016, the Rauner administration asked the Illinois Labor Relations Board to determine if contract talks had stalled.[111] If the labor board rules in favor of the State, the administration could impose its contract terms on the union. The union, which represents about 38,000 State workers, would then have to decide whether to accept the terms, challenge the ruling in court or go on strike.

---

[108] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 12, 2016.
[109] Kim Geiger, "Rauner reverses course on cuts to child care, disability services," *Chicago Tribune*, November 9, 2015,
[110] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 12, 2016.
[111] Doug Finke, "Gov. Rauner seeks labor board ruling on impasse in talks with AFSCME," *The State Journal-Register*, January 15, 2016.

CIVIC FEDERATION RECOMMENDATIONS

The Governor's three-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 FY2019.

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 ongoing budget impasse for FY2016 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 operating shortfall of $4.6 billion, there are no practical measures that would completely balance the FY2016 budget and prevent an increase in the backlog of unpaid bills by the end of FY2016. Unlike FY2015 there are no easy stop-gap fixes, such as interfund borrowing or fund sweeps, that are available or adequate to close such a large operating shortfall. Only difficult choices remain for the State.

Given the projected FY2017 operating shortfall of $5.6 billion, it will require even more difficult cuts, strict spending limits and painful revenue increases to balance the budget and pay down the backlog of bills than the Civic Federation has previously proposed. These proposals are individually discussed in detail in the Recommendations section of this report starting on page 32.

As discussed in the previous section, the FY2016 spending levels in the Governor's three-year projections already assume drastic cuts to major government programs compared to the estimated maintenance level of spending presented in the recommended FY2016 budget. The expenditure levels in the Civic Federation's comprehensive plan are based on the levels in the Governor's three-year projection, a level that is essentially a $1.0 billion cut to FY2016 spending. This expenditure level is also $1.0 billion below the cap recommended by the Civic Federation in last year's State Budget Roadmap under the current pension funding law.

The FY2016 expenditure levels make for a very challenging budgetary starting point for the remaining years through the FY2019 budget. Agency spending, after excluding pension contributions, debt service, employee health insurance and legislatively required transfers grows at an average annual rate of only 2.6% in the Governor's three-year projection. At a minimum, the State must cap its annual spending at these levels in order to begin stabilizing its finances.

Although limiting agency spending to the level included in the Governor's three-year projections is crucial, cuts and spending controls are not enough to stabilize the State's finances in the coming fiscal year or in the long-term. The State must also pursue tax policy changes that will reduce the FY2016 operating deficit, balance the FY2017 budget and generate budgetary surpluses to pay off the backlog of bills and finally end the ongoing fiscal crisis.

The Civic Federation's comprehensive plan proposes the following tax policy changes to address the State's fiscal crisis. These tax changes, although politically unappealing and painful for both individuals and businesses in the State, are chosen because they are of the magnitude necessary to solve the State's financial crisis:

1. Return the income tax rate for individuals to 5.0% from 3.75% and to 7.0% from 5.25% for corporations as of January 1, 2016;
2. Replace Illinois' income tax exemption for all federally taxable retirement income with a narrower exemption that still excludes all Social Security income and only exempts individuals with an adjusted gross income of less than $50,000;
3. Broaden the sales tax base to include services, which will capture a growing area of the State economy;
4. Temporarily eliminate the broad-based sales tax exemption for all food and nonprescription drug purchases from the State's portion of the sales tax; and
5. Reduce the total discount provided to retailers for collecting sales taxes by instituting a monthly cap on the deduction.

In conjunction with these changes, the earned income tax credit in Illinois should be increased from 10% of the federal amount to 15%, to provide additional relief for low income residents. The entire plan would lead to an elimination of the State's unpaid bill backlog, provide achievable spending limits for the State's operating budget through FY2019 and allow for a significant initial deposit into a rainy day fund. The Federation's plan also includes a more equitable proposal for teacher pension funding, which is critical for the Chicago Public Schools' long-term sustainability.[112]

---

[112] For more information on Chicago teachers' pension reform, see p. 42 of this report.

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

State of Illinois: Governor's Three-Year Budget Projection and Civic Federation Comprehensive Plan FY2015-FY2019 (in $ millions)	FY2015	FY2016	FY2017	FY2018	FY2019	$ Change
Revenues						
State Source Revenues	$ 31,273	$ 27,519	$ 28,120	$ 28,907	$ 29,729	$ (1,544)
Federal Revenues	$ 3,331	$ 4,408	$ 4,452	$ 4,497	$ 4,542	$ 1,211
Tax Changes						
Increase IIT (5.0%)	$ -	$ 2,004	$ 4,112	$ 4,266	$ 4,436	$ 4,436
Increase CIT (7.0%)	$ -	$ 366	$ 765	$ 792	$ 818	$ 818
Retirement Income*	$ -	$ 811	$ 1,720	$ 1,823	$ 1,932	$ 1,932
Sales Tax on Food and OTC Drugs	$ -	$ 367	$ 1,122	$ 1,122	$ 1,122	$ 1,122
Sales Tax on Services	$ -	$ -	$ 469	$ 956	$ 975	$ 956
Reduced Retailers' Discount	$ -	$ 28	$ 85	$ 85	$ 85	$ 75
Fund Sweeps	$ 1,284	$ -	$ -	$ -	$ -	$ (1,284)
Interfund Borrowing	$ 454	$ -	$ -	$ -	$ -	$ (454)
New Revenues	**$ 1,738**	**$ 3,577**	**$ 8,273**	**$ 9,045**	**$ 9,369**	**$ 7,631**
Total Revenues	**$ 36,342**	**$ 35,504**	**$ 40,845**	**$ 42,449**	**$ 43,640**	**$ 7,298**
Expenditures						
Net Agency Appropriations	$ 23,164	$ 23,787	$ 24,329	$ 24,993	$ 25,704	$ 2,540
Pension Contributions	$ 6,046	$ 6,631	$ 6,930	$ 7,103	$ 7,233	$ 1,187
Group Insurance Payments	$ 1,565	$ 1,650	$ 1,708	$ 1,768	$ 1,829	$ 264
Debt Service and Transfers	$ 4,583	$ 4,485	$ 5,206	$ 4,840	$ 4,528	$ (55)
CTPF Unfunded Liability	$ -	$ 501	$ 535	$ 560	$ 584	$ 584
TRS Normal Cost Shift	$ -	$ -	$ (240)	$ (528)	$ (800)	$ (800)
EITC Increase 10%-15%	$ -	$ -	$ 124	$ 127	$ 134	$ 134
Supplemental Pension Payment	$ -	$ -	$ -	$ -	$ 364	$ 364
Total Expenditures	**$ 35,358**	**$ 37,054**	**$ 38,593**	**$ 38,863**	**$ 39,576**	**$ 4,218**
Operating Surplus (Deficit)**	**$ 1,031**	**$ (1,550)**	**$ 2,252**	**$ 3,586**	**$ 4,064**	**$ 3,033**
Reserves (Bill Backlog)	**$ (5,355)**	**$ (6,905)**	**$ (4,654)**	**$ (1,068)**	**$ 2,996**	**$ 8,351**

*Revenue estimates for taxing of retirement income exclude taxation of all Social Security income and exempt individuals reporting AGI under $50,000 annually.

**Operating surplus in FY2015 reflects an increase of $47 million due to a Comptroller's budgetary basis adjustment.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)* , *FY17-FY19* , January 6, 2016; Communication with the Illinois Department of Revenue and Teachers' Retirement System, January 20, 2016; Civic Federation calculations.

As shown in the table above, through a comprehensive approach that includes difficult spending restrictions and painful but necessary tax increases, the State can achieve fiscal stability within the next three fiscal years. The plan establishes a rainy day fund to offset future economic downturns and avoid a repetition of the State's ongoing crisis and bill backlog.

Illinois has not maintained a functional rainy day fund, although a law was enacted in 2004 to build such a fund. The law established a goal of maintaining 5.0% 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. Deposits into the fund would be triggered by projected revenue growth of more than 4% from the prior year.

However, transfers based on the statutory formula have not occurred, apparently because annual revenue projections did not meet the threshold requirement and the marginal balances in the fund are used for cash flow problems resulting from timing variations between receipt and disbursement of funds in a given fiscal year.

