The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

STATE OF ILLINOIS FY2013 BUDGET ROADMAP:

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

January 30, 2012

The Civic Federation • 177 N. State Street • Chicago, IL 60601 • 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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EXECUTIVE SUMMARY

Prior to the Governor's annual budget recommendation, the Institute for Illinois' Fiscal Sustainability at the Civic Federation issues an analysis of the State of Illinois' fiscal condition and budget recommendations for the Governor and General Assembly for the coming fiscal year. The State of Illinois FY2013 Budget Roadmap also includes an analysis of Governor Pat Quinn's three-year budget projections published on January 3, 2012. In addition, the FY2013 report provides the Civic Federation's five-year budget projections. Due to data limitations, the Federation's projections are rough forecasts intended to indicate the long-range consequences of current revenue and expenditure policies.

If action is not taken by the Governor and General Assembly to stabilize the State's budget in FY2013 and beyond, Illinois will face continued financial stress and unprecedented backlogs of unpaid bills. The State will struggle with operating deficits over the next five years despite anticipated moderate recovery in the broader economy. Given rising Medicaid and pension costs and the scheduled partial sunset of the income tax increase, the Civic Federation's analysis shows that Illinois' unpaid bills could rise to $34.8 billion by the end of FY2017. Below are key findings and recommendations included in this report.

Civic Federation Findings

- The General Funds operating deficit is projected to increase to $3.2 billion in FY2017 from $508 million in FY2012. This projection assumes that Medicaid appropriations are limited to annual growth of only 2%—well below the anticipated increase in Medicaid costs but consistent with the State's past budget practices.
- Largely due to projected underfunding of the Medicaid program, the State's total unpaid bills—including both General Funds bills and bills outside of the General Funds—are predicted to increase from $9.2 billion at the end of FY2012 to $34.8 billion at the end of FY2017.
- General Funds revenues are projected to decline by $427 million, or 1.3%, to $32.7 billion in FY2017 from $33.1 billion in FY2012. The decline is largely due to the lower income tax rates that take effect in FY2015; all other revenue sources are projected to increase over the next five fiscal years.
- General Funds expenditures are projected to increase by approximately 6.9% from $33.6 billion in the enacted FY2012 budget to $36.0 billion in FY2017. This conservative projection is based on the assumption that the Medicaid program will continue to be underfunded. It accounts for cost increases in group health insurance and pensions but leaves most other areas of the budget unchanged or flat from FY2012.
- General Funds costs for Medicaid are projected to increase by more than 40% to $12.1 billion in FY2017 from $8.6 billion in FY2012. If Medicaid appropriations increased by only 2% a year, well below predicted costs, the backlog of unpaid Medicaid bills would reach $21.0 billion by the end of FY2017.
- General Funds pension costs—including statutorily required State pension contributions and debt service on pension bonds—are projected to increase by approximately 35% from $5.7 billion in FY2012 to $7.8 billion in FY2017. Pension-related costs increase from roughly 17% of total General Funds expenditures in FY2012 to 21.6% in FY2017.
- General Funds costs for State employee group health insurance are projected to increase by approximately 39% from $1.4 billion in FY2012 to $2.0 billion in FY2017. Roughly 91% of the 81,900 retirees covered by the group insurance program do not pay any premiums for their coverage.
- The Governor's three-year budget projections, released on January 3, 2012, show an operating deficit of more than $500 million in FY2012 and a total of $818 million in FY2015. The Governor's projections do not account for the full annual cost of Medicaid or group health insurance based on current policies and do not address the increase in unpaid bills.

Civic Federation Recommendations

1. The Civic Federation recommends that current Illinois retirees and employees hired before January 1, 2011 receive the same annual pension benefit increases as new employees: 3% a year or one-half of the increase in the Consumer Price Index, whichever is less, and that pension benefits be increased by a simple interest rate. The Federation also supports reducing non-vested benefits for current employees, increasing employee contributions or both.

2. The Civic Federation supports requiring all State retirees to share the cost of their health insurance premiums. The Federation also supports abolishing any law or rule that allows retirees who live outside Illinois to pay lower premiums than retirees who live in Illinois for the same insurance coverage.

3. The Civic Federation supports aggressive implementation of Medicaid reform legislation passed in January 2011 that will enroll recipients in managed care networks and move residents from State centers for the developmentally disabled to community settings.

4. The Civic Federation opposes any additional borrowing by the State of Illinois to support its ongoing operations or to pay down its backlog of bills because the State cannot afford any additional debt service. Borrowing for operations also generates one-time revenues that increase future spending pressures.

5. The Civic Federation opposes bargaining unit increases in FY2013 or in the foreseeable future. The Civic Federation urges the Governor to keep the State's dire financial condition in mind as new collective bargaining agreements, effective in FY2013, are negotiated.

6. The Civic Federation supports broadening the base of the individual income tax in Illinois to include federally taxable portions of retirement and Social Security income, thereby stabilizing the State's finances while protecting the lowest-income individuals. The cost of exempting this income from taxation was estimated at $1.1 billion in FY2010, based on a personal income tax rate of 3%, and would be higher at the current rate of 5%.[1]

7. The Civic Federation supports increasing the State tax on cigarettes from the current rate of 98 cents per pack to $1.98 per pack in FY2013 to reduce the State's budget deficit and help pay for public health expenses in the future. The State could expect revenues to increase by approximately $307 million annually from a $1 per pack increase in the cigarette tax.[2]

8. The Civic Federation recommends that the State use its limited resources more effectively by eliminating or consolidating its more than 600 Special Funds and curbing the use of statutory transfers out of General Funds into Special Funds.

9. The Civic Federation recommends that the State develop a comprehensive economic development incentive policy to curb economic brinksmanship by Illinois businesses and allow the State to monitor the relative effectiveness of various incentive programs. Such a policy should be in place before the State renews, expands or creates any economic development incentives.

[1] Illinois State Comptroller, *Fiscal Year 2010 Tax Expenditure Report*, August 2011, p. 7.
[2] Civic Federation calculation based on Illinois Department of Revenue Fiscal Note on SB0044, Mach 20, 2009.

BUDGET OVERVIEW: FY2008 TO FY2012

This section highlights trends in the State of Illinois' General Funds budget for the five fiscal years ending on June 30, 2012.[3] The overview provides historical context for the forecasts and recommendations in subsequent sections of the report.

Illinois was in worse financial condition than most other states when it was forced to confront the recent economic recession.[4] In addition to underfunding its retirement systems for decades, the State skimped on budgetary reserves and ran recurring budget deficits in the years leading up to the economic downturn.

The recession that began in late 2007 exacerbated the State's existing financial problems by reducing revenues and increasing demand for government services. Illinois initially dealt with the crisis by deferring payment of bills, borrowing for operations and using one-time revenue sources. In January 2011 the State enacted a substantial temporary income tax increase. Despite the tax increase, Illinois continues to face severe financial pressures including a mountain of unpaid bills, huge unfunded pension liabilities and high annual debt service payments on pension bonds.

Revenues

Due primarily to the income tax increase, General Funds revenues are projected to total $33.1 billion in FY2012, up 11.7% from $29.7 billion in FY2008.[5]

State of Illinois General Funds Revenues by Source: FY2008-FY2012 (in $ millions)

	FY2008 Actual	FY2009 Actual	FY2010 Actual	FY2011 Actual	FY2012 Updated Projections	$ Change FY2008-FY2012	% Change FY2008-FY2012
Income Taxes (net)	$ 12,179	$ 10,933	$ 9,871	$ 12,825	$ 17,416	$ 5,237	43.0%
Sales Taxes	$ 7,215	$ 6,773	$ 6,308	$ 6,833	$ 7,100	$ (115)	-1.6%
Federal Receipts	$ 4,815	$ 6,567	$ 5,920	$ 5,386	$ 3,830	$ (985)	-20.5%
Other Revenues	$ 5,450	$ 4,871	$ 4,991	$ 4,946	$ 4,795	$ (655)	-12.0%
Total	**$ 29,659**	**$ 29,144**	**$ 27,090**	**$ 29,990**	**$ 33,141**	**$ 3,482**	**11.7%**

Source: Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY13-FY15* , January 3, 2012; Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012* , August 2011, p. 31, 64.

General Funds revenues consist mainly of income and sales taxes—economically sensitive revenues that declined dramatically due to the recession that began in December 2007 and officially lasted until June 2009.[6] Revenues from income and sales taxes fell by 16.6% to $16.2 billion in FY2010 from $19.4 billion in FY2008.

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[3] 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 and discretion. 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 funded with federal revenues.

[4] For a detailed analysis of the State's fiscal crisis, see Illinois State Comptroller, "The State Fiscal Crisis—How Did We Get Here," *Fiscal Focus*, September 2011, pp. 4-12.

[5] Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012*, p. 31.

[6] National Bureau of Economic Research, "US Business Cycle Expansions and Contractions," September 20, 2010.

The large decline in income and sales taxes was partially offset by enhanced federal assistance through the American Recovery and Reinvestment Act of 2009.[7] As a result, total General Funds revenues declined by only 8.7% to $27.1 billion in FY2010 from $29.7 billion in FY2008.

State revenue projections remained weak when the Governor signed the FY2011 budget on July 1, 2010. General funds revenues were originally projected to increase by less than 1% from $27.4 billion in FY2010 to $27.7 billion in FY2011.[8]

On January 13, 2011, the State enacted temporary increases in both the personal and corporate income tax rates.[9] The corporate income tax rate was increased from 4.8% to 7.0% and the personal income tax rate was increased from 3.0% to 5.0%.[10] The increased rates were retroactive to January 1, 2011. The personal income tax rate is set to decline to 3.75% beginning on January 1, 2015 and to 3.25% on January 1, 2025; the corporate rate falls to 5.25% in 2015 and returns to 4.8% in 2025.

The income tax legislation also raised corporate income tax revenues by suspending the net operating loss carryover deduction for corporations (but not for Subchapter S corporations) through FY2014.[11] The net operating loss deduction allows businesses to reduce their current tax liability by deducting losses suffered in prior years from income. Largely due to the income tax increases and suspension of the net operating loss carryover deduction, FY2011 income tax revenues rose 29.9% to $12.8 billion from $9.9 billion in FY2010.

FY2012 represents the first full year of the income tax increase. Income tax revenues are projected to grow to $17.4 billion in FY2012, up 43.0% from $12.2 billion in FY2008. All other General Funds revenues are expected to remain below FY2008 levels in FY2012.

Each year a specific percentage of income tax revenues is withheld or diverted from General Funds to pay for income tax refunds. The percentage is set yearly by the Illinois General Assembly or determined by a statutory formula.[12] Because of inadequate withholding of revenues from General Funds, the backlog of unpaid business income tax refunds stood at $626.9 million at the end of FY2011 and was expected to total $594.2 million at the end of FY2012.[13]

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[7] Public Law 111-5.
[8] Illinois State FY2011 Budget, p. 2-29.
[9] Public Act 96-1496.
[10] The State also collects an additional 2.5% Personal Property Replacement Tax (PPRT), making the effective corporate tax rate 9.5%. Replacement taxes are revenues collected by the State and paid to local governments to replace money that was lost by local governments when their power to impose personal property taxes on business entities was rescinded pursuant to the 1970 Illinois Constitution.
[11] Public Act 96-1496, § 207.
[12] 35 ILCS 5/901. The statutory formula has not been used since FY1998.
[13] Communication between the Civic Federation and the Illinois Department of Revenue, August 31, 2011.

Expenditures

Total General Funds expenditures are expected to increase by 10.8% from $30.4 billion in FY2008 to $33.6 billion in FY2012. The table below is based on the enacted budget as revised during the fall 2011 veto session.[14]

State of Illinois General Funds Expenditures: FY2008-FY2012 (in $ millions)	FY2008 Actual	FY2009 Actual	FY2010 Actual	FY2011 Preliminary Results[1]	FY2012 Revised Enacted[2]	$ Change FY2008-FY2012	% Change FY2008-FY2012
Agency Appropriations	$ 25,289	$ 27,796	$ 26,354	$ 25,845	$ 25,256	$ (33)	-0.1%
Less Unspent Appropriations	$ (385)	$ (507)	$ (896)	$ (338)	$ (904)	$ (519)	134.8%
Net Agency Appropriations	$ 24,904	$ 27,289	$ 25,458	$ 25,507	$ 24,352	$ (552)	-2.2%
Pension Contributions[3]	$ 2,249	$ 2,486	$ 3,466	$ 3,680	$ 4,135	$ 1,886	83.9%
Net Appropriations Spent	**$ 27,153**	**$ 29,775**	**$ 28,924**	**$ 29,187**	**$ 28,487**	**$ 1,334**	4.9%
Statutory Transfers Out							
Legislatively Required Transfers[4]	$ 2,021	$ 2,082	$ 2,007	$ 2,399	$ 2,366	$ 345	17.1%
Debt Service on Pension Obligation Bonds	$ 467	$ 466	$ 564	$ 1,667	$ 1,605	$ 1,138	243.7%
Other Debt Service and Statutory Transfers Out[5]	$ 717	$ 660	$ 1,759	$ 761	$ 1,189	$ 472	65.8%
Total Transfers Out	**$ 3,205**	**$ 3,208**	**$ 4,330**	**$ 4,827**	**$ 5,160**	**$ 1,955**	61.0%
Total Expenditures	**$ 30,358**	**$ 32,983**	**$ 33,254**	**$ 34,014**	**$ 33,647**	**$ 3,289**	**10.8%**

[1]As of November 2011.
[2]As of December 2011.
[3]Pension contributions in FY2010 and FY2011 were made primarily by issuance of pension obligation bonds, rather than from General Funds.
[4]FY2010 interest on short term borrowing includes $1.0 billion to repay failure of revenue borrowing in FY2009.
[5]For FY2009-FY2011 legislatively required transfers include transfers payable at fiscal year end.
Source: State of Illinois, General Obligation Bonds, Series A of January 2012 and Taxable Series B of January 2012, *Preliminary Official Statement* , January 3, 2012, pp. 12-13; Illinois State FY2011 Budget, p. 2-10; Illinois State FY2010 Budget, p. 2-12; Illinois State FY2008 Budget, p. 12-6.

During the veto session, agency appropriations and legislatively required transfers for FY2012 increased by a total of $566 million from the budget signed by Governor Quinn on June 30, 2011.[15] These additions were largely offset by a $404 million increase in planned unspent appropriations[16] and by the use of Other State Funds instead of General Funds to pay for $95 million in pension contributions.

Between FY2008 and FY2012, spending by State agencies—not including State pension contributions—is expected to decline by 2.2% from $24.9 billion in FY2008 to $24.4 billion. It is important to note, however, that annual spending does not necessarily reflect actual yearly costs for Medicaid and employee group health insurance. Medicaid and employee health insurance claims in Illinois may be paid out of future years' appropriations under a provision of Section 25 of the State Finance Act.[17] The provision has repeatedly been used to budget an insufficient amount of Medicaid appropriations to cover costs for a given fiscal year, knowing that the bills will be paid from the next year's appropriations.[18] Employee health insurance was not adequately funded

[14] State of Illinois, General Obligation Bonds, Series A of January 2012 and Taxable Series B of January 2012, *Preliminary Official Statement*, January 3, 2012, pp. 12-13.
[15] Public Acts 97-0641 and 97-0642.
[16] Appropriations remain unspent because they are held back at the Governor's direction or because expenses do not reach budgeted levels. `
[17] 30 ILCS 105/25. Medicaid reform legislation (Public Act 96-1501) enacted in January 2011 phases out this provision by FY2021.
[18] Illinois State Comptroller, "The Section 25 Budget 'Loophole'," *Fiscal Focus*, July 2008, p.7.

in FY2011, resulting in an estimated backlog of bills of $1.2 billion at the end of the fiscal year.[19] Although group health insurance is expected to be fully funded in FY2012, Medicaid is projected to be underfunded by approximately $1.5 billion.[20]

State pension contributions increase by 83.9% to $4.1 billion in FY2012 from $2.2 billion in FY2008. The State sold a total of $7.2 billion of Pension Obligation Bonds (POBs) to make its General Funds pension contributions in FY2010 and FY2011 but will use State-source revenues to make the payments in FY2012.

