The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

STATE OF ILLINOIS FY2014 BUDGET ROADMAP:

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

February 25, 2013

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EXECUTIVE SUMMARY

Prior to publication of the Governor's annual budget recommendation, the Institute for Illinois' Fiscal Sustainability at the Civic Federation issues an analysis of the State of Illinois' fiscal condition and budget recommendations for the Governor and General Assembly for the coming fiscal year. The State of Illinois FY2014 Budget Roadmap also includes an analysis of Governor Pat Quinn's three-year budget projection published on January 11, 2013.[1]

In addition, the FY2014 report provides the Civic Federation's five-year budget projection, based generally on current law and known cost pressures. **Due to data limitations, the Federation's projections are intended to provide a general indication of the long-range consequences of current revenue and expenditure policies.**

The analysis shows that, nearly four years after the official end of the national economic recession, the State of Illinois continues to face severe fiscal pressures. Despite a temporary tax increase and significant reductions to agency spending, the State is burdened with large and growing annual pension expenses and a huge backlog of unpaid bills. Given the scheduled partial sunset of the income tax increase, the Civic Federation's analysis shows that Illinois' unpaid bills could rise to nearly $22 billion by the end of FY2018.

Without action to curtail pension costs, the State will be unable to stabilize its fiscal condition in the next five years. Below are the key findings and recommendations included in this report.

Civic Federation Findings

- The State's backlog of unpaid bills is expected to grow to $21.7 billion in FY2018 from $7.8 billion in FY2013, reflecting rising pension and Medicaid costs and the loss of income tax revenues due to the partial sunset of income tax rate increases beginning on January 1, 2015.[2]
- General Funds pension contributions are projected to increase by 36.6% to $7.0 billion in FY2018 from $5.1 billion in FY2013. Total General Funds pension payments—including contributions and debt service on pension bonds—are projected to increase to $8.6 billion in FY2018 from $6.7 billion in FY2013.
- Total General Funds pension payments are projected to consume 30.9% of State-source general operating revenue in FY2018, up from 22.1% in FY2013.
- If the State enacted comprehensive pension reform, pension contributions could decline by $2.5 billion in FY2018 and the projected backlog of unpaid bills could decrease to $10.8 billion from $21.7 billion.[3]
- From a peak of $30.7 billion in FY2014, State-source General Funds revenue declines to $26.5 billion in FY2016 due to the partial sunset of income tax rate increases. After moderate natural growth, State-source General Funds revenue totals $27.8 billion in FY2018.

[1] State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013. Illinois' fiscal year begins on July 1 and ends on June 30.
[2] Public Act 96-1496. As of January 1, 2011, the personal income tax rate rose to 5.0% from 3% and the corporate rate increased to 7% from 4.8%. The personal income tax rate is scheduled to decline to 3.75% on January 1, 2015 and to 3.25% on January 1, 2025; the corporate rate falls to 5.25% in 2015 and returns to 4.8% in 2025. The first full budget year under lower rates will be FY2016.
[3] Based on actuarial analysis of the impact of House Bill 6258, 97th Illinois General Assembly. That bill has been replaced by Senate Bill 35 and House Bill 98 in the 98th Illinois General Assembly.

- Net State Medicaid costs due to the federal Affordable Care Act—after federal reimbursement—are projected to total $1.4 billion from FY2014 through FY2018, largely due to previously eligible individuals who are expected to enroll regardless of whether the State expands its Medicaid program. Medicaid expansion is expected to bring Illinois $8.4 billion in additional federal revenue through FY2018.[4]
- The General Funds operating deficit is projected at $4.2 billion in FY2018, compared with a modest operating surplus of $667 million in FY2013.

Civic Federation Recommendations

1. The Civic Federation recommends that the State immediately enact comprehensive pension reforms, including significant limits on automatic annual benefit increases and a gradual shift of normal costs to local school districts, public universities and community colleges. Any pension proposal considered by the State should be thoroughly reviewed by actuaries to determine its financial impact prior to legislative action.

2. The Civic Federation recommends that the State of Illinois expand eligibility for Medicaid under the Affordable Care Act due to the resulting significant increase in federal resources compared to projected State expenditures. However, the Civic Federation also recommends that the State plan for additional costs relating to both newly eligible and previously eligible recipients.

3. The Civic Federation recommends that the State continue to pursue the administration's long-term plan to move developmentally disabled individuals from State-run facilities to community care settings. This effort is consistent with federal and State law and is the result of long-term strategic planning by the State. The move to community care is designed to provide better care at a lower cost to the State.

4. The Civic Federation recommends that the State aggressively pursue reductions in retiree health insurance costs under State law. Although the Governor has taken the position that retiree health insurance costs are a subject for collective bargaining, there is no reason not to pursue administrative action to require all retired judges, members of the General Assembly and constitutional officers to pay a portion of their premiums. The Civic Federation also recommends that the State stop allowing retired teachers who live out of State to pay lower health insurance premiums than retired teachers who live in Illinois.

5. The Civic Federation recommends that the State phase out all budget practices that allow bills to be covered by future years' appropriations. The use of the Section 25 exception for group health insurance claims, for example, ensures that the annual cost of the program is not reflected in the budget. The annual budget should cover all expected costs for the fiscal year.

6. The Civic Federation recommends limiting the use of statutory transfers out of General Funds to ensure that State resources are used in the most effective way possible. The State should move to consolidate Special Funds currently supported by transfers out and review programs funded through these accounts as part of the annual General Funds appropriations process.

7. The Civic Federation recommends that the State of Illinois develop a formal economic development policy to guide the awarding of incentives before the State renews, expands or creates any economic development incentives. A transparent economic development policy would

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[4] Illinois Department of Healthcare and Family Services, *Medicaid Financing for the Uninsured: How the Revenues and Costs Are Computed*, http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAHowRevenuesandCostsareComputed.pdf (last visited on February 18, 2013).

effectively curb economic brinksmanship by Illinois businesses by creating a predictable process for applying for and earning tax incentives.

BUDGET OVERVIEW: FY2009 TO FY2013

Nearly four years after the official end of the national economic recession, the State of Illinois has improved its operating budget by temporarily increasing income tax rates and reducing agency spending. Yet Illinois continues to face severe fiscal pressures.

After decades of underfunding its retirement systems, the State is now making annual pension payments that consume more than 22% of State-source general operating revenues.[5] This large and growing pension expense has impeded efforts to clear up a backlog of unpaid bills that totaled more than $9.0 billion at the end of the 2012 budget year.[6] Meanwhile, Illinois is headed for a substantial loss of revenue beginning on January 1, 2015, when the temporary income tax increase is scheduled to be partially rolled back.

This section summarizes major budget developments over the past five years and reviews recent changes in the State's credit ratings.

Revenues

General Funds revenues are projected to increase by $5.3 billion, or 18.0%, to $34.4 billion in FY2013 from $29.1 billion in FY2009.[7] A decline in federal receipts during the period was more than offset by growth in income tax revenues.

Federal revenues had been boosted by the American Recovery and Reinvestment Act of 2009, a federal stimulus program designed to counteract the effects of the recession.[8] Financial assistance from the stimulus program ceased at the end of FY2011. Federal revenues are projected to decline by $2.3 billion, or 35.6%, from $6.6 billion in FY2009 to $4.2 billion in FY2013.

On January 13, 2011, the State enacted temporary increases in both personal and corporate income tax rates.[9] The personal income tax rate was increased from 3.0% to 5.0% and the corporate rate was increased from 4.8% to 7.0%.[10] The higher rates were retroactive to January 1, 2011. Total income tax revenues are projected to grow by $6.9 billion, or 63.0%, to $17.8 billion in FY2013 from $10.9 billion in FY2009.[11]

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[5] This calculation is based on FY2013 pension contributions of $5.1 billion, debt-service payments on pension bonds of $1.6 billion and State-source revenues of $30.2 billion.

[6] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, pp. 11-13 and pp. 41-42; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013. The State's fiscal year begins on July 1 and ends on June 30.

[7] General Funds support the regular operating and administrative expenses of most State agencies and are the funds over which the State has the most control. The operating budget also includes Other State Funds, which are accounts for activities funded by specific revenue sources that may only be used for specific purposes, and Federal Funds (other than those designated for General Funds), which support a variety of State programs with federal revenues.

[8] The national economic recession began in December 2007 and officially lasted until June 2009, according to the National Bureau of Economic Research.

[9] Public Act 96-1496.

[10] Corporations also pay a Personal Property Replacement Tax of 2.5%, bringing the effective corporate tax rate after the increase to 9.5%. Replacement taxes are collected by the State and paid to local governments to replace revenues lost by local governments when their power to impose personal property taxes on business entities was rescinded pursuant to the 1970 Illinois Constitution.

[11] These amounts are net of income tax revenues set aside to pay for income tax refunds.

The personal income tax rate is scheduled to decline to 3.75% on January 1, 2015 and to 3.25% on January 1, 2025; the corporate rate falls to 5.25% in 2015 and returns to 4.8% in 2025. The first full budget year under lower rates will be FY2016.

The following table shows General Funds revenues from FY2009 to FY2013.

State of Illinois General Funds Revenues by Source: FY2009-FY2013 (in $ millions)							
	FY2009 Actual	FY2010 Actual	FY2011 Actual	FY2012 Actual	FY2013 Enacted	$ Change FY2009-FY2013	% Change FY2009-FY2013
Income Taxes	$ 10,933	$ 9,871	$ 12,825	$ 17,973	$ 17,823	$ 6,890	63.0%
Sales Taxes	$ 6,773	$ 6,308	$ 6,833	$ 7,226	$ 7,335	$ 562	8.3%
Other State Sources	$ 4,871	$ 4,991	$ 4,946	$ 4,742	$ 5,009	$ 138	2.8%
Federal Revenue	$ 6,567	$ 5,920	$ 5,386	$ 3,681	$ 4,231	$ (2,336)	-35.6%
Total	**$ 29,144**	**$ 27,090**	**$ 29,990**	**$ 33,622**	**$ 34,398**	**$ 5,254**	**18.0%**

Source: State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement* , January 22, 2013, p. 11; Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012* , August 2011, p. 64.

Expenditures

Total General Funds expenditures increase by $748 million, or 2.3%, to $33.7 billion in FY2013 from $33.0 billion in FY2009. General Funds expenditures consist of appropriations (minus appropriations that remain unspent at the end of the fiscal year) and transfers out to other funds to make debt service payments and for other legislatively required purposes.

It should be noted that the enacted FY2013 budget does not include certain appropriations and transfers that are expected to be approved by the General Assembly but that have not yet been enacted. These amounts were estimated at approximately $1.0 billion in Governor Pat Quinn's three-year budget projection, which was issued on January 11, 2013.[12] Since the projection was issued, a supplemental appropriations bill was passed by the legislature and signed by the Governor on February 7, 2013.[13] This bill included $602 million of the $1.0 billion in additional General Funds expenditures proposed by the Governor: appropriations of $550 million for group health insurance and $52 million for other purposes. If the remaining $423 million of the Governor's proposed additional spending is approved, total FY2013 expenditures will increase to $34.2 billion.

During the last five years, a decrease in State agency spending has been offset by increases in pension contributions and pension-related debt service. General Funds spending by State agencies has declined by $3.4 billion, or 13.1%, from $26.2 billion in FY2009 to $22.8 billion in FY2013. For example, General Funds expenditures for elementary and secondary education have declined by a projected $816.6 million, or 11.1%, from $7.4 billion in FY2009 to $6.5 billion in FY2013.[14]

[12] State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.
[13] Public Act 98-0001.
[14] Illinois State FY2011 Budget, p. 2-24; email communication between Civic Federation and Governor's Office of Management and Budget, July 18, 2012.

Agency spending does not include pension contributions or spending on group health insurance. Contributions to the State's five retirement systems have more than doubled to $5.1 billion in FY2013 from $2.5 billion in FY2009.[15] The increase reflects the State's 50-year pension funding plan, begun in FY1996, which deferred required payments to later years.[16] Largely due to inadequate State contributions, the retirement systems had a total unfunded liability of $96.8 billion as of June 30, 2012 and a combined funded ratio of 39.0%.[17]

The group health insurance appropriation for FY2013 covered only approximately half of the program's anticipated cost.[18] An additional FY2013 appropriation of $550 million for group health insurance was included in the supplemental appropriation enacted on February 7. The FY2013 appropriation for group health insurance also assumed that approximately $350 million of savings would be achieved through collective bargaining. Although the State's main union contracts expired on June 30, 2012, new contracts have not been agreed to and labor negotiations are ongoing.

Costs for group health insurance may be paid out of future years' appropriations under a provision of Section 25 of the State Finance Act.[19] If projected savings are not achieved and the General Assembly does not appropriate additional funds for group health insurance in FY2013, these costs will be added to the State's Section 25 liabilities and paid out of future year appropriations. Any budgeted savings that are not achieved will also add to next year's spending pressures.

Similarly, annual spending on Medicaid as shown in the budget does not necessarily reflect costs incurred by the program because bills may be paid out of future years' appropriations. In FY2013 the Medicaid program faced a funding gap of $2.7 billion due to rising costs and inadequate FY2012 appropriations. Legislation enacted in 2012 was designed to close the gap through $1.6 billion in savings, based on program cuts and reductions in reimbursement rates paid to healthcare providers, and $1.1 billion in increased revenues, including higher tobacco taxes.[20] Because of implementation challenges, savings in FY2013 are not expected to meet the budgeted goal.[21] However, the shortfall is projected to be largely offset by savings in FY2012. In addition, the General Assembly has not approved one part of the Medicaid funding plan—a transfer intended to provide $300 million. That transfer is included in the not yet enacted $423 million in spending proposed by Governor.

Debt service payments on pension bonds increase by $1.1 billion, or 233.0%, to $1.6 billion in FY2013 from $466 million in FY2009. The State sold pension bonds in 2003, 2010 and 2011. Proceeds from the first sale were used to reduce the retirement systems' unfunded liability and to make annual contributions for FY2003 and FY2004. The State issued pension bonds in FY2010 and FY2011 solely to pay for annual contributions.

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[15] Pension contributions in FY2010 and FY2011 were made primarily by the sale of pension bonds, rather than from General Funds.
[16] Public Act 88-0593. The law is designed to achieve 90% funding by FY2045.
[17] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, p. 3. These numbers are based on the market value of assets, rather than asset smoothing.
[18] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 23.
[19] 30 ILCS 105/25.
[20] Illinois Department of Healthcare and Family Services, *Fact Sheet on Final Medicaid Legislative Package*, May 2012, http://www2.illinois.gov/hfs/SiteCollectionDocuments/MedicaidPackageFactSheet.pdf (last visited on January 22, 2013). As used here, the Medicaid program refers to the Medical Assistance Program in the Department of Healthcare and Family Services. Medicaid has no single programmatic appropriation in the State budget.
[21] See p. 23 of this report for more information about implementation of the Medicaid reductions.

The next table shows General Funds expenditures from FY2009 to FY2013. Expenditures in FY2013 include the $602 million of additional spending approved on February 7 but do not include the $423 million in anticipated but not yet enacted spending.

State of Illinois General Funds Expenditures: FY2009-FY2013 (in $ millions)	FY2009 Actual	FY2010 Actual	FY2011 Actual	FY2012 Actual	FY2013 Enacted	$ Change FY2009-FY2013	% Change FY2009-FY2013
Agency Appropriations	$ 26,738	$ 25,209	$ 24,961	$ 24,036	$ 23,436	$ (3,302)	-12.3%
Less Unspent Appropriations	$ (507)	$ (896)	$ (350)	$ (374)	$ (650)	$ (143)	28.2%
Net Agency Appropriations Spent	$ 26,231	$ 24,313	$ 24,611	$ 23,662	$ 22,786	$ (3,445)	-13.1%
Pension Contributions[1]	$ 2,486	$ 3,466	$ 3,680	$ 4,135	$ 5,107	$ 2,621	105.4%
Group Insurance	$ 1,058	$ 1,146	$ 885	$ 1,412	$ 1,100	$ 42	4.0%
Total Appropriations	**$ 29,775**	**$ 28,925**	**$ 29,176**	**$ 29,209**	**$ 28,993**	**$ (782)**	**-2.6%**
Statutory Transfers Out							
Legislatively Required Transfers[2]	$ 2,082	$ 2,007	$ 2,399	$ 2,473	$ 2,533	$ 451	21.7%
Debt Service on Pension Bonds	$ 466	$ 564	$ 1,667	$ 1,607	$ 1,552	$ 1,086	233.0%
Other Debt Service and Transfers Out[3]	$ 660	$ 1,759	$ 739	$ 809	$ 653	$ (7)	-1.1%
Total Transfers Out	**$ 3,208**	**$ 4,330**	**$ 4,805**	**$ 4,889**	**$ 4,738**	**$ 1,530**	**47.7%**
Total Expenditures	**$ 32,983**	**$ 33,255**	**$ 33,981**	**$ 34,098**	**$ 33,731**	**$ 748**	**2.3%**

[1]Pension contributions in FY2010 and FY2011 were made primarily by issuance of pension obligation bonds, rather than from General Funds.

[2]Includes transfers payable as of year end.

[3]Includes interfund borrowing repayment and Budget Stabilization Fund repayment. Interest on short-term borrowing in FY2010 includes $1.0 billion to repay failure of revenue borrowing in FY2009.

Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General funds), FY14-FY16, January 11, 2013*; Illinois State FY2013 Budget, pp. 2-18 and 2-31; Illinois State FY2012 Budget, pp. 2-13 and 2-26; Illinois State FY2011 Budget, pp. 2-10 and 2-20.

Deficit and Unpaid Bills

The State is expected to end FY2013 with a total General Funds deficit of $4.3 billion, compared with a deficit of $3.7 billion at the end of FY2009. The total deficit, which consists of the operating deficit and the accumulated deficit from prior years, had climbed to $6.1 billion in FY2010 due to the impact of the recession.

It is important to note that, in the absence of additional revenues, the FY2013 total deficit will increase if the State enacts the proposed additional expenditures of $423 million. The additional expenditures would reduce the operating surplus now projected for FY2013 and result in a total deficit of roughly $4.7 billion.

The State relied on borrowing to help close the operating deficit from FY2009 to FY2011. As noted previously, the borrowing included the sale of pension bonds to pay for General Funds pension contributions in FY2010 and FY2011. Neither the FY2012 budget nor the enacted FY2013 budget includes borrowing for operations.

The next table shows the General Funds deficit from FY2009 to FY2013, not including the $423 million in additional expenditures for FY2013.

State of Illinois General Funds Deficit: FY2009-FY2013 (in $ millions)					
	FY2009 Actual	**FY2010 Actual**	**FY2011 Actual**	**FY2012 Actual**	**FY2013 Enacted**
Operating Revenues	$ 29,144	$ 27,090	$ 30,163	$ 33,622	$ 34,398
Operating Expenditures	$ 32,983	$ 33,255	$ 33,981	$ 34,098	$ 33,731
Operating Surplus (Deficit)	**$ (3,839)**	**$ (6,165)**	**$ (3,818)**	**$ (476)**	**$ 667**
Borrowing for Operations*	$ 1,000	$ 3,742	$ 5,404	-	-
Operating Surplus (Deficit) After Borrowing for Operations	$ (2,839)	$ (2,423)	$ 1,586	$ (476)	$ 667
Accumulated Deficit from Prior Years	$ (834)	$ (3,673)	$ (6,096)	$ (4,510)	$ (4,986)
Total Deficit	**$ (3,673)**	**$ (6,096)**	**$ (4,510)**	**$ (4,986)**	**$ (4,319)**

*FY2009 amount represents failure of revenue borrowing repaid in FY2010.
Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement* , January 22, 2013, p. 11; State of Illinois, General Obligation Bonds, Series of September 2012, *Official Statement* , September 13, 2012, p. 8; Illinois State FY2011 Budget, p. 2-10.

Illinois has dealt with its General Funds deficit by delaying payments to vendors, social service agencies and local governments and paying those bills from the next year's revenue. The State typically has two months after the close of the fiscal year to pay off the prior year's bills. This lapse period has been extended to six months—through December 31—for the last three fiscal years due to the large amount of outstanding bills on June 30.

As discussed above, the State has also avoided General Funds deficits by underfunding Medicaid and group health insurance and paying those Section 25 liabilities out of future years' appropriations. The ability to defer Medicaid bills in this way was curtailed by legislation enacted in 2012.[22] The new law limited Section 25 liabilities incurred by the State's principal Medicaid agency, the Illinois Department of Healthcare and Family Services, to $700 million in FY2013 and $100 million thereafter, with certain exceptions. Group health insurance liabilities were not limited by the new law. At the end of FY2013, the Section 25 liability is expected to total $1.5 billion for Medicaid and $1.6 billion for group health insurance if the remaining $423 million in supplemental expenditures are not enacted.

Another General Funds liability that does not appear in the budget involves the Community Care Program in the Illinois Department on Aging, which is designed to allow seniors to stay out of nursing homes. The program's monthly caseload has more than doubled to a projected 80,100 in FY2013 from 38,950 in FY2003.[23] The Department on Aging is not covered by the Section 25 exception, but in recent years the State's annual appropriation bills have allowed the program's prior year costs to be paid for out of the next year's funding. These unfunded costs are expected to stand at $318 million at the end of FY2013 if additional supplemental appropriations are not enacted.

In recent years the State has also accumulated unpaid income tax refunds, an additional General Funds liability that is not included in the budget. Unpaid income tax refunds, primarily owed to

[22] Public Act 97-0691.
[23] Illinois Department on Aging, *Fiscal Year 2013 Enacted Budget*, July 2012, p. 14.

businesses, peaked at $735 million at the end of FY2010. The Illinois Department of Revenue expects to end FY2013 with no approved but unpaid tax refunds.[24]

The next table shows unpaid bills and other General Funds liabilities from FY2009 to FY2013. The FY2013 numbers are based on the enacted budget without additional supplemental expenditures. They are based on the assumptions that budgeted Medicaid savings are achieved or offset by savings in FY2012 and that savings on group health insurance are $218 million below the budgeted level.[25] If the additional supplemental expenditures were approved, the General Funds accounts payable would increase and other General Fund liabilities would decline.

As shown in the table, the backlog of bills declines by $1.3 billion from $9.1 billion at the end of FY2012 to $7.8 billion at the end of FY2013. In FY2013 the General Assembly set aside $264 million to pay off General Funds bills and $500 million to reduce the backlog of Medicaid bills.[26] The $500 million will pay off $1 billion in Medicaid bills through a cycle of State spending and federal reimbursement.

State of Illinois Unpaid Bills Backlog on June 30: FY2009-FY2013 (in $ millions)

	FY2009 Actual	FY2010 Actual	FY2011 Actual	FY2012 Actual	FY2013 Enacted
General Funds Accounts Payable	$ (3,953)	$ (6,224)	$ (4,976)	$ (5,024)	$ (4,319)
Medicaid Bills (HFS)[1]	$ (885)	$ (763)	$ (603)	$ (2,164)	$ (1,164)
Medicaid Bills (DHS)[2]	$ (124)	$ (68)	$ (74)	$ (201)	$ (346)
Group Health Insurance Bills[3]	$ (321)	$ (524)	$ (1,049)	$ (1,423)	$ (1,641)
Community Care Program Bills[4]	na	na	$ (100)	$ (178)	$ (318)
Unpaid Income Tax Refunds[5]	$ (219)	$ (735)	$ (646)	$ (69)	$ -
Total	**$ (5,502)**	**$ (8,314)**	**$ (7,448)**	**$ (9,059)**	**$ (7,788)**

[1]General Funds Section 25 liability relating to Illinois Department of Healthcare and Family Services.

[2]General Funds Section 25 liability relating to Illinois Department of Human Services.

[3]General Funds Section 25 liability relating to group health insurance.