The Civic Federation's plan would deposit the full $3.0 billion surplus at the end of FY2019 into a new rainy day fund and would put the State in a position to meet an achievable goal of accumulating reserves equal to 10% of State-source General Funds resources.[113]

In addition to the critical assistance provided the Chicago Public Schools, the plan provides additional direct funding to local governments totaling $394.3 million between FY2016 and FY2019. The funding would be provided through the retirement income added to the income tax base under the existing Local Government Distributive Fund allocation. Local governments receive 10% of the first three percentage points of the individual income tax after accounting for diversions made to pay for refunds.

The table above does not include other funds that could be provided to local governments due to the temporary elimination of the State exemption for food and nonprescription drugs. Once fully implemented, the sales tax on services could provide an additional $234.4 million in annual pass-through funding from the State and significantly more if municipal sales tax rates were applied to the new tax base.

Recommendations

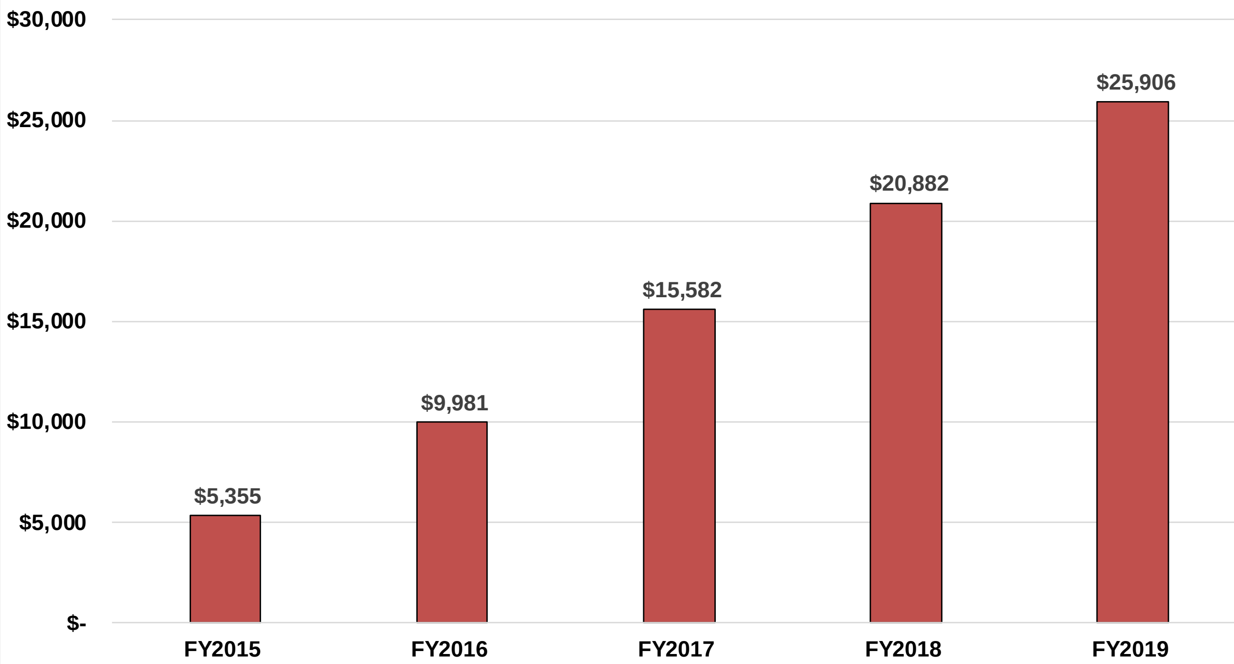
In order to carry out the comprehensive plan described above, the Civic Federation presents the following recommendations for the State of Illinois' FY2017 budget and additional reforms to ensure the long-term stability of the State's finances.

Issue 1: Year-End Backlog of Unpaid Bills

The State of Illinois is expected to end FY2016 with an estimated backlog of unpaid bills of $10.0 billion, based on the revenue and spending estimates in the recent three-year forecast by the Governor's Office.[114] A backlog of $10.0 billion would represent 31.3% of estimated FY2016 General Funds revenues. As shown in the chart below, the backlog would grow to $25.9 billion by the end of FY2019 under the Governor's revenue and spending assumptions and Civic Federation calculations.

[113] A 10% rainy day fund would total approximately $3.9 billion in FY2019.
[114] Illinois Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY17-FY19*, January 6, 2016.

State of Illinois Projected Backlog of Unpaid Bills: FY2015-FY2019 (in $ millions)*



*Estimated General Funds payables and General Funds-related Section 25 liabilities at end of fiscal year.
Source; Civic Federation calculations based on State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY17-FY19*, January 6, 2016; State of Illinois, General Obligation Bonds, Series of January 2016, *Official Statement*, January 15, 2016, pp. 18 and H-3; Illinois Office of the Comptroller, *Section 25 Deferred Liabilities*, http://illinoiscomptroller.gov/?LinkServID=A0FD646B-1CC1-DE6E-2F485BDED411AF81.

Until the State eliminates the backlog, it will not have completed its recovery from the economic downturn that officially ended more than six years ago. Because of the backlog, the State begins each fiscal year in a hole, using revenues from the current year to pay off the previous year's bills and reducing revenues available for current spending. Credit rating agencies have repeatedly cited the large backlog of unpaid bills as a major reason for giving Illinois lower credit ratings than any other state.[115]

As the State pushes these costs from one year to the next, it continues to delay payments to vendors and other service providers, transferring its financial distress to businesses, social service agencies and local governments across the State. It also incurs interest penalties that have recently exceeded $100 million a year.[116] The full cost of this practice to the State's own budget—in higher bids for State work and a smaller pool of bidders willing to do business with the State—is not easy to quantify but is undoubtedly much higher.

In order to pay off the backlog by FY2019, the State must control spending and use operating surpluses to eliminate its accumulated bills. Agency spending, after excluding pension contributions, debt service, group health insurance and legislatively required transfers, starts

---

[115] Fitch Ratings, "Fitch Downgrades Illinois' GO Rating to 'BBB+'; Outlook Revised to Stable," *news release*, October 19, 2015.
[116] For information about interest penalties on State group health insurance bills, see p. 20 of this report.

from a low base in FY2016 and grows at an average annual rate of only 2.6% in the Governor's three-year projection.[117]

In the projection, estimated FY2016 spending is more than $1 billion below the maintenance level presented in the Governor's FY2016 budget proposal.[118] The reductions include a decrease of $397 million, or nearly 32%, in funding for public universities.[119] Human services appropriations are down by $520 million, partly due to cutbacks in the subsidized child care program that are expected to be reversed by FY2017. The human services reductions also reflect the elimination of spending on programs costing $120 million that have not been funded in FY2016 in the absence of a budget.

Although the Civic Federation supports the overall spending levels in the three-year projection, specific spending reductions should be determined by the General Assembly and the Governor.

It should be noted that the backlog estimates presented above are Federation calculations and are somewhat higher than the Governor's estimates of $9 billion in FY2016 and $25.0 billion in FY2019.[120] The numbers are different because the Governor's estimates represent a snapshot as of June 30, while the Federation's estimates are on a budgetary basis and are intended to show accounts payable at the end of one year that will have to be paid from the next year's revenues.

The Federation's estimates include fiscal year-end General Funds payables held at the Comptroller's Office—bills owed to vendors and payments and transfers owed to agencies, pension funds and local governments—as well as payments made during the lapse period and 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.[121]

Under State law, most bills must be paid based on the current year's spending authority.[122] 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.[123] The authority to defer Medicaid bills was sharply restricted beginning in FY2013; group health insurance bills currently represent the major Section 25 liability.[124]

---

[117] Illinois Governor's Office of Management and Budget, *Three Year Projection (General Funds), FY17-FY19*, January 6, 2016.
[118] Illinois State FY2016 Budget, p. 2-23.
[119] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 12, 2016.
[120] For information about the Governor's backlog estimates, see p. 23 of this report.
[121] 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)].
[122] 30 ILCS 105/25(a).
[123] Illinois Office of the Comptroller, "The Section 25 Budget 'Loophole'," *Fiscal Focus*, July 2008, p. 7.
[124] 30 ILCS 105/25. Section 25 liability numbers are available in the State's Comprehensive Annual Financial Report (CAFR). Because the FY2015 CAFR is not yet available, the Civic Federation's estimate is based on the FY2014 number.

The total backlog could grow if the State does not increase the amount of income tax revenues set aside to pay income tax refunds owed to taxpayers.[125] The current diversion rates—the percentage of individual and corporate income taxes diverted from General Funds to pay tax refunds—are too low to cover estimated refunds for FY2016, according to the Governor's Office. Without a budget in place, the diversion rates were determined by statutory formula.

