The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

STATE OF ILLINOIS FY2019 RECOMMENDED OPERATING AND CAPITAL BUDGETS:

Analysis and Recommendations

May 9, 2018

The Civic Federation ● 10 N. Dearborn Street ● Chicago, IL 60602 ● civicfed.org

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

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As debate heats up on the fiscal year 2019 budget, the State of Illinois' financial condition is significantly improved from a year ago. The prolonged budget impasse is over, the operating deficit has narrowed due to an increase in income tax rates and the massive backlog of unpaid bills has been reduced through the sale of bonds.

Despite these positive developments, Illinois still faces severe fiscal problems. The State's staggering public employee pension costs are difficult to reduce because of constitutional protections. Even after the recent borrowing, the bill backlog remains extremely high, hindering the State's ability to deal with future economic downturns.

Illinois still has the lowest credit rating of any state, partly due to the two-year budget standoff that ended in FY2018. In a report in April, Standard & Poor's cited Illinois' "persistent crisis-like budget environment in recent years" as a major reason for its unusually low rating.[1]

Given recent history, the renewal of political stalemate could be the gravest threat facing the State. The current year's budget was enacted by the General Assembly over the Governor's veto, and recent Illinois bond documents have warned potential investors that there is no assurance that budgets will be enacted in future years.[2]

Unfortunately, the Civic Federation **cannot support** Governor Bruce Rauner's recommended FY2019 budget because it is only precariously balanced. The budget has a projected surplus of $351 million that depends on various aggressive assumptions totaling $1.8 billion in savings or additional revenues for the State. It is not clear whether these assumptions are backed up by contingency plans.

In addition, the Federation **cannot support** a budget that does not contain a plan to eliminate the unpaid bill backlog. The budget proposal would apply the $351 million surplus to reduce the backlog, which the Governor's Office projects will total $7.7 billion at the beginning of FY2019. Even assuming the surplus is realized, it is unclear how the State will pay the remaining backlog in future years.

The Civic Federation is **supportive** of several initiatives in the Governor's recommended FY2019 budget, including aligning responsibility for payment of current-service pension costs with decision making about workers' salaries and reducing the State's role in financing health insurance costs for teachers and university and community college employees and retirees. The Federation also **supports** the proposal to enact the "consideration model" of pension reform, while not applying any savings until it is certain that the reform is constitutional.

However, the Federation **cannot support** the Governor's proposal to shift normal (current year) pension costs to local school districts outside Chicago over four years, while returning full responsibility for normal pension costs to Chicago Public Schools in FY2019 after assuming them for the first time in FY2018. The proposal exacerbates inequity to Chicago taxpayers, who also pay for teachers' pensions outside the City.

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[1] Standard & Poor's, "Illinois' $500 Million Series of May 2018A and 2018B GO Bonds Assigned 'BBB-' Rating," *news release*, April 6, 2018, p. 3.

[2] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 9.

Finally, the Federation is **concerned** about the cuts in support to local governments included in the FY2018 budget and proposed to be continued in the FY2019 budget. The General Assembly reduced distributions of income and sales taxes to local governments and transit districts and declined to share the proceeds of the permanent income tax increases. At a time when many local governments face fiscal pressures of their own, the Federation believes that the State should act as a partner in achieving fiscal sustainability.

The Federation urges the Governor and General Assembly to ensure that a balanced, comprehensive, full-year budget is enacted before the end of the fiscal year. Illinois cannot afford another year without a budget. The Federation continues to **recommend** the proposals outlined in its FY2019 State Budget Roadmap, which include prioritizing and funding the State's infrastructure needs and establishing a bipartisan commission to study the restructuring of the State's public university system.[3]

The Civic Federation offers the following key **findings** on the Governor's recommended FY2019 budget:

- The General Funds budget has an operating surplus of $351 million, which is less than 1% of proposed expenditures;
- The projected surplus is based on the following aggressive assumptions about spending reductions and revenue increases totaling $1.8 billion:
    - Sale of the James. R. Thompson Center: As in two of the administration's previous budgets, revenue projections in FY2019 include the sale of the State's main office building in Chicago. The projected net price is $240 million, but the timing and price are uncertain;
    - Savings on group health insurance: The FY2019 budget, like the administration's three previous budgets, relies on changes in the employee health insurance program that have been rejected by the American Federation of State, County and Municipal Employees (AFSCME) and are now the subject of litigation. The changes are expected to save the State $470 million;
    - Pension and health insurance cost shift: Savings of $825 million would come from shifting to school districts, universities and community colleges or eliminating State support for certain pension and health insurance costs. State savings would be offset by $206 million in additional operational funding for universities and community colleges. Cost shifts would require legislative approval;
    - Medicaid reimbursement rate reductions: The State is projected to save $175 million by reducing reimbursement rates and making program cuts, which would require legislative and in some cases federal approval; and
    - Step increases: The budget did not include any provision for step increases for AFSCME workers under their last contract, which expired at the end of FY2015. The State estimates it must pay $300 million for the wage increases after a recent action by the Illinois Supreme Court.
- If the $351 million budget surplus is realized and can be used to pay down outstanding bills, the backlog on a budgetary basis would decline to $9.1 billion at the end of FY2019 from an estimated $9.5 billion at the end of FY2018;
- The Governor's proposed 0.25 percentage point reduction in individual income tax rates to 4.7% from 4.95% is not reflected in the budget balance because it would not take effect until

[3] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2019 Budget Roadmap*, February 9, 2018, https://www.civicfed.org/sites/default/files/illinoisroadmapfy2019.pdf (last accessed on May 5, 2018).

a pension reform proposal is passed by the General Assembly and deemed constitutional by the Illinois Supreme Court;

- General Funds revenues increase by 3.2% to $38.0 billion in FY2019 from $36.8 billion in FY2018, with significant gains expected in corporate income taxes due to strong corporate profits;
- The 10% reduction in income and sales taxes distributed to local governments and public transit districts is continued in FY2019, boosting General Funds revenues by about $80 million;
- General Funds spending increases by less than 1% to $37.6 billion in FY2019 from $37.4 billion in FY2018, with proposed increases for preschool to secondary education, Medicaid, pension contributions and debt service on backlog bonds partially offset by proposed reductions in group health insurance and decreased debt service on maturing pension bonds;
- School districts receive the annual target increase of $350 million specified in education funding reform legislation enacted in August 2017, but they face additional costs of $490 million due to the pension cost shift;
- Proposed higher education funding is relatively flat in FY2019, after accounting for additional appropriations to offset the recommended shift of pension and health insurance costs. Average annual funding for higher education since FY2016 is about 83% of the FY2015 level due to sharp cuts during the budget impasse;
- The State's access to credit markets has improved somewhat since the end of the budget impasse, but spreads to a municipal market index have inched up in the past few weeks, apparently due to concerns that Illinois could once again fail to enact a budget; and
- Illinois has not had a major capital program since 2009. The FY2019 capital budget includes a total of approximately $16.8 billion in new and reauthorized projects but does not include any new revenue sources or increases in existing sources or propose a comprehensive capital improvement plan with a clear prioritization of projects.

The Civic Federation is **concerned** about the following aspects of the Governor's recommended FY2019 budget:

- The General Funds budget is precariously balanced with a surplus of $351 million based on $1.8 billion in aggressive assumptions for spending reductions or additional revenues and no clear contingency plan if the goals are not met;
- Even if the projected operating surplus materializes and is used to reduce unpaid bills, the backlog on a budgetary basis would be $9.1 billion at the end FY2019 with no detailed plan to pay it down;
- Returning normal pension and retiree health insurance costs for Chicago teachers to the Chicago Public Schools in FY2019 would add to the financial distress of the State's largest school district and exacerbate an already inequitable funding arrangement; and
- The proposal to continue a reduction in financial support for local governments is not consistent with the State's obligation to act as a partner to ensure the efficient delivery of services throughout Illinois.

The Civic Federation has the following **recommendations** to stabilize the State's operating budget and establish a balanced financial path out of its ongoing fiscal crisis:

- The most important task before the Governor and General Assembly is to enact a full-year, balanced budget for FY2019 and avoid sliding back into another fiscal crisis;
- To achieve stability in its long-term finances, the State should follow the comprehensive plan in the Civic Federation's FY2019 Budget Roadmap:

- Limiting agency spending growth to 2.1% annually through at least FY2023;
  - Reducing late-payment penalties on overdue State bills;
  - Broadening the income tax base by eliminating the exclusion of federally taxed retirement income;
  - Expanding the sales tax to include services taxed by the State of Wisconsin;
  - Working toward the establishment of a functional rainy day fund to cushion the budget from economic downturns;
  - Enacting a constitutional amendment to clarify the pension protection clause to allow reasonable changes to current employee and retiree benefits;
  - Making supplemental pension payments to its underfunded pension funds to replace debt service on maturing pension obligation bonds;
  - Merging the Chicago and State Teachers' Pension Funds;
  - Consolidating and streamlining other government units, including local pension funds;
  - Restructuring Illinois' public university system to eliminate duplicative programs and more effectively allocate resources across program and campuses; and
  - Initiating a new Capital Improvement Plan so infrastructure needs can be prioritized and funded;
- As the State makes progress on the goals listed above, it should pursue the following measures:
  - Return the lapse period to two months from six;
  - Phase out Section 25 liabilities and other practices that allow current year costs to be paid from future years' appropriations; and
  - Consider a modestly graduated income tax rate structure with a maximum spread of three percentage points.

CIVIC FEDERATION POSITION AND RECOMMENDATIONS

As debate heats up on the fiscal year 2019 budget, the State of Illinois' financial condition is significantly improved from a year ago. The prolonged budget impasse is over, the operating deficit has narrowed due to an increase in income tax rates and the massive backlog of unpaid bills has been reduced through the sale of bonds.

Despite these positive developments, Illinois still faces severe fiscal problems. The State's staggering public employee pension costs are difficult to reduce because of constitutional protections. Even after the recent borrowing, the bill backlog remains extremely high, hindering the State's ability to deal with future economic downturns.

Illinois still has the lowest credit rating of any state, partly due to the two-year budget standoff that ended in FY2018. In a report in April, Standard & Poor's cited Illinois' "persistent crisis-like budget environment in recent years" as a major reason for its unusually low rating.[4]

Given recent history, the renewal of political stalemate could be the gravest threat facing the State. The current year's budget was enacted by the General Assembly over the Governor's veto, and recent Illinois bond documents have warned potential investors that there is no assurance that budgets will be enacted in future years.[5]

Unfortunately, the Civic Federation **cannot support** Governor Bruce Rauner's recommended FY2019 budget because it is only precariously balanced. The budget has a projected surplus of $351 million that depends on various aggressive assumptions totaling $1.8 billion in savings or additional revenues for the State. It is not clear whether these assumptions are backed up by contingency plans.

In addition, the Federation **cannot support** a budget that does not contain a plan to eliminate the unpaid bill backlog. The budget proposal would apply the $351 million surplus to reduce the backlog, which the Governor's Office projects will total $7.7 billion at the beginning of FY2019. Even assuming the surplus is realized, it is unclear how the State will pay the remaining backlog in future years.

The Governor proposes shifting normal (current year) pension costs to local school districts outside Chicago over four years, as well as returning full responsibility for normal pension costs to Chicago Public Schools in FY2019 after assuming them for the first time in FY2018. The Federation **supports** aligning responsibility for paying annual pension costs with decision making about employees' salaries. However, the Federation **cannot support** the Governor's pension cost shift proposal because it exacerbates inequity to Chicago taxpayers, who also pay for teachers' pensions outside the City.

Finally, the Federation is **concerned** about the cuts in support to local government included in the FY2018 budget and proposed to be continued in the FY2019 budget. The General Assembly reduced distributions of income and sales taxes to local governments and transit districts and declined to share the proceeds of the permanent income tax increases. At a time when many local

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[4] Standard & Poor's, "Illinois' $500 Million Series of May 2018A and 2018B GO Bonds Assigned 'BBB-' Rating," *news release*, April 6, 2018, p. 3.
[5] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 9.

governments face fiscal pressures of their own, the Federation believes that the State should act as a partner in achieving fiscal sustainability.

The Federation urges the Governor and General Assembly to ensure that a balanced, comprehensive, full-year budget is enacted before the end of the fiscal year. Illinois cannot afford another year without a budget. The Federation continues to recommend the proposals outlined in its FY2019 State Budget Roadmap, which include prioritizing and funding the State's infrastructure needs and establishing a bipartisan commission to study the restructuring of the State's public university system.[6]

Civic Federation Position

The Civic Federation is **supportive** of several initiatives in the Governor's recommended FY2019 budget, including aligning responsibility for payment of current-service pension costs with decision making about workers' salaries and reducing the State's role in financing health insurance costs for teachers and university and community college employees and retirees.

The Federation also **supports** the proposal to enact the "consideration model" of pension reform, while not applying any savings until it is certain that the reform is constitutional.

However, the Federation has significant concerns about the following aspects of the budget proposal.

Precariously Balanced Budget Proposal

Governor Rauner's proposed FY2019 budget has an operating surplus of $351 million, or less than 1% of recommended expenditures. Although it is encouraging that the difference between revenues and expenditures is positive, the projected surplus is based on aggressive assumptions and it is not clear whether contingency plans are in place in case the goals are not met.

The following assumptions could prove difficult to achieve:

- Sale of the James. R. Thompson Center: As in the administration's previous two budgets, revenue projections in FY2019 include the sale of the State's main office building in Chicago. The FY2019 budget includes revenues of $300 million from the sale ($240 net of associated expenses). Both the timing of the sale and the price are difficult to predict.
- Savings on group health insurance: The FY2019 budget relies on changes in the State's employee health insurance program that have been rejected by the American Federation of State, County and Municipal Employees (AFSCME) and are now the subject of litigation. The changes are expected to save the State $470 million by requiring workers to pay higher premiums or receive less generous coverage. Similar savings have been included in each of the administration's previous budgets. If the changes cannot be achieved through collective bargaining, the administration plans to seek legislation to remove health insurance from labor agreements.
- Pension and health insurance cost shift: Normal pension costs would be shifted to school districts outside Chicago, public universities and community colleges over four years;

[6] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2019 Budget Roadmap*, February 9, 2018, https://www.civicfed.org/sites/default/files/illinoisroadmapfy2019.pdf (last accessed on May 5, 2018).

normal pension and retiree health insurance costs, paid by the State in FY2018, would be shifted back to the Chicago Public Schools in FY2019; additional health insurance costs would be shifted to universities; and the State would end its contributions for retiree health insurance for teachers and community college employees outside Chicago. Total savings from the cost shift are estimated at $825 million, but are offset by $206 million in additional operational funding for universities and community colleges. The cost shift would require legislative approval.

- Medicaid reimbursement rate reductions: The State is projected to save $175 million by reducing reimbursement rates for many healthcare providers by 4% in the second half of FY2019 and eliminating program and rate changes enacted in FY2018. These changes would require legislative and in some cases federal approval.
- Step increases: The budget did not include any provision for step increases for AFSCME workers under their last contract, which expired at the end of FY2015.[7] After the FY2019 budget was issued, the Illinois Supreme Court refused to hear the State's appeal of a lower court ruling that the workers were entitled to the wage increases, meaning that the State is obligated to pay more than $300 million in step increases.[8] It remains to be seen whether these wage increases will be paid in FY2019 or delayed to the future.

Together, these assumptions reduce the FY2019 deficit by $1.8 billion. Inability to achieve several of the assumptions would wipe out the operating surplus, which was intended to be used to reduce the backlog of unpaid bills.

Backlog of Unpaid Bills

Illinois has dealt with its budgetary shortfalls by delaying payments to vendors, social service providers, school districts, local governments and universities, resulting in billions of dollars in unpaid bills at the end of the fiscal year. Because of the backlog, the State begins each fiscal year in a hole, using revenues from the current year to pay off its previous year's bills and limiting revenues available for current spending.

The backlog surged during the two-year budget impasse as the State failed to address the drop in revenues caused by the automatic decline in temporarily increased income tax rates. The peak of $16.7 billion occurred on November 8, 2017, after which the State cleared out about $8.7 billion of the bills using the proceeds of a $6 billion bond sale and related federal Medicaid reimbursements.

As of early May, apparently due to the seasonal influx of tax revenue, the estimated backlog had dipped to $6.4 billion. The Governor's Office projects that the backlog will stand at $7.7 billion at the end of the fiscal year.[9]

The bond sale was financially prudent because the State's coupon rate of 3.5% on the bonds was far below the interest penalties of 9% to 12% that it pays on many overdue bills. According to the Comptroller's Office, Illinois has accrued $1.1 billion in interest penalties since the start of the budget impasse.[10]

[7] Step increases are automatic annual increases for newer workers as they add years of service.
[8] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 32.
[9] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 12, 2018, p. 29.
[10] State of Illinois Comptroller, *Special Report on Late Payment Interest Penalties*, April 24, 2018, p. 3.

Besides use of the modest surplus, the recommended budget does not propose a plan to further reduce the backlog. Until the State eliminates the backlog, it will not have completed its recovery from the Great Recession, which officially ended nearly nine years ago. The State's practice of delaying payments also transfers its financial distress to businesses, social service agencies and local governments.

Chicago Public Schools Pension Costs

The Civic Federation believes that all local governments including school districts in Illinois should assume responsibility for the full normal cost of their employee pensions. The obligation for contributing to a worker's pension should rest with the employer who determines the worker's salary.

However, the Federation has concerns about the Governor's pension cost shift proposal because it promotes a funding structure that is inequitable to Chicago taxpayers.

Prior to FY2018, Chicago taxpayers paid almost all of the employer contribution for Chicago teachers. The State paid for most of the pension costs for all teachers outside Chicago, so as State taxpayers residents of Chicago contributed to those payments as well.

Public pension contributions include two parts: a payment of the normal cost, which is the annual cost of the pension plan's benefits, and a payment to reduce the unfunded liability, the plan's obligations that are not covered by the fund's assets.[11]

As part of education funding legislation enacted in August 2017, the State began paying normal pension and retiree health insurance costs for the Chicago Teachers' Pension Fund (CTPF).[12] That payment amounts to $221 million in FY2018,[13] compared with the State's contribution of $4.1 billion[14] to the Teachers' Retirement System (TRS), which covers teachers outside Chicago.

In FY2019 the Governor proposes to return all of Chicago's normal pension and retiree health insurance costs back to CTPF and shift normal costs for school districts outside Chicago to those districts over four years. Unfunded liability costs for downstate and suburban teachers would continue to be paid by the State, including Chicago taxpayers, who would resume paying all the costs for Chicago teachers' pensions.

The cost of the shift in FY2019 is $228 million for Chicago and $262 million for the 25% shift for all other school districts.[15] The State's contribution to TRS in FY2019 is estimated at $4.2 billion.[16]

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[11] For more information on pension funding, see the Civic Federation, *Illinois Pension Primer: A Plain English Guide to Public Pensions in the State of Illinois*, April 22, 2015, https://www.civicfed.org/sites/default/files/IllinoisPensionPrimer_PlainEnglishGuide.pdf (last accessed on May 4, 2018).
[12] Public Act 100-0465, enacted on August 31, 2017.
[13] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 28.
[14] Illinois State FY2019 Budget, p. 31.
[15] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 31.
[16] Illinois State FY2019 Budget, p. 31.

Chicago Public Schools, Illinois' largest school district, has severe financial problems due to its reliance on short-term borrowing, long-term debt burden and increasing pension costs.[17] Given these challenges, it is not prudent to add to the District's financial burdens and exacerbate an already inequitable funding arrangement.

Support for Local Governments

The FY2018 enacted budget cuts support to local governments in a number of ways. It reduced by 10% both income tax distributions to the Local Government Distributive Fund and sales tax distributions to local transit districts.[18] Moreover, the General Assembly declined to give local governments a share of the increased revenue from increasing income tax rates. The Governor proposes to continue the 10% funding reductions in FY2019,[19] and estimates that they will result in approximately $80 million additional revenue to the State.[20]

Despite the financial pressures facing the State, the Civic Federation is concerned about declining financial support for local government. Many municipalities face financial distress of their own, including declining revenue bases, unfunded pension liabilities and increased borrowing costs as a result of the State's fiscal crises. As it works to resolve its own challenges, the State should continue to act as a partner with local governments in order to ensure the efficient delivery of services throughout Illinois.

Civic Federation Recommendations

The Civic Federation presents the following comprehensive plan and recommendations to stabilize the State's operating budget and establish a balanced financial path out of its ongoing fiscal crisis.

Enact a Comprehensive Balanced Budget for FY2019 and a Multi-Year Plan for Financial Recovery

The most important task before the General Assembly and Governor is to enact a full-year, balanced budget for FY2019 and avoid sliding back into another fiscal crisis. The Civic Federation opposes partial budgets and stopgap measures that would continue spending in FY2019 without the discipline of a comprehensive, balanced budget. The Illinois Constitution requires the Governor to propose and the General Assembly to adopt balanced budgets.[21] The Civic Federation believes that partial measures enacted during the two years without a budget allowed the Governor and General Assembly to avoid these responsibilities.

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[17] For more information on CPS' financial challenges, see the Civic Federation blog, "Update on the Chicago Public Schools' Fiscal Year 2018 Finances," March 30, 2018, https://www.civicfed.org/civic-federation/blog/update-chicago-public-schools-fiscal-year-2018-finances (last accessed on May 4, 2018).
[18] Illinois State FY2019 Budget, p. 146.
[19] Illinois State FY2019 Budget, p. 144.
[20] Communication between the Civic Federation and the Governor's Office of Management and Budget, February 16, 2018.
[21] Ill. Const. art. VIII, sec. 2.

In order to achieve stability in the State's long-term finances, the Civic Federation has proposed a comprehensive financial plan[22] designed to meet the following goals:

- Ensure future annual operating budgets are balanced;
- Eliminate the backlog of unpaid bills;
- Provide achievable spending limits;
- Avoid drastic revenue cliffs;
- Broaden the tax base to provide sustainable revenue sources;
- Include additional assistance for local governments;
- Set aside reserves for an adequate rainy day fund; and
- Address Illinois' long-term challenges, such as unfunded pension liabilities and infrastructure needs.

The Civic Federation's comprehensive plan proposes the following policy changes to address the State's fiscal crisis:

Spending Controls

The Civic Federation recommends that the State of Illinois limit net agency spending growth to 2.1% annually through at least FY2023. This rate is consistent with the maintenance level of growth projected by the Governor's Office. It is close to the Federal Reserve Banks' targeted 2.0% rate of inflation, and the Civic Federation believes that it is a conservative target, since the Governor's projections did not include any salary increases or cost of living adjustments.

Interest Penalties on Overdue Bills

The Civic Federation recommends that the State reduce the late payment penalty in the Prompt Payment Act to a rate that reflects lower economy-wide rates of return, such as the five-year Treasury rate plus one percentage point. The legislature and Governor should also consider a reduction in the timely payment rate in the Insurance Code.

Retirement Income Exclusion

The Civic Federation recommends that the State of Illinois broaden its income tax base by eliminating the tax exclusion for all federally taxable retirement income. This will enhance the State's fiscal stability by providing access to a faster growing portion of the income tax base, generating FY2019 revenues of over $2.5 billion.

Sales Tax on Services

The Civic Federation recommends that the State of Illinois expand the sales tax base to include the fourteen services taxed by the State of Wisconsin. This would broaden the sales tax base, contributing to long-term revenue stability. Following Wisconsin's example could help to achieve implementation more rapidly than other service sales tax proposals. A sales tax on these services implemented in January 2019 could generate about $208 million in additional State revenue in FY2019 at the State's 5.0% rate, growing to $588 million in FY2023.

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[22] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2019 Budget Roadmap*, February 9, 2018, https://www.civicfed.org/sites/default/files/illinoisroadmapfy2019.pdf (last accessed on May 5, 2018).

Rainy Day Fund

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

Constitutional Amendment to Clarify the Pension Protection Clause

The Illinois General Assembly should vote to place a Constitutional amendment on the ballot no later than the 2020 general election that would clarify the pension protection clause and allow reasonable, moderate changes to current employee and retiree benefits necessary to secure the financial sustainability of the State and local governments and the pension systems themselves.

Supplemental Pension Payments

In order to mitigate the underfunding of the State's pension systems due to inadequate statutory payments, the Civic Federation recommends requiring annual supplemental payments of $600 million from FY2020 through FY2034 and $481 million in FY2035. The supplemental payments would replace debt service on maturing pension obligation bonds.

Merger of the Chicago and State Teachers' Pension Funds

The Civic Federation recommends that the Chicago Teachers' Pension Fund (CTPF) be consolidated with the Teachers' Retirement System (TRS) and that the State assume responsibility for the unfunded liability of CTPF. The Federation also recommends that the Chicago Public Schools resume paying for the normal cost of Chicago teachers' pensions and that responsibility for the normal cost of pensions for all teachers outside of Chicago be shifted from the State of Illinois to local school districts over three years.

Restructuring Illinois' Public University System

The recommended FY2019 budget proposes shifting the normal costs of pensions to public universities and community colleges, as well as shifting a portion of employee group health insurance cost to universities. The Civic Federation believes that Illinois would be better served if these changes were part of a more comprehensive restructuring of higher education, and recommends that the Governor create a bipartisan commission to address the need to eliminate duplicative university programs, more effectively allocate resources across programs and campuses and study the potential need to close or consolidate campuses. The Federation also recommends that the nine universities be governed by a single Board of Trustees to facilitate the establishment of statewide goals and rational allocation of State resources.

