



**The Institute for Illinois'  
Fiscal Sustainability**  
AT THE CIVIC FEDERATION

**STATE OF ILLINOIS FY2016 BUDGET ROADMAP:**

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

**February 12, 2015**

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

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# TABLE OF CONTENTS

<b>EXECUTIVE SUMMARY .....</b>	<b>2</b>
CIVIC FEDERATION RECOMMENDATIONS .....	3
CIVIC FEDERATION FINDINGS .....	4
<b>CURRENT BUDGET CHALLENGES .....</b>	<b>5</b>
INCOME TAX RATES AND PENSION PAYMENTS .....	5
FY2015 BUDGET .....	11
OUTLOOK FOR FY2016 .....	14
<b>FIVE-YEAR PROJECTIONS .....</b>	<b>15</b>
PENSION ASSUMPTIONS .....	15
REVENUES .....	18
EXPENDITURES .....	22
DEFICIT AND UNPAID BILLS .....	25
SPENDING REDUCTIONS .....	28
<b>CIVIC FEDERATION COMPREHENSIVE PLAN .....</b>	<b>30</b>
COMPREHENSIVE BUDGET PLAN .....	30
CIVIC FEDERATION RECOMMENDATIONS .....	37
<i>Issue 1: Backlog of Unpaid Bills .....</i>	<i>37</i>
<i>Issue 2: Revenue Cliff from Income Tax Rollback .....</i>	<i>38</i>
<i>Issue 3: Retirement Income Exemption .....</i>	<i>39</i>
<i>Issue 4: Expanding the Sales Tax Base .....</i>	<i>40</i>
<i>Issue 5: The Earned Income Tax Credit .....</i>	<i>41</i>
<i>Issue 6: Revenue Diversions and Special Funds .....</i>	<i>42</i>
<i>Issue 7: Interfund Borrowing and Fund Sweeps .....</i>	<i>43</i>
<i>Issue 8: Local Government Revenue Sharing .....</i>	<i>44</i>
<i>Issue 9: Employee and Retiree Health Insurance Costs .....</i>	<i>45</i>
<i>Issue 10: Rainy Day Fund .....</i>	<i>47</i>
<i>Issue 11: Long-Term Financial Plan .....</i>	<i>49</i>
<b>APPENDIX A: GENERAL FUNDS PENSION CONTRIBUTIONS UNDER EXISTING LAW .....</b>	<b>51</b>
<b>APPENDIX B: ESTIMATED GENERAL FUNDS PENSION CONTRIBUTIONS UNDER EXISTING LAW AND NEW LAW .....</b>	<b>52</b>
<b>APPENDIX C: INCOME TAX RATES IN ILLINOIS AND NEIGHBORING STATES .....</b>	<b>53</b>
<b>APPENDIX D: SERVICE TAXES .....</b>	<b>55</b>

## EXECUTIVE SUMMARY

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

As a new Governor takes office in Illinois, the State remains mired in a financial crisis that began during the Great Recession. Nearly five years after the official end of the national economic downturn, Illinois is still burdened with billions of dollars of unpaid bills.<sup>2</sup> 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 began to help the State cope with these massive problems, but the higher rates began to phase out midway through the current fiscal year. Largely as a result, State income tax revenues are expected to plummet by \$5.2 billion from FY2014 to FY2016.<sup>3</sup> **Because no structural changes in revenues or spending were undertaken for FY2015, the current year's budget is estimated to have a shortfall of as much as \$1.5 billion.**

Meanwhile, the implementation of significant pension changes is on hold pending legal challenges. The Illinois Supreme Court is currently reviewing the constitutionality of a law enacted in December 2013 that would reduce State pension outlays while more quickly and completely funding pension obligations.<sup>4</sup> General Funds pension payments under existing law, including pension contributions and payments on previously issued pension bonds, total \$7.5 billion in FY2015, or 24.8% of State-source revenues.<sup>5</sup>

The Civic Federation has concluded that existing State revenue and spending structures do not provide a sustainable basis for funding essential government services and ongoing liabilities. The often cited alternative of spending reductions alone would only balance the budget and pay off unpaid bills if the State's discretionary spending could be reduced by 25.0%, or more than \$4.1 billion, in one year and was then held at the much lower level for the next five years. Although this method could balance the budget, it would come at the cost of eliminating entire areas of State services or completely restructuring how Illinois government functions.

The Civic Federation's comprehensive plan would immediately stabilize the State of Illinois' operating budget, maintain essential government services and establish a sustainable long-term financial plan for the State. **Spending controls are at the center of this plan, but more revenue is also needed to make up for FY2015's shortcomings while attending to future projected deficits and paying off the backlog of unpaid bills.** The Civic Federation has

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<sup>1</sup> The Governor's budget speech is scheduled for February 18, 2015. The State of Illinois' fiscal year begins on July 1 and ends on June 30.

<sup>2</sup> The recession began in December 2007 and ended in June 2009, according to the National Bureau of Economic Research.

<sup>3</sup> State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY16-FY18*, December 31, 2014. This figure refers to General Funds income taxes, which are net of amounts deducted to pay income tax refunds.

<sup>4</sup> Public Act 98-0599, enacted on December 5, 2013. Documents relating to Illinois Supreme Court case No. 118585 are available at <http://www.state.il.us/court/SupremeCourt/SpecialMatters/2014/default.asp>.

<sup>5</sup> State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY16-FY18*, December 31, 2014.

therefore created a comprehensive tax proposal focused on broadening the base of the State's two largest revenue sources combined with a gradual rollback of the income tax rate to achieve financial sustainability instead of severe retroactive hikes to the rates of either the income or sales tax.

### **Civic Federation Recommendations**

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

- The State should pay off its estimated \$6.4 billion backlog of unpaid bills over the next five years by **establishing spending controls that limit the growth in net agency spending and create annual operating surpluses to fund bill backlog payments.**
- The State should moderate the revenue cliff in FY2015 by retroactively increasing the individual income tax rate to 4.25% from 3.75% and the corporate income tax rate to 6.0% from 5.25% effective January 1, 2015 and rolling back the rates to 4.0% for individuals and 5.6% for corporations on January 1, 2018.
- 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. This will facilitate the rollback of individual income tax rates and enhance the State's fiscal stability by providing access to a growing revenue source.
- The State should broaden its sales tax base by taxing 32 services proposed by Governor Bruce Rauner. Due to the complexity of creating rules and collection procedures for businesses that are not currently required to collect sales taxes, it is estimated that revenues would not be generated until halfway through FY2017.
- The State should temporarily eliminate the existing State sales tax exemption for food and non-prescription drugs until FY2020, when the backlog of unpaid bills is eliminated.
- To offset the impact of higher income tax rates and a broader sales tax on low income residents, the State should gradually increase its Earned Income Tax Credit to 15% of the federal amount by FY2018 from the current 10%.
- To increase financial flexibility and promote budget transparency, the State should end income tax revenue diversions from General Funds for education and human services that began on February 1, 2015 and eliminate many of the State's Special Funds.
- Instead of borrowing from Special Funds, as authorized in the FY2015 budget, the State should permanently transfer out surplus amounts to use for high-priority needs.
- In light of the financial pressures facing Illinois municipalities, as part of its own tax base expansion, the State should also allow local governments to impose municipal taxes on services and on food and non-prescription drugs.
- The State should reduce its employee health insurance costs by requiring higher contributions from employees, particularly for family coverage, and other cost-saving measures.
- The State should enact legislation to begin building a functional rainy day fund with a cap of 10% of General Funds revenues after the backlog of unpaid bills is eliminated.
- The Governor's Office should publish a five-year financial plan, including financial forecasts and strategies to achieve its long-term objectives, before the FY2017 budget is issued.

## Civic Federation Findings

- Based on current trends in revenues and expenditures, the State's backlog of unpaid bills would grow from an estimated \$6.4 billion at the end of FY2015 to \$28.4 billion at the end of FY2020.
- If General Funds spending reductions alone were used to stabilize the State's finances and pay off its backlog of unpaid bills, net agency appropriations would have to decline by \$4.1 billion, or 25.4%, in FY2016, and an additional \$109 million in FY2017 and then be held flat for the next three years.
- Total General Funds pension-related payments—including pension contributions and debt service on pension bonds—more than tripled to \$7.6 billion in FY2014 from \$2.1 billion in FY2008.
- General Funds spending not related to pensions increased by \$133 million, or less than one-half of 1%, to \$28.5 billion in FY2014 from \$28.3 billion in FY2008.<sup>6</sup>
- From FY2016 through FY2020, statutorily required General Funds pension contributions would be roughly \$5.4 billion higher under existing law than under the December 2013 law that has not yet been implemented.
- Largely because of lower income tax rates, income tax revenues are projected to decline by \$5.2 billion, or 35.3%, from \$19.8 billion in FY2014 to \$14.6 billion in FY2016.<sup>7</sup>
- Total General Funds revenues decline by \$4.7 billion, or 12.8%, from \$36.8 billion in FY2014 to \$32.1 billion in FY2016, with increased sales taxes and federal revenues partially offsetting declines in income taxes.
- The diversion of income tax revenues beginning in February 2015 to support education and human services reduces General Funds revenues by approximately \$400 million in FY2015 and \$833 million in FY2016.

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<sup>6</sup> In this calculation, the FY2014 spending figure is reduced by \$600 million to reflect the appropriation in FY2014 of \$600 million to the State's main Medicaid agency to be spent in FY2015.

<sup>7</sup> On January 1, 2015, individual income tax rates declined from 5.0% to 3.75% and corporate income tax rates declined from 7.0% to 5.25%. The rates had been set at 3.0% for individual income taxes and 4.8% for corporate income taxes before they were temporarily increased effective January 1, 2011. Corporations also pay a Personal Property Replacement Tax of 2.5%, which is mainly a revenue source for local governments.

## CURRENT BUDGET CHALLENGES

As a new Governor takes office in Illinois, the State remains mired in a financial crisis that began during the Great Recession. Nearly five years after the official end of the national economic downturn, Illinois is still burdened with billions of dollars of unpaid bills.<sup>8</sup> 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 midway through the current budget year.<sup>9</sup> On January 1, 2015, individual income tax rates that were raised from 3.0% to 5.0% declined to 3.75%; corporate tax rates that were increased from 4.8% to 7.0% dropped to 5.25%.<sup>10</sup>

Largely as a result, income tax revenues deposited into the State's general operating accounts are expected to decline by \$2.3 billion, or 11.6%, to \$17.5 billion in FY2015 from \$19.8 billion in FY2014.<sup>11</sup> Total General Funds revenues (including State and federal sources but excluding borrowing) are projected to decline by \$1.9 billion, or 5.1%, from \$36.8 billion to \$34.9 billion.

Meanwhile, the implementation of significant pension changes is on hold pending legal challenges. The Illinois Supreme Court is currently reviewing the constitutionality of a law enacted in December 2013 that would reduce State pension outlays while more quickly and completely funding pension obligations.<sup>12</sup> General Funds pension payments under existing law, including pension contributions and payments on previously issued pension bonds, total \$7.5 billion in FY2015, or 24.8% of State-source revenues.<sup>13</sup>

### Income Tax Rates and Pension Payments

The FY2015 budget did not address the State's overriding fiscal issue: how to deal with the drop in revenues caused by the income tax rate rollbacks. The income tax rate increases were enacted in January 2011 to offset steep declines in State-source revenues caused by the economic slump. The State's main sources of General Funds revenue—individual income taxes, corporate income taxes and sales taxes—dropped by \$3.3 billion, or 16.8%, from \$19.4 billion in FY2008 to \$16.1 billion in FY2010.<sup>14</sup>

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<sup>8</sup> The recession began in December 2007 and ended in June 2009, according to the National Bureau of Economic Research.

<sup>9</sup> The State's fiscal year begins on July 1 and ends on June 30.

<sup>10</sup> 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 1979 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.

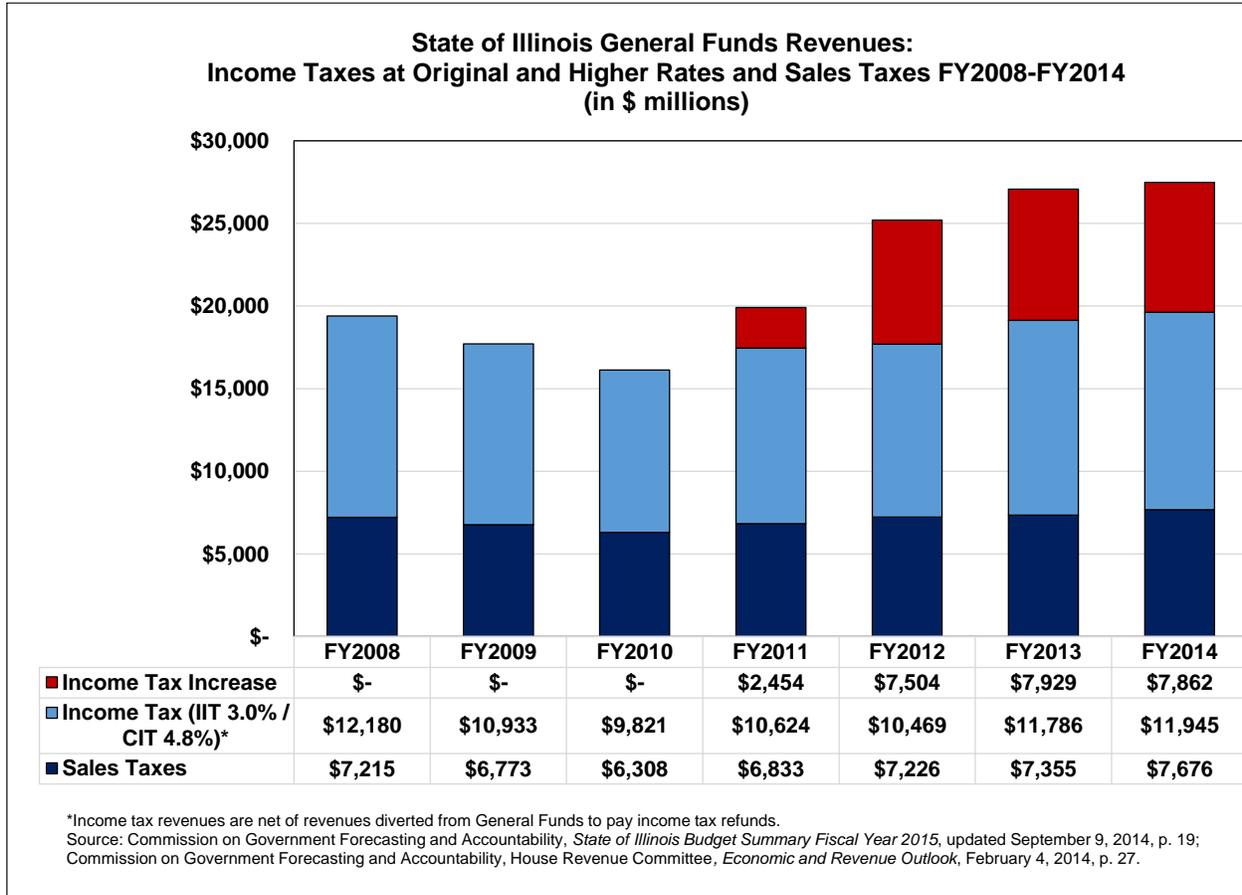
<sup>11</sup> State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)*, FY16-FY18, December 31, 2014.

<sup>12</sup> Public Act 98-0599, enacted on December 5, 2013. Documents relating to Illinois Supreme Court case No. 118585 are available at <http://www.state.il.us/court/SupremeCourt/SpecialMatters/2014/default.asp>.

<sup>13</sup> State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)*, FY16-FY18, December 31, 2014. The revenue figure is \$30.4 billion, based on General Funds revenues of \$35.5 billion minus federal-source revenues of \$4.5 billion and interfund borrowing of \$650 million.

<sup>14</sup> Illinois General Assembly, Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2015*, updated September 9, 2014, p. 19. Income tax revenues are net of income taxes diverted from General Funds to pay income tax refunds.

The following chart shows the decline in these economically sensitive revenue sources after FY2008. It also shows the impact of the income tax rate increases through FY2014, based on estimates by the Illinois General Assembly’s Commission on Government Forecasting and Accountability (COGFA). The higher rates boosted income tax revenues by an estimated total of \$25.7 billion through FY2014: \$2.5 billion in FY2011, \$7.5 billion in FY2012, \$7.9 billion in FY2013 and \$7.9 billion in FY2014.



While State tax collections were shrinking due to the recession, statutorily required State pension contributions were accelerating. Beginning in FY1996, State pension contributions have been based on a 50-year funding plan.<sup>15</sup> 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.<sup>16</sup>

When the funding plan began, the total unfunded liability of the five systems stood at approximately \$19.5 billion.<sup>17</sup> By the end of FY2014, the unfunded liability had grown to \$104.6

<sup>15</sup> Public Act 88-0593, enacted on August 22, 1994.

<sup>16</sup> The 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.

<sup>17</sup> Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, January 2006, p. i. Unfunded liability is the actuarial value of accrued pension benefits that are not covered by pension assets. A pension fund is considered 100% funded when its asset level equals the actuarial accrued liability. This statistic is based on the purchase price (or book value) of assets.

billion, based on the market value of assets, and the combined funded ratio stood at 42.9%.<sup>18</sup> Illinois has the most underfunded retirement systems of any state<sup>19</sup> and the largest pension burden relative to State revenues.<sup>20</sup>

The growth in the unfunded liability is largely attributable to inadequate State contributions. The funding plan and subsequently enacted changes deferred a large portion of the required State contributions to later years. Under existing law, the State is not required to make adequate contributions to keep the unfunded liability from growing until approximately FY2029.<sup>21</sup>

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.<sup>22</sup>

To make its General Funds pension contributions in FY2010 and FY2011, the State issued a total of \$7.2 billion in Pension Obligation Bonds. 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.<sup>23</sup>

Statutorily required contributions grew to \$6.0 billion in FY2014 from \$1.6 billion in FY2008. Debt service on previously issued bonds increased to \$1.7 billion from \$467 million during the same period. Total pension-related payments increased to \$7.6 billion in FY2014 from \$2.1 billion in FY2008.

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

In the next chart, General Funds expenditures not related to pensions total \$29.1 billion in FY2014, an increase of \$733 million, or 2.6%, from \$28.3 billion in FY2008.<sup>24</sup> Increased spending in FY2009 and FY2010 was supported by federal stimulus funds from the American Recovery and Reinvestment Act of 2009.

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<sup>18</sup> State of Illinois, Office of the Auditor General, *Supplemental Digest of Retirement Systems' Audits for the years ending June 30, 2013 and June 30, 2014*, January 22, 2015.

<sup>19</sup> Pew Center on the States, *The Widening Gap Update*, June 2012, p. 5.

<sup>20</sup> Moody's Investors Service, *Illinois State and Local Governments Face Daunting Pension Challenges*, September 5, 2014, p. 2.

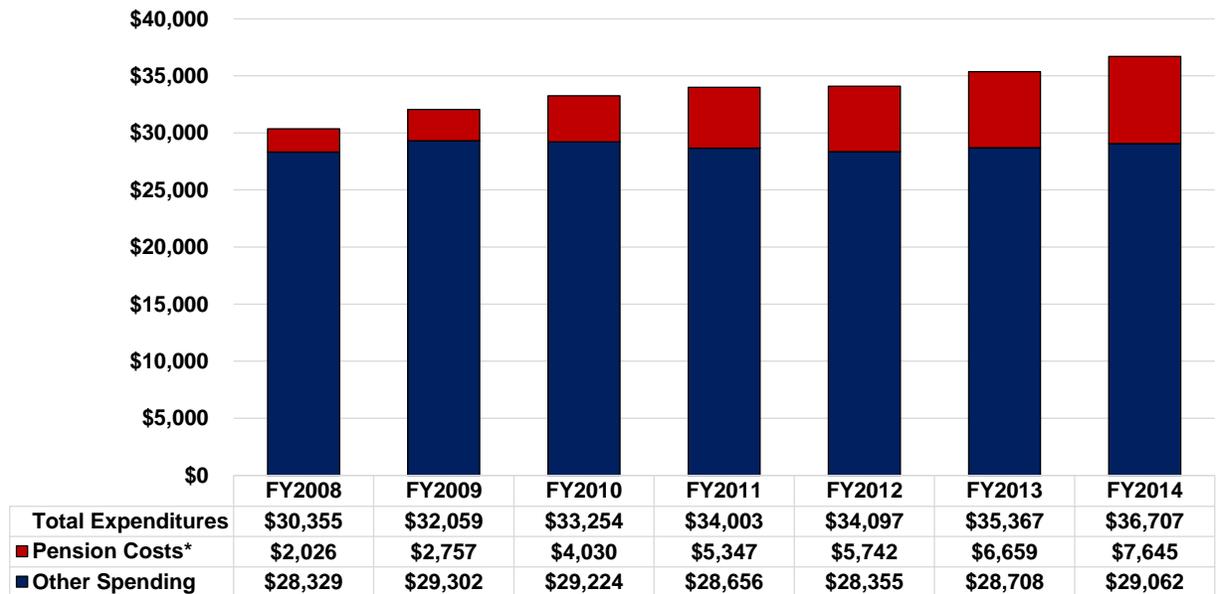
<sup>21</sup> Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2014, p. 8. The contribution amount that is adequate to keep the unfunded liability from growing consists of the normal cost (the amount needed to cover the present value of benefits earned by 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.