General Funds are also used to make statutorily required transfers to other funds, including debt service payments and other legislatively required transfers. Debt service on POBs increases by 243.7% from $467 million in FY2008 to $1.6 billion in FY2012.[21] Total transfers out also increase during the five-year period due to a repayment in FY2012 of funds borrowed from Other State Funds in FY2011.[22]

Total pension-related spending, including contributions and debt service payments, increases from $2.7 billion in FY2008 to $5.7 billion in FY2012. As a share of total General Funds spending, pension-related spending increases from 8.9% to 17.1%.

The tax increase legislation enacted in January 2011 established annual limits on General Funds spending through FY2015.[23] The spending limits are $36.8 billion for FY2012, $37.6 billion for FY2013, $38.3 billion for FY2014 and $39.1 billion for FY2015. If spending exceeds the limit, tax rate increases are rescinded for that year.

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[19] Communication between the Civic Federation and the Department of Healthcare and Family Services, August 25, 2011.
[20] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.
[21] The State's first sale of Pension Obligation Bonds, totaling $10 billion, was in FY2003.
[22] Public Act 96-0958.
[23] Public Act 96-1496.

Deficit and Unpaid Bills

The total General Funds deficit is expected to increase to $5.2 billion in FY2012 from $834 million in FY2008. The total deficit consists of the operating deficit and the accumulated deficit from prior years.

State of Illinois General Funds Deficit: FY2008-FY2012 (in $ millions)	FY2008 Actual	FY2009 Actual	FY2010 Actual	FY2011 Preliminary Results*	FY2012 Revised Enacted**
Operating Revenues	$ 29,659	$ 29,144	$ 27,090	$ 29,991	$ 33,140
Operating Expenditures	$ 30,358	$ 32,983	$ 33,254	$ 34,014	$ 33,648
Operating Surplus (Deficit)	**$ (699)**	**$ (3,839)**	**$ (6,164)**	**$ (4,023)**	**$ (508)**
Borrowing for Operations***	$ -	$ 1,000	$ 3,742	$ 5,426	$ -
Operating Surplus (Deficit) After Borrowing for Operations	$ (699)	$ (2,839)	$ (2,422)	$ 1,403	$ (508)
Accumulated Deficit from Prior Years	$ (135)	$ (834)	$ (3,673)	$ (6,095)	$ (4,692)
Total Deficit	**$ (834)**	**$ (3,673)**	**$ (6,095)**	**$ (4,692)**	**$ (5,200)**

*As of November 2011.

**As of December 2011.

***FY2009 amount represents failure of revenue borrowing repaid in FY2010.

Source: State of Illinois, General Obligation Bonds, Series A of January 2012 and Taxable Series B of January 2012, *Preliminary Official Statement* , January 3, 2012, pp. 12-13; Illinois State FY2011 Budget, p. 2-10; Illinois State FY2010 Budget, p. 2-12.

The total General Funds deficit rose to $6.1 billion in FY2010 before declining to $4.7 billion in FY2011. The FY2011 budget was bolstered by half a year of the tax increase and $5.4 billion of borrowing for operations, including the sale of POBs and bonds based on the settlement of tobacco litigation.

The enacted FY2012 budget does not include borrowing for operations. Despite a full year of the tax increase, the operating deficit is expected to total $508 million. As discussed previously, this shortfall does not reflect the full cost of the Medicaid program. The total year-end General Funds deficit of $5.2 billion consists of the operating deficit ($508 million) and the accumulated deficit from prior years ($4.7 billion).

Illinois has dealt with its General Funds deficit by delaying payments to vendors and local governments. State agencies normally have a lapse period of two months after the fiscal year ends on June 30 in which the next year's revenues may be used to cover the current year's bills.[24] Due to the amount owed at end of the FY2010 and FY2011, the lapse periods for those years were extended from two months to six months.

The following table shows the General Funds backlog of unpaid bills, or accounts payable, from the end of FY2008 to the end of FY2012. Preliminary results for FY2011 show that $1.06 billion of the $1.40 billion operating surplus was used to pay down part of a $6.22 billion backlog of

[24] With the exception of Medicaid and employee health insurance bills, most bills from a given fiscal year must be paid from that year's appropriation. For example, lapse period spending during the first six months of FY2012 is charged to the FY2011 appropriation.

unpaid bills, leaving a backlog of $5.16 billion. The budget plan for FY2012 shows an increase of $508 million in accounts payable, increasing the FY2012 year-end backlog to $5.67 billion.

State of Illinois General Funds Accounts Payable: FY2008-FY2012 (in $ millions)					
	FY2008 Actual	FY2009 Actual	FY2010 Actual	FY2011 Preliminary Results*	FY2012 Revised Enacted**
Accounts Payable Beginning of Year	$ (777)	$ (976)	$ (3,953)	$ (6,224)	$ (5,160)
Paydown of Accounts Payable/ (Increase in Accounts Payable)	$ (199)	$ (2,977)	$ (2,271)	$ 1,064	$ (508)
Accounts Payable End of Year	$ (976)	$ (3,953)	$ (6,224)	$ (5,160)	$ (5,668)

*As of November 2011.

**As of December 2011.

Source: State of Illinois, General Obligation Bonds, Series A of January 2012 and Taxable Series Series B of January 2012, *Preliminary Official Statement* , January 3, 2012, pp. 12-13; Illinois State FY2011 Budget, p. 2-10; Illinois State FY2012 Budget, p. 2-12.

The State also accumulates bill backlogs outside of the General Funds. These backlogs include Medicaid and employee health insurance bills and unpaid tax refunds. At the end of FY2012, these unpaid obligations outside of the General Funds are expected to be roughly $3.6 billion, including $1.8 billion of Medicaid bills.[25]

Total unpaid obligations, including $5.7 billion in unpaid General Funds bills, are expected to be $9.2 billion at the end of FY2012. It would effectively cost the State roughly $8.2 billion to pay down the backlog because Medicaid expenditures are reimbursed by the federal government and a portion of business income tax refunds are not paid from General Funds.

Credit Ratings

In light of Illinois' weak financial condition, the State's credit rating has been downgraded numerous times in the past three years. The most recent downgrade, by Moody's Investor Services, occurred on January 6, 2012, five days before Illinois sold $800 million of General Obligation bonds to support capital projects. Moody's lowered Illinois' debt rating from A1 to A2, the lowest rating among U.S. states.26 Moody's pointed to Illinois' inaction on its severely underfunded pensions and to its chronic backlog of unpaid bills. Moody's also revised the State's outlook from negative to stable.

Two other rating agencies did not change their ratings for Illinois in advance of the bond sale. Standard & Poor's affirmed an A-plus rating but retained a negative outlook, expressing concerns about the State's failure to make meaningful changes to align revenues and expenditures and about

[25] For more information on this estimate, see The Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois Enacted Budget FY2012: A Review of the Operating and Capital Budgets Enacted for the Current Fiscal Year,* September 26, 2011, pp. 36-37, http://www.civicfed.org/sites/default/files/State%20of%20Illinois%20Enacted%20Budget%20FY2012.pdf (last visited on November 23, 2011). The projection for unpaid Medicaid bills was reduced after the report was published due to the enactment of Public Act 97-0641 after the veto session on December 19, 2011, which authorized additional transfers from General Funds to pay for Medicaid costs.

[26] Moody's Investors Service, *New Issue: Moody's Lowers State of Illinois' G.O. Rating to A2 to A1, Assigns A2 Rating to Planned $800 Million Issuance,* January 6, 2012.

the weakness of the pension funds.[27] Fitch Ratings affirmed an A rating with a stable outlook but said that the State needed a long-term solution to the gap between revenues and expenditures.[28]

The following chart compares Illinois' General Obligation bond ratings in December of 2008 to the current ratings from each agency.

State of Illinois General Obligation Bond Ratings			
	Decmber 2008	**January 2012**	**Reductions**
Fitch	AA-	A	5
Moody's	Aa3	A2	4
S&P	AA	A+	3

Source: Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012* , August 2011, pp. 187-189; State of Illinois Capital Markets, *Rating Agency Reports* , http://www2.illinois.gov/gov/capitalmarkets/Pages/Documents.aspx.

The next chart compares all three major agencies' current ratings for California and Illinois General Obligation bonds. Illinois is rated lower than California by Moody's, but the State has a higher rating than California from the other two agencies.

General Obligation Bond Ratings for Illinois and California: January 2012		
	Illinois	**California**
Fitch	A	A-
Moody's	A2	A1
S&P	A+	A-

Source: State of Illinois Capital Markets, *Rating Agency Reports* , http://www2.illinois.gov/gov/capitalmarkets/Pages/Documents.aspx; California State Treasurer, *State of California's Current GO Credit Ratings* , http://www.buycaliforniabonds.com/bcb/ratings.asp.

Debt ratings are one of the factors that are weighed heavily by underwriters and investors when determining the interest rate the State must pay to issue debt. Consequently, the declines in the State's ratings have led to an overall increase in Illinois' debt service cost in recent years compared to other municipal issuers.[29]

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[27] Standard & Poor's, *Illinois: General Obligation*, January 6, 2012.
[28] Fitch Ratings, *Fitch Affirms Illinois' GO Bonds at 'A'; Outlook Stable*, January 5, 2012.
[29] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *Cost of the Crisis: An Analysis of the Additional Bond Costs Paid by the State of Illinois Due to the State's Ongoing Fiscal Crisis,* August 30, 2010.

GOVERNOR'S THREE-YEAR BUDGET PROJECTIONS

Governor Pat Quinn released a three-year budget projection for the State of Illinois on January 3, 2012.[30] The multiyear budget plan, required by law to be issued during the first week of January, provides an update to the FY2012 State budget after changes made during the General Assembly's veto session and gives revenue and spending projections for the next three fiscal years.[31] This is only the second year that the Governor has been required to release these projections in advance of his annual budget recommendation. In most budget years the Governor is required to submit a budget to the General Assembly by the third Wednesday in February; however, the FY2013 budget deadline has been delayed until February 22, 2012.[32]

Revenues

The updated FY2012 General Funds revenue estimate of $33.1 billion in the three-year projections is slightly lower than the $33.2 billion estimate originally used by the General Assembly to develop the budget.[33] This decline is largely attributable to much lower expectations for federal revenues, which fell by 20.9% from $4.8 billion in the original enacted FY2012 projections to $3.8 billion in the latest projections. The decline in federal revenues is due to reduced appropriations for the State's Medicaid program in the revised FY2012 budget, which also reduced the amount of federal matching dollars received by the State. The loss of federal revenues is mostly offset by projected increases in other State revenues, including growth of $107 million in personal income taxes, $345 million in corporate income taxes and $514 million in sales taxes.

The three-year projections for General Funds revenues show moderate annual growth in FY2013 and FY2014. As enacted in January 2011, the State's income tax increase is scheduled to partially sunset halfway through FY2015, when the personal income tax rate will decline to 3.75% from 5.0% and the corporate income tax rate will fall to 5.25% from 7.0% on January 1, 2015. The rate reductions lead to a 4.3% decline in General Funds revenues in FY2015 to $33.5 billion from $35.0 billion in FY2014.

Sales tax revenues are projected to grow at a compound annual rate of 2.6% from FY2012 through FY2015, increasing from $7.1 billion to $7.6 billion.[34] The $470 million increase in sales tax collections amounts to a total increase of 6.6% between FY2012 and the end of FY2015.

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[30] Governor's Office of Management and Budget, *Three-Year Projections (General Funds), FY13-FY15,* January 3, 2012.
[31] Public Act 96-1354.
[32] Public Act 97-0669.
[33] 97th Illinois General Assembly House Resolution 110.
[34] The State collects sales taxes at a rate of 6.25%, of which the State portion is 5 percentage points and 1.25 percentage points are passed through to county and municipal governments.

The following chart shows the Governor's General Funds revenue projections for FY2012 through FY2015.

State of Illinois Governor's Three-Year Plan: Total General Funds Revenues FY2012-FY2015 (in $ millions)						
Revenue Source	**FY2012**	**FY2013**	**FY2014**	**FY2015**	**$ Change**	**% Change**
State Taxes and Fees						
Personal Income Tax	$ 15,062	$ 15,273	$ 15,791	$ 14,315	$ (747)	-5.0%
Corporate Income Tax	$ 2,354	$ 2,550	$ 2,718	$ 2,446	$ 92	3.9%
Sales Tax	$ 7,100	$ 7,235	$ 7,385	$ 7,570	$ 470	6.6%
Other	$ 2,969	$ 3,029	$ 3,019	$ 3,049	$ 80	2.7%
Total State Taxes and Fees	**$ 27,485**	**$ 28,087**	**$ 28,913**	**$ 27,380**	**$ (105)**	**-0.4%**
Federal Sources	**$ 3,830**	**$ 4,200**	**$ 4,200**	**$ 4,200**	**$ 370**	**9.7%**
Transfers In	**$ 1,826**	**$ 1,844**	**$ 1,862**	**$ 1,881**	**$ 55**	**3.0%**
Total Revenue	**$ 33,141**	**$ 34,131**	**$ 34,975**	**$ 33,461**	**$ 320**	**1.0%**

Source: Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY13-FY15* , January 3, 2012.

Expenditures

According to the Governor's economic and fiscal policy report that accompanied the three-year forecasts, the lack of significant revenue growth and the increase in the State's pension-related costs will continue to put a strain on the State's annual operating budgets.[35] To cope with the pressure, the Governor plans to cut State agency operating budgets in FY2013 and hold them flat through FY2015. Within the State agency budgets, the Governor's three-year plan avoids cutting the operating budgets for education and Medicaid programs in FY2013. Instead these categories, which total $8.9 billion annually for education and $6.6 billion annually for Medicaid and other related healthcare programs, are held flat at FY2012 levels through FY2015.

The following table shows the agency operating appropriations by general category from the Governor's three-year projections.

State of Illinois Governor's Three-Year Plan: Agency Operating Appropriations by Category: FY2012-FY2015 (in $ millions)						
Operating Category	**FY2012**	**FY2013**	**FY2014**	**FY2015**	**$ Change**	**% Change**
Education Funding	$ 8,946	$ 8,946	$ 8,946	$ 8,946	$ -	0.0%
Human Services	$ 6,873	$ 6,523	$ 6,523	$ 6,523	$ (350)	-5.1%
Healthcare	$ 6,639	$ 6,639	$ 6,639	$ 6,639	$ -	0.0%
Public Safety	$ 1,531	$ 1,408	$ 1,408	$ 1,408	$ (123)	-8.0%
Government Services	$ 1,104	$ 1,016	$ 1,016	$ 1,016	$ (88)	-8.0%
Economic Development	$ 94	$ 87	$ 87	$ 87	$ (7)	-7.4%
Quality of Life	$ 68	$ 63	$ 63	$ 63	$ (5)	-7.4%
Total Agency Operations	$ 25,255	$ 24,682	$ 24,682	$ 24,682	$ (573)	-2.3%
Unspent Appropriations	$ (904)	$ (500)	$ (500)	$ (500)	$ 404	-44.7%
Total Agency Budgets	**$ 24,351**	**$ 24,182**	**$ 24,182**	**$ 24,182**	**$ (169)**	**-0.7%**

Source: Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY13-FY15* , January 3, 2012.

[35] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report*, January 3, 2012.