Comprehensive Capital Improvement Planning and Funding

The Civic Federation recommends that the State of Illinois initiate a new Capital Improvement Plan that comprehensively assesses and prioritizes infrastructure needs. The road and transit portion of the plan should be initially funded by an increase in the motor fuel tax, which has not been raised since 1990. The State should further consider vehicle miles traveled and congestion taxes to ensure the long-term sustainability of transportation funding revenues.

Consolidating and Streamlining Government Units in Illinois

In addition to recommending the merger of CTPF with TRS, the Civic Federation supports the following government consolidation initiatives:

- Consolidate local pension funds;
- Merge the offices of the Illinois Comptroller and Treasurer;
- Authorize any township to be dissolved by referendum;
- Consolidate property tax administration roles in Cook County; and
- Dissolve the Illinois International Port District.

Future Changes

As the State makes progress on the goals listed above, it should pursue the following measures to give the State's finances more long-term sustainability:

- Return the lapse period to two months from six;
- Phase-out Section 25 liabilities and other practices that allow current years' costs to be paid from future years' appropriations;
- Shift normal pension costs from the State to public universities and community colleges; and
- Consider a modestly graduated income tax rate structure with a maximum spread of 3.0 percentage points that could generate additional revenues and lower rates for low income taxpayers, while protecting against excessive disparities and rate increases. Such a change would require an amendment to the Illinois Constitution.

BUDGET OVERVIEW

As debate heats up on the fiscal year 2019 budget, the State of Illinois' financial condition is significantly improved from a year ago. The prolonged budget impasse is over, the operating deficit has narrowed due to an increase in income tax rates and the massive backlog of unpaid bills has been reduced through the sale of bonds.

Despite these positive developments, Illinois still faces severe fiscal problems. The State's staggering public employee pension costs are difficult to reduce because of constitutional protections. Even after the recent borrowing, the bill backlog remains extremely high, hindering the State's ability to deal with future economic downturns.

Budget Impasse

Illinois' budget impasse stemmed from a failure to deal with the drop in revenues caused by a partial rollback of income tax rates in January 2015. Governor Bruce Rauner, a Republican who took office at the beginning of 2015, has made pro-business reforms a condition for approving additional revenues, but Democrats who control the General Assembly have not agreed to those terms.[23]

Income tax rates had been raised temporarily to offset a steep decline in economically sensitive State revenues related to the Great Recession and pay for climbing pension contributions required by State law. In January 2011, individual income tax rates were temporarily increased to 5.0% from 3.0% and corporate tax rates were raised to 7.0% from 4.8%.[24] Rates automatically declined to 3.75% for individuals and 5.25% for corporations in January 2015.

Because the revenue loss covered only half the fiscal year in 2015, the State was able to plug that year's budget hole by using one-time measures, including transfers to General Funds from balances built up in other State accounts and advance funding of Medicaid expenses from the prior year's revenues.[25] The challenge of balancing the budget was greater in FY2016, the year of Governor Rauner's first budget proposal, because it was also the first full fiscal year with lower income tax rates.

Like most other states, Illinois has balanced budget requirements.[26] The Illinois Constitution requires the Governor to present a budget in which proposed expenditures do not exceed funds

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[23] Governor Rauner's policy agenda has varied somewhat over time but has generally included a freeze on property taxes coupled with restrictions on public union collective bargaining, changes to the workers' compensation system for employees hurt on the job and term limits for lawmakers.

[24] 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.

[25] State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016, pp. 17-18. General Funds support the regular operating and administrative expenses of most agencies and are the funds over which the State has the most control. For many years prior to FY2018, General Funds consisted of the General Revenue Fund, Education Assistance Fund, Common School Fund and General Revenue-Common School Special Account Fund. Three additional accounts—the Fund for the Advancement of Education, Commitment to Human Services Fund and Budget Stabilization Fund—were added to General Funds in FY2018. In this report, the numbers for prior years have been adjusted to reflect the change in FY2018.

[26] National Association of State Budget Officers, *Budget Processes in the States*, Spring 2015, pp. 52-54.

estimated to be available for the fiscal year.[27] The Constitution also requires that the legislature make appropriations for all expenditures of public funds by the State and that appropriations for a fiscal year not exceed funds estimated by the General Assembly to be available during that year.[28] There is no provision requiring that a budget be enacted or prohibiting the carrying over of a deficit from one year to the next.

With Governor Rauner and the General Assembly unable to agree on tax increases or spending cuts, Illinois operated without complete General Funds budgets in FY2016 and FY2017.[29] The Governor's proposed budget for FY2018, issued on February 15, 2017, had an operating deficit of at least $4.6 billion.[30] To close the gap, the budget proposal relied on a bipartisan agreement among legislators that was not achieved.

Even in the absence of a full budget, most historical State spending continued because of court orders, federal consent decrees, and existing statutory requirements. State employees were paid due to a July 2015 State court ruling. In both FY2016 and FY2017, the Governor signed appropriation bills for elementary and secondary education, ensuring that public schools could open on time.

The main areas of State government not fully paid were universities, community colleges, Monetary Award Program (MAP) tuition grants for low income college students, group health insurance for employees and retirees, social service programs not covered by Medicaid and operational costs of certain agencies. Severe funding restrictions led to staffing and program cuts and declining enrollment at many public colleges and universities.[31] A survey in March 2017 by the United Way of Illinois found that 46% of the 463 responding human services agencies had reduced the number of clients served and one-quarter had closed programs due to lack of State funding.[32]

The impact of the budget impasse on residents' lives and Illinois' reputation is difficult to measure and may only be fully known in the long run. As the State continued to accrue expenses that exceeded revenues, the fiscal results included growth in the backlog of unpaid bills and related late-payment interest penalties, declining credit ratings and increasing borrowing costs compared with less troubled states.

Eventually, the cash shortfall became so critical that areas that were supposed to be funded, such as public schools, had to wait months for State dollars. The budget crisis also spread to the Illinois

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[27] Ill. Const. art. VIII, sec. 2(a).
[28] Ill. Const. art. VIII, sec. 2(b).
[29] For more information on Illinois' budget impasse, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2016 Recommended Operating Budget*, May 7, 2015, https://www.civicfed.org/iifs/publications/FY16_ILRecommendedBudget; *State of Illinois FY2017 Budget Roadmap*, February 11, 2016, https://www.civicfed.org/iifs/publications/FY2017IllinoisRoadmap; *State of Illinois FY2017 Recommended Operating Budget*, May 3, 2016, https://www.civicfed.org/iifs/publications/FY17_ILRecommendedBudget; *State of Illinois FY2018 Budget Roadmap*, February 10, 2017, https://www.civicfed.org/sites/default/files/reportroadmapfy18.pdf; and *State of Illinois FY2018 Recommended Operating and Capital Budgets*, May 9, 2017, https://www.civicfed.org/sites/default/files/fy18recommendedbudgetanalysis.pdf.
[30] Illinois State FY2018 Budget, p. 78, https://www2.illinois.gov/sites/budget/Documents/Budget%20Book/FY2018%20Budget%20Book/FY2018OperatingBudgetBook.pdf (last accessed on April 27, 2018).
[31] Rick Seltzer, "Picking up the Pieces in Illinois," *Inside Higher Ed*, July 10, 2017.
[32] United Way of Illinois, *United Way of Illinois Post-Stop Gap Funding Survey: High Level Findings*, April 6, 2017.

Lottery, which halted sales of the popular Powerball and Mega Millions games because the agency did not have budgetary authority to contribute to the prize pool.

When the General Assembly ended its regular spring session on May 31, 2017 without passing a budget, S&P and Moody's Investors Service dropped the State's credit rating to one notch above junk status and warned of further downgrades.[33] The end of May has been regarded as a critical budget deadline because after that time a three-fifths vote of both the House and Senate, rather than a simple majority, is required for legislation to be effective immediately.[34]

Facing the threat of a junk rating, the General Assembly passed budget legislation on July 4—three days after the start of the new fiscal year. Under the legislature's financial plan, income tax rates rose to 4.95% from 3.75% for individuals and returned to 7.0% from 5.25% for corporations. The budget package was immediately vetoed by Governor Rauner, who said it was unbalanced and included tax increases without any economic reforms.[35]On July 6, the General Assembly enacted an FY2018 budget by voting to override the Governor's veto.[36]

The budget drama did not end on July 6. A large portion of elementary and secondary education spending was made contingent on a separate education funding reform measure that had been passed by the legislature but not yet signed by Governor Rauner.[37] After the Governor issued an amendatory veto on August 1, some school districts said they might have to borrow money, cut programs or even shut down without the critical State aid.[38]

That threat was averted by the enactment of compromise legislation at the end of August that restored disputed funding for the financially troubled Chicago Public Schools.[39] The legislation also established a $75 million tax credit program for private school tuition.

FY2018 Enacted Budget

On paper, the General Assembly's FY2018 budget showed a modest operating surplus of about $360 million due largely to additional income tax revenue. The surplus was intended to be used to pay debt service on bonds sold to reduce the bill backlog.[40] Although the budget package authorized

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[33] Elizabeth Campbell, "Illinois Rushes to Enact Budget to Avoid Junk Rating," *Bloomberg*, July 3, 2017.
[34] Ill. Const. art. IV, sec. 10. If legislation does not receive the required three-fifths vote after May 31 of a given calendar year, it is not effective until June 1 of the next calendar year.
[35] 100th Illinois General Assembly, Senate Bill 6, *Governor's Message*, July 4, 2017, http://www.ilga.gov/legislation/fulltext.asp?DocName=10000SB0006gms&GA=100&SessionId=91&DocTypeId=SB&LegID=98849&DocNum=0006&GAID=14&Session=Public Act (last accessed on April 25, 2018).
[36] The enacted budget package consisted of three pieces of legislation: Public Act 100-0021 (appropriations), Public Act 100-0022 (revenues) and Public Act 100-0023 (statutory changes needed to implement the budget).
[37] 100th Illinois General Assembly, Senate Bill 1, passed by the General Assembly on May 31, 2017.
[38] Dave McKinney and Julia Jacobs, "Needy Illinois schools face anxiety over looming state aid cutoff," *Reuters*, August 2, 2017.
[39] Public Act 100-0465, enacted on August 31, 2017. For more information on the new school funding formula, see the Civic Federation blog, "What the New Illinois School Funding Formula Means for Chicago Public Schools," September 1, 2017, https://www.civicfed.org/civic-federation/blog/what-new-illinois-school-funding-formula-means-chicago-public-schools (last accessed on April 25, 2018).
[40] For more information on the General Assembly's budget, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation blog, "Illinois Ends Two-Year Budget Standoff," July 7, 2017, https://www.civicfed.org/iifs/blog/illinois-ends-two-year-budget-standoff (last accessed on February 8, 2018).

the sale of up to $6 billion in backlog bonds, the General Assembly's plan called for only $3 billion to be issued.

Despite an estimated $4.5 billion in additional income tax revenue, the Governor's Office of Management and Budget (GOMB) currently expects an FY2018 operating deficit of $590 million.[41] The shortfall is due to several initial budgetary assumptions that have not been realized.

For instance, projected debt service in FY2018 rose to $527 million after the Governor's Office decided to issue the full $6 billion of backlog bonds authorized by the budget legislation. In addition, $300 million in revenues ($240 million net of associated expenses) from Governor Rauner's proposed sale of the James R. Thompson Center in Chicago did not materialize because the transaction has not taken place. The Governor's budget proposal in FY2017 also included the Thompson Center sale.[42]

The General Assembly's FY2018 budget also assumed savings of $500 million through the creation of a new Tier 3 pension plan that would shift costs for new employees to school districts, universities and community colleges. The plan, which was also part of the Governor's budget proposal, is currently not expected to take effect until FY2020. Actuarial reviews supporting the savings estimate have not been released publicly.

To help balance the budget in FY2018, GOMB plans to transfer about $875 million to General funds from other State accounts.[43] The Governor's Office also implemented $156 million in General Funds spending reductions affecting many human services programs that had been targeted for cuts in the administration's previous budgets.

The $6 billion bond sale in October 2017 immediately reduced the backlog of outstanding bills by about $8.7 billion from a peak of $16.7 billion.[44] In addition to the authorized par amount of $6 billion, the State received a premium of about $500 million on the bond price and $2.2 billion in federal Medicaid reimbursements related to the use of part of the proceeds to pay down Medicaid bills.

Governor's Recommended FY2019 Budget

Although the backlog remains massive, the FY2019 budget involved fewer challenges than the Rauner administration's previous budgets because of the tax increase. The Governor's budget proposal, presented on February 14, 2018, has an operating surplus of $351 million, which would be used to reduce outstanding bills.

The Governor proposes rolling back the individual income tax rate by one-quarter of a percentage point to 4.7%, which would decrease revenues by an estimated $917 million.[45] However, the change would take effect only if the General Assembly approves offsetting pension savings of about $900 million. The pension proposal would have to be approved by the General Assembly and

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[41] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, pp. 27-29.
[42] Illinois State FY2017 Budget, p. 55.
[43] The General Assembly authorized transfers of about $293 million in FY2018 and interfund borrowing of up to $1.2 billion through calendar year 2018 to pay down the backlog. To help balance the budget, GOMB intends to use that authority to transfer $275 million from other State funds and borrow $600 million that would not be repaid.
[44] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, pp. 27-30.
[45] Illinois State FY2019 Budget, p. 31.

upheld by the Illinois Supreme Court, which has issued several rulings against pension benefit cuts in in the past four years.[46] Although the pension changes and tax rate reduction are described in the FY2019 budget book, the budget does not rely on their implementation.[47]

To rein in costs in FY2019, the Governor recommends shifting State pension and health insurance expenses to school districts and public employees. Pension costs for CPS that were taken over by the State as part of the 2017 education funding reform legislation would be returned to Chicago. The budget proposal requires public universities and community colleges to pick up additional pension and healthcare costs, but many of those costs would be offset by increased operational funding in FY2019.

Additional savings would come from a cut in Medicaid reimbursement rates for most healthcare providers and reduced spending on human services programs. Recommended appropriations for elementary and secondary education reflect the annual target increase of $350 million in the new education funding formula. The administration is also requesting $1.1 billion in supplemental appropriations for FY2018, largely consisting of unfunded costs in FY2017 during the budget impasse.

FY2019 revenue is boosted by continuing the 10% reduction in the amount of income and sales taxes directed to local governments and public transit districts, a practice that began in FY2018. The FY2019 budget, like the budget proposals in FY2017 and FY2018, relies on the sale of the Thompson Center. It also recommends interfund borrowing of $600 million in FY2019—the remainder of the amount authorized by the legislature in the FY2018 budget—that would not be repaid.

Recent Developments

The pension-cost shift, a key component of the Governor's FY2019 budget, quickly came under fire from both Republicans and Democrats in the General Assembly.[48] Nearly 60% of House members have signed onto a resolution opposing the shift because of concerns that it could lead to large increases in property taxes and tuition rates.[49]

Illinois' financial pressures increased in March, when the State learned it was responsible for more than $300 million in labor costs that were not included in the FY2019 budget proposal.[50] The State's largest union, the American Federation of State, County and Municipal Employees (AFSCME), has been operating without a contract since the end of FY2015. An appeals court ruled in November 2017 that the State violated the law when it stopped awarding step increases after the contract expired.[51] The State appealed the ruling to the Illinois Supreme Court, but the high court on March 21 declined to hear the case. The ruling means that the State will have to pay retroactive step

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[46] Illinois Supreme Court opinions are available at
http://www.illinoiscourts.gov/OPINIONS/SupremeCourt/2015/118585.pdf,
http://www.illinoiscourts.gov/Opinions/SupremeCourt/2016/119618.pdf and
http://illinoiscourts.gov/Opinions/SupremeCourt/2014/115811.pdf (last accessed on May 6, 2018).

[47] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 32.

[48] Tom Kacich, "Pension-cost shift a 'nonstarter' for many lawmakers," *The News-Gazette*, February 18, 2018.

[49] 100th Illinois General Assembly, House Resolution 27, filed on January 11, 2017.

[50] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 32.

[51] Step increases are automatic annual increases for newer workers as they add years of service.

increases and future increases in the absence of a new collective bargaining agreement, according to recent bond documents.[52] It remains to be seen whether there are sufficient appropriations to cover the wage increases.

House and Senate committees have been holding budget hearings for several months, but budget considerations were overshadowed by electoral politics. All of Illinois' executive officers, including the Governor, and all of the House seats are up for election in November. The legislature took a two-week break after the March 20 primary.

Budget negotiations appeared to begin in earnest in mid-April, when Governor Rauner held a meeting with General Assembly leaders. The Governor requested that the leaders appoint representatives to participate in budget discussions with his staff and that the legislature agree on a revenue estimate that will be used as a basis for the budget talks.[53] For several years beginning in 2011, the budget approved by the legislature was built on revenue estimates originating in the House, but that process stopped during the budget impasse.[54]

Meanwhile, new monthly reports from the Comptroller's Office have drawn more attention to Illinois' bill backlog and related late-payment interest penalties. The State is required to pay annual interest penalties of up to 12% on many overdue bills. As of the end of March, the backlog stood at $8.2 billion, including $774 million of unpaid interest penalties.[55]

As of early May, apparently due to the seasonal influx of tax revenue, the estimated backlog had dipped to $6.4 billion. The Governor's Office projects that the backlog will stand at $7.7 billion at the end of the fiscal year.[56]

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[52] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 32.

[53] Doug Finke, "Gov. Rauner, legislative leaders focus on budget, gun control," *The State Journal-Register*, April 12, 2018.

[54] For more information on Illinois' revenue estimates, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation blog, "Forecasting Revenue for the State of Illinois," April 20, 2018, https://www.civicfed.org/iifs/blog/forecasting-revenue-state-illinois (last accessed on April 28, 2018).

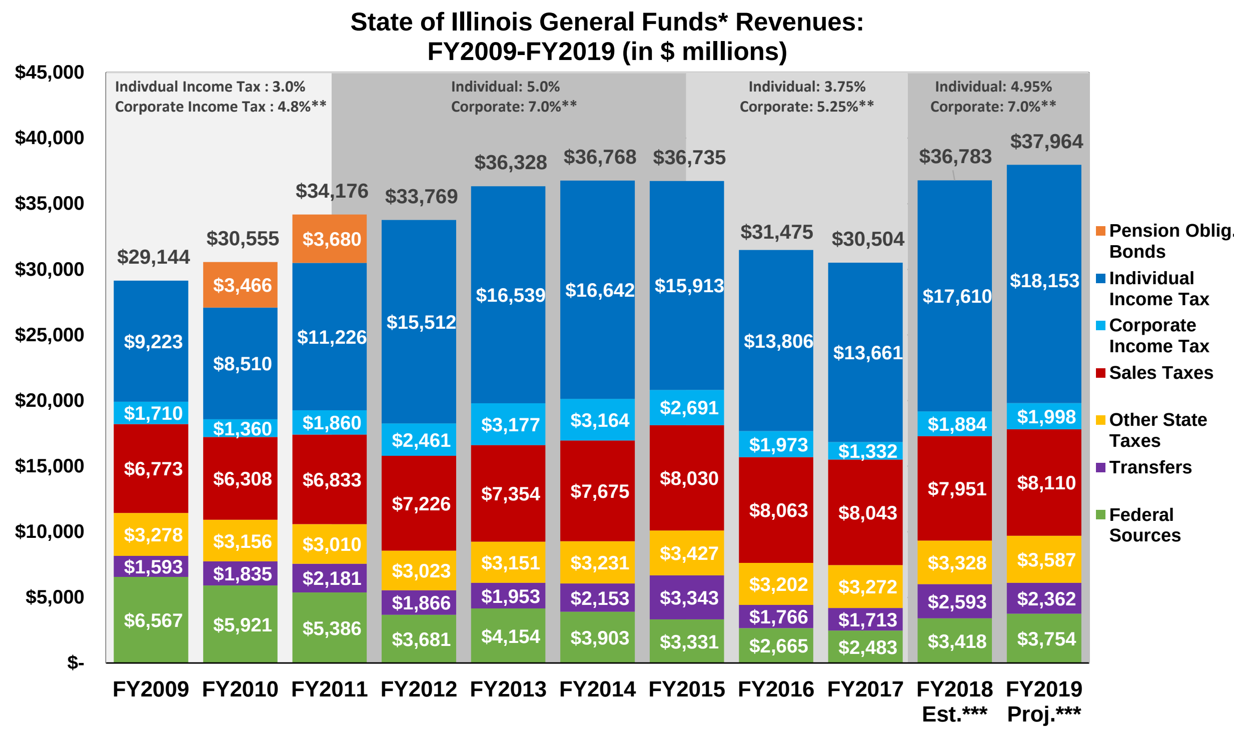
[55] State of Illinois Comptroller, *Debt Transparency Report Summary*, March 31, 2018, p. 3.

[56] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 12, 2018, p. 29. For more information on the backlog, see p. 41 of this report.

REVENUES

The State of Illinois generates annual operating resources by collecting taxes and fees levied by the State, as well as grants and reimbursements provided by the federal government. The Governor's proposed FY2019 budget projects total revenues of $68.0 billion, of which $38.0 billion are available for General Funds spending.[57] The remaining revenues that are not included in the General Funds are restricted for specific purposes, shared through revolving funds between government agencies, held in trusts or generally not available for discretionary spending by the General Assembly.[58]

The following chart shows the 10-year trend in General Funds revenue by major source.



* Includes revenues allocated to the General Funds, Fund for the Advancement of Education, Committment to Human Services Fund and Budget Stabilization Fund. Income tax amounts are net of diversions to the Income Tax Refund Fund.
** Corporations also pay a Personal Property Replacement Tax of 2.5%.
*** The FY2018 and FY2019 Budgets exclude revenues transferred to the Local Government Distributive Fund and transit districts.
Source: Illinois State FY2019 Budget, pp. 62-63 and 143-155; Illinois State FY2018 Budget, pp. 78-79 and 160-169; Illinois State FY2017 Budget, pp. 160-168; Illinois State FY2016 Budget, pp. 4-9 to 4-17; Illinois State FY2015 Budget, pp. 3-12 to 3-19; Illinois State FY2014 Budget, pp. 3-11 to 3-20; Illinois State FY2013 Budget, pp. 3-10 to 3-19; Illinois State FY2012 Budget, pp. 5-12 to 5-23.

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[57] Illinois State FY2019 Budget, pp. 114-115. 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.
[58] Beginning in February 2015 the Illinois Income Tax Act required that 1/15 of the individual income taxes collected by the State be diverted to two restricted-use special funds to support human service programs and education spending. In FY2018 the State recategorized these funds as General Funds. Throughout this Report these funds are treated as General Funds for all years.

Income Taxes

The chart above begins during the Great Recession, when both income taxes and sales taxes declined dramatically. Total income and sales tax revenues reached a nadir of $9.9 billion and $6.3 billion, respectively in FY2010. The State weathered these years with the assistance of temporary federal stimulus spending,[59] causing total federal funds to peak at $6.6 billion in FY2009. The State also issued pension obligation bonds that brought in $3.5 billion and $3.7 billion for pension payments in FY2010 and FY2011, respectively.

Although state-source revenues began to stabilize and show marginal growth in FY2011, overall revenue projections remained weak when the State enacted its FY2011 budget. Halfway through the FY2011 fiscal year, the State approved temporary increases for both the personal and corporate income tax rates, to 5.0% and 7.0%, respectively.[60]

After four years at temporarily increased rates, the individual income tax rate automatically declined on January 1, 2015, to 3.75% and the corporate income tax rate declined to 5.25%. Due to the half year of lower income tax rates, net income tax revenues declined by $1.2 billion to $18.6 billion in FY2015 from $19.8 billion in FY2014. Despite this decline, total revenues in FY2015 were nearly equal to FY2014 because the State relied on $1.2 billion in fund sweeps and $377 million in interfund borrowing.[61]

Fiscal year 2016 was the first full year of the lower rates, which resulted in a $4.0 billion decline in net income tax revenues from the peak year of FY2014, or a 20.3% drop. Income tax revenues remained low in FY2017 at $15.0 billion, the lowest since FY2011.

On July 6, 2017, after two years with no budget and facing a nearly $15 billion bill backlog, the General Assembly permanently restored the corporate rate to 7.0% and raised the individual rate to 4.95%.[62] Accordingly, income tax revenues are projected to increase to $19.5 billion in FY2018. This figure appears smaller than it would have in prior years, because the FY2018 budget requires distributions to the Local Government Distributive Fund to be deposited directly.[63] In addition, the General Assembly reduced these distributions by 10%, which the Governor proposes to continue in FY2019.[64] As a result, $1.1 billion of income tax revenue is excluded from the General Funds total in FY2018.

Throughout the rate changes of the past decade, income taxes have been the largest source of State revenues, making up approximately half of State-source General Funds revenues. The recent rate increases drive that ratio higher, from 49.4% in FY2017 to a projected 53.1% in FY2019. Based on the strength of the economy, income tax revenues are projected to increase by 3.4% from FY2018 to FY2019 to a total of $20.2 billion.[65]

[59] The American Recovery and Reinvestment Act, Pub.L. 111-5.
[60] Public Act 96-1496, enacted on January 13, 2011.
[61] Illinois State FY2018 Budget, p. 169.
[62] Public Act 100-0022, enacted on July 6, 2017.
[63] Public Act 100-002, enacted on July 6, 2017.
[64] Illinois State FY2019 Budget, p. 144.
[65] Illinois State FY2019 Budget, p. 139.

