Institute for Illinois' Fiscal Sustainability at the Civic Federation

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CIVIC FEDERATION PROPOSES FIVE-YEAR PLAN TO STABILIZE ILLINOIS BUDGET WHILE PROTECTING ESSENTIAL GOVERNMENT SERVICES

(CHICAGO) – In a report released today, the Civic Federation's Institute for Illinois' Fiscal Sustainability proposes a comprehensive five-year plan that responds to the dire reality of Illinois' financial condition with painful, but necessary recommendations. The plan immediately stabilizes the State's operating budget and establishes a sustainable long-term financial plan that would pay off Illinois' unpaid bill backlog of approximately $6.4 billion. The full 56-page report is available at www.civicfed.org.

Nearly five years after the official end of the national economic downturn, Illinois is still burdened with billions of dollars in unpaid bills. The State's five pension systems, underfunded for decades and further weakened by recession-driven investment losses, are consuming a growing share of annual operating revenues. Temporary income tax rate increases enacted in 2011 helped the State cope with these massive problems, but the higher rates began to phase out on January 1, 2015 and the State's income tax revenues are expected to plummet by $5.2 billion between FY2014 and FY2016.

"The incomplete FY2015 budget resulted in a greater deterioration of Illinois' finances and made the necessary actions to fix this crisis even more painful," said Laurence Msall, president of the Civic Federation. "Illinois cannot afford such a steep rollback of its tax rates without eliminating entire areas of State services or completely restructuring the government." After examining the effectiveness of multiple budget scenarios based on the fundamental long-term financial goals detailed on the next page, the Federation proposes the following recommendations as part of a comprehensive five-year plan:

1. **Fix Fiscal Cliff in FY2015**: Rather than sharply dropping income tax rates by 25% in one year, the State should retroactively increase the income tax rate to 4.25% for individuals and 6.0% for corporations as of January 1, 2015. The State could then provide additional tax relief by rolling back the rates on January 1, 2018 to 4.0% for individuals and 5.6% for corporations.
2. **Control State Spending:** The State should restrict discretionary spending growth from the 2.7% level shown in its three-year projections to 2.0%, closer to the rate of inflation. This could reduce total State spending by $1.3 billion over five years.
3. **Broaden the Income Tax Base to Include Some Retirement Income**: Out of the 41 states that impose an income tax, Illinois is one of only three that exempt all pension income. To create greater equity among taxpayers, the State's income tax base should include non-Social Security retirement income from individuals with a total income of more than $50,000.
4. **Expand Sales Tax Base to Include Services**: Illinois should expand its sales tax base to include a list of 32 service taxes proposed by Governor Rauner. Due to the complexity of sourcing rules and collections for new businesses that are not currently required to collect sales taxes, it is estimated this expansion could take up to two fiscal years to fully implement.
5. **Temporarily Eliminate Sales Tax Exemption for Food and Non-Prescription Drugs**: To provide much-needed immediate revenue, the State should temporarily eliminate the tax exemption for food and non-prescription drugs. The State should apply the full 6.25% sales tax rate to food and over-the-counter drug purchases through FY2019 and then reinstate the exemption in FY2020 after the service tax expansion is fully implemented and the State's backlog of unpaid bills is eliminated.
6. **Expand the Earned Income Tax Credit to Provide Assistance to Low Income Residents**: To help soften the impact of the State's fiscal crisis on low income residents, the Civic Federation proposes an increase in the State's Earned Income Tax Credit from 10% of the federal credit to 15% of the federal credit by FY2018.

The complexity and painfulness of the Civic Federation's proposal is necessary for the State to achieve fundamental goals toward long-term financial stability. The Federation's five-year plan **ensures annual operating budgets are balanced** and uses annual surpluses to **eliminate the State's backlog of unpaid bills** by the end of FY2020. The plan also **provides achievable spending limits** and could reduce State spending by $1.3 billion over the next five years.

Drastic revenue cliffs are avoided with a moderate retroactive income tax increase and a smaller planned rollback. The Civic Federation's proposal **broadens the State's tax base to provide sustainable revenue sources**. The tax base remaining after FY2020 would be more sustainable due to the elimination of certain exemptions and the inclusion of services in the sales tax base. Under the five-year plan, the State could also make a **significant deposit into a rainy day fund** by the end of FY2020. Reserves in the rainy day fund would need to be protected by extensive restrictions on access to the funds, but could be used to help the State weather future fiscal emergencies.

The plan also **includes additional assistance for local governments.** By adding retirement income and services to the tax base and temporarily eliminating the State exemption for food and non-prescription drugs, local governments would be allowed to access much-needed additional revenue. In light of the financial pressures facing Illinois municipalities, the Civic Federation also encourages the State to allow local governments to impose municipal taxes on services and on food and non-prescription drug.

The Civic Federation's plan assumes lower pension payments based on the pension reform law that was passed in December 2013 and is currently awaiting appeal to the Illinois Supreme Court. It is uncertain whether some or all of the new pension law will be upheld by the court. If the law does not survive legal challenge, budget surpluses included in the Federation's five-year plan could absorb the financial impact of increased pension payments but would not be available to pay down the unpaid bill backlog. This scenario could leave the State with an unpaid bill backlog of at least $5.4 billion at the end of FY2020. The impact on Illinois' credit rating and operating costs would also be significant.

The Civic Federation continues to believe State contributions under current law are not sustainable and that savings of the magnitude projected under the new law are needed to stabilize the State's finances.

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The Institute for Illinois' Fiscal Sustainability at the Civic Federation is made possible by a generous grant from the John D. and Catherine T. MacArthur Foundation. The Institute's mission is to improve the State's decision-making process by providing timely fiscal policy analysis and recommendations to State officials, the media and the public through education and digital outreach. Please visit www.civicfed.org/iifs for more information.