[4]Unappropriated costs relating to Community Care Program at Illinois Department on Aging. The FY2011 number is an estimated minimum amount.

[5]Approved but unpaid income tax refunds.

Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement* , January 22, 2013, p. 12; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16* , January 11, 2013; Communication between Civic Federation and Governor's Office of Management and Budget, January 25, 2013; Illinois State Comptroller's website at http://www.ioc.state.il.us/index.cfm/linkservid/A0FD646B-1CC1-DE6E-2F485BDED411AF81/showMeta/0/; State of Illinois, General Obligation Bonds, Series of September 2012, *Official Statement* , September 13, 2012, pp. 9 and 39; Illinois State FY2011 Budget, p. 2-10.

[24] Email communication between the Civic Federation and the Illinois Department of Revenue, September 4, 2012.
[25] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 25, 2013.
[26] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 24.

Credit Ratings

Following numerous downgrades in the past five years, the State of Illinois has the lowest credit rating of any state from two of the three major rating agencies. Illinois has the lowest credit rating from Moody's Investors Service and Standard & Poor's and the second lowest behind California from Fitch Ratings.

The last downgrade occurred on January 25, 2013, when S&P lowered the rating by one notch to A- due to the State's failure to enact pension reform during the final days of the 97th Illinois General Assembly.[27] The rating agency concluded that comprehensive pension legislation was unlikely during the current legislative session, given the General Assembly's recent track record, and that any reforms might be difficult to implement due to legal challenges. On January 31, 2013, S&P raised California's credit rating to A from A-.[28]

The following table shows recent Illinois credit ratings by the three agencies.[29]

State of Illinois General Obligation Bond Ratings: FY2008-FY2013

	Moody's	Standard & Poor's	Fitch
FY2008	Aa3	AA	AA
FY2009	A1	AA-	A
FY2010	A1, Aa3*	A+	A-, A+*
FY2011	A1	A+	A
FY2012	A2	A+	A
FY2013	A2	A, A-	A

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

Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2013* , August 2012, p. 185; Standard & Poor's, "Illinois General Obligation Debt Rating Lowered to 'A-' from 'A' on Weakened Pension Funded Ratios; Outlook Negative," *news release* , January 25, 2013.

S&P retained a negative outlook on Illinois' credit, signaling the possibility of another downgrade in the next two years. The rating agency warned that Illinois could fall into the BBB category because of inaction on pension problems and the scheduled partial rollback of income tax rates.

Recently both Moody's and Fitch have also issued warnings about further downgrades of Illinois' credit rating. Moody's changed the State's outlook to negative from stable on December 13, 2012, after no action was taken on comprehensive pension reform during the legislature's fall veto session.[30] On January 11, 2013, Fitch announced that a downgrade of Illinois' credit rating could be expected in six months if the State did not limit annual pension expenses and bolster the funding of its retirement systems.[31] Like S&P's downgrade, Fitch's move followed the legislature's inaction on pensions in January 2013.

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[27] Standard & Poor's, "Illinois General Obligation Debt Rating Lowered to 'A-' from 'A' on Weakened Pension Funded Ratios; Outlook Negative," *news release*, January 25, 2013.

[28] Standard & Poor's, "Rating on California GO Debt Raised to 'A' on Improved Fiscal and Cash Position," *news release*, January 31, 2013.

[29] See Appendix A for an explanation of ratings scales and definitions used by the major rating agencies.

[30] Moody's Investors Service, "Rating Action: Moody's Revises State of Illinois' rating outlook to negative from stable; general obligation rating affirmed at A2," *news release*, December 13, 2012.

[31] Fitch Ratings, "Fitch Places Illinois GO Bonds on Rating Watch Negative," *news release*, January 11, 2013.

Credit ratings are one of the factors that are weighed heavily by underwriters and investors when determining the interest rate the State must pay to issue debt. The declines in the State's rating have led to an overall increase in Illinois' debt service cost in recent years compared to other municipal issuers.[32]

Illinois had been scheduled to sell $500 million of general obligation bonds on January 30, 2013. The bonds were to be sold through a competitive bidding process, with the proceeds used to finance school construction and other capital projects.

On the morning of the scheduled sale, however, the Governor's Office announced that it would postpone the offering due to unfavorable market conditions triggered by the S&P downgrade.[33] Officials said the decision followed conversations with potential buyers. A new date for the bond sale has not yet been announced.

[32] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *Cost of the Crisis: An Analysis of the Additional Bond Costs Paid by the State of Illinois Due to the State's Ongoing Fiscal Crisis*, August 30, 2010.
[33] Brian Chappatta and Michelle Kaske, "Illinois Delays $500 Million Bond Offer After S&P Rating Cut," *Bloomberg.com*, January 30, 2013.

GOVERNOR'S THREE-YEAR BUDGET PROJECTION

The Governor's Office of Management and Budget (GOMB) published its annual three-year budget projection for the State of Illinois on January 11, 2013.[34] The multiyear budget plan and accompanying economic and fiscal policy report reviews the outlook for the Illinois economy and provides State revenue and spending projections for the next three fiscal years.[35] The projection also includes updated FY2012 budget results and new estimates for the FY2013 enacted budget.

The three-year State budget projection is required under law to be published by the Governor the first week of January.[36] The multi-year budget information provides a context for the Governor's budget recommendation, which under the State Budget Law is required to be delivered to the General Assembly by the third Wednesday in February unless the General Assembly approves a change in the date. For FY2014 the Governor's budget speech has been postponed until March 6, 2013.[37]

The Governor's projection for FY2013 through FY2016 focuses on the impact of the partial sunset of income tax rate increases enacted in FY2011.[38] Due to the rollback of the income tax increases halfway through FY2015, the State expects annual General Funds revenues to decline by $3.8 billion in FY2016 from FY2013. By law the personal income tax rate is scheduled to decline from 5.0% to 3.75% on January 1, 2015 and to 3.25% on January 1, 2025; the corporate rate falls from 7.0% to 5.25% in 2015 and returns to 4.8% in 2025. The projection shows the significant spending cuts necessary to balance the budget in light of the rollback. Although the projection shows expenditures matching the lower resources after the cuts in FY2015 and FY2016, the budget projection does not specify which programs would be reduced or eliminated in order to achieve this level of annual savings.

This section compares the budget estimates for FY2013 to the Governor's three-year projection for revenues, appropriations and total expenditures through FY2016.

Revenues

According to the three-year projection, total General Funds revenues increase by $600 million to $35.0 billion in FY2014 from an estimated $34.4 billion in FY2013 before declining over the next two fiscal years. General Funds revenues total $33.2 billion in FY2015 and $30.5 billion in FY2016. This marks a total decline of $3.8 billion from FY2013, attributable to the partial sunset of the income tax rate increases that begins halfway through FY2015.

The State temporarily raised income tax rates in January 2011 from 3% to 5% for individual taxpayers and from 4.8% to 7.0% for corporations.[39] On January 1, 2015, individual income tax rates are scheduled to roll back to 3.75% and corporate tax rates are scheduled to decline to 5.25%. The State budget year begins on July 1, which puts the first full-year impact of the partial rollbacks in FY2016.

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[34] Governor's Office of Management and Budget, *Three-Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.
[35] Public Act 96-1354.
[36] Public Act 96-1354.
[37] Public Act 98-0002.
[38] Public Act 96-1496.
[39] Including the 2.5% Personal Property Replacement Tax (PPRT) applied to corporate income and collected by the State on behalf of local governments, the total corporate tax rate in Illinois is 9.5%.

From peak to trough, the Governor's projection shows a $4.7 billion decrease in total income tax revenues from $18.6 billion in FY2014 to $13.9 billion in FY2016. This loss is slightly offset by continued growth in sales taxes and other sources of General Funds revenues over the same period. Sales taxes are projected to increase by $430 million and other sources grow by an additional $59 million. Federal revenues decline by $250 million through FY2016, but this amount does not account for spending reductions in the Medicaid program shown for FY2015 and FY2016 that would reduce federal reimbursements in those years.[40] The following chart shows total projected General Funds revenues for FY2013 through FY2016.

State of Illinois Governor's Three-Year Plan: Total General Funds Revenues FY2013-FY2016 (in $ millions)						
Revenue Sources	**FY2013**	**FY2014**	**FY2015**	**FY2016**	**$ Change**	**% Change**
State Taxes and Fees						
Personal Income Tax	$ 15,273	$ 15,717	$ 14,255	$ 12,188	$ (3,085)	-20.2%
Corporate Income Tax	$ 2,513	$ 2,871	$ 2,116	$ 1,708	$ (805)	-32.0%
Sales Tax	$ 7,335	$ 7,385	$ 7,570	$ 7,765	$ 430	5.9%
Other State Sources	$ 3,047	$ 3,043	$ 3,073	$ 3,106	$ 59	1.9%
Total State Taxes and Fees	**$ 28,168**	**$ 29,016**	**$ 27,014**	**$ 24,767**	**$ (3,401)**	**-12.1%**
Federal Revenue	**$ 4,231**	**$ 4,222**	**$ 4,441**	**$ 3,981**	**$ (250)**	**-5.9%**
Transfers In	**$ 1,962**	**$ 1,723**	**$ 1,749**	**$ 1,775**	**$ (187)**	**-9.5%**
Total Revenue	**$ 34,360**	**$ 34,960**	**$ 33,203**	**$ 30,523**	**$ (3,837)**	**-11.2%**

Source: Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16* , January 11, 2013.

Although income tax revenues decline considerably from FY2013 to FY2016, the projection assumes an underlying growth in the personal income tax base that is masked by the reduction in the income tax rate halfway through FY2015. GOMB and the Illinois Department of Revenue (IDOR) focus on the anticipated growth in wages and salaries for Illinois as the leading indicator to predict future personal income tax revenues. According to IHS Global Insight, the State's economic consulting firm, wages and salaries are expected to show moderate growth from FY2013 through FY2016.[41] GOMB's projection for corporate income taxes is similarly based on anticipated changes in domestic corporate profits in Illinois as reported by IHS Global Insight, which show a slight decline through FY2015 before growing by 2.1% in FY2016. Accordingly, the corporate income tax base is projected to decline slightly over the same period. However, the projection includes an increase in total corporate income tax revenue of $237 million from FY2013 to FY2014, primarily due to the expiration of federal expensing rules that have reduced corporate tax liabilities in recent years.[42]

[40] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, p. 30. Federal revenues would be reduced by an additional $202 million in FY2015 and $454.5 million in FY2016 to account for the loss of the 50% federal matching funds for Medicaid projected in the healthcare budget.
[41] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report*, January 11, 2013, p. 4.
[42] Communication between Civic Federation and the Governor's Office of Management and Budget, February 1, 2013.

The following chart shows the underlying assumptions used in the three-year projection and the corresponding economic indicators.

Governor's Three-Year Projections: Economic Indicators and Assumed Growth Rates FY2013-FY2016				
Economic Indicator	**FY2013**	**FY2014**	**FY2015**	**FY2016**
Wages and Salaries	2.4%	3.1%	3.6%	3.9%
Dividends, Interest and Rent	6.9%	-4.1%	-1.2%	2.1%
Assumed Growth Rate				
Personal Income Tax	3.1%	1.1%	1.2%	2.1%
Corporate Income Tax	1.9%	-1.1%	-0.3%	0.6%

Communication between Civic Federation and the Governor's Office of Management and Budget, February 1, 2013.

Expenditures

To balance the general operating budget in the face of the decline in revenues through FY2016, net agency appropriations are projected to decline by $4.2 billion to $18.5 billion in FY2016 from $22.6 billion in FY2013. This total excludes the State's annual pension contributions, group health insurance, debt service and other required expenditures of the State.

In FY2014 total agency appropriations increase by $105 million or less than 1.0%. To accommodate the projected loss of revenues in subsequent years, agency operating budgets would be cut by 5.4% in FY2015 and 13.6% in FY2016, according to the Governor's projection. The budget projection does not specify which programs would be reduced or eliminated in order to achieve this level of annual savings.

The following table shows agency appropriations by spending area projected for FY2013 through FY2016.

State of Illinois Governor's Three-Year Plan: Agency Operating Appropriations by Category FY2013-FY2016 (in $ millions)						
Operating Category	**FY2013**	**FY2014**	**FY2015**	**FY2016**	**$ Change**	**% Change**
Education Funding	**$ 8,521**	**$ 8,127**	**$ 7,735**	**$ 6,690**	**$ (1,831)**	**-21.5%**
Human Services	**$ 5,123**	**$ 5,496**	**$ 5,183**	**$ 4,478**	**$ (645)**	**-12.6%**
Department of Aging	$ 785	$ 971	$ 916	$ 791	$ 6	0.8%
Department of Human Services	$ 3,256	$ 3,461	$ 3,264	$ 2,820	$ (436)	-13.4%
Other	$ 1,081	$ 1,064	$ 1,003	$ 867	$ (214)	-19.8%
Healthcare	**$ 6,804**	**$ 7,060**	**$ 6,656**	**$ 5,747**	**$ (1,057)**	**-15.5%**
Public Safety	**$ 1,433**	**$ 1,431**	**$ 1,349**	**$ 1,165**	**$ (268)**	**-18.7%**
Government Services	**$ 1,261**	**$ 996**	**$ 939**	**$ 811**	**$ (450)**	**-35.7%**
Economic Development	**$ 78**	**$ 66**	**$ 62**	**$ 54**	**$ (24)**	**-30.8%**
Quality of Life	**$ 62**	**$ 61**	**$ 58**	**$ 50**	**$ (12)**	**-19.4%**
Total Agency Appropriations	**$ 23,282**	**$ 23,237**	**$ 21,982**	**$ 18,995**	**$ (4,287)**	**-18.4%**
Less Unspent Appropriations	$ (650)	$ (500)	$ (500)	$ (500)	$ 150	-23.1%
Net Agency Appropriations	**$ 22,632**	**$ 22,737**	**$ 21,482**	**$ 18,495**	**$ (4,137)**	**-18.3%**

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.

Total General Funds expenditures, including appropriations for pension contributions and group health insurance, combined with debt service and other transfers, are projected to increase by $741 to a total of $34.9 billion in FY2014 from $34.1 billion in the FY2013 enacted budget. This represents a 2.2% year-to-year increase. Expenditures then decline by $4.3 billion over the next two years, from $34.9 billion in FY2014 to $30.5 billion in FY2016. However, total expenditures between FY2013 and FY2016 are projected to decline by a total of $3.6 billion, due to increases that partially offset other budget reductions. The State's pension contributions increase by $1.4 billion and State group health insurance increases by $798 million. Meanwhile, agency operating budgets are reduced by $4.1 billion, statutory transfers are reduced by $332 million, capital bond debt service declines by $71 million, pension bond debt service declines by $134 million and interfund borrowing of $132 million is only required in FY2013.

The Governor's projection also shows additional spending not yet approved by the General Assembly of $1.0 billion in FY2013. The largest portion of the requested supplemental spending is an increase of $550 million to fund the State's group health insurance program, which was only provided with 6 months of funding in the FY2013 enacted budget.[43] The request also includes a transfer of $151 million to fund a portion of the State's Medicaid Program and $173 million for the Department on Aging.[44]

The following chart shows total General Funds expenditures from FY2013 through FY2016.

State of Illinois Governor's Three-Year Projection: Total General Funds Expenditures FY2013-FY2016 (in $ millions)

	FY2013	FY2014	FY2015	FY2016	$ Change	% Change
Net Agency Appropriations	**$ 22,632**	**$ 22,737**	**$ 21,482**	**$ 18,495**	**$ (4,137)**	**-18.3%**
Pension Contributions						
Teachers' Retirement System	$ 2,777	$ 3,513	$ 3,621	$ 3,753	$ 976	35.1%
Universities' Retirement	$ 1,253	$ 1,360	$ 1,399	$ 1,392	$ 139	11.1%
Other State Employees	$ 1,144	$ 1,238	$ 1,285	$ 1,466	$ 322	28.1%
Total Pension Contributions	**$ 5,174**	**$ 6,111**	**$ 6,305**	**$ 6,611**	**$ 1,437**	**27.8%**
Statutory Transfers Out						
Legislatively Required Transfers	$ 2,533	$ 2,658	$ 2,180	$ 2,201	$ (332)	-13.1%
Group Insurance*	$ 550	$ 1,197	$ 1,271	$ 1,348	$ 798	145.1%
Debt Service on Capital Bonds	$ 521	$ 502	$ 465	$ 450	$ (71)	-13.6%
Debt Service on Pension Bonds	$ 1,552	$ 1,655	$ 1,501	$ 1,418	$ (134)	-8.6%
Interfund Borrowing Repayment	$ 132	$ -	$ -	$ -	$ (132)	-100.0%
Total Transfers Out	**$ 5,288**	**$ 6,012**	**$ 5,417**	**$ 5,417**	**$ 129**	**2.4%**
Additional FY2013 Spending**	**$ 1,025**	$ -	$ -	$ -	**$ (1,025)**	**-100.0%**
Total Expenditures	**$ 34,119**	**$ 34,860**	**$ 33,203**	**$ 30,523**	**$ (3,596)**	**-10.5%**

* The FY2013 State Group Health appropriation only includes six months of funding for the program.

**Spending anticipated to complete FY2013 budget plan but not originally approved by the General Assembly.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY14-FY16*, January 11, 2013.

General Funds Budget and Unpaid Bills

After showing modest surpluses totaling $242 million in FY2013 and $100 million in FY2014, through the large reductions in agency appropriations and total expenditures the Governor's projection shows a balanced budget in FY2015 and FY2016 through additional cuts to match the State's declining resources.

[43] See page 31 of this report for more details on the State's group health insurance.

[44] Communication between Civic Federation and the Governor's Office of Management and Budget, January 30, 2013.

Although the Governor's projection shows balanced annual revenues and expenditures from FY2013 through FY2016, the State accumulated a significant backlog of unpaid bills from previous years. The State's unpaid bills backlog includes both General Funds accounts payable and Section 25 liabilities, which consist mainly of Medicaid and group health insurance bills.

The following chart shows the General Funds budget plan included in the Governor's three-year projection for FY2013 through FY2016.

State of Illinois Governor's Three-Year Projection: General Funds Surplus (Deficit) FY2013-FY2016 (in $ millions)

	FY2013	FY2014	FY2015	FY2016
Revenues				
State Taxes and Fees	$ 28,168	$ 29,016	$ 27,014	$ 24,767
Federal Sources	$ 4,231	$ 4,222	$ 4,441	$ 3,981
Transfers In	$ 1,962	$ 1,723	$ 1,749	$ 1,775
Total Revenues	**$ 34,360**	**$ 34,960**	**$ 33,203**	**$ 30,523**
Expenditures				
Agency Operating Budgets	$ 22,632	$ 22,737	$ 21,482	$ 18,495
Pension Contributions	$ 5,174	$ 6,111	$ 6,305	$ 6,611
Legislatively Required Transfers	$ 2,533	$ 2,658	$ 2,180	$ 2,201
Debt Service on Capital Bonds	$ 521	$ 502	$ 465	$ 450
Debt Service on Pension Bonds	$ 1,552	$ 1,655	$ 1,501	$ 1,418
Interfund Borrowing Repayment	$ 132	$ -	$ -	$ -
Total Expenditures	**$ 34,119**	**$ 34,860**	**$ 33,203**	**$ 30,523**
Addition FY2013 Spending*	**$ 1,025**	$ -	$ -	$ -
Surplus/(Deficit)	**$ (784)**	**$ 100**	**$ -**	**$ -**

*Spending anticipated to complete FY2013 budget plan but not originally approved by the General Assembly.

Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.

The budget plans above for FY2015 and FY2016 do not account for the loss of federal revenues due to the projected reduction in Medicaid spending in FY2015 and FY2016.[45] These cuts would lead to the loss of the 50% reimbursement for Medicaid spending resulting in revenue declines of approximately $202 million and $454.5 million in each year respectively and the corresponding increase in deficits at the end of each fiscal year.

[45] State of Illinois, General Obligation Bonds, Series of February 2013, Preliminary Official Statement, p. 30.

Total unpaid bills are projected to decline to $7.3 billion at the end of FY2014 from $8.3 billion at the end of FY2013. In FY2015 and FY2016, the backlog is expected to remain at $7.3 billion as the loss of income tax revenues prevents the State from paying down its accumulated bills.

State of Illinois Governor's Three-Year Projection: Unpaid Bills Backlog on June 30 FY2013-FY2016 (in $ millions)

	FY2013	FY2014	FY2015	FY2016
Total Revenues	$ 34,360	$ 34,960	$ 33,203	$ 30,523
Total Expenditures	$ 34,118	$ 34,860	$ 33,203	$ 30,523
Surplus/(Deficit)	$ 242	$ 100	$ -	$ -
General Funds Accounts Payable	$ (5,119)	$ (5,019)	$ (5,019)	$ (5,019)
Total Section 25 Bills*	$ (3,169)	$ (2,232)	$ (2,232)	$ (2,232)
Total (Year End)	$ (8,288)	$ (7,251)	$ (7,251)	$ (7,251)

*Total Section 25 bills are revised downward by $173 million in FY2014 and subsequent years from the published projections per communication between Civic Federation staff and Governor's Office of Management and Budget, February 1, 2013.

Source: State of Illinois, Governor's Office of Management and Budget, Three Year Budget Projections (General Funds), FY14-FY16, January 11, 2013.

As discussed above, if federal reimbursements were reduced in FY2015 and FY2015 due to the projected reduction in Medicaid spending, then unpaid General Funds bills would increase by $202 million and $454.5 million, respectively.

FIVE-YEAR BUDGET PROJECTION

The State of Illinois has faced continued financial stress and minimal economic recovery since the national recession officially ended in June 2009. Economic indicators for the State have consistently trailed national trends, indicating the possibility of only moderate recovery hampered by a continued lag in the State's housing market and poor government finances.[46]

As a government strives to recover from a financial crisis, it is particularly important to undertake a long-term financial planning process.[47] A long-term financial plan highlights long-range financial issues and helps governments look beyond budget gap-bridging measures toward remedying structural problems.

As discussed in the previous section, recent budget reform legislation in Illinois requires the Governor's Office of Management and Budget to provide in January of each year the administration's fiscal policy intentions for the upcoming fiscal year and the next two fiscal years.[48] Governor Quinn's projection for FY2014 to FY2016 was issued on January 11, 2013.

This section of the report presents the Civic Federation's budget projection for FY2014 to FY2018. A five-year time horizon for financial planning is recognized as a best practice by the Government Finance Officers Association.[49] The Governmental Accounting Standards Board has also proposed that state and local governments report five-year budget projections as supplementary information to their financial statements.[50]

The Civic Federation's projections are intended to provide an overview of the largest General Funds revenue sources and known spending pressures through FY2018. Due to significant data limitations, these forecasts should not be viewed as precise predictions. Medicaid costs are particularly difficult to forecast due to uncertainties relating to program changes and the impact of the Affordable Care Act.

General Funds Expenditures

General Funds expenditures are expected to increase by $3.3 billion, or 9.9%, from $33.7 billion in FY2013 to $37.1 billion in FY2018. This projection is based on known spending pressures and the assumption that the Medicaid program will not be underfunded because of new restrictions on the deferral of Medicaid bills.[51]

The projection shows spending pressures in order to demonstrate the size of the State's financial problems. In contrast, the Governor's three-year projection illustrated the drastic across-the-board cuts to agency spending in FY2015 and FY2016 that would be required to balance the budget in the face of revenue losses due to the partial sunset of income tax rate increases.[52]

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[46] Moody's Analytics, *State of Illinois Economic Forecast*, January 2013, p. 4.
[47] Shayne Kavanagh, *Fiscal First Aid and Financial Recovery,* (Chicago: GFOA, 2011), p. 37-44.
[48] Public Act 96-1354.
[49] Government Finance Officers Association, *Best Practice: Long-Term Financial Planning,* February 22, 2008, http://www.gfoa.org/downloads/LongtermFinancialPlanningFINAL.pdf (last visited on January 13, 2012).
[50] Joan Quigley, "Five-Year Forecasts proposed; GASB Seeks Detailed Issuer Projections," *Bond Buyer*, December 6, 2011.
[51] Public Act 97-0691.
[52] State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.