The following table shows income taxes collected by the State of Illinois from FY2015 through the proposed FY2019 budget projections, including the amounts diverted to pay for tax refunds.

State of Illinois Total Income Tax Revenues FY2015-FY2019 General Funds (in $ millions)							
Income Tax Increment	**FY2015**	**FY2016**	**FY2017**	**FY2018 Est.**	**FY2019 Proposed**	**5-Year $ Change**	**5-Year % Change**
Individual Income Tax							
Tax Rate	5% to 3.75%	3.75%	3.75%	4.95%	4.95%		
Individual Income Tax	$ 17,682	$ 15,301	$ 14,929	$ 20,038	$ 20,633	$ 2,951	16.7%
Pass-Through Entities*	n/a	n/a	$ 456	$ 612	$ 630	n/a	n/a
Gross Individual Income Tax	**$ 17,682**	**$ 15,301**	**$ 15,384**	**$ 20,649**	**$ 21,263**	**$ 3,581**	**20.3%**
Refund Fund Transfer	$ (1,768)	$ (1,494)	$ (1,723)	$ (2,024)	$ (2,063)	$ (295)	16.7%
Deposits into LGDF**	n/a	n/a	n/a	$ (1,016)	$ (1,047)	n/a	n/a
Net Individual Income Tax	**$ 15,913**	**$ 13,806**	**$ 13,661**	**$ 17,610**	**$ 18,153**	**$ 2,240**	**14.1%**
Corporate Income Tax							
Tax Rate	7% to 5.25%	5.25%	5.25%	7.00%	7.00%		
Gross Corporate Income Tax	$ 3,129	$ 2,336	$ 1,610	$ 2,434	$ 2,520	$ (609)	-19.5%
Refund Fund Transfer	$ (438)	$ (362)	$ (278)	$ (426)	$ (391)	$ 47	-10.7%
Deposits into LGDF**	n/a	n/a	n/a	$ (124)	$ (131)	n/a	n/a
Net Corporate Income Tax	**$ 2,691**	**$ 1,973**	**$ 1,332**	**$ 1,884**	**$ 1,998**	**$ (693)**	**-25.8%**
Total Income Taxes (net)	**$ 18,604**	**$ 15,779**	**$ 14,993**	**$ 19,494**	**$ 20,151**	**$ 1,547**	**8.3%**

* The State began reporting income from pass-through business entities, such as partnerships and S-corporations, separately from other individual income starting in FY2017.

** In FY2018 the State began removing income tax distributions to the Local Government Distributive Fund from both revenues and expenditures in General Funds reporting.

Source: Illinois State FY2019 Budget, pp. 143-145.

After accounting for the amount set aside to pay tax refunds, net individual income taxes available for General Funds spending are projected to have increased by $2.2 billion to $18.2 billion in FY2019 compared to $15.9 billion in FY2015. Since FY2014, the last full year with similar tax rates, net individual income tax revenues will have risen by $1.5 billion, or 9.1%.

Net corporate income tax revenues have fallen by 17.9% since FY2014, when the tax rate was the same, and 25.8 % since FY2015, when the temporary tax increase partially rolled back mid-year. Part of the reason for the drop is the reclassification of income tax from pass-through entities, such as partnerships, LLCs and S-Corporations, into the individual income tax category beginning in FY2017. Another reason is the increased use of net operating losses to offset positive income since a $100,000 cap was lifted in tax year 2014.[66] However, corporate income tax revenues are expected to increase substantially in FY2019 as this effect levels out and corporate profits remain strong. It should be noted that the State also collects the Personal Property Replacement Tax on behalf of local governments at a rate of 2.5% on corporate income, making the current effective corporate income tax rate in Illinois 9.5%.

[66] Illinois State FY2019 p. 145.

Other General Funds Revenue

The following table compares revenue amounts included in the Governor's proposed FY2019 budget to current estimates of FY2018 General Funds revenues.

State of Illinois General Funds Revenues: Estimated FY2018 and Governor's Recommended FY2019 (in $ millions)				
	FY2018 Est.	FY2019 Proj.	$ Change	% Change
State Taxes				
Income Taxes (net)	$ 19,494	$ 20,151	$ 657	3.4%
Individual (net)	$ 17,610	$ 18,153	$ 543	3.1%
Corporate (net)	$ 1,884	$ 1,998	$ 114	6.1%
Sales Taxes	$ 7,951	$ 8,110	$ 159	2.0%
Public Utility Taxes	$ 890	$ 868	$ (22)	-2.5%
Cigarette Tax	$ 351	$ 348	$ (3)	-0.9%
Liquor Gallonage Taxes	$ 172	$ 173	$ 1	0.6%
Estate Tax	$ 275	$ 275	$ -	0.0%
Insurance Taxes & Fees	$ 395	$ 397	$ 2	0.5%
Corporate Franchise Tax & Fees	$ 205	$ 203	$ (2)	-1.0%
Interest on State Funds & Investments	$ 46	$ 46	$ -	0.0%
Cook County Intergovernmental Transfer	$ 244	$ 244	$ -	0.0%
Other Sources	$ 750	$ 1,033	$ 283	37.7%
Total State Taxes	**$ 30,773**	**$ 31,848**	**$ 1,075**	**3.5%**
Transfers				
Lottery	$ 719	$ 733	$ 14	1.9%
Riverboat Transfers & Receipts	$ 270	$ 263	$ (7)	-2.6%
Other	$ 729	$ 766	$ 37	5.1%
Fund Reallocations	$ 275	$ -	$ (275)	-100.0%
Interfund Borrowing*	$ 600	$ 600	$ -	0.0%
Total Transfers	**$ 2,592**	**$ 2,362**	**$ (230)**	**-8.9%**
Total State Revenues	**$ 33,365**	**$ 34,210**	**$ 845**	**2.5%**
Federal Sources	**$ 3,418**	**$ 3,754**	**$ 336**	**9.8%**
Total Revenue	**$ 36,783**	**$ 37,964**	**$ 1,181**	**3.2%**

* The Governor's FY2019 Budget proposes not to repay $600 million of interfund borrowing in FY2018 and FY2019

Source: Illinois State FY2019 Budget, pp. 62, 115.

Sales taxes have been collected at the same rate over the last decade and increase by $159 million to $8.1 billion in FY2019. The State collects sales taxes at a rate of 6.25% and retains 5.0 percentage points to fund its operations while passing along the remaining portions to county and local governments. The FY2018 Budget trimmed distributions to public transit districts by 10% and arranged for them to be deposited directly into those funds, lowering the General Funds total.[67] The State also imposed a 2.0% fee on sales tax collected on behalf of local governments, but these

[67] Illinois State FY2019 Budget, p. 146.

revenues are directed to a special fund for sales tax administration and do not affect General Funds receipts.[68]

Tax revenues could potentially outperform the FY2019 forecast depending on the outcome of a U.S. Supreme Court case, *South Dakota v. Wayfair, Inc.*[69] The justices are reconsidering the 1992 precedent set in *Quill Corp. v. North Dakota*, which held that states could not impose sales taxes on online sellers with no physical presence in the state.[70] Legislation whose constitutionality depends on the Supreme Court overturning precedent has passed the Illinois Senate, and would require sales tax collections from online retailers with at least $100,000 in gross sales receipts in the State.[71]

Tax revenues other than income and sales taxes are forecast to be nearly unchanged in FY2019, falling by $24 million from FY2018. Earnings on State investments are projected to be flat at $46 million.

Transfers are projected to be down 8.9% from FY2018. The largest difference is that the FY2019 budget does not include fund reallocations, authorized by the General Assembly for the FY2018 budget in the amount of $293 million. The Governor's office includes only $275 million in its projection due to limited amounts available in other funds.[72] The Governor does, however, propose to use the remaining $600 million in interfund borrowing authorized for FY2018 but that does not expire until December 31, 2018. He also proposes to forgive the debt for both years, and thus the borrowing is included in both FY2018 and FY2019 as a revenue.[73]

Federal sources were artificially low during the two-year budget impasse because they are driven largely by federal Medicaid reimbursements. Medicaid bills had accumulated as part of the State's bill backlog until a federal court ordered expedited payment and the State finally adopted full-year appropriations for FY2018.[74] Accordingly, federal reimbursements increased dramatically as the State began to catch up on bills, in the amount of $1.0 billion for FY2018 bills. The State also received $1.2 billion that it applied to prior-year bills to reduce the backlog directly.[75] These receipts are not included in the budget's revenue total for FY2018.[76]

Even with the $1.0 billion of reimbursements generated by bond proceeds, the FY2018 number appears artificially low. The FY2018 budget authorized the use of an additional $740 million from the Drug Rebate Fund to pay off Medicaid managed care bills.[77] Spending from this appropriation occurred during the FY2017 lapse period, but generated federal reimbursements in FY2018 for the Drug Rebate Fund, rather than the General Funds.[78] The General Funds will resume responsibility

[68] Public Act 100-0023, enacted on July 6, 2017.
[69] *South Dakota v. Wayfair, Inc.*, No. 17-494 (U.S. S. Ct. argued Apr. 17, 2018).
[70] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[71] 100th Illinois General Assembly, Senate Bill 2577, Senate Committee Amendment 1, passed by Senate on April 17, 2018.
[72] Illinois State FY2019 Budget, p. 58.
[73] Illinois State FY2019 Budget, p. 60.
[74] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, pp. 30-31
[75] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 30.
[76] Illinois State FY2019 Budget, p. 58.
[77] Public Act 100-0021, enacted on July 6, 2017.
[78] Communication between the Civic Federation and the Governor's Office of Management and Budget, April 30, 2018.

for these bills in FY2019 and thus receive the reimbursements; even without backlog bond proceeds, total federal revenues are projected to be $336 million higher in FY2019 than in FY2018.

New Revenue Proposals

For the third year in a row, the proposed FY2019 budget includes the sale of the James R. Thompson Center to support operating expenses.[79] The Governor's budget expects the sale to bring $300 million in revenue for the State, which after expenses associated with the sale would net $240 million. This one-time revenue source would not be part of the State's ongoing tax base and would only be available for spending in FY2019. The estimated net revenue has been revised upwards by $40 million since the sale was originally proposed in the FY2017 budget.[80] Since the sale did not occur in FY2018, the projected $300 million in revenue has been removed from the estimate for that year, increasing the deficit. The likelihood of a sale in FY2019 remains unclear; Mayor Rahm Emanuel has insisted that the State bear the costs of reconstructing the Chicago Transit Authority's Clark/Lake station inside the building.[81]

Legislative Revenue Forecast

Going into FY2019, revenue forecasts by the executive and legislative branches are $99 million apart—less than 0.3% of expected revenues and among the closest they have been in recent years.[82] The Governor's Office of Management and Budget (GOMB) forecasts General Funds revenue of $37.96 billion in FY2019, while the legislature's Commission on Government Forecasting and Accountability (COGFA) forecasts $37.87 billion. The relatively small differences between the two estimates are offsetting. COGFA estimates $164 million less individual income tax revenue than GOMB and $76 million less sales tax revenue, but $77 more in corporate income tax. Both estimates include one-time revenues of $300 million from the proposed sale of the James R. Thompson Center in Chicago and $600 million in borrowing from other State funds, which the Governor does not plan to repay.

[79] Illinois State FY2019 Budget, p. 49.
[80] Mike Hoffman, Acting Director of Central Management Services, Testimony before Senate Appropriations I Committee, March 15, 2017.
[81] Alice Bazerghi, "Thompson Center redesign proposal includes 'super tower'," *Chicago Sun-Times*, April 27, 2018.
[82] Illinois General Assembly, Commission on Government Forecast and Accountability, *FY 2019 Economic Forecast and Revenue Estimate and FY 2018 Revenue Update*, February 27, 2018, p. 33.

APPROPRIATIONS AND EXPENDITURES

The recommended FY2019 budget proposes total appropriations of $73.0 billion, including $35.3 billion in General Funds spending authority.[83] The budget proposal also includes $29.2 billion in appropriations from Other State Funds and $8.5 billion in Federal Funds appropriations.

Proposed General Funds expenditures total $37.6 billion.[84] General Funds expenditures include both spending from appropriations and transfers out of General Funds to make interest and principal payments on previously issued bonds and for other legislatively required purposes.

General Funds support the regular operating and administrative expenses of most agencies and are the funds over which the State has the most control.[85] Other State Funds are accounts for activities funded by specific revenue sources that may only be used for specific purposes. Federal Funds (other than those designated for General Funds) use federal revenues to support a variety of State programs.

Total Appropriations by Fund Type

The following table shows appropriations by type of fund from FY2015 through FY2019. Recommended total appropriations for FY2019 of $73.0 billion are up by $1.3 billion, or 1.9%, from $71.6 billion in FY2018. Proposed FY2019 General Funds appropriations increase by $309 million, or 0.9%, from the year before. Over the five-year period, total appropriations grow by $5.9 billion, or 8.8%, from $67.0 billion in FY2015, while General Funds appropriations increase by $3.1 billion, or 9.7%, from $32.2 billion in FY2015.

State of Illinois Appropriations by Fund Type: FY2015-FY2019 (in $ millions)

	FY2015 Enacted	FY2016 Enacted*	FY2017 Enacted*	FY2018 Enacted	FY2019 Rec.	Two-Year $ Change	Two-Year % Change	Five-Year $ Change	Five-Year % Change
General Funds**	$ 32,183	$ 28,983	$ 33,470	$ 34,994	$ 35,303	$ 309	0.9%	$ 3,120	9.7%
Other State Funds	$ 26,678	$ 26,651	$ 28,613	$ 28,125	$ 29,184	$ 1,059	3.8%	$ 2,506	9.4%
Federal Funds	$ 8,186	$ 8,137	$ 8,419	$ 8,509	$ 8,490	$ (19)	-0.2%	$ 304	3.7%
Total	**$ 67,047**	**$ 63,771**	**$ 70,502**	**$ 71,628**	**$ 72,977**	**$ 1,349**	**1.9%**	**$ 5,930**	**8.8%**

*Enacted appropriations in FY2016 and FY2017 include appropriations under statutory continuing appropriation authority, court orders and consent decrees.
**The definition of General Funds was changed in FY2018 to include the Commitment to Human Services Fund, Fund for the Advancement of Education and Budget Stabilization Fund. General Funds numbers in FY2015, FY2016 and FY2017 have been adjusted to include those funds.
Source: Illinois State FY2019 Budget, pp. 62 and 84; Illinois State FY2018 Budget, pp. 78, 98 and 99; Illinois State FY2017 Budget, p. 97.

For FY2016 and FY2017, the years of the State's budget impasse, General Funds appropriations include continuing appropriations, which statutorily authorize spending without any specific action by the General Assembly, and appropriations under court orders and consent decrees. The FY2018 budget included an additional $1.9 billion in General Funds appropriations for FY2017.[86]

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[83] Illinois State FY2019 Budget, p. 84.
[84] Illinois State FY2019 Budget, p. 62.
[85] Before FY2018 General Funds consisted of four funds: the General Revenue Fund, Education Assistance Fund, Common School Fund and General Revenue-Common School Fund. The definition of General Funds was changed in FY2018 to include three additional funds: the Fund for the Advancement of Education, Commitment to Human Services Fund and Budget Stabilization Fund. For year-to-year comparisons in this report, all seven funds are included in General Funds.
[86] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 24.

It is important to recognize that total appropriations do not accurately reflect State spending because spending from Other State Funds and Federal Funds is often significantly below appropriated amounts. In FY2017, for example, actual spending from Other State Funds was $31.1 billion, 7.2% below the $33.5 billion appropriated amount.[87] Actual spending from Federal Funds in FY2017 was $5.0 billion, 40.8% below the $8.4 billion appropriation.

Appropriations from Other State Funds and Federal Funds do not affect the operating deficit, which is based on General Funds revenues and expenditures. General Funds spending from appropriations is typically somewhat below the appropriated amount due to unspent agency appropriations and other adjustments.

General Funds Appropriated Spending

To understand State spending pressures, it is helpful to distinguish appropriated agency spending from pension contributions and group insurance payments. The legislature generally has more discretion over agency appropriations than the other two spending categories.[88] Pension contributions are based on State law, determined by Illinois' five retirement systems and covered by continuing appropriations. Group insurance consists mainly of health insurance for employees and retirees, which is covered by State law and union contracts.

The following table shows appropriated spending for these categories from FY2015 through FY2019.

State of Illinois General Funds Appropriated Expenditures by Category: FY2015-FY2019 (in $ millions)

	FY2015	FY2016	FY2017	FY2018	FY2019 Rec.	Two-Year $ Change	Two-Year % Change	Five-Year $ Change	Five-Year % Change
Agency Appropriations Spent	$ 23,534	$ 20,564	$ 24,060	$ 25,121	$ 25,768	$ 647	2.6%	$ 2,234	9.5%
Pension Contributions	$ 6,047	$ 6,632	$ 6,951	$ 7,002	$ 7,212	$ 210	3.0%	$ 1,165	19.3%
Group Insurance	$ 1,565	$ -	$ -	$ 1,858	$ 1,450	$ (408)	-22.0%	$ (115)	-7.3%
Total	**$ 31,146**	**$ 27,196**	**$ 31,011**	**$ 33,981**	**$ 34,430**	**$ 449**	**1.3%**	**$ 3,284**	**10.5%**

Source: Illinois State FY2019 Budget, pp. 31 and 62; Illinois State FY2018 Budget, pp. 30 and 78; Illinois State FY2017 Budget, p. 63.

Proposed agency spending from appropriations increases by $647 million, or 2.6% to $25.8 billion in FY2019 from $25.1 billion in FY2018 and by $2.2 billion, or 9.5%, from $23.5 billion in FY2015. The FY2015 figure is artificially depressed because of an appropriation that was shifted from that year to FY2014 to improve the budget balance in FY2015. Specifically, $600 million that was appropriated from General Funds for Medicaid in FY2014 was deposited into another State fund and used to pay FY2015 Medicaid bills.[89] If agency spending in FY2015 is adjusted to include the $600 million, the increase from FY2015 to FY2019 is 6.5% instead of 9.5%.

Proposed pension contributions increase by $210 million, or 3.0%, to $7.2 billion in FY2019 from $7.0 billion in FY2018 and by $1.2 billion, or 19.3% from $6.0 billion in FY2015. The Governor recommends reducing statutorily required pension contributions in FY2019 by shifting current-year costs (known as normal costs) to school districts outside of Chicago and public universities over four years. The proposal would lower required State contributions by a total of $363 million in

[87] Illinois State FY2019 Budget, p. 83.
[88] Medicaid is considered as discretionary in this analysis, even though most spending changes in the Medicaid program require changes in State law, administrative rules and/or approval from the federal government.
[89] Illinois State FY2017 Budget, pp. 69-70.

FY2019 by allocating $262 million to local school districts and $101 million to universities.[90] However, the additional pension costs for universities and community colleges would be offset by an increase in operational funding.

General Funds group insurance payments decline by $408 million, or 22.0%, to $1.45 billion in FY2019 from $1.86 billion in FY2018. The proposed FY2019 spending level proposed is also $115 million, or 7.3%, below FY2015's $1.57 billion. As in each of the administration's previous budgets, the State's health insurance costs would be lowered significantly by requiring employees to choose between increased premiums or reduced coverage. The FY2019 savings are estimated at $470 million from maintenance levels.[91]

The proposal was a major sticking point in negotiations between the State and its largest union, the American Federation of State, County and Municipal Employees (AFSCME) over a new contract to replace the agreement that expired at the end of FY2015. The union is challenging the administration's effort to implement its final offer in a lawsuit pending in the Illinois Fourth District Court of Appeals.[92] The Governor plans to support legislation to remove employee health insurance from collective bargaining.[93]

In addition to State workers and retirees, the State group health insurance program covers public university employees and retirees. The FY2019 budget recommends increasing the share of health insurance costs paid by universities by $105 million to $150 million from $45 million. Like additional pension costs, these added health insurance costs would be offset in FY2019 by increased operational spending.[94]

General Funds Agency Spending and Appropriations by Area

The next table shows spending by area of government. Actual spending by area is shown for FY2015 through FY2017, estimated expenditures for FY2018 and proposed appropriations for FY2019. The appropriation amounts for FY2019 are higher than expected spending because they do not include unspent appropriations, which are given as a lump sum in the budget book and not distributed across areas or agencies. The FY2018 estimated expenditures are somewhat overstated because they reflect agencies' estimates of unspent appropriations, which are below the aggregate

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[90] State of Illinois, Governor's Office of Management and Budget, *Fiscal Year 2019 Budget Briefing*, February 14, 2018, p.9.
[91] State of Illinois, Governor's Office of Management and Budget, *Fiscal Year 2019 Budget Briefing*, February 14, 2018, p.9.
[92] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, pp. 32-33.
[93] Illinois State FY2019 Budget, p. 48.
[94] State of Illinois, Governor's Office of Management and Budget, *Fiscal Year 2019 Budget Briefing*, February 14, 2018, p.9.

estimate by the Governor's Office of Management and Budget (GOMB).[95] GOMB estimates total unspent appropriations of $1.0 billion in FY2018 and $872 million in FY2019.[96]

State of Illinois General Funds Agency Expenditures and Appropriations by Area: FY2015-FY2019 (in millions)									
	FY2015 Exps.	FY2016 Exps.	FY2017 Exps.	FY2018 Est. Exps.	FY2019 Rec. Approps.	Two-Year $ Change	Two-Year % Change	Five-Year $ Change	Five-Year % Change
P-12 Education	$ 6,745	$ 7,001	$ 7,474	$ 7,983	$ 8,313	$ 330	4.1%	$ 1,568	23.2%
Higher Education*	$ 1,940	$ 623	$ 2,150	$ 1,836	$ 2,063	$ 227	12.4%	$ 123	6.3%
Economic Development	$ 77	$ 29	$ 32	$ 46	$ 60	$ 14	30.4%	$ (17)	-22.1%
Public Safety	$ 1,597	$ 1,129	$ 1,475	$ 1,756	$ 1,729	$ (27)	-1.5%	$ 132	8.3%
Human Services	$ 5,434	$ 4,680	$ 5,713	$ 5,746	$ 5,781	$ 35	0.6%	$ 347	6.4%
Healthcare	$ 6,524	$ 6,090	$ 5,990	$ 7,113	$ 7,875	$ 762	10.7%	$ 1,351	20.7%
Environment and Culture	$ 54	$ 39	$ 59	$ 55	$ 55	$ -	0.0%	$ 1	1.9%
Government Services**	$ 1,197	$ 990	$ 1,285	$ 1,309	$ 869	$ (440)	-33.6%	$ (328)	-27.4%

*Higher Education includes funding from the Personal Property Tax Replacement Fund of $97.1 million in FY2017 and $103.5 million in FY2018 and FY2019.
**Government Services does not include group insurance.
Source: Civic Federation calculations based on Illinois State Operating Budget Detail, FY2016-FY2019, https://www.illinois.gov/gov/budget/pages/default.aspx.

P-12 Education

General Funds funding for preschool to secondary education increases by $330 million, or 4.1%, in FY2019 to $8.3 billion from $8.0 billion in FY2018 and by $1.6 billion, or 23.2%, from $6.7 billion in FY2015.[97] School funding is one of Governor Rauner's stated priorities[98] and has been the only area of agency spending showing consistent growth since FY2015.

The increase in proposed spending on P-12 education in FY2019 reflects $350 million for the State's new school funding formula. That amount is the annual target increase in a law enacted in August 2017[99] following the Governor's amendatory veto of a previous bill.[100] The new school funding formula is an evidence-based model that replaced the old formula, which was intended to supplement school districts' local resources but was criticized for inadequately funding school districts across Illinois and resulting in highly disparate per pupil spending levels.[101]

The new model sets a target funding level, or "adequacy target," based on a school district's needs and calculates local capacity to fund schools based on the assessed value of property available to the school district for taxing, rather than setting the same funding level for every student, as did the previous formula. It also establishes a base funding minimum to hold current funding levels harmless, and rolls many of the block grants and categorical grants into the base funding minimum calculation.

Chicago Public Schools (CPS), the State's largest school district, was expected to gain additional State funding of about $293 million from the new evidence-based formula in FY2018. This includes about $221 million to cover CPS teacher normal pension and retiree health insurance costs

[95] Communication between the Civic Federation and the Governor's Office of Management and Budget, May 4, 2018.
[96] Illinois State FY2019 Budget, p. 31.
[97] P-12 education funding does not include State contributions to the Teachers' Retirement System, the pension fund for teachers outside of Chicago.
[98] Illinois State FY2019 Budget, Governor's Cover Letter.
[99] Public Act 100-0465, enacted on August 31, 2017.
[100] 100th Illinois General Assembly, Senate Bill 1, amendatory veto on August 1, 2017.
[101] For more information on the new school funding formula, see the Civic Federation blog, "What the New Illinois School Funding Formula Means for Chicago Public Schools," September 1, 2017, https://www.civicfed.org/civic-federation/blog/what-new-illinois-school-funding-formula-means-chicago-public-schools (last accessed on April 25, 2018).

and approximately $71 million of an additional $350 million available through the new formula for allocation statewide. The additional pension and retiree health insurance costs for Chicago teachers are shown under the Government Services spending area in the budget. In FY2019 the Rauner administration proposes to return the normal pension and retiree health insurance costs, totaling $228 million in that year, to CPS.