<sup>22</sup> Public Act 94-0004, enacted 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, 2013 and June 30, 2014*, January 22, 2015.

<sup>23</sup> State of Illinois, General Obligation Bonds, Series of May 2014, *Official Statement*, April 25, 2014, p. 75.

<sup>24</sup> This does not account for additional spending funded outside of General Funds, such as a \$1-a-pack increase in the State cigarette tax in FY2013 that was part of a plan to close a \$2.7 billion funding gap in the Medicaid program.

**State of Illinois General Funds Expenditures:  
Pension-Related Costs Compared With Other Spending FY2008-FY2014  
(in \$ millions)**



\* Includes State contributions under existing law and debt service on Pension Obligation Bonds. Pension contributions in FY2010 and FY2011 were made through issuance of bonds and included for purposes of comparability.  
Source: State of Illinois, General Obligation Bonds, *Official Statements*, 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, 2013*, March 2014, pp. 119-123.

However, as explained below, the FY2014 spending number is inflated by \$600 million due to Medicaid appropriations in FY2014 that were used to pay for FY2015 costs. After deducting this amount, General Funds expenditures not related to pensions total \$28.5 billion in FY2014, **an increase of \$133 million, or less than one-half of 1%, from FY2008**. During the same period, **inflation as measured by the Consumer Price Index increased by 10%.**<sup>25</sup>

A prominent measure of State spending is the Foundation Level of elementary and secondary public school funding, which represents the minimum per child amount of financial support that should be available to provide for the basic education of each student.<sup>26</sup> General State Aid, the main State spending program for elementary and secondary education, is designed to help fill the gap between the Foundation Level and the amount a school district can provide from local property tax revenues and other local resources. The Foundation Level has been unchanged since FY2010 at a per pupil amount of \$6,119, but General State Aid has represented less than 95% of the amount required to fully fund the Foundation Level since FY2012.<sup>27</sup> General State Aid funding for FY2014 of \$4.3 billion represented 88.7% of the \$5.0 billion required to fully fund the Foundation Level.

<sup>25</sup> U.S. Department of Labor, Bureau of Labor Statistics, CPI Inflation Calculator, [http://www.bls.gov/data/inflation\\_calculator.htm](http://www.bls.gov/data/inflation_calculator.htm) (last visited on January 27, 2015).

<sup>26</sup> 105 ILCS 5/18-8.05(B).

<sup>27</sup> Illinois State Board of Education, Division of Funding and Disbursement Services, *General State Aid*, October 15, 2014, <http://www.isbe.net/funding/pdf/gsa-historical.pdf> (last visited on January 27, 2015).

In addition to funding pension payments while keeping other expenditures relatively flat, the increased income tax revenue was used to help reduce the mountain of unpaid bills that began to accumulate in FY2009. General Funds payables and other liabilities **declined from approximately \$8.8 billion at the end of FY2012 to \$6.2 billion at the end of FY2014.**<sup>28</sup>

Illinois has General Funds payables and other liabilities despite its balanced budget requirements. Under the Illinois Constitution and State law, the Governor must recommend and the General Assembly must pass a balanced budget for each fiscal year.<sup>29</sup> However, operating deficits can arise during the year if revenues fail to meet expectations or additional spending is approved.

General Funds payables at the end of the fiscal year are paid from the next year's revenues, leaving a hole in that year's budget. These payables are covered by current fiscal year appropriations and represent amounts that must be paid during the lapse period, the period of time after the end of the fiscal year when this year's bills may be paid with next year's revenues.<sup>30</sup>

Certain other costs may be incurred during the year without showing up in that year's budget; these costs may be deferred and paid from the next year's appropriations.<sup>31</sup> Such liabilities were formerly concentrated in the Medicaid program and now mainly involve group health insurance.<sup>32</sup>

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<sup>28</sup> For more information, 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, pp. 53-56, [http://www.civicrof.org/sites/default/files/REPORT\\_StateofIllinoisEnactedBudgetFY2015.pdf](http://www.civicrof.org/sites/default/files/REPORT_StateofIllinoisEnactedBudgetFY2015.pdf) (last visited on January 25, 2015).

<sup>29</sup> Illinois Constitution, Article VIII, Section 2(a) and 2(b); 15 ILCS 20/50-5(a).

<sup>30</sup> The lapse period was permanently extended to six months in FY2013 under Public Act 97-0932, enacted on August 10, 2012.

<sup>31</sup> As part of the FY2013 restructuring, the ability to defer Medicaid costs in this way was limited by Public Act 97-691, enacted on June 14, 2012.

<sup>32</sup> Public Act 97-0691, enacted on June 14, 2012, limited such liabilities incurred by State's main Medicaid agency to \$700 million in FY2013 and \$100 million thereafter, with an exception for costs incurred by the end of the fiscal year but not recorded until after June 30.

The following table shows estimates of General Funds payables and other liabilities from the end of FY2008 to the end of FY2014. These numbers are rough estimates. Data on General Funds payables have **regularly been provided** in State budgets and bond documents, but information on other liabilities **has not been readily available**. General Funds payables consist of what has been submitted for processing by the Comptroller's Office and what is expected to be submitted by the end of the lapse period; other General Funds liabilities are more difficult to track because they are held at various State agencies.

<b>State of Illinois Estimated General Funds Unpaid Bill Backlog at Fiscal Year End: FY2008-FY2014 (in \$ millions)</b>							
	<b>FY2008</b>	<b>FY2009</b>	<b>FY2010</b>	<b>FY2011</b>	<b>FY2012</b>	<b>FY2013</b>	<b>FY2014</b>
General Funds Payables	\$ 975	\$ 3,953	\$ 6,224	\$ 4,976	\$ 5,024	\$ 4,142	\$ 4,081
Healthcare and Human Services*	\$ 2,051	\$ 1,009	\$ 810	\$ 760	\$ 2,476	\$ 634	\$ 500
Group Health Insurance	\$ 113	\$ 321	\$ 524	\$ 1,049	\$ 1,183	\$ 1,351	\$ 1,500
Other**	\$ 4	\$ 220	\$ 735	\$ 646	\$ 72	\$ 157	\$ 103
<b>Total</b>	<b>\$ 3,143</b>	<b>\$ 5,503</b>	<b>\$ 8,293</b>	<b>\$ 7,431</b>	<b>\$ 8,755</b>	<b>\$ 6,284</b>	<b>\$ 6,184</b>

\*Includes Illinois Departments of Healthcare and Family Services and Human Services and Illinois Department on Aging.

\*\*Includes unpaid income tax refunds and back wages owed to union members due to a legal dispute over raises.

Source: Civic Federation calculations based on State of Illinois, General Obligation Bonds, Official Statements, January 7, 2010, February 23, 2011, March 13, 2012, September 5, 2012, April 25, 2014; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY16-FY18*, December 31, 2014; Illinois Office of the Comptroller, *Section 25 Deferred Liabilities*, <http://www.ioc.state.il.us/index.cfm/fiscal-condition/section-25/download-pdf-section-25-deferred-liabilities-in-thousands/>; Communication between Civic Federation and Governor's Office of Management and Budget and Illinois Department of Revenue.

## FY2015 Budget

Governor Pat Quinn's recommended budget for FY2015 proposed keeping the higher income tax rates that were scheduled to decline on January 1, 2015.<sup>33</sup> This proposal was not accepted by the General Assembly, and the enacted FY2015 budget signed by Governor Quinn in June 2014 does not include additional revenues or spending reductions.

The following chart, based on the most recent numbers available from the Governor's Office of Management and Budget (GOMB), summarizes the FY2014 and FY2015 General Funds budgets.

<b>State of Illinois General Funds Budget: FY2014-FY2015 (in \$ millions)</b>				
	<b>FY2014 Actual</b>	<b>FY2015 Revised*</b>	<b>\$ Change</b>	<b>% Change</b>
Revenues				
Individual Income Tax	\$ 16,642	\$ 14,844	\$ (1,798)	-10.8%
Corporate Income Tax	\$ 3,164	\$ 2,666	\$ (498)	-15.7%
Sales Tax	\$ 7,675	\$ 7,950	\$ 275	3.6%
Other State Sources	\$ 5,384	\$ 4,934	\$ (450)	-8.4%
<b>Total State Sources</b>	<b>\$ 32,865</b>	<b>\$ 30,394</b>	<b>\$ (2,471)</b>	<b>-7.5%</b>
<b>Federal Sources</b>	<b>\$ 3,903</b>	<b>\$ 4,496</b>	<b>\$ 593</b>	<b>15.2%</b>
<b>Total Revenues</b>	<b>\$ 36,768</b>	<b>\$ 34,890</b>	<b>\$ (1,878)</b>	<b>-5.1%</b>
Expenditures				
Pension Contributions	\$ 5,989	\$ 6,046	\$ 57	1.0%
Debt Service on Pension Bonds	\$ 1,656	\$ 1,503	\$ (153)	-9.2%
<b>Total Pension Expenditures</b>	<b>\$ 7,645</b>	<b>\$ 7,549</b>	<b>\$ (96)</b>	<b>-1.3%</b>
<b>Non-Pension Expenditures</b>	<b>\$ 29,062</b>	<b>\$ 28,171</b>	<b>\$ (891)</b>	<b>-3.1%</b>
<b>Total Expenditures</b>	<b>\$ 36,707</b>	<b>\$ 35,720</b>	<b>\$ (987)</b>	<b>-2.7%</b>
Operating Surplus (Deficit)	\$ 61	\$ (830)	\$ (891)	-1460.7%
Borrowing for Operations	\$ -	\$ 650	\$ 650	na
<b>Operating Surplus (Deficit) After Borrowing for Operations</b>	<b>\$ 61</b>	<b>\$ (180)</b>	<b>\$ (241)</b>	<b>-395.1%</b>

\*As of December 2014.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)*, FY16-FY18, December 31, 2014.

Instead of making structural changes in revenues or expenditures, the FY2015 budget uses short-term measures to cover operating expenses.<sup>34</sup> These measures include \$650 million of borrowing from funds outside the General Funds (known as interfund borrowing), which must be repaid

<sup>33</sup> For more information, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2015 Recommended Operating Budget: Analysis and Recommendations*, May 13, 2014, <http://www.civicfed.org/sites/default/files/Illinois%20Recommended%20FY2015%20Budget.pdf> (last visited on January 27, 2015).

<sup>34</sup> For more information, see 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, pp. 53-56, [http://www.civicfed.org/sites/default/files/REPORT\\_StateofIllinoisEnactedBudgetFY2015.pdf](http://www.civicfed.org/sites/default/files/REPORT_StateofIllinoisEnactedBudgetFY2015.pdf) (last visited on January 25, 2015).

within 18 months.<sup>35</sup> Depending on which accounts are tapped, the State might have to pay interest at a relatively low rate on the borrowed funds.

In addition, \$600 million was appropriated to the Illinois Department of Healthcare and Family Services, the State's main Medicaid agency, in FY2014 to be transferred to the Healthcare Provider Relief Fund and spent in FY2015.<sup>36</sup> This measure increased FY2014 General Funds spending and reduced FY2015 General Funds spending.

Beginning on February 1, 2015, State law requires that a specific share of income tax revenues from individuals, estates and trusts be diverted from General Funds to provide additional funding for education and human services.<sup>37</sup> Two new funds, the Fund for the Advancement of Education and the Commitment to Human Services Fund, will each receive 1/30 (about 3.33%) of net income tax revenues from individuals, trusts and estates annually through FY2024; in February 2025 the share increases to 1/26 (about 3.85%).<sup>38</sup> A total of \$200 million was appropriated from the Fund for the Advancement of Education to the Board of Education.<sup>39</sup> The Department of Human Services received an appropriation of \$101 million from the Commitment to Human Services Fund, and the Department on Aging received \$99 million.<sup>40</sup>

On paper, there appears to be a decrease of \$891 million in General Funds expenditures not related to pensions from \$29.1 billion in FY2014 to \$28.2 billion in FY2015.<sup>41</sup> However, after adjusting for shifting of funds from year to year and among State accounts, spending not related to pensions increases by \$709 million from FY2014.

Despite this increase, GOMB estimated in July 2014 that the budget underfunded known costs by \$753 million.<sup>42</sup> The total included costs that could be incurred in FY2015 without appropriations, as well as costs that would have to be cut if they were not funded with supplemental appropriations later in the year.

Governor Quinn signed the FY2015 budget after describing it as “incomplete.”<sup>43</sup> Days after the budget was signed, a ruling by the Illinois Supreme Court appeared to suggest that the court might take an expansive view of the provision in the Illinois Constitution that protects pension benefits.<sup>44</sup> The July 3 ruling, which related to health insurance premium subsidies for State retirees, triggered speculation that the high court might reject the 2013 pension changes.

Illinois has had the lowest rating of any state from all three major credit rating agencies since June 2013.<sup>45</sup> In July 2014, citing the enacted FY2015 budget and the Supreme Court ruling,

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<sup>35</sup> Public Act 98-0682, enacted on June 30, 2014.

<sup>36</sup> Public Act 98-0642, enacted on June 9, 2014, p. 2.

<sup>37</sup> Public Act 96-1496, enacted on January 13, 2011. The provision can be found at 35 ILCS 5/901 (f) and (g).

<sup>38</sup> Net income tax refers to income tax collections minus statutorily required deductions of amounts used to cover tax refunds.

<sup>39</sup> Public Act 98-0677, enacted on June 30, 2014.

<sup>40</sup> Public Act 98-0680, enacted on June 30, 2014, pp. 8 and 56.

<sup>41</sup> State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY16-FY18*, December 31, 2014.

<sup>42</sup> State of Illinois. General Obligation Bonds, Series of May 2014, *Supplement to the Official Statement*, July 18, 2014.

<sup>43</sup> Illinois Government News Network, “Governor Quinn Statement on Fiscal Year 2015 Budget,” *news release*, May 30, 2014.

<sup>44</sup> Illinois Supreme Court, *Kanerva v. Weems* (2014 IL 115811, July 3, 2014).

<sup>45</sup> Illinois' credit is rated A minus by Standard & Poor's and Fitch Ratings and A3 by Moody's Investors Service.

Standard & Poor's revised its outlook for Illinois from developing to negative.<sup>46</sup> A negative outlook means that the State's credit rating could be downgraded within two years unless its financial condition improves. The FY2015 budget "is not structurally balanced and will contribute to growing deficits and payables that will likely pressure the state's liquidity," S&P stated.<sup>47</sup>

In his inaugural address on January 12, 2015, Governor Bruce Rauner announced a freeze on "non-essential" State spending.<sup>48</sup> Later that day the new Governor signed an Executive Order requiring executive branch agencies to halt the awarding of discretionary contracts and grants, with certain exceptions, and to manage their budgets to avoid the need for supplemental spending.<sup>49</sup>

A subsequent news release about a meeting between the GOMB Director and financial officials at State agencies indicated that the new administration does not plan to do any interfund borrowing and does not want to push more unpaid bills into FY2016.<sup>50</sup> The news release described an FY2015 budget hole of nearly \$1.5 billion, apparently consisting of \$650 million in budgeted appropriations funded by the interfund borrowing; an existing operating deficit of \$180 million (as shown in the most recent GOMB estimates); and approximately \$670 million in known costs that were not appropriated in the FY2015 budget.

The \$35.7 billion FY2015 General Funds budget shown in the table above is based on the assumption that agencies live within the enacted budget. In other words, the \$670 million has already been subtracted from the budget. If those costs must be funded within the current budget, then cuts would have to be made in other areas.

Discretionary spending in the FY2015 budget—narrowly defined to exclude pension contributions, group insurance, Medicaid, debt service and legislatively required transfers—totals about \$16.2 billion. Since the fiscal year is more than half over, it is reasonable to assume that more than half the budget has been spent. That suggests that up to 19% of the remaining discretionary budget may have to be cut to fill the hole.

The most pressing need for additional funding in FY2015 appears to involve State-subsidized child care for low income families. According to advocates, the Child Care Assistance Program at the Illinois Department of Human Services is facing a \$300 million shortfall and could run out of money as early as February 2015.<sup>51</sup> Child care costs are among the liabilities that may be paid from future years' appropriations, which means that bills will be deferred until FY2016 unless spending is cut by reducing enrollment, for example.<sup>52</sup>

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<sup>46</sup> Standard & Poor's, *Illinois Outlook Revised to Negative from Developing Following End of Fiscal 2015 Budget*, July 23, 2014.

<sup>47</sup> Standard & Poor's, *Illinois Outlook Revised to Negative from Developing Following End of Fiscal 2015 Budget*, July 23, 2014.

<sup>48</sup> Illinois Government News Network, "Governor Rauner signs first Executive Order addressing state's fiscal crisis: Review of spending, procurement & personnel decisions ordered; Halts awarding of contracts & grants; Instructs sale of surplus state property, conservation," *news release*, January 12, 2015.

<sup>49</sup> State of Illinois, Executive Order 15-08, *Executive Order to Address the State's Fiscal Crisis*, January 12, 2015.

<sup>50</sup> Illinois Government News Network, "Readout of GOMB Meeting with Agency Chief Financial Officers," *news release*, January 14, 2015.

<sup>51</sup> Illinois Action for Children, *State Child Care Funding in Jeopardy as of February 2015*, [http://www.actforchildren.org/site/DocServer/Child\\_Care\\_Funding\\_Crisis\\_Fact\\_Sheet\\_IAFC\\_012015\\_FINAL.pdf?docID=7921](http://www.actforchildren.org/site/DocServer/Child_Care_Funding_Crisis_Fact_Sheet_IAFC_012015_FINAL.pdf?docID=7921) (last visited on January 27, 2015).

<sup>52</sup> 30 ILCS 105/25 (b-4).

The Illinois Department of Corrections also faces funding shortages in FY2015. State officials have said that some State prisons could run out of money to make their payrolls by April.<sup>53</sup> To deal with the shortfalls, Governor Rauner reportedly wants the General Assembly to grant him more authority to reallocate funds to higher priority areas.<sup>54</sup>

### **Outlook for FY2016**

The budget year that begins on July 1, 2015 is the first full fiscal year under the lower tax rates. According to GOMB's three-year General Funds budget projection issued on December 31, 2014, income tax revenues are expected to decline by \$2.9 billion to \$14.6 billion in FY2016. Total General Funds revenues are projected at \$32.1 billion, a decrease of \$2.8 billion.

The three-year projection by the Quinn administration shows an operating deficit of \$5.8 billion in FY2016, based on an increase of \$2.1 billion in expenditures to \$37.8 billion. The total increase includes \$1.6 billion in additional expenditures not related to pensions and \$560 million in increased pension spending. The additional non-pension spending reflects a restoration of funding for human services and public safety, which were assumed to be cut in FY2015, and to Medicaid, which was funded in FY2015 from FY2014 revenues.

Pension costs increase significantly in FY2016, but the increase is much larger if the new pension law is not implemented. A lower court ruled in November 2014 that the law was unconstitutional, and the Illinois Supreme Court is scheduled to hear oral arguments in the case in March 2015.

Because of the uncertainty surrounding the new law, the Governor's FY2016 budget recommendation is expected to include pension contributions that have been certified by the State's five retirement systems under existing law. Required FY2016 General Funds contributions are estimated at \$6.7 billion, up \$644.2 million from \$6.0 billion in FY2015. This sharp increase is largely due to a reduction in the assumed investment rates of return by the three largest pension funds. This is offset somewhat by lower debt service costs as a result of the final retirement in FY2015 of the pension bonds issued in 2010.

According to rough estimates by the Civic Federation, the required FY2016 General Funds contribution under the new law would be \$5.5 billion—a reduction of \$1.2 billion from the required contribution under existing law.

Governor Rauner's budget address is scheduled for February 18. The new Governor has not yet made any specific proposals about changes in revenue or spending, although in a recent speech he criticized State personnel costs.<sup>55</sup> The State's contract with its largest union, the American Federation of State, County and Municipal Employees (AFSCME), will expire on June 30, 2015.

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<sup>53</sup> Doug Finke, "Some state prisons could run out of money by April; day care funding also coming up short," *State Journal-Register*, February 5, 2015.

<sup>54</sup> Doug Finke, "Some state prisons could run out of money by April; day care funding also coming up short," *State Journal-Register*, February 5, 2015.

<sup>55</sup> Monique Garcia and Kim Geiger, "Gov. Rauner still talking about Illinois' problems, not solutions," *Chicago Tribune*, January 22, 2015.

## **FIVE-YEAR PROJECTIONS**

The following section presents five-year projections of the State of Illinois' finances through FY2020. A benchmark projection is provided based on the three-year projection published by the Governor's Office of Management and Budget on December 31, 2014, with certain modifications.<sup>56</sup> This projection was extended for an additional two years to show the longer-term consequences of current budget policies. An often-discussed alternative spending plan based on reducing spending only to balance the budget and eliminate the backlog of unpaid bills is also presented.