The current rates are 9.75% for individual income taxes and 15.2% for corporate income taxes. Without a budget in place, the diversion rates were determined by statutory formula. The rates needed to pay expected tax refunds for the rest of FY2016 are above 10.2% for individual taxes and above 17.3% for corporate taxes.[126]

Civic Federation Recommendation on Unpaid Bills

The Civic Federation recommends that the State of Illinois eliminate its fiscal year-end backlog of unpaid bills by FY2019 by controlling spending and generating annual operating surpluses to pay down the bill backlog.

Issue 2: 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.[127]

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.[128] 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 adequacy of reserves is one of the factors considered by credit rating agencies in assessing a state's financial condition. In downgrading Illinois' bond rating in October 2015, Fitch Ratings cited the State's inability to grow reserves during an economic expansion as one reason for its vulnerability to the next economic downturn.[129]

Illinois has not maintained a functional rainy day fund, although a law was enacted in 2004 to build such a fund. [130] The law established a goal of maintaining 5.0% of General Funds revenues

[125] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, January 6, 2016, p. 6.
[126] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, January 6, 2016, p. 6.
[127] Illinois Governor's Office of Management and Budget, *Illinois Economic and Fiscal Policy Report*, January 6, 2016, pp. 5-6.
[128] Government Finance Officers Association, *Best Practice: Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund*, October 2009.
[129] Fitch Ratings, "Fitch Downgrades Illinois' GO Rating to 'BBB+'; Outlook Revised to Stable," *news release*, October 19, 2015.
[130] Public Act 93-660, enacted on February 2, 2004.

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.[131] The Budget Stabilization Fund had $275 million at the end of FY2015—less than 1.0% of General Funds revenues of $36.4 billion.

Instead of being used to withstand fiscal emergencies, the fund is used for cash flow problems resulting from timing variations between receipt and disbursement of funds in a given fiscal year.[132] 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.[133]

In 2014 the Commission on Government Forecasting and Accountability (COGFA) concluded that raising the funding goal to 10.0% of General Funds revenues from 5.0% made sense in light of recent revenue volatility.[134] 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.[135]

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 a functional rainy day fund after the State's backlog of unpaid bills is paid off in FY2019 because the State's first priority should be using surpluses to establish a sound budget structure. However, as recommended by COGFA, a legislative framework should be put in place as soon as possible to permit funding of a rainy day fund after the backlog is eliminated.[136]

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.

---

[131] The law was amended to prohibit any deposits into the fund in FY2008.

[132] Commission on Government Forecasting and Accountability, *Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 88.

[133] 30 ILCS 105/6z-51(b). The law was amended to defer cash repayment for FY2011 until July 15, 2011.

[134] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 99.

[135] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 103.

[136] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 102.

Issue 3: Revenue Loss from Income Tax Rate Rollback

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 FY2016.

The partial rollback of the income tax increase reduced the individual rate to 3.75% from 5.0% and the corporate rate to 5.25% from 7.0% and caused total General Funds revenues (excluding interfund borrowing) to decline by $1.9 billion in FY2015 to $34.6 billion. Revenues declined by an additional $2.7 billion in FY2016 to $31.9 billion, amounting to an aggregate two-year decline of $4.9 billion, or 13.3%, from the FY2014 total of $36.8 billion.

Although the FY2015 budget was balanced with one-time measures including $1.3 billion of fund sweeps and $454 million of interfund borrowing, the State does not appear to have similar amounts available to balance the FY2016 budget. In addition, the FY2016 budget operating deficit is much deeper due to the full year of the lower tax rates.

The Governor's three-year projection shows that even after several years of underlying growth, General Funds revenues are projected to total only $34.3 billion in FY2019, which is still $2.5 billion below the peak in FY2014.

Previous proposals from the Civic Federation to eliminate operating deficits caused by the income tax rollback included raising income taxes to a level below the temporary rates passed in FY2011 and included reductions over the next five years. However, due to the delay in action to address the revenue losses since FY2015, the State's financial condition has further deteriorated. A comprehensive solution now requires both higher rates and less opportunity for future tax relief until the backlog of unpaid bills is reduced.

In addition, savings from the pension reforms that were slated to begin in FY2016 are no longer possible due to the Illinois State Supreme Court's ruling that the changes were unconstitutional. This increased the annual contributions by more than $1.0 billion annually compared to projected costs that would have taken place under the new law and makes solving the State's financial crisis much more difficult.

Although temporary taxes or one-time revenues may be used as part of a short-term reaction to a fiscal crisis, it is not sound public policy to engineer unmanageable reductions in State resources without a plan to mitigate those revenue losses. Although the State could consider reducing its income tax rates after paying off the remainder of its bill backlog in FY2019, it is imprudent to build in automatic future tax policy changes that could cause another financial crisis for the State.

Civic Federation Recommendation on the Income Tax Rate Rollback

The Civic Federation recommends retroactively increasing the income tax rates as of January 1, 2016 to 5.0% for individuals and 7.0% for corporations to mitigate a large portion of the current financial crisis and begin paying down a larger portion of the State's unpaid bills in the near term, giving relief to vendors and local governments.

Issue 4: Retirement Income Exemption

Unlike the federal government, which taxes certain levels of Social Security and other retirement income, Illinois exempts all retirement income from the State's income tax base.[137] Out of the 41 states that impose an income tax, Illinois is only one of three that exempts all pension income and one of 27 that excludes all federally taxable Social Security income.[138] The Illinois Comptroller reports that this exemption of federally taxable retirement income reduced individual income tax revenues by $2.2 billion in FY2013.[139] The cost of this exemption will increase over time due to a population shift in Illinois, with the number of senior citizens expected to grow from 1.7 million in 2010 to 2.7 million by 2030.[140]

Excluding Social Security income, all other federally taxable retirement income exempted by Illinois as of 2013 totaled $38.2 billion.[141] If income from individuals with a total adjusted gross income of less than $50,000 were also excluded from this tax base, the total untaxed income in Illinois totaled an estimated $29.4 billion in FY2013. Historically, the retirement tax base grows at a much higher annual rate than regular income. Retirement income in Illinois has grown at an average annual rate of 6.0%, while revenue from the individual income tax has averaged only 2.7% growth over the last 15 years.[142] Including the high growth portion of the income tax base from retirement income would provide for a more sustainable revenue source for the State ranging between $1.5 billion and $2.0 billion annually.

Illinois is an outlier regionally among bordering states in exempting all retirement income. Although Michigan, Indiana, Wisconsin, Iowa and Missouri all exempt Social Security income, they all also charge income taxes on other retirement income. Indiana has the lowest rate of 3.4%, which is a flat income tax rate applied to non-Social Security retirement income. Iowa charges the highest rate, which is the top rate on its graduated income tax scale of 8.68% applied to earners above $67,230.

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 exemption for retirement income, excluding Social Security income and all income from individuals with taxable income of less than $50,000. This will enhance the State's fiscal stability by providing access to a faster growing portion of the State's income tax base.

---

[137] 35 ILCS 5/203.

[138] Chicago Metropolitan Agency for Planning, *Charting Progress Toward a More Efficient Regional and State Tax System via Indicators*, July 18, 2013. http://www.cmap.illinois.gov/about/updates/-/asset_publisher/UIMfSLnFfMB6/content/charting-progress-toward-a-more-efficient-regional-and-state-tax-system-via-indicators (last visited on February 5, 2015)

[139] Illinois Office of the Comptroller, *Tax Expenditure Report, Fiscal Year 2013*, p. 6.

[140] Illinois Office of the Comptroller, *Tax Expenditure Report, Fiscal Year 2013*, p. 7.

[141] Internal Revenue Service, SOI Tax Stats – Historic Tables, Illinois 1999-2013. http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2 (last visited on February 1, 2016)

[142] Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 23.

Issue 5: The Earned Income Tax Credit

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 2015 single individuals claiming no dependents and income less than $14,820 could claim a maximum federal credit of $503 and married individuals without children could claim the same credit if their annual income was below $20,330. For a married couple with three or more children and an income of $53,267 or less, the maximum credit that could be claimed was $6,242. Single individuals with three or more children may also claim the highest credit level of $6,242 with an income of $47,747 or less.

Illinois currently matches 10% of the federal credit, which cost the State an estimated $231.4 million in FY2014. If the credit was increased by 50%, payments would increase by $624 for the highest level of benefits available to married individuals with three or more dependents.