The school funding legislation included a five-year pilot program offering up to $75 million per year in income tax credits to individuals or businesses that donate to private school scholarships for low income students. The program took effect in the 2018-2019 school year and the State is first affected by the revenue loss in FY2019.

The FY2019 budget proposes an increase of $11 million, or 2.4%, to $454 million in funding for early childhood education.[102] Proposed education funding increases in FY2019 are partially offset by other reductions, including $15 million in cuts for after school programs.[103]

Higher Education

Higher education was one of the areas of State government hit hardest by the two-year budget deadlock. Higher education includes nine public universities; the Illinois Community College Board, which distributes funds to 48 community colleges; and the Monetary Award Program (MAP), which provides college tuition grants for low income students.[104]

In FY2016, higher education received $623 million in State general operating funds—less than one-third of the FY2015 level of $1.9 billion. A stopgap budget enacted on June 30, 2016 provided approximately $1 billion more, which could be used to cover FY2016 costs as well as FY2017 costs through the end of calendar year 2016.[105] When the stopgap funding expired on December 31, 2016, it was not replaced until a budget was enacted on July 6, 2017—five days after the start of the new fiscal year—that included supplemental funding for FY2017. The additional appropriations boosted higher education spending to $2.2 billion in FY2017, but funding declined to $1.8 billion in FY2018.

The FY2019 budget proposal of $2.06 billion appears to be significantly higher than spending in both FY2015 and FY2018. However, the main reason is $206 million provided for the Board of Higher Education, of which $101 million would be distributed to universities and community colleges to offset the proposed shift in pension costs and $105 million would go to universities to offset the shift in health insurance costs.[106] Without those amounts, proposed funding is $1.86 billion, an increase of $21 million from FY2018 and decrease of $83 million from FY2015.

The following table show shows General Funds funding for higher education from FY2015 through FY2019. The numbers include additional funding in FY2017, FY2018 and FY2019 from the

[102] Illinois State FY2019 Budget, p. 454.
[103] Illinois State FY2019 Budget, p. 453.
[104] Higher education also includes the Illinois Board of Higher Education, Math and Science Academy and State Universities Civil Service System. Higher education budget numbers presented here do not include State contributions to the State Universities Retirement System or group health insurance payments for university employees and retirees.
[105] For more information on the FY2017 stopgap budget, see the Institute for Illinois' Fiscal Sustainability at the Civic Federation blog, "'Lifeline' Plan Would Partially fund Higher Education, Human Services,'" April 28, 2017, https://www.civicfed.org/iifs/blog/lifeline-plan-would-partially-fund-higher-education-human-services (last accessed on May 1, 2018).
[106] Illinois State FY2019 Budget, p. 459.

Personal Property Replacement Tax (PPRT) Fund, a special account not previously used for higher education, but do not include pension contributions or health insurance payments.

State of Illinois General Funds Expenditures and Appropriations for Higher Education: FY2015-FY2019 (in $ thousands)[1]

	FY2015 Exps.	FY2016 Exps.	FY2017 Exps.	FY2018 Est. Exps.	FY2019 Approps.	Two-Year $ Change	Two-Year % Change	Five-Year $ Change	Five-Year % Change	Average Annual Funding FY2016-FY2019	Average Annual Funding as % of FY2015
Chicago State	$ 36,102	$ 20,107	$ 36,331	$ 32,698	$ 32,698	$ -	0.0%	$ (3,404)	-9.4%	$ 30,459	84.4%
Eastern Illinois	$ 42,903	$ 12,457	$ 42,976	$ 38,132	$ 38,678	$ 546	1.4%	$ (4,225)	-9.8%	$ 33,061	77.1%
Governors State	$ 23,858	$ 6,974	$ 24,072	$ 21,656	$ 21,656	$ -	0.0%	$ (2,202)	-9.2%	$ 18,590	77.9%
Northeastern Illinois	$ 36,899	$ 10,695	$ 36,957	$ 33,209	$ 33,209	$ -	0.0%	$ (3,690)	-10.0%	$ 28,518	77.3%
Western Illinois	$ 51,445	$ 14,911	$ 51,445	$ 46,301	$ 46,301	$ -	0.0%	$ (5,144)	-10.0%	$ 39,740	77.2%
Illinois State	$ 72,227	$ 20,935	$ 72,263	$ 65,004	$ 65,004	$ -	0.0%	$ (7,223)	-10.0%	$ 55,801	77.3%
Northern Illinois	$ 90,985	$ 26,403	$ 91,093	$ 81,984	$ 81,984	$ -	0.0%	$ (9,001)	-9.9%	$ 70,366	77.3%
Southern Illinois	$ 199,558	$ 57,482	$ 199,819	$ 180,914	$ 179,914	$ (1,000)	-0.6%	$ (19,644)	-9.8%	$ 154,532	77.4%
University of Illinois	$ 643,719	$ 180,094	$ 650,898	$ 583,006	$ 583,006	$ -	0.0%	$ (60,713)	-9.4%	$ 499,251	77.6%
Total Universities	**$ 1,197,696**	**$ 350,059**	**$ 1,205,854**	**$ 1,082,904**	**$ 1,082,450**	**$ (454)**	**0.0%**	**$ (115,246)**	**-9.6%**	**$ 930,317**	**77.7%**
Board of Higher Education	$ 10,002	$ 2,070	$ 25,142	$ 10,057	$ 210,845	$ 200,788	1996.5%	$ 200,843	2008.0%	$ 62,029	620.2%
Community College Board[2]	$ 338,319	$ 75,918	$ 384,304	$ 310,992	$ 306,215	$ (4,777)	-1.5%	$ (32,104)	-9.5%	$ 269,357	79.6%
ISAC[3]	$ 10,690	$ 6,023	$ 13,218	$ 11,318	$ 42,628	$ 31,310	276.6%	$ 31,938	298.8%	$ 18,297	171.2%
ISAC/MAP[3]	$ 364,050	$ 169,793	$ 502,621	$ 401,342	$ 401,342	$ -	0.0%	$ 37,292	10.2%	$ 368,775	101.3%
Math and Science Academy	$ 17,859	$ 17,956	$ 17,733	$ 18,031	$ 18,177	$ 146	0.8%	$ 318	1.8%	$ 17,974	100.6%
State Universities Civil Service	$ 1,158	$ 712	$ 1,206	$ 1,059	$ 1,082	$ 23	2.2%	$ (76)	-6.6%	$ 1,015	87.6%
Adjustment for Pension and Health Insurance Increases[4]	$ -	$ -	$ -	$ -	$ (206,000)	$ (206,000)	na	$ (206,000)	na	na	na
Total	**$ 1,939,774**	**$ 622,531**	**$ 2,150,078**	**$ 1,835,703**	**$ 1,856,739**	**$ 21,036**	**1.1%**	**$ (83,035)**	**-4.3%**	**$ 1,616,263**	**83.3%**

[1]Does not include funding for the State Universities Retirement System, College Insurance Program or State Employees' Group Insurance Program.
[2]Includes funding from the Personal Property Tax Replacement Fund of $97.1 million in FY2017, $103.5 million in FY2018 and $103.5 million in FY2019.
[3]The Illinois Student Assistance Commission administers the Monetary Award Progam.
Adjustment to offset increases shown eleswhere in budget for pension costs tor universities and community colleges and group health insurance costs for universities.
Source: Civic Federation calculations based on Illinois State FY2016-FY2019 Operating Budget Details, https://www.illinois.gov/gov/budget/Pages/default.aspx.

Funding for universities is approximately level with FY2018 at $1.1 billion, which represented a reduction of about 10% from FY2017. MAP grants are funded at the FY2018 level of $401 million. The Illinois Student Assistance Commission, which administers MAP grants, receives an additional $20 million for veterans’ scholarships.[107]

With the Governor’s proposed FY2019 appropriations, adjusted for the increase to offset additional pension and group health insurance costs, average annual funding since FY2016 would be at 83.3% of the FY2015 level. While universities receive an average of 77.7% of FY2015 funding during the period, MAP grant amounts slightly exceed the FY2015 level.

Human Services

Proposed funding for human services increases by $35 million, or 0.6%, to $5.78 billion in FY2019 from $5.75 billion FY2018 and by $347 million, or 6.4%, from $5.43 billion in FY2015. The five-year period included a significant reduction in funding to $4.68 billion during the budget standoff in FY2016.

The FY2019 budget proposal for the Department of Human Services (DHS) is $3.75 billion, up slightly from estimated FY2018 spending of $3.73 billion.[108] The main increase is for developmental disability grants, which cover higher wages for caregivers.[109] A federal judge ruled in August 2017 that the State was out of compliance with a consent decree involving community care for the developmentally disabled, owing largely to the lack of in-home aides, whose wages had not been increased by the State for many years.[110]

[107] Illinois State FY2019 Budget, p. 488.
[108] Illinois State FY2019 Budget, p. 296.
[109] Illinois State FY2019 Budget, p. 28.
[110] The opinion is available at https://www.equipforequality.org/wp-content/uploads/2017/08/Ligas-Order-Granting-Motion-to-Enforce.pdf (last accessed on May 8, 2018).

Many program cuts implemented by the Governor's Office in FY2018 to curb the operating deficit are left in place in FY2019, including reductions to addiction prevention, youth employment and after school programs. Mental health grants and addiction treatment services, which had spending reductions in FY2018, face further cuts in FY2019.

DHS' spending on child care services is expected to increase slightly in FY2019 but is significantly below FY2018 appropriations.[111] The administration has cited decreased enrollment in the Child Care Assistance Program, which helps low income families pay for child care so parents can work or go to school. In July 2015 eligibility in the child care program was limited to families with incomes at 50% of the Federal Poverty Level, down from 185%. The threshold was subsequently increased to 162% in November 2015 and returned to 185% in October 2017. In addition, the administration received permission from federal authorities not to implement a requirement that families renew their eligibility every year. Renewals have continued to be required every six months, further decreasing the number of participants by making it more difficult to retain services.[112]

The proposed FY2019 budget for the Department on Aging is $933 million, a decrease of $8 million from estimated spending of $942 million in FY2018 and $108 million from FY2018 enacted appropriations. Officials attributed the decrease from the appropriated amount to shifting seniors in the Community Care Program to Medicaid managed care organizations under the budget of the Department of Healthcare and Family Services (HFS) and to discontinuing a rate increase for home care aides enacted by the legislature in 2017.[113]

Healthcare

Proposed FY2019 appropriations for healthcare of nearly $7.9 billion represent an increase of $762 million, or 10.7%, from FY2018 estimated spending of $7.1 billion and 20.7% from $6.5 billion in FY2015. Most healthcare spending involves the State's Medicaid program, which is primarily administered by HFS.

Trends in General Funds Medicaid spending are difficult to track because of heavy reliance on other State accounts and recent changes in the program, including the expansion of Medicaid coverage under the Affordable Care Act (ACA) and the enrollment of recipients in managed care organizations.

As previously discussed, General Funds spending on Medicaid is understated in FY2015 by $600 million.[114] Instead of using that amount of General Funds in FY2015, the State appropriated $600 million from General Funds in FY2014 and deposited it in another account—the Healthcare Provider Relief Fund—to pay for FY2015 Medicaid costs.Similarly, the administration has requested a supplemental FY2018 General Funds appropriation for HFS of $442 million, which is attributed in the budget book to unpaid prior-year liabilities.[115] However, GOMB acknowledged

[111] Illinois State FY2019 Budget, p. 295.
[112] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 31, 2018.
[113] Testimony by Jean Bohnhoff, Director of the Illinois Department on Aging, to the House Human Services Appropriations Committee, March 8, 2018.
[114] Illinois State FY2017 Budget, pp. 69-70.
[115] Illinois State FY2019 Budget, p. 112.

that it had initially expected the amount to be deposited into the Healthcare Provider Relief Fund in FY2017 but used to pay Medicaid costs in FY2018.[116]

Despite the difficulty in allocating Medicaid costs to a particular year, it is clear that liabilities have grown recently. Including General Funds and related accounts that can be used for general purposes, total costs are projected to rise by $1.9 billion, or 15.4%, to $14.2 billion in FY2019 from $12.3 billion in FY2015.[117] Legislation enacted in September 2015 to address the opioid epidemic contributed to the increase in costs over that period.[118] The ACA expansion accounts for $2.5 billion of the FY2019 liability and $700 million of the liability growth since FY2015.

Most Medicaid spending in Illinois is currently reimbursed by the federal government at 50.74%; for every $1 in appropriations, net State spending is 49.26 cents.[119] From January 2014 through the end of calendar year 2016, the federal government paid the entire bill for recipients who became eligible under the ACA. Federal reimbursement declined to 95% in January 2017 and 94% in January 2018 and is scheduled to be 93% in calendar year 2019. The State's net cost for these enrollees is expected to increase by about $20 million to $162 million in FY2019 from $142 million in FY2018.[120] Of the 3.1 million Medicaid recipients in November 2017, 619,951 or 20.1%, were eligible due to the ACA. ACA-related bills are paid from the Healthcare Provider Relief Fund and not from General Funds.

In an attempt to improve care and reduce costs over time, the State is expanding Medicaid managed care to cover 80% of recipients, up from about 63% in December 2017.[121] Certain additional HFS costs in FY2019 are related to the shifting of recipients in other agencies, including the Department on Aging and DHS, to managed care organizations paid from HFS' budget.

The FY2019 budget proposes $51 million in supplemental appropriations in FY2018 for Medicaid rate increases approved by the General Assembly as part of the FY2018 budget legislation but not funded.[122] The administration seeks to discontinue those rate increases in FY2019 and save $150 million by implementing 4% rate cuts for most healthcare providers in the last six months of the fiscal year.[123] These changes will require legislative approval and federal authorization is also likely to be needed for the rate reductions.

Other Areas

Proposed FY2019 funding for Government Services declines by $440 million, or 33.6%, to $869 million from $1.3 billion in FY2018 and by $328 million, or 27.4%, from $1.2 billion in FY2018. In FY2018 Government Services included the State's $221 million contribution for CPS pension

[116] Communication between the Civic Federation and the Governor's Office of Management and Budget, April 18, 2018.
[117] Illinois Department of Healthcare and Family Services, *Fiscal Year 2019 Budget Overview*, February 14, 2018, p.11.
[118] Public Act 99-0480, enacted on September 11, 2015.
[119] Illinois' general reimbursement rate declines to 50.31% in federal fiscal year 2019, which begins on October 1, 2017.
[120] Illinois Department of Healthcare and Family Services, *Fiscal Year 2019 Budget Overview*, February 14, 2018, p. 10.
[121] Illinois Department of Healthcare and Family Services, "HealthChoice Illinois launches January 1, focusing on whole-person health," *news release*, December 28, 2017.
[122] Illinois State FY2019 Budget, p. 112.
[123] Illinois Department of Healthcare and Family Services, *Fiscal Year 2019 Budget Overview*, February 14, 2018, p.8.

and retiree health costs. As previously discussed, the administration proposes to eliminate the FY2019 payment of $228 million.

Government Services funding also declines in FY2019 because of a proposal to eliminate State health insurance payments for retired teachers and community college employees outside of Chicago. State contributions to the Teachers' Retirement Insurance Program (TRIP) and the College Insurance Program (CIP) were $114 million and $4 million, respectively, in FY2018[124] and are scheduled at $125 million and $4 million in FY2019.[125]

Retirees with at least 20 years of service who are covered by the State group insurance program do not pay any premiums. A law[126] to eliminate premium-free health insurance was struck down by the Illinois Supreme Court in 2014.[127] However, participants in TRIP and CIP are required to pay significant premiums.[128] The State provides about 24% of annual revenues for TRIP and 15% for CIP, both of which are not financially viable in the long run, even with the current State contributions.[129]

Government Services includes legislative and judicial agencies and offices of elected officials. The FY2019 budget proposes spending reductions to each of those areas, including a cut of $59 million, or 17.0%, to the Illinois Supreme Court, to $286 million from $344 million in FY2018.

Proposed funding for Public Safety declines slightly to $1.73 billion in FY2019 from $1.76 billion in FY2018. The administration is also seeking supplemental FY2018 appropriations of $420 million for the Department of Corrections to pay for operational costs not covered in FY2017.[130]

General Funds Expenditures

Expenditures from General Funds consist of appropriated spending, net of unspent appropriations and other adjustments, and statutory transfers out. Proposed FY2019 expenditures increase by $240 million, or 0.6%, to $37.6 billion from $37.4 billion in FY2018 and by $1.9 billion, or 5.3%, from $35.7 billion in FY2015. As previously discussed, FY2015 expenditures are understated by $600 million due to advance funding of Medicaid costs in FY2014.

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[124] Illinois State FY2019 Budget, pp. 457 and 493.
[125] State of Illinois, Governor's Office of Management and Budget, *Fiscal Year 2019 Budget Briefing*, February 14, 2018, p. 9.
[126] Public Act 97-0695, enacted on June 21, 2012.
[127] The Illinois Supreme Court opinion is available at http://www.illinoiscourts.gov/Opinions/SupremeCourt/2014/115811.pdf (last accessed on May 8, 2018).
[128] Doug Finke, "Opponents: Rauner Insurance Changes Will Hurt State Workers, Retired Teachers," *The State Journal Register*, February 17, 2018.
[129] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Teachers' Retirement Insurance Program & the College Insurance Program*, July 2017 Update, p. 1.
[130] Illinois State FY2019 Budget, p. 112.

The next table shows General Funds expenditures from FY2015 through FY2019.

State of Illinois General Funds Expenditures: FY2015-FY2019 (in $ millions)	FY2015	FY2016	FY2017 Prelim.	FY2018 Est.	FY2019 Rec.	Two-Year $ Change	Two-Year % Change	Five-Year $ Change	Five-Year % Change
Agency Appropriations	$ 24,583	$ 22,351	$26,520	$26,133	$26,640	$ 507	1.9%	$ 2,057	8.4%
(Unspent Appropriations)*	$ (1,049)	$ (1,787)	$ (2,460)	$ (1,012)	$ (872)	$ 140	-13.8%	$ 177	-16.9%
Net Agency Appropriations Spent	$ 23,534	$ 20,564	$24,060	$25,121	$25,768	$ 647	2.6%	$ 2,234	9.5%
Pension Contributions	$ 6,047	$ 6,632	$ 6,951	$ 7,002	$ 7,212	$ 210	3.0%	$ 1,165	19.3%
State Group Insurance	$ 1,565	$ -	$ -	$ 1,858	$ 1,450	$ (408)	-22.0%	$ (115)	-7.3%
Net Appropriations Spent	**$ 31,146**	**$ 27,196**	**$31,011**	**$33,981**	**$34,430**	**$ 449**	**1.3%**	**$ 3,284**	**10.5%**
Statutory Transfers Out									
Legislatively Required Transfers	$ 2,489	$ 2,472	$ 2,385	$ 586	$ 396	$ (190)	-32.4%	$ (2,093)	-84.1%
Debt Service on Pension Bonds	$ 1,502	$ 1,423	$ 1,609	$ 1,579	$ 1,246	$ (333)	-21.1%	$ (256)	-17.0%
Debt Service on Capital Bonds	$ 592	$ 556	$ 626	$ 701	$ 758	$ 57	8.1%	$ 166	28.0%
Repayment of Interfund Borrowing	$ -	$ -	$ 15	$ -	$ -	$ -	na	$ -	na
Debt Service on Backlog Borrowing	$ -	$ -	$ -	$ 527	$ 782	$ 255	48.4%	$ 782	na
Total Transfers Out**	**$ 4,583**	**$ 4,451**	**$ 4,635**	**$ 3,392**	**$ 3,183**	**$ (209)**	**-6.2%**	**$ (1,400)**	**-30.5%**
Total Expenditures[5]	**$ 35,729**	**$ 31,647**	**$35,646**	**$37,373**	**$37,613**	**$ 240**	**0.6%**	**$ 1,884**	**5.3%**

*Unspent appropriations include Comptroller prior year adjustments of $12 million in FY2015, $12 million in FY2016 and $5 million in FY2017, as well as appropriated intrafund deposits of $51 million in FY2017.

**Totals may not sum due to rounding.

Source: Illinois State FY2017 Budget, p. 91; Illinois State FY2018 Budget, pp. 30 and 93; Illinois State FY2019 Budget, pp. 62 and 77.

Increases in net appropriations spent in FY2019 are offset by decreases in transfers out, which include legislatively required transfers and debt service transfers. Statutory transfers in FY2019 decline by $209 million, or 6.2%, to $3.2 billion from $3.4 billion in FY2018 and by $1.4 billion, or 30.5%, from $4.6 billion in FY2015.

The decrease in legislatively required transfers to $396 million in FY2019 from $2.5 billion in FY2015 is largely a matter of accounting. Prior to FY2018, income taxes and sales taxes to be distributed to local governments and public transit districts were deposited into General Funds and then transferred to special accounts. Since that time, the revenues have been deposited directly into the Local Government Distributive Fund, Public Transportation Fund and Downstate Public Transportation Fund so local governments can access the money more quickly.

Before the change, the three transfers were by far the largest of about 30 legislatively required transfers, totaling $1.9 billion in FY2017.[131] Because the FY2018 budget was not enacted until five days after the start of the fiscal year, $216 million of scheduled transfers were made from General Funds in FY2018 before the change took effect. That glitch largely explains the decline in legislatively required transfers from $586 million in FY2018 to $396 million in FY2019.

Transfers out to pay debt service decline slightly in FY2019 to $2.79 billion from $2.81 billion in FY2018.[132] A reduction in the debt service transfer associated with pension bonds more than offsets an increase in the debt service transfer related to bonds issued in October 2017 to reduce the backlog of unpaid bills. Over the five-year period, debt service transfers grow by $692 million, or 33.0%, from $2.1 billion in FY2015 due to increased debt service on capital bonds and debt service required on the new backlog bonds.

131 Illinois State FY2019 Budget, p. 113.

132 For more information on debt service transfers, see p. 48 of this report.

PENSIONS

Illinois' retirement systems are among the most poorly funded of any state.[133] At the end of FY2017, unfunded liabilities totaled $129.1 billion and the combined funded ratio stood at 39.8%.[134] If the funded ratio were at 100%, pension assets would be sufficient to cover projected pension benefits when they are owed—based on a wide array of economic and demographic assumptions.

The State's 50-year funding plan, which began in FY1996, requires the five retirement systems to reach 90% funding by FY2045. The five systems are the Teachers' Retirement System (TRS), which covers public school teachers outside Chicago; State Employees' Retirement System (SERS), for most State employees who are not eligible for another State plan; State Universities Retirement System (SURS), for faculty and staff of universities and community colleges; and the Judges' and General Assembly Retirement Systems. To achieve the 90% funding goal, annual State contributions are currently projected to rise to $19.6 billion in the next 27 years from $7.8 billion in FY2018.[135]

Even with those increases, contributions are not expected to be sufficient to keep unfunded liabilities from growing until FY2029.[136] The State's funding plan and subsequent statutory changes deferred a large portion of required contributions to future years, which propped up annual budgets at the expense of the pension funds.

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133 The Pew Charitable Trusts, *The State Pension Funding Gap: 2016*, April 12, 2018.

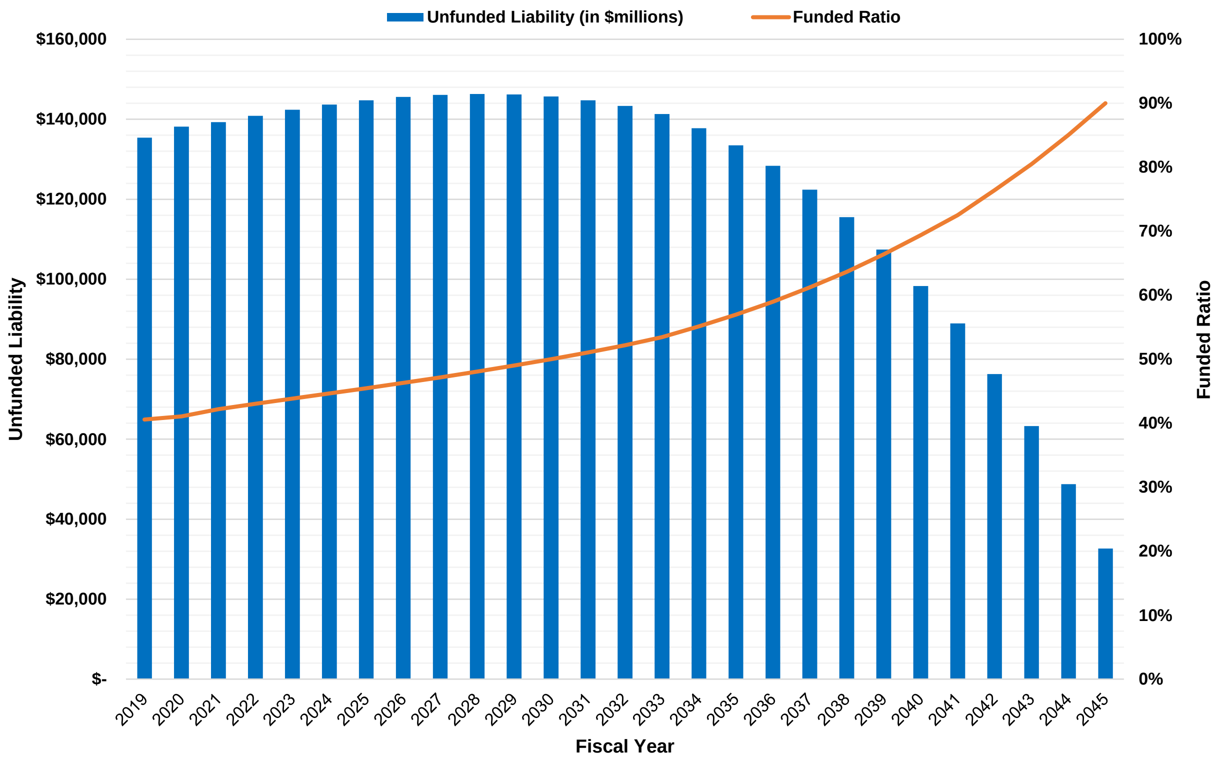
134 Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems Financial Condition as of June 30, 2017*, March 2018, p. 31. These figures are based on the market value of assets. The unfunded liability and funded ratio based on asset smoothing were $128.9 billion and 39.9%.