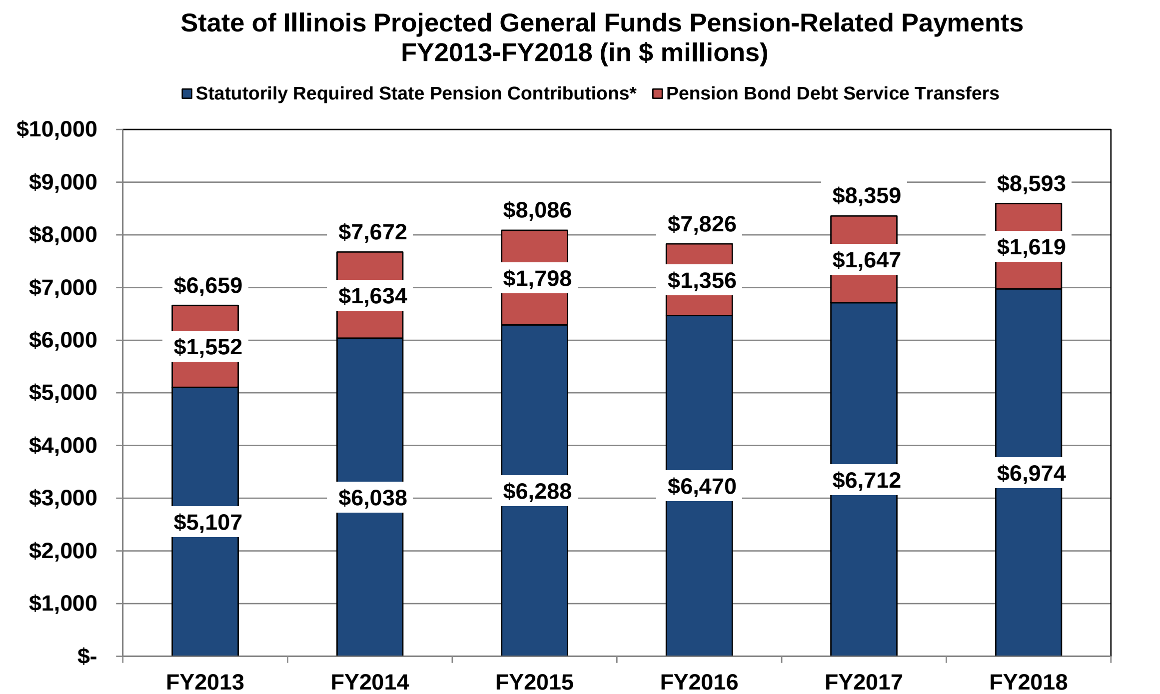
The Civic Federation's spending projection focuses on pensions, Medicaid and group health insurance—areas in which cost increases have been among the hardest to control. Other State operations, including education, are left unchanged from FY2014 levels shown in the Governor's three-year budget projection.

The projection in this section does not incorporate any wage or salary increases for State employees. Although the State's main union contracts expired on June 30, 2012, new contracts have not been agreed to and labor negotiations are ongoing. According to published reports, the State's largest union, Council 31 of the American Federation of State, County and Municipal Employees, agreed to a one-year wage freeze, but the administration is seeking to freeze salaries for the three-year term of the new contract and to require employees and retirees to pay much higher health insurance premiums.[53]

Pensions

General Funds pension contributions are expected to increase by $1.9 billion, or 36.6%, to $7.0 billion in FY2018 from $5.1 billion in FY2013.[54] After adding debt service payments on pension bonds, total pension payments rise to $8.6 billion in FY2018 from $6.7 billion in FY2013.

The next table shows General Funds pension contributions and debt service payments from FY2013 to FY2018.



*For FY2014 through FY2018, General Funds contributions to the State Employees' Retirement System are assumed to be 66% of total State contributions and General Funds contributions to the State Universities Retirement System are assumed to be reduced by contributions from the State Pensions Fund at the FY2013 level of $150 million. Required contributions to the Teachers' Retirement System Guaranteed Minimum Annuity Reserve are based on the $1.1 million certified amount in FY2014.
Source: State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p.11; Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, pp. 7-12; Communication between the Civic Federation and the Governor's Office of Management and Budget, September 21, 2012.

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[53] Doug Finke, "AFSCME to members: Put away cash for possible strike," *State Journal-Register*, February 11, 2013.

[54] General Funds pension contributions consist of total required contributions minus payments to the State Employees' Retirement System from Other State Funds for employees on payrolls not supported by General Funds (approximately 34% of the total SERS contribution). General Funds contributions to the State Universities Retirement System are reduced to reflect payments from the State Pensions Fund at the FY2013 level of $150 million, representing resources of the Unclaimed Property Trust Fund. For more information on the calculation of General Funds pension contributions, see Appendix C.

The State funds five retirement systems: the Teachers' Retirement System (TRS); State Employees' Retirement System (SERS); State Universities Retirement System (SURS); Judges' Retirement System (JRS) and General Assembly Retirement System (GARS).[55] The systems had a total of 760,955 members as of June 30, 2012.[56]

TRS covers public school teachers outside of Chicago and SURS covers employees of State universities and community colleges. JRS covers judges; GARS covers members of the legislature, constitutional officers and clerks of the House and Senate; and SERS covers most State employees not eligible for another plan. Nearly 78% of the State's FY2013 General Funds pension contributions are for non-State employees.

TRS covers public school teachers outside of Chicago and SURS covers employees of State universities and community colleges. JRS covers judges; GARS covers members of the legislature, constitutional officers and clerks of the House and Senate; and SERS covers most State employees not eligible for another plan. Nearly 78% of the State's FY2013 General Funds pension contributions are for non-State employees.

State contributions to the five systems are determined by a 50-year funding plan that began in FY1996.[57] After a phase-in period of 15 years, the law requires State contributions at a level percentage of payroll sufficient to achieve a 90% funded ratio by the end of FY2045. The funded ratio shows the percentage of the actuarial accrued liability that is covered by a system's assets. The actuarial accrued liability is an estimate of the value of benefits already earned. The unfunded liability represents the amount by which a system's actuarial accrued liability exceeds its assets.

The State funding plan and subsequently enacted changes deferred a large portion of required State contributions to later years. As a result, the funding schedule does not require the State to make adequate contributions to keep unfunded liabilities from growing until approximately 2030.[58] State contributions required by the statutory funding plan have also been less than those required under the reporting standards of the Governmental Accounting Standards Board.[59]

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[55] The State also contributes to the Public School Teachers' Pension and Retirement Fund of Chicago; that contribution is expected to total $10.9 million in FY2013.

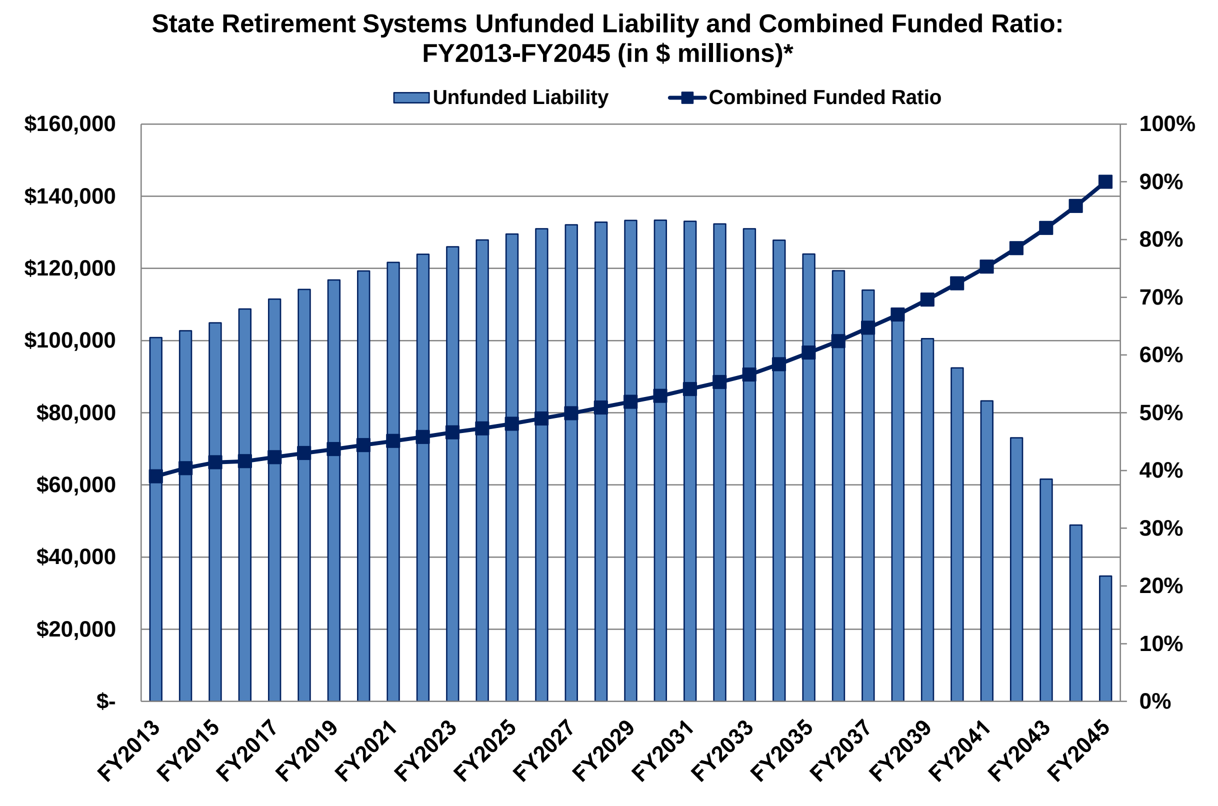
[56] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 52. Membership includes active members, inactive members entitled to benefits and retirees.

[57] Public Act 88-0593, amended by Public Acts 93-0002, 93-0839, 94-0004 and 96-0043.

[58] Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, p.7. The contribution amount that is adequate to keep unfunded liabilities from growing consists of the normal cost, which is 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 unfunded liabilities, is not enough to pay down unfunded liabilities.

[59] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 54.

The following chart shows the retirement systems' most recent funding projections through FY2045, based on current State law.

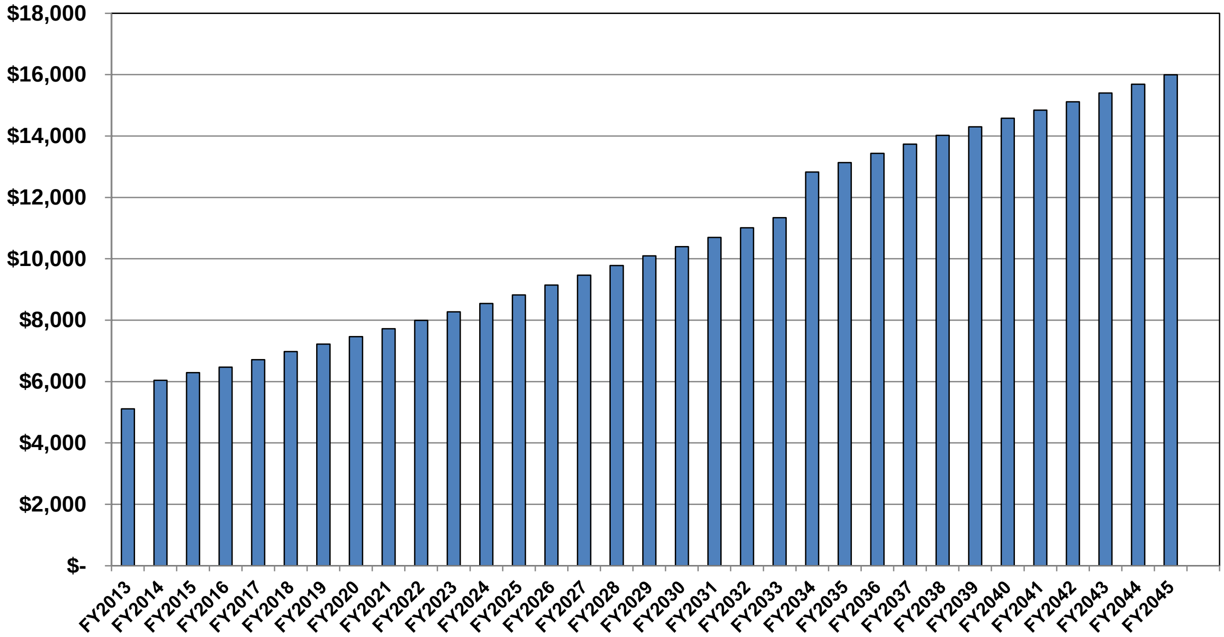


*Asset values are based on asset smoothing rather than market value. See Appendix B for data.
Source: Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, p. 7.

Compliance with the funding schedule depends on the State's ability to make the payments required under the law. In order to meet the 90% funding goal, General Funds contributions are currently expected to increase to $16.0 billion by FY2045.

The next chart shows projected annual General Funds contributions under existing law from FY2013 to FY2045. As shown below, required contributions increase significantly in FY2034. From FY2005 through FY2033, contributions are reduced by the amount of debt service paid on pension bonds issued in 2003.[60] Those bonds are completely paid off at the end of FY2033, resulting in an increase in pension contributions.

State of Illinois Projected General Funds Contributions to Retirement Systems: FY2013-FY2045 (in $ millions)*



*See Appendix C for data.
Source: State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, pp. 7-12; State Employees' Retirement System of Illinois, *Annual Actuarial Valuation as of June 30, 2012,* October 22, 2012, pp. 23-24; State Universities Retirement System of Illinois, *Actuarial Valuation Report as of June 30, 2012,* September 21, 2012, p. 27.

Actual required contributions might vary from those shown above due to changes in actuarial assumptions or results that differ from the assumptions. FY2014 General Funds contributions were projected at approximately $5.4 billion in the systems' actuarial reports in the fall of 2011 but will actually total $6.0 billion.[61]

The State's largest retirement system, TRS, had projected in December 2011 that it would need a State contribution of $2.9 billion in FY2014, up from $2.7 billion in FY2013.[62] The actual certified contribution amount for FY2014 is $3.4 billion.[63] The increase stems partly from changes in actuarial assumptions, including a decision in September 2012 to lower the assumed investment rate of return to 8.0% from 8.5%. In addition, TRS earned a 0.76% return on its investments in FY2012, down from 23.6% in FY2011.

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[60] State of Illinois, General Obligation Bonds. Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 59.
[61] Civic Federation calculation based on retirement systems' actuarial valuation reports as of June 30, 2011.
[62] Teachers' Retirement System of the State of Illinois, *June 30, 2011 Actuarial Valuation of Pension Benefits*, December 2011, p. 29.
[63] Teachers' Retirement System of the State of Illinois, *June 30, 2012 Actuarial Valuation of Pension Benefits*, October 2012, p. 2.

On March 30, 2012, TRS' Board of Trustees determined that it could no longer rely on the State to follow the pension funding law and that action had to be taken to prevent the fund from becoming insolvent.[64] TRS reached that conclusion after analyzing how much of the State's future revenues will have to go toward pension costs under current law. The pension fund has not taken a position on pension legislation, but its officials have held numerous meetings with TRS members to warn them about the system's precarious financial situation.[65]

General Funds pension costs also include principal and interest payments on Pension Obligation Bonds (POBs) issued by the State in FY2003, FY2010 and FY2011.[66] Illinois sold $10 billion of POBs in FY2003, of which $7.3 billion was used to reduce the retirement systems' unfunded liability and other proceeds were used to pay part of the FY2003 State contribution and all of the FY2004 State contribution. The State also issued a total of $7.2 billion in POBs to make its General Funds pension contributions for FY2010 and FY2011. Debt service costs decline in FY2016 due to final retirement of the FY2010 POBs in FY2015.

As discussed above, the legislation that authorized the FY2003 POBs required that the State's statutorily required pension contributions be reduced by the annual debt service owed on the bonds.[67] The FY2003 POBs were financed over 30 years and the last bonds will be retired in FY2033.

The State pays debt service owed on the FY2010 and FY2011 POBs from General Funds without any deductions from statutorily required pension contributions. The FY2010 POBs are retired over five years and the FY2011 series are eight-year bonds. The principal repayment on the FY2011 POBs is delayed until after the majority of the FY2010 bonds have been repaid. This back loading of the principal for the FY2011 POBs keeps the aggregate debt service owed on both series relatively level but significantly increases the total cost of the FY2011 bonds.

The FY2010 POBs totaled $3.5 billion and will cost a total of $382 million in interest over five years. The FY2011 bonds, which totaled $3.7 billion, will cost a total of $1.3 billion in total interest over eight years. Although the amount borrowed only increased by $234 million, or 6.8%, the State will pay $897.5 million more in interest, or 234.8%, for the FY2011 bonds.

The State will repay a total of $15.5 billion in outstanding POB principal with interest costs of $8.8 billion, for a total of $24.2 billion in POB debt service between FY2013 and FY2033.[68]

Medicaid

Medicaid is a joint federal-state program that funds medical services for certain categories of low-income people, including children and their parents, pregnant women, the elderly and the disabled.

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[64] Teachers' Retirement System of the State of Illinois, "Statement of the Teachers' Retirement System Board of Trustees," *news release*, October 29, 2012.
[65] Teachers' Retirement System of the State of Illinois, *Teachers' Retirement System Town Hall Meeting*, December 2012.
[66] Pension Obligation Bonds are taxable General Obligation bonds, backed by the full faith and credit of the State for the punctual payment of interest and principal.
[67] Public Act 93-0002.
[68] State of Illinois, General Obligation Bonds. Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 40.

Average annual enrollment in the Illinois Medicaid program grew by 14.1% to 2.78 million recipients in FY2012 from 2.43 million in FY2009.[69]

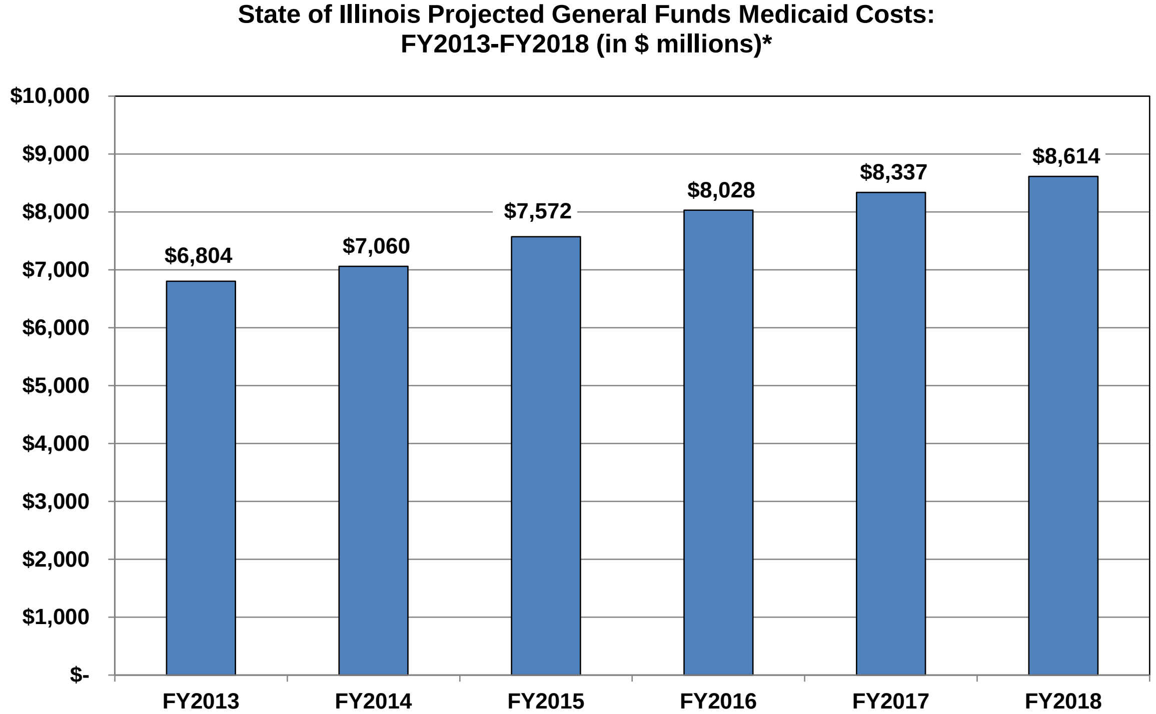
As a program involving several State agencies, Medicaid has no single programmatic appropriation in the State budget. The Medical Assistance program at the Illinois Department of Healthcare and Family Services (HFS) is used as the best available approximation to the Medicaid program.[70] HFS Medicaid costs totaled approximately $13.9 billion in FY2012 and are funded from General Funds and Other State Funds.[71]

The Civic Federation's five-year projection assumes that base General Funds Medicaid costs will grow at an annual rate of 3%. This growth rate is based on the increase in Medicaid spending from FY2013 to FY2014 shown in the Governor's three-year budget projection.[72]

In addition to base Medicaid costs, the Civic Federation's projection includes costs relating to the federal Affordable Care Act (ACA). Illinois has not yet decided whether to expand Medicaid eligibility in 2014 under the ACA.[73] Regardless of whether the State participates in the expansion, additional Medicaid costs are expected due to previously eligible individuals who had not enrolled in the program but are expected to sign up due to the insurance requirements of the ACA and publicity surrounding the law.

[69] Illinois State FY2013 Budget, p. 5-129; Communication between the Civic Federation and the Governor's Office of Management and Budget, February 14, 2013.
[70] The Illinois Department of Healthcare and Family Services (HFS) administers the State's Medicaid program and accounts for most of its spending, but roughly $2 billion a year in expenditures are made by other agencies. Although HFS' Medical Assistance program is the best available approximation to the Medicaid program, roughly 10% of its appropriations are outside of the Medicaid program.
[71] Illinois Department of Healthcare and Family Services, *FY12 Budget Update: FY12 Medicaid Costs Less Than Expected*, November 2012; Illinois Department of Healthcare and Family Services, *Annual Report Medical Assistance Program Fiscal Years 2009, 2010, 2011*, March 30, 2012, p.22.
[72] State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013. However, the Civic Federation's projection does not include cuts to Medicaid in FY2015 and FY2016 shown the Governor's projection.
[73] Proposed legislation (98th Illinois General Assembly, Senate Bill 26 and House Bill 106, introduced on January 10, 2013) would authorize expanded eligibility for Medicaid under the ACA.

As shown in the next chart, General Funds Medicaid costs are projected to increase by $1.8 billion, or 26.6%, from $6.8 billion in FY2013 to $8.6 billion in FY2018.



*The Medical Assistance program at the Illinois Department of Healthcare and Family Services is used as the best available approximation to the Medicaid program.
Source: State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-16*, January 11, 2013 and Civic Federation calculations . See Appendix D for data.

It is important to note that Medicaid spending in Illinois is generally reimbursed by the federal government at a rate of 50%.[74] That means that the budget impact of Medicaid expenditures is half of the total amount of spending. In the General Funds, for example, a $1 appropriation for Medicaid represents 50 cents in State-funded spending and 50 cents in federally funded spending.[75] The chart above shows gross General Funds Medicaid costs, including both State-funded and federally-funded spending.

In addition to General Funds, the Illinois Medicaid program receives a significant amount of funding from Other State Funds sources, including rebates paid by prescription drug manufacturers, proceeds from the settlement of tobacco-related litigation and payments by local governments and healthcare providers that are structured to bring in additional federal matching funds.