The projections presented in this report are intended to provide an overview of the largest General Funds revenue sources and spending pressures through FY2020. They should be viewed as rough illustrations of the consequences of various policy decisions and not as predictions.

### **Pension Assumptions**

The projections in this section are based on the assumption that pension legislation enacted in December 2013 is implemented in FY2016.<sup>57</sup> This is in contrast to the State's three-year projection, which uses contributions under existing law. The Civic Federation believes that State contributions under existing law are not sustainable and that savings of the magnitude projected under the new law are needed to stabilize Illinois' fiscal condition.

The new law has not been put into effect because of legal challenges by labor unions, employees and retirees. A Sangamon County Circuit Court judge ruled in November 2014 that the law violated the pension protection clause of the Illinois Constitution.<sup>58</sup> The Illinois Supreme Court agreed to the State's request to expedite the appeal process and is scheduled to hear oral arguments in the case in March 2015.<sup>59</sup>

The new law lowers payments to current and future retirees mainly by reducing annual benefit increases.<sup>60</sup> Workers hired before 2011 currently receive automatic annual compounded benefit increases of 3% upon retirement. The new law, which applies to four of the State's five pension systems, also raises retirement ages for younger workers and caps the salary on which pension benefits are based.<sup>61</sup>

The pension legislation represents the State's first actuarially sound pension funding plan, resulting in 100% funding over 30 years. Illinois' existing pension law, which took effect in 1995, was designed to achieve 90% funding by FY2045. That law and subsequently enacted

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<sup>56</sup> State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY16-FY18*, December 31, 2014.

<sup>57</sup> Public Act 98-0599, enacted on December 5, 2013.

<sup>58</sup> Illinois Constitution, Article XIII, Section 5, states: "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."

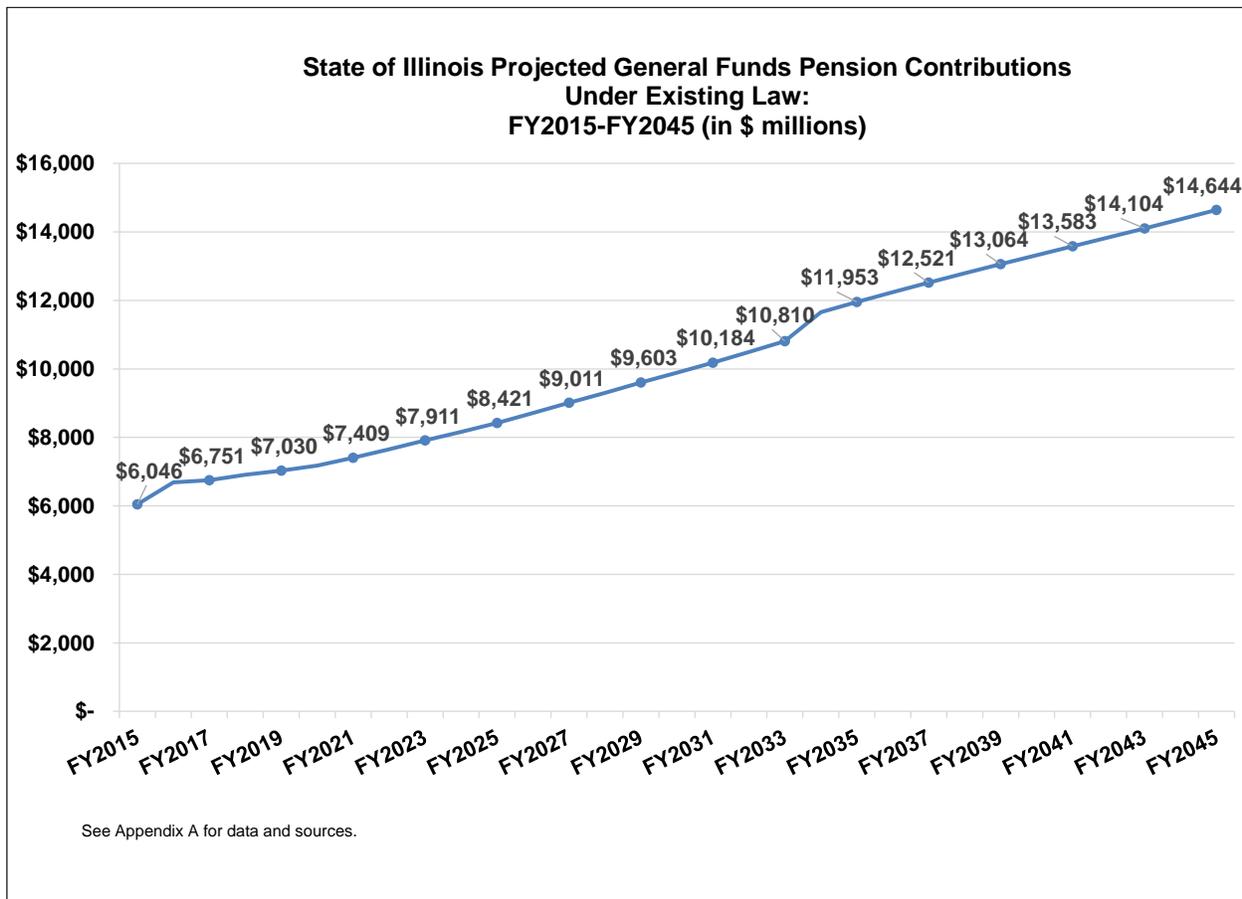
<sup>59</sup> Documents relating to Illinois Supreme Court case No. 118585 are available at <http://www.state.il.us/court/SupremeCourt/SpecialMatters/2014/default.asp>.

<sup>60</sup> A summary of the law's provisions can be found on the website of the Teachers' Retirement System at <https://trs.illinois.gov/press/reform/sb1.htm> (last visited on January 30, 2015).

<sup>61</sup> The new law applies to the Teachers' Retirement System (TRS), the State Employees' Retirement System (SERS), the State Universities Retirement System (SURS) and the General Assembly Retirement System (GARS). The Judges' Retirement System (JRS) is not affected.

changes deferred a large portion of required contributions to later years. As of June 30, 2014, State retirement systems had a combined funded ratio of 42.9% and total unfunded liability of \$104.6 billion, based on the market value of assets.<sup>62</sup>

The following chart shows projected General Funds pension contributions under existing law from FY2015 through FY2045. General Funds account for approximately 89% of total State pension contributions.<sup>63</sup> The projections are based on the retirement systems' actuarial valuations as of June 30, 2014.<sup>64</sup> Contributions increase by 142.2% to \$14.6 billion in FY2045 from \$6.0 billion in FY2015.



It is important to understand that actuarial projections are made at a specific date and depend on assumptions about investment returns, inflation rates, wage increases, mortality rates and other factors. Actual contribution amounts in future years will vary from projections due to deviations between the assumptions and actual experience.

After the new pension law was enacted, actuaries for the retirement systems and for the legislature's Commission on Government Forecasting and Accountability (COGFA) reviewed the impact of the changes on accrued pension liabilities and required State contributions. These reviews were based on actuarial valuations as of June 30, 2013, the most recent available data at

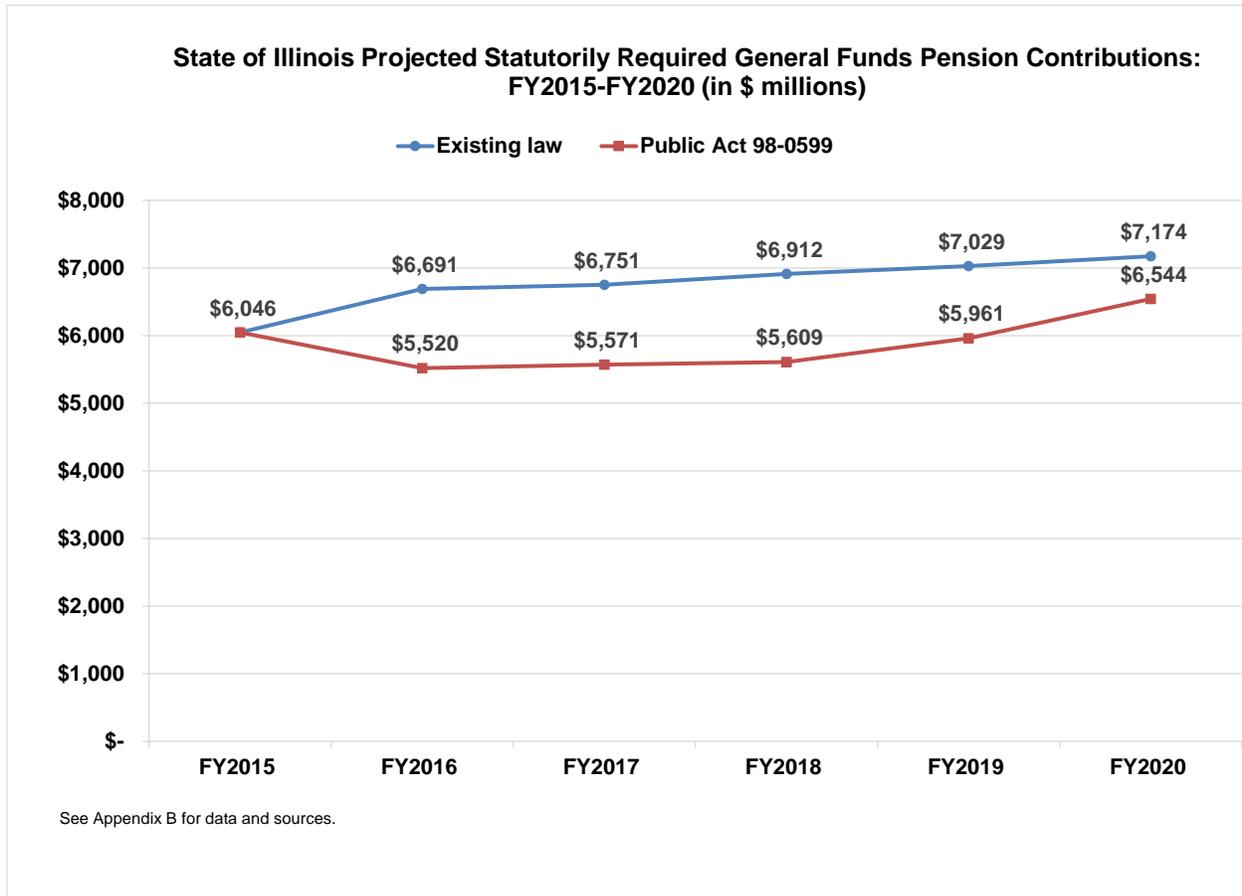
<sup>62</sup> State of Illinois, Office of the Auditor General, *Supplemental Digest of Retirement Systems' Audits for the years ending June 30, 2013 and June 30, 2014*, January 22, 2015.

<sup>63</sup> State of Illinois, General Obligation Bonds, Series of May 2014, *Official Statement*, April 25, 2014, p. 20.

<sup>64</sup> For data and sources, see Appendix A.

the time. The study by COGFA’s actuary showed a \$21.1 billion reduction in accrued liabilities and a decrease in total contributions of \$137.4 billion.<sup>65</sup>

The Civic Federation used the review done by COGFA’s actuary to compare required contributions under the new and old laws, updated for the actuarial valuation done as of June 30, 2014.<sup>66</sup> This projection, shown in the next chart, assumes that the new law is implemented in FY2016.



General Funds pension contributions in FY2016 would be roughly \$1.2 billion lower at \$5.5 billion under the new law compared with \$6.7 billion under existing law. Estimated savings decline to \$630 million in FY2020 because of supplemental State funding required under the new law. Beginning in FY2016, the new law requires that 10% of the reduction in contributions be used to pay down the unfunded liability. The State must contribute an additional \$364 million in FY2019 and \$1 billion a year beginning in FY2020 to pay down the unfunded liability until the systems are fully funded.

The pension contributions in this report only cover contributions to the five State-funded pension funds. In the State’s projection, the pension contributions include State contributions to the Teachers’ Retirement Insurance Program (TRIP), the College Insurance Program (CIP) and the

<sup>65</sup> Commission on Government Forecasting and Accountability, *Segal Actuarial Cost Study on P.A. 98-0599 (SB 1)*, March 26, 2014. Approximately 75% of the contribution reduction is due to benefit changes. The remainder is due to supplemental contributions by the State beginning in FY2016.

<sup>66</sup> For more information on methodology, see Appendix B.

pension fund for Chicago Public Schools (CPS) teachers.<sup>67</sup> In this report, contributions to TRIP, CIP and the CPS pension fund are included in agency spending.

## Revenues

The five-year benchmark projection for General Funds revenues shows the effect of current State tax policy, which creates a significant revenue cliff beginning in FY2015 and extending through FY2016 due to lower income tax rates. Although this section is intended to show the five-year trend for the State's revenues, FY2014 estimates are also included to illustrate the full impact of the income tax rate changes.

The benchmark projection shows that, even after four years of underlying growth in revenues, the State will still not have returned to its peak FY2014 resource levels by FY2020 due to the partial rollback of the income tax rates in FY2015. This is due to the size of the revenue cliff created by the reduction of income tax rates on January 1, 2015, when the individual rate was reduced to 3.75% from 5.0% and the corporate rate was reduced to 5.25% from 7.0%. This amounts to a 25% reduction in the rates.

General Funds revenues are projected to be \$1.4 billion lower in FY2020, totaling \$35.4 billion compared to a total of \$36.8 billion in FY2014. The lowest point in the five-year projections occurs in FY2016, when General Funds revenues decline to \$32.1 billion or \$4.7 billion less than FY2014.

Income taxes make up more than half of total General Funds revenues and are the State's largest source of operating revenue. The partial rollback of the increased individual income tax rate and corporate income tax rate lead to a dramatic loss of State operating resources beginning in FY2015.

Due to the change in rates, the State's three-year projections show income taxes falling from \$19.8 billion in FY2014 to \$17.5 billion in FY2015 and \$14.6 billion in FY2016. The income tax revenues in FY2016 represent the first full year of the lower rates and include a loss of individual income taxes totaling \$4.3 billion and corporate income taxes totaling \$826 million from FY2014. This amounts to a total peak to trough income tax decline of \$5.2 billion.

After the decline in FY2016, revenues from the individual income tax begin to grow again due to expected economic activity. The State's three-year projection includes an underlying growth rate of 3.4% annually for individual income taxes through FY2018.

For the purpose of extending the three-year projection through FY2020, individual income taxes are assumed to continue growing at the same rate of 3.4% annually in FY2019 and FY2020.

Corporate income tax revenues are projected to grow at a rate of 3.5% and 3.6% in FY2017 and FY2018. Due to a potential softening of the economy in FY2018, as projected by the State's economic forecasting consultants, corporate income taxes in the five-year benchmark projection are held flat in FY2019 and grow by 2.7% in FY2020.<sup>68</sup>

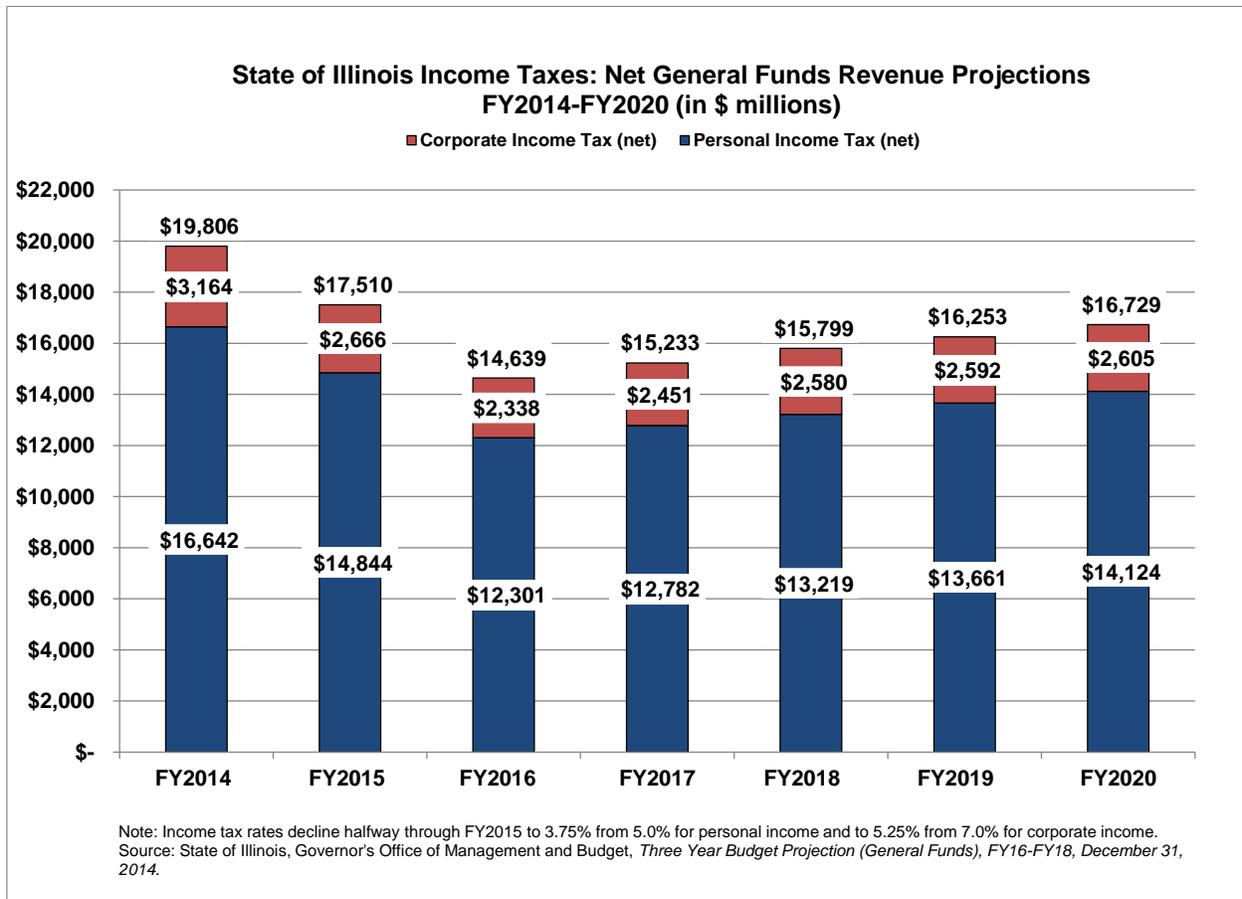
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<sup>67</sup> TRIP provides health insurance for retired public school teachers outside of Chicago. CIP provides health insurance for retired community college employees outside of Chicago.

<sup>68</sup> Communication between the Civic Federation and Illinois Department of Revenue, January 21, 2015.

After the two additional years of growth, income taxes still total only \$16.7 billion in FY2020, \$3.1 billion less than the FY2014 estimate of \$19.8 billion.

The following chart shows the projected decline in income tax revenue in FY2015 and FY2016 and the expected moderate growth through FY2020.



Total State-source General Funds revenue projections through FY2020 show that the revenue decline from the income tax rate reductions is partially offset by growth in other sources. Sales taxes are the second largest contributor to State-source revenues, totaling \$7.7 billion in FY2014, and are projected to increase by 2.0% annually, totaling \$9.1 billion by FY2020. The State collects sales taxes at a rate of 6.25%, of which 5.0-percentage points are revenues for the State while 1.25-percentage points are distributed to local and county governments.

The benchmark projection shows total State-source revenues are \$2.1 billion less in FY2020, at \$30.8 billion compared to \$32.9 billion in FY2014. Income taxes remain \$3.1 billion less in FY2020 than FY2014 but are partially offset by an increase of \$1.5 billion in sales taxes. Other State-source revenues and transfers-in, which mostly consist of gaming revenues and lottery proceeds, are not considered economically sensitive sources. These revenue categories are shown at relatively flat growth rates of 1.0% in FY2019 and FY2020.

The following table shows projections for State-source revenues from FY2014 through FY2020.