135 Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems Financial Condition as of June 30, 2017*, March 2018, pp. 36 and 105.

136 Illinois General Assembly, Commission on Government Forecasting and Accountability, *Illinois State Retirement Systems Financial Condition as of June 30, 2017*, March 2018, p. 105.

The following chart provides the most recent estimates of total unfunded liabilities and combined funded ratios for the State's retirement systems from FY2019 through FY2045.

State of Illinois Retirement Systems Projected Financial Condition: FY2019 to FY2045



* For data, see Appendix.
Source: Illinois General Assembly, Commission on Government Forecasting and Accountibility, *Illinois State Retirement Systems Financial Condition as of June 30, 2017*, March 2018, pp. 105.

Pension costs have recently consumed a growing portion of the general operating budget.[137] General Funds pension-related payments—including contributions as well as debt service on pension bonds[138]— climbed to $8.6 billion in FY2018 from $2.1 billion in FY2008. That represents an increase to 23.0% of General Funds expenditures from 6.8%.[139]

To address the budget pressures, the State in 2011 created a second, significantly less generous tier of benefits for new employees.[140] While State workers hired before 2011 receive automatic annual compounded benefit increases of 3% upon retirement, the annual increase for new employees is 3% or one-half of the rise in the Consumer Price Index, whichever is less, on a simple-interest basis. State contributions are expected to decline sharply over time as new employees represent a larger

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137 General Funds account for approximately 89% of total contributions.
138 The State issued pension bonds in 2003 to increase the assets in its pension funds and make required annual contributions and in 2010 and 2011 to make required contributions.
139 These calculations do not reflect the pension payment for Chicago teachers discussed below, which is not shown in the pension line in the State budget. If the Chicago teachers' pensions were included, total pension costs would increase to $8.8 billion and pensions would account for 23.6% of total spending.
140 Public Act 96-0889, enacted on April 14, 2010.

share of the workforce.[141] However, the low Tier 2 benefits, which were not matched by lower employee contributions, may not be sustainable due to legal and equity issues.[142]

Efforts to reduce pension benefits for existing employees and retirees have been blocked by the Illinois Supreme Court. Legislation enacted in 2013 for four of the five State funds included an actuarially sound employer pension contribution schedule and a limitation on the automatic annual benefit increase for both current employees and retirees, among other provisions.[143] The high court ruled in 2015 and 2016 that the State law and subsequent benefit changes enacted for two City of Chicago pension funds[144] violated the pension protection clause in the Illinois Constitution.[145] That clause states that pension benefits are part of a contractual relationship and cannot be diminished or impaired.[146]

State pension contributions stabilized in FY2018 due to statutory changes included in that year's budget legislation.[147] The main change involved smoothing of State pension contributions, which is intended to moderate the budgetary impact of new actuarial assumptions adopted by the retirement systems. Governor Rauner proposed contribution smoothing in each of his first three recommended budgets.[148]

Before the smoothing provisions were enacted, the State's total FY2018 contributions were expected to increase by nearly $1 billion from $7.8 billion in FY2017 to $8.8 billion because of revised actuarial assumptions by TRS and SERS. Smoothing reduced total FY2018 contributions by $909 million to $7.9 billion.[149]

With smoothing, any changes in required State contributions due to revised actuarial assumptions are recognized equally over a five-year period instead of all at once in the year they take effect. The smoothing also applies retroactively to changes in actuarial assumptions that first affected State contributions during FY2014 through FY2017. That means that the State will reduce FY2018 and future contributions by amounts that are now considered overpayments under smoothing.

Revised assumptions such as lower assumed rates of investment return increase accrued liabilities and raise State contribution requirements. Smoothing spreads the contribution increase over a number of years, reducing State costs in the near-term but increasing costs over time due to forgone investment income. TRS, Illinois' largest pension fund, said the State will have to pay three dollars

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[141] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. E-29.
[142] Tara Garcia Mathewson, "Illinois Issues: The Next Pension Time Bomb," *NPR Illinois 91.9 UIS*, March 30, 2016. Many Tier 2 members are paying more than the full cost of their benefits, effectively subsidizing the State by helping to pay down its unfunded liability. Most State employees are not currently covered by Social Security, but Tier 2 benefit caps might eventually be considered too low to meet minimum standards for exemption from Social Security coverage.
[143] Public Act 98-0599, enacted on December 5, 2013.
[144] Public Act 98-0641, enacted on June 9, 2014.
[145] The Illinois Supreme Court opinions are available at http://www.illinoiscourts.gov/OPINIONS/SupremeCourt/2015/118585.pdf and http://www.illinoiscourts.gov/Opinions/SupremeCourt/2016/119618.pdf (last accessed on May 6, 2018).
[146] Ill. Const. art. XIII, sec. 5.
[147] Public Act 100-0023, enacted on July 6, 2017.
[148] Illinois State FY2018 Budget, pp. 177-178; Illinois State FY2017 Budget, p. 188; Illinois State FY2016 Budget, p. 5-3.
[149] State of Illinois, Office of the Auditor General, *State Actuary's Report*, December 2017, pp. 11-12.

in the future for every dollar in current contribution reductions due to smoothing.[150] In a TRS newsletter, smoothing was described as "this latest decision to kick the can down the road."[151]

The FY2018 budget legislation also shifted certain costs for high-paid employees from the State to local employers. Individual school districts, universities and community colleges are now required to pay current service costs for the portion of employees' salaries in excess of the Governor's salary of $177,400.

Another provision of the budget legislation authorized a Tier 3 benefit plan for new employees with both traditional defined benefit and 401(k)-style defined contribution components. Tier 3 pension costs for teachers outside Chicago and university and community college employees would be paid by local employers, rather than the State. The pension funds were not required to implement Tier 3 immediately, and the new benefit plan is not expected to take effect until FY2020.[152] Tier 3 was part of Governor Rauner's proposed FY2018 budget and was projected to save the State about $500 million annually.[153] However, actuarial evaluations of the Tier 3 plan that could support the savings estimate have not been released publicly. Documents filed in connection with Illinois' bond sale in April explain that the State "makes no prediction" about the impact of Tier 3 on State pension contributions.[154]

The Governor's FY2019 budget proposes to reduce State contributions by shifting normal costs for public university and community college employees and school teachers outside Chicago to the local employers over four years.[155] Normal cost is the cost of benefits earned each year. The normal cost shift would reduce State contributions by $363 million in FY2019. However, $101 million of that amount, the portion related to universities and community colleges, would be reimbursed in FY2019 through increased operating funding.

The FY2019 budget proposal would also return responsibility for the normal pension costs of Chicago to the City in FY2019. As part of education funding legislation enacted in August 2017, the State began paying normal pension and retiree health insurance costs for the Chicago Teachers' Pension Fund (CTPF).[156] That payment amounts to $221 million in FY2018[157] and is estimated at $228 million in FY2019.[158]

Another pension-related proposal is described in the Governor's FY2019 budget but not tied to the projected budget balance. The administration recommends enactment of the "consideration model" of pension reform to save $900 million per year.[159] The savings would be approximately offset through a 0.25 percentage point reduction in individual income tax rates to 4.7% from 4.95%. The pension changes would require approval by the legislature and would be expected to face

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[150] Teachers' Retirement System of the State of Illinois, "TRS follows new law and lowers the State's FY2018 contribution by $531 million," *news release*, August 23, 2017.
[151] Teachers' Retirement System of the State of Illinois, "Executive Director's Message: State Lowered TRS Funding by $500 Million," *Topics & Reports*, Winter 2018, p. 1.
[152] Teachers' Retirement System of the State of Illinois, "New Tier 3 Benefit Structure," https://www.trsil.org/news-and-events/New-Tier3-Benefit-Structure (last accessed on May 7, 2018).
[153] Illinois State FY2018 Budget, p. 38.
[154] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. E-32.
[155] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. 30.
[156] Public Act 100-0465, enacted on August 31, 2017.
[157] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. 27.
[158] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. 30.
[159] Illinois State FY2019 Budget, p. 31.

constitutional challenges. The tax cut would only go into effect if the pension changes were implemented.[160]

A version of the consideration model, long supported by Senate President John Cullerton, was passed by the Senate in 2017 but was not taken up by the House.[161] The bill offers employees a choice between existing 3% automatic annual compounded benefit increases or the continuing ability to have salary increases counted in the formula that calculates the base pension benefit. Supporters believe the approach will pass constitutional muster because, in accordance with principles of contract law, it provides employees with "consideration"—something of value—in exchange for accepting revised benefits.[162] Opponents, including labor unions, argue that the proposal violates the Illinois Constitution because both options represent a diminishment of benefits.

[160] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. 31.
[161] 100th Illinois General Assembly, Senate Bill 16, passed by the Senate on May 17, 2017.
[162] Doug Finke, "Illinois Senate to try again on pension reform, *The State Journal-Register*, January 21, 2017.

BUDGET BALANCE AND BACKLOG

The proposed FY2019 budget has an operating surplus of $351 million, which amounts to less than 1% of recommended expenditures of $37.6 billion and would be used to reduce the State's bill backlog. The following table shows operating results and plans from FY2015 through FY2019.

State of Illinois General Funds Budget Results and Plans: FY2015-FY2019
(in $ millions)

	FY2015	FY2016	FY2017 Prelim.	FY2018 Est.	FY2019 Rec.
Operating Revenues					
State Source Revenues[1]	$ 33,404	$ 28,810	$ 28,021	$ 33,365	$ 34,210
Federal Revenues	$ 3,331	$ 2,665	$ 2,483	$ 3,418	$ 3,754
Total Operating Revenues	**$ 36,735**	**$ 31,475**	**$ 30,504**	**$ 36,783**	**$ 37,964**
Operating Expenditures					
Net Agency Appropriations Spent[2]	$ 23,534	$ 20,564	$ 24,060	$ 25,121	$ 25,768
Pension Contributions	$ 6,047	$ 6,632	$ 6,951	$ 7,002	$ 7,212
State Group Insurance	$ 1,565	$ -	$ -	$ 1,858	$ 1,450
Total Appropriations Spent	$ 31,146	$ 27,196	$ 31,011	$ 33,981	$ 34,430
Statutory Transfers Out					
Legislatively Required Transfers	$ 2,489	$ 2,472	$ 2,385	$ 586	$ 396
Debt Service[3]	$ 2,094	$ 1,979	$ 2,250	$ 2,807	$ 2,786
Total Statutory Transfers Out[4]	$ 4,583	$ 4,451	$ 4,635	$ 3,392	$ 3,183
Total Operating Expenditures	**$ 35,729**	**$ 31,647**	**$ 35,646**	**$ 37,373**	**$ 37,613**
Operating Surplus (Deficit)	**$ 1,006**	**$ (172)**	**$ (5,142)**	**$ (590)**	**$ 351**

[1]Includes fund transfers of $1.234 billion and net interfund borrowing of $377 million in FY2015; fund transfers of $275 million and interfund borrowing of $600 million in FY2018; and interfund borrowing of $600 million in FY2019. The interfund borrowing was forgiven in FY2015 and is proposed to be forgiven in FY2018 and FY2019.

[2]Agency appropriations minus unspent appropriations and other adjustments.

[3]Includes repayment of $15 million in interfund borrowing in FY2017.

[4]Totals may not sum due to rounding.

Source: Illinois State FY2017 Budget, p. 91; Illinois State FY2018 Budget, pp. 30 and 93; Illinois State FY2019 Budget, pp. 62 and 77..

Despite the rollback of income tax rates midway through FY2015, the State reported a $1 billion surplus that year due to fund transfers and advance funding of Medicaid. In FY2016 the impact of the tax rate rollback was partially offset by a drop in spending due to the budget impasse, but the bill backlog grew as expenses continued to accrue in the absence of a complete budget. The deficit reached $5.1 billion in FY2017, fueled by lower than expected revenues and increased spending, based partly on supplemental appropriations in the enacted FY2018 budget.

Budget results in FY2018 and FY2019 remain uncertain. The estimated FY2018 deficit of $590 million does not reflect the administration's request for $1.1 billion in supplemental appropriations to pay for Medicaid costs and cover the backlogged operational expenses of several agencies. These costs are included in the backlog numbers, according to administration officials.[163]

The projected surplus in FY2019 depends on a number of assumptions that could prove difficult to achieve:

- Sale of the James. R. Thompson Center: As in the administration's previous two budgets, revenue projections in FY2019 include the sale of the State's main office building in

[163] Communication between the Civic Federation and the Governor's Office of Management and Budget, May 3, 2018.

Chicago. The FY2019 budget includes revenues of $300 million from the sale ($240 net of associated expenses). Both the timing of the sale and the price are difficult to predict.

- Savings on group health insurance: The FY2019 budget relies on changes in the State's employee health insurance program that have been rejected by the American Federation of State, County and Municipal Employees (AFSCME) and are now the subject of litigation. If these changes, estimated to save $470 million, cannot be achieved through collective bargaining, the administration plans to seek legislation to remove health insurance from labor agreements.
- Pension and health insurance cost shift: Normal pension costs would be shifted to school districts outside Chicago, public universities and community colleges over four years; normal pension and retiree health insurance costs, paid by the State in FY2018, would be shifted back to the Chicago Public Schools in FY2019; additional health insurance costs would be shifted to universities; and the State would end its contributions for retiree health insurance for teachers and community college employees outside Chicago. Total savings from the cost shift are estimated at $825 million, but are offset by $206 million in additional operational funding for universities and community colleges. The cost shift would require legislative approval.
- Step increases: After the Illinois Supreme Court refused to hear its appeal of a lower court decision, the State is obligated to pay more than $300 million in step increases owed to AFSCME members under their last contract, which expired at the end of FY2015.[164] It remains to be seen whether these wage increases will be paid in FY2019 or delayed to the future.

Together, these assumptions reduce the FY2019 deficit by $1.8 billion. It is unclear whether the administration has developed contingency plans to address potential problems in meeting its revenue and expenditure goals.

Illinois has dealt with its budgetary shortfalls by delaying payments to vendors, school districts, local governments and universities, resulting in billions of dollars in unpaid bills at the end of the fiscal year. Because of the backlog, the State begins each fiscal year in a hole, using revenues from the current year to pay off its previous year's bills and limiting revenues available for current spending.

The State has six months after the end of a given fiscal year to pay bills based on that year's appropriations.[165] Certain other bills, known as Section 25 liabilities and consisting mainly of group health insurance and Medicaid bills, may be paid from appropriations in future years.[166] During the budget impasse in FY2016 and FY2017, State agencies also entered into contracts for historically purchased goods and services without any appropriation authority but with vendors expecting future payments.[167]

The backlog of unpaid bills peaked at $16.7 billion on November 8, 2017, according to the Illinois Comptroller's Office, which measures the backlog at a point in time instead of on a budgetary

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[164] [164] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 13, 2018, p. 32.
Step increases are automatic annual increases for newer workers as they add years of service.
[165] 30 ILCS 105/25 (m).
[166] 30 ILCS 105/25.
[167] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 12, 2018, p. 23.

basis.[168] Many of the bills involved group health insurance, which had received no general operating funds since the end of FY2015. In November 2017, the State cleared out a significant portion of the bills using the proceeds of a $6 billion sale of General Obligation bonds that was authorized by the General Assembly as part of the FY2018 budget.[169]

The bond sale immediately reduced the backlog by about $8.7 billion and was mainly used to pay down group health insurance and Medicaid bills.[170] In addition to the authorized par amount of $6 billion, the State received a premium of roughly $500 million on the bond price and $2.2 billion in federal Medicaid reimbursements.[171]

The bond sale was financially prudent because the State's coupon rate of 3.5% on the bonds was far below the steep interest penalties it pays on many overdue bills.[172] Under the State Prompt Payment Act, interest accrues at 1% a month, or 12% annually, on proper bills that are not paid within 90 days.[173] Other claims, including those from healthcare providers, accrue interest at 9% a year after 30 days under the timely payment provisions of the Illinois Insurance Code.[174] According to the Comptroller's Office, the State has accrued $1.1 billion in interest penalties since the start of the budget impasse.[175]

The following chart, based on data from the Comptroller's Office, shows the State's bill backlog from January 2011 through May 3, 2018. As of early May, apparently due to the seasonal influx of

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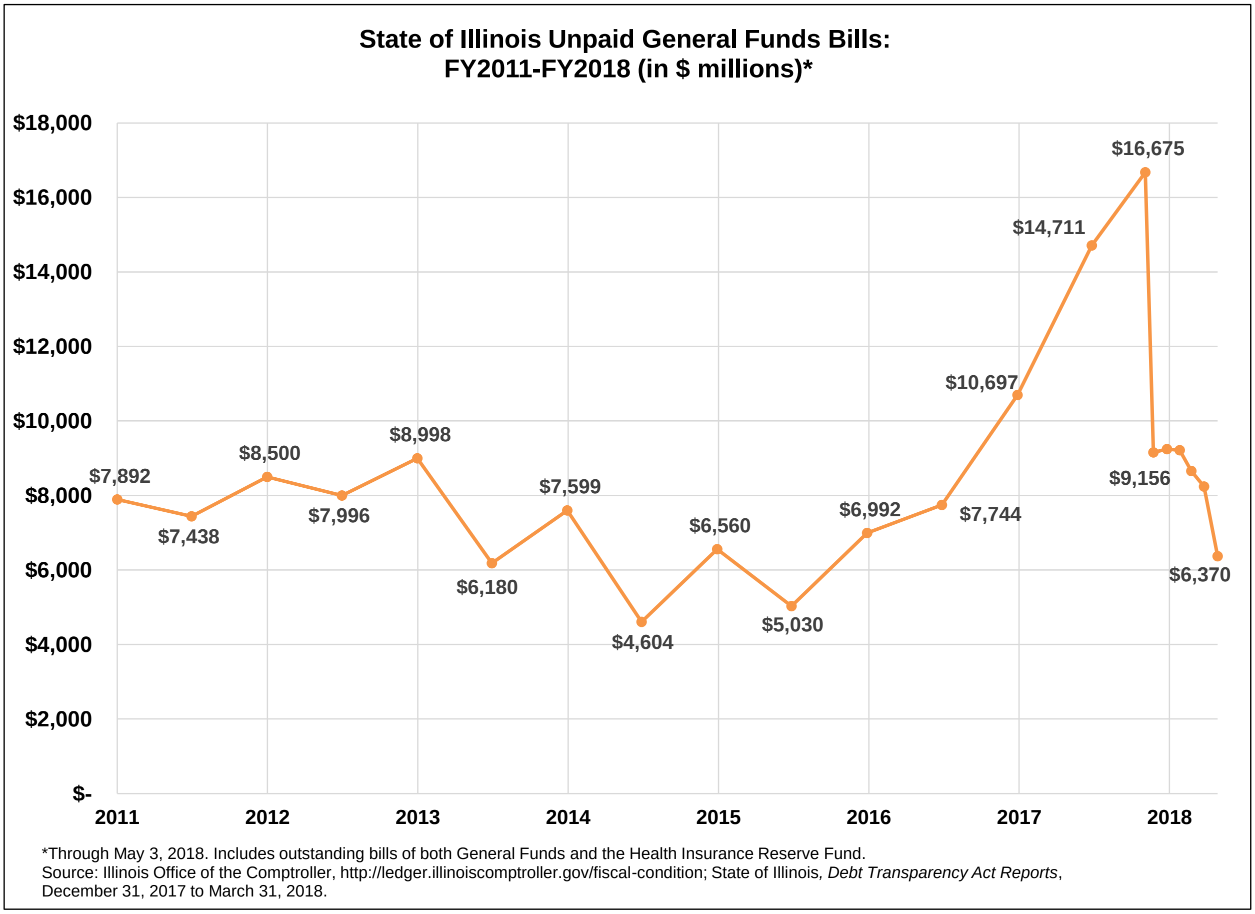
[168] State of Illinois Comptroller, http://illinoiscomptroller.gov/ (last accessed on May 3, 2018).
[169] Public Act 100-0023, enacted on July 6, 2017.
[170] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 12, 2018, p. 30.
[171] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 12, 2018, pp. 27 and 30.
[172] Certain payables, such as transfers to local governments and other State funds, are not eligible for penalty interest.
[173] 30 ILCS 540. Proper bills are defined as those that include the information needed to process the payment.
[174] 215 ILCS 5/368(a).
[175] State of Illinois Comptroller, *Special Report on Late Payment Interest Penalties*, April 24, 2018, p. 3.

tax revenue, the estimated backlog had dipped to $6.4 billion. The Governor's Office projects that the backlog will stand at $7.7 billion at the end of the fiscal year.[176]



[176] State of Illinois, General Obligation Bonds, Series of May 2018, *Preliminary Official Statement*, April 12, 2018, p. 29.

DEBT BURDEN AND RATINGS

The State of Illinois currently pays debt service on four major types of bonds: General Obligation (GO) bonds for capital projects, GO bonds for pension obligations, GO bonds to pay backlogged bills and Build Illinois bonds.

All three types of GO bonds are guaranteed by a pledge of the full faith and credit of the State, which is a legally binding pledge to pay both principal and interest on these loans as required by the bond agreements prior to any other use of State funds. The State is authorized under the General Obligation Bond Act to issue bonds to fund a variety of capital investments including roads, schools, mass transit, environmental projects and other facilities.[177]

In 2003 the State amended the Act to include the authorization to issue Pension Obligation bonds (POBs), used to increase the assets in its pension funds and make the required annual contributions to the State's five retirement systems. The State issued additional POBs in FY2010 and FY2011.

As part of its FY2018 budget, the General Assembly approved borrowing up to $6 billion to pay off bills that had rapidly accumulated during the State's two-year budget impasse.[178] The Governor's Office of Management and Budget issued all $6 billion in November 2017.[179] The bonds will be repaid over twelve years and cost the State $1.9 billion in interest.

Illinois also depends on several types of revenue bonds to fund capital projects. Unlike GO bonds, revenue bonds are not guaranteed by the full faith and credit of the State but rather pledge a portion of specific State revenues. By far the largest ongoing revenue bond issuances are the Build Illinois bonds, which began in 1985. Build Illinois bonds are backed by a pledge of the State's portion of sales tax receipts.[180] The total bond authorization under the Build Illinois Bonds Act has been increased by the General Assembly on several occasions since the late 1980s.[181] The State most recently issued $210 million of capital bonds and $339 million of refunding bonds under the Build Illinois credit in September 2016.[182]

Debt Service

In FY2019 the State of Illinois is scheduled to pay debt service totaling $3.8 billion due on $34.4 billion of principal owed for all outstanding GO and revenue bonds.[183] The State currently owes $15.8 billion in interest on these bonds through FY2043 for a total outstanding debt service cost of $50.2 billion.

The largest portion of the $4.4 billion FY2019 debt service payment is due on capital purpose GO bonds totaling $1.7 billion. Debt service in FY2019 totals $1.6 billion for POBs, $787 million for backlog bonds and $300 million for Build Illinois bonds.