<u>Civic Federation Recommendation on the Earned Income Tax Credit</u>
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.

Issue 6: Expanding the Sales Tax Base

The scope of Illinois' fiscal crisis is so large that raising income taxes and broadening the income tax base 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 the 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%. The State charges 6.25 percentage points and the remaining 4.0 percentage points are charged by local taxing authorities.

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 other states leading to greater volatility and higher rates.[143]

The State currently provides sales tax exemptions and refunds totaling $3.5 billion that would otherwise be available to fund its operations.[144] The largest exemption from the sales tax is the

---

[143] Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682,* December 31, 2014, p. 66 (See Appendix C on p. 55 for a regional comparison to other states).
[144] Illinois Comptroller, *Tax Expenditure Report, Fiscal Year 2014*, p. B-1.

exclusion of food and drug purchases from the full State rate of 6.25%. This exemption reduced the State's sales tax revenues by $1.7 billion annually as of FY2014.[145]

Illinois also excludes services from its sales tax base, with the exception of several public utility taxes. In recent years, 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 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.[146] However, medical services, professional services and legal services typically are not subject to sales taxes in most states. A narrower application of the sales tax on services that excludes all business-to-business transactions, medical services and professional services, directed at taxing only general consumer services would increase annual General Funds revenue by an estimated $956 million once fully implemented.[147]

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 generate an additional $600 million in General Funds revenue. The largest revenue generating area of the Governor's proposal was taxing professional services such as attorneys ($127 million), customer computer programing services ($57 million), marketing consultants ($30 million) and advertising agencies ($28 million). Other large areas included sewer and refuse services for both residential and industrial use ($46 million), taxing personal rental property ($36 million), and membership fees to golf clubs ($26 million). However, this proposal has not been publicly revisited by the Governor's administration or introduced as legislation.

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 (IDOR), 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.[148]

If lawmakers intend to tax services in Illinois, according to the IDOR 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

---

[145] Illinois Comptroller, *Tax Expenditure Report, Fiscal Year 2014*, p. 4.
[146] Communication between the Civic Federation and Illinois Department of Revenue, January 19, 2016.
[147] Communication between the Civic Federation and Illinois Department of Revenue, January 19, 2016.
[148] Fiorito v. Jones, 39 Ill.2d 531, 236, N.E. 2d 698 (Ill. 1968).

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, financial, legal and some other strictly business services. These items could be broadly protected from taxation while adhering to the Illinois Constitution's uniformity clause that requires real and substantial differences 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 at least two years to allow for implementation.[149] Even after legislative action is taken to authorize taxing consumer 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.

Unlike the new tax on consumer services, taxing food and drug purchases could immediately bring in additional revenue to the State. Food and drug purchases in Illinois are taxed statewide at a rate of 1.0% but are exempt from the 5.0% rate collected for the State and additional 0.25% rate collected by the State but passed through to local governments.[150] The exemption for food purchases makes up approximately $1.0 billion of the State's tax expenditure. Drugs and medical devices make up the remaining $700 million with nonprescription drugs making up roughly 7.5% of that total.

Although very few States apply their full sales tax rate to food purchases and prescription drugs, most do not exempt nonprescription drugs.[151] While it is a commendable intention to reduce the cost of food and drugs to low income residents of Illinois by exempting those items from sales taxes, such relief is not targeted to low income residents and is provided for all food and drug purchases. As the State faces huge deficits and a backlog of unpaid bills, it cannot currently afford this generous tax expenditure. By eliminating the exemption for food and over-the-counter drugs and applying the full 6.25% sales tax rate to those purchases, the State could bring in much-needed revenue immediately from its 5% portion of the rate and provide some additional resources to local governments by expanding their portion of the sales tax by 0.25% from their current 1.0% distribution.

---

[149] Communication between the Civic Federation and Illinois Department of Revenue, January 21, 2015.
[150] The 1.0% sales tax on food and drugs benefits municipalities. The Regional Transportation Authority collects 1.25% on food, drugs and medical devices in Cook County and 0.75% in the collar counties of DuPage, Lake, McHenry and Will.
[151] Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 23.

Immediate revenue is needed because a necessary expansion of the State's sales tax base to include additional services will take time to implement. It is important to note that low income residents who qualify for federal food and nutrition assistance, such as SNAP and WIC, do not pay sales taxes on food purchased through these programs. The State can also consider increases in programs directly focused on assisting low income residents such as the Earned Income Tax Credit to help mitigate the additional cost from the elimination of the exemption.

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 excluding medical, financial and legal services. The State should also temporarily eliminate the sales tax exemption for food and nonprescription drugs to broaden the State's sales tax base. Once the sales tax on services is implemented and the State's backlog of bills is eliminated, the sales tax exemption for food and nonprescription drugs could be reinstated after FY2019.

Issue 7: Chicago and State Teachers' Pension Funding Reform

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 as well as 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 with representation for all teachers' pension funds. However, the current separate member plans would be maintained. 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 FY2015 was $145.7 million. State assumption of the CTPF unfunded liability would have reduced its FY2015 required contribution by approximately $488 million, helping to stabilize the district's finances.

The current situation in which local school districts 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.

The State currently pays approximately $800 million of the annual normal cost of TRS pensions, with school districts covering about $85 million.[152] The shift 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:

- The State created the current expensive and unsustainable situation that has led to $62.7 billion in unfunded liability and a funded ratio of 42.0% for TRS as of June 30, 2015[153] and $9.6 billion in unfunded liability and a funded ratio of 52.0% 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.

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.

---

152 Teachers' Retirement System of the State of Illinois, *Actuarial Valuation Report, June 30, 2015 Actuarial Valuation of Pension Benefits*, January 7, 2016, pp. 28-29 and 70-71. The school district share includes administrative expenses of approximately $24 million.

153 These figures are based on asset smoothing. The unfunded liability was $61.7 billion and the funded ratio was 42.9% based on the market value of assets. For more information, see Teachers' Retirement System of the State of Illinois, *Actuarial Valuation Report, June 30, 2015 Actuarial Valuation of Pension Benefits*, January 7, 2016, p. 28.

154 These figures are based on asset smoothing. The unfunded liability was $9.2 billion and the funded ratio was 53.7% based on the market value of assets. For more information, see Public School Teachers' Pension and Retirement Fund of Chicago, *Actuarial Valuation and Review as of June 30, 2015*, December 9, 2015, p. iv.

__Issue 8: Constitutional Amendment Limiting the Pension Protection Clause__

The State of Illinois has unfunded public employee pension liabilities of $111.0 billion[155] 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 struck down reforms passed by the General Assembly in 2013 that reduced pension benefits for some State employees and retirees.[156] The reforms of Public Act 98-0599 for four State pension funds included an actuarially sound employer pension contribution schedule, a limitation on the automatic annual annuity increase for both current employees and retirees, a pensionable salary cap, phased-in increases in the retirement age and a one percentage point decrease in employee contributions to the plan. These reforms were ruled a violation of the Illinois Constitution's pension protection clause.

The Illinois Constitution states that, "membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[157] The Illinois Supreme Court ruled that this protection applies to both accrued benefits for retirees and future benefits for existing employees. This has left the State unable to reduce benefits that were in place when current employees were hired – even though the State has been unable to afford that level of benefits, jeopardizing essential government services and the solvency of the pension funds.

In the early 1900s, state courts considered pensions to be gratuities from the government that could be changed or repealed at any time. This legal approach changed over time in most states to provide more protection to employees. Most pension benefits are now covered by contract or property rights theories that generally protect previously accrued benefits. The protection of benefits that are not yet accrued varies significantly by state. In general, this means that legal protections are strongest for current retirees. Even for current retirees, however, some courts have provided lesser levels of protection for cost of living adjustments.

Illinois is considered to have among the most stringent pension protections. It is one of a handful of states, including New York and Arizona, with specific constitutional provisions barring benefit reductions.

__Civic Federation Recommendation on Amending Constitutional Pension Protections__

In the interest of protecting the future solvency of the State's pension funds and stabilizing the State's finances, the Civic Federation urges legislators to approve a proposed amendment to the Illinois Constitution for the November 2016 statewide ballot. The proposed amendment should specify that the pension protection clause applies only to

---

[155] Illinois Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2015, p. 2. This figure is based on the market value of assets as of June 30, 2015. The total is $112.9 billion based on the smoothed value of assets.

[156] Illinois Supreme Court opinion is available at http://www.illinoiscourts.gov/OPINIONS/SupremeCourt/2015/118585.pdf.