The projections do not account for the full annual cost of the Medicaid program and appear to assume that significant cuts in Medicaid spending will be enacted. The Governor's accompanying report notes that anticipated Medicaid costs were underfunded in the FY2012 budget by roughly $2 billion. The Medicaid costs that were not funded in FY2012 will be carried over into FY2013 as unpaid bills. Despite the inadequate funding in FY2012, the Governor's projections show Medicaid appropriations remaining flat from FY2012 through FY2015. The projections also do not reflect annual increases in the cost of providing healthcare services. Medicaid reform legislation enacted in January 2011 is not expected to generate significant savings for several years.[36]

Although the three-year projections show a decline in State appropriations to support agency operations, the overall expenditures of the State increase over the same period. The State's annual pension contributions are expected to grow by $1.8 billion, or 42.8%, between FY2012 and FY2015, from $4.1 billion to $5.9 billion. Total agency operations are to be reduced by $170 million, statutory transfers out decrease by $140 million and the state's debt service owed for capital and pension bonds also declines slightly.

The following table shows the three-year General Funds expenditures projections for FY2012 through FY2015.

State of Illinois Governor's Three-Year Plan: Total General Funds Expenditures FY2012-FY2015 (in $ millions)

	FY2012	FY2013	FY2014	FY2015	$ Change	% Change
Agency Operating Budgets	$ 24,352	$ 24,182	$ 24,182	$ 24,182	$ (170)	-0.7%
Pension Contributions	$ 4,135	$ 5,250	$ 5,593	$ 5,905	$ 1,770	42.8%
Statutory Transfers Out	$ 2,366	$ 2,226	$ 2,226	$ 2,226	$ (140)	-5.9%
Capital Bond Debt Service	$ 563	$ 494	$ 520	$ 465	$ (98)	-17.4%
Pension Bond Debt Service	$ 1,605	$ 1,552	$ 1,655	$ 1,501	$ (104)	-6.5%
Interfund Borrowing Repayment	$ 626	$ 140	$ -	$ -	na	na
Total Expenditures	**$ 33,647**	**$ 33,844**	**$ 34,176**	**$ 34,279**	**$ 632**	**1.9%**

Source: Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY12-FY15* , January 3, 2012.

As shown in the table above, increases in required pension contributions outpace projected declines in all other categories of spending. The decrease in statutory transfers of $140 million matches the amount of a one-time transfer into a new Special Fund for FY2012 added to the enacted budget in the veto session.[37]

The debt service transfer to pay for principal and interest on the State's outstanding Pension Obligation Bonds (POBs) declines slightly in FY2015 due to the final retirement of the five-year bonds sold to make the State's annual pension contribution in FY2010. However, the State begins paying more significant amounts of principal during the next fiscal year on the eight-year POBs sold to make the FY2011 contribution to the pension funds, which will increase the POB debt service transfer in FY2016.

The debt service transfer for capital purpose bonds is relatively flat and declines slightly in FY2015 even as the State continues to sell General Obligation Bonds in support of the ongoing capital budget. The General Funds cost of the State's capital borrowing does not increase because

[36] Public Act 96-1501. Savings are largely related to the growth of managed care, and it is expected to take several years to enroll recipients in managed care networks.
[37] Public Act 97-0641.

the State enacted new revenue sources outside of the General Funds to support the additional capital borrowing through the Capital Projects Fund.[38]

General Funds Surplus and Deficits

By the end of FY2012, the total General Funds cost of paying down the State's outstanding liabilities, including Medicaid bills and net of federal reimbursements, is expected to total roughly \$8.2 billion.[39] The Governor's three-year budget projections do not provide funding to significantly reduce these obligations. As shown in the table below, the budget projections only generate moderate surpluses in FY2013 and FY2014 before the income tax increases partially sunset in FY2015. The decline in revenues associated with the personal income tax rate reduction from 5.0% to 3.75% and the corporate income tax rate from 7.0% to 5.25% on January 1, 2015 will create a significant operating deficit, totaling \$818 million.

The table below compares expenditures to revenues and shows the deficits and surpluses for FY2012 to FY2015 included in the Governor's three-year projections.

State of Illinois Governor's Three-Year Plan: Total General Funds Surplus/(Deficit): FY2012-FY2015 (in \$ millions)

	FY2012	FY2013	FY2014	FY2015
Total Revenues	\$ 33,141	\$ 34,131	\$ 34,975	\$ 33,461
Total Expenditures	\$ 33,647	\$ 33,844	\$ 34,176	\$ 34,279
Surplus/(Deficit)	**\$ (507)**	**\$ 287**	**\$ 799**	**\$ (818)**

Source: Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY13-FY15* , January 3, 2012.

The projected General Funds surpluses shown above are not enough to significantly pay down the State's outstanding liabilities. Rather than use General Funds resources to pay down the State's backlog of bills, the Governor's economic and fiscal policy report suggests borrowing to pay down the \$7 billion in liabilities the Governor's Office calculates the State had accumulated as of December 2011.[40] The Governor proposes using debt proceeds to repay \$3.5 billion in unpaid bills held by the Illinois State Comptroller, \$2 billion in unpaid Medicaid bills, \$500 million for tax refunds owed to businesses and \$1 billion in unpaid State Group Health Insurance bills. However, the terms of the borrowing, such as the repayment schedule and total estimated debt service costs, are not included in the report. It also does not appear that the State could afford additional debt service cost in FY2015 when revenues are expected to drop due to the scheduled partial sunset of the income tax increases. The State should expect an additional drop in revenues in FY2016, when the lower income tax rates from the partial sunset are in effect for the entire year.

As part of the FY2012 budget proposal last year, the Governor recommended a similar borrowing plan, calling for the sale of \$8.75 billion in General Obligation Restructuring Bonds to be repaid over 15 years. It was estimated that the interest costs associated with the debt repayment would total approximately \$4.0 billion. The proposed borrowing plan did not gain support in the General Assembly and was not included in the FY2012 enacted budget.

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[38] See page 23 of this report for the five-year Debt Service Transfer chart for more information on the State's annual debt costs.
[39] See page 13 of this report for a discussion of the deficit and unpaid bills and the estimated total backlog of liabilities.
[40] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report*, January 3, 2011, pp. 2-3.

Both the Governor's three-year projections and the economic and fiscal policy report note that the initial projections for expenditures and revenues are meant to be a preview of the challenges facing the State for the FY2013 budget and are expected to change prior to the release of the Governor's formal budget proposal.

FIVE-YEAR BUDGET PROJECTIONS

As a government recovers from a financial crisis, it is particularly important to undertake a long-term financial planning process.[41] A long-term financial plan highlights long-range financial issues and helps governments look beyond budget gap-bridging measures toward remedying structural problems.

As discussed in the previous section, recent budget reform legislation in Illinois requires the Governor's Office of Management and Budget to provide in January of each year the administration's fiscal policy intentions for the upcoming fiscal year and the next two fiscal years.[42] Governor Quinn's projections for FY2013 to FY2015 were issued on January 3, 2012.

This section of the report presents the Civic Federation's budget projections for FY2013 to FY2017. A five-year time horizon for financial planning is recognized as a best practice by the Government Finance Officers Association.[43] The Governmental Accounting Standards Board has proposed that state and local governments report five-year budget projections as supplementary information to their financial statements.[44] A five-year outlook is of critical importance in Illinois due to the scheduled partial sunset of recent tax rate increases on January 1, 2015. The first full fiscal year in which the reduced tax rates are to be in effect is FY2016.

The Civic Federation's projections are intended to provide a rough overview of expected revenues and spending pressures through FY2017. Due to significant data limitations, these forecasts should not be viewed as precise predictions.

General Funds Expenditures

General Funds expenditures are expected to increase by 6.9% from $33.6 billion in FY2012 to $36.0 billion in FY2017. This projection is based on the Civic Federation's forecast incorporating known spending pressures and the assumption that the Medicaid program will be underfunded, resulting in substantial growth in unpaid bills.

The Civic Federation's spending projections focus on Medicaid, pensions and group health insurance—areas in which cost increases have been among the hardest to control. Other State operations, including education, are left unchanged from the FY2012 budget.

The projections also do not reflect any salary increases for State workers. The State's current contract with its largest union, Council 31 of the American Federation of State, County and Municipal Employees, calls for increases of 1.25% on January 1, 2012 and 2% on February 1, 2012. On July 1, 2011, Governor Quinn cancelled all scheduled FY2012 raises for employees in 14 agencies, citing inadequate appropriations by the General Assembly.[45] The current contract expires at the end of FY2012 and the State has begun negotiations on a new contract.

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[41] Shayne Kavanagh, *Fiscal First Aid and Financial Recovery,* (Chicago: GFOA, 2011), p. 37-44.
[42] Public Act 96-1354.
[43] Government Finance Officers Association, *Best Practice: Long-Term Financial Planning*, February 22, 2008, http://www.gfoa.org/downloads/LongtermFinancialPlanningFINAL.pdf (last visited on January 13, 2012).
[44] Joan Quigley, "Five-Year Forecasts proposed; GASB Seeks Detailed Issuer Projections," *Bond Buyer*, December 6, 2011.
[45] Doug Finke, Quinn cancels $76 million in state employee raises," *State Journal-Register*, July 1, 2011. A raise of 2% was scheduled for July 1, 2011.

Medicaid

Medicaid is a joint federal-state program that funds medical services for certain categories of low-income people, including children, pregnant women, the elderly and the disabled. Enrollment in the Illinois Medicaid program grew by 16.2% to 2.7 million recipients at the end of FY2011 from 2.4 million at the end of FY2008.[46]

As a program involving several state agencies, Medicaid has no single programmatic appropriation in the State budget. The Medical Assistance program at the Illinois Department of Healthcare and Family Services (HFS) is used as the best available approximation to the Medicaid program.[47] Total HFS Medicaid costs are estimated at $14.3 billion in FY2012.[48]

The Civic Federation's projections assume that Medicaid appropriations will be limited to an annual increase of 2% and that underfunding of the Medicaid program will result in growing unpaid Medicaid bills and increasing delays in the payment of healthcare providers. This assumption is based on a recent analysis by HFS and is consistent with past Illinois budget practices.[49]

General Funds Medicaid costs are projected to increase by 41.7% from $8.6 billion in FY2012 to $12.1 billion in FY2017, according to a recent analysis by HFS.[50] General Funds costs of the program are projected to increase 13.0% between FY2012 to FY2013 due to an anticipated decline in resources from Other State Funds. Between FY2014 and FY2017, program costs are expected to increase at an average annual rate of 5.8%.

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[46] Illinois Department of Healthcare and Family Services, *Five Year Enrollment History*, http://www2.illinois.gov/hfs/agency/Program%20Enrollment/Pages/Statewide.aspx (last visited on January 5, 2012). These enrollment numbers only cover people receiving comprehensive benefits. An additional 309,387 people received limited benefits at the end of FY2011.

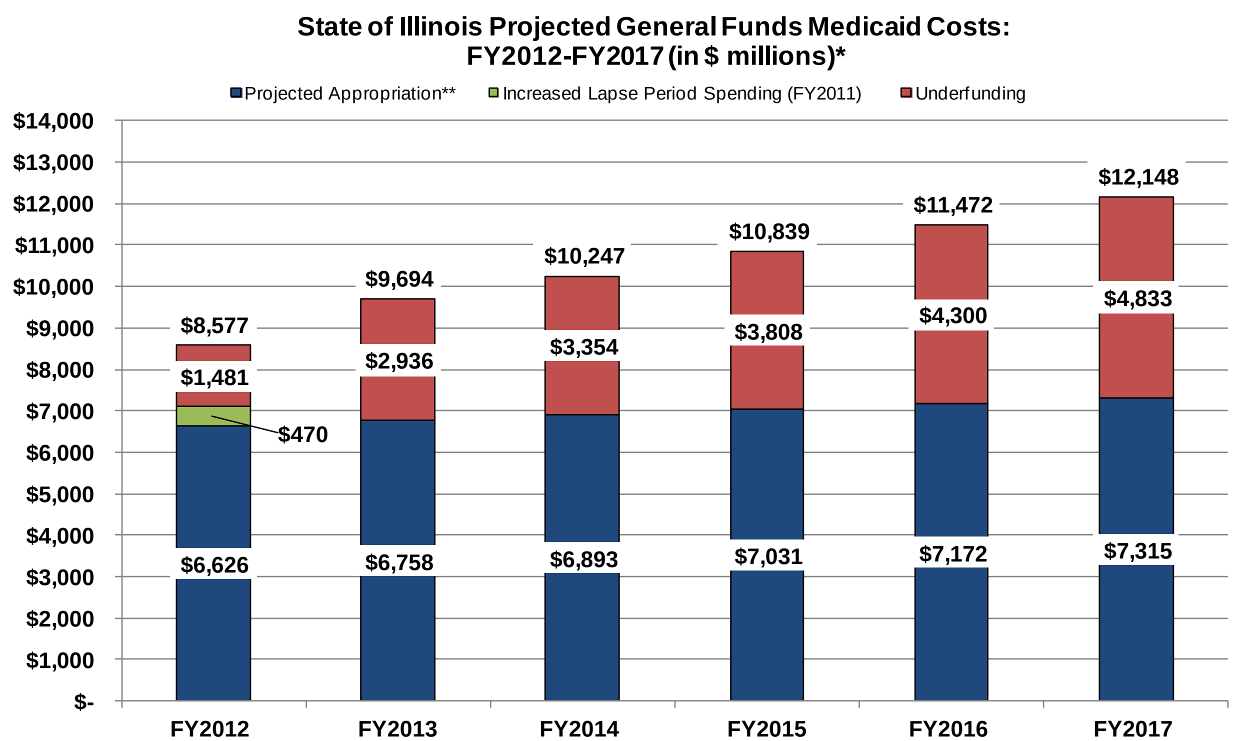
[47] The Illinois Department of Healthcare and Family Services (HFS) administers the State's Medicaid program and accounts for most of its spending, but roughly $2 billion a year in expenditures are made by other agencies. Although HFS' Medical Assistance program is the best available approximation to the Medicaid program, roughly 10% of its appropriations are outside of the Medicaid program.

[48] Illinois Department of Healthcare and Family Services, *Annual Report Medical Assistance Program Fiscal Years 2008, 2009, 2010*, April 1, 2011, p.17 and communication between the Civic Federation and the Illinois Department of Healthcare and Family Services, January 10, 2012.

[49] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

[50] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

The following chart compares projected General Funds Medicaid costs with appropriations. In its analysis, HFS assumed that appropriations would increase by 2% a year from FY2012 to FY2017.[51] HFS' total General Funds costs for FY2012 reflect $470 million of increased lapse period spending for FY2011.



* The Illinois Department of Healthcare and Family Services' Medical Assistance program is used as the best available approximation to the Medicaid program. The Medical Assistance program includes most of the State's Medicaid operations; however, it does not include Medicaid-funded programs run by other state agencies and includes certain activities that are not part of the Medicaid program.
** Projected' appropriations for FY2013 to FY2017 are assumed to increase by 2% a year.
Source: Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

[51] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

The next table shows five-year projections of the growth in unpaid Medicaid bills, based on HFS' analysis.[52] Unpaid bills increase in FY2012 because the program is underfunded by approximately $1.5 billion. As a result, the backlog of unpaid Medicaid bills is expected to grow to roughly $1.8 billion by the end of FY2012 from approximately $300 million at the end of FY2011, meaning that it will take longer for healthcare providers to be paid. If the increase in Medicaid appropriations were limited to 2% a year going forward, unpaid Medicaid bills would grow to $21.0 billion by the end of FY2017.