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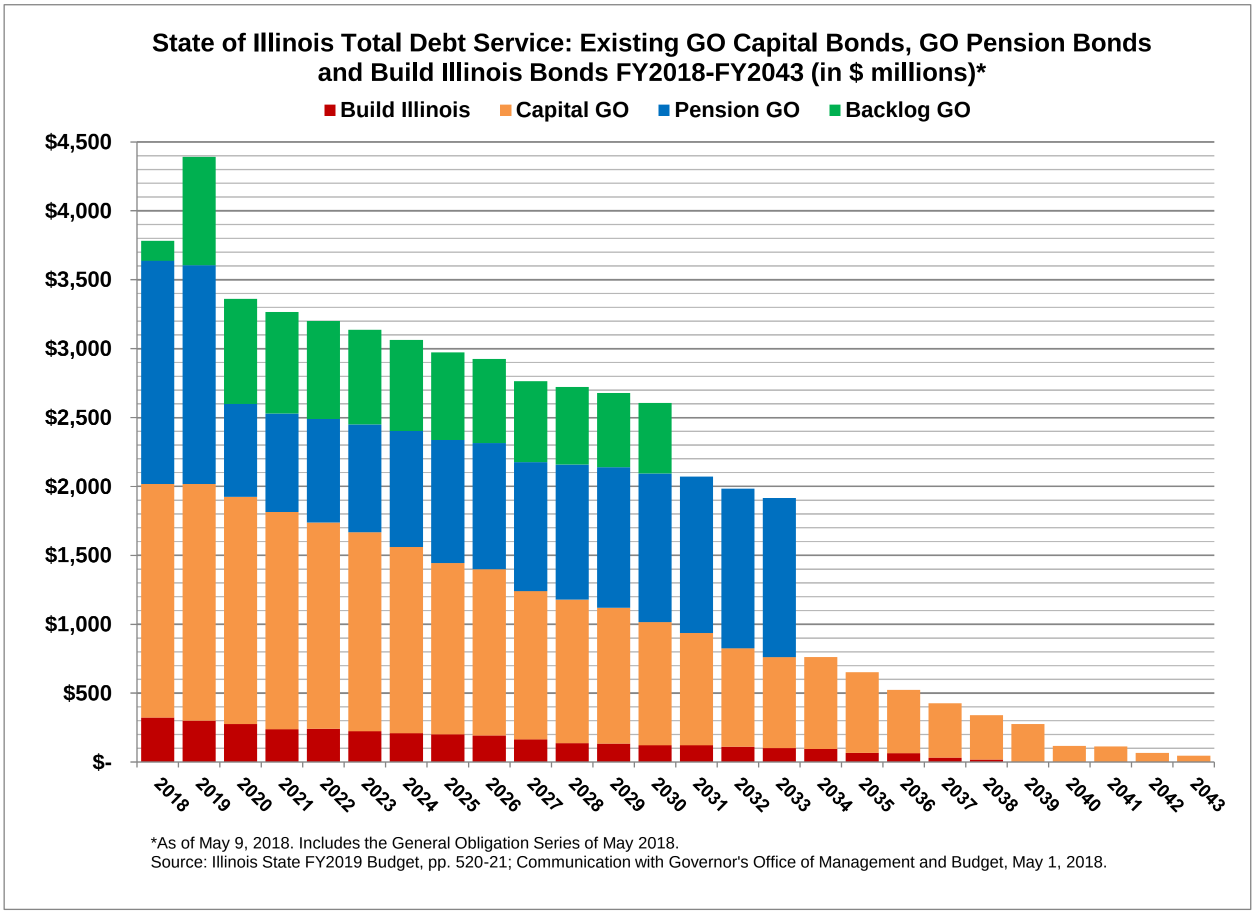
[177] General Obligation Bond Act, 30 ILCS 330/1.
[178] Public Act 100-0023, enacted on July 6, 2017.
[179] State of Illinois, General Obligation Bonds, Series of November 2017D, *Official Statement*, October 25, 2017, pp. i, ii.
[180] Build Illinois Bond Act, 30 ILCS 425.
[181] Build Illinois Bond Act, 30 ILCS 425.
[182] State of Illinois, Build Illinois bonds, Junior Obligation Series of September 2016, *Official Statement*, August 25, 2016.
[183] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, pp. 34, 40.

Based on the State's current bonded indebtedness, debt service payments will peak in FY2019 at $4.4 billion and will decline by over $1.0 billion the next year, once the State has paid off the FY2011 POBs.

The following chart shows total debt service for existing Pension Obligation bonds, GO capital bonds and other capital bonds through FY2043.



In general, the State is required under the General Obligation Bonds Act and the Build Illinois Bonds Act to issue bonds with level principal payments for the life of each bond series.[184] Moreover, refunding bonds are generally prohibited from extending the principal maturities of the bonds they refund.[185] Because interest accrues on only the outstanding portion of each bond series, these rules result in a downward sloping debt service schedule for both types of capital bonds and the backlog bonds.

The State made exceptions to the level principal rule for the Pension Obligation bonds. Under the 2003 pension bond authorization, the State issued $10 billion in POBs that are repaid through FY2033, of which $7.2 billion was used to increase the assets of the State's retirement systems. The remainder was used to make the part of the State's statutorily required contributions that would have otherwise been made from General Funds resources in FY2003 and the entire FY2004 contribution. The pension bond authorization was increased in FY2010 by $3.5 billion and again in

[184] General Obligation Bond Act, 30 ILCS 330/9; Build Illinois Bond Act, 30 ILCS 425/6.
[185] General Obligation Bond Act, 30 ILCS 330/16.

FY2011 by $3.7 billion to make the annual contributions that otherwise would have come from the State's General Funds. The FY2010 POBs were repaid through FY2015 and the FY2011 POBs will be completely retired in FY2019.

The FY2011 POBs backloaded the principal repayment into the later years of the bonds and paid mostly interest only until the FY2010 bonds were completely paid off in FY2015. The FY2003 POBs are also backloaded. The State paid interest only on that series through FY2007, then annual principal amounts increased to $50 million per year from FY2008 through FY2011 and to $100 million per year from FY2012 through FY2016. In FY2017, principal repayment began increasing annually by increments of $25 million, $50 million or $100 million through FY2033, when $1.1 billion is due in the final year of the series. More than 75% of the principal borrowed will be repaid in the final 10 years of the debt service schedule, leading to interest costs of $11.9 billion over 30 years due on the original $10 billion of borrowed funds.

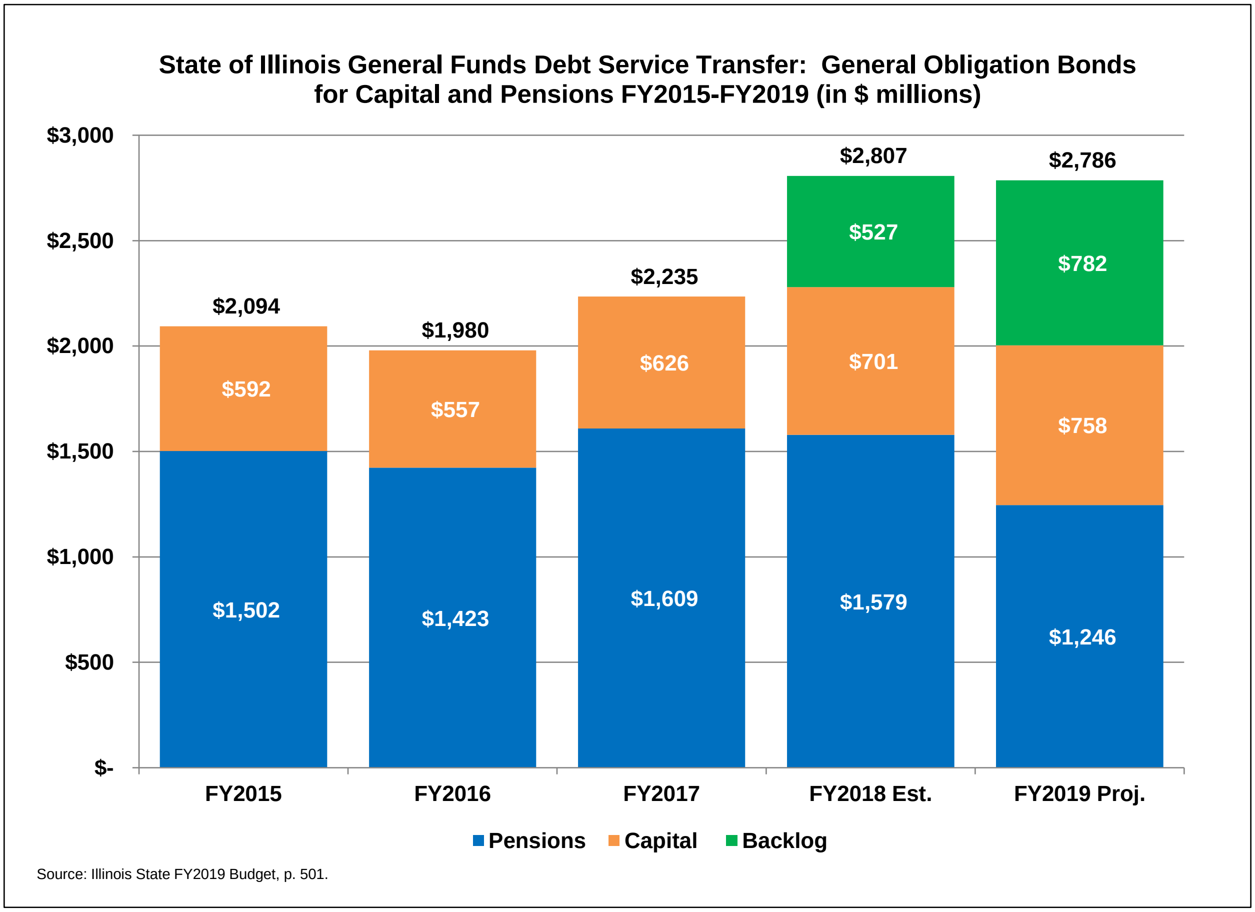
Interest on the $3.5 billion of POBs sold in FY2010 totaled $382 million over five years. The FY2011 bonds, which totaled $3.7 billion, cost the State a total of $1.3 billion of interest over eight years.[186] The FY2011 pension debt included $234 million more principal than the FY2010 POBs, or 6.8%, but the interest owed on the bonds was $897.5 million greater, or 234.8%. The significant increase in the borrowing costs is due to the backloaded structure of the FY2011 bonds.

Debt Service Transfers

Although the total debt service represents the entire annual payment due to bond holders during the fiscal year, only a portion of the repayment is made through a transfer from the General Funds. Build Illinois bonds are paid through sales taxes diverted outside the General Funds and through the Capital Projects Fund. The General Funds debt service transfer for FY2019 totals $2.8 billion, or 8.3% of projected state-source General Funds resources and a decrease of $21 million from FY2018.[187] GO capital bonds are funded through transfers from the Road Fund, Capital Projects Fund, School Infrastructure and State Construction Fund, in addition to the General Funds.

[186] Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2015*, August, 1 2014, p 194.
[187] Illinois State FY2019 Budget, p. 31.

The following chart shows the General Funds cost of debt service paid on the State's General Obligation bonds, both capital and pension related, for FY2015 through FY2019.



The debt service transfer associated with capital GO bonds in FY2019 increases by $57 million, totaling $758 million compared to $701 million in FY2018. Over the last five years the General Funds debt service cost for capital bonds has increased $166 million from a total of $592 million in FY2015. The operating budget incurs higher costs for capital purpose debt service due to the shortfall in revenues in the Capital Projects Fund.[188] Despite an enacted package of revenues to fund the new borrowing associated with the *Illinois Jobs Now!* capital program, the State has incurred additional General Funds cost. However, improvement in the condition of the Capital Projects Fund and slower than expected issuance of new debt have lowered the expected FY2018 operating fund contribution to $701 million from projections in last year's Budget, when it was projected at $773 million.[189] The FY2018 Budget relieved some pressure on the Capital Projects Fund by requiring $1.1 billion for Series D bonds to come from the Road Fund instead.[190]

The structure of the debt service on the State's POBs was designed to remain relatively flat as the FY2010 and FY2011 bonds were repaid. The transfer for POB debt service totaled $1.5 billion in

[188] For more information on the Capital Projects Fund see page 65 of this report.
[189] Illinois State FY2018 Budget, p. 525.
[190] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Capital Plan Analysis FY2019*, April 2018, p. 35.

FY2015 and remained relatively flat through FY2018. The transfer will step down to $1.2 billion in FY2019 in anticipation of the final maturity of the 2011 series.[191]

Funding to pay for the Build Illinois bonds debt service is diverted from the State's portion of sales tax receipts prior to being deposited into the General Funds. Although these bonds are not paid for through a General Funds transfer, the cost of the Build Illinois bonds reduces the amount of sales tax revenues that would otherwise be available to fund the annual operating budget.

Outstanding Debt

During FY2018 the State issued $6.0 billion of bonds to pay down backlogged bills, and thus far has issued $1.25 billion of bonds for capital projects.[192] This is $250 million lower than the $1.5 billion estimated in the FY2019 Budget.[193] The following chart shows the total principal, interest and debt service at the beginning of FY2019 compared to FY2018 for all GO bonds and Build Illinois bonds currently outstanding.

State of Illinois Total Outstanding General Obligation and Build Illinois Bonds FY2018 and FY2019 (in $ millions)*				
	FY2018	**FY2019**	**$ Change**	**% Change**
Principal				
GO Capital	$13,710.7	$14,021.5	$ 310.8	2.27%
GO Pension	$10,975.0	$ 9,925.0	$ (1,050.0)	-9.57%
GO Backlog	$ -	$ 6,000.0	$ 6,000.0	
Build Illinois	$ 2,489.1	$ 2,272.1	$ (217.0)	-8.72%
Total Principal	**$27,174.8**	**$32,218.6**	**$ 5,043.8**	**18.56%**
Interest				
GO Capital	$ 6,892.4	$ 6,907.8	$ 15.4	0.22%
GO Pension	$ 5,261.9	$ 4,693.3	$ (568.6)	-10.81%
GO Backlog	$ -	$ 1,791.8	$ 1,791.8	
Build Illinois	$ 878.3	$ 772.5	$ (105.8)	-12.04%
Total Interest	**$13,032.7**	**$14,165.4**	**$ 1,132.7**	**8.69%**
Debt Service				
GO Capital	**$20,603.1**	**$20,929.3**	**$ 326.2**	**1.58%**
GO Pension	**$16,236.9**	**$14,618.3**	**$ (1,618.6)**	**-9.97%**
GO Backlog	**$ -**	**$ 7,791.8**	**$ 7,791.8**	
Build Illinois	**$ 3,367.4**	**$ 3,044.6**	**$ (322.8)**	**-9.59%**
Total	**$40,207.4**	**$46,384.0**	**$ 6,176.6**	**15.36%**

* As of the beginning of the fiscal year.
Source: State of Illinois, General Obligation Bonds, Series of May 2018, Official Statement, April 25, 2018, pp. 34, 40; Illinois State FY2018 Budget, pp. 543, 544

Total outstanding capital purpose GO bonds increased by $311 million from $13.7 billion at the beginning of FY2018 to $14.0 billion at the beginning of FY2019. The combined total debt service owed on all outstanding capital GO bonds totals $20.9 billion at the beginning of FY2019 compared to $20.6 billion in FY2018. The interest owed these bonds increased by $15 million to $6.9 billion in FY2019.

[191] Illinois State FY2019 Budget, p. 501.
[192] Illinois State FY2019 Budget, p. 518, State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018.
[193] Illinois State FY2019 Budget, p. 502.

All $6.0 billion of backlog GO bonds will be outstanding at the beginning of FY2019, along with $1.8 billion of the original $1.9 billion in interest. The issuance of the backlog bonds caused total GO debt as a percentage of State personal income to rise from 4.07% in FY2017 to 4.73% in FY2018, which will drop to 4.31% in FY2019.[194] Similarly, total GO debt per capita rose from $1,862 to FY2017 to $2,539 in FY2018, and will drop to $2,423 in FY2019.

Total principal owed on all outstanding POBs in FY2019 totals $9.9 billion, a decrease of $1.1 billion from the total of $11.0 billion in FY2018.[195] The outstanding interest owed on the pension debt declined by $568 million to $4.7 billion during FY2018 from $5.3 billion at the beginning of that fiscal year. The remaining debt service, including principal and interest, on the State's pension bonds totals $14.6 billion in FY2019 compared to $16.2 billion in FY2018. The State has not issued new POBs since FY2011.

Beginning in FY2010, the new Build Illinois bonds sold to support the *IllinoisJobsNow!* capital spending program also receive a transfer from the Capital Projects Fund to pay for the increase in debt service. Although the new Build Illinois bonds are structured to receive additional funding from the revenue package of taxes and fees approved in 2009 to fund the increased capital appropriations, the bonds are still backed by the State's sales tax revenues.[196] The State is required to transfer the larger of 3.8% of its share of the sales taxes collected each year or the certified annual debt service owed on all outstanding Build Illinois bonds.[197]

In FY2019 the outstanding Build Illinois bonds principal totals $2.3 billion compared to $2.5 billion in FY2018. The interest owed on the loans through FY2038 totals $773 million as of FY2018, which is a decrease of $106 million from FY2018. Total outstanding debt service on Build Illinois bonds decreased by $323 million to $3.0 billion during FY2018.

The following chart compares the outstanding principal, interest and total debt service on all Build Illinois bonds, GO capital bonds, GO backlog bonds and POBs from FY2015 to FY2019.

[194] Illinois State FY2019 Budget p. 516.
[195] Illinois State FY2019 Budget, p. 520.
[196] For more information on the State capital budget, see page 58 of this report.
[197] 30 ILCS 425, Sec. 13; 35 ILCS 120, Sec. 3.

State of Illinois Total Outstanding Debt Service: General Obligation and Build Illinois Bonds Five-Year Comparison FY2015 to FY2019 (in $ millions)*							
	FY2015	**FY2016**	**FY2017**	**FY2018**	**FY2019****	**5-year $ Change**	**5-year % Change**
Principal							
GO Capital	$14,337.3	$ 14,144.9	$15,244.8	$13,710.7	$14,021.5	$ (315.8)	-2.2%
GO Pension	$13,975.2	$ 12,700.0	$12,000.0	$10,975.0	$ 9,925.0	$ (4,050.2)	-29.0%
GO Backlog	$ -	$ -	$ -	$ -	$ 6,000.0	$ 6,000.0	
Build Illinois	$ 2,982.3	$ 2,748.9	$ 2,514.6	$ 2,489.1	$ 2,272.1	$ (710.2)	-23.8%
Total Principal	**$31,294.8**	**$ 29,593.8**	**$29,759.4**	**$27,174.8**	**$32,218.6**	**$ 923.8**	**3.0%**
Interest							
GO Capital	$ 7,923.8	$ 7,599.7	$ 7,411.2	$ 6,892.4	$ 6,907.8	$ (1,016.0)	-12.8%
GO Pension	$ 7,245.4	$ 6,540.7	$ 5,884.3	$ 5,261.9	$ 4,693.3	$ (2,552.1)	-35.2%
GO Backlog	$ -	$ -	$ -	$ -	$ 1,791.8	$ 1,791.8	
Build Illinois	$ 1,220.9	$ 1,084.3	$ 965.1	$ 878.3	$ 772.5	$ (448.4)	-36.7%
Total Interest	**$16,390.0**	**$ 15,224.7**	**$14,260.6**	**$13,032.7**	**$14,165.4**	**$ (2,224.6)**	**-13.6%**
Debt Service							
GO Capital	**$22,261.1**	**$ 21,744.6**	**$22,656.0**	**$20,603.1**	**$20,929.3**	**$ (1,331.8)**	**-6.0%**
GO Pension	**$21,220.6**	**$ 19,240.7**	**$17,884.3**	**$16,236.9**	**$14,618.3**	**$ (6,602.3)**	**-31.1%**
GO Backlog	**$ -**	**$ -**	**$ -**	**$ -**	**$ 7,791.8**	**$ 7,791.8**	
Build Illinois	**$ 4,203.2**	**$ 3,833.2**	**$ 3,479.7**	**$ 3,367.4**	**$ 3,044.6**	**$ (1,158.6)**	**-27.6%**
Total	**$47,684.9**	**$ 44,818.5**	**$44,020.0**	**$40,207.4**	**$46,384.0**	**$ (1,300.9)**	**-2.7%**

* As of the beginning of the fiscal year.

** For all debt outstanding as of May 9, 2018.

Source: State of Illinois, General Obligation Bonds, Series of May 2018, Official Statement, April 25, 2018, pp. 34, 40; Illinois State FY2018 Budget, pp. 543, 544; State of Illinois, General Obligation Bonds, Series of June 2016, Official Statement, June 23, 2016, p. 28; Illinois State FY2017 Budget, pp. 527, 528; Illinois State FY2016 Budget, pp. 7-10, 7-11; State of Illinois, General Obligation Bonds, Series May 2014, *Official Statement* , April 25, 2014, p.53; State of Illinois, Build Illinois Bonds, Series of March 2014, *Official Statement* , March 11, 2014, p. 20;

Excluding the backlog bonds, the State of Illinois has paid off more principal debt than it has issued over the last five fiscal years. Net of this reduction, the State increased the total outstanding principal by $924 million. Total interest owed on the State's outstanding debt has declined by $2.2 billion over the last five years, primarily due to the decreased interest payments on the State's outstanding POBs and low prevailing interest rates on new issuances. Interest owed through FY2033 on POBs is $2.6 billion less in FY2019 than it was in FY2015.

Outstanding interest on capital purpose GO bonds has decreased by $1.0 billion over five years due to and low prevailing interest rates throughout the period.[198] New issuances generally carried lower rates than maturing bonds, and the State was able to issue refunding transactions for interest savings.[199] The State owes $6.9 billion in interest on capital GO bonds for debt repaid through FY2043 compared to $7.9 billion in FY2015.

The interest owed on all outstanding Build Illinois Bond debt through FY2038 declined by $448 million over five years, from $1.2 billion in FY2015 to $773 million in FY2019.

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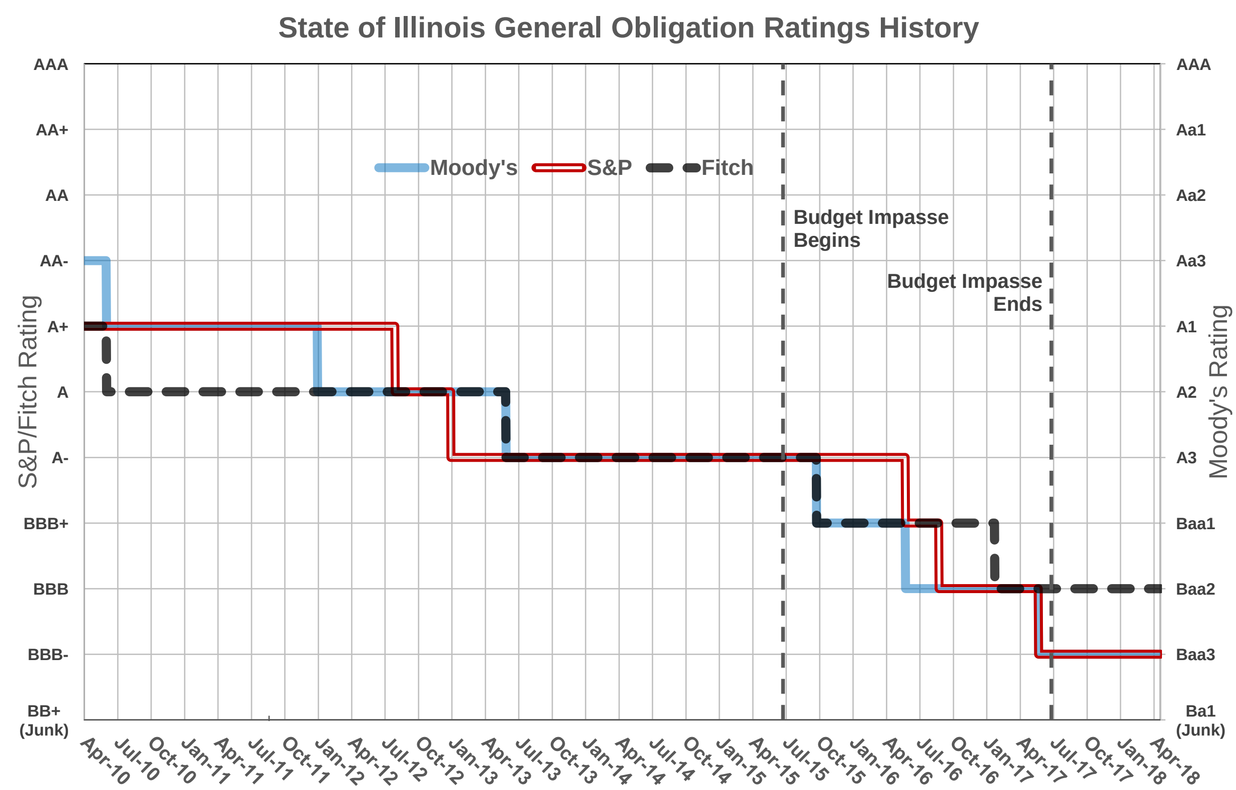
198 Bloomberg Markets, BVAL Muni Benchmark 30Y, https://www.bloomberg.com/quote/BVMB30Y:IND (last accessed on May 2, 2018).

199 State of Illinois, General Obligation Bonds, Series of October 2016, *Official Statement*.

Bond Ratings

Bond ratings are one of the factors that weigh heavily in determining the interest rates the State must pay to issue debt. The State of Illinois' GO ratings have been lowered by all three rating agencies multiple times over the last several years, which has led to an overall increase in debt service costs above better rated governments. The following chart shows the history of GO Bond ratings since 2010.



Source: Illinois General Assembly, Commission on Government Forecasting and Accountablity,*State of Illinois Budget Summary Fiscal Year 2018*, Updated September 5, 2017, p. 208.

Illinois currently has the lowest GO rating of any state by all three ratings agencies. At the time of this report, both Standard and Poor's and Moody's place the State's general obligation credit at the lowest investment grade, one notch above junk. Fitch rates the bonds one notch higher. Both Moody's and Fitch maintain a negative outlook, indicating their view that there will be further downgrades. Standard & Poor's changed its outlook to stable following the adoption of the FY2018 budget.[200] The following chart shows the current ratings for Illinois' General Obligation Bonds and Build Illinois bonds.