[157] Illinois Constitution, Article XIII, Section 5.

accrued benefits, giving the State legislature the discretion to make adjustments to non-accrued future benefits for existing employees.

Issue 9: Supplemental Pension Payments

The State of Illinois determines its annual pension contributions using a statutory formula that does not adhere to accepted actuarial standards. Due to the reduced funding levels built into the State's 50-year plan to achieve 90% funding, even after making its full statutory contributions the total liability of its retirement systems is expected to continue to grow annually until FY2030 under current law. An actuarially sound pension funding plan calculates annual contributions to achieve a target of 100% funding within at most 30 years and should not allow for growth in the unfunded liability.

Under the pension reform law, Public Act 98-0599, the State would have moved to an actuarially based 30-year funding plan and made supplemental contributions to achieve 100% funding even sooner. However, these provisions were overturned when the pension reform law was ruled unconstitutional in its entirety by the Illinois Supreme Court. The State now remains on its original inadequate 50-year funding plan that took effect in FY1996.

In light of the current fiscal crisis it is impossible for the State to generate the funding necessary improve its pension funding plan until its operating budget is stabilized. However, the supplemental payment plan included in the pension reform law could still be affordable and would put the State on track to reach 100% funding within the next 30 years.

The pension reform legislation mandated two additional annual payments by the State that 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.

The first supplemental payment was based on contribution savings from the reduced benefits under the law and is no longer applicable. However, a second kind of supplemental payment was based on State debt service savings that take place starting in in FY2019. The State sold Pension Obligation bonds in FY2010 and FY2011 totaling $7.2 billion to make its annual contributions to the retirement systems. The annual debt service for these bonds totals more than $1.0 billion until its final payment of $365 million is made in FY2019. 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.

Based on current actuarial estimates, if the State made similar supplemental payments starting in FY2019 the State's retirement systems would experience a decline in unfunded liabilities beginning in FY2025 and would be 100% funded by FY2043.

In all, these supplemental payments would total $24.4 billion but would increase the assets of the retirement systems by $74.4 billion by FY2045 assuming a long-term rate of return equal to the current 7.5% used by the Teachers' Retirement System, the largest of the five funds.

The following table shows the application of the supplemental payments totaling $364 million in FY2019 and $1.0 billion each year after until the systems are 100% funded, based on the most recent actuarial reports on the pension systems.[158]

State of Illinois Pension Funding Projections: Supplemental Annual Contribution FY2019 to FY2045 (in $ thousands)

Fiscal Year	Supp. Contribution Value*	Accrued Liabilities	Actuarial Value of Assets	Unfunded Liabilities	Funded Ratio	Total Asssets with Supp. Value	Reduced Unfunded Liabilities	Increased Funded Ratio
2019	$ 364	$ 218,600	$ 98,920	$ (119,680)	45%	$ 99,284	$ (119,316)	45%
2020	$ 1,391	$ 225,424	$ 103,670	$ (121,754)	46%	$ 105,061	$ (120,363)	47%
2021	$ 2,496	$ 232,194	$ 108,511	$ (123,683)	47%	$ 111,007	$ (121,187)	48%
2022	$ 3,683	$ 238,894	$ 113,414	$ (125,480)	47%	$ 117,097	$ (121,797)	49%
2023	$ 4,959	$ 248,515	$ 118,398	$ (130,117)	48%	$ 123,357	$ (125,158)	50%
2024	$ 6,331	$ 252,034	$ 123,448	$ (128,586)	49%	$ 129,779	$ (122,255)	51%
2025	$ 7,806	$ 258,441	$ 128,582	$ (129,859)	50%	$ 136,388	$ (122,053)	53%
2026	$ 9,391	$ 264,717	$ 133,835	$ (130,882)	51%	$ 143,226	$ (121,491)	54%
2027	$ 11,096	$ 270,835	$ 139,218	$ (131,617)	51%	$ 150,314	$ (120,521)	56%
2028	$ 12,928	$ 276,771	$ 144,711	$ (132,060)	52%	$ 157,639	$ (119,132)	57%
2029	$ 14,897	$ 282,508	$ 150,344	$ (132,164)	53%	$ 165,241	$ (117,267)	58%
2030	$ 17,015	$ 288,032	$ 156,118	$ (131,914)	54%	$ 173,133	$ (114,899)	60%
2031	$ 19,291	$ 293,387	$ 162,136	$ (131,251)	55%	$ 181,427	$ (111,960)	62%
2032	$ 21,737	$ 298,497	$ 168,397	$ (130,100)	56%	$ 190,134	$ (108,363)	64%
2033	$ 24,368	$ 303,342	$ 174,953	$ (128,389)	58%	$ 199,321	$ (104,021)	66%
2034	$ 27,195	$ 307,909	$ 182,578	$ (125,331)	59%	$ 209,773	$ (98,136)	68%
2035	$ 30,235	$ 312,178	$ 190,601	$ (121,577)	61%	$ 220,836	$ (91,342)	71%
2036	$ 33,503	$ 316,131	$ 199,056	$ (117,075)	63%	$ 232,559	$ (83,572)	74%
2037	$ 37,015	$ 319,764	$ 207,999	$ (111,765)	65%	$ 245,014	$ (74,750)	77%
2038	$ 40,792	$ 323,066	$ 217,472	$ (105,594)	67%	$ 258,264	$ (64,802)	80%
2039	$ 44,851	$ 326,040	$ 227,522	$ (98,518)	70%	$ 272,373	$ (53,667)	84%
2040	$ 49,215	$ 328,681	$ 238,204	$ (90,477)	72%	$ 287,419	$ (41,262)	87%
2041	$ 53,906	$ 331,013	$ 249,590	$ (81,423)	75%	$ 303,496	$ (27,517)	92%
2042	$ 58,949	$ 333,078	$ 261,779	$ (71,299)	79%	$ 320,728	$ (12,350)	96%
2043	$ 64,370	$ 334,937	$ 274,897	$ (60,040)	82%	$ 339,267	$ 4,330	101%
2044	$ 69,198	$ 336,675	$ 289,093	$ (47,582)	86%	$ 358,291	$ 21,616	106%
2045	$ 74,387	$ 338,367	$ 304,530	$ (33,837)	90%	$ 378,917	$ 40,550	112%

*Assumes $364 million payment in FY2019 and $1.0 billion annually from FY2020 until 100% funded in FY2043 with 7.5% long-term rate of return.

Source: Commission on Government Forecasting and Accountibility, *November 2015 Special Pension Briefing* , November 2015, p. 9.

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

[158] Commission on Government Forecasting and Accountability, *November 2015 Special Pension Briefing*, November 2015, p. 9.

System as also recommended in this report.[159] Due to the size of the CTPF liability compared to the State's existing five systems, the inclusion would not dramatically change the funding ratio.

The growth in the State of Illinois' already large unfunded pension liability is often cited by the three major bond agencies as a contributing factor to the State's low bond ratings.[160] Reinstating the supplemental payment plan would more quickly start to decrease unfunded liabilities and act as a spending control that would prioritize pension costs until the systems are fully funded.

It should be noted that the State also sold POBs in FY2003 that are repaid through FY2033. The debt service for these bonds is heavily backloaded, with principal payments ballooning from $647 million in FY2020 to $1.2 billion in FY2032 and FY2033.

Combined, the debt related pension stabilization transfer and remaining debt service will total more than the current debt service amounts through FY2033. In FY2020 the combined $1.0 billion pension transfer and remaining POB debt service will total $1.6 billion and this total will increase to $2.2 billion through FY2033.

However, the debt service cost of the 2003 bonds is offset in the statutory calculation of the State's annual pension contributions. So the cost of these bonds should not impede the State from making supplemental pension payments with the savings from the retirement of the FY2010 and FY2011 POBs.

<u>Civic Federation Recommendation on Supplemental Pension Payments</u>
In order to mitigate the impact of the State's inadequate statutory pension funding plan, the State should make supplemental payments corresponding to the reduced debt service obligations associated with retiring Pension Obligation bonds beginning in FY2019 until all five State retirement systems are 100% funded.