State of Illinois Five-Year Projections: State-Source General Funds Revenue									
FY2014-FY2020 (in \$ millions)									
Revenue Sources	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	\$ Change	% Change
<b>Income Taxes</b>									
Individual Income Tax (net)	\$ 16,642	\$ 14,844	\$ 12,301	\$ 12,782	\$ 13,219	\$ 13,661	\$ 14,124	\$ (2,518)	-17.0%
Corporate Income Tax (net)	\$ 3,164	\$ 2,666	\$ 2,338	\$ 2,451	\$ 2,580	\$ 2,592	\$ 2,605	\$ (559)	-21.0%
<b>Total Income Taxes</b>	<b>\$ 19,806</b>	<b>\$ 17,510</b>	<b>\$ 14,639</b>	<b>\$ 15,233</b>	<b>\$ 15,799</b>	<b>\$ 16,253</b>	<b>\$ 16,729</b>	<b>\$ (3,077)</b>	<b>-17.6%</b>
Sales Taxes	\$ 7,675	\$ 7,950	\$ 8,204	\$ 8,475	\$ 8,772	\$ 8,947	\$ 9,126	\$ 1,451	18.3%
Other State Sources	\$ 5,384	\$ 5,584	\$ 4,801	\$ 4,812	\$ 4,822	\$ 4,870	\$ 4,919	\$ (465)	-8.3%
<b>Total State Sources</b>	<b>\$ 32,865</b>	<b>\$ 31,044</b>	<b>\$ 27,644</b>	<b>\$ 28,520</b>	<b>\$ 29,393</b>	<b>\$ 30,071</b>	<b>\$ 30,774</b>	<b>\$ (2,091)</b>	<b>-6.7%</b>

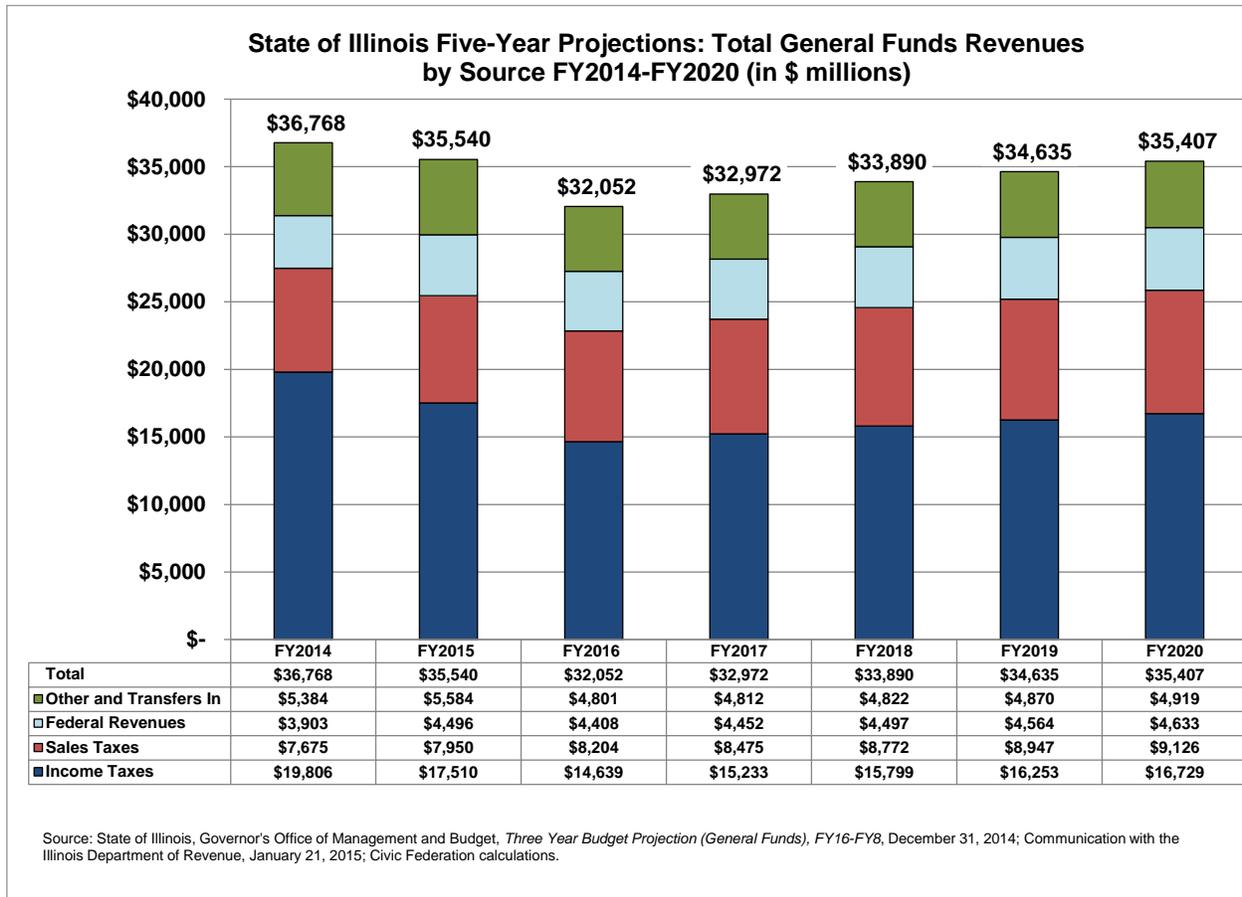
Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY16-FY18*, Decembr 31, 2014; Communication with the Illinois Department of Revenue, January 21, 2015; Civic Federation calculations.

The final component of the State's General Funds revenue is federal resources. The federal government provides annual funding for a variety of State programs, including road and bridge improvements, education, economic development, public housing and environmental projects. However, most of the funds are appropriated outside the General Funds for designated purposes in Other State Funds. The majority of federally provided General Funds revenues are reimbursements for Medicaid expenditures.

Federal revenue projections in the following chart are based on the State's three-year projection through FY2018. Federal revenue is assumed to grow at a rate of 3.5% for FY2019 and FY2020 to match projected increases from the prior three years. In all, federal revenues are \$730 million higher, totaling \$4.6 billion in FY2020 up from a total of \$3.9 billion in FY2014.

Total General Funds revenues from State and federal sources are projected be \$1.3 billion lower, or 3.7%, totaling \$35.4 billion in FY2020 compared to \$36.8 billion in FY2014. It should be noted that within the five-year projection, from peak to trough, total General Funds revenues are expected to decline by \$4.7 billion to \$32.1 billion in FY2016 compared to \$36.8 billion in FY2014.

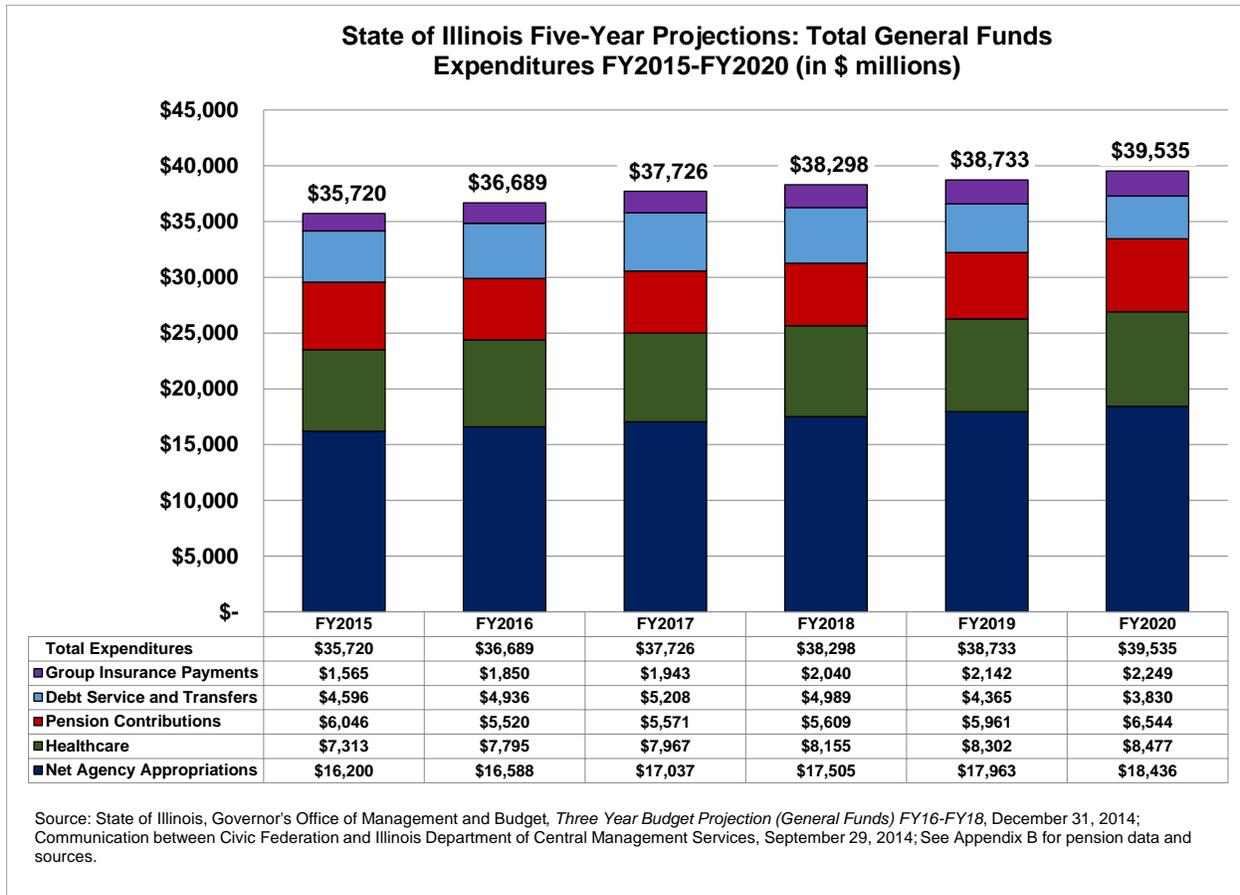
The following chart shows total General Funds revenue projections by source for FY2014 through FY2020.



## Expenditures

The benchmark expenditure projection extends the State's three-year projection through FY2020, with changes to pension contributions discussed above and to Medicaid spending related to the Affordable Care Act (ACA). General Funds expenditures are projected to increase by \$3.8 billion, or 10.7%, to \$39.5 billion in FY2020 from \$35.7 billion in FY2015.

The following chart shows total General Funds expenditure projections for FY2015 through FY2020.



The chart shows net agency spending (after deducting unspent appropriations) separately from other spending categories because the State has the most control over these areas. Net agency spending grows by \$2.2 billion to \$18.4 billion in FY2020 from \$16.2 billion in FY2015 based on the three-year projection. The State's forecast assumes an annual increase of 2.7% in net agency spending from FY2016 through FY2020. This increase does not include any cost-of-living adjustments in new union contracts beginning on July 1, 2015 but does incorporate step increases, which are based on length of service.

Following the State's three-year projection, the benchmark forecast assumes that spending in FY2015 does not exceed enacted appropriations; in other words, there are no supplemental appropriations and no unappropriated costs are incurred. However, net agency spending includes enacted appropriations based on the authorized \$650 million of interfund borrowing. Spending is

assumed to increase significantly in FY2016 particularly in the area of human services to make up for reductions in FY2015.

Many other parts of the General Funds budget are regarded as non-discretionary because spending levels are set by law, court order or contract. The ability to modify such spending varies widely. While General Obligation Bonds are covered by an irrevocable and continuing appropriation of the amounts needed to make principal and interest payments, legislatively required transfers out of General Funds can be changed by the General Assembly.

Medicaid is an entitlement program under which certain categories of low income people are entitled to specified medical services. The program is partly financed by the federal government, which mandates certain coverage. For coverage that is not federally required, Medicaid costs cannot be cut without reductions in program eligibility, benefits or reimbursement rates paid to healthcare providers.

The Healthcare category in the chart reflects General Funds appropriations to the State's main Medicaid agency, the Illinois Department of Healthcare and Family Services (HFS), and tracks the State's projection.<sup>69</sup> Medicaid funding increases by 6.3% from FY2015 to FY2016 and by 1.5% per year thereafter. As previously discussed, \$600 million was appropriated to HFS in FY2014 to be transferred outside of General Funds and spent in FY2015.<sup>70</sup> This inflated FY2014 General Funds spending and understated FY2015 General Funds spending.

The State's projection does not account for additional State costs beginning in calendar year 2017 due to the expansion of Medicaid eligibility under the ACA. Beginning in January 2014, the national health care law gave states like Illinois that chose to participate the ability to provide Medicaid coverage to the major population that had not been covered: low income, non-elderly, non-disabled adults without dependent children.

State Medicaid expenditures are generally reimbursed by the federal government at a rate known as the Federal Medical Assistance Percentage (FMAP), which varies by state depending on per capita income. The federal matching rate for Illinois is currently 50.76%.<sup>71</sup> However, the federal government is scheduled to pay 100% of the cost for the newly eligible ACA population for the first three years of the program, through calendar year 2016; 95% in 2017; 94% in 2018; 93% in 2019; and 90% thereafter.

Newly eligible Illinois recipients have signed up more quickly than expected. Before the expansion began, HFS had projected that 161,000 newly eligible individuals would sign up by the end of 2014 and 342,000 by the end of 2017. The FY2015 budget was based on an estimate of 385,000 by the end of FY2015. The latest figures on HFS' website show 540,877 newly

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<sup>69</sup> This is based on the category of Healthcare in the State's three-year projection, which mainly covers General Funds appropriations to HFS.

<sup>70</sup> Public Act 98-0642, enacted on June 9, 2014, p. 2.

<sup>71</sup> U.S. Department of Health & Human Services, Office of the Assistant Secretary for Planning and Evaluation, *ASPE FMAP 2015 Report* and *ASPE FMAP 2014 Report*, <http://aspe.hhs.gov/health/reports/2014/FMAP2015/fmap15.cfm> (last visited on February 6, 2015). An enhanced FMAP of 65.53% applies to the Children's Health Insurance Program in federal fiscal year 2015.

eligible recipients as of the end of December 2014.<sup>72</sup> The agency has not yet published a revised estimate of 2017 enrollment.

Beginning in 2017, when the federal government stops paying the entire bill, the State's cost for newly eligible recipients will depend on both the number of recipients and the average cost per person, measured as the per member per month (PMPM) cost. A recent report, using the December 2014 enrollment number and a PMPM cost of \$882, estimated the State's additional cost from the ACA at \$2 billion from 2017 through 2020.<sup>73</sup> This PMPM figure does not reflect actual costs; it is the number used in the State's application for a Section 1115 Waiver, which would provide additional federal funding to overhaul the Medicaid program.<sup>74</sup>

According to HFS officials, the FY2015 budget is based on a projected PMPM cost of \$521 for newly eligible recipients, but actual costs have come in much lower at approximately \$230 through September 2014.<sup>75</sup> The ACA-related costs in the chart are based on a PMPM amount of \$376, an average of the two numbers, inflated at 1.5%, the same growth rate used for other Medicaid costs in the State's projection.

For the Civic Federation projection, the number of recipients is increased at 1.4% a year from 2017 through 2020, the average annual growth rate for Medicaid adult enrollment forecast by the Congressional Budget Office in April 2014.<sup>76</sup> The number excludes ACA enrollees in the Cook County public health system's CountyCare program. Under a special financing arrangement, **no State money is used to draw federal Medicaid reimbursement for the Cook County Health and Hospitals System. CountyCare had 80,372 members as of December 2014.**<sup>77</sup>

Based on these assumptions, the State's ACA-related cost is estimated to rise from \$55.0 million in FY2017 (when the 5% share is in effect for only half of the fiscal year) to \$203.9 million in FY2020 and to total \$534.9 million over the period. A revised State-produced estimate is expected to be presented when the FY2016 budget is issued.

Group health insurance is a benefit provided to employees and retirees under State law and collective bargaining agreements.<sup>78</sup> The Civic Federation projection follows and extends the State projection, which assumes that health insurance costs grow by 5% a year in FY2017 and FY2018, after increasing by 18.2% in FY2016. The reasons for the significant increase in FY2016 were not explained.

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<sup>72</sup> Illinois Department of Healthcare and Family Services, *Affordable Care Act Enrollment by Age, Race and Gender as of August 2014*, <http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAEnrollmentSummaryData.pdf> (last visited on February 6, 2015).

<sup>73</sup> Ellen Jean Hirst, "Illinois Medicaid expansion could carry hefty price," *Chicago Tribune*, February 3, 2015.

<sup>74</sup> State of Illinois, Governor's Office of Health Innovation and Technology, *The Path to Transformation: Illinois 1115 Waiver Proposal*, June 4, 2014.

<sup>75</sup> Communication between the Civic Federation and the Illinois Department of Healthcare and Family Services, February 4, 2015. This cost covers ACA enrollees in the traditional fee-for-service Medicaid program and not in managed care.

<sup>76</sup> Congress of the United States, Congressional Budget Office, *Updated Budget Projections: 2014 to 2024*, April 2014, Detail of Spending and Enrollment for Medicaid for CBO's April 2014 Baseline. This is a national estimate and is not broken down by state.

<sup>77</sup> Illinois Department of Healthcare and Family Services, *Affordable Care Act Enrollment by Age, Race and Gender as of August 2014*, <http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAEnrollmentSummaryData.pdf> (last visited on February 6, 2015).

<sup>78</sup> The group insurance appropriation in the General Funds budget includes a relatively small amount of life insurance—less than 1% of the total FY2015 appropriation.

The State's contributions for retiree health insurance increased in FY2015 after an Illinois Supreme Court ruling on a 2012 law requiring State retirees to pay health insurance premiums. The high court ruled on July 3, 2014 that State subsidies for retiree health insurance premiums are a pension benefit covered by the pension protection clause of the Illinois Constitution.<sup>79</sup>

According to the State's Department of Central Management Services, State retirees were projected to pay \$91 million more in FY2015 due to the 2012 law.<sup>80</sup> However, the loss of retirees' premiums in FY2015 was offset by an appropriation that was \$90 higher than previously anticipated costs. In addition, a lower court has ordered the State to refund about \$63 million in premiums that it had already collected from 90,000 retirees.<sup>81</sup>

### **Deficit and Unpaid Bills**

The five-year benchmark projection shows that the State's operating expenses will exceed revenues from FY2015 through FY2020. As a result, the backlog of unpaid bills is expected to climb from approximately \$6.4 billion at the end of FY2015 to \$28.4 billion at the end of FY2020.

These projections are intended to show the consequences of existing fiscal policy and should not be viewed as a budget forecast. It is not realistic to imagine that the State could function with obligations of this magnitude.

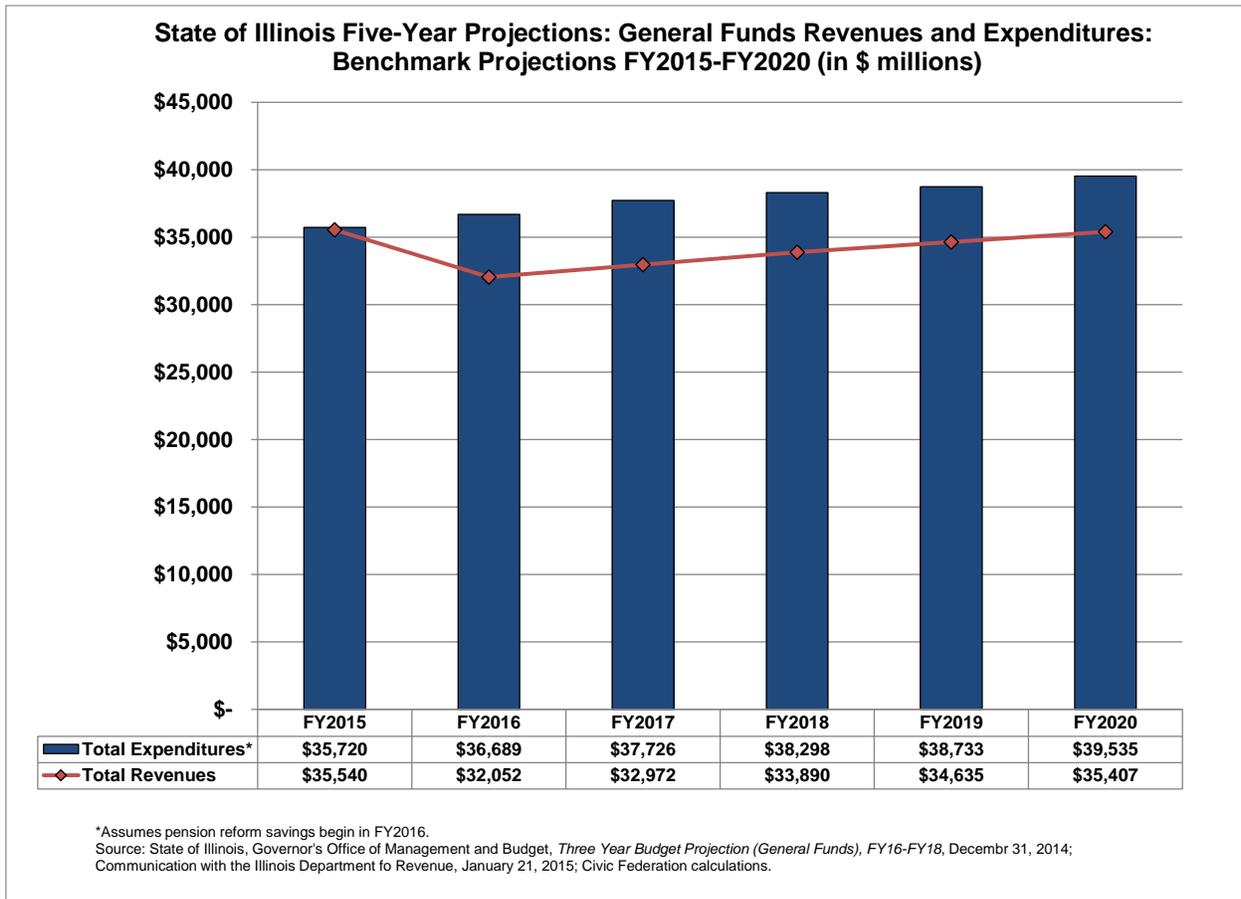
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<sup>79</sup> Illinois Supreme Court, *Kanerva v. Weems* (2014 IL 115811, July 3, 2014).