[74] Federal matching payments for the Children's Health Insurance Program (CHIP) are at a rate of 65% and are scheduled to increase to 85% under the Affordable Care Act beginning in 2016. Due to data limitations, this increase is not reflected in the estimates above. CHIP provides health coverage to children in families whose income is too high to qualify for Medicaid. Illinois had 329,104 enrollees in FY2010.
[75] The Medicaid program is also funded by transfers out of General Funds, which are not reflected in the chart but are discussed below. Transfers out are shown as net amounts in the budget. The FY2013 budget includes a $500 million transfer out of General Funds to pay down Medicaid bills. Another $151 million transfer to fund Medicaid costs has not yet been enacted.

Base Medicaid Costs

A 3% annual increase in base General Funds Medicaid costs would be a much slower growth rate than previously projected by HFS. In April 2012, HFS projected that General Funds and related costs would increase by an average of 5.2% annually from FY2012 to FY2017.[76]

The projected slowdown in cost increases appears to be connected to plans to enroll Medicaid recipients in managed care. Managed care, also known as coordinated care, is designed to improve the quality of care and lower costs by rewarding healthcare providers for keeping people healthy, rather than tying payment to the volume of services provided. A Medicaid reform law enacted in 2011 requires that half of Medicaid recipients be enrolled in coordinated care by January 1, 2015.[77] HFS recently issued a rollout schedule that calls for two-thirds of recipients to be covered by care coordination by the 2015 deadline.[78] Currently 270,851 Medicaid recipients, less than 10% of the total, are enrolled in Health Maintenance Organization-style managed care.[79]

The State is also moving to close State-run institutions for the developmentally disabled and relocate residents to community settings. Jacksonville Developmental Center in Jacksonville was closed in November 2012 and the State is in the process of closing Murray Developmental Center in Centralia. According to the State officials, it cost an average of $200,000 a year for a resident to live at Jacksonville, compared with an average of $84,000 in a smaller community setting.[80] On February 19, 2013, a group of parents of residents of the Murray Center have filed a federal lawsuit to prevent or delay the center's closing.[81] Costs for the developmentally disabled are covered by Medicaid but are in the budget of the Illinois Department of Human Services rather than HFS.[82]

Significant steps were taken to reduce Medicaid costs in FY2013 to close an estimated $2.7 billion funding gap. A package of legislation enacted in June 2012 authorized $1.36 billion in program reductions; $240 million in reimbursement rate cuts to healthcare providers; and $900 million in additional revenue, including a $1-a-pack increase in the State cigarette tax.[83] At a General Assembly hearing on February 21, 2013, HFS Director Julie Hamos said that program savings in FY2013 are expected to be approximately $464.5 million short of the target but that the shortfall will be largely offset by $395 million in savings in FY2012.[84]

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[76] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, April 2012.
[77] Public Act 96-1501.
[78] Illinois Department of Healthcare and Family Services, *Care Coordination Roll-Out Plan, January 2013-January 2015*, November 29, 2012.
[79]Illinois Department of Healthcare and Family Services, *Managed Care Enrollment*, http://www2.illinois.gov/hfs/ManagedCare/Pages/Enrollment.aspx (last visited on February 17, 2013).
[80] State of Illinois, "Governor Quinn Announces Successful Community Transition for Jacksonville Developmental Center Residents," *news release*, November 29, 2012.
[81] Brian Brueggemann, "Murray Center parents file federal suit to prevent closure," *Belleville News Democrat*, February 20, 2013.
[82] State savings due to moving residents to community setting from State institutions are not included in the Civic Federation projections due to data limitations.
[83] The main laws are Public Acts 97-0689, 97-0688 and 97-0691. The remaining part of the plan, a $150 million transfer from General Funds designed to generate $300 million through a cycle of State spending and federal reimbursement, had not been approved as of the publication date of this report. For more information on the Medicaid restructuring plan, see the Civic Federation's Institute for Illinois' Fiscal Sustainability, *State of Illinois Enacted Budget FY2013: A Review of the Operating Budget for the Current Fiscal Year*, October 8, 2012, pp. 31-36, http://www.civicfed.org/StateofIllinoisEnactedBudgetFY2013.
[84] HFS Director Julie Hamos, testimony before the House Appropriations Committee on Human Services, February 21, 2013.

HFS has instituted major program reductions, such as cancelling coverage for 28,039 parents in the FamilyCare program and ending Illinois Cares Rx, a prescription drug program for 186,000 seniors. Several program changes, however, have been blocked or delayed by the federal government and the Joint Committee on Administrative Rules (JCAR), the General Assembly committee that oversees agency rulemaking. For example, the federal government turned down a plan, expected to save $7.7 million, to raise minimum standards used to determine whether elderly and disabled people qualify to be placed in nursing homes and apartment-style housing.[85] JCAR rejected a rule relating to hospital payment for preventable conditions; a compromise is being negotiated with hospitals, but HFS does not expect to achieve $29 million of the projected $30 million in savings.[86]

Another change, estimated to save $15 million, has been held up by a federal lawsuit from parents of children who are dependent on ventilators. The lawsuit, which argues that planned Medicaid cuts violate the Americans with Disabilities Act by forcing the children to receive care in institutions, rather than at home, is being negotiated.[87]

A four-prescription-a-month limit on drugs that was projected to save $180 million has been phased in gradually, due to initial logjams in processing requests for medical exceptions, and is now expected to save $90 million in FY2013.[88] Closer scrutiny of drug use has helped the agency to uncover duplicate and inappropriate prescriptions, according to HFS officials.[89]

The largest projected saving—$350 million—is designed to remove ineligible recipients from the program by improving eligibility screening, but HFS officials have publicly questioned the validity of the savings projection, which came from the Illinois Hospital Association.[90] In addition, the tightened screening did not get underway until January 1, 2013 due to preparation requirements for a private vendor. The effort is now expected to save roughly $150 million in FY2013.[91]

If the Medicaid funding gap is not closed, then unpaid bills could accumulate at the end of FY2013. A provision of Section 25 of the State Finance Act has allowed Medicaid costs to be paid from future years' appropriations.[92] In general, Section 25 requires that bills incurred in a given year be paid out of that year's appropriation. There is a lapse period, which typically lasts two months, during which next year's revenues may be used to pay this year's bills.[93] However, what is known as the Section 25 exception permits the State to pay Medicaid bills out of future years' appropriations. This exception has allowed the State to appropriate inadequate amounts for Medicaid in order to make the budget appear balanced. In the meantime, Medicaid bills pile up outside the budget.

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[85] Illinois Department of Healthcare and Family Services, *SMART Act Implementation Status Report*, House Human Services Appropriation Committee Hearing, February 21, 2013, p. 6.

[86] Illinois Department of Healthcare and Family Services, *SMART Act Implementation Status Report*, House Human Services Appropriation Committee Hearing, February 21, 2013, p. 5.

[87] T.B. v. Julie Hamos, No. 12-5356 (N.D. Ill filed July 9, 2012).

[88] Illinois Department of Healthcare and Family Services, *SMART Act Implementation Status Report*, House Human Services Appropriation Committee Hearing, February 21, 2013, p. 7.

[89] Communication between the Civic Federation and the Illinois Department of Healthcare and Family Services, November 16, 2012.

[90] Julie Hamos, Director of the Illinois Department of Healthcare and Family Services, statement to the HFS Medicaid Advisory Committee, September 21, 2012.

[91] Illinois Department of Healthcare and Family Services, *SMART Act Implementation Status Report*, House Human Services Appropriation Committee Hearing, February 21, 2013, p. 1.

[92] 30 ILCS 105/25 (b-4). Use of this Section 25 exception is significantly reduced under Public Act 97-3397.

[93] The lapse periods for FY2010, FY2011 and FY2012 were extended to six months due to the large amount of outstanding bills at the end of the fiscal year.

Legislation enacted in 2012 significantly curtails the State's ability to defer HFS Medicaid bills beginning at the end of FY2013.[94] The new law limits these deferred liabilities to $700 million in FY2013 and $100 million thereafter, with certain exceptions.

Costs Related to the Affordable Care Act

Medicaid expansion is one of the key provisions of the ACA designed to reduce the number of people without health insurance. Non-senior, non-disabled adults without dependent children—regardless of income—have generally not been eligible for Medicaid.

The ACA extends Medicaid coverage to all adult citizens with annual incomes up to 133% of the federal poverty level (effectively 138%, or $15,415 for an individual in 2013, because 5% of income is disregarded in determining eligibility). The federal government is scheduled to pay 100% of the cost for the newly eligible population for the first three years of the program; 95% in 2017; 94% in 2018; 93% in 2019; and 90% thereafter.

The Medicaid expansion was made optional for states by a U.S. Supreme Court opinion in June 2012.[95] The Supreme Court generally upheld the ACA but ruled that the federal government could not withhold matching funds for states' existing Medicaid programs if they chose not to participate in the ACA expansion.

Under State law, Illinois is banned from expanding eligibility for Medicaid until January 2015.[96] The Illinois moratorium does not apply to Medicaid expansions required as a federal condition of state participation in the Medicaid program. Because participation in the ACA expansion is optional, however, the moratorium must be lifted to allow Illinois to participate in 2014. Proposed legislation in the General Assembly would lift the moratorium.[97]

The legislature lifted the ban in 2012 for the limited purpose of allowing Cook County's public health system to gain early access to Medicaid coverage for newly eligible recipients in its County Care plan.[98] But the federal government approved County Care only through December 31, 2013, meaning that 115,000 patients intended to be enrolled in the plan could lose Medicaid coverage unless Illinois joins the federal expansion in 2014.

If Illinois expands Medicaid eligibility under the ACA, HFS estimates that there would be 510,000 new Medicaid recipients by 2017.[99] Of that total, an estimated 342,000 would be newly eligible under the ACA and 168,000 would be individuals who were previously eligible but had not enrolled in the program.

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[94] Public Act 97-0691.
[95] Kaiser Family Foundation, *A Guide to the Supreme Court's Affordable Care Act Decision*, July 2012, pp. 5-6.
[96] Public Act 97-0687.
[97] 98th Illinois General Assembly, Senate Bill 26 and House Bill 106, both introduced on January 10, 2013.
[98] Public Act 97-0687.
[99] Illinois Department of Healthcare and Family Services, *New Medicaid Clients Under Affordable Care Act: Explanation of Enrollment Numbers*, http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAExplanationofenrollment.pdf (last visited on February 18, 2013); Illinois Department of Healthcare and Family Services, *E-news*, February 2013, http://www2.illinois.gov/hfs/PublicInvolvement/enews/Pages/February.aspx (last visited on February 18, 2013).

Illinois would not initially face costs for newly eligible recipients until the second half of FY2017, because the federal government will pay all their costs through calendar year 2016. The State plans to use Other State Funds for payments and expenses relating to these recipients.[100]

Estimates by HFS indicate that approximately 58% of the newly eligible will enroll in the first year, with enrollment ramping up over the next four years.[101] Costs for the newly eligible are estimated at an initial rate of $454 per member per month in 2014 and rise at a rate of 2% a year.[102] According to HFS, $454 is 10% more than the agency spends on low-income parents in the FamilyCare program. HFS is proposing that newly eligible recipients receive the same benefits as FamilyCare enrollees, but the agency increased the cost estimate to account for uncertainties about the medical status of the new population. Plans call for enrolling the newly eligible recipients in managed care.[103]

The next table shows HFS' estimates of federal and State costs for newly eligible recipients from calendar year 2014 to calendar year 2020.

State of Illinois Estimated Cost of Newly Eligible Medicaid Recipients under the Affordable Care Act 2014-2020 (in $ millions)

	Federal Match	Federal Revenues	State Cost
2014	100%	$ 1,081.9	$ -
2015	100%	$ 1,656.2	$ -
2016	100%	$ 1,858.4	$ -
2017	95%	$ 1,877.3	$ 98.8
2018	94%	$ 1,894.7	$ 120.9
2019	93%	$ 1,912.0	$ 143.9
2020	90%	$ 1,887.3	$ 209.7
Total		**$ 12,167.8**	**$ 573.3**

Source: Illinois Department of Healthcare and Family Services, *Medicaid Financing for the Uninsured: How the Revenues and Costs Are Computed,* http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAHowRevenuesandCostsareComputed.pdf.

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[100] State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013. The Governor's projection does not account for newly eligible recipients in the General Funds.

[101] Illinois Department of Healthcare and Family Services, *Medicaid Financing for the Uninsured: How the Revenues and Costs Are Computed*, http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAHowRevenuesandCostsareComputed.pdf (last visited on February 18, 2013).

[102] Illinois Department of Healthcare and Family Services, *Medicaid Financing for the Uninsured: How the Revenues and Costs Are Computed*, http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAHowRevenuesandCostsareComputed.pdf (last visited on February 18, 2013).

[103] Illinois Department of Healthcare and Family Services, *Care Coordination Roll-Out Plan, January 2013-January 2015*, November 29, 2012.

Critics of Medicaid expansion are concerned that the federal government might reduce scheduled Medicaid reimbursement rates due to its own budgetary problems.[104] To ease those concerns, the proposed legislation in Illinois ends coverage for the newly eligible population if the federal reimbursement rate drops below 90%.

Medicaid spending for previously eligible individuals who enroll because of the ACA will be reimbursed by the federal government at the regular rate—50% for Illinois—rather than at the ACA expansion rate. Regardless of whether or not Illinois decides to expand the program, previously eligible individuals are expected to enroll because of publicity surrounding the ACA and policies that steer individuals to Medicaid if they are not eligible to obtain insurance coverage through a new ACA-mandated health insurance exchange.[105]

Although HFS has not issued total cost projections for previously eligible recipients, the agency has indicated its assumptions about enrollment and per member costs. HFS estimates that 51% of the 168,000 previously eligible enrollees will be adults and 49% children and that approximately 58% will enroll in calendar year 2014.[106] Adults are initially expected to cost $454 a month, the same as the newly eligible, children are expected to cost $219 and those costs are expected to increase by 2% a year.[107]

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[104] Jamey Dunn, "Even in the President's home state, backlash still exists for the Supreme Court's ruling on the Affordable Care Act," *Illinois Issues*, September 2012.
[105] Kaiser Family Foundation, *The Cost and Coverage Implications of the ACA Medicaid Expansion: National and State-by-State Analysis*, November 2012, p. 29.
[106] Illinois Department of Healthcare and Family Services, *Costs 2014 (Essentially HMA Analysis)*, Handout to Medicaid Advisory Committee, November 8, 2011; Illinois Department of Healthcare and Family Services, *E-News*, February 2013.
[107] Communication between the Civic Federation and the Illinois Department of Healthcare and Family Services, February 14, 2013.

The following table shows the Civic Federation's estimates of net State costs for previously eligible but not enrolled recipients from FY2014 to FY2018. For the purpose of these estimates, new enrollees have been phased in in monthly increments. Net State costs, after federal reimbursements, increase to $366 million in FY2018 from $29 million in FY2014.

State of Illinois Estimated Cost of Previously Eligible But Not Enrolled Medicaid Recipients: FY2014-FY2018 (in $ millions)

	Total Recipients*	Federal Revenues	Net State Cost**	Total Cost
FY2014	48,888	$ 29	$ 29	$ 58
FY2015	122,052	$ 180	$ 180	$ 360
FY2016	153,720	$ 300	$ 300	$ 600
FY2017	164,556	$ 343	$ 343	$ 686
FY2018	168,000	$ 366	$ 366	$ 733

*Represents total number of previously eligible but not enrolled recipients enrolled as of June 30 of each year due to the Affordable Care Act. New enrollment begins halfway through FY2014.

**State cost after federal reimbursement of 50%.

Source: Civic Federation calculations based on Illinois Department of Healthcare and Family Services (HFS), *New Medicaid Clients Under Affordable Care Act: Expanation of Enrollment Numbers* , http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAExplanationofenrollment.pdf; HFS, *Medicaid Financing for the Uninsured: How Revenues and Costs are Computed* , http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAHowRevenuesandCostsareComputed.pdf; HFS, E-News, February 2013; HFS, *Costs 2014 (Essentially HMA Analysis)* , Handout to Medicaid Advisory Committee, November 8, 2011; Communication between Civic Federation and HFS, February 14, 2013.

The total cost estimates in the chart at the beginning of this section were gross numbers, meaning that they showed total spending without deducting federal reimbursements. That chart did not include spending on newly eligible Medicaid recipients under the ACA because such a large share is covered by the federal government.

The next table shows estimated net State General Funds costs—after federal reimbursement—for all components of spending. Net State costs have been estimated for fiscal years, rather than calendar years. Net costs increase by $1.0 billion, or 29.9%, to $4.4 billion in FY2018 from $3.4 billion in FY2013.

State of Illinois Projected General Funds Medicaid Costs After Federal Reimbursement: FY2013-FY2018 (in $ millions)						
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
Base Costs	$ 3,402	$ 3,501	$ 3,606	$ 3,714	$ 3,826	$ 3,941
ACA Previously Eligible Costs	$ -	$ 29	$ 180	$ 300	$ 343	$ 367
ACA Newly Eligible Net Costs	$ -	$ -	$ -	$ -	$ 49	$ 110
Total Net Costs	**$ 3,402**	**$ 3,530**	**$ 3,786**	**$ 4,014**	**$ 4,218**	**$ 4,418**

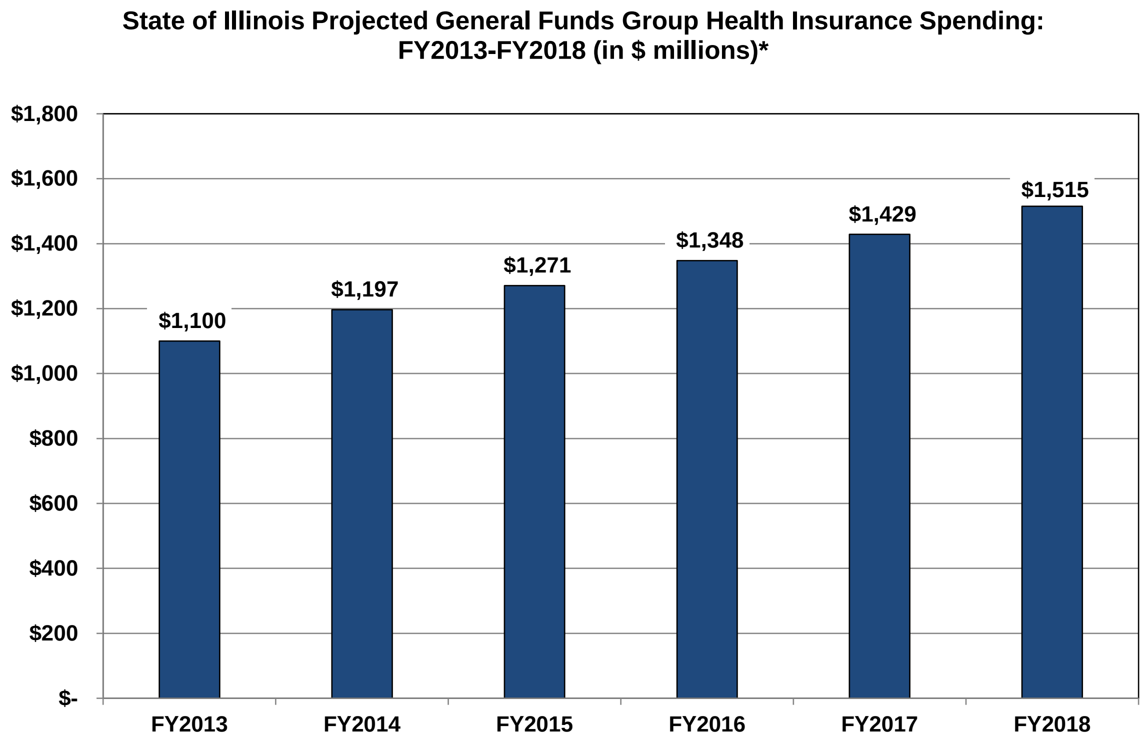
Source: Civic Federation calculations based on Illinois Department of Healthcare and Family Services (HFS), *New Medicaid Clients Under Affordable Care Act: Expanation of Enrollment Number, http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAExplanationofenrollment.pdf;* HFS, *Medicaid Financing for the Uninsured: How Revenues and Costs are Computed, http://www2.illinois.gov/hfs/SiteCollectionDocuments/ACAHowRevenuesandCostsareComputed.pdf;* HFS, *E-News,* February 2013; HFS, *Costs 2014 (Essentially HMA Analysis)* , Handout to Medicaid Advisory Committee, November 8, 2011; Communication between Civic Federation and HFS, February 14, 2013.

State Group Health Insurance

The State Employees' Group Insurance Program provides health insurance coverage to an estimated 358,552 participants, including employees and retirees and their dependents.[108] Costs of the program, estimated to total $2.6 billion in FY2013, are paid from General Funds and other sources, including the State's Road Fund, State universities and member contributions.[109]

General Funds spending for group health insurance is projected to increase by 37.7% from $1.1 billion in FY2013 to $1.5 billion in FY2018. In the chart on the following page, projections for FY2013 to FY2016 are from the Governor's Office of Management and Budget (GOMB).[110] Spending in FY2017 and FY2018 is assumed to increase at an annual rate of 6%, approximately the same growth rate used by GOMB for FY2015 and FY2016.[111]

[108] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2013*, March 2012, p. 7. The program also provides life insurance at a relatively small cost to the State of Illinois.
[109] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2013*, March 2012, pp. 2 and 6.
[110] Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.
[111] The Governor's Office of Management and Budget forecasts a spending increase of 8.8% in FY2014, which is said to make up for previous underappropriation.



* For FY2013-FY2016, projections are from the Governor's Office of Management and Budget. For FY2017 and FY2018, spending is assumed to grow at 6% a year.
Source: Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.

The State offers both a traditional health insurance plan, which allows participants to choose any doctor or hospital, and managed care plans such as Health Maintenance Organizations (HMOs), which generally restrict choices. Membership in the traditional plan has declined by 18.1% to an estimated 116,952 participants in FY2013 from 142,779 in FY2005.[112] In FY2013, 67.4% of total participants were expected to be enrolled in managed care. Retirees, however, overwhelmingly choose the more expensive traditional health plan. In FY2013, 64.9% of retirees were expected to be enrolled in the traditional plan.[113]

Until June 2012, Illinois law stated that State employees who retired before January 1, 1998 and those who retired after that date with at least 20 years of service were not required to pay health insurance premiums.[114] Exceptions included General Assembly members and constitutional officers, who could retire with as few as four years of service and not pay any premiums, and judges, who could retire with as few as six years of service and not pay premiums.[115]

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[112] Civic Federation calculation based on Commission on Government Forecasting and Accountability, *Fiscal Year 2006 Liabilities of the State Employees' Group Insurance Program,* March 2005, p. 4; Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2013*, March 2012, p.7.
[113] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 7.
[114] 5 ILCS 375/10. The State has 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.
[115] General Assembly members elected before January 1, 2011 can retire at age 62 with four years of service; those elected on or after that date must be 67 with eight years of service. Judges elected or appointed before January 1, 2011 can retire at 62 with six years of service; judges elected or appointed on or after that date must be 67 with eight years of service.

As a result, approximately 90% of the more than 80,000 retirees covered by the State's group insurance program did not pay any health insurance premiums as of January 2011.[116] The State's cost for retiree health insurance coverage in FY2013 was projected at $684.3 million, while retirees' contributions were estimated at $25.8 million.[117] These figures do not include the cost of coverage for retirees' dependents; all retirees are required to pay premiums for their dependents.