Issue 10: 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.[161] The retailer's 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.[162]

Illinois' retailer's discount of 1.75%, with no monthly limit, has been the third highest in the U.S., behind Colorado at 3.3% and Missouri at 2.0%.[163]

---

[159] For more information on this proposal, see p. 42 of this report.
[160] For more information on the State's bond ratings and debt costs, see p. 16 of this report.
[161] Federation of Tax Administrators, State Sales Tax Rates and Vendor Discounts, January 1, 2016, http://www.taxadmin.org/assets/docs/Research/Rates/vendors.pdf (last visited on February 5, 2016).
[162] 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%).
[163] Illinois General Assembly, Tax Policy Subcommittees, Joint Revenue & Finance and State Government Administration Committees, *Report on Findings*, May 28, 2014, p. 13.

Among other neighboring states, Indiana and Kentucky have bracket systems with the highest rate applying to the smallest collection amounts.[164] Indiana's rates range from 0.26% to 0.73%, and Kentucky's range from 1.5% to 1.75% with a maximum of $50 per month. Wisconsin has a rate of 0.5% with a $1,000 monthly maximum and Iowa does not offer a retailer's discount.

The retailer's discount in Illinois is expected to cost the State approximately $125 million in lost revenue in FY2016, according to the Illinois Department of Revenue.[165] If the amount of sales tax kept by each retailer was capped at $200 per month, the State would save about $85 million over 12 months. The Department of Revenue estimates that this action would only affect the largest five percent of retailers.

At a time when Illinois' financial condition has required cutbacks to essential services, the State cannot afford to provide this generous reimbursement to retailers. Illinois' retailer's discount is high compared with other states. Capping the amount of reimbursement would be preferable to lowering the rate because it would minimize the impact on small retailers.

<u>Civic Federation Recommendation on the Retailer's Discount</u>
The Civic Federation recommends that the State of Illinois cap the retailer's discount at $200 per month for each retailer to recoup revenue that it cannot afford to give up in light of its financial condition.

Issue 11: Tax and Budget Reforms

The Civic Federation's comprehensive plan will put the State on sound financial footing at the end of FY2019 with the backlog of bills eliminated and progress made toward building a rainy day fund to help prevent future fiscal crises. Achieving these goals must be the highest priority.

By FY2019 if spending is limited the State could begin a comprehensive process of revising its tax policy to make it more sustainable. However, a thoughtful process of determining the proper tax policy to avoid future crises and limit the negative effects of taxation on business and individuals should be undertaken immediately.

Over the next three years, 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:

- <u>Graduated individual income tax</u>: The permanent income tax rate of 5.0% recommended in the Federation's comprehensive plan 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 without affecting revenues should be

---

[164] Federation of Tax Administrators, State Sales Tax Rates and Vendor Discounts, January 1, 2016, http://www.taxadmin.org/assets/docs/Research/Rates/vendors.pdf (last visited on February 5, 2016).
[165] Communication between the Civic Federation and the Illinois Department of Revenue, February 3, 2016.

considered.[166] Moving from a flat tax rate to a graduated rate structure would require an amendment to the Illinois Constitution;[167]

- Reinstate the food and drug exemption: The Federation's FY2017 roadmap plan includes applying the State's full sales rate of 6.25% to food and nonprescription drugs, instead of the existing 1.0% tax, which is distributed to local governments. Although this change is needed to help solve the State's financial problems, it moves Illinois out of line with most of its neighbors and could place a disproportionate burden on low income residents;
- Reduce the sales tax rate: Due to combine State and local rates, the City of Chicago has the highest sales tax of any major municipality in the country at 10.25%. Given the broader base that would include general consumer services, the State could consider lowering its rate, thereby providing Statewide tax relief;
- 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.[168] 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; and
- 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.[169] 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.

---

166 For regional comparison of rates and tax structures to other states, see Appendix B on p. 53.
167 Illinois Constitution, Article IX, Section 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, 2016).
168 30 ILCS 105/25(m).
169 For more information on Section 25 liabilities, see p. 34 of this report.

APPENDIX A: DEBT COMPARISION

The following tables show the calculations used for the debt cost comparisons used in this report. For the chart on page 16 showing the comparative yield between various 'A' level debt and the yields charged to the State for the Series January 2016 bonds, the trend lines are smoothed for easier comparison.

Benchmark yields for each category of debt are provided for 2018, 2021 and 2036. The remaining benchmark yields are extrapolated using the average rate for growth between the actual data points.

State of Illinois Bond Cost Comparision										
Benchmark AAA Rated Bonds					Illinois, GO Bonds, Series January 2016					
Maturity	Yield	Principal	Interest	Debt Service	Yield	Principal	Interest	Debt Service	Increase Cost
2017	0.39	$ 19.2	$ 8.7	$ 27.9	1.15	$ 19.2	$ 16.2	$ 35.4	$ 7.4
2018	0.52	$ 19.2	$ 8.6	$ 27.8	1.75	$ 19.2	$ 15.9	$ 35.1	$ 7.3
2019	0.69	$ 19.2	$ 8.5	$ 27.7	2.00	$ 19.2	$ 15.6	$ 34.8	$ 7.1
2020	0.87	$ 19.2	$ 8.4	$ 27.6	2.20	$ 19.2	$ 15.2	$ 34.4	$ 6.8
2021	1.04	$ 19.2	$ 8.2	$ 27.4	2.40	$ 19.2	$ 14.8	$ 34.0	$ 6.6
2022	1.24	$ 19.2	$ 8.0	$ 27.2	2.60	$ 19.2	$ 14.3	$ 33.5	$ 6.3
2023	1.44	$ 19.2	$ 7.8	$ 27.0	2.87	$ 19.2	$ 13.8	$ 33.0	$ 6.0
2024	1.64	$ 19.2	$ 7.5	$ 26.7	3.08	$ 19.2	$ 13.3	$ 32.5	$ 5.8
2025	1.84	$ 19.2	$ 7.2	$ 26.4	3.22	$ 19.2	$ 12.7	$ 31.9	$ 5.5
2026	2.04	$ 19.2	$ 6.9	$ 26.1	3.33	$ 19.2	$ 12.1	$ 31.3	$ 5.2
2027	2.07	$ 19.2	$ 6.5	$ 25.7	3.49	$ 19.2	$ 11.4	$ 30.6	$ 5.0
2028	2.09	$ 19.2	$ 6.1	$ 25.3	3.57	$ 19.2	$ 10.8	$ 30.0	$ 4.7
2029	2.12	$ 19.2	$ 5.7	$ 24.9	3.66	$ 19.2	$ 10.1	$ 29.3	$ 4.4
2030	2.14	$ 19.2	$ 5.3	$ 24.5	3.74	$ 19.2	$ 9.4	$ 28.6	$ 4.1
2031	2.17	$ 19.2	$ 4.9	$ 24.1	4.10	$ 19.2	$ 8.7	$ 27.9	$ 3.8
2032	2.20	$ 19.2	$ 4.4	$ 23.6	3.93	$ 19.2	$ 7.9	$ 27.1	$ 3.4
2033	2.22	$ 19.2	$ 4.0	$ 23.2	3.98	$ 19.2	$ 7.1	$ 26.3	$ 3.1
2034	2.25	$ 19.2	$ 3.6	$ 22.8	3.91	$ 19.2	$ 6.4	$ 25.6	$ 2.8
2035	2.27	$ 19.2	$ 3.2	$ 22.4	4.08	$ 19.2	$ 5.6	$ 24.8	$ 2.5
2036	2.30	$ 19.2	$ 2.7	$ 21.9	4.33	$ 19.2	$ 4.8	$ 24.0	$ 2.1
2037	2.33	$ 19.2	$ 2.3	$ 21.5	4.05	$ 19.2	$ 4.0	$ 23.2	$ 1.7
2038	2.35	$ 19.2	$ 1.8	$ 21.0	4.10	$ 19.2	$ 3.2	$ 22.4	$ 1.4
2039	2.38	$ 19.2	$ 1.4	$ 20.6	4.13	$ 19.2	$ 2.4	$ 21.6	$ 1.0
2040	2.40	$ 19.2	$ 0.9	$ 20.1	4.27	$ 19.2	$ 1.6	$ 20.8	$ 0.7
2041	2.43	$ 19.2	$ 0.5	$ 19.7	4.27	$ 19.2	$ 0.8	$ 20.0	$ 0.4
Total		**$ 480.0**	**$ 133.3**	**$ 613.3**		**$ 480.0**	**$ 238.3**	**$ 718.3**	**$ 105.0**

Note: Benchmark AAA yields used in 2018, 2026 and 2036, the remaining benchmark yields are extrapolated using the average growth between data points.

Source: Yahoo Finance, Composite Bond Rates, http://finance.yahoo.com/bonds/composite_bond_rates (last visited February 2, 2016). State of Illinois, General Obnligation Bonds, Series January 2016, *Official Statement* , January 15, 2016.