<sup>80</sup> Communication between the Civic Federation and the Illinois Department of Central Management Services, August 5, 2014 and September 18, 2014.

<sup>81</sup> Doug Finke, "State retirees to get letters on insurance premium settlement," *State Journal-Register*, January 22, 2015.

The following chart shows total projected General Funds revenues compared to total expenditures from FY2015 through FY2020, if current trends continue.



As previously discussed, these projections assume that the pension legislation enacted in December 2013 is implemented in FY2016.<sup>82</sup> Spending pressures would be greater and the backlog of unpaid bills larger under the State's existing pension funding plan.

The annual General Funds operating deficit is projected to increase from \$180 million in FY2015 to \$4.8 billion in FY2017 and then decline to \$4.1 billion in FY2020. The operating deficit declines due to natural growth in State-source revenues and a reduction in debt service as the pension bonds issued in 2011 are fully paid off.

<sup>82</sup> Public Act 98-0599, enacted on December 5, 2013.

The following table shows major revenue sources and spending categories from FY2015 to FY2020.

State of Illinois Five-Year Projections: General Funds Operating Surplus (Deficit)								
Benchmark Projections FY2015-FY2020 (in \$ millions)								
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	\$ Change	% Change
<b>Revenues</b>								
State Source Revenues	\$ 31,044	\$ 27,644	\$ 28,520	\$ 29,393	\$ 30,071	\$ 30,774	\$ (270)	-0.9%
Federal Revenues	\$ 4,496	\$ 4,408	\$ 4,452	\$ 4,497	\$ 4,564	\$ 4,633	\$ 137	3.0%
<b>Total Revenues</b>	<b>\$ 35,540</b>	<b>\$ 32,052</b>	<b>\$ 32,972</b>	<b>\$ 33,890</b>	<b>\$ 34,635</b>	<b>\$ 35,407</b>	<b>\$ (133)</b>	<b>-0.4%</b>
<b>Expenditures</b>								
Net Agency Appropriations	\$ 16,200	\$ 16,588	\$ 17,037	\$ 17,505	\$ 17,963	\$ 18,436	\$ 2,236	13.8%
<b>Original Pension Contributions</b>	<b>\$ 6,046</b>	<b>\$ 6,691</b>	<b>\$ 6,751</b>	<b>\$ 6,912</b>	<b>\$ 7,029</b>	<b>\$ 7,174</b>	<b>\$ 1,128</b>	<b>18.7%</b>
Reduction Due to Reform	\$ -	\$ (1,171)	\$ (1,180)	\$ (1,303)	\$ (1,068)	\$ (630)	\$ (630)	na
<b>New Pension Contributions</b>	<b>\$ 6,046</b>	<b>\$ 5,520</b>	<b>\$ 5,571</b>	<b>\$ 5,609</b>	<b>\$ 5,961</b>	<b>\$ 6,544</b>	<b>\$ 497</b>	<b>8.2%</b>
Healthcare	\$ 7,313	\$ 7,795	\$ 7,912	\$ 8,030	\$ 8,150	\$ 8,273	\$ 960	13.1%
Medicaid ACA Costs	\$ -	\$ -	\$ 55	\$ 126	\$ 152	\$ 204	\$ 204	na
Group Insurance Payments	\$ 1,565	\$ 1,850	\$ 1,943	\$ 2,040	\$ 2,142	\$ 2,249	\$ 684	43.7%
Debt Service and Transfers	\$ 4,596	\$ 4,936	\$ 5,208	\$ 4,989	\$ 4,365	\$ 3,830	\$ (767)	-16.7%
<b>Total Expenditures*</b>	<b>\$ 35,720</b>	<b>\$ 36,689</b>	<b>\$ 37,726</b>	<b>\$ 38,298</b>	<b>\$ 38,733</b>	<b>\$ 39,535</b>	<b>\$ 3,815</b>	<b>10.7%</b>
<b>Operating Surplus (Deficit)</b>	<b>\$ (180)</b>	<b>\$ (4,637)</b>	<b>\$ (4,754)</b>	<b>\$ (4,408)</b>	<b>\$ (4,098)</b>	<b>\$ (4,129)</b>	<b>\$ (3,948)</b>	<b>2188.6%</b>

\*Assumes savings from pension reforms begin in FY2016 and supplemental payments in FY2019 and FY2020.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)*, FY16-FY18, December 31, 2014; Communication with the Illinois Department of Revenue, January 21, 2015; Civic Federation calculations.

Illinois has dealt with its General Funds deficits by delaying payments to vendors, social service agencies and local governments in order to pay those bills from the next year's revenue. Beginning in FY2013, the State's lapse period—the period after the end of the fiscal year during which this year's bills can be paid from next year's revenues—was permanently extended from two to six months.<sup>83</sup>

Certain other costs may be incurred during the year without showing up in that year's budget; these costs may be deferred and paid from the next year's appropriations.<sup>84</sup> Such liabilities were formerly concentrated in the Medicaid program and now mainly involve group health insurance.<sup>85</sup> In this projection, it is assumed that the increase in unpaid bills involves budgeted expenses.

The next chart shows the General Funds backlog of unpaid bills from FY2015 to FY2020, based on current State policy. Total unpaid bills could increase to \$28.4 billion in FY2020 from \$6.4 billion in FY2015 if nothing is done to curb expenditures or increase revenues.

State of Illinois Backlog of Unpaid Bills						
Benchmark Projections FY2015-FY2020 (in \$ millions)						
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
Beginning of Year	\$ (6,184)	\$ (6,364)	\$ (11,001)	\$ (15,755)	\$ (20,164)	\$ (24,262)
Surplus (Deficit)	\$ (180)	\$ (4,637)	\$ (4,754)	\$ (4,408)	\$ (4,098)	\$ (4,129)
<b>Unpaid Bills End of Year</b>	<b>\$ (6,364)</b>	<b>\$ (11,001)</b>	<b>\$ (15,755)</b>	<b>\$ (20,164)</b>	<b>\$ (24,262)</b>	<b>\$ (28,390)</b>

Source: Governor's Office of Management and Budget, *Three Year Budget Projection (General funds)*, FY16-FY18, December 31, 2014; Communication with the Governor's Office of Management and Budget; Civic Federation calculations.

<sup>83</sup> 30 ILCS 105/25(m).

<sup>84</sup> As part of the FY2013 restructuring, the ability to defer Medicaid costs in this way was limited by Public Act 97-691, enacted on June 14, 2012.

<sup>85</sup> Public Act 97-0691, enacted on June 14, 2012, limited such liabilities incurred by State's main Medicaid agency to \$700 million in FY2013 and \$100 million thereafter, with an exception for costs incurred by the end of the fiscal year but not recorded until after June 30.

It is unclear how the State could continue to provide basic government services if unpaid bills were allowed to grow to the levels shown above. The State would need to use more than two-thirds of FY2020 revenues to pay off the FY2019 backlog, significantly draining FY2020 resources and creating unsustainable payment delays.

## Spending Reductions

Based on the benchmark five-year projections, if the State were to balance its operating budgets and eliminate its backlog of unpaid bills between FY2015 and FY2020 through spending reductions alone, net agency appropriations would need to be reduced by approximately \$28.5 billion, or 27.3%, from the total five year discretionary spending in the benchmark projection.

The reductions would begin in FY2015, when agency appropriations would need to decline by \$180 million to eliminate the General Funds deficit and prevent the backlog of unpaid bills from growing. To balance the FY2016 budget, the State would need to cut \$4.1 billion or 11.1% of the total General Funds expenditures in the benchmark projection. Finally, in FY2017 an additional \$109 million would need to be cut to bring the net agency appropriations total to \$11.8 billion from the severely reduced FY2016 total of \$12.0 billion. The State would then need to hold the appropriations at the FY2017 total until FY2020 to pay down the unpaid bills, which would only have declined to \$5.7 billion at the end of FY2017 from \$6.2 billion at the end of FY2014.

The following table shows the five-year projection of the necessary reductions in net agency appropriations to balance the General Funds budget and eliminate the State's backlog of bills between FY2015 and FY2019.

State of Illinois Five-Year Projections: General Funds Operating Surplus (Deficit)								
Balance Budget by Reductions Only FY2015-FY2020 (in \$ millions)								
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	\$ Change	% Change
<b>Revenues</b>								
State Source Revenues	\$ 31,044	\$ 27,644	\$ 28,520	\$ 29,393	\$ 30,071	\$ 30,774	\$ (270)	-0.9%
Federal Revenues	\$ 4,496	\$ 4,408	\$ 4,452	\$ 4,497	\$ 4,564	\$ 4,633	\$ 137	3.0%
<b>Total Revenues</b>	<b>\$ 35,540</b>	<b>\$ 32,052</b>	<b>\$ 32,972</b>	<b>\$ 33,890</b>	<b>\$ 34,635</b>	<b>\$ 35,407</b>	<b>\$ (133)</b>	<b>-0.4%</b>
<b>Expenditures</b>								
Net Agency Appropriations	\$ 16,200	\$ 16,020	\$ 11,951	\$ 11,842	\$ 11,842	\$ 11,842	\$ (4,358)	-26.9%
Cut to Appropriations	\$ (180)	\$ (4,069)	\$ (109)	\$ -	\$ -	\$ -	\$ 180	
<b>Reduced Appropriations</b>	<b>\$ 16,020</b>	<b>\$ 11,951</b>	<b>\$ 11,842</b>	<b>\$ 11,842</b>	<b>\$ 11,842</b>	<b>\$ 11,842</b>	<b>\$ (4,178)</b>	<b>-26.1%</b>
<b>Original Pension Contributions</b>	<b>\$ 6,046</b>	<b>\$ 6,691</b>	<b>\$ 6,751</b>	<b>\$ 6,912</b>	<b>\$ 7,029</b>	<b>\$ 7,174</b>	<b>\$ 1,128</b>	<b>18.7%</b>
Reduction Due to Reform	\$ -	\$ (1,171)	\$ (1,180)	\$ (1,303)	\$ (1,068)	\$ (630)	\$ (630)	na
<b>New Pension Contributions</b>	<b>\$ 6,046</b>	<b>\$ 5,520</b>	<b>\$ 5,571</b>	<b>\$ 5,609</b>	<b>\$ 5,961</b>	<b>\$ 6,544</b>	<b>\$ 497</b>	<b>8.2%</b>
Healthcare	\$ 7,313	\$ 7,795	\$ 7,912	\$ 8,030	\$ 8,150	\$ 8,273	\$ 960	13.1%
Medicaid ACA Costs	\$ -	\$ -	\$ 55	\$ 126	\$ 152	\$ 204	\$ 204	na
Group Insurance Payments	\$ 1,565	\$ 1,850	\$ 1,943	\$ 2,040	\$ 2,142	\$ 2,249	\$ 684	43.7%
Debt Service and Transfers	\$ 4,596	\$ 4,936	\$ 5,208	\$ 4,989	\$ 4,365	\$ 3,830	\$ (767)	-16.7%
<b>Total Expenditures*</b>	<b>\$ 35,540</b>	<b>\$ 32,052</b>	<b>\$ 32,531</b>	<b>\$ 32,635</b>	<b>\$ 32,612</b>	<b>\$ 32,941</b>	<b>\$ (2,599)</b>	<b>-7.3%</b>
<b>Operating Surplus (Deficit)</b>	<b>\$ -</b>	<b>\$ 0</b>	<b>\$ 441</b>	<b>\$ 1,255</b>	<b>\$ 2,023</b>	<b>\$ 2,465</b>	<b>\$ 2,465</b>	<b>na</b>
<b>Backlog of Unpaid Bills</b>	<b>\$ (6,184)</b>	<b>\$ (6,184)</b>	<b>\$ (6,184)</b>	<b>\$ (5,743)</b>	<b>\$ (4,488)</b>	<b>\$ (2,465)</b>	<b>\$ 3,719</b>	<b>-60.1%</b>
<b>Bills Reduction</b>	<b>\$ -</b>	<b>\$ 0</b>	<b>\$ 441</b>	<b>\$ 1,255</b>	<b>\$ 2,023</b>	<b>\$ 2,465</b>	<b>\$ 2,465</b>	<b>na</b>
<b>Unpaid Bills End Of Year</b>	<b>\$ (6,184)</b>	<b>\$ (6,184)</b>	<b>\$ (5,743)</b>	<b>\$ (4,488)</b>	<b>\$ (2,465)</b>	<b>\$ 0</b>	<b>\$ 6,184</b>	<b>-100.0%</b>

\*Assumes savings from pension reforms begin in FY2016 and supplemental payments in FY2019 and FY2020.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)*, FY16-FY18, December 31, 2014; Communication with the Illinois Department of Revenue, January 21, 2015; Civic Federation calculations.

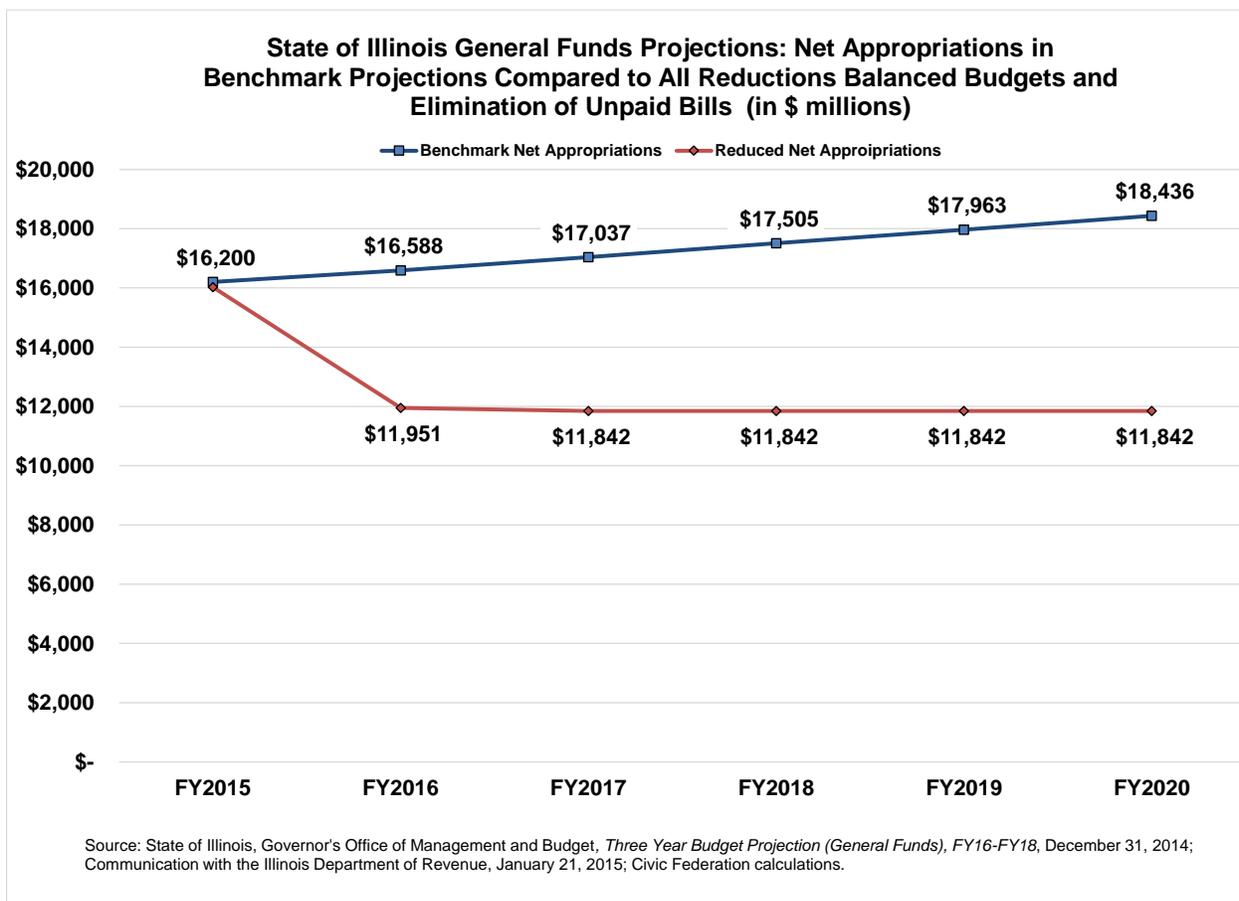
The prospect of reducing net agency appropriations by \$4.1 billion or 25.4% in FY2016 is both unlikely and imprudent. After removing elements of the budget that are difficult to change due to law, contract or court order, most of the cuts would likely be centered on education and human services programs that are not federally reimbursed under Medicaid. Cuts of this size could involve the elimination of large portions of government services widely regarded as essential and would total 25.4% of the net agency appropriations in FY2016.

If the State could achieve the extraordinarily austere spending limits included in the five-year projection above, it would balance its operating budgets and eliminate the backlog of unpaid bills.

However, the State would be especially exposed to additional financial stress from an economic downturn or the possibility that the savings from the new pension law are eliminated or delayed by an adverse court ruling. Since the State does not maintain adequate reserves in a rainy day fund, it would remain extremely vulnerable to any major changes in revenues or spending requirements throughout the five-year spending cut plan.

Similarly, there is no room in the reductions-only proposal to provide additional funding for local governments without imposing even deeper cuts.

The following chart shows the change in net appropriations from the benchmark projection that would need to take place in order to achieve budget plan above.



Simply reducing appropriations has an additional drawback: it does not allow the State to significantly reduce its unpaid bills until FY2019 and FY2020. Such a delay would extend the crisis that began in FY2009 for an additional three fiscal years. Although a long-term financial plan based on budget cuts alone does allow for significant tax relief to individuals and corporations in the near term, it also continues the cycle of annual financial crises and the resulting negative impact on service providers and local governments for the majority of the five-year horizon of the projection.

## **CIVIC FEDERATION COMPREHENSIVE PLAN**

The benchmark projection in the previous section illustrates how current State revenue and spending structures do not provide a sustainable basis for funding essential government services and ongoing liabilities. The often-cited alternative of spending reductions alone would only balance the budget if the State's discretionary spending could be reduced by 25.0%, or more than \$4.1 billion, in one year. The bills could be paid off if spending was then held at the much lower level for the next five years. Although this method could balance the budget it would come at the cost of eliminating entire areas of State services or completely restructuring how the government functions.

The Civic Federation presents the following comprehensive plan and recommendations to immediately stabilize the State of Illinois' operating budget, maintain essential government services and establish a sustainable long-term financial plan for the State.

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

It is also important to recognize that the State is in a significantly more difficult fiscal position after the approval of an incomplete FY2015 budget and the rollback of income tax rates as of January 1, 2015. The failure of the State to address the fiscal cliff means a higher bill backlog to pay off and a much lower revenue base from which to develop a plan that achieves the above goals. Spending controls are at the center of this comprehensive plan, but more revenue is also needed to make up for FY2015's shortcomings while attending to future projected deficits and paying off unpaid bills. The Civic Federation has therefore created a comprehensive tax proposal focused on broadening the base of the State's two largest revenue sources combined with a gradual rollback of the income tax rate to achieve financial sustainability instead of severe retroactive hikes to the rates of either the income or sales tax.

The first element necessary to address the long-term financial sustainability of the State budget is to control spending so that surpluses are available to eliminate the backlog of unpaid bills and create a rainy day fund. As explored in the previous section, the State would not be able to make sufficient cuts in FY2016 to balance its budget without eliminating significant core services. However, by restricting spending growth in discretionary spending areas from the 2.7% level shown in the State's three-year projections to a 2.0% rate closer to inflation, the State could reduce its total spending by \$1.3 billion over the next five years.

A lower level of growth in discretionary spending can then be combined with a comprehensive tax policy that:

1. Reduces the fiscal cliff by retroactively increasing the income tax rate to 4.25% for individuals and 6.0% for corporations as of January 1, 2015;<sup>86</sup>
2. Broadens the income and sales tax bases to capture growing areas of the State economy; and
3. Provides income tax relief without creating a fiscal cliff in any one year by more gradually rolling back the income tax rate to the long-term sustainable rate of 4.0% for individuals and 5.6% for corporations.

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 FY2020 and allow for a significant initial deposit into a rainy day fund. The plan also provides much needed additional assistance to local governments in crisis.

***Address the FY2015 Budget, Fix the Fiscal Cliff and Provide Income Tax Relief***

Rather than dropping by 25% in one year, which leads to an annualized loss of more than \$5.0 billion from FY2014 to FY2016, a combination of a moderate retroactive increase in the individual and corporate income tax with a planned rollback in the income tax rates would allow the State to provide tax relief while planning for the decline in revenue over the next five years. The Civic Federation's plan would retroactively increase the individual income tax rate to 4.25% from 3.75% and the corporate income tax rate to 6.0% from 5.25% as of January 1, 2015 and roll back the rates to 4.0% for individuals and 5.6% for corporations on January 1, 2018. The Civic Federation believes it is important to provide tax relief as originally promised under the temporary income tax increase enacted in 2011. However, the Federation does not support a tax policy that creates an unmanageable revenue cliff at the same time the State still struggles with a massive backlog of unpaid bills. Choosing a more moderate rate and making it retroactive, while painful, is necessary to fix the broken FY2015 budget and avoid the additional revenue cliff in FY2016.<sup>87</sup>

The retroactive increase helps eliminate the interfund borrowing totaling \$650 million in the enacted FY2015 budget and the \$180 million operating deficit. The Federation proposal also requires that the State limit its FY2015 budget to currently appropriated totals and sweep \$250 million in excess balances from the State's Special Funds in FY2015. As discussed earlier in this report, many areas of the FY2015 did not receive adequate appropriations to fund a full year of operations. In order to live within the budget as enacted the State will need to reallocate funding by cutting non-essential spending and reallocating appropriations to high priority areas of the budget.