In June 2012, Illinois enacted legislation that eliminated premium-free health coverage for retirees.[118] The legislation did not specify how retiree health insurance premiums would be determined, leaving that decision to the State's Department of Central Management Services (CMS). CMS has said that retiree premiums, like other healthcare benefits, will be negotiated with the State's unions. Premiums are expected to be based in part on retirees' pensions, with those receiving larger pensions required to pay higher premiums.[119] CMS' decisions on premiums will be subject to review by the General Assembly's Joint Commission on Administrative Rules.

As of the publication date of this report, CMS has not proposed rules relating to retiree health insurance premiums. Health insurance premiums for employees and retirees are a key issue in ongoing negotiations over union contracts to replace agreements that expired at the end of FY2012.[120] The State's largest union, Council 31 of the American Federation of State, County and Municipal Employees (AFSCME), is reportedly considering a strike due to health insurance premium increases demanded by the Governor's Office.[121] Meanwhile, a lawsuit filed by AFSCME and other unions to overturn the new retiree health insurance law is pending in Sangamon County Circuit Court.[122]

The FY2013 budget assumed that the State would save approximately $350 million on group health insurance due to changes to be agreed to by labor unions.[123] Because the contract issues have not yet been resolved, it is now projected that the FY2013 General Funds appropriation of $1.1 billion will be $218 million less than the amount needed to fully fund the annual cost of group health insurance.[124]

Any unfunded costs will add to the State's backlog of unpaid bills. Unpaid health insurance bills grew to $1.4 billion in FY2012 and are projected to increase by $218 million in FY2013 due to the

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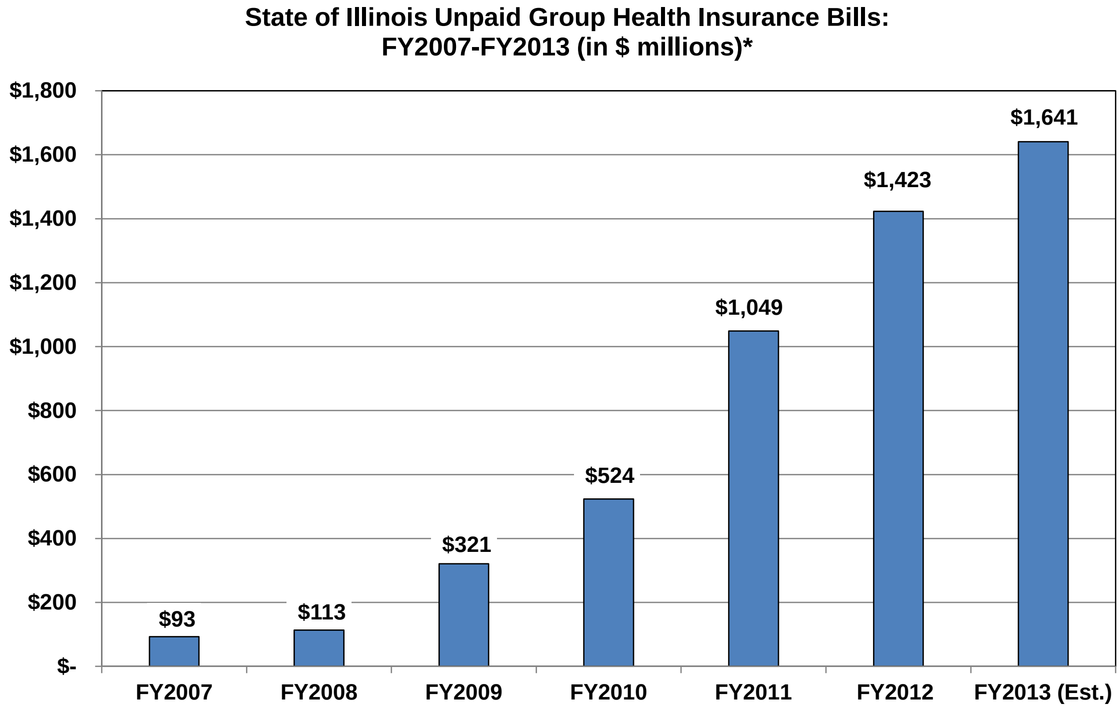
[116] Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services*, February 17, 2011, p. 2.
[117] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program FY2013*, March 2012, p. 13. The State contribution includes funding from General Funds and Other State Funds.
[118] Public Act 97-0695.
[119] Illinois Department of Central Management Services, memo from Director Malcolm Weems to Representative Tom Cross on SB1313—Retiree Healthcare Proposal, May 9, 2012.
[120] Monique Garcia, "Quinn, state workers firmly at odds in contract dispute; Pay raises, health care benefits are key points of contention," *Chicago Tribune*, December 10, 2012.
[121] Doug Finke, "AFSCME to members: Put away cash for possible strike," *State Journal-Register*, February 11, 2013.
[122] Council 31 AFSCME, "Hearing set on motion to dismiss retiree health lawsuit," January 15, 2013, http://www.afscme31.org/news/hearing-set-on-motion-to-dismiss (last visited on February 12, 2013).
[123] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 24, 2013.
[124] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 24, 2013.

funding shortfall.[125] As a result of insufficient funds, some doctors are waiting more than 11 months for the State to pay claims.[126]

The total annual cost of group health insurance has not been reflected in the State budget due to a provision of Section 25 of the State Finance Act that allows group health insurance bills, like Medicaid bills, to be paid from future years' appropriations.[127] As shown in the next chart, Section 25 deferred liabilities relating to group health insurance have increased by 1,664.5%, from $93 million at the end of FY2007 to a projected $1.6 billion at the end of FY2013.



*Section 25 liabilities relating to group health insurance as of June 30.
Source: Communication between the Civic Federation and Governor's Office of Management and Budget, January 24, 2013; Illinois State Comptroller's website at http://www.ioc.state.il.us/index.cfm/linkservid/A0FD646B-1CC1-DE6E-2F485BDED411AF81/showMeta/0/.

[125] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 24, 2013.
[126] Illinois Department of Central Management Services, *Notice Regarding QCHP and QCDP Claim Payment Delay*, February 8, 2013. http://www2.illinois.gov/cms/Employees/benefits/Insurance/Pages/QCHPQCDPClaimPaymentDelay.aspx (last visited on February 12, 2013)
[127] 30 ILCS 105/25 (b-4).

Unpaid group health insurance bills rose sharply starting in FY2009, when deferral of Medicaid bills began to be restricted by federal stimulus legislation.[128] A new law that imposes limitations on the deferral of Medicaid bills does not cover health insurance bills.[129]

The State also contributes to the Teachers' Retirement Insurance Program (TRIP) and the College Insurance Program (CIP), which cover retired teachers and retired community college employees outside of Chicago.[130] Unlike most retirees in the State group health program, retirees in TRIP and CIP have been required to pay health insurance premiums.

The FY2013 budget includes appropriations for TRIP and CIP that are lower than the contribution amounts required by State law.[131] However, these contributions are covered by continuing appropriation, meaning that the full required contribution will continue to be paid, unless the law mandating the payments is changed.[132] The required contribution amounts for TRIP and CIP, respectively, are $86.7 million and $4.2 million in FY2013 and $90.4 million and $4.4 million in FY2014.[133]

Retirees covered by TRIP effectively obtain subsidies if they live out of state. Under Illinois law, TRIP retirees who do not have access to the State's managed care networks—including those who live outside of Illinois—pay half as much in premiums for the traditional health plan.[134] For example, the monthly premium is $342.85 for a TRIP retiree aged 65 or older without Medicare who does not have access to managed care. The premium is $685.68 for the same retiree who does have access to managed care.[135]

Total General Fund Costs

Based on the Civic Federation's five-year projection presented in this section, the State's total General Funds expenditures will increase by $3.3 billion, or 9.9%, to approximately $37.1 billion in FY2018 from $33.7 billion in FY2013. The projected increase holds expenditures flat in most areas of the budget after FY2014 and does not account for any increases in employee wages or changes in commodity prices. The projection incorporates increases in annual appropriations for Medicaid that reflect the estimated General Funds cost of the program, including increases related to the rollout of the federal Affordable Care Act (ACA). The projection also takes into account increases in statutorily required pension contributions, group health insurance costs and debt service payments.

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[128] Illinois State Comptroller, "The State Fiscal Crisis—How Did We Get Here?" *Fiscal Focus*, September 2011, p.7. The American Recovery and Reinvestment Act of 2009 required that many Medicaid healthcare providers be paid within 30 days.
[129] Public Act 97-0691.
[130] In the projections in this report, contributions to TRIP and CIP are included in agency appropriations.
[131]5 ILCS 375/6.6(c) and 5 ILCS 375 6.10(c). The FY2013 budget includes a contribution of $62.6 million for TRIP and no contribution for CIP.
[132] 40 ILCS 15/1.3 and 40 ILCS 15/1.4.
[133] Teachers' Retirement System of the State of Illinois, Letter to Governor Pat Quinn on Teacher Health Insurance Security Fund Certification for FY2014, November 1, 2012; State Universities Retirement System of Illinois, Letter to Governor Pat Quinn on certification of projected contributions to the Community College Health Insurance Security Fund for FY2014, October 26, 2012; Communication between the Civic Federation and the Governor's Office of Management and Budget, April 5, 2012.
[134] 5 ILCS 375/6.5(e)(2) and (3).
[135] Teachers' Retirement Insurance Program, *Benefit Choice Options*, Effective July 1, 2011-June 30, 2012, p. 4, http://www2.illinois.gov/cms/Employees/benefits/Teachers/Pages/TRIPRates.aspx (last visited on February 13, 2013).

The following table compares the FY2013 General Funds budget to projected expenditures for FY2014 through FY2018.

State of Illinois Five-Year Projections: Total General Funds Expenditures FY2013-FY2018 (in $ millions)								
	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	$ Change	% Change
Net Agency Appropriations	**$ 15,982**	**$ 15,677**	**$ 15,677**	**$ 15,677**	**$ 15,677**	**$ 15,677**	**$ (305)**	**-1.9%**
Medicaid Costs								
Base Cost	$ 6,804	$ 7,002	$ 7,212	$ 7,428	$ 7,651	$ 7,881	$ 1,077	15.8%
ACA Previously Eligible Cost	$ -	$ 58	$ 359	$ 600	$ 686	$ 733	$ 733	na
Total Medicaid Cost	**$ 6,804**	**$ 7,060**	**$ 7,571**	**$ 8,028**	**$ 8,337**	**$ 8,614**	**$ 1,810**	**26.6%**
Pension Costs								
Pension Contributions	$ 5,107	$ 6,111	$ 6,288	$ 6,470	$ 6,712	$ 6,974	$ 1,867	36.6%
Debt Service on Pension Bonds	$ 1,552	$ 1,655	$ 1,798	$ 1,356	$ 1,647	$ 1,619	$ 67	4.3%
Total Pension Costs	**$ 6,659**	**$ 7,766**	**$ 8,086**	**$ 7,826**	**$ 8,359**	**$ 8,593**	**$ 1,934**	**29.0%**
Group Health Insurance	**$ 1,100**	**$ 1,197**	**$ 1,271**	**$ 1,348**	**$ 1,429**	**$ 1,515**	**$ 415**	**37.7%**
Legislatively Required Transfers Out	**$ 2,533**	**$ 2,658**	**$ 2,180**	**$ 2,201**	**$ 2,201**	**$ 2,201**	**$ (332)**	**-13.1%**
ACA Newly Eligible Net Cost	**$ -**	**$ -**	**$ -**	**$ -**	**$ 98**	**$ 121**	**$ 121**	**na**
Debt Service on Capital Bonds*	**$ 653**	**$ 487**	**$ 431**	**$ 418**	**$ 383**	**$ 360**	**$ (293)**	**-44.9%**
Total Expenditures	**$ 33,731**	**$ 34,845**	**$ 35,216**	**$ 35,498**	**$ 36,484**	**$ 37,080**	**$ 3,349**	**9.9%**

*Includes interfund borrowing repayment of $132 million in FY2013.

Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement* , January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General funds), FY14-FY16* , January 11, 2013; Communication between Civic Federation and the Governor's Office of Management and Budget February 1, 2013.

Statutorily required pension contributions increase by $1.9 billion, or 36.6%, to 7.0 billion in FY2018 from $5.1 billion in FY2013. Total pension payments, including contributions and debt service on pension bonds, grow to $8.6 billion from $6.7 billion in FY2013.

Medicaid costs are projected to increase by $1.8 billion, or 26.6%, to $8.6 billion in FY2018 from $6.8 billion in FY2013. It should be noted that the total Medicaid cost presented above is reimbursed by the federal government at a rate of approximately 50%, so that the actual State portion of the cost is only half of what is presented. It is assumed that the State will pay for its portion of costs for newly eligible Medicaid recipients under the ACA through a transfer out of General Funds. The ACA newly eligible net cost line in the table represents the net amount to be spent by the State after the federal reimbursement rate is reduced from 100% to 95% halfway through FY2017 and to 94% halfway through FY2018.

In the chart above, the legislatively required transfers out of General Funds are held flat at $2.2 billion from FY2016 forward, following data provided in the Governor's three-year projection.[136]

Estimates of the annual transfers required to repay the State's outstanding capital purpose and pension bonds are included in the projections above. These transfers are slightly different from the actual debt service owed by the State as reported in the debt chapters of the Governor's annual budget or the official statements accompanying the State's bond sales. The transfer amounts represent the actual General Funds debt service cost and account for prefunding payments required by the State's Bond Authorization Act, timing of the final retirement of bonds and other incremental revenue sources available within the General Obligation Bond Retirement and Interest (GOBRI) Fund such as interest income on balances held in the fund.

[136] Legislatively required transfers are amounts paid out of the General Funds to Other State Funds each year as required by law to facilitate revenue sharing with local governments and fund specific programs not included in the General Funds budget.

Total debt service transfers, including amounts needed to repay interfund borrowing from FY2011, decline by $264.3 million from $2.2 billion in FY2013 to $1.9 billion in FY2018.

The following chart shows annual General Funds debt service transfers on all outstanding capital purpose bonds, pension bonds and repayment of interfund borrowing from FY2013 through FY2018.[137]

State of Illinois General Funds Debt Service: Total General Funds Transfer FY2013-FY2018 (in $ millions)						
Bond Type	**FY2013**	**FY2014**	**FY2015**	**FY2016**	**FY2017**	**FY2018**
Capital Bonds						
Existing Capital Bonds	$ 485.4	$ 467.2	$ 411.2	$ 398.4	$ 364.1	$ 341.4
Illinois Jobs Now Capital Bonds	$ 19.5	$ 20.1	$ 19.7	$ 19.3	$ 18.9	$ 18.5
Total Capital Transfer	**$ 504.8**	**$ 487.3**	**$ 430.9**	**$ 417.7**	**$ 383.0**	**$ 359.8**
Pension Bonds						
2003 POB	$ 556.1	$ 552.2	$ 548.2	$ 546.2	$ 566.8	$ 586.3
2010 POB	$ 763.6	$ 738.0	$ 361.9	-	-	-
2011 POB	$ 232.8	$ 364.8	$ 591.0	$ 872.0	$ 1,036.1	$ 986.9
Total POB Transfer	**$ 1,552.5**	**$ 1,655.0**	**$ 1,501.1**	**$ 1,418.3**	**$ 1,602.9**	**$ 1,573.2**
Interfund Borrowing Transfer	**$ 140.0**		**$ -**	**$ -**	**$ -**	**$ -**
Total Debt Service Transfer	**$ 2,197.3**	**$ 2,142.2**	**$ 1,932.0**	**$ 1,836.0**	**$ 1,985.9**	**$ 1,933.0**

Source: Communication between Civic Federation and Governor's Office of Management and Budget, February 19, 2013.

Although the decline in total debt service transfers will provide some budgetary relief, the annual debt service owed by the State is still much higher than in recent years. In FY2009 the General Funds transfer for debt service totaled $1.1 billion. In FY2010 and FY2011, the State issued $7.2 billion in Pension Obligation Bonds (POBs) to make its annual pension contributions. As shown in the chart above, there is a slight decline in POB debt service in FY2015 attributable to the final retirement of the FY2010 POBs. However, payments for the FY2011 POBs increase that year and will not be fully repaid until FY2019.

General Funds Revenues

General Funds revenues are primarily made up of State income taxes, sales taxes and funds provided by the federal government.[138] The majority of federal revenues are reimbursements to the State for Medicaid expenditures.[139] General Funds revenues from State and federal sources are projected to decrease by 4.3% to $32.9 billion in FY2018 from $33.4 billion in FY2013.

Income taxes, which make up more than half of total General Funds revenues, are the State's largest source of revenue. The change in the personal and corporate income tax rates enacted in January 2011 dramatically increased the resources available to support State operations through FY2014.[140] The partial sunset of the income tax rate scheduled for January 1, 2015 will lead to a significant reduction in resources in FY2015. The five-year projection in this chapter shows the

[137] FY2013 capital bond debt service shown in the Total General Funds Expenditures includes bonds not yet sold in the current fiscal year and differs slightly from the amount in the Total General Funds Transfer table, which only includes payments for currently issued bonds. Communication between Civic Federation and Governor's Office of Management and Budget, February 19, 2013.
[138] General Funds support the regular operating and administrative expenses of most State agencies and are the funds over which the State has the most control. The operating budget also includes Other State Funds, which are accounts for activities funded by specific revenue sources that may only be used for specific purposes, and Federal Funds (other than those designated for General Funds), which support a variety of State programs with federal revenues.
[139] State Medicaid expenditures are generally reimbursed at a 50% rate by the federal government.
[140] Public Act 96-1496.

additional decline in revenues in FY2016 and moderate growth in FY2017 and FY2018 after the rollback of the increased rates.

The five-year General Funds revenue projection includes trends for State-source revenues as currently enacted. Federal revenue projections are based on reimbursements for Medicaid appropriations as currently enacted for FY2013 plus anticipated growth from FY2014 through FY2018. Federal revenues for newly eligible Medicaid recipients under the ACA are expected to be received and spent in other designated funds and are not included in the General Funds revenues discussed in this section.[141]

This analysis is intended to provide a rough indication of the resources available to the State to pay for General Funds operations through the next five budget cycles. Especially in the case of federal revenue from Medicaid reimbursements, the assumptions used for this projection is based on the best available data but should be considered as approximations intended to show the magnitude of the program's expenses and resources.

State-Source Revenues

State-source revenues for FY2013 through FY2016 are based on the Governor's three-year projection as discussed earlier in this report. The growth rates used to develop the three-year projection are then extended through FY2017 and FY2018 to show a five-year outlook. The final two years of the projection assume continued moderate to low growth trends used by the Illinois Department of Revenue (IDOR) and Governor's Office of Management and Budget (GOMB) to develop the three-year projections. The majority of State-source revenues come from economically sensitive income taxes and sales taxes, which are expected to experience moderate to low growth, slightly trailing national economic trends.[142] However, the partial sunset of the increased personal and corporate income tax rates scheduled for halfway through FY2015 masks any underlying growth in total State-source revenues through FY2018.[143]

The five-year projection shows a total State-source revenue decline of nearly $2.4 billion to $27.8 billion in FY2018 from $30.2 billion in FY2013. Driving this decline is a total loss of $3.1 billion in income taxes, which is partially offset by an increase of $846.2 million in sales taxes and $121.4 million in other noneconomic sources of revenue such as transfers and State fee revenues.

The chart below shows the total State-source General Funds projection for FY2013 through FY2018.

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[141] If Illinois expands its Medicaid program with the Affordable Care Act, it is assumed that federal revenues related to newly eligible recipients all will be deposited into Other State Funds.
[142] Moody's Analytics, *State of Illinois Economic Forecast*, January 2013, p. 9.
[143] On January 1, 2015 the State personal income tax rate declines to 3.75% from 5.0% and the corporate income tax rate declines from 7.0% to 5.25%. The State also collects a Personal Property Replacement Tax (PPRT) at a rate of 2.5% on corporate income on behalf of local governments.

State of Illinois Five-Year Projection: State-Source General Funds Revenue FY2013-FY2018 (in $ millions)								
Revenue Sources	**FY2013**	**FY2014**	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**$ Change**	**% Change**
Income Taxes								
Personal Income Tax (net)	$ 15,272.5	$ 15,716.3	$ 14,255.1	$ 12,187.7	$ 12,550.8	$ 12,920.7	$ (2,351.7)	-15.4%
Corporate Income Tax (net)	$ 2,550.0	$ 2,870.6	$ 2,115.5	$ 1,707.7	$ 1,719.7	$ 1,731.7	$ (818.3)	-32.1%
Total Income Taxes	**$ 17,822.5**	**$ 18,586.9**	**$ 16,370.7**	**$ 13,895.3**	**$ 14,270.5**	**$ 14,652.4**	**$ (3,170.0)**	**-17.8%**
Sales Taxes	**$ 7,335.0**	**$ 7,385.0**	**$ 7,570.0**	**$ 7,765.0**	**$ 7,967.7**	**$ 8,181.2**	**$ 846.2**	**11.5%**
Other State Sources	**$ 3,047.0**	**$ 3,043.0**	**$ 3,073.0**	**$ 3,106.0**	**$ 3,137.1**	**$ 3,168.4**	**$ 121.4**	**4.0%**
Subtotal State Taxes & Fees	**$ 28,204.5**	**$ 29,014.9**	**$ 27,013.7**	**$ 24,766.3**	**$ 25,375.2**	**$ 26,002.1**	**$ (2,202.4)**	**-7.8%**
Transfers-In	$ 1,962.0	$ 1,723.0	$ 1,749.0	$ 1,775.0	$ 1,790.8	$ 1,806.7	$ (155.3)	-7.9%
Total State Sources	**$ 30,166.5**	**$ 30,737.9**	**$ 28,762.7**	**$ 26,541.3**	**$ 27,166.0**	**$ 27,808.8**	**$ (2,357.7)**	**-7.8%**

Source: State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement* , January 22, 2013, p. 11; Governor's Office of Management and Budget, *Three-Year Budget Projection (General Funds), FY14-FY16* , January 11, 2013; Communication between the Civic Federation and the Governor's Office of Management and Budget, February 1, 2013.

The Governor's three-year projection assumes the personal income tax base will grow between 1.7% and 2.9% annually from FY2014 through FY2016.[144] This growth was based on projected increases in wages and salaries between 3.1% and 3.9% in the same years provided by the economic consulting firm IHS Global Insight.[145] Wages and salaries are the primary economic indicator used to project personal income tax revenues along with recommendations and data provided by the Illinois Department of Employment Security (IDES). Based on the input from IDES and historic trends, GOMB has presented lower than baseline expectations for personal income tax growth in anticipation that professional and business services employment in Illinois will continue to lag behind IHS projections.[146] This growth is masked by the decline in the personal income tax rate to 3.75% from 5.0% halfway through FY2015, leading to annual personal income tax revenue losses of 9.3% in FY2015 and 14.7% in FY2016. After incurring a total decline of $3.5 billion personal income tax revenue from FY2014 to FY2016, the projection above assumes continued personal income tax base growth of 2.9% in FY2017 and FY2018. This leads to personal year-to-year income tax revenue increases of $363.2 million and $370.0 million in FY2017 and FY2018.

The Governor's three-year projection assumes base corporate income tax revenues decline in FY2014 by 1.1% and in FY2015 by 0.3% before increasing slightly in FY2016 by 0.6%. The corporate income tax revenues in the table above assume continued corporate income tax growth of 0.6% in FY2017 and FY2018. These projections are based on domestic corporate profit growth indicators provided by IHS Global Insight that show a decline of 4.1% in FY2014 and a decline of 1.2% in FY2015 before growth of 2.1% in FY2016. Although the five-year projection assumes these changes in base corporate income tax revenues, similar to the personal income tax, the scheduled sunset of the corporate income tax increase on January 1, 2015 is the largest factor in the projection from FY2014 through FY2018. Corporate income tax rates are scheduled to roll back to 5.25% from 7.0% on January 1, 2015. The lower rate leads to a total peak to trough decline of $1.2 billion in annual corporate income tax revenues from $2.9 billion in FY2014 to $1.7 billion in FY2016.