State of Illinois Bond Cost Comparision										
Benchmark AA Rated Bonds					Illinois, GO Bonds, Series January 2016					
Maturity	Yield	Principal	Interest	Debt Service	Yield	Principal	Interest	Debt Service	Increase Cost
2017	0.45	$ 19.2	$ 10.6	$ 29.8	1.15	$ 19.2	$ 16.2	$ 35.4	$ 5.6
2018	0.58	$ 19.2	$ 10.5	$ 29.7	1.75	$ 19.2	$ 15.9	$ 35.1	$ 5.5
2019	0.79	$ 19.2	$ 10.4	$ 29.6	2.00	$ 19.2	$ 15.6	$ 34.8	$ 5.2
2020	1.01	$ 19.2	$ 10.2	$ 29.4	2.20	$ 19.2	$ 15.2	$ 34.4	$ 5.0
2021	1.22	$ 19.2	$ 10.0	$ 29.2	2.40	$ 19.2	$ 14.8	$ 34.0	$ 4.8
2022	1.42	$ 19.2	$ 9.8	$ 29.0	2.60	$ 19.2	$ 14.3	$ 33.5	$ 4.6
2023	1.62	$ 19.2	$ 9.5	$ 28.7	2.87	$ 19.2	$ 13.8	$ 33.0	$ 4.3
2024	1.83	$ 19.2	$ 9.2	$ 28.4	3.08	$ 19.2	$ 13.3	$ 32.5	$ 4.1
2025	2.03	$ 19.2	$ 8.9	$ 28.1	3.22	$ 19.2	$ 12.7	$ 31.9	$ 3.8
2026	2.23	$ 19.2	$ 8.5	$ 27.7	3.33	$ 19.2	$ 12.1	$ 31.3	$ 3.6
2027	2.30	$ 19.2	$ 8.0	$ 27.2	3.49	$ 19.2	$ 11.4	$ 30.6	$ 3.4
2028	2.37	$ 19.2	$ 7.6	$ 26.8	3.57	$ 19.2	$ 10.8	$ 30.0	$ 3.2
2029	2.44	$ 19.2	$ 7.1	$ 26.3	3.66	$ 19.2	$ 10.1	$ 29.3	$ 2.9
2030	2.51	$ 19.2	$ 6.7	$ 25.9	3.74	$ 19.2	$ 9.4	$ 28.6	$ 2.7
2031	2.58	$ 19.2	$ 6.2	$ 25.4	4.10	$ 19.2	$ 8.7	$ 27.9	$ 2.5
2032	2.65	$ 19.2	$ 5.7	$ 24.9	3.93	$ 19.2	$ 7.9	$ 27.1	$ 2.2
2033	2.72	$ 19.2	$ 5.2	$ 24.4	3.98	$ 19.2	$ 7.1	$ 26.3	$ 1.9
2034	2.79	$ 19.2	$ 4.7	$ 23.9	3.91	$ 19.2	$ 6.4	$ 25.6	$ 1.7
2035	2.86	$ 19.2	$ 4.1	$ 23.3	4.08	$ 19.2	$ 5.6	$ 24.8	$ 1.5
2036	2.93	$ 19.2	$ 3.6	$ 22.8	4.33	$ 19.2	$ 4.8	$ 24.0	$ 1.3
2037	3.00	$ 19.2	$ 3.0	$ 22.2	4.05	$ 19.2	$ 4.0	$ 23.2	$ 1.0
2038	3.07	$ 19.2	$ 2.4	$ 21.6	4.10	$ 19.2	$ 3.2	$ 22.4	$ 0.8
2039	3.14	$ 19.2	$ 1.8	$ 21.0	4.13	$ 19.2	$ 2.4	$ 21.6	$ 0.6
2040	3.21	$ 19.2	$ 1.2	$ 20.4	4.27	$ 19.2	$ 1.6	$ 20.8	$ 0.4
2041	3.28	$ 19.2	$ 0.6	$ 19.8	4.27	$ 19.2	$ 0.8	$ 20.0	$ 0.2
Total		**$ 480.0**	**$ 165.5**	**$ 645.5**		**$ 480.0**	**$ 238.3**	**$ 718.3**	**$ 72.8**

Note: Benchmark AA yields used in 2018, 2026 and 2036, the remaining benchmark yields are extrapolated using the average growth between data points.
Source: Yahoo Finance, Composite Bond Rates, http://finance.yahoo.com/bonds/composite_bond_rates (last visited February 2, 2016). State of Illinois, General Obnligation Bonds, Series January 2016, *Official Statement* , January 15, 2016.

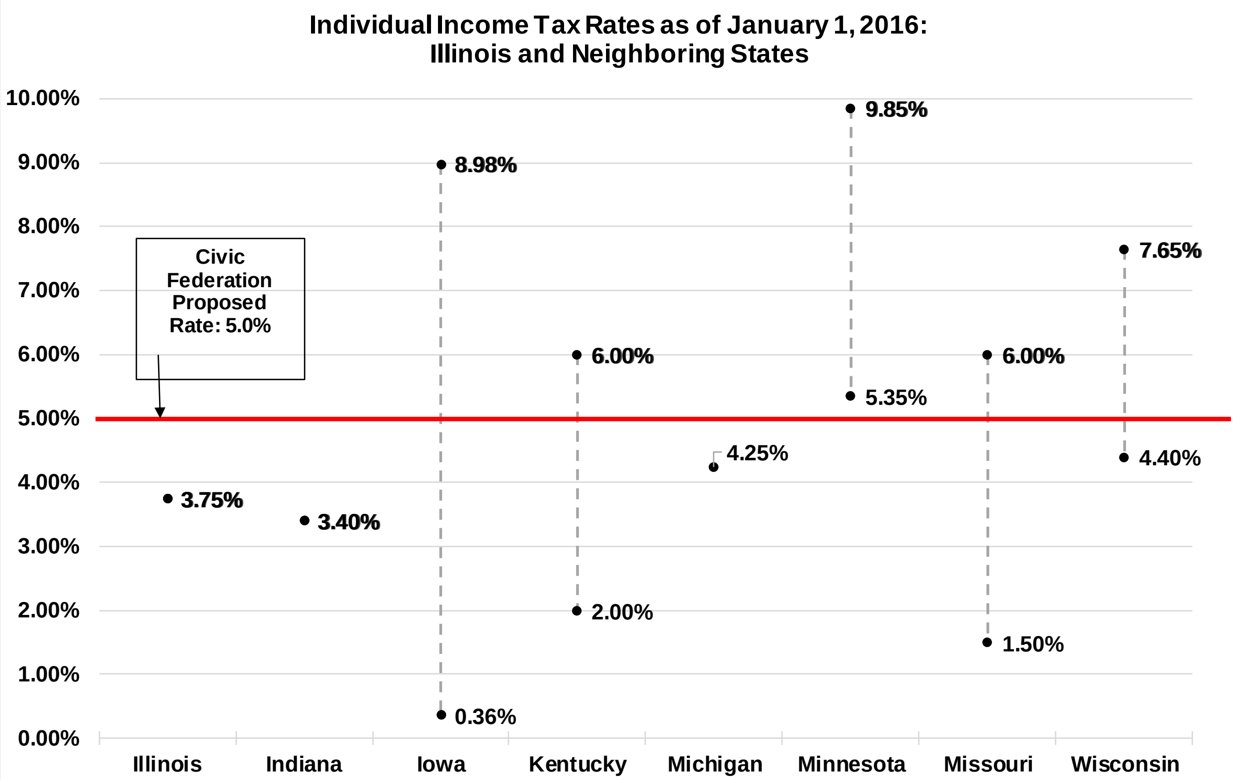
State of Illinois Bond Cost Comparision										
Benchmark A Rated Bonds					Illinois, GO Bonds, Series January 2016					
Maturity	Yield	Principal	Interest	Debt Service	Yield	Principal	Interest	Debt Service	Increase Cost
2017	0.68	$ 19.2	$ 12.4	$ 31.6	1.15	$ 19.2	$ 16.2	$ 35.4	$ 3.8
2018	0.81	$ 19.2	$ 12.2	$ 31.4	1.75	$ 19.2	$ 15.9	$ 35.1	$ 3.7
2019	1.02	$ 19.2	$ 12.1	$ 31.3	2.00	$ 19.2	$ 15.6	$ 34.8	$ 3.5
2020	1.23	$ 19.2	$ 11.9	$ 31.1	2.20	$ 19.2	$ 15.2	$ 34.4	$ 3.3
2021	1.44	$ 19.2	$ 11.6	$ 30.8	2.40	$ 19.2	$ 14.8	$ 34.0	$ 3.2
2022	1.63	$ 19.2	$ 11.4	$ 30.6	2.60	$ 19.2	$ 14.3	$ 33.5	$ 3.0
2023	1.81	$ 19.2	$ 11.1	$ 30.3	2.87	$ 19.2	$ 13.8	$ 33.0	$ 2.8
2024	2.00	$ 19.2	$ 10.7	$ 29.9	3.08	$ 19.2	$ 13.3	$ 32.5	$ 2.6
2025	2.18	$ 19.2	$ 10.3	$ 29.5	3.22	$ 19.2	$ 12.7	$ 31.9	$ 2.4
2026	2.37	$ 19.2	$ 9.9	$ 29.1	3.33	$ 19.2	$ 12.1	$ 31.3	$ 2.2
2027	2.48	$ 19.2	$ 9.5	$ 28.7	3.49	$ 19.2	$ 11.4	$ 30.6	$ 2.0
2028	2.60	$ 19.2	$ 9.0	$ 28.2	3.57	$ 19.2	$ 10.8	$ 30.0	$ 1.8
2029	2.71	$ 19.2	$ 8.5	$ 27.7	3.66	$ 19.2	$ 10.1	$ 29.3	$ 1.6
2030	2.83	$ 19.2	$ 8.0	$ 27.2	3.74	$ 19.2	$ 9.4	$ 28.6	$ 1.4
2031	2.94	$ 19.2	$ 7.4	$ 26.6	4.10	$ 19.2	$ 8.7	$ 27.9	$ 1.3
2032	3.05	$ 19.2	$ 6.8	$ 26.0	3.93	$ 19.2	$ 7.9	$ 27.1	$ 1.0
2033	3.17	$ 19.2	$ 6.3	$ 25.5	3.98	$ 19.2	$ 7.1	$ 26.3	$ 0.9
2034	3.28	$ 19.2	$ 5.7	$ 24.9	3.91	$ 19.2	$ 6.4	$ 25.6	$ 0.7
2035	3.40	$ 19.2	$ 5.0	$ 24.2	4.08	$ 19.2	$ 5.6	$ 24.8	$ 0.6
2036	3.51	$ 19.2	$ 4.4	$ 23.6	4.33	$ 19.2	$ 4.8	$ 24.0	$ 0.5
2037	3.62	$ 19.2	$ 3.7	$ 22.9	4.05	$ 19.2	$ 4.0	$ 23.2	$ 0.3
2038	3.74	$ 19.2	$ 3.0	$ 22.2	4.10	$ 19.2	$ 3.2	$ 22.4	$ 0.2
2039	3.85	$ 19.2	$ 2.3	$ 21.5	4.13	$ 19.2	$ 2.4	$ 21.6	$ 0.1
2040	3.97	$ 19.2	$ 1.5	$ 20.7	4.27	$ 19.2	$ 1.6	$ 20.8	$ 0.1
2041	4.08	$ 19.2	$ 0.8	$ 20.0	4.27	$ 19.2	$ 0.8	$ 20.0	$ 0.0
Total		$ 480.0	$ 195.3	$ 675.3		$ 480.0	$ 238.3	$ 718.3	$ 43.0