State of Illinois Projected Unpaid Medicaid Bills: FY2012-FY2017 (in $ millions)*

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Unpaid Bills Beginning of Year	$ 291	$ 1,772	$ 4,708	$ 8,062	$ 11,870	$ 16,170
Increase in Unpaid Bills**	$ 1,481	$ 2,936	$ 3,354	$ 3,808	$ 4,300	$ 4,833
Unpaid Bills End of Year	**$ 1,772**	**$ 4,708**	**$ 8,062**	**$ 11,870**	**$ 16,170**	**$ 21,003**

*The Illinois Department of Healthcare and Family Services' Medical Assistance program is used as the best available approximation to the Medicaid program. The Medical Assistance program includes most of the State's Medicaid operations; however, it does not include Medicaid-funded programs run by other state agencies and includes certain activities that are not part of the Medicaid program.

**General Funds Medicaid appropriations are assumed to increase by 2% a year.

Source: Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook* , January 2012.

Annual Medicaid costs can exceed appropriations because State law allows Medicaid expenses, unlike most other State expenses, to be paid from future years' appropriations.[53] This provision of Section 25 of the State Finance Act has repeatedly been used to budget an insufficient amount of Medicaid appropriations to cover costs for a given fiscal year, knowing that the bills will be paid from the next year's appropriations.[54] The amount of Medicaid liabilities deferred under this provision, known as Section 25 liabilities, was lower between FY2009 and FY2011 than in the mid-2000s because of a requirement under the American Recovery and Reinvestment Act of 2009 (ARRA) that certain Medicaid payments be made within 30 days.[55]

Medicaid funding is extremely complex. State Medicaid expenditures are reimbursed by the federal government at a rate known as the Federal Medical Assistance Percentage (FMAP). The FMAP for Illinois rose to 61.88% as a result of ARRA but has dropped back to 50% since stimulus funding ended on June 30, 2011.

In addition to General Funds, the Medicaid program receives funding from a number of other sources, including rebates paid by prescription drug manufacturers, proceeds from the settlement of tobacco-related litigation and payments by local governments and healthcare providers that are structured to enhance federal reimbursements. These other funding sources outside the General Funds are relatively stable.

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[52] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.
[53] 30 ILCS 105/25. Medicaid reform legislation (Public Act 96-1501) enacted in January 2011 phases out this provision by FY2021, but the projected levels of Section 25 liabilities would exceed the limits in the legislation beginning in FY2014. The limits are: $6.0 billion for FY2012, $5.3 billion for FY2013, $4.6 billion for FY2014, $4 billion for FY2015, $3.3 billion for FY2016, $2.6 billion for FY2017, $2.0 billion for FY2018, $1.3 billion for FY2019, $600.0 million for FY2020 and zero thereafter.
[54] Illinois State Comptroller, "The Section 25 Budget 'Loophole'," *Fiscal Focus*, July 2008, p.7.
[55] Illinois State Comptroller, "The State Fiscal Crisis—How Did We Get Here," *Fiscal Focus*, September 2011, p. 7.

General Funds appropriations in the State budget are gross amounts, meaning they represent authorized state spending before netting out federal reimbursements. In simple terms, a $1 reduction in State Medicaid spending results in a 50-cent reduction in federal reimbursement and a net State saving of 50 cents.

Simply reducing Medicaid appropriations will not reduce Medicaid spending. Medicaid is an entitlement program under which certain categories of low-income people who meet eligibility requirements are entitled to specified medical services. To reduce Medicaid spending would require reductions in program eligibility, benefits or reimbursement rates paid to healthcare providers such as hospitals, nursing homes and pharmacies.

In attempting to control Medicaid costs, states face restrictions on program reductions. Certain coverage is mandated by the federal government, although states also provide optional benefits. As a condition of continued participation in the Medicaid program, national healthcare reform legislation enacted in 2010 generally required that states not tighten existing eligibility requirements.[56] Several states that have tried to reduce Medicaid costs by cutting rates paid to healthcare providers have faced lawsuits charging that they are not complying with federal law requiring rates to be adequate to assure access to healthcare.[57] The U.S. Supreme Court heard arguments in October 2011 in a case involving California's attempt to cut Medicaid payment rates.[58]

In Illinois' FY2012 budget, Medicaid appropriations were reduced from Governor Quinn's recommended level without being accompanied by significant program cuts. The General Assembly rejected the Governor's proposal to reduce reimbursement rates for hospitals and other healthcare providers by 6%. The legislature also rejected the Governor's proposal to eliminate a prescription drug program for seniors for which the State is not reimbursed by the federal government. Instead, spending on the program was cut in half by restricting income standards for eligibility. Eligibility standards for Illinois Cares Rx could be tightened because spending on the program is not federally reimbursed. As indicated in the previous chart, this year's underfunding of the General Funds Medicaid budget by approximately $1.5 billion will lead to an increase in unpaid Medicaid bills at the end of FY2012 and longer payment delays for healthcare providers.

HFS' five-year projections assume savings due to Medicaid reform legislation enacted in Illinois in January 2011.[59] The legislation is designed to make significant long-term changes in the State's Medicaid program, including enrolling half of recipients in coordinated care programs by January 1, 2015. The goal of coordinated or managed care is to provide financial incentives to healthcare providers to provide better preventive care and to limit unnecessary medical services. Illinois launched its first experiment with mandatory Health Maintenance Organization (HMO) coverage of Medicaid recipients in May 2011. The pilot program in the Chicago suburbs covers approximately 40,000 elderly and disabled people, the most expensive categories of Medicaid recipients. HFS assumes savings of $350 million due to coordinated care for the five-year period

[56] The Patient Protection and Affordable Care Act, P.L. 111-148, as amended by the Health Care and Education Reconciliation Act of 2010, P.L. 111-151, together known as the Affordable Care Act, Section 2001(b). The requirement specifies that existing coverage must remain in place until an insurance exchange established by a state under the Act is determined to be fully operational, which is likely to be January 2014.
[57] Christine Vestal, "Medicaid: a year of excruciating decisions," *Stateline*, January 11, 2012, http://www.stateline.org/live/details/story?contentId=624072 (last visited on January 11, 2011).
[58] Adam Liptak, "For Justices' First Day Back, a Knotty Case Involving Medicaid Cutbacks, *New York Times*, October 4, 2011.
[59] Public Act 96-1501.

beginning in FY2013.[60] These numbers include federal reimbursements, meaning that net State savings would be approximately half as much after the reduction in federal revenues.

HFS' projections do not reflect the impact of national healthcare reform. Beginning in 2014, Medicaid will cover needy, non-elderly adults without children. Although the federal government is scheduled to pay for 100% of the costs of newly eligible recipients through 2016, the program's expansion is also expected to increase enrollment of those who were previously eligible but had not signed up for the program.[61] The State will pay roughly 50% of the costs of those participants. A recent analysis for HFS estimated that 296,356 new recipients would enroll in FY2014 and that additional State cost would be between $136.2 million and $224.7 million.[62]

Pensions

General Funds pension costs are projected to increase by 35.2% from $5.7 billion in FY2012 to $7.8 billion in FY2017. Pension-related costs include statutorily required State pension contributions and debt service on pension bonds. Pension costs are projected to increase from 17.1% of total General Funds expenditures in FY2012 to 21.6% in FY2017.

In the chart below, contribution projections for FY2013 to FY2015 are from the Governor's Office of Management and Budget.[63] For FY2016 and FY2017, contribution projections are based on data contained in actuarial valuation reports as of June 30, 2011 for the State's five retirement systems.[64] The chart also includes the total General Funds debt service cost of outstanding Pension Obligation Bonds (POBs).[65]

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[60] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

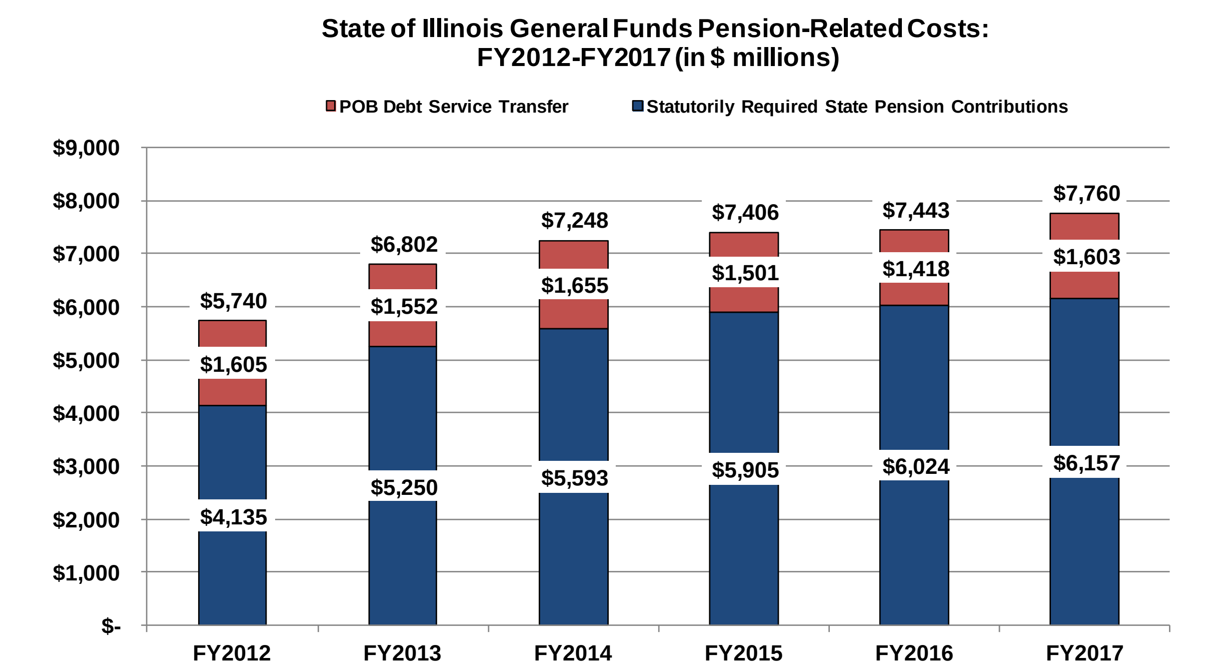
[61] John Holahan and Irene Headen, Kaiser Commission on Medicaid and the Uninsured, *Medicaid Coverage and Spending in Health Reform: National and State-by-State Results for Adults at or Below 133% FPL*, May 2010, p. 4.

[62] Illinois General Assembly Advisory Committee on Medicaid, Costs 2014, HFS Handouts, November 8, 2011.

[63] Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY13-FY15*, January 3, 2012. http://www.state.il.us/budget/2012%20Three%20Year%20Projection.pdf (last visited on January 4, 2012).

[64] Data from the systems' actuarial valuation reports as of June 30, 2011 were adjusted to conform to pension contributions in the State's General Funds budget plan. The SERS General Funds contribution was assumed to be 66% of the total certified SERS contribution; $1.2 million for minimum retirement benefits was added to the TRS contribution; and $40 million in non-state employer contributions was deducted from the SURS contribution. Projections for FY2013 to FY2017 do not include State contributions to the Public School Teachers' Pension and Retirement Fund of Chicago ($10.4 million in FY2012), the College Insurance Program ($4.4 million in FY2012) or the Teachers' Retirement Insurance Program ($87.6 million in FY2012) but do include a portion of debt service on 2003 Pension Obligation Bonds collected by SERS through payroll deduction ($54.3 million in FY2012).

[65] Communication between the Civic Federation and the Governor's Office of Management and Budget, January 5, 2012. Annual General Funds transfers to the General Obligation Bond Retirement and Interest (GOBRI) Fund to pay principal and interest owed for POBs vary from total debt service owed due to statutorily required advance transfers and supplemental funding sources available in the GOBRI Fund, such as interest earned on fund balances, capitalized interest, payments from other funds and unspent bond proceeds.



Source: Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY13-FY15*, January 3, 2012; Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012*, August 2011, p. 185. Civic Federation projections based on: Teachers' Retirement System, *June 30, 2011 Actuarial Valuation Results,* Memorandum to Board of Trustees from Kathleen Farney, October 19, 2011; State Universities Retirement System, "2013 Statutory Contribution--The Facts," *news release*, November 18, 2011; State Universities Retirement System, *Draft Actuarial Valuation Report as of June 30, 2011*, November 9, 2011; State Employees' Retirement System of Illinois, *Annual Actuarial Valuation as of June 30, 2011*, October 25, 2011, p. 8; Judges' Retirement System, *Actuarial Valuation as of June 30, 2011*, October 25, 2011, p. 12; General Assembly Retirement System, *Actuarial Valuation as of June 30, 2011*, October 24, 2011, p. 13.

State pension contributions are determined by a 50-year funding plan that began in FY1996.[66] After a phase-in period of 15 years, the law requires State contributions at a level percentage of payroll sufficient to achieve a 90% funded ratio by the end of FY2045. The retirement systems calculate and certify by November 15 of each year the amounts needed from the State to meet the funding requirements for the next fiscal year. As of June 30, 2011, the systems had total unfunded liabilities of $83.1 billion and a combined funded ratio of 43.3%.[67]

To reduce pension costs, the State in April 2010 created a two-tier benefits system with a lower level of benefits for workers hired on or after January 1, 2011.[68] The new tier of benefits includes higher retirement ages, a maximum pensionable salary and lower cost of living adjustments. As a result of the changes, total statutorily required State contributions are expected to decline significantly through 2045.[69]

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[66] Public Act 88-0593. The five retirement systems are the Teachers' Retirement System (TRS), the State Employees' Retirement System (SERS), the State Universities Retirement System (SURS), the Judges' Retirement System (JRS) and the General Assembly Retirement System (GARS).

[67] Commission on Government Forecasting and Accountability, *Monthly Briefing*, November 2011, p. 10. The statistics in the text are based on the market value of assets, rather than the smoothed value of assets, in which unexpected investment gains or losses are recognized over a five-year period. Market value is widely believed to provide a more realistic valuation of the true financial position of a retirement system. A funded ratio shows the percentage of accrued liabilities that are covered by assets. For more information on the State's pension systems, see Commission on Government Forecasting and Accountability, *A Report on the Financial Condition of the Illinois State Retirement Systems as of June 30, 2010*, March 2011.

[68] Public Act 96-0889.

[69] Commission on Government Forecasting and Accountability, *A Report on the Appropriateness of the 90% Funding Target of Public Act 88-593*, June 2011, p. 27.

In the short term, however, the pensionable salary cap for new employees will lead to higher State contributions.[70] With State contributions calculated as a level percentage of payroll for existing and new employees, higher contributions are needed in the earlier years to offset decreasing payroll growth in later years when the workforce is increasingly made up of employees hired on or after January 1, 2011. Four of the retirement systems did not take this change into account until recently, leading to large increases in their certified contributions for FY2013.[71]

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

Under the legislation that authorized the FY2003 POBs, the State's statutorily required pension contributions are reduced by the annual debt service owed on the bonds.[72] The original FY2003 POBs were financed over 30 years and the last bonds will be retired in FY2033.

The State pays debt service owed on the FY2011 and FY2012 POBs from General Funds without any deductions from statutorily required pension contributions. The FY2010 POBs are retired over five years and the FY2011 series are eight-year bonds. The principal repayment on the FY2011 POBs is delayed until after the majority of the FY2010 bonds have been repaid. This back loading of the principal for the FY2011 POBs keeps the aggregate debt service owed on both series relatively level but significantly increases the total cost of the FY2011 bonds.