State of Illinois: Current Ratings				
	GO Bonds		Build Illinois Bonds	
Company	Rating	Outlook	Rating	Outlook
Fitch Ratings	BBB	Negative	AA+	Stable
Moody's Investors Service	Baa3	Negative	Baa3	Negative
Standard & Poor's	BBB-	Stable	AA-	Stable

Source: Illinois State FY2019 Budget, p. 514.

All three companies affirmed their current ratings when the State went to market with the May 2018 capital GO series.[201] However, the State was warned of further downgrades if it fails to enact a balanced budget for FY2019 and address the bill backlog and unfunded pension liabilities. S&P noted that, "Illinois' deficit operations—if they go unresolved—represent the leading identifiable source of downward pressure on its credit rating," and cited the "confluence of its daunting long-term liability profile and persistent crisis-like budget environment in recent years."[202]

While the State's credit ratings have not recovered from the two-year budget impasse, its access to markets has improved somewhat. When it sold the backlog bonds and capital projects bonds in late 2017, the spreads to a municipal market index had lowered substantially.[203] This means that the State paid lower interest rates relative to prevailing rates than it did the year before. However, the May 2018 issuance saw spreads inch upward once again, reflecting concerns by the market that the State could once again fail to enact a budget.[204] The following chart compares the spreads on the three issuances, along with the expected spread for a generic BBB-rated credit on the date that the May 2018 series was priced. All three issuances priced at significantly higher spreads than a generic credit would expect.

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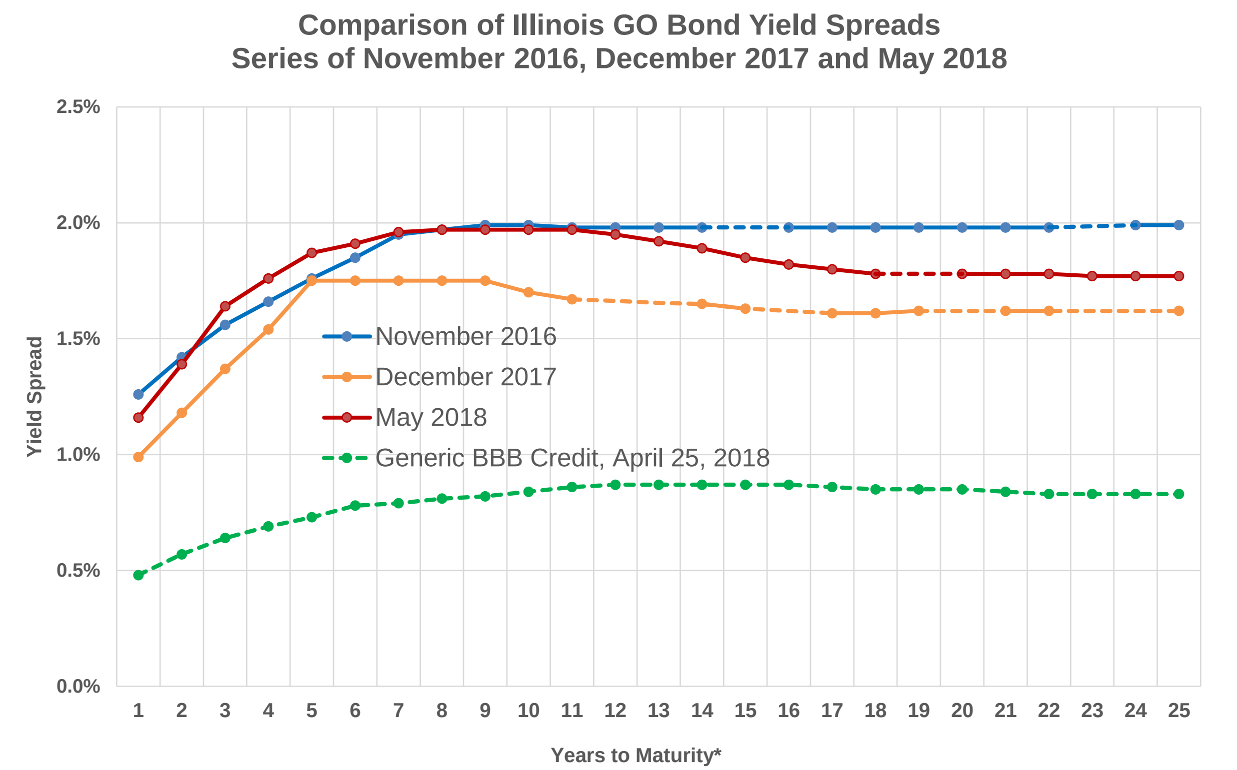
[200] Karen Pierog, "Illinois avoids downgrade to junk as S&P affirms BBB-minus rating," *Reuters*, July 12, 2017, https://www.reuters.com/article/us-illinois-ratings/illinois-avoids-downgrade-to-junk-as-sp-affirms-bbb-minus-rating-idUSKBN19X2PW (last accessed on April 30, 2018).

[201] Fitch Ratings, "Fitch Rates Illinois' $500MM GOs 'BBB'; Outlook Remains Negative," *press release*, April 9, 2018; Moody's Investors Service, "Rating Action: Moody's assigns Baa3 to Illinois' $500M Series of May 2018 GO Bonds; outlook negative," *press release*, April 6, 2018; S&P Global Ratings, "Illinois' $500 Million Series Of May 2018A And 2018B GO Bonds Assigned 'BBB-' Rating," *press release*, April 6, 2018.

[202] S&P Global Ratings, "Illinois' $500 Million Series Of May 2018A And 2018B GO Bonds Assigned 'BBB-' Rating," *press release*, April 6, 2018.

[203] Institute for Illinois' Fiscal Sustainability at the Civic Federation blog, https://www.civicfed.org/iifs/blog/illinois-completes-6-billion-backlog-borrowing (last accessed on May 2, 2018).

[204] Laila Kearney and Karen Pierog, "Illinois GO, hovering above 'junk' credit, among prominent deals next week," *Reuters*, April 20, 2018, https://www.reuters.com/article/us-usa-municipals-deals/illinois-go-hovering-above-junk-credit-among-prominent-deals-next-week-idUSKBN1HR2TZ (last accessed on May 2, 2018).



*Maturities with coupons other than 5.00% are omitted.
Source: Thompson Reuters Muncipal Market Data interpolated AAA benchmark rates as of November 8, 2016, November 29, 2017 and April 25, 2018; State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018; State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement*, November 8, 2016; State of Illinois, General Obligation Bonds, Series of December 2017, *Official Statement*, November 29, 2017.

Variable Rate Debt and Swaps

Due to its recent downgrades, the State is closer to a possible exposure to liabilities associated with its swaps portfolio.

Illinois' debt portfolio includes five derivative instruments, also known as swaps, associated with variable rate bonds with a notional value of $600 million that were sold in 2003.[205] These swap contracts convert the State's variable rate debt to synthetically fixed rate payments through agreements with counterparties that are intended to offset interest rate risk.

Under the terms of the contract, if the State's credit rating falls below a certain threshold the deal is terminated and the State must pay the market value of the deals at the time of the termination. The State also then would continue to pay the variable rate interest on the loans as set forth in the original bond sale.

Due to the State's deteriorating credit quality, the State entered negotiations with all four counterparties during 2016. Two of the swaps were transferred to a new counterparty, and all of the swaps now have lower ratings termination thresholds. Following the downgrades in June 2017, the State continued to negotiate for lower thresholds.

As a result of the renegotiations and the State's current credit ratings, a two-notch downgrade by either Moody's or S&P would trigger termination of all but the Deutsche Bank Swap (which has the

[205] Series 2003B, the State's only variable-rate series. Illinois State FY2018 Budget, p. 529.

largest termination value). A three-notch downgrade by either company would terminate all five swaps. The following table summarizes the results of the swap renegotiations.

State of Illinois Interest Rate Swap Agreements 2016 and 2017 Renegotiation Results (in $ thousands)					
Prior Counterparty	**New Counter-party**	**Notional Value**	**Original Ratings Termination Threshold**	**2016-17 Ratings Termination Threshold**	**Current Ratings Termination Threshold**
AIG Financial Products	Barclays	$ 54,000	S&P - below BBB Moody's - below Baa2	S&P - below BBB- Moody's - below Baa3	S&P - below BB+ Moody's - below Ba1
Merrill Lynch Capital Markets	Barclays	$ 54,000	S&P - below BBB Moody's - below Baa2	S&P - below BBB- Moody's - below Baa3	S&P - below BB+ Moody's - below Ba1
Bank of America	Bank of America	$ 54,000	S&P - below BBB Moody's - below Baa2	S&P - below BBB- Moody's - below Baa3	S&P - below BB+ Moody's - below Ba1
JP Morgan Chase	JP Morgan Chase	$ 54,000	S&P - below BBB Moody's - below Baa2	S&P - below BBB- Moody's - below Baa3	S&P - below BB+ Moody's - below Ba1
Loop Capital/ Deutsche Bank	Deustche Bank	$384,000	S&P - below BBB Moody's - below Baa2	S&P - below BB+ Moody's - below Ba1	S&P - below BB+ Moody's - below Ba1
Total		**$600,000**			

Source: Illinois State FY2018 Budget, pp. 529, 530; State of Illinois, General Obligation Bonds, Series of November 2016, *Official Statement* , November 8, 2016, p. 31; Illinois State FY2017 Budget, p. 515; Elizabeth Campbell, "Illinois Reduces Risk of Bank Swap Fees If Rating Is Cut to Junk," *Bloomberg* , June 12, 2017.

As a result of the negotiations, the State agreed to receive lower variable interest rates under the two swaps associated with Barclays. One swap rate was reduced from 83.2% to 82.7% of one-month LIBOR. The other was reduced from 81.32% to 80.82% of one-month LIBOR. The following table shows the current swap terms and present value.

State of Illinois Interest Rate Swap Agreements Interest Rates and Present Value (in $ thousands)							
Current Counterparty	**Notional Value**	**Fixed Rate Paid**	**Variable Rate Currently Received**	**Present Value 12/31/2015**	**Present Value 12/31/2016**	**Present Value 12/31/2017**	**Present Value 4/4/2018**
Barclays	$ 54,000	3.89%	82.7% of 1M LIBOR	$ (11,999)	$ (9,490)	$ (8,216)	$ (6,562)
Barclays	$ 54,000	3.89%	80.82% of 1M LIBOR	$ (12,091)	$ (9,677)	$ (8,390)	$ (6,757)
Bank of America	$ 54,000	3.89%	SIFMA	$ (12,091)	$ (10,109)	$ (9,567)	$ (7,571)
JP Morgan Chase	$ 54,000	3.89%	SIFMA	$ (12,586)	$ (10,388)	$ (8,783)	$ (7,464)
Deustche Bank	$384,000	3.89%	SIFMA	$ (89,274)	$ (74,519)	$ (64,466)	$ (54,965)
Total	**$600,000**			**$(138,040)**	**$(114,184)**	**$ (99,423)**	**$ (83,320)**

Source: State of Illinois, General Obligation Bonds, Series of May 2018, Official Statement, April 25, 2018, p. 37; Illinois State FY2019 Budget, pp. 505, 506; Illinois State FY2018 Budget, pp. 529, 530; Illinois State FY2017 Budget, p. 515.

As of December 31, 2015 the State's swaps portfolio had a negative value of $138.0 million.[206] While the value worsened to negative $153.3 million[207] during the low interest rate environment of 2016, rising interest rates since that period improved the present value to negative $114.2 million as

[206] Illinois State FY2017 Budget, p. 515.

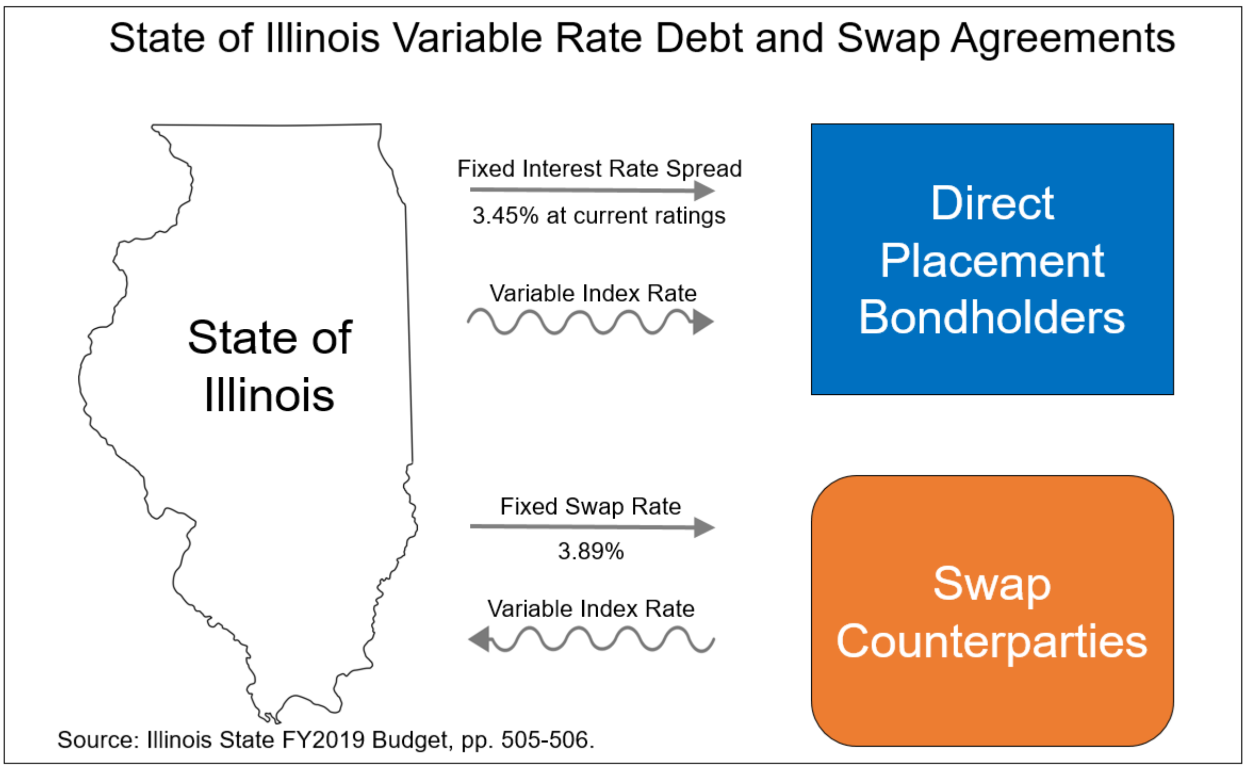
[207] State of Illinois, General Obligation Bonds, Series of November 2016, Official Statement, November 8, 2016, p. 31.

of December 31, 2016,[208] negative $99.4 million by December 31, 2017,[209] and negative $83.3 million by April 4, 2018.[210]

In order to maintain its variable rate debt, the State also maintained letters of credit totaling $600 million. When the six letter of credit agreements expired in November 2016, the State replaced them with direct placement agreements in which four banks purchased all of the outstanding variable rate bonds.[211] The new agreements will expire on November 7, 2018.

Under the direct placement agreements, the State pays the bondholder banks an interest rate spread plus a floating index interest rate.[212] The current spread is 3.45%, but will rise if the state is downgraded. Prior to the 2017 downgrades, the spread stood at 2.95%.[213] The State also pays a synthetically fixed interested rate of 3.89% on the $600 million principal amount of variable rate debt to the counterparties to its swaps. Finally, it receives a floating interest rate payment from the counterparties. Combined with the private placement agreements, this makes for a current effective interest cost of 7.34%, plus the floating index rate for the variable rate bonds, minus the floating index rate paid by the swap counterparties.

The following illustration shows the relationships between the various parties to the synthetic fixed variable rate transactions.



[208] Illinois State FY2018 Budget, p. 529.
[209] Illinois State FY2019 Budget p. 506.
[210] State of Illinois, General Obligation Bonds, Series of May 2018, *Official Statement*, April 25, 2018, p. 37.
[211] Illinois State FY2019 Budget, p. 507.
[212] Either SIFMA or 70% of one month LIBOR. Illinois State FY2019 Budget, p. 506.
[213] Illinois State FY2018 Budget, p. 530.

CAPITAL BUDGET

Unlike the State's General Funds budget, which is intended to cover only the cost of the State's operations for the current fiscal year, capital appropriations are reauthorized over multiple years as planning, engineering and construction of capital investments commences. The total spending proposed in the FY2019 capital budget includes funding from the State, grants from the federal government and local matching funds. Since 2005 the capital budget has been proposed in a separate document from the State's operating budget and is not part of the annual General Funds expenditures.

Illinois' Capital Needs

Illinois has not had a major capital program since 2009. The *Illinois Jobs Now!* FY2010 capital budget included $18.0 billion in new projects as well as $11.0 billion of reappropriations from previous years.[214] Since then, new appropriations have averaged approximately $3.8 billion annually.

The 2018 state report card issued by the American Society of Civil Engineers gives Illinois a C- for the overall quality of its infrastructure.[215] The road and transit categories each received a D. The Federal Highway Administration reports 2,243 structurally deficient bridges in Illinois, 8.4% of the State's total.[216] A recent report by the Regional Transportation Authority accuses the State of chronically underfunding transit and states that capital needs are outpacing uncertain revenues.[217]

In addition to transportation infrastructure, the Governor's FY2019 Capital Budget calls attention to other infrastructure needs, such as the $7.4 billion backlog in deferred maintenance at State facilities and modernization of the State's information technology systems.[218]

Addressing Illinois' infrastructure needs will not be cheap. The Illinois Department of Transportation (IDOT) estimates that additional revenues of $1.7 billion annually are needed to keep up with maintenance of existing highway and transit infrastructure.[219] Needed improvements in these systems would cost an additional $2.25 billion each year. These figures do not include other important infrastructure, such as airports, freight rail, waterways and non-transportation infrastructure.

In November 2016 voters approved a lockbox amendment to the Illinois Constitution that restricts some transportation-derived revenue sources to transportation-related expenditures.[220] While proponents argued that the amendment would prevent fund sweeps that divert transportation funds for other uses, the amendment did not result in expanded revenues for those funds.

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[214] Illinois General Assembly, Commission on Government Forecasting and Accountability, *Capital Plan Analysis FY2019*, April 2018, p. 8.
[215] American Society of Civil Engineers, Illinois Section, *Report Card for Illinois Infrastructure*, 2018, https://www.infrastructurereportcard.org/wp-content/uploads/2016/10/FINAL-REPORT-CARD-FOR-2018-IL-Infrastucture.pdf (last accessed on May 3, 2018).
[216] Federal Highway Administration, *Deficient Bridges by Highway System 2016*, December 31, 2016, https://www.fhwa.dot.gov/bridge/nbi/no10/defbr16.cfm#a (last accessed on May 3, 2018).
[217] Regional Transportation Authority, "Invest in Transit: The 2018-2023 Regional Transit Strategic Plan for Chicago and Northeastern Illinois," p. 14.
[218] Illinois State FY2019 Capital Budget, pp. 21-26.
[219] Communication between the Civic Federation and the Illinois Department of Transportation, December 1, 2017.
[220] Rummana Hussain, "Illinois voters approve 'Safe Roads Amendment'," *Chicago Sun-Times*¸ November 8, 2016.

Additionally, while the General Assembly's FY2018 budget held transportation expenditures flat to FY2017 levels,[221] according to IDOT officials it permanently shifted approximately $300 million in transportation expenses from General Funds to transportation-related funds, effectively reducing transportation spending by that amount.[222]

For decades the standard funding source for capital investments in transportation has been the motor fuel tax (MFT), but the revenue produced by this tax has eroded over time. Illinois has not raised the MFT from the flat rate of $0.19 per gallon in over 28 years.[223] Since that time, construction costs have doubled while gas tax revenue has grown by only 20%.[224] Since 2013, 24 states have raised or reformed their gas taxes, including three that border Illinois.[225] The Chicago Metropolitan Agency for Planning suggests that Illinois may need to increase the tax by $0.10 to $0.15 per gallon to meet its transportation needs.[226]

Illinois has made the pain of raising the MFT more difficult by being one of only a few states that also assess a general sales tax on gasoline.[227] However, the revenue produced by the sales tax is not tied to transportation funding. The FY2018 budget also eliminated a 20% sales tax discount on gasoline blended with ethanol,[228] which includes most gasoline sold in the Midwest.[229] The elimination of the discount is expected to produce approximately $100 million for the State's General Funds.[230]

In addition to the State sales tax, Chicago-area drivers pay more for special reformulated gasoline required by the Environmental Protection Agency.[231] The metro area is in "non-attainment status" due to poor air quality.[232] Despite these high costs, further raising the MFT could encourage alternatives to driving and help improve Chicago air quality.

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[221] Chicago Metropolitan Agency for Planning, "FY18 budget impacts on state finances, regional transportation, and local governments," http://www.cmap.illinois.gov/updates/all/-/asset_publisher/UIMfSLnFfMB6/content/fy18-budget-impacts-on-state-finances-regional-transportation-and-local-governments (last accessed on May 3, 2018).
[222] Communications between the Civic Federation and the Illinois Department of Transportation, December 4, 2017 and February 22, 2018.
[223] 35 ILCS 505/2(a).
[224] Chicago Metropolitan Agency for Planning, "Adequate Transportation Funding: Reforming the Motor Fuel Tax," p. 3, http://www.cmap.illinois.gov/documents/10180/17016/FY15-0061+ADEQUATE+TRANSPORTATION+FUNDING.pdf/60dc6491-b463-436c-b877-ac82e54f0ce3, (last accessed May 3, 2018).
[225] Institute for Taxation and Economic Policy, "How Long Has It Been Since Your State Raised Its Gas Tax?" June 28, 2017, https://itep.org/how-long-has-it-been-since-your-state-raised-its-gas-tax-4 (last accessed on May 3, 2018).
[226] Testimony by Chicago Metropolitan Agency for Planning before the Illinois General Assembly, House Transportation Committee, December 19, 2017.
[227] National Conference of State Legislatures, "Motor Fuel Sales Taxes and Other Taxes on Fuel Distributors or Suppliers," Updated June 2012, http://www.ncsl.org/research/transportation/fuel-sales-taxes-and-other-related-taxes.aspx (last accessed on May 3, 2018).
[228] 35 ILCS 105/3-10.
[229] U.S. Energy Information Administration, "Frequently Asked Questions: How much ethanol is in gasoline, and how does it affect fuel economy?" March 29, 2017, https://www.eia.gov/tools/faqs/faq.php?id=27&t=4 (last accessed on May 3, 2018).
[230] Illinois General Assembly, Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary, Fiscal Year 2018*, Updated September 5, 2017, p. 29.
[231] Whet Moser, "Why Gas Is So Expensive During the Summer (And Especially in Chicago)," *Chicago Magazine*, March 27, 2012, http://www.chicagomag.com/Chicago-Magazine/The-312/March-2012/Why-Gas-Is-So-Expensive-During-the-Summer-And-Especially-in-Chicago/ (last accessed on May 3, 2018).
[232] U.S. Environmental Protection Agency, "Illinois Nonattainment/Maintenance Status for Each County by Year for All Criteria Pollutants," April 30, 2018, https://www3.epa.gov/airquality/greenbook/anayo_il.html (last accessed on May 3, 2018).

Despite the relative stability of the MFT, transportation experts have concerns about its long-term viability. Average fuel efficiency has risen and is expected to continue rising.[233] Transportation planners have recommended examining both congestion pricing and a vehicle miles traveled (VMT) tax, which would assess drivers based on the distance they drive, ensuring the reliability of revenues even as cars become more fuel efficient.[234] A number of other states are testing VMT pilot programs to assess the feasibility of implementation and address the privacy concerns inherent in tracking vehicles.[235]

Proposed FY2019 Capital Budget

The Governor's recommended FY2019 capital budget includes a total of approximately $16.8 billion in new and reauthorized projects and marks the ninth year since the initiation of the *Illinois Jobs Now!* capital spending program.[236] However, the proposal does not include any new revenue sources or increases in existing sources.

The enacted FY2018 capital budget included $14.1 billion of which $3.6 billion were new appropriations and $10.5 billion were reauthorized projects.[237] The $16.8 billion recommended for FY2019 includes $7.8 billion of new appropriations and $9.0 billion of previously approved spending authority proposed for reauthorization.

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[233] U.S. Bureau of Transportation Statistics, "Table 4-23M: Average Fuel Efficiency of U.S. Light Duty Vehicles," https://www.bts.gov/content/average-fuel-efficiency-us-light-duty-vehicles-0 (last accessed on May 3, 2018).
[234] Chicago Metropolitan Agency for Planning, "Transportation System Funding Concepts," August 2016, p. 5, http://www.cmap.illinois.gov/documents/10180/570463/Transportation+System+Funding+Concepts/a40cfa4a-4743-4cfb-83c3-44f1d1d0ef02 (last accessed on May 3, 2018).
[235] Daniel Vock, "With Gas Taxes in Peril, More States Study Alternatives," *Governing*, January 16, 2018.
[236] Illinois State FY2019 Capital Budget, p. 31.
[237] Illinois State FY2018 Capital Projects List, https://www.illinois.gov/gov/budget/Documents/Budget%20Book/FY%202017%20Budget%20Book/FY2017IllinoisCapitalProjectsList.xls (last accessed on April 26, 2017).