Once the FY2015 budget is balanced, the State must also address the remaining fiscal cliff in FY2016 and its unpaid bills. Therefore, the State must combine the spending controls described above with a broadening of its tax base that will allow it to access growing areas of the State economy.

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<sup>86</sup> 8.5% including the Personal Property Replacement Tax of 2.5% collected on corporate income, which is mainly a revenue source for local governments.

<sup>87</sup> See Appendix C for comparisons of Illinois' current and proposed individual and corporate income tax rates to neighboring states.

## Retirement Income Exemption

Unlike the federal government, which taxes certain levels of Social Security and other retirement income, Illinois exempts all retirement income from its income tax base.<sup>88</sup> 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.<sup>89</sup> The Illinois Comptroller reports that this exemption of federally taxable retirement income reduced individual income tax revenues by \$2.2 billion in FY2013.<sup>90</sup> The cost of this exemption is expected to 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.<sup>91</sup>

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.

Excluding Social Security income, all other federally taxable retirement income exempted by Illinois as of 2012 totaled \$39.7 billion.<sup>92</sup> 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 would total \$30.8 billion. 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 6.5%, while revenue from the individual income tax has averaged only 2.7% growth over the last 15 years.<sup>93</sup> Including this high growth portion of the income tax base helps to provide for a more sustainable revenue source for the State.

## Sales Tax Exemptions

Illinois' second largest tax expenditure is the exemption of food and drug purchases from the State's full sales tax rate. In FY2013 the exemption reduced total sales tax revenue by \$1.6 billion. Although very few States apply their full tax sales tax rate to food purchases and prescription drugs, most do not exempt non-prescription drugs.<sup>94</sup> 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 only low income residents and is provided for all food and drug purchases. The expansive nature of this exemption is much more

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<sup>88</sup> 35 ILCS 5/203.

<sup>89</sup> 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](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 February 5, 2015).

<sup>90</sup> Illinois Comptroller, *Tax Expenditure Report, Fiscal Year 2013*, p. 6.

<sup>91</sup> Illinois Comptroller, *Tax Expenditure Report, Fiscal Year 2013*, p. 7.

<sup>92</sup> Internal Revenue Service, SOI Tax Stats – Historic Tables, Illinois 1999-2012. <http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2> (last visited on February 7, 2015).

<sup>93</sup> Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 23.

<sup>94</sup> Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 23.

expensive than a focused antipoverty program. 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 on food by 0.25% from their current 1.0% distribution. 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 understand 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 Civic Federation plan also calls for annual increases in the Earned Income Tax Credit to help low income residents cope with the additional cost from the elimination of the exemption.

Illinois does not apply its sales tax to services, with the exception of several public utility taxes, which narrows the sales tax base considerably. However, due to the complexity of sourcing rules and collections for new businesses that are not currently required to collect sales taxes, it is estimated that it would take up to two fiscal years after enacting a tax on services before the State would receive significant revenues from the additional tax base.<sup>95</sup> Therefore, a temporary elimination of the exemption for food and non-prescription drugs is proposed. The State exemption would be reinstated in FY2020 once the service taxes are fully implemented, the State’s backlog of bills is eliminated and the State can actually afford such a large tax expenditure.<sup>96</sup> The Federation’s service tax proposal follows the list of 32 service taxes proposed by Governor Rauner and is estimated to start generating revenue halfway through FY2017.<sup>97</sup>

The following chart compares Illinois’ current and proposed sales tax rates to neighboring states. Temporarily eliminating the sales tax exemption for food would place Illinois out of the mainstream of its neighbors for a few years, but adding additional services to the tax base would not.

<b>Sales Tax Rates: Illinois and Neighboring States</b>					
	<b>Tax Rate</b>	<b>Services Taxed</b>	<b>Food</b>	<b>Prescription Drugs</b>	<b>Non-Prescription Drugs</b>
<b>Illinois</b>					
Current	6.25%	17	Yes - 1.0%	Yes - 1.0%	Yes - 1.0%
Proposed	6.25%	46	Yes - 6.5%	Yes - 1.0%	Yes - 6.5%
<b>Indiana</b>	7.00%	29	No	No	Yes - 7.0%
<b>Iowa</b>	6.00%	24	No	No	Yes - 6.0%
<b>Kentucky</b>	6.00%	28	No	No	Yes - 6.0%
<b>Michigan</b>	6.00%	26	No	No	Yes - 6.0%
<b>Minnesota</b>	6.875%	66	No	No	No
<b>Missouri</b>	4.225%	26	Yes - 1.225%	No	Yes - 4.225%
<b>Wisconsin</b>	5.00%	76	No	No	Yes - 5.0%

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

<sup>95</sup> Communication between the Civic Federation and Illinois Department of Revenue, January 21, 2015.

<sup>96</sup> The State should make a policy decision in concert with local governments to determine whether the exemptions should also be reinstated for local government sales taxes. In making this decision, State leaders must be careful not to create a revenue cliff for local governments.

<sup>97</sup> See Appendix D for the full list of services.

### ***Expand the Earned Income Tax Credit to Provide Assistance to Low Income Residents***

The complexity and painfulness of the Civic Federation's proposal puts the scope of the State's fiscal problems in perspective. State spending must be controlled, individuals and businesses will need to pay more in taxes and unaffordable exemptions must be eliminated. However, in order to compensate for the impact on low income residents of Illinois, the Federation's plan allows additional assistance by increasing the State's Earned Income Tax Credit by 2% of the federal amount in FY2016 and FY2017 and an additional 1% in FY2018 for a total of 15% of the federal credit.

The following table shows a five-year projection of the comprehensive plan recommended by the Civic Federation.

<b>State of Illinois Five-Year Projections: General Funds Operating Surplus (Deficit)</b>								
<b>Civic Federation Comprehensive Plan FY2015-FY2020 (in \$ millions)</b>								
	<b>FY2015</b>	<b>FY2016</b>	<b>FY2017</b>	<b>FY2018<sup>1</sup></b>	<b>FY2019</b>	<b>FY2020</b>	<b>\$ Change</b>	<b>% Change</b>
<b>Revenues</b>								
State Source Revenues	\$ 31,044	\$ 27,644	\$28,520	\$ 29,393	\$ 30,071	\$ 30,774	\$ (270)	-0.9%
Federal Revenues	\$ 4,496	\$ 4,408	\$ 4,452	\$ 4,497	\$ 4,564	\$ 4,633	\$ 137	3.0%
<b>Tax Changes</b>								
Increase IIT (4.25% decline to 4.0% in FY2018)	\$ 128	\$ 1,768	\$ 1,704	\$ 1,322	\$ 911	\$ 942	\$ 814	637.6%
Increase CIT (6.0% decline to 5.6% in FY2018)	\$ 71	\$ 166	\$ 355	\$ 269	\$ 171	\$ 176	\$ 105	149.1%
Retirement Income (exclude S.S./less than \$50K)	\$ 356	\$ 1,827	\$ 1,566	\$ 1,619	\$ 1,672	\$ 1,780	\$ 1,424	400.1%
Sales Tax Food <sup>2</sup>	\$ 263	\$ 1,077	\$ 1,104	\$ 1,131	\$ 1,160	\$ -	\$ (263)	-100.0%
Sales Tax OTC Drugs	\$ 13	\$ 52	\$ 53	\$ 55	\$ 56	\$ -	\$ (13)	-100.0%
Sales Tax on Services <sup>3</sup>	\$ -	\$ -	\$ 325	\$ 666	\$ 682	\$ 699	na	na
Eliminate Diversions	\$ -	\$ 833	\$ 865	\$ 895	\$ 925	\$ 956	\$ 956	na
Eliminate Interfund Borrowing	\$ (650)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 650	-100.0%
Fund Sweeps	\$ 250	\$ -	\$ -	\$ -	\$ -	\$ -	\$ (250)	-100.0%
<b>Total Revenues</b>	<b>\$ 35,970</b>	<b>\$ 37,774</b>	<b>\$38,944</b>	<b>\$ 39,847</b>	<b>\$ 40,212</b>	<b>\$ 39,960</b>	<b>\$ 3,991</b>	<b>11.1%</b>
<b>Expenditures</b>								
Net Agency Appropriations	\$ 16,200	\$ 16,595	\$16,920	\$ 17,258	\$ 17,597	\$ 17,939	\$ 1,739	10.7%
<b>Original Pension Contributions</b>	<b>\$ 6,046</b>	<b>\$ 6,691</b>	<b>\$ 6,751</b>	<b>\$ 6,912</b>	<b>\$ 7,029</b>	<b>\$ 7,174</b>	<b>\$ 1,128</b>	<b>18.7%</b>
Reduction Due to Reform	\$ -	\$ (1,171)	\$ (1,180)	\$ (1,303)	\$ (1,068)	\$ (630)	na	na
<b>New Pension Contributions<sup>4</sup></b>	<b>\$ 6,046</b>	<b>\$ 5,520</b>	<b>\$ 5,571</b>	<b>\$ 5,609</b>	<b>\$ 5,961</b>	<b>\$ 6,544</b>	<b>\$ 497</b>	<b>8.2%</b>
Healthcare	\$ 7,313	\$ 7,795	\$ 7,912	\$ 8,030	\$ 8,150	\$ 8,273	\$ 960	13.1%
Medicaid ACA Costs	\$ -	\$ -	\$ 53	\$ 119	\$ 143	\$ 190	\$ 190	na
Group Insurance Payments	\$ 1,565	\$ 1,850	\$ 1,943	\$ 2,040	\$ 2,142	\$ 2,249	\$ 684	43.7%
Debt Service and Transfers	\$ 4,596	\$ 4,611	\$ 4,883	\$ 4,989	\$ 4,365	\$ 3,830	\$ (767)	-16.7%
Increase in Local Government Distribution from Income Taxes <sup>5</sup>	\$ 24	\$ 99	\$ 105	\$ 113	\$ 121	\$ 129	\$ 105	436.5%
Increase EITC (phase in 15% of federal credit)	\$ -	\$ 44	\$ 90	\$ 115	\$ 117	\$ 119	na	na
<b>Total Expenditures</b>	<b>\$ 35,744</b>	<b>\$ 36,514</b>	<b>\$37,478</b>	<b>\$ 38,272</b>	<b>\$ 38,597</b>	<b>\$ 39,272</b>	<b>\$ 3,528</b>	<b>9.9%</b>
<b>Operating Surplus (Deficit)</b>	<b>\$ 225</b>	<b>\$ 1,261</b>	<b>\$ 1,467</b>	<b>\$ 1,574</b>	<b>\$ 1,615</b>	<b>\$ 688</b>	<b>\$ 463</b>	<b>205.3%</b>

<sup>1</sup>Income tax rates retroactively increased on January 1, 2015 to 4.25% for individuals and 6.0% for corporations, then reduced on January 1, 2018 to 4.0% for individuals and 5.6% for corporations.

<sup>2</sup>Also permits local governments to extend municipal sales tax to food and non-prescription drugs.

<sup>3</sup>Anticipated delay in implementation due to adoption of tax collection procedures by organizations not currently affected by sales tax.

<sup>4</sup>Assumes savings from pension reforms begin in FY2016 and includes supplemental payments.

<sup>5</sup>Includes increased local revenues due to tax on retirement income; does not include any increase due to sales tax on food, drugs or services.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds)*, FY16-FY18, December 31, 2014; Communication with the Illinois Department of Revenue, January 21, 2015; Civic Federation calculations.

The following table shows the use of annual surpluses from the comprehensive plan to make payments toward the backlog of unpaid bills. The Civic Federation also recommends the establishment of an adequate rainy day fund and as shown in the table below. Under the comprehensive proposal, the State could make a significant deposit of \$646 million 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.

**State of Illinois Backlog of Unpaid Bills and Rainy Day Fund  
Comprehensive Plan FY2015-FY2020 (in \$ millions)**

	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
Beginning of Year	\$ (6,184)	\$ (5,959)	\$ (4,698)	\$ (3,231)	\$ (1,657)	\$ (42)
Surplus (Deficit)	\$ 225	\$ 1,261	\$ 1,467	\$ 1,574	\$ 1,615	\$ 688
<b>(Unpaid Bills)/Rainy Day Fund</b>	<b>\$ (5,959)</b>	<b>\$ (4,698)</b>	<b>\$ (3,231)</b>	<b>\$ (1,657)</b>	<b>\$ (42)</b>	<b>\$ 646</b>

Source: Governor's Office of Management and Budget, *Three Year Budget Projection (General funds), FY16-FY18*, December 31, 2014; Communication with the Governor's Office of Management and Budget; Civic Federation calculations.

By broadening the tax base while controlling increases in expenditures, the State could pay down just under half of the backlog of bills by the end of FY2017 and completely eliminate the backlog within five years, even as income tax rates are rolled back in FY2018 and the State sales tax exemptions for food and over-the-counter drugs are reinstated in FY2020. The tax base remaining after FY2020 would be more sustainable due to the elimination of some exemptions and the inclusion of services in the sales tax base.

It should be noted that the budget plan above assumes the lower pension payments based on the pension reform law passed in December 2013. Currently the law is before the Illinois Supreme Court and it is uncertain whether some or all of the new pension law will be upheld by the court.

Fortunately, the comprehensive plan includes surpluses adequate to absorb the financial impact given the possibility that the State's new pension law may not survive legal challenge. If the original contribution amount shown is paid by the State in FY2016 it would reduce the amount of the unpaid bills that could be eliminated by \$5.4 billion over the full five-year plan, but the State would still manage to make balanced budgets each year.

Assuming the pension law is upheld, the State would be able to eliminate the full \$6.2 billion bill backlog from the end of FY2014 and deposit \$646 million in a rainy day fund by the end of FY2020. Going forward the State would be able to continue to make deposits into the rainy day fund with a target reserve of 10.0% of General Fund revenues.

In order to limit operating spending outside the General Funds, the State should also forgo the additional income tax diversions that began in FY2015 to fund human services and education spending.<sup>98</sup> These diversions each reduce State resources by 1/30 of the individual income tax receipts and allow for a significant amount of operating expenditures to be shifted outside of the annual budget process.

Illinois has not maintained a functional rainy day fund, although a law was enacted in 2004 to build such a fund.<sup>99</sup> 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. 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.

However, transfers based on the statutory formula have not occurred, apparently because annual revenue projections did not meet the threshold requirement.<sup>100</sup> The Budget Stabilization Fund was originally funded at \$226 million in 2001 by a transfer from the Tobacco Settlement

<sup>98</sup> Public Act 96-1496, enacted on January 13, 2011.

<sup>99</sup> Public Act 93-660, enacted on February 2, 2004.

<sup>100</sup> The law was amended to prohibit any deposits into the fund in FY2008.

Recovery Fund.<sup>101</sup> It received a single additional one-time infusion of \$50 million in FY2004.<sup>102</sup> The Budget Stabilization Fund had \$276 million at the end of FY2014—less than 1% of General Funds revenues of \$36.8 million.<sup>103</sup>

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.<sup>104</sup> 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.<sup>105</sup>

The Civic Federation plan would deposit the full \$646 million surplus at the end of FY2020 into a new rainy day fund and would put the State in a position to make significant annual deposits with the achievable goal of accumulating reserves equal to 10% of General Funds resources.<sup>106</sup>

Finally, the plan provides additional direct funding to local governments totaling \$671 million between FY2016 and FY2020. 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.

Additional assistance not included in the table above would be provided by the temporary elimination of the State exemption for food and non-prescription drugs and the expansion of the municipal food and drug rate to 1.25% from the current 1.0%. Local governments in crisis should also be allowed to access much-needed additional revenue through the elimination of the local food and non-prescription drug exemption and, eventually, the expansion of the sales tax base to additional services.

The comprehensive long-term financial plan shown above illustrates the possibility that with significant policy changes the State could achieve all of the goals proposed by the Civic Federation while also proving income tax relief over the next five years.

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<sup>101</sup> State of Illinois, Comprehensive Annual Finance Report for Fiscal Year Ended June 30, 2001, pp. I-13 to I-14.

<sup>102</sup> State of Illinois, Governor's Office of Management and Budget, *Fiscal Year 2004 – Year End Financial Overview*, p. 3.

<sup>103</sup> State of Illinois, General Obligation Bonds, Series of May 2014, *Supplement to the Official Statement*, July 18, 2014.

<sup>104</sup> Commission on Government Forecasting and Accountability, *Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 88.

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

<sup>106</sup> Commission on Government Forecasting and Accountability, *Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 99.

## **Civic Federation Recommendations**

This section presents the Civic Federation’s recommendations for the State of Illinois’ FY2016 budget as well as long-term reforms to stabilize the State’s financial condition. Based on the analysis in this report, the following steps should be taken by the Governor and General Assembly in fixing the FY2015 budget, developing the FY2016 budget and planning for the budget years through FY2020.

### ***Issue 1: Backlog of Unpaid Bills***

As shown in this report, the State of Illinois is expected to end FY2015 with an estimated backlog of unpaid bills of \$6.4 billion, based on the enacted budget. Although the current total is well below the fiscal year-end peak of approximately \$8.8 billion in FY2012, the backlog still represents 17.4% of total FY2015 General Funds resources. Given existing spending trends and expected revenue losses under current law, the backlog could grow to more than \$28 billion by the end of FY2020 if nothing is done to counteract those trends.

Until the State eliminates this backlog, it will not have completed its recovery from the economic downturn that ended nearly five years ago. Because of the backlog, the State begins each fiscal year in a hole, using revenue from the current year to pay off the previous year’s bills and reducing resources available for current spending. Credit rating agencies have repeatedly cited the large backlog of unpaid bills as a major reason for giving Illinois lower ratings than any other state.<sup>107</sup>

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 government agencies across the State. The 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 easily quantifiable but undoubtedly significant.

It is essential that the Governor and General Assembly limit spending increases and dedicate budget surpluses to paying down the bill backlog.

### **Civic Federation Recommendation on Unpaid Bills**

**The Civic Federation recommends that the State of Illinois eliminate its backlog of unpaid bills within the next five years by establishing spending controls that create annual operating surpluses to pay down the bill backlog.**

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<sup>107</sup> For example, see Moody’s Investors Service, *Illinois Tax-Rate Extension, Pension Reforms Would Reduce Fiscal Stress*, April 18, 2014.

### ***Issue 2: Revenue Cliff 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. State resources dropped dramatically in the current fiscal year due to the partial rollback of the income tax increase passed in FY2011, which reduces the individual rate to 3.75% from 5.0% and the corporate rate to 5.25% from 7.0%. Total General Funds revenues (excluding interfund borrowing) decline by \$1.9 billion in FY2015 to \$34.9 billion and by an additional \$2.8 billion in FY2016 to \$32.1 billion. This amounts to an aggregate two-year decline of \$4.7 billion, or 12.8% of the FY2014 total of \$36.8 billion.

Even after several years of underlying growth, General Funds revenues are projected to total only \$35.4 billion in FY2020, which is still \$1.4 billion below the peak in FY2014. Based on the analysis of net agency appropriations in the previous section, reducing spending alone is not a practical solution. Net agency appropriations would need to be reduced by 25.4% in FY2016 from current FY2015 levels simply to balance the budget and held at this level for the next five fiscal years in order to slowly pay off the backlog of bills by the end of FY2020.

After removing elements of the budget that are difficult to change due to law, contract or court order, most of the cuts would likely be centered on education and human services programs that are not federally reimbursed under Medicaid. Cuts of this size could involve the elimination of large portions of government services widely regarded as essential.

In light of a \$6.2 billion accumulated backlog of unpaid bills at the end of FY2014, the State is not in a position to abruptly reduce tax rates without a plan to balance its operating budget and pay down its bills. Due to the lack of action taken to address the revenue cliff in the FY2015 budget, the State must now retroactively move to stabilize the State's finances.

In addition, savings from the new pension law that were slated to begin in FY2016 are in question due to the ongoing legal challenges and pending ruling on the law by the Illinois State Supreme Court regarding the law. The projections included in this report include more than \$5.0 billion in savings from FY2016 through FY2020 that could be eliminated if the court rules against the new State pension law.

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. By reducing the income tax rates gradually over the next five years, the State could avoid the dramatic losses in any one year caused by current tax policy, while providing significant tax relief. A gradual reduction allows for realistic spending adjustments to mitigate operating losses caused by the lower tax rates.