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

The State will repay a total of $16.3 billion in outstanding POB principal with interest costs of $9.5 billion, for a total of $25.8 billion in POB debt service between FY2012 and FY2033. The following chart shows the total pension related debt service owed by the State on all outstanding POBs.[73]

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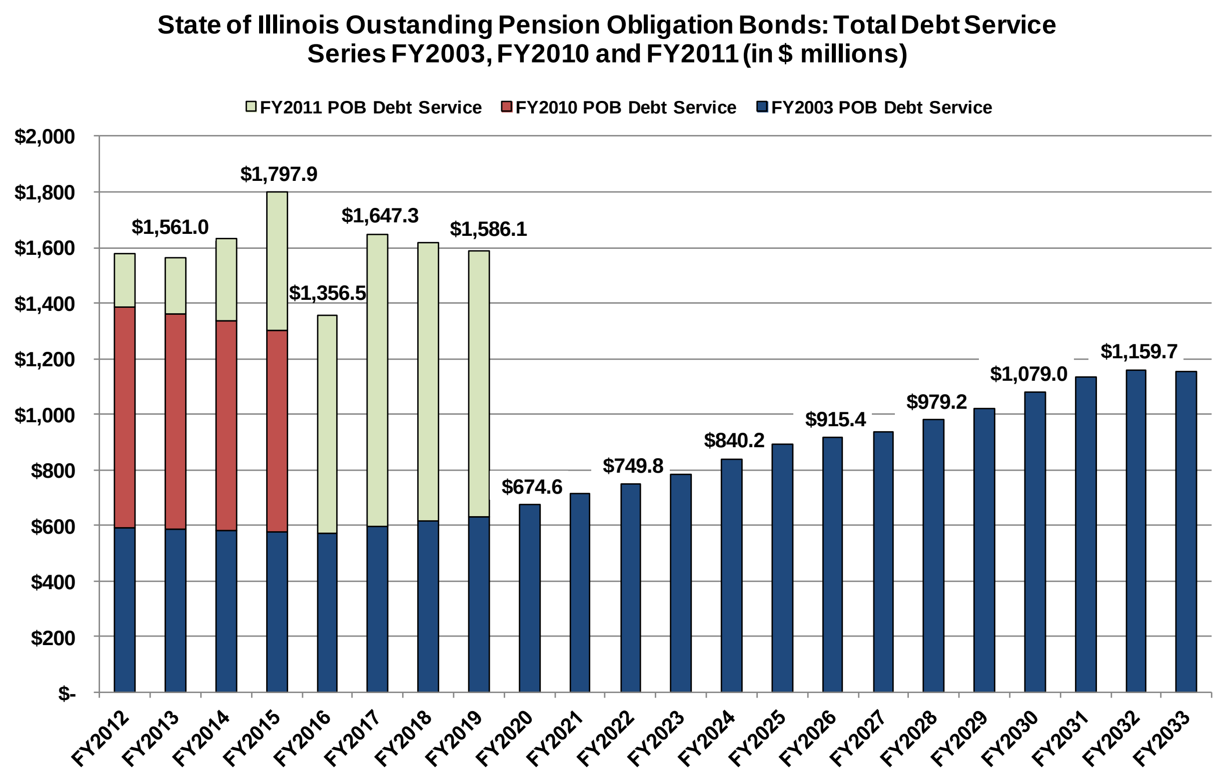
[70] State Universities Retirement System, "2013 Statutory Contribution—The Facts," *news release,* November 18, 2011.
[71] For more information on FY2013 pension contributions, see The Institute for Illinois' Fiscal Sustainability blog, *State Pension Contributions in FY2013 to Exceed Forecasts by $535 Million*, November 21, 2011, http://www.civicfed.org/iifs/blog/state-pension-contributions-fy2013-exceed-forecasts-535-million (last visited on November 30, 2011).
[72] Public Acts 98-593, 94-004, 93-009.
[73] Debt service in the chart varies slightly from annual General Funds transfers to pay amounts owed on the POBs due to statutorily required advance funding transfers and supplemental funding sources available in the General Obligation Bond Retirement and Interest (GOBRI) Fund such as interest earned on fund balances, capitalized interest, payments from other funds and unspent bond proceeds.

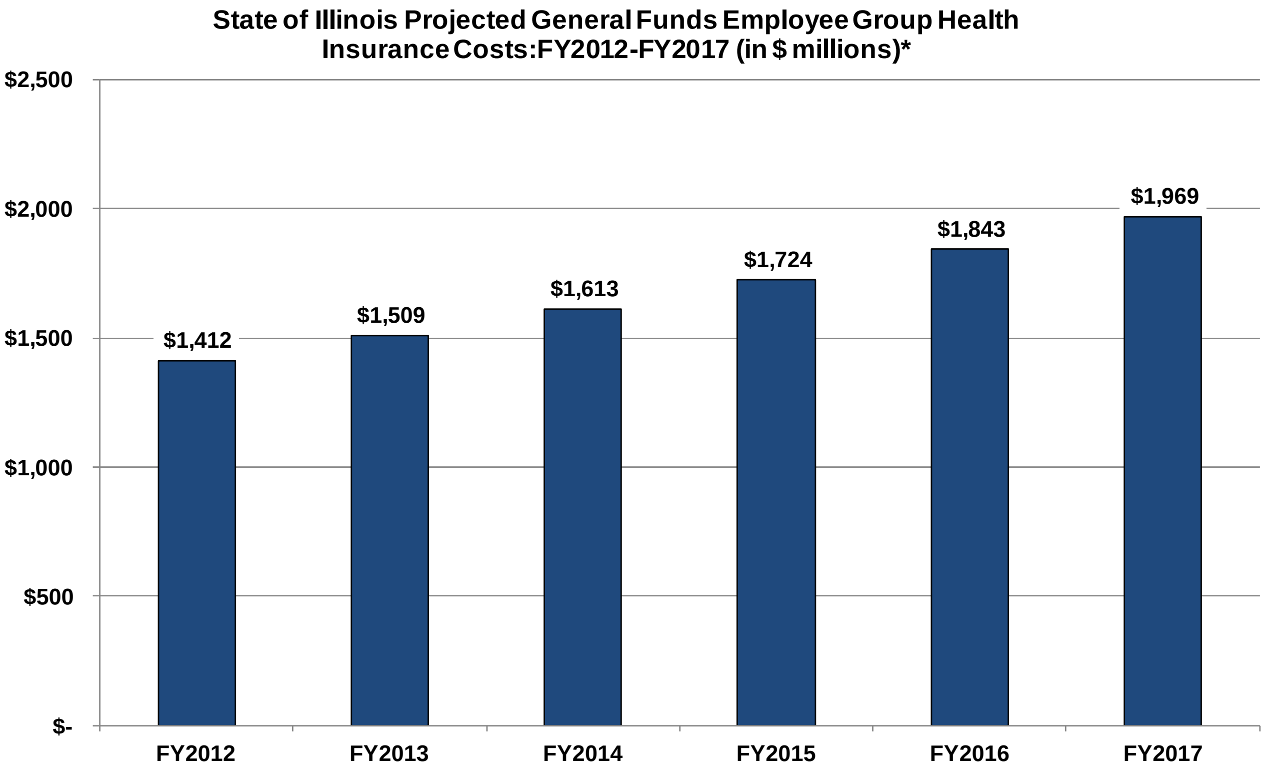


Source: Commission on Government Forecasting and Accountability, *Report on the Financial Condition of the Illinois State Retirement Systems as of June 30, 2010, March 2011*, p.108. See Appendix XX for details on principal and interest components of each POB series.

State Group Health Insurance

The State Employees' Group Insurance Program provides health insurance coverage to an estimated 355,428 participants, including employees and retirees and their dependents.[74] Costs of the program, estimated to total $2.4 billion in FY2012, are paid from General Funds and other sources, including the State's Road Fund, State universities and member contributions.[75]

General Funds costs for employee group health insurance are projected to increase by 39.4% from $1.4 billion in FY2012 to nearly $2.0 billion in FY2017. In the chart below, projections for FY2013 to FY2017 assume a compound annual growth rate of approximately 6.7%.[76]



*Projections for FY2013-FY2017 based on compound annual growth rate of 6.688% for total group health costs from FY2007-FY2011.
Source: Email communication between the Civic Federation and the Governor's Office of Management and Budget, August 11, 2011; Civic Federation projections based on Commission on Government Forecasting and Accountability, Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012, March 2011, p. 8.

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[74] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 6.

[75] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 3. FY2012 costs were difficult to estimate because of a dispute involving the awarding of managed care contracts by the Illinois Department of Healthcare and Family Services. For more information on the dispute, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog, "Court Likely to Decide Dispute Over State Employee Health Insurance," July 28, 2011, at http://www.civicfed.org/civic-federation/blog/court-likely-decide-dispute-over-state-employee-health-insurance (last visited on December 7, 2011).

[76] Civic Federation calculation based on increase in total State group health liabilities from FY2007 to FY2011. See Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 8.

The State offers both a traditional health insurance plan, which allows participants to choose any doctor or hospital, and managed care plans such as Health Maintenance Organizations (HMOs), which generally restrict choices. The traditional health plan is more costly and requires participants to pay higher premiums. Membership in the traditional plan declined by 17.9% to an estimated 117,154 participants in FY2012 from 142,779 in FY2005.[77] In FY2012 67.0% of total participants were expected to be enrolled in managed care.

Retirees overwhelmingly choose the more expensive traditional health plan. In FY2011 two-thirds of retirees were enrolled in the traditional plan.[78] Illinois law provides that State employees who retired before January 1, 1998 and those who retired after that date with at least 20 years of service do not pay healthcare premiums.[79] Exceptions include General Assembly members, who can retire with as few as four years of service and not pay any premiums, and judges, who can retire with as few as six years of service and not pay premiums.

As of February 2011, 91.0% of the 81,900 retirees covered by the group insurance program were not required to pay any premiums.[80] The State was expected to pay $497.6 million for health insurance coverage for retirees in FY2011, while retirees were expected to pay $12.0 million.[81]

The State makes contributions to the State group health program on a pay-as-you go basis rather than prefunding future obligations to retirees. As of June 30, 2010, the program's accrued liabilities for current and future retirees were estimated at $28.6 billion.[82]

The State also makes General Fund contributions to two other programs, the Teachers' Retirement Insurance Program (TRIP) and the College Insurance Program (CIP), to cover retired teachers outside Chicago and downstate retired community college employees.[83] In FY2012 those contributions were expected to be $87.6 million and $4.4 million, respectively.[84] As of June 30, 2010, TRIP's total accrued liabilities were estimated at $16.1 billion[85] and CIP's total accrued

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[77] Civic Federation calculation based on Commission on Government Forecasting and Accountability, *Fiscal Year 2006 Liabilities of the State Employees' Group Insurance Program*, March 2005, *p. 4;* Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 6.
[78] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 7.
[79] 5 ILCS 375/10. The State contributes 5% of the premium cost for each full year of service, up to a maximum of 100% for retirees with 20 or more years of service.
[80] Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services,* February 17, 2011, p. 2.
[81] Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services,* February 17, 2011, p. 2. These numbers do not include participants' out-of-pocket costs such as co-payments and deductibles.
[82] SEGIP—GASB 45 Projection as of June 30, 2010, Letter from Gabriel Roeder Smith & Company to Illinois Department of Healthcare and Family Services, December 6, 2010.
[83] Certain members of the Teachers' Retirement System are eligible for retiree healthcare benefits under the State Employees' Group Insurance Program rather than under the Teachers' Retirement Insurance Program. See Teachers' Retirement Insurance Program GASB No. 43 Actuarial Valuation Report as of June 30, 2009, January 7, 2010, p. 25.
[84] Email communication between the Civic Federation and the Governor's Office of Management and Budget, August 11, 2011.
[85] TRIP—GASB 43 Projection as of June 30, 2010, Letter from Gabriel Roeder Smith & Company to Illinois Department of Healthcare and Family Services, December 21, 2010.

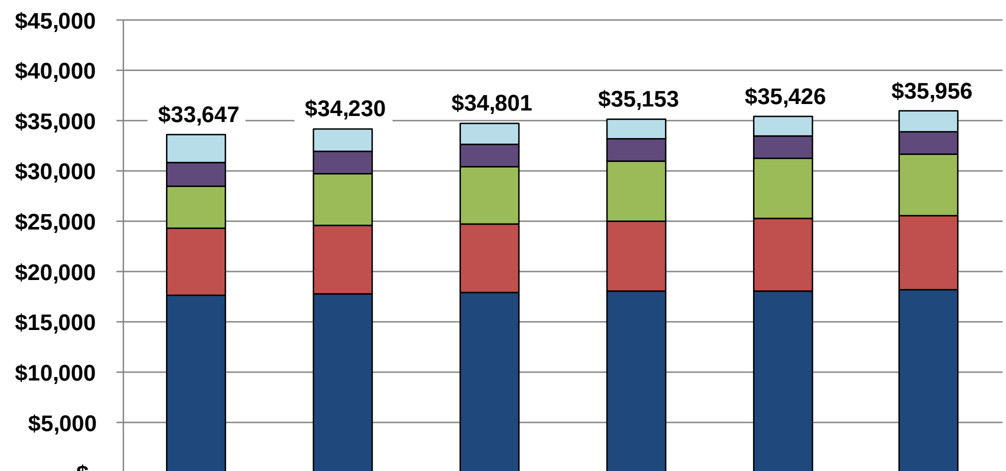
liabilities were estimated at $2.1 billion.[86] Participants in TRIP and CIP, unlike most retirees in the State employee group health plan, are required to pay premiums.

Total Expenditures and Costs

Based on the projections in this section, the State's total General Funds expenditures will increase to approximately $36.0 billion in FY2017, a 6.9% increase from the FY2012 enacted budget of $33.6 billion. The projected increase of $2.3 billion holds expenditures flat in most areas of the budget after FY2012 and does not account for any increases in employee wages or changes in commodity prices. The projections incorporate increases in the annual appropriations for Medicaid that are included in a recent five-year analysis by HFS, which are far below the total anticipated General Funds costs of the program.[87] The projections also take into account increases in statutorily required pension contributions, anticipated group health insurance costs and current estimates of debt service payments and legislatively required transfers.

The following chart compares the enacted FY2012 General Funds budget to projected expenditures for FY2013 through FY2017.

State of Illinois Five-Year Projections: Total General Funds Expenditures FY2012-FY2017 (in $ millions)



	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Total Expenditures	$33,647	$34,230	$34,801	$35,153	$35,426	$35,956
Debt Service and Interfund Transfers	$2,794	$2,186	$2,175	$1,966	$1,861	$1,987
Legislatively Required Transfers Out	$2,366	$2,226	$2,226	$2,226	$2,226	$2,226
Pension Contributions	$4,135	$5,250	$5,593	$5,905	$6,024	$6,157
Medicaid Appropriation*	$6,639	$6,758	$6,893	$7,031	$7,172	$7,315
Base Operating Budget	$17,713	$17,810	$17,914	$18,025	$18,144	$18,270

*Medicaid appropriation assumes the annual 2.0% appropriation increase included in the HFS projections for FY2013-FY2017 but does not account for fully funding General Funds Medicaid costs.
Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY12-FY15*, January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012; Civic Federation calculations based on communications with the Governor's Office of Management and Budget and the Illinois Department of Healthcare and Family Services.