The following table compares the capital budget proposed by the Governor for FY2019 to the proposed and enacted capital budgets for FY2018.

State of Illinois Capital Budget: FY2018 and FY2019 (in $ millions)			
	FY2018 Proposed	FY2018 Enacted	FY2019 Proposed
New Appropriations			
Transportation	$ 2,616.8	$ 2,636.8	$ 2,710.6
Environmental Protection	$ 853.1	$ 21.1	$ 1,768.1
Captial Development Board	$ 782.0	$ 341.0	$ 1,158.0
Comm. & Econ. Opportunity	$ -	$ 24.3	$ 1,344.0
Natural Resources	$ 107.2	$ 140.1	$ 400.8
All Other	$ 487.6	$ 410.1	$ 436.0
Total New Appropriations	**$ 4,846.6**	**$ 3,573.4**	**$ 7,817.4**
Reappropriations			
Transportation	$ 7,548.7	$ 7,845.8	$ 7,024.4
Environmental Protection	$ 1,926.1	$ 1,931.3	$ 854.3
Captial Development Board	$ 2,078.9	$ 645.5	$ 964.4
Comm. & Econ. Opportunity	$ 789.3	$ 10.6	$ 34.8
Natural Resources	$ 410.7	$ 83.2	$ 129.0
All Other	$ 77.9	$ 4.4	$ 6.6
Reappropriations	**$ 12,831.7**	**$ 10,520.9**	**$ 9,013.5**
Total Capital Appropriations	**$ 17,678.3**	**$ 14,094.3**	**$ 16,830.9**

Source: Illinois State FY2019 Capital Budget, p. 38; Illinois State FY2018 Capital Budget, p. 41; Illinois State FY2019 Budget Detail Spreadsheet, https://www2.illinois.gov/sites/budget/Documents/Budget%20Book/FY%202019/FY19-Operating-Budget-Detail.xls (last visited May 2, 2018).

Funding for statewide road and bridge construction remains the largest portion of the State's capital expenditures. The proposed FY2019 capital budget includes $9.7 billion in total spending for the Illinois Department of Transportation including the annual road program for ongoing surface transportation improvements (roads, bridges and mass transit).[238] Of the total allocated to IDOT, $7.0 billion represents amounts proposed for reauthorization from previous years and $2.7 billion is new funding.[239]

Expenditures

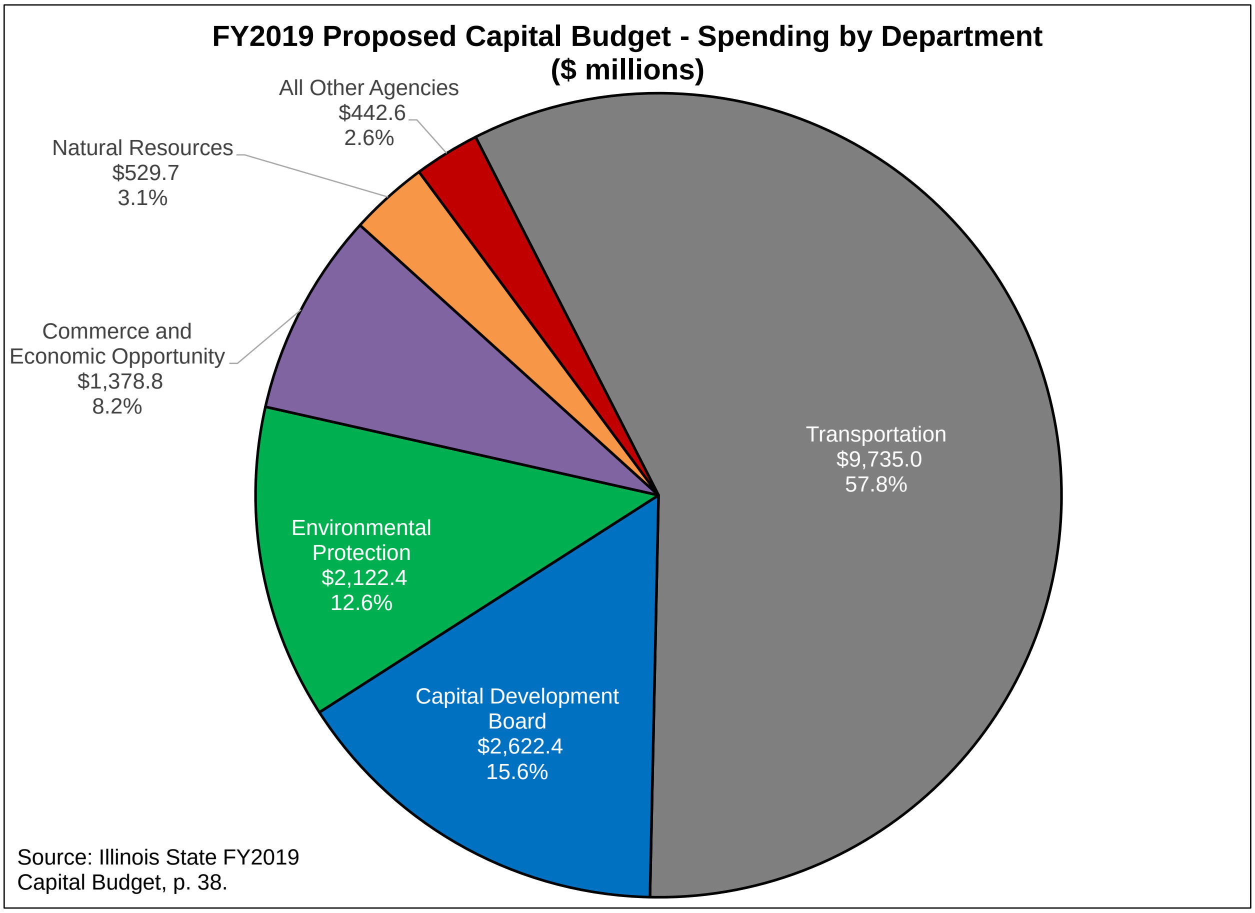
As part of the recommended FY2019 capital budget, the Governor recommends new funding totaling $630 million for areas of critical deferred maintenance needs at State facilities.[240] The Capital Development Board has reported average annual growth of $550 million in deferred maintenance at state-owned facilities since FY2012.[241] State facilities currently have a backlog of nearly $7.4 billion in deferred maintenance including office buildings, hospitals, laboratories, residential care facilities, prisons, parks, historic sites, fairgrounds and other storage facilities.[242]

[238] Illinois State FY2019 Capital Budget, p. 28.
[239] Illinois State FY2019 Capital Budget, p. 38.
[240] Illinois State FY2019 Capital Budget, p. 21.
[241] Illinois State FY2019 Capital Budget, p. 23.
[242] Illinois State FY2019 Capital Budget, p. 21.

The State has only invested $436 million in maintaining these properties since *Illinois Jobs Now!* began in FY2010.[243]

The proposed FY2018 capital budget also includes $400 million in new funding for technology upgrades. The Governor's capital budget continues to fund $250 million over five to six years on an Enterprise Resource Planning (ERP) system that would centralize financial and project management data. An additional $150 million would be spent on other information technology projects.[244]

The following chart shows the total FY2018 capital budget by department.



Revenues

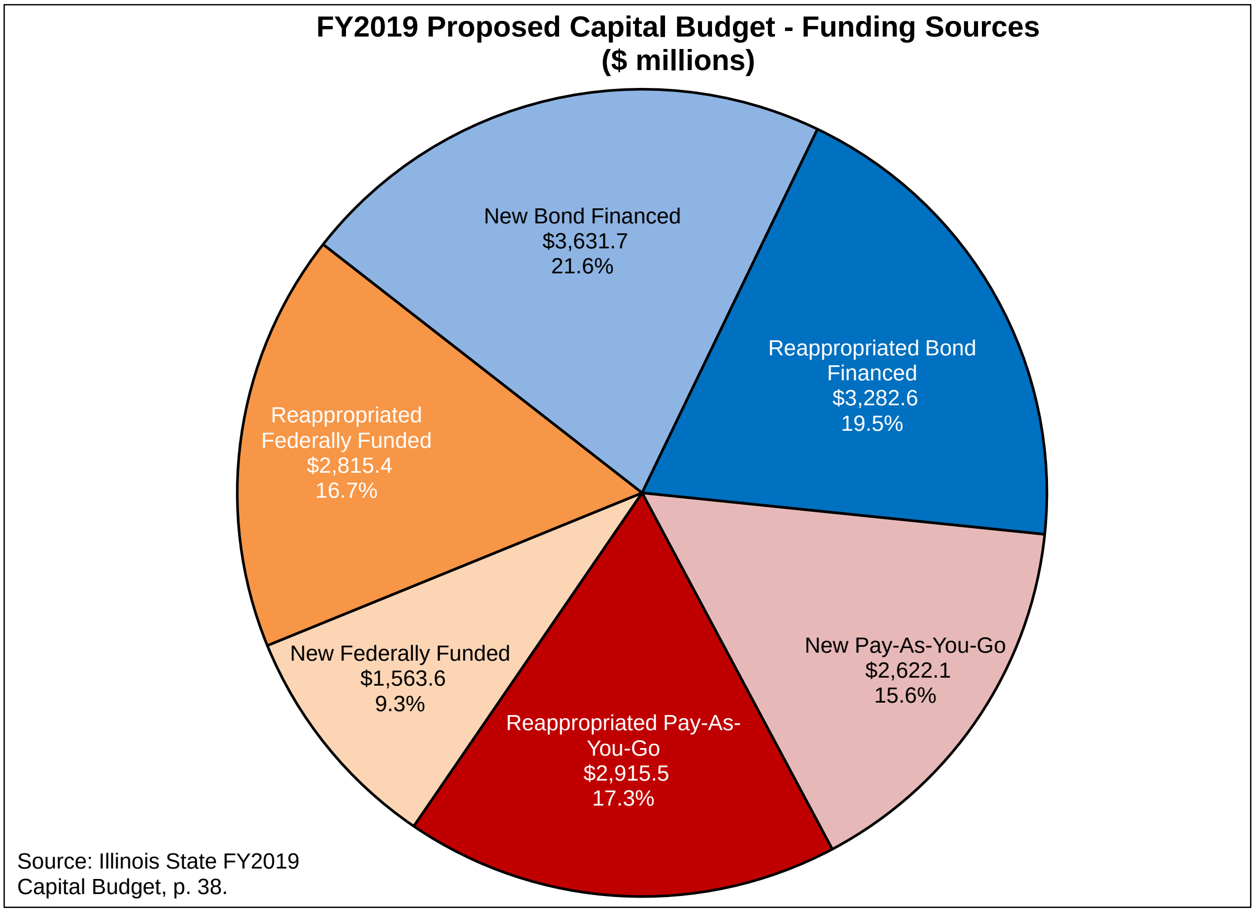
Projects funded using bond proceeds make up $6.9 billion of the total proposed spending in FY2019, while $9.9 billion are pay-as-you-go projects financed with currently available State and federal resources.[245]

The largest single source of pay-as-you-go funding comes from the federal government. Federal funds support $1.6 billion of new projects and $2.8 billion of the reappropriations, for a total of

[243] Illinois State FY2019 Capital Budget, p. 23.
[244] Illinois State FY2019 Capital Budget, p. 26.
[245] Illinois State FY2018 Capital Budget, p. 38.

$4.4 billion in capital funds.[246] The State collects the remaining pay-as-you-go funding through user taxes and fees including motor fuel taxes, vehicle fees, licensing and other related charges. The FY2019 capital budget includes $2.6 billion in new projects and $2.9 billion in reappropriations funded by State sources.[247]

The following chart shows the total FY2019 capital budget by the type of project funding.



Total appropriations in the State's capital budget have declined to approximately $14.1 billion in the enacted FY2018 capital budget from $29.1 billion in FY2010. Total appropriations would grow under the Governor's FY2019 recommended budget to $16.8 billion. Due to the addition of new projects and the lack of a comprehensive capital improvement plan to explain the annual prioritization and completion of projects, it is unclear which of the original projects have been completed and how much of the current budget represents additional authorizations passed in the intervening years.

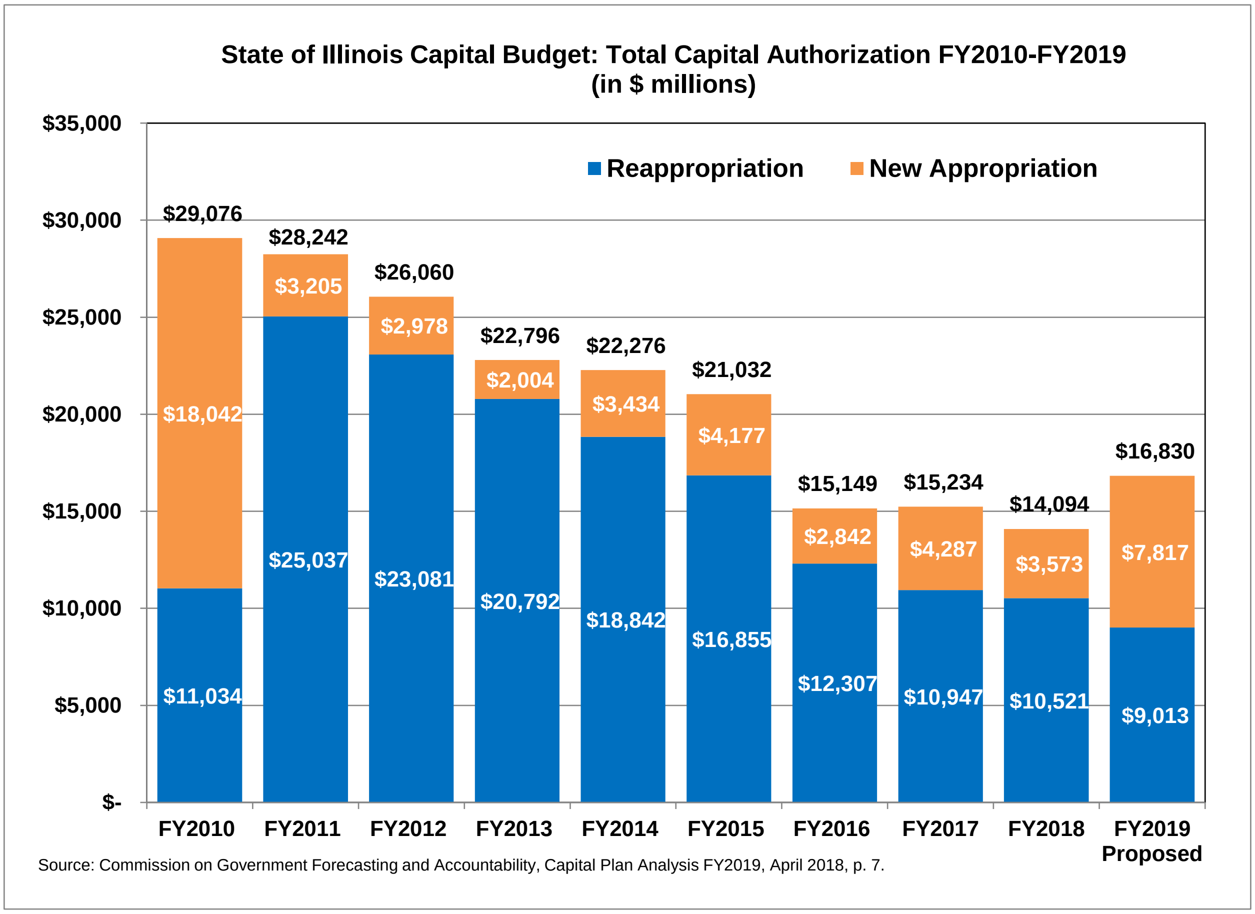
The *Illinois Jobs Now!* FY2010 capital budget included $18.0 billion in new projects added to $11.0 billion of reappropriations from previous years.[248] Since the initial *Illinois Jobs Now!* spending was approved, the State has authorized new projects annually that add up to a total of $34.3 billion from FY2011 through the proposed FY2019 budget, an average of $3.8 billion per

[246] Illinois State FY2018 Capital Budget, p. 38.
[247] Illinois State FY2018 Capital Budget, p. 38.
[248] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p.7.

year. The largest amount of new projects since FY2010 were approved in FY2015 totaling $4.2 billion. The Governor's proposed FY2019 appropriation for new capital projects is significantly higher at $7.8 billion.

Reappropriations from the *Illinois Jobs Now!* program increased to $25.0 billion in FY2011 and then declined over the next six years to a low of $10.5 billion in FY2018. Reappropriations proposed in the FY2019 capital budget, if adopted, would be even lower at $9.0 billion.

The following chart shows the total new and reappropriated amounts in the capital budget approved by the State of Illinois from FY2010 through FY2019.



The State relies heavily on the sale of bonds to fund the capital budget. The State has issued $14.0 billion in General Obligation and Build Illinois bonds to pay for capital projects since the *Illinois Jobs Now!* spending program began in FY2010.[249] A package of dedicated revenue sources was authorized to pay for the additional debt service related to spending on *Illinois Jobs Now!*[250] The new taxes and fees consist of the following:

- Statewide legalization and taxation of video poker;
- Expanded sales tax on candy, sweetened beverages and some hygiene products;

[249] Illinois State FY2019 Budget, p. 518; Illinois State FY2017 Budget, p. 525. For more details on the State's total debt burden and annual debt service costs see page 46 of this report.
[250] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2011, pp. 9-10.

- Leasing a portion of State lottery operations;
- Increased per-gallon tax on beer, wine and liquor; and
- Increased license and vehicle fees.

The proceeds from these sources are deposited in the Capital Projects Fund and used to pay for debt service on new capital bonds and some ongoing capital expenses.[251] This is intended to limit the General Funds impact of the additional debt sold to pay for the new capital budget.

However, the taxes and fees have yet to produce the funding levels projected when *Illinois Jobs Now!* was originally approved.[252] In FY2019 Capital Projects Fund revenues are projected to total $876.0 million compared to an estimated $837.0 million in FY2018. However, the legislative projections provided when the spending was approved in FY2010 anticipated revenues of $943 million to $1.2 billion annually.[253]

The following table shows the revenues deposited into the Capital Projects Fund from FY2010 through the projections for FY2019. The original legislative projections are also included in the table for comparison. Actual revenues meeting or exceeding the original projections are highlighted.

Capital Projects Fund: Revenues by Source
(in $ millions - revenues that meet or exceed original projections are highlighted)

Source	Original Projections	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018 Est.	FY2019 Est.
Video Poker Tax*	$288 - $534	$ -	$ -	$ -	$ 24.5	$ 114.4	$ 195.7	$ 251.6	$ 296.3	$ 336.0	$ 367.0
Lottery Fund	$ 150	$ 33	$ 54.1	$ 65.2	$ 135.0	$ 145.0	$ 8.0	$ -	$ 15.0	$ 9.0	$ 10.0
Sales Tax	$ 65	$ 39	$ 52.0	$ 52.7	$ 54.0	$ 55.0	$ 55.9	$ 56.9	$ 58.0	$ 59.0	$ 60.0
Liquor Tax	$ 108	$ 78	$ 105.2	$ 114.8	$ 115.1	$ 115.0	$ 116.4	$ 118.4	$ 122.9	$ 124.0	$ 126.0
Vehicle Related	$ 332	$ 117	$ 294.6	$ 299.7	$ 298.4	$ 304.0	$ 310.6	$ 308.1	$ 316.6	$ 307.0	$ 311.0
Other	$ -	$ -	$ (0.1)	$ 0.1	$ 0.3	$ 0.4	$ 0.4	$ 0.1	$ 0.5	$ 2.0	$ 2.0
Total	**$943 - $1,189**		**$ 505.8**	**$ 532.5**	**$ 627.3**	**$ 733.8**	**$ 687.0**	**$ 735.1**	**$ 809.3**	**$ 837.0**	**$ 876.0**

*FY2013 does not include one-time video poker operator fees totaling $33.5 million.

Source: Commission on Government Forecasting and Accountability, *Capital Plan Analysis FY2019* , April 2018, p. 9; Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2011, pp. 9-10.

Historically, only the liquor tax has regularly produced revenues in excess of the original projections. The largest historical shortfalls in revenues were related to the gaming sources from leasing the management of the lottery out to a private company and the legalization of video poker in Illinois.[254]

The lease to manage the State's lottery has been especially problematic. It was assumed that the contract would earn the State $150 million annually when *Illinois Jobs Now!* was enacted, but revenues have been *de minimus* since FY2015.[255] After several years of delays in the management

[251] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 9.
[252] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 9.
[253] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2011, pp. 9-10.
[254] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 9.
[255] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 9.

bidding process and then disputes over performance requirements, the State has requested the termination of the agreement with its vendor. However, only one vendor responded to the RFP and the original vendor remains on a month-to-month contract.

In FY2017 video gaming revenue totaling $296.3 million was for the first time within the original projected range of $288 million to $534 million annually. Due to administrative delays, the first video poker machines were not put into service until September 2012,[256] and thus FY2013 was the first year that the capital budget received revenue from the 30% tax on video gaming.

Since then, video gaming under performance has largely been due to the ability of local governments to opt out of video gaming or to continue existing local bans on the machines. Under the law establishing legalized video poker, five-sixths of the tax revenues generated are used for capital project funding and the remainder is shared with local governments where the machines are in service.[257] According to a report from the Commission on Government Forecasting and Accountability, 37.4% of the Illinois population lives in communities where video gaming is illegal.[258] However, this represents a significant expansion in video gaming since FY2017, when the percentage was 46.5%.[259] Chicago, where video gaming remains prohibited, represents 21.0% of the State's population.[260]

Although gaming-related revenues have accounted for the largest shortfall in capital funding, as shown in the table above, all other sources of capital projects revenue except liquor taxes continue to fall short.

The Capital Projects Fund is statutorily required to make an annual payment of $245 million to General Funds.[261] However, the payment is often offset by additional General Funds resources used to cover debt service costs not accounted for by the Capital Projects Fund. When the Capital Projects Fund does not have adequate revenue to cover the debt service and other statutory expenses, the State uses resources from the Road Fund or the General Funds to make up the difference.[262] These additional debt service costs are repaid in the subsequent year.

Because current-year revenues have been insufficient to support all required transfers out of the Capital Projects Fund, the Comptroller is $1.4 billion behind on transfers out.[263] The FY2018 budget relieved some pressure on the Capital Projects fund by requiring that debt service on the $1.1 billion Transportation Series D bonds be paid instead by the Road Fund.

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[256] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 11.
[257] Public Act 96-0034, enacted July 13, 2009.
[258] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 11.
[259] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2017, April 2016, p. 11.
[260] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 9.
[261] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 10.
[262] Public Act 96-0034, enacted on July 19, 2009.
[263] Illinois General Assembly, Commission on Government Forecasting and Accountability, Capital Plan Analysis FY2019, April 2018, p. 10.

APPENDIX: RETIREMENT SYSTEMS PROJECTED FINANCIAL CONDITION

The following table shows the most recent projections of total liabilities and combined funded ratios for the State of Illinois' five retirement systems from FY2019 through FY2045.

State of Illinois Retirement Systems Financial Condition: FY2019 to FY2045				
Fiscal Year	**Accrued Liabilities**	**Actuarial Value of Assets**	**Unfunded Liabilities (in $ millions)**	**Funded Ratio**
2019	$ 227,849	$ 92,439	$ 135,410	41%
2020	$ 234,431	$ 96,299	$ 138,132	41%
2021	$ 240,924	$ 101,644	$ 139,280	42%
2022	$ 247,291	$ 106,411	$ 140,880	43%
2023	$ 253,511	$ 111,151	$ 142,360	44%
2024	$ 259,568	$ 115,908	$ 143,660	45%
2025	$ 265,443	$ 120,690	$ 144,753	45%
2026	$ 271,112	$ 125,531	$ 145,580	46%
2027	$ 276,540	$ 130,432	$ 146,108	47%
2028	$ 281,728	$ 135,403	$ 146,326	48%
2029	$ 286,665	$ 140,476	$ 146,189	49%
2030	$ 291,328	$ 145,647	$ 145,681	50%
2031	$ 295,697	$ 150,945	$ 144,752	51%
2032	$ 299,753	$ 156,430	$ 143,322	52%
2033	$ 303,549	$ 162,236	$ 141,313	53%
2034	$ 307,026	$ 169,261	$ 137,765	55%
2035	$ 310,176	$ 176,705	$ 133,471	57%
2036	$ 312,998	$ 184,634	$ 128,364	59%
2037	$ 315,504	$ 193,132	$ 122,372	61%
2038	$ 317,807	$ 202,292	$ 115,515	64%
2039	$ 319,607	$ 212,194	$ 107,412	66%
2040	$ 321,225	$ 222,946	$ 98,279	69%
2041	$ 323,604	$ 234,669	$ 88,935	73%
2042	$ 323,792	$ 247,498	$ 76,294	76%
2043	$ 324,842	$ 261,579	$ 63,264	81%
2044	$ 325,824	$ 277,071	$ 48,753	85%
2045	$ 326,816	$ 294,135	$ 32,682	90%

Source: Illinois General Assembly, Commission on Government Forecasting and Accountibility, *Illinois State Retirement Systems Financial Condition as of June 30, 2017* , March 2018, p. 105.