The State collects sales taxes at a rate of 6.25%, of which 5.0-percentage points are revenues to the State while 1.25-percentage points are distributed to local and county governments. The Governor's three-year projection assumes sales taxes will grow only marginally, by 0.7% from

[144] Communication between Civic Federation and Governor's Office of Management and Budget, February 1, 2013.
[145] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report (Public Act 96-1354)*, January 11. 2013, p. 2.
[146] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report (Public Act 96-1354)*, January 11. 2013, p. 2.

FY2013 to FY2014, and then at a moderate rate of 2.5% and 2.6% annually in FY2015 and FY2016. The five-year projection assumes additional growth of 2.6% in FY2017 and FY2018.

All other State sources and transfers in, which are not considered economically sensitive sources, are shown at relatively flat growth rates of 1.0% and 0.89% in FY2017 and FY2018.

Several noneconomic tax policy changes also factor into the State income tax projections. Due to the elimination of the State's backlog of unpaid income tax refunds in FY2013, the amount the State sets aside from its gross income tax receipts to pay tax refunds is expected to be reduced leading to increases in the amount available in the General Funds. In FY2014 the personal income tax diversion rate is expected to be reduced to 9.0% from 9.75% and the corporate income tax diversion rate reduced to 12.0% from 14.0%.[147]

The General Funds revenue projections in this section also take into account increases in tax exemptions and credits, known as tax expenditures, passed in the fall 2011 veto session.[148]

The largest business tax incentive included in the package was a reduction in corporate income tax liabilities for the CME Group, which owns the Chicago Mercantile Exchange and the Chicago Board of Trade. The sales factors for the exchanges are reduced to 63.77% in FY2013 and 27.4% in FY2014. Currently the sales factors at the exchanges are 100%, meaning that all of the trades made at the exchanges are considered Illinois sales and taxed at the full corporate tax rate of 7.0%. By reducing the sales factor percentage, the State reduces the corporate income tax liability for CME. This incentive is expected to reduce State revenues by approximately $85 million annually beginning in FY2013.

The legislation also included State tax credits for the Sears Corporation expected to reduce personal income tax receipts by $15 million annually for the next 10 years.

The Earned Income Tax Credit (EITC) is a federal program that allows low and moderate income workers to reduce their tax burden and receive refunds. Since January 1, 2000, Illinois has allowed individuals who qualify for the program to claim 5% of the federal credit toward their State income tax returns. Public Act 97-0652 increased the credit in Illinois to 10% in FY2013, which will reduce State personal income tax revenues by roughly $100 million annually.

The standard individual income tax deduction in Illinois was set at $2,000 on December 31, 2000. Under the new law, that amount increases to $2,050 in FY2013 and thereafter is automatically adjusted based on the Consumer Price Index for All Urban Areas to account for inflation. This tax break is expected to reduce personal income tax revenues to the State by $30 million in FY2013, $50 million in FY2014 and $75 million in FY2015 and beyond.

As part of the income tax increase legislation passed in January 2011, the State suspended the net operating loss deduction for businesses, other than Subchapter S corporations, through December 31, 2014 in order to maximize receipts from the corporate income tax rate increase.[149] The net operating loss deduction allows businesses reporting a loss in total annual income to reduce future tax liabilities by their losses and spread the amounts out for up to 12 years. It was estimated that suspending the deduction would increase annual State revenues by $250 million. The net

[147] Communication between Civic Federation and the Governor's Office of Management and Budget, January 24, 2013.
[148] Public Act 97-0636 and 97-0652.
[149] Public Act 96-1496.

operating loss deduction was reinstated by Public Act 97-0636 but capped at $100,000 per year. It is estimated that this change will reduce State revenues by $50 million a year through FY2014 and that the full reinstatement in FY2015 will reduce General Funds revenues by approximately $300 million annually.

Federal Revenues

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 the federally-provided General Funds revenues are reimbursements for State Medicaid expenditures. The State receives federal Medicaid reimbursements after it has expended funds on the program.

In general, the federal government reimburses the State for approximately 50% of its Medicaid expenditures. The Governor's three-year projection showed estimated federal revenues based on Medicaid spending in FY2013 and FY2014. In FY2015 and FY2016, however, the Governor's projection showed dramatic cuts in Medicaid spending with no commensurate reductions in federal revenues. The Civic Federation's projection for FY2015 through FY2018 shows growth in federal revenues in line with expected increases in Medicaid spending.[150]

Federal revenue projections in the following table are based on the Governor's three-year projection through FY2014, increased by 3.0% through FY2018 to match expected growth in base Medicaid spending. It also shows the increase in General Funds federal revenue due to the Affordable Care Act.

State of Illinois Five-Year Projections: General Funds Federal Revenues
FY2013 to FY2018 (in $ millions)

	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
Medicaid Base Reimbursement*	$ 4,231	$ 4,193	$ 4,319	$ 4,448	$ 4,582	$ 4,719
Previously Eligible Enrollees**	$ -	$ 29	$ 180	$ 300	$ 343	$ 366
Total Federal Revenues	**$ 4,231.0**	**$ 4,222.0**	**$ 4,498.7**	**$ 4,748.5**	**$ 4,924.9**	**$ 5,085.6**

*FY2013 and FY2014 reflect Governor's three-year projection. Civic Federation calculations for FY2015 through FY2018 assume 3.0% increase in reimbursements coinciding with the estimated growth in Medicaid program costs.

**Federal reimbursement at 50% of State spending on previously eligible but not enrolled Medicaid recipients who enroll due to the Affordable Care Act.

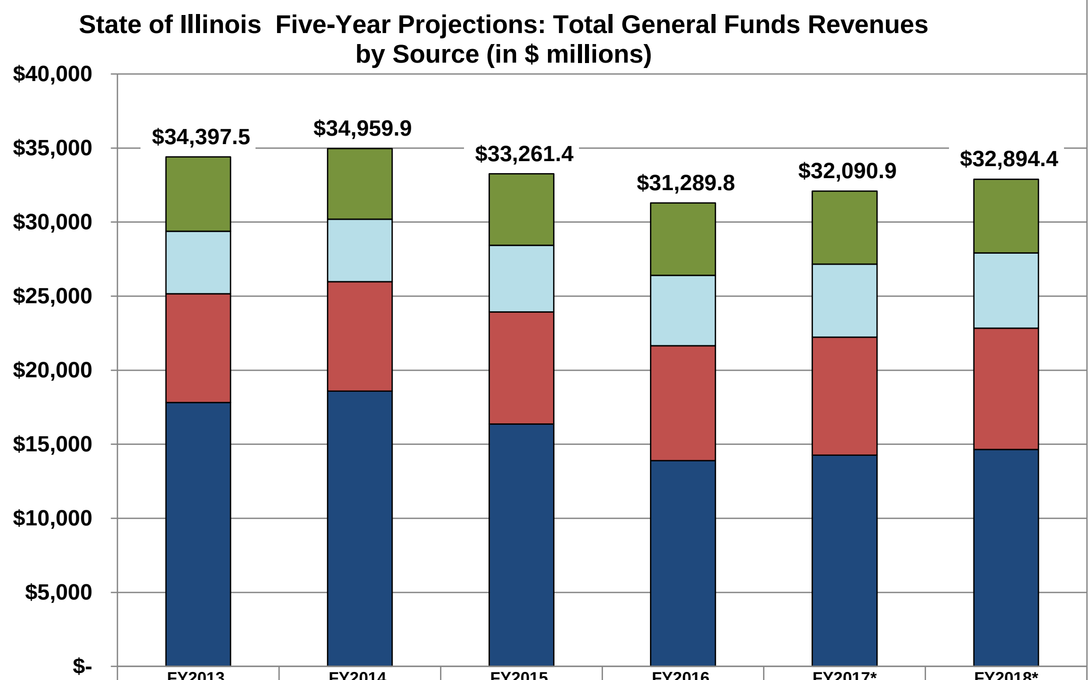
Source: Governor's Office of Management and Budget, *Three-Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.

Total General Funds Revenues

Total General Funds revenues from State and federal sources are projected to decline by $1.5 billion, or 4.4%, to $32.9 billion in FY2018 from $34.4 billion in FY2013. This decline includes $3.1 billion in income tax losses partially offset by increases of $846.2 million in sales taxes and $854.6 million in increased federal revenues. It should be noted that within the five-year projection, from peak to trough total General Funds revenues are expected to decline by $3.7 billion to $31.3 billion in FY2016 compared to $35.0 billion in FY2014.

[150] See p. 24 of this report for a discussion of the Civic Federation's projection of Medicaid spending.

The following chart shows total General Funds revenue projections by source for FY2013 through FY2018 by source.



	FY2013	FY2014	FY2015	FY2016	FY2017*	FY2018*
Total General Funds Revenue	$34,397.5	$34,959.9	$33,261.4	$31,289.8	$32,090.9	$32,894.4
Other	$5,009.0	$4,766.0	$4,822.0	$4,881.0	$4,927.9	$4,975.2
Federal Revenues	$4,231.0	$4,222.0	$4,498.7	$4,748.5	$4,924.9	$5,085.6
Sales Taxes	$7,335.0	$7,385.0	$7,570.0	$7,765.0	$7,967.7	$8,181.2
Income Taxes	$17,822.5	$18,586.9	$16,370.7	$13,895.3	$14,270.5	$14,652.4

*Civic Federation projection for FY2017 and FY2018 based on growth rates used in Governor's three-year projection.
State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; Governor's Office of Management and Budget, *Three-Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013; Communication between the Civic Federation and the Governor's Office of Management and Budget,

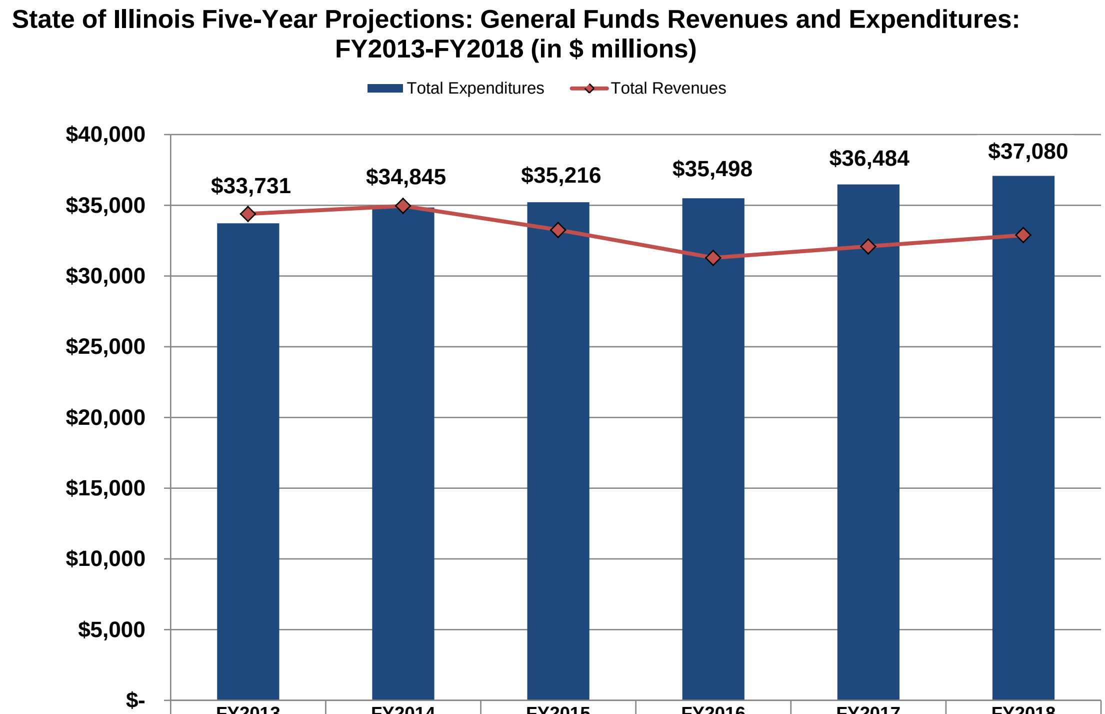
General Funds Deficits and Unpaid Bills

The Civic Federation's five-year projection shows that the State of Illinois' operating expenses will exceed revenues from FY2015 through FY2018. As a result, if nothing is done unpaid bills are projected to climb from $7.8 billion at the end of FY2013 to $21.7 billion at the end of FY2018.

This projection might understate the actual growth in unpaid bills. As discussed previously, the forecast incorporates only selected spending pressures and assumes a relatively modest increase of 3% a year in base Medicaid costs. Although assumptions about underlying revenue growth are also conservative, it is unlikely that any increase in economic activity could offset the loss of income tax revenues related to the rollback of tax rate increases halfway through FY2015.

The analysis shows the magnitude of the State's pending fiscal crisis. Despite painful cuts to the Medicaid program, expenditures remain unsustainable because of large and growing annual pension expenses.

The following chart shows total projected General Funds revenues compared to total expenditures from FY2013 through FY2018.



	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
Total Expenditures	$33,731	$34,845	$35,216	$35,498	$36,484	$37,080
Total Revenues	$34,396	$34,959	$33,261	$31,290	$32,091	$32,894
Operating Surplus (Deficit)	$667	$114	$(1,955)	$(4,208)	$(4,393)	$(4,186)

Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General funds), FY14-FY16*, January 11, 2013; Communication between Civic Federation and the Governor's Office of Management and Budget February 1, 2013.

As previously discussed, these estimates only take into account known pension contribution increases, increased Medicaid costs, the actual cost of debt service transfers and estimated cost increases in the State's group health insurance program. All other State costs are held flat at the FY2014 level shown in the Governor's three-year budget projection.[151]

Although the projections show a small surplus in FY2014, annual General Funds deficits increase dramatically in FY2015 and FY2016 due to the scheduled reduction in income tax rates and continued expenditure growth.[152] The General Funds operating deficit peaks in FY2017 at $4.4 billion before declining slightly to $4.2 billion in FY2018 due to natural revenue growth.

[151] Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY14-FY16*, January 11, 2013.
[152] Under Public Act 96-1496, the personal income tax rate will decline from 5.0% to 3.75% on January 1, 2015 and the corporate income tax rate will decline from 7.0% to 5.25%.

The following table shows major revenue sources and spending categories that contribute to operating deficits from FY2015 to FY2018.

State of Illinois Five-Year Projections: General Funds Operating Surplus (Deficit) FY2013-FY2018 (in $ millions)						
	FY2013	**FY2014**	**FY2015**	**FY2016**	**FY2017**	**FY2018**
Revenues						
State Source Revenues	$ 30,165	$ 30,737	$ 28,763	$ 26,541	$ 27,166	$ 27,809
Federal Revenues	$ 4,231	$ 4,222	$ 4,499	$ 4,749	$ 4,925	$ 5,086
Total Revenues	**$ 34,396**	**$ 34,959**	**$ 33,261**	**$ 31,290**	**$ 32,091**	**$ 32,894**
Expenditures						
Pension-Related Costs	$ 6,659	$ 7,766	$ 8,086	$ 7,826	$ 8,359	$ 8,593
Medicaid Costs	$ 6,804	$ 7,060	$ 7,571	$ 8,028	$ 8,337	$ 8,614
Other Expenditures	$ 20,268	$ 20,019	$ 19,559	$ 19,644	$ 19,788	$ 19,874
Total Expenditures	**$ 33,731**	**$ 34,845**	**$ 35,216**	**$ 35,498**	**$ 36,484**	**$ 37,080**
Operating Surplus (Deficit)	**$ 667**	**$ 114**	**$ (1,955)**	**$ (4,208)**	**$ (4,393)**	**$ (4,186)**

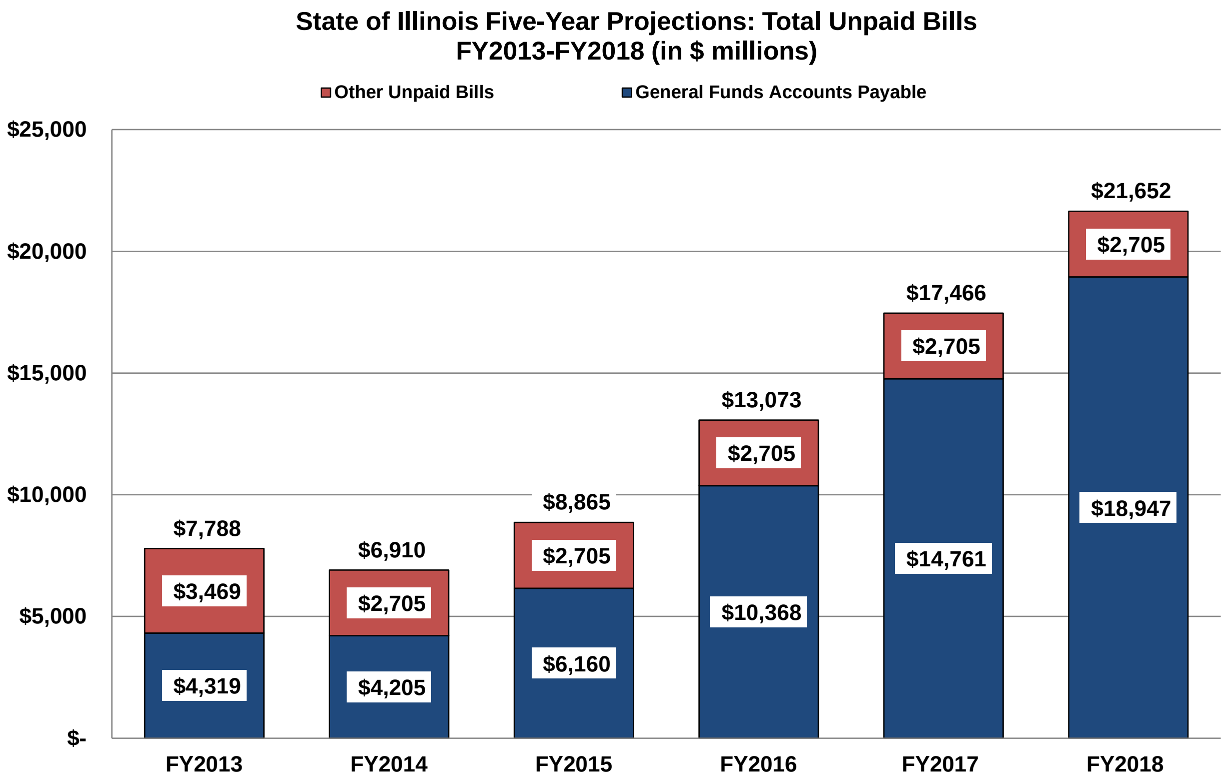
Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General funds)*, FY14-FY16, January 11, 2013; Communication between Civic Federation and the Governor's Office of Management and Budget, February 1, 2013.

Illinois has dealt with its General Funds deficits by delaying payments to vendors, social service agencies and local governments and paying those bills from the next year's revenue. The State typically has two months after the close of the fiscal year to pay off the prior year's bills. This lapse period has been extended to six months—through December 31—for the last three fiscal years due to the large amount of outstanding bills on June 30. Unpaid General Funds bills are expected to increase to $18.9 billion at the end of FY2018 from $4.3 billion at the end of FY2013.

The State has also masked General Funds deficits by underfunding Medicaid and group health insurance and paying those liabilities out of future years' appropriations.[153] The ability to defer Medicaid bills in this way was curtailed by legislation enacted in 2012.[154] The new law limited these kinds of liabilities incurred by the State's principal Medicaid agency, the Illinois Department of Healthcare and Family Services, to $700 million in FY2013 and $100 million thereafter, with certain exceptions. Group health insurance liabilities were not limited by the new law. This analysis assumes that the State will not underfund group health insurance costs and that group health insurance expenses will contribute to the annual operating deficit. However, past budget practice suggests that the State may be more likely to underappropriate for group health insurance, allowing bills to accumulate outside of the General Funds budget.

[153] Costs for the Community Care Program in the Department on Aging have been deferred through a different budgetary technique. These costs are not addressed in the projections due to data limitations.
[154] Public Act 97-0691.

The following table shows projected General Funds accounts payable and other liabilities from FY2013 to FY2018. Other liabilities remain flat from FY2014 because of the limitation on Medicaid bill deferrals and the assumption that group health insurance costs will be fully funded. If no changes are made to curb current government costs, total unpaid bills increase to $21.7 billion in FY2018 from $7.8 billion in FY2013.



Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General funds), FY14-FY16*, January 11, 2013; Communication between Civic Federation and the Governor's Office of Management and Budget, February 1, 2013.

Pension Reform Savings

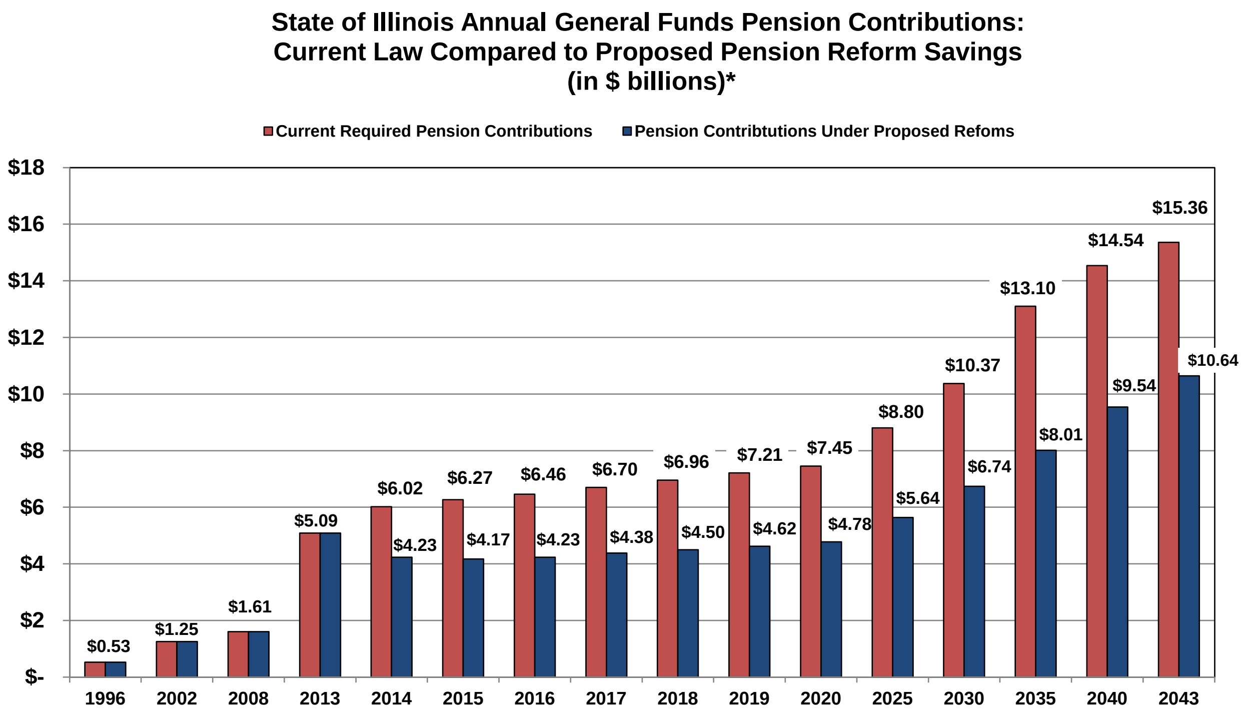
The projected growth in unpaid bills to $21.7 billion as shown in the Civic Federation's five-year projection is based on anticipated spending pressures under current law. One of the largest areas of growth in Illinois' budget involves increases in the State's annual pension contributions.