The projections in the chart above show the expected Medicaid appropriations separately from other State agency appropriations. The base operating budget for State agencies increases slightly

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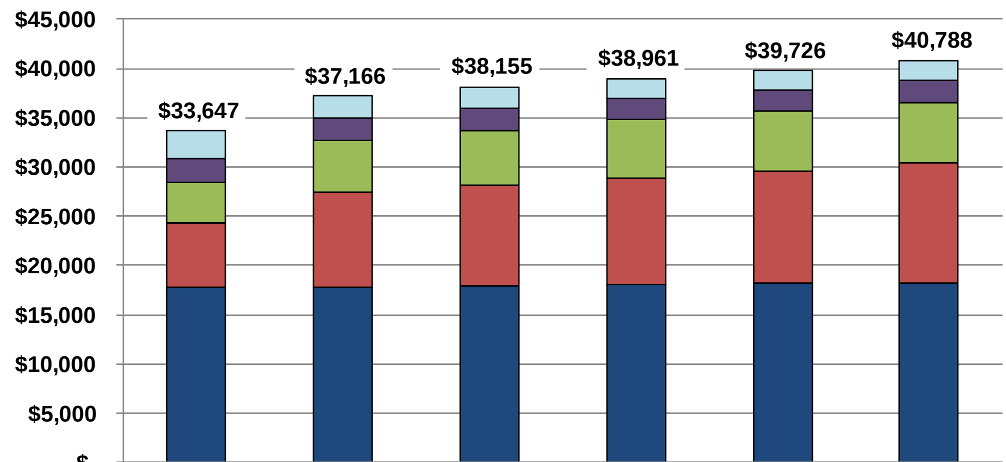
[86] CIP—GASB 43 Projection as of June 30, 2010, Letter from Gabriel Roeder Smith & Company to Illinois Department of Healthcare and Family Services, December 6, 2010.
[87] See page 16 of this report for more details on the State's Medicaid program.

through FY2017 due to the anticipated increase in the cost of the State group health insurance program but holds all other expenditures flat.[88] As discussed earlier in this section, the enacted FY2012 Medicaid appropriation underfunds the total projected General Funds cost by approximately $1.5 billion. The chart above assumes the State will only spend the enacted appropriation of $6.6 billion on Medicaid in FY2012 and will only fund projected appropriations for FY2013 through FY2017 that grow by 2.0% a year, as shown in the HFS analysis. As discussed previously, the Medicaid funding levels in the table above would result in a backlog of unpaid Medicaid bills totaling $21.0 billion by FY2017.

If the State funded the total anticipated annual cost of the Medicaid program rather than limiting annual appropriation growth to 2%, the budget would increase dramatically in FY2013 and each year through FY2017. Accounting for the total anticipated cost of the Medicaid program, projected annual General Funds costs would increase by 10.5%, or $3.5 billion, from $33.6 billion in FY2012 to $37.2 billion in FY2013. By FY2017 total General Funds costs would increase by 21.2% to $40.8 billion in FY2017, a $7.1 billion increase from the enacted FY2012 budget.

The following chart shows total General Funds expenditures enacted for FY2012 compared to total projected General Funds costs for FY2013 to FY2017.

State of Illinois Five-Year Projections: General Funds Total FY2012 Expenditures Compared to Total Costs FY2013-FY2017 (in $ millions)



	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Total Costs	$33,647	$37,166	$38,155	$38,961	$39,726	$40,788
Debt Service and Interfund Transfers	$2,794	$2,186	$2,175	$1,966	$1,861	$1,987
Legislatively Required Transfers Out	$2,366	$2,226	$2,226	$2,226	$2,226	$2,226
Pension Contributions	$4,135	$5,250	$5,593	$5,905	$6,024	$6,157
Total Projected Medicaid Cost*	$6,639	$9,694	$10,247	$10,839	$11,472	$12,148
Base Operating Budget	$17,713	$17,810	$17,914	$18,025	$18,144	$18,270

*The figure for FY2012 is General Funds appropriation.
Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY12-FY15*, January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012; Civic Federation calculations based on communications with the Governor's Office of Management and Budget and the Illinois Department of Healthcare and Family Services.

[88] See page 21 of this report for more details on the State group health insurance program.

In both charts above, the total General Funds projections hold the State's annual legislatively required transfers flat at $2.2 billion from FY2013 forward, following data provided in the Governor's three-year projections.[89]

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

Total debt service transfers, including amounts needed to repay interfund borrowing from FY2011, decline by $167.2 million from $2.2 billion in FY2012 to approximately $2.0 million in FY2017.

The following chart shows annual General Funds debt service transfers on all outstanding capital purpose bonds, pension bonds and repayment of interfund borrowing from FY2012 through FY2017.[90]

State of Illinois General Funds Debt Service: Total General Funds Transfer FY2012-FY2017 (in $ millions)

Bond Type	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Capital Bonds						
Existing Capital Bonds	$ 535.6	$ 481.7	$ 507.4	$ 452.4	$ 430.4	$ 371.4
Illinois Jobs Now Capital Bonds	$ 12.9	$ 12.7	$ 12.5	$ 12.4	$ 12.1	$ 11.9
Total Capital Transfer	**$ 548.5**	**$ 494.4**	**$ 519.9**	**$ 464.8**	**$ 442.6**	**$ 383.3**
Pension Bonds						
2003 POB	$ 559.8	$ 556.1	$ 552.2	$ 548.2	$ 546.2	$ 566.8
2010 POB	$ 784.7	$ 763.6	$ 738.0	$ 361.9	-	-
2011 POB	$ 261.0	$ 232.8	$ 364.8	$ 591.0	$ 872.0	$ 1,036.7
Total POB Transfer	**$ 1,605.5**	**$ 1,552.5**	**$ 1,655.0**	**$ 1,501.1**	**$ 1,418.3**	**$ 1,603.5**
Interfund Borrowing Transfer	**$ 626.0**	**$ 140.0**	**$ -**	**$ -**	**$ -**	**$ -**
Total Debt Service Transfer	**$ 2,154.0**	**$ 2,046.9**	**$ 2,174.9**	**$ 1,965.9**	**$ 1,860.8**	**$ 1,986.8**

Source: Communication between Civic Federation and Governor's Office of Management and Budget, January 5, 2012.

Although the decline in total debt service transfers will provide some budgetary relief, the annual debt service owed by the State is still much higher than in recent years. In FY2009 the General Funds transfer for debt service totaled $1.1 billion. In FY2010 and FY2011, the State issued $7.2 billion in Pension Obligation Bonds (POBs) to make its annual pension contributions. As shown in the chart above, there is a slight decline in POB debt service in FY2015 attributable to the final retirement of the FY2010 POBs. However, as principal repayment on the FY2011 and FY2003 POBs will continue to increase, debt service transfers will begin to rise again in FY2017 and beyond.

The State enacted spending caps for FY2012 through FY2015 as part of the income tax increase

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

[90] Communication between Civic Federation and Governor's Office of Management and Budget, January 5, 2012.

legislation passed in January 2011.[91] If the State budget exceeds the caps, the income tax rates revert to the original levels for that year. The personal income tax rate would decline from 5.0% to 3.0% and the corporate income tax would decline from 7.0% to 4.8%. The spending limits are $36.8 billion for FY2012, $37.6 billion for FY2013, $38.3 billion for FY2014 and $39.1 billion for FY2015.

The FY2012 enacted budget totaling $33.6 billion is well below the spending cap of $36.8 billion. The General Funds expenditure projections in the first chart in this section, which do not account for fully funding all Medicaid program costs, remain well below the spending caps with expenditures of $34.4 billion in FY2013, 34.8 billion in FY2014 and $35.2 billion in FY2015.

The second set of estimates, which fully fund total anticipated Medicaid costs, come much closer to the spending caps. The General Funds budgets based on projected costs total $37.2 billion in FY2013, $38.2 billion in FY2014 and $39.0 billion in FY2015. It is important to recognize that the General Funds projections are very conservative estimates of the annual cost of funding State operations and do not account for annual increases outside of pensions, Medicaid and group health insurance.

General Funds Revenues

General Funds revenues are primarily made up of income taxes and sales taxes levied by the State and funds provided by the federal government. The majority of federal revenues are reimbursements to the State for Medicaid expenditures.[92] General Funds revenues from State and federal sources are projected to decrease by 1.3% to $32.7 billion in FY2017 from $33.1 billion in FY2012.

Income taxes, which make up more than half of the total General Funds revenues, are by far the State's largest source of revenue. The change in the personal and corporate income tax rates enacted in January 2011 has dramatically increased the resources available to support State operations through FY2014.[93] However, as noted in the review of the Governor's three-year projections on page 11, the partial sunset of the income tax rate scheduled for January 1, 2015 will also lead to a significant reduction in resources in FY2015. The five-year projections in this chapter show the additional decline in revenues in FY2016 due to a full year of the lower income tax rates. Moreover, in the fall veto session, the General Assembly passed a large package of tax exemptions and credits, also known as tax expenditures, for corporations, individuals and the working poor that will reduce General Funds revenues in the coming years.

The following revenue projections include trends for State-source revenues as currently enacted. Federal revenues projections are based on reimbursements for Medicaid appropriations as enacted for FY2012 and appropriation levels included in the analysis by the Illinois Department of Healthcare and Family Services (HFS) for FY2013 through FY2017, which are far lower than the total expected costs of the program.

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[91] Public Act 1496.

[92] State Medicaid expenditures are generally reimbursed at a 50% rate. See the Medicaid section of this chapter on page 16 for more details on these expenditures.

[93] Public Act 96-1496.

The following revenue projections are based on the growth trends presented in the Governor's three-year projections. This analysis is intended to provide a rough indication of the resources available to the State in the next five budget cycles.

State-Source Revenues

State-source revenue trends in this section are based on the Governor's three-year projections and are extended to FY2016 and FY2017 to show a five-year outlook. In preparing its estimates, the Governor's Office of Management and Budget (GOMB) increased base personal income tax revenues by between 2.5% and 4% annually and base corporate income tax revenues at a rate of 2.5% annually.[94] Based on the GOMB projections for the next three years, sales taxes are assumed to grow at a compound annual rate of 2.16% through FY2017. All other State sources and transfers-in are shown at relatively flat growth rates from the GOMB projections of 0.99% and 0.89%, respectively.

Although the projections assume the annual growth rates discussed above, they also have been adjusted to take into account factors such as the income tax rate changes in FY2015 when the personal income tax is scheduled to be reduced to 3.75% from 5.0% and the corporate rate declines from 7.0% to 5.25%.[95]

Total State-source General Funds revenues are projected to decline by 3.9% to $28.2 billion in FY2017 from $29.3 billion in FY2012. The decline is entirely due to the lower income tax rates that take effect in FY2015; all other revenues sources are projected to increase over the next five fiscal years.

As shown in the table below, State-source revenue projections will fluctuate more dramatically in the intervening years. After increasing by $1.4 billion to a total of $30.8 billion in FY2014, State-source General Funds revenues fall to $29.3 billion in FY2015 and to their lowest point in the five-year projection in FY2016, totaling $27.3 billion. In FY2016 the State's operating resources are projected to be $2.1 billion or 7% lower than FY2012.

[94] Communication between Civic Federation and the Governor's Office of Management and Budget, January 10, 2012. Base personal income tax growth is calculated using the average growth for FY2016 and FY2017from the Governor's three-year projections of 3.25%.

[95] The State also collects an additional 2.5% Personal Property Replacement Tax on corporate income that is passed through to local governments, increasing the current total effective tax rate on corporations to 9.5% and after January 1, 2015 to 7.75%.

The following chart shows projected State-source General Funds revenues by source for FY2012 through FY2017.

State of Illinois Five-Year General Funds Revenue Projections:* Total State Sources FY2012-FY2017 (in $ millions)						
Revenue Source	**FY2012 GOMB Projected**	**FY2013 GOMB Projected**	**FY2014 GOMB Projected**	**FY2015 GOMB Projected**	**FY2016 Civic Fed. Projected**	**FY2017 Civic Fed. Projected**
State Taxes and Fees						
Personal Income Tax (net)	$ 15,062.0	$ 15,273.0	$ 15,791.0	$ 14,315.0	$ 12,498.6	$ 12,904.8
Corporate Income Tax (net)	$ 2,354.0	$ 2,550.0	$ 2,718.0	$ 2,446.0	$ 2,050.9	$ 2,102.2
Sales Taxes	$ 7,100.0	$ 7,235.0	$ 7,385.0	$ 7,570.0	$ 7,733.5	$ 7,900.6
Other State Sources	$ 2,969.0	$ 3,029.0	$ 3,019.0	$ 3,049.0	$ 3,076.1	$ 3,349.9
Subtotal State Taxes & Fees	**$ 27,485.0**	**$ 28,087.0**	**$ 28,913.0**	**$ 27,380.0**	**$ 25,359.2**	**$ 26,257.5**
Transfers-In	$ 1,826.0	$ 1,844.0	$ 1,862.0	$ 1,881.0	$ 1,899.6	$ 1,918.4
Total State Sources	**$ 29,311.0**	**$ 29,931.0**	**$ 30,775.0**	**$ 29,261.0**	**$ 27,258.8**	**$ 28,175.9**

*FY2016 and FY2017 base revenue increases are calculated at the following growth rates: personal income tax 3.25%, corporate income tax 2.5%, sales taxes 2.16%, other state sources 0.89% and transfers in 0.99%.

Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY13-FY15* , January 3, 2012; communication between the Civic Federation and the Governor's Office of Management and Budget, January 9, 2012.

The General Funds revenue projections in this section also take into account increases in tax exemptions and credits, known as tax expenditures, passed in the veto session that will reduce State revenue.[96] Public Act 97-0636 and Public Act 97-0652 are estimated to reduce total General Funds revenues by at least $236.4 million in FY2013 and $371.4 million in FY2014.[97]

The largest business tax break included in the package was a reduction in corporate income tax liabilities for the CME Group, which owns the Chicago Mercantile Exchange and the Chicago Board of Trade. The sales factors for the exchanges will be reduced to 63.77% in FY2013 and 27.4% in FY2014. Currently, the sales factors at the exchanges are 100%, meaning that all of the trades made at the exchanges are considered Illinois sales and taxed at the full corporate tax rate of 7.0%. By reducing the sales factor percentage, the State reduces the corporate income tax liability for CME. This incentive is expected to cost the State $43 million in FY2013 and $85 million in FY2014.

The legislation also included State tax credits worth $15 million for the Sears Corporation over the next 10 years. The bills additionally reduced inheritance tax receipts by increasing the ceiling for the State's estate tax exemption from $2.0 million to $3.5 million beginning on January 1, 2012 and to $4.0 million in FY2013. The estimated cost to the State for the estate tax change totals $41 million in FY2013 and $64 million in FY2014.

As part of the income tax increase legislation passed in January 2011, the State suspended the net operating loss deduction for businesses, other than Subchapter S corporations, through December 31, 2014 in order to maximize receipts from the corporate income tax rate increase.[98] The net operating loss deduction allows businesses reporting a loss in total annual income to reduce future tax liabilities by their losses and spread the amounts out for up to 12 years. It was estimated that suspending the deduction would increase annual State revenues by $250 million. The net operating loss deduction was reinstated through the tax break legislation but capped at $100,000 per year. It is estimated that this change will cost the State $50 million a year. The reinstatement of the rule

[96] Public Act 97-0636, 97-0652.
[97] Kathy Bergen, "Sears-CME tax breaks pass," *Chicago Tribune*, December 14, 2011.
[98] Public Act 96-1496.

does not take effect until December 31, 2012, so it is not expected to affect FY2012 State revenues.

The Earned Income Tax Credit (EITC) is a federal program that allows low and moderate income workers to reduce their tax burden and receive refunds. Since January 1, 2000, Illinois has allowed individuals who qualify for the program to claim 5% of the federal credit toward their State income tax returns. The tax break legislation increases the credit in Illinois to 7.5% in FY2012 and 10% in FY2013, which will cost the State an estimated $55 million and $110 million in the respective fiscal years. The EITC will cost the State a total of $105 million in FY2010 at the 5% level.[99]

The standard individual income tax deduction in Illinois was set at $2,000 on December 31, 2000. Under the new law, that amount increases to $2,050 in FY2013 and thereafter is automatically adjusted equivalent to the Consumer Price Index for All Urban Areas to account for inflation. This tax break is expected to cost the State $30 million in FY2013 and $45 million in FY2014.