Note: Benchmark A yields used in 2018, 2026 and 2036. The remaining benchmark yields are extrapolated using the average growth between data points.

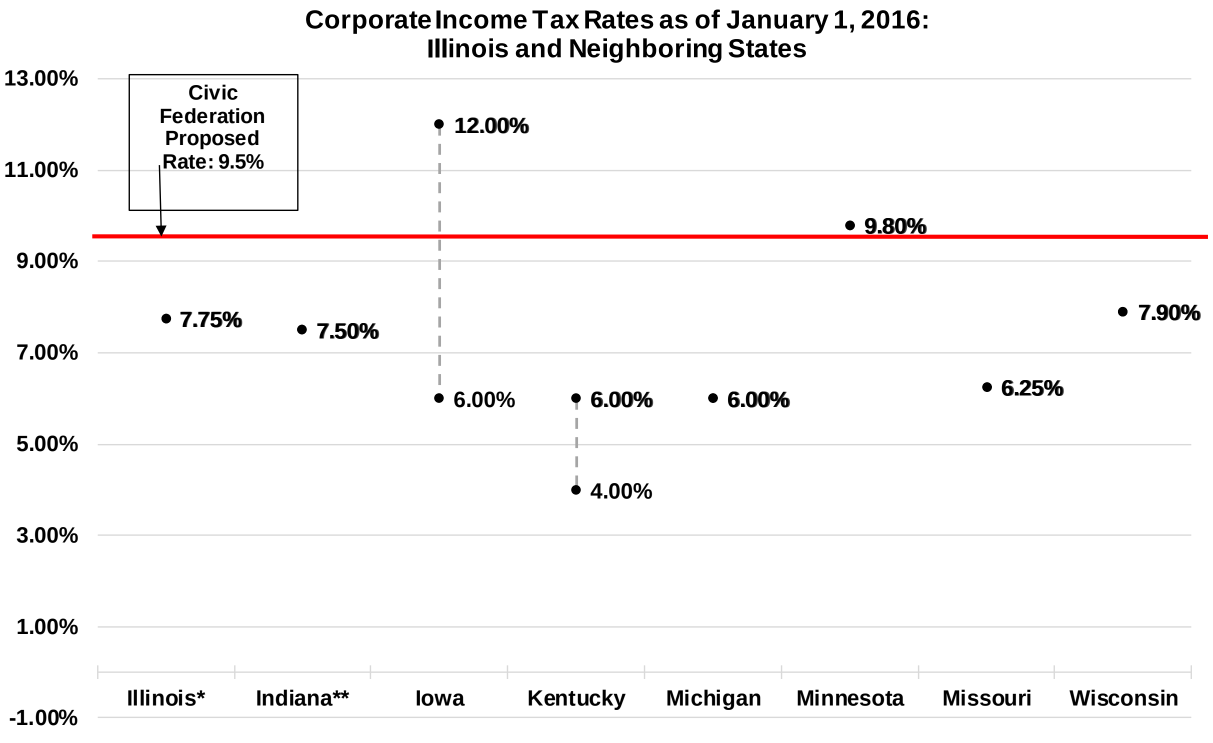
Source: Yahoo Finance, Composite Bond Rates, http://finance.yahoo.com/bonds/composite_bond_rates (last visited February 2, 2016). State of Illinois, General Obligation Bonds, Series January 2016, *Official Statement,* January 15, 2016.

APPENDIX B: INCOME TAX RATES IN ILLINOIS AND NEIGHBORING STATES

The following charts compare Illinois' current and proposed individual and corporate rates to those 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)*, February 2016.



* Current and proposed Illinois corporate income tax rates include 2.5% personal property replacement tax.
**Indiana's corporate tax rate is scheduled to decrease 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: SALES TAX EXPANSION

The following table compares sales taxes in Illinois to other surrounding states including the treatment of services, food and drugs. The proposal to expand the sales tax to include consumer services is based on a broad definition and for comparability to other states, it is estimated that it would increase the number of unique categories taxed by approximately 73 service areas. However, the proposal is not to tax a specific list of services by name or specific code.

For more details on the proposal to expand the sales tax base see p. 39 of this report.

Sales Tax Rates: Illinois and Neighboring States

	Tax Rate	Services Taxed	Food	Prescription Drugs	Non-Prescription Drugs
Illinois					
Current	6.25%	17	Yes - 1.0%	Yes - 1.0%	Yes - 1.0%
Proposed	6.25%	90	Yes - 6.5%	Yes - 1.0%	Yes - 6.5%
Indiana	7.00%	24	No	No	Yes - 7.0%
Iowa	6.00%	94	No	No	Yes - 6.0%
Kentucky	6.00%	28	No	No	Yes - 6.0%
Michigan	6.00%	26	No	No	Yes - 6.0%
Minnesota	6.875%	66	No	No	No
Missouri	4.225%	26	Yes - 1.225%	No	Yes - 4.225%
Wisconsin	5.00%	76	No	No	Yes - 5.0%

*The proposal to expand the sales tax base to include consumer services would add approximately 73 unique catagories to the existing 17.

Source: Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98 - 0682, p. 67.*