Proposed legislation in the General Assembly would significantly reduce State pension costs by reducing benefits, increasing employee contributions and shifting normal costs, or current service costs, for TRS and SURS to actual employers.[155] Much of the savings relates to the automatic benefit increase, which is now 3% a year, compounded, for retirees and employees hired before January 1, 2011. Under the proposed legislation, the automatic increase would be limited to $750 a year. Other changes for those hired before January 1, 2011 include a phased-in increase in retirement age; a phased-in two percentage point increase in contributions; and a pensionable salary cap. School districts, community colleges and universities would take over the State's normal pension cost at a rate of 0.5% of payroll per year for normal costs incurred after July 1, 2013, until costs are fully shifted.

[155] 98th Illinois General Assembly, Senate Bill 35, introduced on January 10, 2013 and House Bill 98, introduced on January 9, 2013.

Actuarial reviews of the impact of the legislation have been done for the largest three of the four affected retirement systems.[156] The analysis indicated that proposed changes would reduce the State's total unfunded pension liability by $28 billion, or 29%, from $95 billion to $68 billion.[157] State General Funds pension contributions in FY2014 would decline to $4.2 billion from a projected $6.0 billion under current law.[158]

The next chart shows estimated State General Funds contributions under the proposed legislation compared with required contributions under current law through FY2043. Under the proposed legislation, pension obligations would be fully funded by FY2043.



*Analysis based on 97th Illinois General Assembly, House Bill 6258 (replaced by Senate Bill 35 and House Bill 98 in 98th General Assembly). Includes Teachers', Employees' and Universities Retirement Systems but not General Assembly Retirement System, for which actuarial analysis was not available. HB6258 does not apply to Judges' Retirement System; contributions to Judges' system under current law are included in both sets of data above.
Source: Civic Federation calculations based on retirement systems' FY2012 actuarial valuations and actuarial valuations on impact of HB6258 prepared for Teachers', Employees' and Universities Retirement Systems, December 2012.

If State law were changed to achieve pension reform of the magnitude shown above and these savings were available beginning in FY2014, the State could experience significant growth in the FY2014 surplus to $1.9 billion from $115 million. Rather than a deficit of $2.0 billion in FY2015, a moderate surplus of $145 million could be achieved. Comprehensive reform could also lead to

[156] The legislation affects TRS, SURS, the State Employees' Retirement System (SERS) and the General Assembly Retirement System (GARS) but not the Judges' Retirement System (JRS). Actuarial reviews have been done for TRS, SURS and SERS but not for GARS, which accounted for only $304 million of the total accrued liability of $158.6 billion as of June 30, 2012. The actuarial analysis was for the 97th General Assembly version of the bill, House Bill 6258, which is substantially similar to the 98th General Assembly versions, Senate Bill 35 and House Bill 98.
[157] State Representative Daniel Biss, "House Bill 6258: Actuarial Analysis Demonstrates Significant Savings," *news release*, December 21, 2012. These numbers are based on the actuarial, or smoothed, value of assets rather than the market value of assets.
[158] For a link to the underlying actuarial analyses, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog, http://www.civicfed.org/iifs/blog/analysis-pension-reform-proposal-shows-significant-state-savings.

much lower projected deficits in FY2016 through FY2018, peaking at $2.1 billion in FY2017 rather than $4.4 billion.

It is important to note that any comprehensive pension changes would be challenged in court on constitutional grounds. The Illinois Constitution provides that membership in any pension system in the State is an enforceable contractual relationship and that member benefits “shall not be diminished or impaired.”[159] Legal opinions have varied on the interpretation of this provision.[160]

The following chart shows the budget impact of the savings that could be achieved if the magnitude of pension reform discussed above were enacted and survived legal challenge.

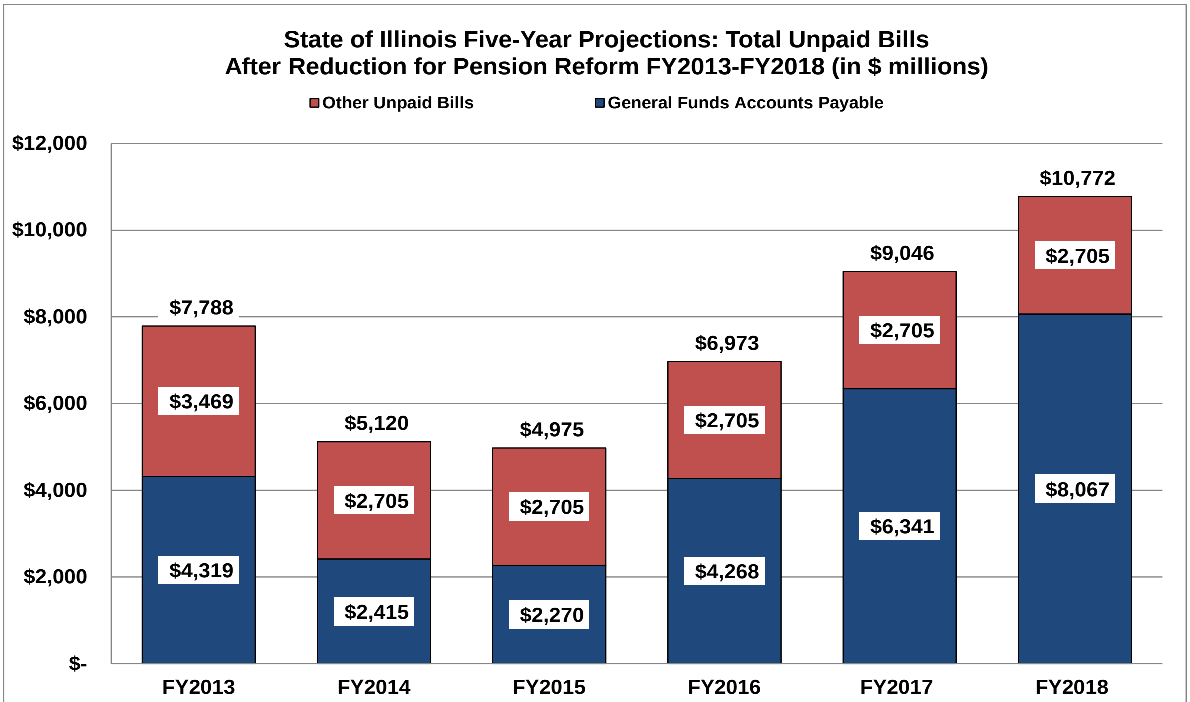
State of Illinois Five-Year Projections: General Funds Operating Surplus (Deficit) Reduced for Pension Refom Savings FY2013-FY2018 (in $ millions)

	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
Revenues						
State Source Revenues	$ 30,165	$ 30,737	$ 28,763	$ 26,541	$ 27,166	$ 27,809
Federal Revenues	$ 4,231	$ 4,222	$ 4,499	$ 4,749	$ 4,925	$ 5,086
Total Revenues	**$ 34,396**	**$ 34,959**	**$ 33,261**	**$ 31,290**	**$ 32,091**	**$ 32,894**
Expenditures						
Pension-Related Costs	$ 6,659	$ 7,766	$ 8,086	$ 7,826	$ 8,359	$ 8,593
Less Pension Reform Savings	$ -	$ (1,790)	$ (2,100)	$ (2,230)	$ (2,320)	$ (2,460)
New Pension Costs	$ 6,659	$ 5,976	$ 5,986	$ 5,596	$ 6,039	$ 6,133
Medicaid Costs	$ 6,804	$ 7,060	$ 7,571	$ 8,028	$ 8,337	$ 8,614
Other Expenditures	$ 20,268	$ 20,019	$ 19,559	$ 19,664	$ 19,788	$ 19,874
Total Expenditures	**$ 33,731**	**$ 33,055**	**$ 33,116**	**$ 33,288**	**$ 34,164**	**$ 34,621**
Operating Surplus (Deficit)	**$ 665**	**$ 1,904**	**$ 145**	**$ (1,998)**	**$ (2,073)**	**$ (1,726)**

Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement* , January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, *Three Year Budget Projection (General funds)* , FY14-FY16, January 11, 2013; Communication between Civic Federation and the Governor's Office of Management and Budget February 1, 2013; Civic Federation calculations based on Commission on Government Forecasting and Accountability, Special Pension Briefing,November 2012; actuarial valuations on impact of HB6258 prepared for Teachers', Employees' and Universities Retirement Systems, December 2012.

[159] Illinois Constitution, Article XIII, Section 5.
[160] For a collection of legal opinions on the Illinois pension clause, see the Illinois Senate Democrats’ website, http://www.senatedem.ilga.gov/index.php/component/content/article/108-public-information-brochures/1517-pension-debate (last visited on February 18, 2013).

If the surpluses in FY2013 through FY2015 shown above were applied to the backlog of General Funds accounts payable, the total unpaid bills would decline to $10.8 billion in FY2018 from $21.7 billion. The following chart shows the reduced bills based on estimated savings from pension reform of the magnitude shown above from FY2013 through FY2018, assuming the changes become effective in FY2014.



Source: Public Act 98-0001; State of Illinois, General Obligation Bonds, Series of February 2013, Preliminary Official Statement, January 22, 2013, p. 11; State of Illinois, Governor's Office of Management and Budget, Three Year Budget Projection (General funds), FY14-FY16, January 11, 2013; Communication between Civic Federation and the Governor's Office of Management and Budget February 1, 2013; Civic Federation calculations based on Commission on Government Forecasting and Accountability, Special Pension Briefing,November 2012; actuarial valuations on impact of HB6258 prepared for Teachers', Employees' and Universities Retirement Systems, December 2012.

CIVIC FEDERATION RECOMMENDATIONS

This section presents the Civic Federation's recommendations for the State of Illinois' FY2014 budget and 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 developing the FY2014 budget.

Issue 1: Pension Reform

The State's underfunded pensions represent an enormous budgetary challenge. The total unfunded liability of the five retirement systems stood at $96.8 billion as of June 30, 2012 and the combined unfunded ratio was 39.0%.[161]

Illinois' pension funding law requires the State to make contributions sufficient to reach 90% funding for each system by FY2045.[162] The plan, which began in FY1996, deferred contributions to later years to ease near-term budget pressures.

As a result, statutorily required State contributions are expected to absorb 16.9% of State-source General Funds revenue in FY2013 and a projected 25.1% in FY2018. After adding debt payments on pension bonds, those percentages increase to 22.1% in FY2013 and a projected 30.9% in FY2018.

Pension costs account for such a large share of the State budget that it no longer appears reasonable to expect the State to make its required payments. For example, in March 2012 the State's largest pension fund, the Teachers' Retirement System (TRS), concluded that it could no longer rely on the State to meet its existing obligations and that major changes were needed to keep the pension fund from becoming insolvent.[163] The TRS Board reached that conclusion after analyzing how much of the State's future revenues will have to go toward pension costs under current law.

Nearly 78% of the State's General Funds pension contributions in FY2013 relate to TRS and the State Universities Retirement System (SURS), whose participants are not State employees. Participants in TRS and SURS are employed by local school districts outside of Chicago, public universities and community colleges. These employers determine the salary levels on which pensions are based but bear little responsibility for pension funding.

Proposed legislation in the General Assembly would significantly reduce State pension costs by reducing benefits, increasing employee contributions and shifting normal costs, or current service costs, for TRS and SURS to actual employers.[164] Much of the savings relates to the automatic benefit increase, which is now 3% a year, compounded, for retirees and employees hired before January 1, 2011. Under the proposed legislation, the automatic increase would be limited to $750 a year. Other changes for those hired before January 1, 2011 include a phased-in increase in retirement age; a phased-in two percentage point increase in contributions; and a pensionable salary cap. School districts, community colleges and universities would take over the State's

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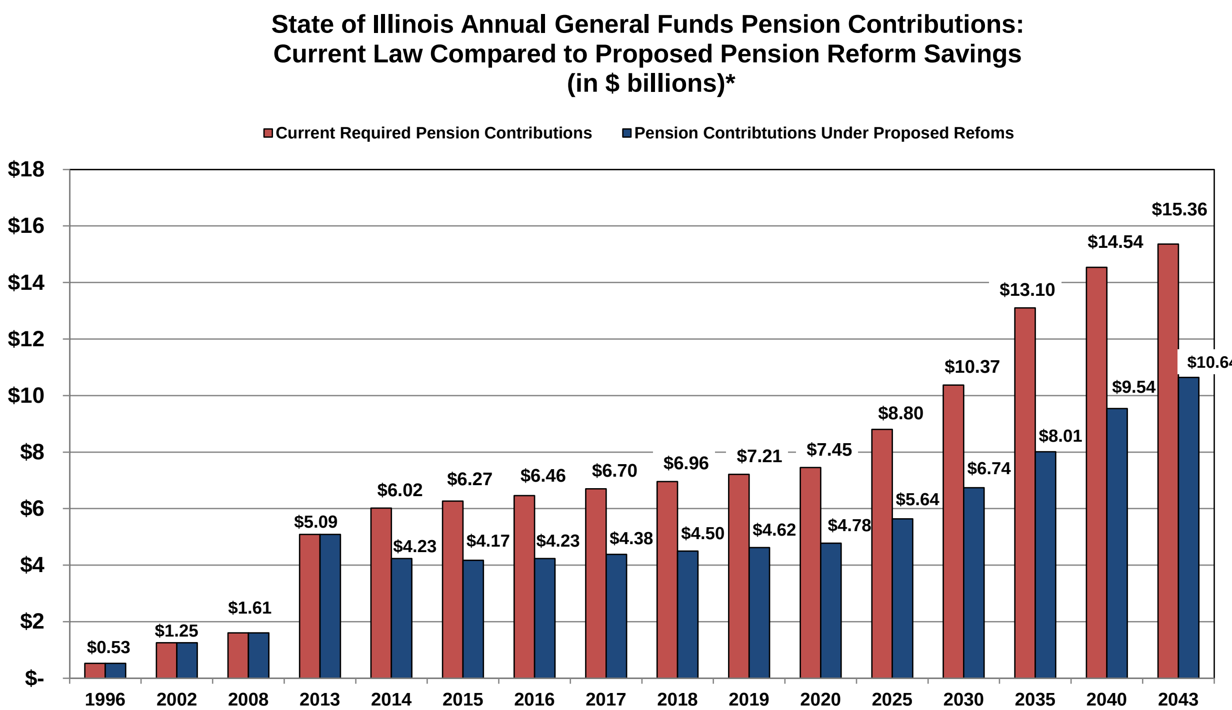
[161] Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, p. 3. These numbers are based on the market value of assets, without asset smoothing.
[162] Public Act 88-0593, as amended.
[163] Teachers' Retirement System of the State of Illinois, *Board of Trustees Resolution*, March 30, 2012.
[164] 98th Illinois General Assembly, Senate Bill 35, introduced on January 10, 2013 and House Bill 98, introduced on January 9, 2013.

normal pension cost at a rate of 0.5% of payroll per year for normal costs incurred after July 1, 2013, until costs are fully shifted.

As noted in the previous section, actuarial reviews of the impact of the legislation have been done for the largest three of the four affected retirement systems.[165] The analysis indicated that proposed changes would reduce the State's total unfunded pension liability by $28 billion, or 29%, from $95 billion to $68 billion.[166] State General Funds pension contributions in FY2014 would decline to $4.2 billion from a projected $6.0 billion under current law.[167]

The next chart shows estimated State General Funds contributions under the proposed legislation compared with required contributions under current law through FY2043. Under the proposed legislation, pension obligations would be fully funded by FY2043.



*Analysis based on 97th Illinois General Assembly, House Bill 6258 (replaced by Senate Bill 35 and House Bill 98 in 98th General Assembly). Includes Teachers', Employees' and Universities Retirement Systems but not General Assembly Retirement System, for which actuarial analysis was not available. HB6258 does not apply to Judges' Retirement System; contributions to Judges' system under current law are included in both sets of data above.
Source: Civic Federation calculations based on retirement systems' FY2012 actuarial valuations and actuarial valuations on impact of HB6258 prepared for Teachers', Employees' and Universities Retirement Systems, December 2012.

It is important to note that any comprehensive pension changes would be challenged in court on constitutional grounds. The Illinois Constitution provides that membership in any pension system

[165] The legislation affects TRS, SURS, the State Employees' Retirement System (SERS) and the General Assembly Retirement System (GARS) but not the Judges' Retirement System (JRS). Actuarial reviews have been done for TRS, SURS and SERS but not for GARS, which accounted for only $304 million of the total accrued liability of $158.6 billion as of June 30, 2012. The actuarial analysis was for the 97th General Assembly version of the bill, House Bill 6258, which is substantially similar to the 98th General Assembly versions, Senate Bill 35 and House Bill 98.
[166] State Representative Daniel Biss, "House Bill 6258: Actuarial Analysis Demonstrates Significant Savings," *news release*, December 21, 2012. These numbers are based on the actuarial, or smoothed, value of assets rather than the market value of assets.
[167] For a link to the underlying actuarial analyses, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog, http://www.civicfed.org/iifs/blog/analysis-pension-reform-proposal-shows-significant-state-savings.

in the State is an enforceable contractual relationship and that member benefits "shall not be diminished or impaired."[168] Legal opinions have varied on the interpretation of this provision.[169]

Civic Federation Recommendations for State Pension Reform

The State cannot comply with statutory pension funding requirements and also pay for the costs of running State government. In light of fiscal realities, the Civic Federation recommends that the State enact pension changes of the kind and magnitude described above, including significant limits on automatic annual benefit increases and a gradual shift of normal costs to local school districts, public universities and community colleges. Because legal challenges are inevitable, these actions must be taken immediately. Any pension proposal considered by the State should be thoroughly reviewed by actuaries to determine its financial impact both in the short run and over the long term.

Issue 2: Medicaid and the Affordable Care Act

Illinois' Medicaid program is undergoing a major transformation. The Illinois Department of Healthcare and Family Services (HFS) is moving to enroll two-thirds of recipients in managed care by January 2015.[170] Managed care is designed to improve the quality of care and lower costs by rewarding healthcare providers for keeping people healthy, rather than tying payment to the volume of services provided. The agency's target for managed care enrollment exceeds the 50% requirement in a Medicaid reform law passed in 2011.[171]

At the same time, the State is working to implement significant program reductions authorized in June 2012 for budgetary reasons.[172] Some of the changes have also improved the quality of medical services, according to HFS officials. For example, a four-prescription a month limit on drugs, which is still being phased in, has helped the agency to uncover duplicate and inappropriate prescriptions.[173] An effort to tighten eligibility screening for the program, which relies heavily on electronic records, is likely to ease concerns about the provision of services to ineligible recipients.

The State is also facing a decision on whether to expand Medicaid eligibility under the Affordable Care Act (ACA) in 2014. For newly eligible recipients, the State would not bear additional costs until calendar year 2017 because the federal government reimburses 100% of costs from 2014 through 2016. HFS expects 342,000 newly eligible recipients to enroll by 2017. According to HFS estimates, Illinois is expected to receive $12.2 billion in additional federal revenues due to the ACA from 2014 to 2020.[174] The State would pay $573.3 for newly eligible recipients from 2017 to 2020, when the reimbursement rate declines from 95% to 90%.

In addition, many individuals who were previously eligible but not enrolled in the program are expected to enroll regardless of the State's decision on expansion. HFS expects 168,000 previously eligible individuals to enroll by 2017. HFS believes that these individuals will enroll because of

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[168] Illinois Constitution, Article XIII, Section 5.
[169] For a collection of legal opinions on the Illinois pension clause, see the Illinois Senate Democrats' website, http://www.senatedem.ilga.gov/index.php/component/content/article/108-public-information-brochures/1517-pension-debate (last visited on February 18, 2013).
[170] Illinois Department of Healthcare and Family Services, *Care Coordination Roll-Out Plan, January 2013-January 2015*, November 29, 2012.
[171] Public Act 96-1501.
[172] See p. 26 of this report for a discussion of Medicaid program reductions.
[173] Communication between the Civic Federation and the Illinois Department of Healthcare and Family Services, November 16, 2012.
[174] See p. 28 of this report for a discussion of the ACA.

publicity surrounding the ACA and policies that steer individuals to Medicaid if they are not eligible to obtain insurance coverage through a new ACA-mandated health insurance exchange. Federal reimbursement for previously eligible recipients will be at the regular rate of 50% in Illinois. Civic Federation calculations, based on HFS data, show that the State's total net cost for these recipients (after federal reimbursement) would be $1.2 billion from FY2014 to FY2018.

Civic Federation Recommendations for Medicaid and the Affordable Care Act

The Civic Federation recommends that the State of Illinois expand eligibility for Medicaid under the Affordable Care Act due to the resulting significant increase in federal resources compared to projected State expenditures. However, the Civic Federation also recommends that the State plan for additional costs relating to both newly eligible and previously eligible recipients. Any savings due to costs previously covered by the State that are fully or partly covered by the federal government under the ACA should be set aside to pay additional State costs.

Issue 3: Community-Based Care

The State is moving to close State-run institutions for the developmentally disabled and relocate residents to community settings. Jacksonville Developmental Center in Jacksonville was closed in November 2012 and the State is in the process of closing Murray Developmental Center in Centralia. According to the State officials, it cost an average of $200,000 a year for a resident to live at Jacksonville, compared with an average of $84,000 in a smaller community setting.[175] Costs for the developmentally disabled are covered by Medicaid but are in the budget of the Illinois Department of Human Services rather than HFS.

In addition to the fiscal impact, moving people from institutions to community care supports the U.S. Supreme Court's landmark 1999 opinion in the Olmstead case. In that case, the court ruled that the federal Americans with Disabilities Act requires states to provide services in the most integrated setting appropriate to the needs of individuals, consistent with individuals' wishes and the resources available to the state.[176]

The closures of the Jacksonville and Murray centers are part of a long-term agenda announced by Governor Pat Quinn in November 2011.[177] The agenda calls for the closure of up to four of the State's eight developmental centers, reducing the number of residents by at least 600 by the end of FY2014. This initiative is in line with Illinois' Medicaid reform legislation enacted in 2011, which calls for shifting of more residents of long-term care facilities to community settings.[178] A five-year strategic plan issued by the Illinois Department of Human Services (DHS) in 2010 recommended that the State accelerate its relocation of developmental center residents into less restrictive settings to meet national benchmarks by 2017.[179]

The decision to close centers for the developmentally disabled has been opposed by labor unions, some parents of residents and certain legislators.[180] On February 19, 2013, a group of parents of

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175 State of Illinois, "Governor Quinn Announces Successful Community Transition for Jacksonville Developmental Center Residents," *news release*, November 29, 2012.
176 U.S. Department of Justice, *Olmstead: Community Integration for Everyone*, http://www.ada.gov/olmstead/index.htm (last visited on February 20, 2013).
177 State of Illinois, *Governor Quinn's Rebalancing Initiative*, November 2011.
178 Public Act 96-1501.
179 Illinois Department of Human Services, Division of Developmental Disabilities, *Strategic Plan for 2011-2017*, July 2010, p. 7.
180 Chris Wetterich, "AFSCME challenges transfers from JDC," *State Journal-Register*, July 28, 2012.

residents of the Murray Center filed a federal lawsuit to prevent or delay the center's closing.[181] A bill was introduced in the General Assembly in January 2013 to delay any additional developmental center closings until a study is conducted on the impact of the Jacksonville closing.[182]

<u>Civic Federation Recommendation for Community-Based Care</u>
The Civic Federation recommends that the State continue to pursue the administration's long-term plan to move developmentally disabled individuals from State-run facilities to community care settings. This effort is consistent with federal and State law and is the result of long-term strategic planning by the State. The move to community care is designed to provide better care at a lower cost to the State.

