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The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

STATE OF ILLINOIS FY2018 BUDGET ROADMAP:

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

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EXECUTIVE SUMMARY

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

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

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

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

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

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

[1] Governor Bruce Rauner is scheduled to present his budget proposal for FY2018 on February 15, 2017. The State of Illinois' fiscal year begins on July 1 and ends on June 30.
[2] In re Pension Reform Litigation, 2015 IL 118585, May 8, 2015. A prior Illinois Supreme Court opinion, Kanerva v. Weems (2014 IL 115811, July 3, 2014), blocked the State from reducing retiree health insurance benefits.
[3] State of Illinois Governor's Office of Management and Budget, *Bills Outstanding – Summary*, https://www.illinois.gov/gov/budget/Documents/Bill_Backlog_Presentation_%201.15.17.pdf (last visited on February 9, 2017).
[4] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Monthly Briefing for the Month Ended: January 2017*, p. 16, http://cgfa.ilga.gov/Upload/0117revenue.pdf (last visited on February 9, 2017).

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

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

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

Civic Federation Recommendations

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

Issue 1: Spending Controls

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

Issue 2: Increasing Income Tax Rates

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

Issue 3: Retirement Income Exclusion

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

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

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

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

Issue 5: Business Tax Changes

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

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

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

Issue 7: Consolidating and Streamlining Government Units in Illinois

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

Issue 8: Borrowing to Clear the Unpaid Bill Backlog

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

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

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

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

Issue 9: Supplemental Pension Payments

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

Issue 10: Rainy Day Fund

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

Future Changes

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

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

Civic Federation Findings

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

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

ILLINOIS BUDGET IMPASSE

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

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

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

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

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

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

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

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

Path to Financial Crisis

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

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

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

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

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

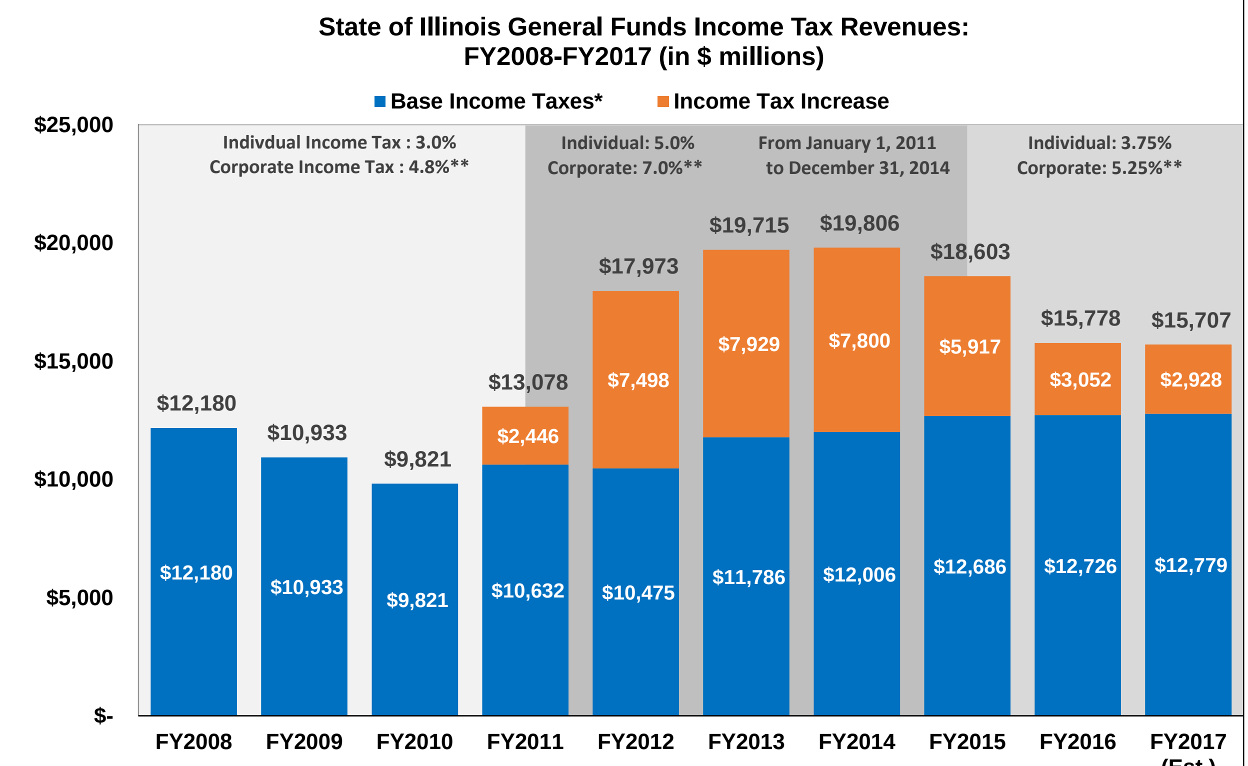
[16] General Funds support the regular operating and administrative expenses of most agencies and are the funds over which the State has the most control. The General Funds consist of the General Revenue Fund, the Education Assistance Fund, the Common School Fund and the General Revenue-Common School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

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

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

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

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



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

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

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

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