The following chart shows cost estimates attributed to the Commission on Government Forecasting and Accountability for the enacted tax changes published in the *Chicago Tribune*.[100]

State of Illinois: Annual Costs of FY2012 Veto Session Tax Expenditure Bills FY2013-FY2014 (in $ millions)		
Public Act 97-0636		
Description	**FY2013**	**FY2014**
CME Sales Factor Change*	$ 43.0	$ 85.0
Live Theater Production Credit	$ 2.0	$ 2.0
Reinstate Net Operating Loss Deduction**	$ 50.0	$ 50.0
Estate Tax Deduction Increase	$ 41.0	$ 64.0
New Champion Labs EDGE Credit	$ 0.4	$ 0.4
Sears Corporation Tax Credit	$ 15.0	$ 15.0
Subtotal	**$ 151.4**	**$ 216.4**
Public Act 97-0652		
EITC	$ 55.0	$ 110.0
Personal Income Tax Exemption Increase	$ 30.0	$ 45.0
Subtotal	**$ 85.0**	**$ 155.0**
Total Tax Incentives	**$ 236.4**	**$ 371.4**

*CME Sales Factor is reduced to 63.77% for the 2013 calendar year and then to 27.54% thereafter.

**Net Operating Loss Deduction was capped at $100,000 through December 31, 2014 and then is fully reinstated.

Source: Kathy Bergen, "Sears-CME tax breaks pass," *Chicago Tribune* , December 14, 2011.

The total cost of the tax expenditures in the table above does not include the cost of other tax credits renewed in the legislation. All business tax credits set to expire in 2011, 2012 and 2013 are automatically renewed and extended for five-years. This supersedes the provisions of the Illinois tax code enacted in 1994 to include an automatic sunset provision for tax credits.[101] The law requires that all tax credits have a “reasonable and appropriate sunset date” and if one is not

[99] Illinois State Comptroller, *Fiscal Year 2010 Tax Expenditure Report*, August 2011, p. 5.
[100] Kathy Bergen, "Sears-CME tax breaks pass," *Chicago Tribune*, December 14, 2011, pp. 1, 10.
[101] 36 ILCS 5/250.

directly enacted all credits sunset five years after they are enacted by the legislature. It is unclear to how many credits the general extension will apply.

The sales tax credits on the sale of ethanol, gasohol and biodiesel set to expire in 2013 are extended to 2018. The gasohol credit cost the State $102 million in FY2010 and the biodiesel credit cost $83 million.[102]

The Research and Development Credit, which predates the automatic sunset provisions, allows companies to reduce their taxable income by 6.5% of any qualifying expenditures that increase research activity in the State. The credit was first enacted on July 1, 1990 and ran through December 31, 2003. The General Assembly extended the credit through December 31, 2011. Although the credit was allowed to expire halfway through FY2011, it is now reinstated and extended through January 16, 2016. Due to the amended expiration date, businesses that made qualifying expenditures over the past year may choose to claim those credits. An earlier version of the bill included a fiscal analysis provided by the Illinois Department of Revenue that estimated the renewal would cost the State $40 million in FY2012 and each year after.[103]

The Governor's three-year revenue growth projections were reduced to account for the losses attributable to the tax break package.[104] However, the exact projections of how much the base revenues were impacted have not been published.

Federal Revenues

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

The Governor's three-year projections assume that federal revenues will increase slightly from $3.8 billion in FY2012 to $4.2 billion in FY2013 and remain flat through FY2015. Spending also remains flat in the Governor's three-year projection.

However, a recent analysis by HFS assumes an annual increase of 2% in General Funds Medicaid appropriations from FY2013 through FY2017.[105] Both the Governor's three-year projections and the HFS projections are far lower the total annual anticipated cost of the program.[106]

In general, the federal government reimburses the State for approximately 50% of its paid Medicaid expenditures. The State only receives federal Medicaid reimbursements after it has actually expended funds on the program. Consequently, the projections for future federal revenues are based on the appropriations projected by HFS rather than total Medicaid program costs, since the total costs far exceed currently enacted State resources.

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[102] Illinois State Comptroller, *Fiscal Year 2010 Tax Expenditure Report*, August 2011, p. B-1.
[103] Illinois Department of Revenue, Fiscal Note Senate Bill 397, House Committee Amendment 3, November 29, 2011.
[104] Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY13-FY15*, January 3, 2012.
[105] HFS is the central agency that administers the Medicaid program for the State of Illinois. Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.
[106] See the Medicaid Program discussion on page 16 for details on the total program cost.

Accounting for the expected annual increase of 2.0% in Medicaid appropriations, total federal revenues are expected to increase to $4.5 billion in FY2017 from $3.8 billion in FY2012.

The following chart shows total federal revenue projections that were included in the Governor's three-year projections and the increase in federal revenues if the State funds Medicaid appropriations as shown in the HFS analysis.

State of Illinois Five-Year Projections: General Funds Federal Revenues
FY2012 to FY2017 (in $ millions)

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Governor's 3-Year Projection	$ 3,830	$ 4,200	$ 4,200	$ 4,200	$ 4,200	$ 4,200
Medicaid Reimbursement Increase*	$ -	$ 60	$ 127	$ 196	$ 266	$ 338
Total Federal Revenues*	**$ 3,830.0**	**$ 4,259.6**	**$ 4,327.2**	**$ 4,396.1**	**$ 4,466.4**	**$ 4,538.1**

*The increase over the Governor's three-year projections is calculated based on the State funding Medicaid appropriations at levels projected by Department of Healthcare and Family Services; For more on Medicaid projections see page 16 of this report.
Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY13-FY15* , January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook* , January 2012.

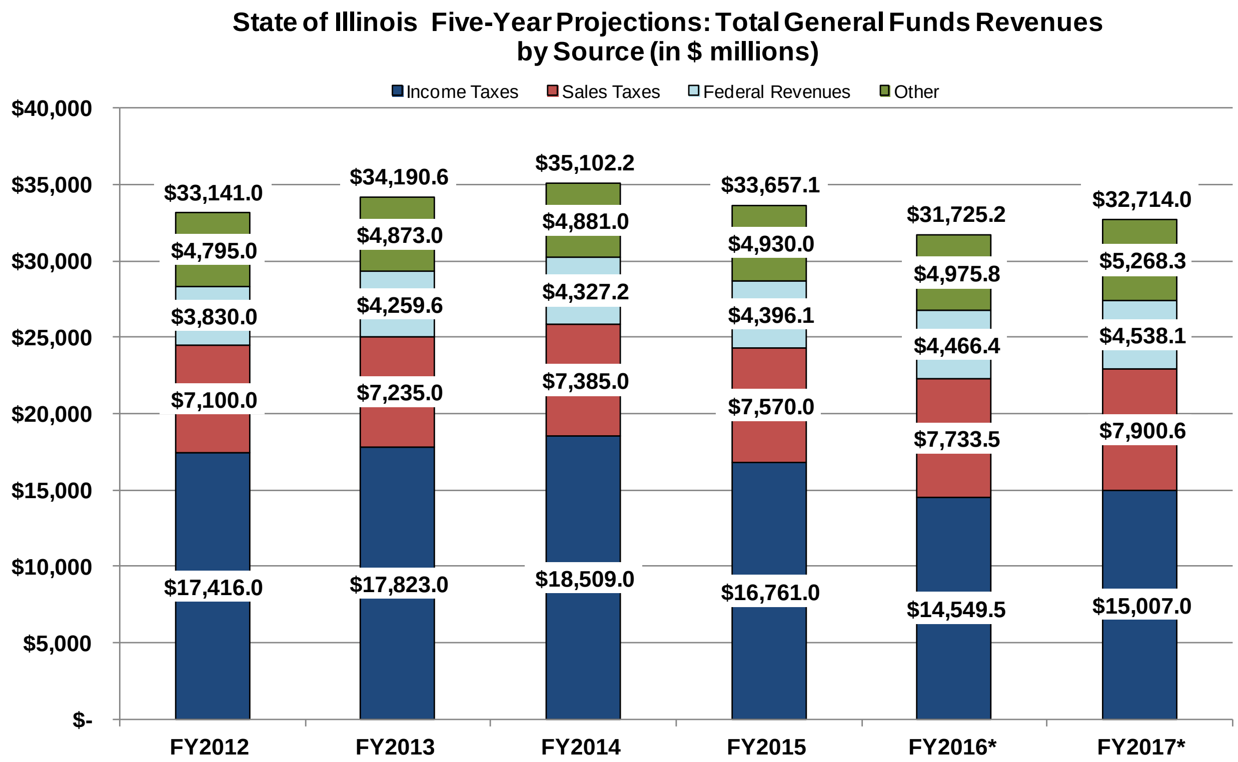
These projections do not account for any increased costs or reimbursements that may accompany the implementation of national healthcare reform scheduled for FY2014. The projections in this section account for savings and reduced reimbursements relating to the Medicaid reforms enacted in January 2011. Any reductions in the program expenditures due to additional Medicaid reforms by the State would also lead to a corresponding loss of 50% of those savings from total General Funds revenues.

Total General Funds Revenues
Combined General Funds revenues from State and federal sources are projected to total $32.7 billion in FY2017. This is a decrease of $427.0 million, or 1.3%, from the FY2012 projection of $33.1 billion.

Increases in some General Funds revenues will be offset by a projected decline of $2.4 billion in total income taxes to $15.0 billion in FY2017 from $17.4 billion in FY2012 due to the scheduled change in income tax rates. The largest increase in revenues over the five years is in State sales taxes, which increase by $800.6 million to $7.9 billion in FY2017 from $7.1 billion in FY2012. Federal revenues increase from $3.8 billion to $4.5 billion due to increased funding for the Medicaid program by 2.0% a year assumed by the HFS five year analysis.[107] These revenues cannot be achieved without increasing the annual appropriation for Medicaid, and are still far lower than the total estimated General Funds cost of the program.

[107] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

The following chart shows total General Funds revenue projections for FY2012 through FY2017 by source.



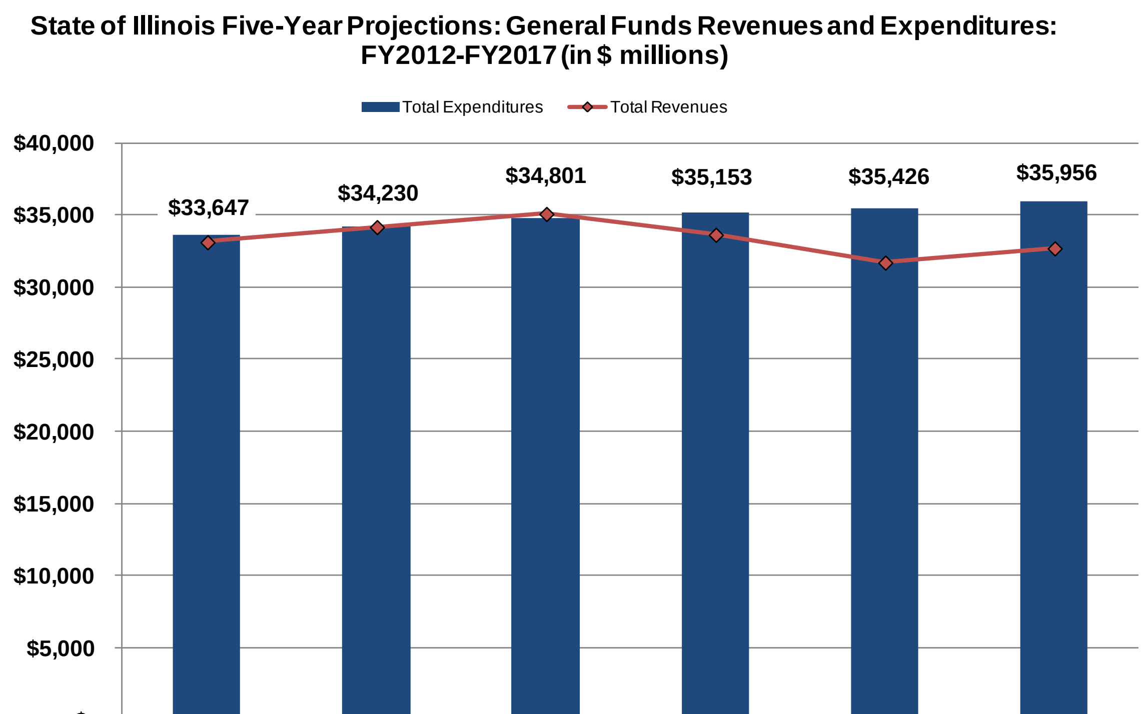
*Civic Federation projections based on growth rates used in Governor's three-year projections.
Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY13-FY15*, January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012; communication between the Civic Federation and the Governor's Office of Management and Budget, January 9, 2012.

General Funds Deficits and Unpaid Bills

The Civic Federation's five-year projections of General Funds expenditures and revenues show that the State of Illinois' operating expenses will exceed revenues in FY2012 and every other fiscal year but one over the next five budgets. This analysis shows that without significant changes to the budget the State will have insufficient resources to fund its current programs, even while significantly underfunding the expected cost of the Medicaid program. It also demonstrates the magnitude of the pending fiscal crisis when the State's increased income tax rates are scheduled to partially sunset halfway through FY2015.

If action is not taken by the Governor and General Assembly to stabilize the State's budget in FY2013 and beyond, Illinois will face continued financial stress and unprecedented backlogs of unpaid bills. The projected operating deficits over the next five years are on par with the imbalances experienced during the recent economic recession, even though moderate recovery in the broader economy is expected during the same period.

The following chart shows total projected General Funds revenues compared to total expenditures from FY2012 through FY2017.



	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Total Expenditures	$33,647	$34,230	$34,801	$35,153	$35,426	$35,956
Total Revenues	$33,141	$34,191	$35,102	$33,657	$31,725	$32,714

Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY12-FY15*, January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012; Civic Federation calculations based on communications with the Governor's Office of Management and Budget and the Illinois Department of Healthcare and Family Services.

As previously discussed, these estimates only take into account known pension contribution increases, 2.0% growth in annual appropriations for Medicaid, the actual cost of debt service transfers and estimated cost increases in the State's group health insurance program. All other State costs are held flat at FY2012 levels.

The projected General Funds operating deficit declines from $508 million in FY2012 to $40 million in FY2013 due to growth in total revenues, reductions in interfund borrowing repayment, a small decline in capital purpose debt service and reduced legislatively required transfers out.

Although the projections show a small surplus in FY2014, annual General Funds deficits increase dramatically in FY2015 and FY2016 due to the reduction in income tax rates and continued expenditure growth.[108] The General Funds operating deficit peaks in FY2016 at $3.7 billion before declining slightly to $3.2 billion in FY2017 due to natural revenue growth.

The following table shows projected General Funds operating deficits from FY2012 through FY2017 by major revenue source and spending category.

State of Illinois Five-Year Projections: General Funds Operating Surplus (Deficit) FY2012-FY2017 (in $ millions)

	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Revenues						
State Source Revenues	$ 29,311	$ 29,931	$ 30,775	$ 29,261	$ 27,259	$ 28,176
Federal Revenues	$ 3,830	$ 4,260	$ 4,327	$ 4,396	$ 4,466	$ 4,538
Total Revenues	**$ 33,141**	**$ 34,191**	**$ 35,102**	**$ 33,657**	**$ 31,725**	**$ 32,714**
Expenditures						
Pension-Related Costs	$ 5,740	$ 6,802	$ 7,248	$ 7,406	$ 7,443	$ 7,760
Medicaid Appropriations	$ 6,639	$ 6,758	$ 6,893	$ 7,031	$ 7,172	$ 7,315
Other Expenditures	$ 21,268	$ 20,670	$ 20,660	$ 20,716	$ 20,812	$ 20,880
Total Expenditures	**$ 33,647**	**$ 34,230**	**$ 34,801**	**$ 35,153**	**$ 35,426**	**$ 35,956**
Operating Surplus (Deficit)	**$ (508)**	**$ (40)**	**$ 301**	**$ (1,496)**	**$ (3,701)**	**$ (3,242)**

Source: Governor's Office of Management and Budget, *Three Year Budget Projections (General Funds), FY12-FY15*, January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012; Civic Federation calculations based on communications with the Governor's Office of Management and Budget and the Illinois Department of Healthcare and Family Services.