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

**The Civic Federation recommends the elimination of the revenue cliff in FY2015 by retroactively increasing the income tax rates in the current fiscal year and then rolling them back gradually thereafter. By reinstating a portion of the higher rate to 4.25% for individuals and 6.0% for corporations the State can 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. Both the individual income tax rate and the corporate income tax rate should be gradually reduced by a total of 20% from the higher temporary rates of 5.0% for individuals and 7.0% for corporations. The Civic Federation proposes achieving the total reduction by reducing the individual income tax rate to 4.0% from 4.25% and the corporate rate to 5.6% from 6.0% on January 1, 2018.**

### ***Issue 3: 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.<sup>108</sup> 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.<sup>109</sup> The Illinois Comptroller reports that this exemption of federally taxable retirement income reduced individual income tax revenues by \$2.2 billion in FY2013.<sup>110</sup> 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.<sup>111</sup>

Excluding Social Security income, all other federally taxable retirement income exempted by Illinois as of 2012 totaled \$39.7 billion.<sup>112</sup> 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 \$30.8 billion in FY2012. 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 6.5%, while revenue from the individual income tax has averaged only 2.7% growth over the last 15 years.<sup>113</sup> 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.

### ***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 facilitate the rollback of individual income tax rates and enhance the State's fiscal stability by providing access to a faster growing portion of the State's income tax base.**

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<sup>108</sup> 35 ILCS 5/203.

<sup>109</sup> 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](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 February 5, 2015)

<sup>110</sup> Illinois Comptroller, *Tax Expenditure Report, Fiscal Year 2013*, p. 6.

<sup>111</sup> Illinois Comptroller, *Tax Expenditure Report, Fiscal Year 2013*, p. 7.

<sup>112</sup> Internal Revenue Service, SOI Tax Stats – Historic Tables, Illinois 1999-2012. <http://www.irs.gov/uac/SOI-Tax-Stats---Historic-Table-2> (last visited on February 7, 2015)

<sup>113</sup> Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 23.

#### ***Issue 4: Expanding the Sales Tax Base***

According to a recent 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.<sup>114</sup>

The largest exemption from the sales tax is the exclusion of food and drug purchases from the full State rate of 6.25%. This exemption reduced the State's sales tax revenues by \$1.6 billion annually as of FY2013.

Illinois also excludes services from its sales tax base, with the exception of several public utility taxes. A variety of revenue estimates have been produced to illustrate the range of revenue the State may be able to earn 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.<sup>115</sup> However, most states exempt medical services from sales taxes and no state has successfully endeavored to add all services possible after its sales tax had been established. A narrower application of the sales tax on services that excludes all business-to-business transactions, medical services and professional services and is focused on general consumer services would increase annual General Funds Revenues by \$937 million.<sup>116</sup>

During the 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.<sup>117</sup> The largest revenue generating area of the Governor's proposal was taxing professional services such as attorneys (\$127 million), customer computer programming 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).

The revenue estimate for taxing the 32 services was based on a FY2011 report produced by the Commission on Government Forecasting and Accountability.<sup>118</sup> The items included in the list are expected to be controversial and face intense opposition and legal challenges from a variety of special interest groups.

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.<sup>119</sup> Even after legislative action is taken to authorize taxing services, the complexity of collecting the tax may require new rules for sourcing and other administrative guidelines. Some of the new procedures may require review and approval by the legislature's Joint Committee on Administrative Rules. Other delays due to technology acquisition for businesses that do not currently collect sales taxes and

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<sup>114</sup> Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 66.

<sup>115</sup> Communication between the Civic Federation and Illinois Department of Revenue, January 21, 2015.

<sup>116</sup> Communication between the Civic Federation and Illinois Department of Revenue, January 21, 2015.

<sup>117</sup> See Appendix D for a full list of these services.

<sup>118</sup> Commission on Government Forecasting and Accountability, *Service Taxes 2011 Update*, April 2011, pp. 18-22.

<sup>119</sup> Communication between the Civic Federation and Illinois Department of Revenue, January 21, 2015.

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 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 exempted from the 5.0% rate collected for the State and additional 0.25% rate collected by the State but passed through to local governments.<sup>120</sup> The exemption for food purchases makes up approximately \$1.0 billion of the State's expense. Drugs and medical devices make up the remaining \$600 million with non-prescription drugs making up roughly 7.5% of that total.

Although very few States apply their full tax sales tax rate to food purchases and prescription drugs, most do not exempt non-prescription drugs.<sup>121</sup> 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.

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 the 32 services recommended by Governor Rauner and temporarily eliminate the sales tax exemption for food and non-prescription 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 non-prescription drugs could be reinstated by FY2020.**

### ***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.

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<sup>120</sup> 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.

<sup>121</sup> Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 23.

As of 2013 single individuals claiming no dependents and income less than \$14,340 could claim a maximum federal credit of \$487 and married individuals without children could claim the same credit if their income was below \$19,680. For a married couple with three or more children and an income of \$51,567 or less the maximum credit that could be claimed was \$6,044. Single individuals with three or more children may also claim the highest credit level of \$6,044 with an income of \$46,227 or less.

Illinois currently matches 10% of the federal credit, which cost the State an estimated \$162.2 million in FY2013. If the credit was increased by 50%, payments would increase by \$302 for the highest level of benefits available to married individuals with three or more dependents.

#### **Civic Federation Recommendation on the Earned Income Tax Credit**

**The Civic Federation recommends mitigating some of the impact of the tax measures included in the comprehensive plan on lower income residents by phasing in a 50% increase to the amount of the federal EITC match by the State of Illinois. The match should be increased by 2.0% in both FY2016 and FY2017, and then an additional 1.0% in FY2018 to bring the total match to 15.0%.**

#### ***Issue 6: Revenue Diversions and Special Funds***

Illinois has approximately 550 Special State Funds, which were created to receive earmarked revenues that are only used for designated purposes. Special Funds consist of all State accounts except General Funds, Highway Funds, Bond Financed Funds, Debt Service Funds, Federal and State Trust Funds and Revolving Funds.<sup>122</sup>

Over time the number of Special Funds has increased, consuming ever larger portions of the State budget. Special Funds receive resources through transfers or appropriations from General Funds or directly from other sources, such as designated State taxes and fees and federal grants.

Beginning on February 1, 2015, State law required that a specific share of individual income tax revenues be diverted from General Funds to provide additional funding for education and human services.<sup>123</sup> This requirement, which is contained in a provision of the 2011 law that temporarily increased income tax rates, was designed to provide a guaranteed source of funding to these two areas of the budget after the income tax rate increases began to be phased out.<sup>124</sup>

Under the new requirement, a portion of net revenues from individual income taxes will go to two new funds: the Fund for the Advancement of Education and the Commitment to Human Services Fund.<sup>125</sup> Each of the new funds will receive 1/30 (about 3.33%) of net individual income tax revenues annually through FY2024; in February 2025 the share increases to 1/26 (about 3.85%).

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<sup>122</sup> Illinois State FY2015 Budget, pp. 1-7 and 9-7. General Funds pay for the regular operating and administrative expenses of most State agencies. Highway Funds support State and local transportation-related activities. Bond Financed Funds pay for capital improvements. Debt Service Funds accumulate money used to pay interest and principal on debt obligations. Federal Trust Funds support grants and contracts between State agencies and the federal government. State Trust Funds hold funds for other entities or individuals. Revolving Funds finance the operation of State agencies that provide services to other State agencies on a cost reimbursement basis and support local capital projects.

<sup>123</sup> The diversion also applies to net receipts from estates and trusts.

<sup>124</sup> Public Act 96-1496, enacted on January 13, 2011. The provision can be found at 35 ILCS 5/901 (f) and (g).

<sup>125</sup> Net revenues exclude the share of individual income tax revenues diverted to pay income tax refunds.

In the enacted FY2015 budget, a total of \$400 million was appropriated from the two new funds. This amount is expected to grow to \$833 million in FY2016 and to reach \$956 million in FY2020.<sup>126</sup>

Although this revenue is still available to the State, it is essentially hidden from public view due to the intense focus on General Funds during the annual budget process. The diversion makes the budget process less transparent and hinders lawmakers' ability to direct resources each year to the areas of highest priority.

The new diversions are the latest proof that the State should review all of its Special Funds with the aim of eliminating the vast majority of them. In most cases, segregating revenues into special purpose funds is a practice that should be reserved for a few priority or mandatory programs. The State should be afforded maximum flexibility in allocating resources to meet policy priorities. One of the exceptions might involve Medicaid, a program in which State spending is reimbursed by the federal government at a general rate of 50.76%.<sup>127</sup> A great deal of confusion surrounds State Medicaid spending because appropriations are shown on a gross basis (including federal spending) in the General Funds budget, while State resources used for Medicaid are less than half the appropriated amount. In the case of Medicaid, consideration should be given to consolidating all resources in a separate fund outside of the General Funds budget, if transparency in the process can be maintained.

#### **Civic Federation Recommendation on Revenue Diversion and Special Funds**

**The Civic Federation recommends repealing the new statutory diversions of income tax revenues from General Funds and eliminating the vast majority of Special Funds to increase lawmakers' flexibility to allocate resources annually to the areas of highest priority. Any future efforts to shift resources outside of the scrutiny of the General Funds budgeting process should be carefully scrutinized.**

#### ***Issue 7: Interfund Borrowing and Fund Sweeps***

The State of Illinois FY2015 budget includes authorization to borrow up to \$650 million of the balances available in the State's Special Funds to pay for its ongoing operations. The measure is intended to offset some of the \$1.9 billion in General Funds revenue losses due to the roll back of the income tax rates instead of reducing spending or raising other revenues. However, due to the requirement that the amounts used to fund the FY2015 budget are repaid within the next 18 months the measure increases future budget stress and extends the current budget crisis into future years. The one-time resource also creates a gap in the subsequent FY2016 budget year.

The Civic Federation opposes borrowing for operations but recognizes the need for additional resources to adequately fund the State's FY2015 operating costs.

In the past the State has accessed surplus fund balances in the Special Funds to reduce annual budget deficits without the requirement to repay these amounts. This is known as fund sweeps. In FY2010 the State approved fund sweeps totaling \$351.7 million as part of the operating budget.<sup>128</sup> After accounting for the appropriations needs of the Special Funds the State was able

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<sup>126</sup> Civic Federation calculation based on revenue estimates included on page 18.

<sup>127</sup> The current reimbursement rate is 100% for newly eligible recipients under the Affordable Care Act.

<sup>128</sup> Public Act 96-0044, enacted on July 15, 2009.

to access a total of \$287 million in additional General Funds operating resources through funds sweeps.<sup>129</sup>

The State of Illinois has approximately 550 Special Funds that receive earmarked revenues and are used for designated purposes outside of and sometimes to supplement the regular General Funds operating budget. The Civic Federation believes that segregated funds should only be used for high priority areas of the State's budget. The Federation is also concerned that the excessive use of fund delineation by the State shields a large portion of the State's annual spending from the scrutiny of the annual budget process.

### **Civic Federation Recommendation on Interfund Borrowing and Fund Sweeps**

**The Civic Federation recommends that the State of Illinois avoid interfund borrowing in FY2015 and instead pursue fund sweeps totaling \$250 million. As part of the review of the State's Special Funds to determine the amount of surplus balances that can be transferred to the General Funds, the State should consolidate and eliminate any of the Special Funds that do not serve a critical purpose. The State should shift those areas of the budget funded by Special Funds to the General Funds budget to be considered for appropriation as part of the annual budget process.**

### ***Issue 8: Local Government Revenue Sharing***

The City of Chicago and many other local governments in Illinois are facing ongoing financial pressure due to severely underfunded pensions. Under existing law, Chicago is required to increase its statutory pension contributions by \$627.4 million next year, exacerbating its structural deficit and rising debt service payments.<sup>130</sup>

Despite such problems, local governments did not share in the additional revenues collected by the State due to the 2011 income tax rate increases. In enacting the tax increases, the State limited the previous 10% share of net income taxes distributed to local governments to only the original 3.0% individual income tax rate and 4.8% corporate income tax rate.<sup>131</sup> This change maximized the revenues available to the State as it attempted to recover from the Great Recession.

Going forward, the State should try to share additional revenues with local governments in light of their financial distress. The budget plan proposed by the Civic Federation is not able to give local governments a share of the revenues from higher income tax rates while at the same time meeting other goals for the State's finances. However, the plan offers the following benefits for local governments:

- Tax on retirement income: Local governments receive 10% of the net revenues generated by the proposed elimination of the State's exemption for retirement income, based on the original 3.0% tax rate rather than the higher rate proposed by the Civic Federation. This

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<sup>129</sup> Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary, Fiscal Year 2015*, updated September 9, 20-14, p. 228

<sup>130</sup> For more information on the financial condition of the City of Chicago, see The Civic Federation, *City of Chicago FY2015 Proposed Budget: Analysis and Recommendations*, November 3, 2014, <http://www.civicfed.org/sites/default/files/City%20of%20Chicago%20FY2015%20Proposed%20Budget%20Analysis.pdf> (last visited on February 8, 2015).

<sup>131</sup> Income tax revenues are distributed to local governments through a transfer out of General Funds to the Local Government Distributive Fund. See 35 ILCS 5/901(b).

is expected to provide local governments with \$24 million in FY2015, rising to \$129 million by FY2020.

- Expansion of sales tax to services: The State's general sales tax rate of 6.25% would be applied to certain services. The State keeps 5% of the purchase price and the remaining 1.25% is paid to local governments. Local governments would receive an estimated \$175 million from this expansion in FY2020. In addition, the Civic Federation's proposal would allow local governments to levy a municipal sales tax on services.
- Tax on food and non-prescription drugs: The State's general sales tax rate of 6.25% does not apply to food and drugs; instead, the State taxes these items at 1.0% and distributes the proceeds to municipalities. The Civic Federation's plan would tax food and non-prescription drugs at the general sales tax rate until FY2020. As a result, municipalities would receive a 1.25% share, rather than 1.0%.<sup>132</sup> In addition, local governments should be permitted to expand the municipal sales tax to food and non-prescription drugs, and the local option would not automatically terminate in FY2020.<sup>133</sup>

**Civic Federation Recommendation on Local Government Revenue Sharing**

**In light of the financial pressures facing Illinois municipalities, the State should allow local governments to impose municipal taxes on services and on food and non-prescription drugs.**

***Issue 9: Employee and Retiree Health Insurance Costs***

Group health insurance is a benefit provided to more than 360,000 employees, retirees and their dependents pursuant to State law and collective bargaining agreements. Although the State made progress in controlling the program's costs over the past few years, these efforts hit a roadblock in 2014.

On July 3, 2014, the Illinois Supreme Court held that State subsidies for retiree health insurance premiums are a retirement benefit covered by the pension protection clause of the Illinois Constitution.<sup>134</sup> The ruling was in response to a State law enacted in 2012 that eliminated premium-free health insurance coverage for retirees.<sup>135</sup>

At the time, more than 90% of State retirees did not pay any health insurance premiums.<sup>136</sup> Based on the 2012 law, retirees covered by Medicare were required to pay 1% of their pension

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<sup>132</sup> For the City of Chicago, this could result in an increase in revenue of approximately \$7.6 million a year based on current tax collections on food and drugs by the Regional Transportation Authority. The RTA collects a 1.25% tax on food and drugs in Cook County.

<sup>133</sup> At Chicago's local sales tax rate of 1.25%, this could generate approximately \$37.9 million per year for the City.

<sup>134</sup> Illinois Supreme Court, *Kanerva v. Weems* (2014 IL 115811, July 3, 2014).

<sup>135</sup> Public Act 97-0695, enacted on June 21, 2012.

<sup>136</sup> Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services*, February 17, 2011, p. 2. The State paid the entire bill for health insurance premiums for those who retired prior to 1998. For those who retired beginning in 1998, the State contributed 5% of the premium cost for each full year of service, up to a maximum of 100% for retirees with 20 or more years of service. General Assembly members and constitutional officers could retire with as few as four years of service and not pay any premiums, and judges could retire with as few as six years of service and not pay premiums.

benefit amount for health insurance and those not covered by Medicare were required to pay 2% beginning in FY2014. Those amounts doubled to 2% and 4% in FY2015.<sup>137</sup>

As a result of the high court's decision and subsequent lower court rulings, the State stopped collecting those premiums and is preparing to refund premiums that it had already collected from 90,000 retirees.<sup>138</sup> The additional premiums had been expected to reduce State costs by \$91 million in FY2015.<sup>139</sup>

The increased retiree health insurance premiums were part of a three-year agreement with the State's main labor union, the American Federation of State, County and Municipal Employees (AFSCME), that ends on June 30, 2015. In exchange for wage increases, AFSCME agreed to increased health insurance costs and other changes for both employees and retirees. The State initially forecasted health insurance savings of \$903 million from the contract, which were partially offset by \$222 million in wage increases.<sup>140</sup>

Despite the setback related to the high court ruling, many of these changes apparently have been successful in reining in health insurance costs. State savings have come from moving Medicare-eligible retirees to Medicare Advantage plans, increasing employee contributions and other program changes, according to the Illinois Department of Central Management Services (CMS).

After rising at an average annual rate of 7.1% from \$2.0 billion in FY2009 to \$2.6 billion in FY2013, costs levelled off in FY2014 and were expected to increase by less than 1.0% in FY2015.<sup>141</sup> Before the Illinois Supreme Court ruling, retirees were expected to pay 19.4% of their health insurance costs in FY2015, compared with 1.3% in FY2009; after the ruling, the share in FY2015 declines to approximately 4.4%.<sup>142</sup>

The State's options for controlling retiree health care costs are unclear in the wake of the high court's decision. It remains to be seen, for example, whether a State decision to end its expensive traditional health insurance plan, which allows participants to choose any doctor or hospital, could be challenged successfully in court by retirees.<sup>143</sup> Retirees who are not eligible for Medicare and have not been moved to Medicare Advantage plans generally choose traditional insurance rather than managed care.

However, the court ruling does not apply to current employees. In the new labor agreement to replace the contract that expires at the end of FY2015, the State should reduce its employee health care costs by increasing the share paid by employees and/or reducing health insurance

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<sup>137</sup> Illinois Department of Central Management Services, AFSCME Master Contract, Appendix B, [http://www2.illinois.gov/cms/Employees/Personnel/Documents/emp\\_afscme\\_chg\\_appendixB.pdf](http://www2.illinois.gov/cms/Employees/Personnel/Documents/emp_afscme_chg_appendixB.pdf) (last visited on September 14, 2014).

<sup>138</sup> Doug Finke, "State retirees to get letters on insurance premium settlement," *State Journal-Register*, January 22, 2015.

<sup>139</sup> Communication between the Civic Federation and the Illinois Department of Central Management Services, August 5, 2014 and September 18, 2014.

<sup>140</sup> Illinois Department of Central Management Services, *AFSCME 2012-2015 Contract Summary*, Submission to Commission on Government Forecasting and Accountability, April 16, 2013.

<sup>141</sup> Commission on Government Forecasting and Accountability, *FY2015 Liabilities of the State Employees' Group Health Insurance Program*, March 2014, p. 10.

<sup>142</sup> Communication between the Civic Federation and the Illinois Department of Central Management Services, September 29, 2014.

<sup>143</sup> Although participants in the traditional plan may choose any medical services provider, they receive enhanced benefits for using doctors and hospitals that are members of a network.

benefits. This could be done through further contribution increases or changes in deductibles and co-payments.

State of Illinois employees paid 16.9% of their health insurance costs in FY2014 and 17.7% of their dependents' costs.<sup>144</sup> The contribution level for employees is above the average of 13.0% for public employers in the Kaiser Foundation's 2014 health benefits survey, but below the average of 21% for private, for-profit firms.<sup>145</sup> The contribution level for dependents is well below the Kaiser figures of 24% for public employers and 30% for for-profit firms.

This issue is particularly relevant in light of the excise tax on high-cost health plans beginning in 2018 under the Affordable Care Act. In order to avoid possible payment of this tax, which is widely known as the Cadillac Tax, the State might need to reduce health insurance benefits. The tax is imposed when the total cost of the plan exceeds certain thresholds, which means that shifting costs to workers would not change the potential tax burden.<sup>146</sup>

### **Civic Federation Recommendation on Employee and Retiree Health Insurance Costs**

**In light of the Illinois Supreme Court's recent decision regarding retiree health insurance premiums, the Civic Federation recommends that the State reassess its options to curb costs, including the possibility of eliminating its traditional insurance plan. The Federation also recommends that the State should negotiate future contribution increases for employees, particularly with regard to family coverage, and reductions in coverage.**

### ***Issue 10: Rainy Day Fund***

All governments should place a portion of their general operating revenues in a general fund reserve or "rainy day" fund.<sup>147</sup> 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. Fitch Ratings noted in January 2012, for example, that Illinois' financial options were limited during the recession because it failed to build reserves prior to the Great Recession.<sup>148</sup> In April 2014, Standard & Poor's stated that Illinois' "financial flexibility will continue to be constrained without a meaningful budget stabilization or rainy day fund."<sup>149</sup>

Before the economic downturn in 2007, rating agencies provided a guideline to governments that 3% to 5% of revenues should be set aside in a rainy day fund, according to a recent report by the Illinois General Assembly's Commission on Government Forecasting and Accountability

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<sup>144</sup> Communication between the Civic Federation and the Illinois Department of Central Management Services, September 29, 2014.