Issue 4: State Retiree Health Insurance

Until June 2012, Illinois law stated that State employees who retired before January 1, 1998 and those who retired after that date with at least 20 years of service were not required to pay health insurance premiums.[183] Exceptions included General Assembly members and constitutional officers, who could retire with as few as four years of service and not pay any premiums, and judges, who could retire with as few as six years of service and not pay premiums.[184]

Approximately 90% of the more than 80,000 retirees covered by the State's group insurance program did not pay any health insurance premiums as of January 2011.[185] The State's cost for retiree health insurance coverage in FY2013 was projected at $684.3 million, while retirees' contributions were estimated at $25.8 million.[186] These figures do not include the cost of coverage for retirees' dependents; all retirees are required to pay premiums for their dependents.

In June 2012, Illinois enacted legislation that eliminated premium-free health coverage for retirees.[187] The legislation did not specify how retiree health insurance premiums would be determined, leaving that decision to the State's Department of Central Management Services (CMS). CMS has said that retiree premiums, like other healthcare benefits, will be negotiated with the State's unions. Premiums are expected to be based in part on retirees' pensions, with those receiving larger pensions required to pay higher premiums.[188]

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[181] Brian Brueggemann, "Murray Center parents file federal suit to prevent closure," *Belleville News Democrat*, February 20, 2013.
[182] 98th Illinois General Assembly, House Bill 97, introduced on January 9, 2013.
[183] 5 ILCS 375/10. 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. See p. 31 of this report for more information about State retiree health insurance.
[184] General Assembly members elected before January 1, 2011 can retire at age 62 with four years of service; those elected on or after that date must be 67 with eight years of service. Judges elected or appointed before January 1, 2011 can retire at 62 with six years of service; judges elected or appointed on or after that date must be 67 with eight years of service.
[185] Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services*, February 17, 2011, p. 2.
[186] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program FY2013*, March 2012, p. 13. The State contribution includes funding from General Funds and Other State Funds.
[187] Public Act 97-0695.
[188] Illinois Department of Central Management Services, memo from Director Malcolm Weems to Representative Tom Cross on SB1313—Retiree Healthcare Proposal, May 9, 2012.

As of the publication date of this report, CMS has not proposed rules relating to retiree health insurance premiums. Health insurance premiums for employees and retirees are a key issue in ongoing negotiations over union contracts to replace agreements that expired at the end of FY2012.[189]

The State also contributes to the Teachers' Retirement Insurance Program (TRIP), which covers retired teachers outside of Chicago. Unlike most retirees in the State group health program, retirees in TRIP have been required to pay health insurance premiums.

Retirees covered by TRIP effectively obtain subsidies if they live out of state. Under Illinois law, TRIP retirees who do not have access to the State's managed care networks—including those who live outside of Illinois—pay half as much in premiums for the traditional health plan.[190] For example, the monthly premium is $342.85 for a TRIP retiree aged 65 or older without Medicare who does not have access to managed care. The premium is $685.68 for the same retiree who does have access to managed care.[191]

Civic Federation Recommendations for State Retiree Health Insurance

The Civic Federation recommends that the State aggressively pursue reductions in retiree health insurance costs under State law. The administration has taken the position that retiree health insurance costs are a subject for collective bargaining. That should not prevent the State from taking administrative action to require retired judges, members of the General Assembly and constitutional officers to pay premiums. The Civic Federation also recommends that the State stop allowing retired teachers who live out of State to pay lower health insurance premiums than retired teachers who live in Illinois.

Issue 5: Underappropriation of Group Health Insurance and Community Care Programs

To help balance its operating budget, the State has routinely appropriated less than the expected costs of certain programs for the current year with the understanding that these costs can be covered in the next year's budget. This practice makes it difficult to evaluate the actual cost of State government.

Medicaid bills have been deferred under the Section 25 exception to the State Finance Act, which allows current year costs to be covered by future appropriations.[192] However, legislation enacted in 2012 significantly curtails the State's ability to defer Medicaid bills of the Illinois Department of Healthcare and Family Services beginning at the end of FY2013.[193] The new law limits these deferred liabilities to $700 million in FY2013 and $100 million thereafter, with certain exceptions.

State group health insurance bills, which are also covered by the Section 25 exception, began to grow in FY2009, as the federal stimulus program restricted the State's ability to defer Medicaid bills. Unpaid group health insurance bills totaled $1.4 billion at the end of FY2012 and could rise to $1.6 billion by the end of FY2013.[194]

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[189] Monique Garcia, "Quinn, state workers firmly at odds in contract dispute; Pay raises, health care benefits are key points of contention," *Chicago Tribune*, December 10, 2012.

[190] 5 ILCS 375/6.5(e)(2) and (3).

[191] Teachers' Retirement Insurance Program, *Benefit Choice Options*, Effective July 1, 2011-June 30, 2012, p. 4, http://www2.illinois.gov/cms/Employees/benefits/Teachers/Pages/TRIPRates.aspx (last visited on February 13, 2013).

[192] 30 ILCS 105/25 (b-4).

[193] Public Act 97-0691.

[194] See p. 31 of this report for more information on group health insurance bills.

The Department on Aging is not covered by the Section 25 exception, but the State has deferred bills relating to its Community Care program through budget language that allows current-year appropriations to cover prior year costs. The Community Care program provides services designed to help seniors stay out of nursing homes. The program's monthly caseload has more than doubled to a projected 80,100 in FY2013 from 38,950 in FY2003.[195] Unfunded costs for the program are expected to stand at $318 million at the end of FY2013 if supplemental appropriations are not enacted.

Civic Federation Recommendation on Underappropriation

The Civic Federation recommends that the State phase out all budget practices that allow bills to be covered by future years' appropriations. These practices ensure that the annual cost of State government is not reflected in the budget. Annual agency budgets should cover all expected costs for the fiscal year.

Issue 6: Statutory Transfers Out of General Funds

The State of Illinois' annual General Funds expenditures include payments to Other State Funds through statutory transfers that are not part of the appropriation process. These transfers fund a wide range of State expenses outside the General Funds, including annual debt service owed on outstanding bonds, revenue sharing with local governments and payments to revolving funds. However, statutory transfers are also used to fund some State operations outside the General Funds through appropriations involving the State's more than 600 Special Funds.

In its first annual report, the Governor's Budgeting for Results Commission recommended that all statutory transfers be evaluated for history, intent and current need in the areas funded.[196] The goal is to ensure that State resources deliver the greatest possible value to taxpayers. The report suggested that funding provided for ongoing State operations through statutory transfers out of General Funds should be largely eliminated, excluding transfers for debt service, local government revenue sharing, payments to revolving funds and cash flow transfers. Instead, ongoing State operations historically funded by statutory transfers should be reviewed annually as part of the State's General Funds appropriations process.

At a time of significant fiscal strain, the State should scrutinize all annual operating spending as part of the annual appropriation process and ensure that all resources are allocated to the most critical priorities.

Civic Federation Recommendation for Statutory Transfers Out

The Civic Federation recommends limiting the use of statutory transfers out of General Funds to ensure that State resources are used in the most effective way possible. The Federation supports the Budgeting for Results Commission's recommendation to end the funding of State operations through statutory transfers out, excluding transfers for debt service, local government sharing, revolving funds and cash flow purposes. The State should move to consolidate Special Funds currently supported by transfers out and review programs funded through these accounts as part of the annual General Funds appropriations process.

[195] Illinois Department on Aging, *Fiscal Year 2013 Enacted Budget*, July 2012, p. 14.
[196] State of Illinois, *Budgeting for Results Commission Report*, November 2, 2011, p. 11.

Issue 7: Economic Development Policy

The State of Illinois does not currently have a comprehensive policy on economic development incentives. Instead, the State has a wide variety of incentives reducing specific State or local tax burdens that are provided mostly upon request by corporations. This creates an uncertain tax environment for businesses in Illinois and, as witnessed during the fall 2011 veto session, can leave the State vulnerable to competition from other states that try to entice businesses with financial incentives to relocate or expand outside of Illinois.

In FY2010, the most recent year for which data are available, the State spent a total of $313.6 million on tax incentives for businesses. According to 2009 Illinois Department of Revenue data, only 0.7% of the more than 450,000 corporations filing taxes in Illinois take advantage of these tax incentives. As discussed in the Governor's three-year projection, the various incentives approved in the fall of 2011 are expected to reduce State revenues by approximately $100 million annually.

The Government Finance Officers Association has developed a best practice on economic development planning for state and local governments and recommends jurisdictions using economic development incentives create a policy on the appropriate parameters for use of such incentives.[197] At a minimum, an economic development policy should contain the following elements:

Goals and Objectives: Goals and measurable objectives create a context and accountability for the use of economic development incentives. Common goals used in economic development include: target economic sectors, business retention and/or recruitment, geographic focus, job creation, blight mitigation, improving economically distressed neighborhoods and environmental improvements.

Financial Incentive Tools and Limitations: An economic development policy should define the types of incentives and the extent to which the jurisdiction will use them. For example, governments may choose to grant an entitlement to any firm that meets minimum qualifications, or may choose to provide incentives based on an assessment of individual firms. Governments may also establish maximum funding for a particular program.

Evaluation Process: A clearly defined evaluation process should be outlined in an economic development policy for the purposes of consistency and transparency. Evaluation activities and factors typically include:

- How a proposal measures up to established economic development criteria;
- A cost/benefit analysis;
- An evaluation of tax base impact, both in terms of increases in taxable value and, where a TIF is proposed, the impact on all overlapping taxing jurisdictions;
- Analysis of the impact of a project on existing businesses;
- A determination of whether the project would have proceeded if the incentive is not provided; and
- A jurisdiction may also wish to include in its policy a list of required documentation for the economic development application and the officials who are a part of the review team.

[197] Government Finance Officers Association, *Developing an Economic Incentive Policy*, October 17, 2008, http://www.gfoa.org/index.php?option=com_content&task=view&id=1596 (last visited February 22, 2013).

Performance Standards: An economic development policy should require that specific performance standards be established for each project receiving incentives. Not only will these performance standards help a jurisdiction gauge the effectiveness of its overall economic development program, but may also be used to recover promised financial benefits, through clawbacks or linkage agreements, of recipients failing to fulfill their commitments.

Monitoring and Compliance: A process should be established for regular monitoring of the economic development incentives granted and the performance of each project receiving incentives. The policy should also provide for organizational placement and staffing of this activity. The monitoring process should examine performance standards relative to each economic development agreement and determine whether the goals for each project are achieved within the defined timeframe. Ongoing monitoring of these projects should become part of an overall economic development program.

Civic Federation Recommendation for Economic Development

The Civic Federation recommends that the State of Illinois develop a formal economic development policy to guide the awarding of incentives. A transparent economic development policy would effectively curb economic brinksmanship by Illinois businesses by creating a predictable process for applying for and earning tax incentives. Such a policy should be in place before the State renews, expands or creates any economic development incentives. The policy should also determine which tax incentives are most beneficial to the State.

APPENDIX A: BOND RATINGS

The State of Illinois is currently the lowest rated state by Standard & Poor's (A-) and Moody's Investors Service (A2). Illinois has the second lowest rating of any state from Fitch Ratings (A), ahead of only California. All three agencies have a negative outlook on the State.

Despite the low ratings compared to other states, Illinois' bonds are still considered investment grade. This means that investors can be assured of the government's good credit and face little or no risk of default, according to the agencies' rating definitions. The State would need to be downgraded at least four more levels to be considered at risk of default by the issuer or a speculative grade credit. Speculative grade bonds are sometimes referred to as junk bonds and typically pay much higher rates of interest to investors due to the additional risk of defaulting on the loans.

The chart below shows the letter ratings and definitions for each level of bond as described by each rating agency. Within each letter rating the agencies have three grades of credit. Both Fitch and S&P use a plus sign, no sign and minus sign to delineate where within each level the credit stands. Moody's system is slightly different and includes the numbers 1, 2 and 3 to show a credit's stratification within a particular letter grade (1 being the highest quality and 3 the lowest).

Major Credit Rating Agencies: Ratings Scales and Definitions

	Moody's	Definition	S&P	Definition	Fitch	Definition
Investment Grade	Aaa	Highest quality, subject to the lowest level of credit risk	AAA	Extremely strong capacity to meet financial commitments, highest rating	AAA	Lowest default risk, exceptionally strong capacity for payment of financial commitments and highly unlikely to be adversely affected by foreseeable events
Investment Grade	Aa	High quality and are subject to very low credit risk	AA	Very strong capacity to meet financial commitments	AA	Very low default risk, very strong capacity for payment of financial commitments and not significantly vulnerable to foreseeable events
Investment Grade	A	Upper-medium grade and are subject to low credit risk	A	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances	A	Low default risk, strong capacity for payment of financial commitments but more vulnerable to adverse business or economic conditions
Investment Grade	Baa	Medium-grade and subject to moderate credit risk and may possess certain speculative characteristics	BBB	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions	BBB	Low default risk, adequate capacity for payment of financial commitments but adverse business or economic conditions are more likely to impair this capacity
Above Investment Grade, Below Speculative						
Speculative Grade	Ba	Speculative and are subject to substantial credit risk	BB	Considered highest speculative grade by market participants	BB	Elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time; however, business or financial flexibility exists which supports the servicing of financial commitments
Speculative Grade	B	Speculative and are subject to high credit risk	B	More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments	B	Material default risk is present, but a limited margin of safety remains; financial commitments are currently being met but capacity for continued payment is vulnerable to deterioration in the business and economic environment
Speculative Grade	Caa	Speculative of poor standing and are subject to very high credit risk	CCC	Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments	CCC	Default is a real possibility
Speculative Grade	Ca	Speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest	CC	Currently highly vulnerable	CC	Default of some kind appears probable.
Speculative Grade	C	Lowest rated and are typically in default, with little prospect for recovery of principal or interest	C	Currently highly vulnerable obligations and other defined circumstances	C	Default is imminent or inevitable, or the issuer is in standstill.

Source: Fitch Ratings, *Definitions of Ratings and Other Forms of Opinion* , August 2012, http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf; Moody's Investor Services, *Ratings Symbols and Definitions* , June 2012, http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004; Standard & Poor's, *Standard & Poor's Ratings Definitions* , June 2012, http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245335682757.

APPENDIX B: DATA ON FUNDING OF ILLINOIS RETIREMENT SYSTEMS

The table below shows estimates of total unfunded liability and combined funded ratio for the State's five retirement systems from FY2013 to FY2045, based on projections as of June 30, 2012 by the systems' actuaries.

It should be noted that the numbers in the table reflect asset smoothing, rather than the market value of assets. Since FY2009, State law has required that the actuarial value of assets be based on asset smoothing, in which unexpected gains or losses in any fiscal year are recognized over five fiscal years.[198] The market value of assets is more volatile than the smoothed value, but market values provide a more realistic view of the systems' actual financial position at the time of measurement.

State of Illinois Retirement Systems:
Projected Unfunded Laiibility and Funded Ratio*
FY2013-FY2045 (in $ millions)

Fiscal Year	Unfunded Liability	Combined Funded Ratio	Fiscal Year	Unfunded Liability	Combined Funded Ratio
FY2013	$ 100,828	39.0%	FY2030	$ 133,385	52.9%
FY2014	$ 102,708	40.4%	FY2031	$ 133,084	54.1%
FY2015	$ 104,942	41.4%	FY2032	$ 132,309	55.3%
FY2016	$ 108,752	41.6%	FY2033	$ 131,010	56.6%
FY2017	$ 111,526	42.3%	FY2034	$ 127,837	58.4%
FY2018	$ 114,199	43.0%	FY2035	$ 123,973	60.4%
FY2019	$ 116,789	43.7%	FY2036	$ 119,366	62.4%
FY2020	$ 119,296	44.4%	FY2037	$ 113,966	64.7%
FY2021	$ 121,686	45.1%	FY2038	$ 107,714	67.0%
FY2022	$ 123,936	45.8%	FY2039	$ 100,558	69.6%
FY2023	$ 126,005	46.6%	FY2040	$ 92,451	72.4%
FY2024	$ 127,888	47.3%	FY2041	$ 83,304	75.3%
FY2025	$ 129,552	48.1%	FY2042	$ 73,040	78.5%
FY2026	$ 130,968	49.0%	FY2043	$ 61,598	82.0%
FY2027	$ 132,064	49.9%	FY2044	$ 48,890	85.8%
FY2028	$ 132,843	50.9%	FY2045	$ 34,747	90.0%
FY2029	$ 133,296	51.9%			

*Values reflect asset smoothing rather than market value of assets.

Source: Commission on Government Forecasting and Accountability, *Special Pension Briefing* , November 2012, p. 7.

[198] Public Act 96-0043.

APPENDIX C: DATA ON GENERAL FUNDS PENSION CONTRIBUTIONS

This appendix shows the underlying data used to calculate projected total General Funds pension contributions to the State's five retirement systems from FY2013 to FY2045 under current pension law.[199] The five systems are the Teachers' Retirement System (TRS), State Employees' Retirement System (SERS), State Universities Retirement System (SURS), Judges' Retirement System (JRS) and General Assembly Retirement System (GARS).

The retirement systems are required to certify to the State the annual statutory contribution required to comply with the law. Beginning with the FY2014 contribution, the systems' proposed contribution amounts are reviewed by a State Actuary, a newly created position in the Office of the Auditor General.[200] By November 1 of the current fiscal year, each retirement system is now required to submit a proposed certification for the next fiscal year to the State Actuary. The retirement systems must consider any changes recommended by the State Actuary before submitting final contribution amounts by January 15 of each year.

General Funds contributions to the retirement systems consist of the certified amounts minus other sources of funding.[201] The main difference involves SERS, which receives approximately 34% of its contribution from Other State Funds. These Other State Funds contributions reflect employees who are paid from sources outside of the General Funds.[202] In addition, a portion of the required contribution to SURS—$150 million in FY2013—has recently been made from the State Pensions Fund, which is funded from unclaimed property. This report assumes that contributions from the State Pensions Fund will remain at the FY2013 level.

In this report, contributions to the Teachers' Retirement Insurance Program (TRIP), the College Insurance Program (CIP) and the Chicago Public School (CPS) Teachers' Pension and Retirement Fund of Chicago are included in agency spending, rather than in pension contributions.[203] The Governor's three-year projection includes contributions to TRIP, CIP and CPS as part of pension contributions, at the level appropriated in the FY2013 budget. The State plans to contribute $10.9 million to the CPS pension fund in FY2013. In the case of TRIP and CIP, FY2013 appropriations were below the amounts required by State law.[204] However, contributions to TRIP and CIP are covered by continuing appropriation, which means that the full contributions of $86.7 million to TRIP and $4.2 million to CIP will continue to be paid, unless the law is changed.[205]

[199] Public Act 88-0593, as amended by Public Acts 93-0002, 93-0839, 94-0004 and 96-0043.
[200] Public Act 97-0694.
[201] In addition to the adjustments discussed here, the SURS contribution is reduced by an estimated $42 million a year in federal funds, and the TRS contribution is increased by the estimated required contribution to the guaranteed minimum annuity reserve, with the amount reduced each year from $1.1 million in FY2014 to reflect the projected decline in benefits paid from the reserve.
[202] Commission on Government Forecasting and Accountability, *State Pension Appropriations by Fund FY2013-FY2014*, January 28, 2013.
[203] TRIP and CIP provide health insurance to retired teachers and community college employees outside of Chicago.
[204] 5 ILCS 375/6.6(c) and 5 ILCS 375 6.10(c). The FY2013 budget includes $62.6 million for TRIP and nothing for CIP.
[205] 40 ILCS 15/1.3 and 40 ILCS 15/1.4.

The table below shows contribution amounts for FY2013 to FY2045. The FY2013 and FY2014 numbers come from State bond documents.[206] The numbers for FY2015 and thereafter are Civic Federation estimates of General Funds contributions based on the retirement systems' actuarial projections as of June 30, 2012 and reflecting the adjustments discussed above.

State of Illinois Projected General Funds Contributions to Retirement Systems: FY2013-FY2045 (in $ millions)

	TRS	SERS	SURS	JRS	GARS	Total
FY2013	$ 2,703	$ 1,041	$ 1,261	$ 88	$ 14	$ 5,107
FY2014	$ 3,439	$ 1,098	$ 1,360	$ 127	$ 14	$ 6,038
FY2015	$ 3,548	$ 1,160	$ 1,434	$ 131	$ 15	$ 6,288
FY2016	$ 3,680	$ 1,199	$ 1,445	$ 131	$ 15	$ 6,470
FY2017	$ 3,854	$ 1,237	$ 1,473	$ 132	$ 16	$ 6,712
FY2018	$ 4,005	$ 1,285	$ 1,533	$ 134	$ 17	$ 6,974
FY2019	$ 4,166	$ 1,328	$ 1,577	$ 134	$ 17	$ 7,222
FY2020	$ 4,321	$ 1,369	$ 1,622	$ 135	$ 18	$ 7,465
FY2021	$ 4,487	$ 1,412	$ 1,668	$ 136	$ 18	$ 7,721
FY2022	$ 4,663	$ 1,456	$ 1,715	$ 136	$ 19	$ 7,989
FY2023	$ 4,850	$ 1,501	$ 1,764	$ 137	$ 20	$ 8,272
FY2024	$ 5,032	$ 1,544	$ 1,811	$ 137	$ 21	$ 8,545
FY2025	$ 5,223	$ 1,588	$ 1,856	$ 137	$ 21	$ 8,825
FY2026	$ 5,438	$ 1,636	$ 1,907	$ 138	$ 22	$ 9,141
FY2027	$ 5,660	$ 1,686	$ 1,960	$ 139	$ 23	$ 9,468
FY2028	$ 5,874	$ 1,734	$ 2,009	$ 140	$ 24	$ 9,781
FY2029	$ 6,087	$ 1,785	$ 2,060	$ 141	$ 25	$ 10,098
FY2030	$ 6,287	$ 1,833	$ 2,107	$ 142	$ 26	$ 10,395
FY2031	$ 6,482	$ 1,884	$ 2,156	$ 144	$ 27	$ 10,693
FY2032	$ 6,687	$ 1,938	$ 2,212	$ 146	$ 28	$ 11,011
FY2033	$ 6,898	$ 1,988	$ 2,276	$ 149	$ 29	$ 11,340
FY2034	$ 8,048	$ 2,226	$ 2,360	$ 158	$ 31	$ 12,823
FY2035	$ 8,238	$ 2,284	$ 2,419	$ 161	$ 32	$ 13,134
FY2036	$ 8,417	$ 2,342	$ 2,480	$ 165	$ 33	$ 13,437
FY2037	$ 8,588	$ 2,400	$ 2,540	$ 169	$ 35	$ 13,732
FY2038	$ 8,751	$ 2,459	$ 2,603	$ 173	$ 36	$ 14,022
FY2039	$ 8,902	$ 2,519	$ 2,667	$ 177	$ 37	$ 14,302
FY2040	$ 9,043	$ 2,579	$ 2,732	$ 182	$ 39	$ 14,575
FY2041	$ 9,177	$ 2,641	$ 2,802	$ 186	$ 40	$ 14,846
FY2042	$ 9,309	$ 2,702	$ 2,873	$ 191	$ 42	$ 15,117
FY2043	$ 9,448	$ 2,764	$ 2,947	$ 197	$ 43	$ 15,399
FY2044	$ 9,589	$ 2,827	$ 3,023	$ 202	$ 45	$ 15,686
FY2045	$ 9,752	$ 2,890	$ 3,100	$ 208	$ 46	$ 15,996

Source: State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 11; Commission on Government Forecasting and Accountability, *Special Pension Briefing*, November 2012, pp. 7-12; State Employees' Retirement System of Illinois, *Annual Actuarial Valuation as of June 30, 2012*, October 22, 2012, pp. 23-24; State Universities Retirement System of Illinois, *Actuarial Valuation Report as of June 30, 2012*, September 21, 2012, p. 27.

[206] State of Illinois, General Obligation Bonds, Series of February 2013, *Preliminary Official Statement*, January 22, 2013, p. 27.