<sup>145</sup> The Kaiser Family Foundation and Health Research & Educational Trust, *Employer Health Benefits 2014 Annual Survey*, September 10, 2014, pp. 103-104.

<sup>146</sup> Segal Consulting, "Affordable Care Act's Excise Tax on High-Cost Health Plans," *Health Care Reform Insights*, October 2014.

<sup>147</sup> Government Finance Officers Association, *Best Practice: Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund*, October 2009.

<sup>148</sup> Fitch Ratings, "Fitch Affirms Illinois' GO Bonds at 'A'; Outlook Stable," *news release*, January 5, 2012.

<sup>149</sup> Standard & Poor's, *Developing Story: Illinois Is Facing Crucial Decisions As It Determines Its Credit Path*, April 9, 2014.

(COGFA).<sup>150</sup> The report concluded that rainy day fund caps were often set too low and that even if a state achieved its target amount of funding the amounts were not adequate to cover the drastic revenue declines during the recession.

Approximately 48 states currently have some kind of reserve fund, although the funds in certain states, including Illinois, are not considered true rainy day funds. The COGFA report found that rainy day fund balances around the country have averaged around 2.7% to 4.74% of expenditures in recent years.<sup>151</sup>

Illinois has not maintained a functional rainy day fund, although a law was enacted in 2004 to build such a fund.<sup>152</sup> 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. 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.<sup>153</sup> The Budget Stabilization Fund had \$276 million at the end of FY2014—less than 1.0% of General Funds revenues of \$36.8 billion.<sup>154</sup>

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.<sup>155</sup> 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.<sup>156</sup>

COGFA was recently charged with studying the volatility of Illinois' revenue sources and reviewing options for adequately funding a rainy day fund.<sup>157</sup> The commission concluded that raising the funding goal to 10.0% of General Funds revenues from 5.0% made sense in light of recent revenue volatility.<sup>158</sup> In FY2015 this would represent an increase from \$1.77 billion to \$3.54 billion.

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

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<sup>150</sup> Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 75.

<sup>151</sup> Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 103.

<sup>152</sup> Public Act 93-660, enacted on February 2, 2004.

<sup>153</sup> The law was amended to prohibit any deposits into the fund in FY2008.

<sup>154</sup> State of Illinois, General Obligation Bonds, Series of May 2014, *Supplement to Official Statement*, July 18, 2014, Tables 1 and 1A.

<sup>155</sup> Commission on Government Forecasting and Accountability, *Revenue Volatility Study, Public Act 98-0682*, December 31, 2014, p. 88.

<sup>156</sup> 30 ILCS 105/6z-51(b). The law was amended to defer cash repayment for FY2011 until July 15, 2011.

<sup>157</sup> Public Act 98-0682, enacted on June 30, 2014.

<sup>158</sup> Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 99.

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.<sup>159</sup>

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 FY2020 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.<sup>160</sup>

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

**The State of Illinois should work toward building a rainy day fund equal to 10% of General Funds revenues to cushion the budget from the next economic downturn. Legislation must explicitly indicate when deposits will be made and in what amount and the circumstances under which withdrawals will be allowed.**

### ***Issue 11: Long-Term Financial Plan***

As a government recovers from a financial crisis, it is particularly important to undertake a long-term financial planning process.<sup>161</sup> A long-term financial plan highlights long-range financial issues and helps governments look beyond budget gap-bridging measures, such as one-time or temporary revenue sources, toward remedying structural problems. A time horizon of at least five years for financial planning is recognized as a best practice by the Government Finance Officers Association (GFOA).<sup>162</sup>

Since 2011 the State of Illinois Governor's Office of Management and Budget (GOMB) has been required to issue an annual economic and fiscal policy report by January 1.<sup>163</sup> The report outlines long-term economic and fiscal policy objectives and plans and provides budget projections for the next three fiscal years.

Although these reports have significantly increased publicly available information about the State's fiscal condition, they do not represent the kind of comprehensive financial plan recommended by public finance experts. A long-term financial plan goes beyond financial forecasting and develops strategies "to achieve long-term sustainability in light of the government's service objectives and goals."<sup>164</sup>

According to the GFOA and the National Advisory Council on State and Local Budgeting, a long-term financial plan should include an analysis of historic financial trends; an assessment of problems and opportunities facing the jurisdiction including an analysis of the financial environment; a description of financial policies, service level preferences and financial goals; a five-year forecast of revenues and expenditures that uses alternative economic, planning and policy assumptions; an analysis of liabilities and fund balance; a narrative that discusses

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<sup>159</sup> Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 103.

<sup>160</sup> Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98-0682*, December 31, 2014, p. 102.

<sup>161</sup> Shayne Kavanagh, *Fiscal First Aid and Financial Recovery*, (Chicago: GFOA, 2011), pp. 37-44.

<sup>162</sup> Government Finance Officers Association, *Best Practice: Long-Term Financial Planning*, February 22, 2008.

<sup>163</sup> Public Act 96-1354, enacted on July 28, 2010.

<sup>164</sup> Government Finance Officers Association, *Best Practice: Long-Term Financial Planning*, February 22, 2008.

strategies, actions and scenarios needed to address financial imbalances and other long-term issues; and the identification of key assumptions used to develop the plan.<sup>165</sup>

**Civic Federation Recommendation on Long-Term Financial Plan**

**The Civic Federation recommends that the State of Illinois work on a formal, five-year financial plan to be published prior to the release of the FY2017 budget. The plan should be updated annually to reflect actual budget results and changes in economic conditions.**

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<sup>165</sup> See Shayne Kavanagh, *Financing the Future: Long-Term Financial Planning for Local Government* (Chicago: GFOA, 2007) and National Advisory Council on State and Local Budgeting, *Recommended Budget Practices*, (Chicago: GFOA, 1998), pp. 37-44.

## APPENDIX A: GENERAL FUNDS PENSION CONTRIBUTIONS UNDER EXISTING LAW

This appendix provides data on projected General Funds pension contributions from FY2015 through FY2045 under Public Act 88-0593, which took effect in 1995, and subsequent amendments.

The FY2015 contribution is the appropriation in the current year's budget. The FY2016 contribution is based on the amount certified by the Boards of Trustees of the five retirement systems in January 2015. The projections for future years are based on the most recent actuarial valuations by the retirement systems, as of June 30, 2014.

State pension contributions come from both General Funds and other funds. For contributions from FY2016 through FY2045, it was assumed that General Funds contributions to the State Employees' Retirement System (SERS) represent 65% of total State contributions to SERS. It was also assumed that General Funds contributions to the State Universities Retirement System (SURS) are net of \$131 million a year in unclaimed property resources from the State Pensions Fund and \$46 million a year from federal, trust and other sources.<sup>166</sup>

State of Illinois General Funds Pension Contributions Under Existing Law: FY2015-FY2045 (in \$ millions)*							
FY2015	\$ 6,046	FY2023	\$ 7,911	FY2031	\$ 10,184	FY2039	\$ 13,064
FY2016	\$ 6,691	FY2024	\$ 8,161	FY2032	\$ 10,491	FY2040	\$ 13,324
FY2017	\$ 6,751	FY2025	\$ 8,421	FY2033	\$ 10,810	FY2041	\$ 13,583
FY2018	\$ 6,912	FY2026	\$ 8,711	FY2034	\$ 11,659	FY2042	\$ 13,841
FY2019	\$ 7,030	FY2027	\$ 9,011	FY2035	\$ 11,953	FY2043	\$ 14,104
FY2020	\$ 7,175	FY2028	\$ 9,302	FY2036	\$ 12,240	FY2044	\$ 14,372
FY2021	\$ 7,409	FY2029	\$ 9,603	FY2037	\$ 12,521	FY2045	\$ 14,644
FY2022	\$ 7,654	FY2030	\$ 9,892	FY2038	\$ 12,796		

\*TRS contributions for FY2017 through FY2020 do not include reimbursements for minimum benefit payments, which amounted to \$1.0 million in FY2015 and \$900,000 in FY2016. SERS contributions are based on the assumption that 65% of total contributions come from General Funds in FY2016 through FY2020, the same percentage as in FY2015, and do not include debt service on 2003 pension bonds, which amounted to \$52.4 million in FY2015 and \$52.0 million in FY2016. SURS contributions are based on the assumption that the State Pensions Fund accounts for \$131 million a year after FY2015, the same amount used in the State's three-year budget projection in December 2014, and that federal, trust and other sources account for \$46 million a year from FY2017 through FY2020, the same amount as in FY2016.

Source: Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems Financial Condition as of June 30, 2013*, March 2014, pp. 98 and 133-138; Teachers' Retirement System of the State of Illinois, *Actuarial Valuation Report: June 30, 2014 Actuarial Valuation of Pension Benefits*, October 30, 2014, p. 53; State Employees' Retirement System of Illinois, *Draft Annual Actuarial Valuation as of June 30, 2014*, October 21, 2014, p. 27; State Universities Retirement System of Illinois, *Draft Actuarial Valuation Report as of June 30, 2014*, October 9, 2013, pp. 26 and 105; Judges' Retirement System of Illinois, *Draft Annual Actuarial Valuation as of June 30, 2014*, October 24, 2014, pp. 24-25; General Assembly Retirement System of Illinois, *Draft Annual Actuarial Valuation as of June 30, 2014*, October 24, 2014, pp. 25-26.

<sup>166</sup> The assumption about resources from the State Pensions Fund is based on figures used in the State's three-year budget projection issued on December 31, 2014 and is below the \$197 million allocated from the State Pensions Fund in FY2015.

## APPENDIX B: ESTIMATED GENERAL FUNDS PENSION CONTRIBUTIONS UNDER EXISTING LAW AND NEW LAW

This appendix provides data on projected General Funds pension contributions under Public Act 88-0593, as amended, and Public Act 98-0599, which has not been implemented. The assumptions used to determine the portion of total State contributions from General Funds under either law are the same as those used in Appendix A.

After the new pension law was enacted, actuaries for the retirement systems and for the legislature's Commission on Government Forecasting and Accountability (COGFA) reviewed the impact of the changes on accrued pension liabilities and required State contributions.<sup>167</sup> These reviews were based on actuarial valuations as of June 30, 2013, the most recent available data at the time.

The Civic Federation used the review done by COGFA's actuary to compare required contributions under the new and old laws, updated for the actuarial valuation done as of June 30, 2014. The difference between projected contributions under the two laws based on the 2013 valuation was applied to the projected contributions under the old law to estimate contributions under the new law.

Projected State of Illinois General Funds Pension Contributions Under Existing Law and Public Act 98-0599 (in \$ millions)*						
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020
Existing Law	\$ 6,046.4	\$ 6,690.6	\$ 6,750.9	\$ 6,912.2	\$ 7,029.4	\$ 7,174.4
Public Act 98-0599	\$ 6,046.4	\$ 5,519.7	\$ 5,571.4	\$ 5,608.7	\$ 5,961.5	\$ 6,543.8

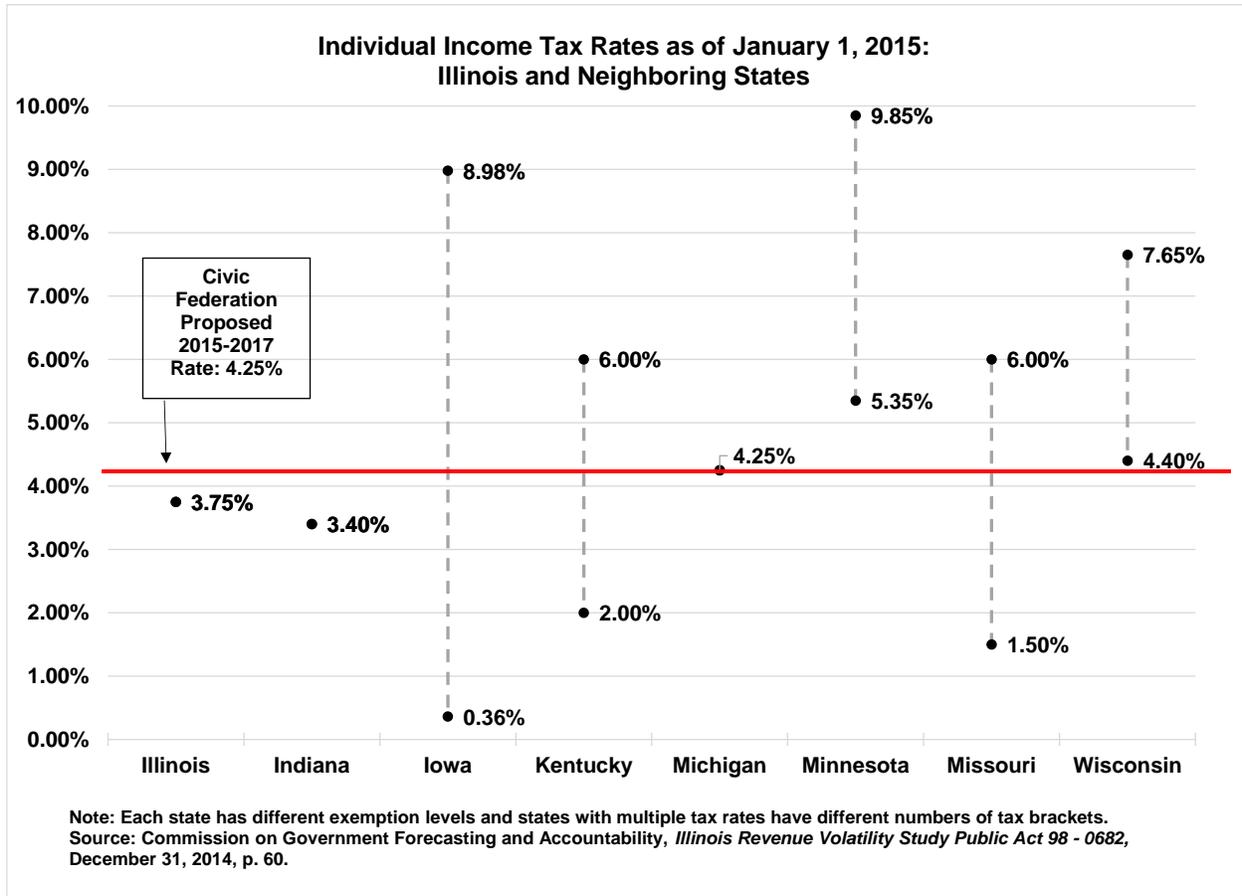
\*TRS contributions for FY2017 through FY2020 do not include reimbursements for minimum benefit payments, which amounted to \$1.0 million in FY2015 and \$900,000 in FY2016. SERS contributions are based on the assumption that 65% of total contributions come from General Funds in FY2016 through FY2020, the same percentage as in FY2015, and do not include debt service on 2003 pension bonds, which amounted to \$52.4 million in FY2015 and \$52.0 million in FY2016. SURS contributions are based on the assumption that the State Pensions Fund accounts for \$131 million a year after FY2015, the same amount used in the State's three-year projection in December 2014 and that federal, trust and other sources account for \$46 million a year from FY2017 through FY2020, the same amount as in FY2016.

Source: Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems Financial Condition as of June 30, 2013*, March 2014, pp. 98 and 133-138; Teachers' Retirement System of the State of Illinois, *Actuarial Valuation Report: June 30, 2014 Actuarial Valuation of Pension Benefits*, October 30, 2014, p. 53; State Employees' Retirement System of Illinois, *Draft Annual Actuarial Valuation as of June 30, 2014*, October 21, 2014, p. 27; State Universities Retirement System of Illinois, *Draft Actuarial Valuation Report as of June 30, 2014*, October 9, 2013, pp. 26 and 105; Judges' Retirement System of Illinois, *Draft Annual Actuarial Valuation as of June 30, 2014*, October 24, 2014, p. 24; General Assembly Retirement System of Illinois, *Draft Annual Actuarial Valuation as of June 30, 2014*, October 24, 2014, p. 25; Commission on Government Forecasting and Accountability, *Segal Actuarial Cost Study on P.A. 98-0599 (SB 1)*, March 26, 2014, Exhibits 4-6; Teachers' Retirement System of the State of Illinois, *June 30, 2013 Actuarial Valuation of Pension Benefits*, January 2014, p. 36; State Employees' Retirement System of Illinois, *Annual Actuarial Valuation as of June 30, 2013*, October 29, 2013, p. 24; State Universities Retirement System of Illinois, *Actuarial Valuation Report as of June 30, 2013*, October 8, 2013, p. 26; Judges' Retirement System of Illinois, *Annual Actuarial Valuation as of June 30, 2013*, October 25, 2013, p. 7; General Assembly Retirement System of Illinois, *Annual Actuarial Valuation as of June 30, 2013*, October 23, 2013, p. 7.

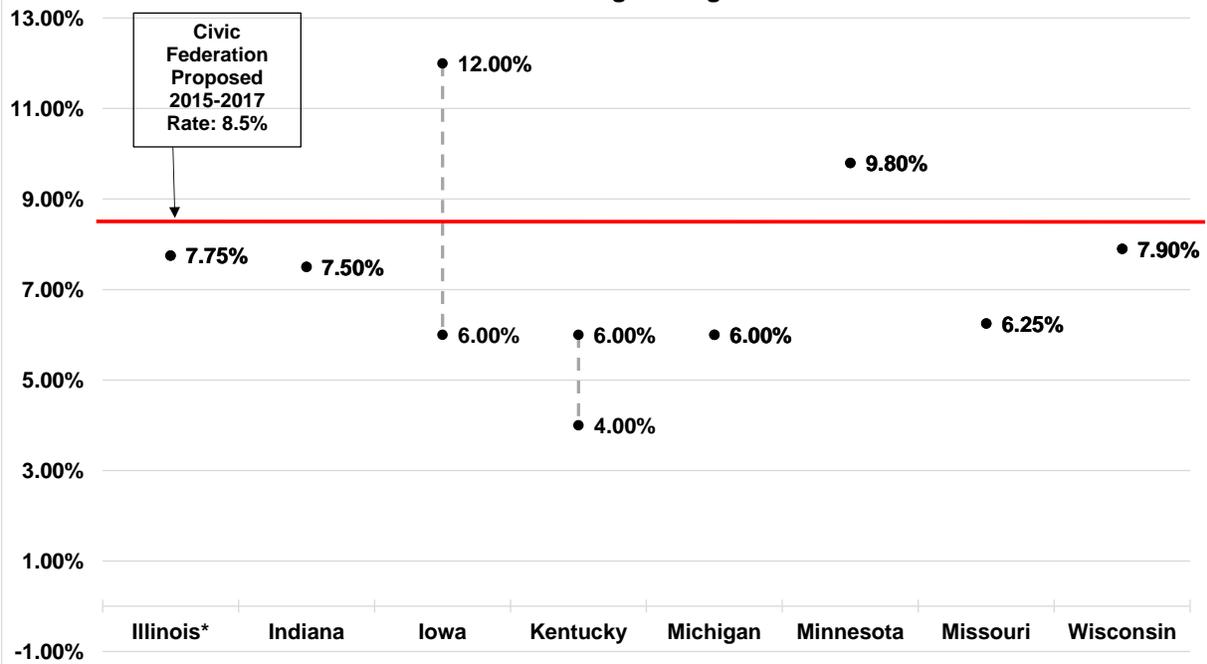
<sup>167</sup> Public Act 98-0599 covers four of the State's retirement systems: the Teachers', Employees' and State Universities Retirement Systems. It does not apply to the Judges' Retirement System.

## APPENDIX C: INCOME TAX RATES IN ILLINOIS AND NEIGHBORING STATES

The following charts compare Illinois' current and proposed individual and corporate income tax rates to those in neighboring states.



**Corporate Income Tax Rates as of January 1, 2015:  
Illinois and Neighboring States**



\* Current and Proposed Illinois corporate income tax rates include 2.5% personal property replacement tax.

Note: Each state has different exemptions and states with multiple tax rates have different numbers of tax brackets.  
Source: Commission on Government Forecasting and Accountability, *Illinois Revenue Volatility Study Public Act 98 - 0682*, December 31, 2014, p. 64.

## **APPENDIX D: SERVICE TAXES**

The following list of services to be subject to Illinois' sales tax was proposed by Governor Bruce Rauner in July 2014, before he was elected.<sup>168</sup>

- General warehousing and storage
- Refrigerated warehousing and storage
- Mini-storage
- Marine towing service (including tugboats)
- Packing and crating
- Sewer and refuse, industrial and residential use
- Travel agent services
- Sales of advertising time or space: billboards
- Sales of advertising time or space: radio and TV advertising
- Advertising agencies
- Armored car services
- Check and debt collection
- Commercial art and graphic design
- Commercial linen supply
- Interior design and decorating
- Maintenance and janitorial services
- Marketing consulting services
- Printing
- Investigation services
- Public relations services
- Secretarial and court reporting services
- Security guards and patrol services
- Telemarketing bureaus and other contact centers
- Telephone answering services
- Testing laboratories (excluding medical)
- Custom computer programming services
- Information services
- Attorneys
- Personal property rentals
- Chartered flights (with pilot)
- Trailer parks (overnight)
- Membership fees in golf clubs

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<sup>168</sup> Bruce Rauner and Evelyn Sanguinetti, *Bring Back Blueprint: Corporate Welfare Reform*, July 17, 2014, pp.8-9.