These deficits do not include funding to pay down the State's backlog of liabilities at the end of FY2012. Unpaid General Funds bills at the end of FY2012 are expected to increase from $5.2 billion at the end of FY2011 to $5.7 billion due to the operating shortfall described above. If no actions are taken to close the operating deficits described above, the accumulated backlog of unpaid General Funds bills will increase by 144.3% by the end of FY2017 and total $13.8 billion. This assumes the $300 million operating surplus in FY2014 is applied to the backlog of bills at the end of the year and not used on additional expenses or used to increase the State's fund balance.

[108] On January 1, 2015 the personal income tax rate will be reduced from 5.0% to 3.75% and the corporate income tax rate will decline from 7.0% to 5.25%, Public Act 96-1496.

The following table shows the projected growth in General Funds unpaid bills between FY2012 and the end of FY2017 based on the annual deficit projections in the table above.

State of Illinois General Funds: Backlog of Unpaid Bills FY2012-FY2017 (in $ millions)						
	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Unpaid Bills Beginning of Year	$ (5,160)	$ (5,668)	$ (5,708)	$ (5,407)	$ (6,903)	$ (10,604)
Change In Unpaid Bills	$ (508)	$ (40)	$ 301	$ (1,496)	$ (3,701)	$ (3,242)
Unpaid Bills End of Year	**$ (5,668)**	**$ (5,708)**	**$ (5,407)**	**$ (6,903)**	**$ (10,604)**	**$ (13,846)**

Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY12-FY15* , January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook* , January 2012; Civic Federation calculations based on communications with the Governor's Office of Management and Budget and the Illinois Department of Healthcare and Family Services.

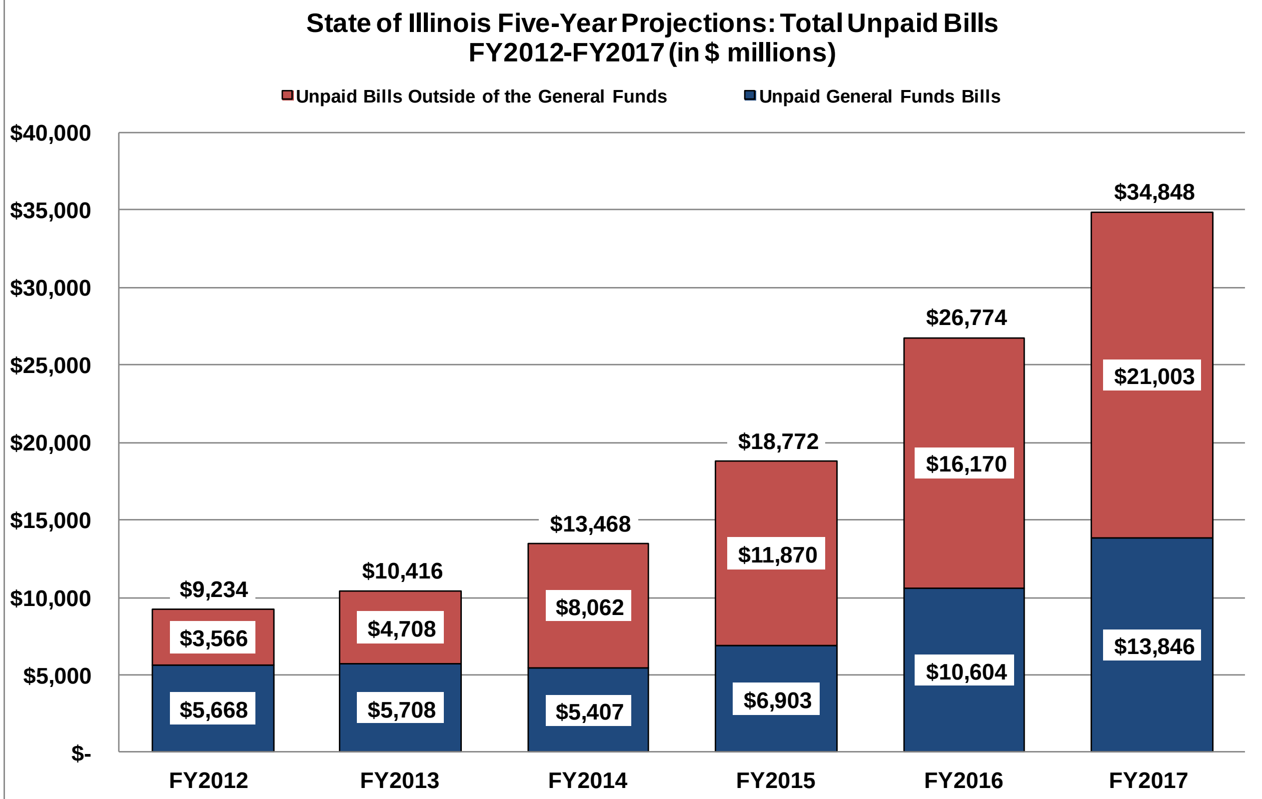
At the end of FY2012, the State is also expected to have liabilities of $3.6 billion outside of the General Funds, including $1.8 billion in Medicaid bills, $1.2 billion of group health insurance claims and $594 million in unpaid business tax refunds. To pay down the total of $9.2 billion in liabilities would effectively cost the State roughly $8.2 billion after accounting for federal reimbursements for Medicaid and the portion of the business income tax refunds not paid from General Funds.

As shown in the table on page 19 of this report, underfunding of the General Funds cost of the Medicaid program based on the recent HFS analysis will cause unpaid Medicaid bills to grow to $21.0 billion by the end of FY2017. Much of this growth is due to the expectation that annual cost increases will far outpace the 2.0% increase in annual appropriations used in the HFS analysis.[109]

If significant changes are not made to bridge the gap between current revenue and expenditure trends, the State's ongoing General Funds operating deficits and underfunding of Medicaid costs will increase the total unpaid bills on hand to $34.8 billion by FY2017. This projection of unpaid bills at the end of FY2017 exceeds total General Funds revenues in that year of $32.7 billion.

[109]See p. 19 of this report for more information on the Medicaid program.

The following chart shows the projected increase in total unpaid bills including General Funds bills and other bills outside of the General Funds from FY2012 through FY2017.



Source: Governor's Office of Management and Budget, *Three-Year Budget Projections (General Funds), FY12-FY15*, January 3, 2012; Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012; Civic Federation calculations based on communications with the Governor's Office of Management and Budget and the Illinois Department of Healthcare and Family Services.

CIVIC FEDERATION RECOMMENDATIONS

This section presents the Civic Federation's recommendations for the State of Illinois' FY2013 budget and long-term reforms to stabilize the State's financial condition. Based on the analysis in this report, the following steps should be pursued by the Governor and General Assembly in developing the FY2013 budget.

Issue 1: State Pensions

The State's underfunded pensions represent an enormous budgetary challenge. The current pension funding law[110] was enacted at the end of FY1995, when total unfunded accrued liabilities stood at approximately $19.5 billion.[111] As of June 30, 2011, the five retirement systems had total unfunded liabilities of $83.1 billion and a combined funded ratio of 43.3%.[112]

Although Illinois' pension funding problems were exacerbated by investment losses in FY2008 and FY2009, they are mainly due to insufficient State funding. The statutory funding plan called for a 90% funded ratio by 2045 but did not require the State to make contributions adequate to keep unfunded liabilities from growing until approximately 2034.[113] Beginning in FY2005, State contributions were reduced by the amount of debt service on pension bonds issued in FY2003.[114] State contributions for FY2006 and FY2007 were also reduced by law.[115]

Pension reforms enacted in 2010 established lower benefits for employees hired on or after January 1, 2011.[116] Even after those reforms, General Funds pension costs including debt service payments on pension bonds are projected to total $7.8 billion, or 21.6% of General Funds spending, in FY2017. [117]

The State's largest retirement system is the Teachers' Retirement System (TRS), which provides coverage to teachers employed by public school districts across the State, excluding the Chicago Public Schools. Although most TRS members are not State employees, the State is responsible for 93.3% of the system's employer funding.[118]

A bill pending in the General Assembly is designed to lower State pension costs and improve funding of the State retirement systems.[119] The bill would require current employees to choose among three options: retaining existing pension benefits but making significantly higher

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[110] Public Act 88-0593.
[111] Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, January 2006, p. i. This statistic is based on the market value of assets.
[112] Commission on Government Forecasting and Accountability, *Monthly Briefing*, November 2011, p. 10. The statistics in the text are based on the market value of assets. A funded ratio shows the percentage of accrued liabilities that are covered by assets.
[113] Commission on Government Forecasting and Accountability, *Report on the 90% Funding Target of Public Act 88-0593*, January 2006, p. 25.
[114] Public Act 93-0002. The bonds will be retired in 2033.
[115] Public Act 94-0004.
[116] Public Act 96-0889.
[117] See p. 20 of this report for more details on the five-year pension cost priojections.
[118] State of Illinois, General Obligation Bonds, Series A of January 2012 and Taxable Series B of January 2012, *Preliminary Official Statement*, January 3, 2012, p. 50.
[119] 97th Illinois General Assembly, Senate Bill 512.

contributions; receiving the reduced benefits now available to new workers (with lower contributions for all employees); or enrolling in a 401(k)-style plan.[120]

State contributions under the bill would be set by statute for FY2013 and then be based on a level percentage of state revenue rather than on a level percentage of payroll, as under current law. Although a complete actuarial analysis of the bill has not been performed, annual State contributions are expected to be higher for seven to ten years, with a substantially higher State contribution in the first year.[121] After several years, annual State contributions would be lower than under current law. State contributions would increase at a much slower rate under the proposed plan because the main state taxes—the income tax and sales tax—are assumed to grow at an average annual rate of 2.3%, compared with projected payroll growth of 4.4%.[122]

In the past two years, nine states have enacted laws to reduce automatic annual pension benefit increases for current retirees.[123] The latest was Rhode Island, which in November 2011 passed a law that suspended future annual benefit increases until the combined funded ratio of the Employees' Retirement System, the Judicial Retirement Benefits Trust and the State Police Retirement Trust exceeds 80%.[124] An interim increase would be paid at five-year intervals, with the amount of the increase based on investment returns. The interim increase and any future annual increase would be applied only to the member's first $25,000 of pension income, although that limit would grow at the same rate as the annual increase. According to Rhode Island officials, automatic annual increases for retirees were one of the most expensive aspects of the pension system.[125]

Under the Illinois pension reforms enacted in 2010, state employees hired on or after January 1, 2011 receive annual increases of 3% or one-half of the annual increase in the Consumer Price Index, whichever is less.[126] Current Illinois retirees and employees hired before January 1, 2011 receive automatic annual increases of 3%. New workers benefits are increased by a simple interest rate, while retirees and existing employee benefits grow more quickly because they receive compound-interest increases.

Governor Pat Quinn recently announced plans to convene a pension work group that will seek to strengthen the State's retirement systems.[127] The Governor's pension task force in 2009 was not able to reach consensus on a final report.[128]

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[120] Traditional pension plans are defined benefit plans, in which employers are responsible for a specified level of benefits at retirement, typically based on an employee's earnings, length of service or both. 401(k)-style plans are defined contribution plans, in which employers are responsible for specified contributions but do not commit to provide specified benefits at retirement.

[121] Commission on Government Forecasting and Accountability, 97th Illinois General Assembly, Senate Bill 512, as amended by House Amendment 2, *Pension Impact Note*, November 8, 2011.

[122] Commission on Government Forecasting and Accountability, 97th Illinois General Assembly, Senate Bill 512 as amended by House Amendment 1, *Pension Impact Note*, November 3, 2011.

[123] For more information on states that have reduced automatic annual pension increases for retirees, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog at http://www.civicfed.org/iifs/blog/states-reduce-automatic-annual-pension-increases-retirees-0 (last visited on December 22, 2011).

[124] Rhode Island Retirement Security Act (2011-H 6319 A as amended, 2011-S 1111 A as amended).

[125] State of Rhode Island, Office of the General Treasurer, *Secure Path RI, Frequently Asked Questions, FAQ by Design, Cost of Living Adjustment, FAQs – COLA*, http://www.treasury.ri.gov/secure-path-ri/faq/cola.php (last visited on December 22, 2011).

[126] Public Act 96-0889.

[127] Chris Wetterich, "Quinn wants pension reform this year," *State Journal-Register*, January 10, 2012.

Civic Federation Recommendations for State Pensions

It remains unclear how the State can comply with statutory pension funding requirements and also pay for other costs of running State government. In light of fiscal realities, the Civic Federation recommends that current Illinois retirees and employees hired before January 1, 2011 receive the same annual benefit increases as new workers: 3% a year or one-half of the increase in the CPI, whichever is less, and that benefits be increased by a simple interest rate. The Federation also supports reducing non-vested benefits for current employees, increasing employee contributions or both.

It is likely that the changes supported by the Civic Federation would be challenged in court on constitutional grounds. The Illinois Constitution provides that membership in any pension system in the State is an enforceable contractual relationship and that members' benefits "shall not be diminished or impaired."[129] Legal opinions have varied on whether this prohibition applies to non-vested benefits of current employees.[130] Despite the legal controversy, this change must be pursued in the interests of the State's financial health. Any pension proposal considered by the State should be thoroughly reviewed by actuaries to determine the financial impact both in the short run and over the long term.

Issue 2: State Retiree Health Insurance

The State Employees' Group Insurance Program has an estimated 355,428 participants, including employees and retirees and their dependents.[131] General Funds costs for the program are projected to increase by 39.4% from $1.4 billion in FY2012 to $2.0 billion in FY2017.

The State pays the entire bill for health insurance premiums for 91% of the 81,900 retirees in the program.[132] Under Illinois law, employees who retired before January 1, 1998 and those who retired after that date with at least 20 years of service do not pay healthcare premiums.[133] Exceptions include General Assembly members, who can retire with as few as four years of service and not pay any premiums, and judges, who can retire with as few as six years of service and not pay premiums.

Two-thirds of retirees participate in the State's traditional insurance plan, rather than in less costly managed care plans.[134] The State was expected to pay $497.6 million for health insurance coverage for retirees in FY2011, while retirees were expected to pay $12.0 million.[135]

In April 2011 the Illinois Department of Healthcare and Family Services (HFS) announced plans to award four new managed care contracts at an estimated savings of $102 million in FY2012 and

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[128] State of Illinois, *Report of the Pension Modernization Task Force*, November 2009.
[129] Illinois Constitution, Article XIII, Section 5.
[130] Eric Zorn, "Counterpoint: Can Illinois reduce pension benefits going forward?" *Chicago Tribune*, Change of Subject blog, April 13, 2010.
[131] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 6.
[132] Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services*, February 17, 2011, p. 2.
[133] 5 ILCS 375/10.
[134] Commission on Government Forecasting and Accountability, *Liabilities of the State Employees' Group Health Insurance Program Fiscal Year 2012*, March 2011, p. 7.
[135] Commission on Government Forecasting and Accountability, *Request for Proposals to Provide Consulting Services*, February 17, 2011, p. 2. These numbers do not include participants' out-of-pocket costs such as co-payments and deductibles.

more than $1 billion over the 10-year term of the contracts.[136] The General Assembly's Commission on Government Forecasting and Accountability (COGFA) overrode the proposed action and the dispute has been the subject of a lawsuit in Sangamon County Circuit Court.[137] The General Assembly passed a bill on May 30, 2011 authorizing COGFA to reject proposed group health insurance contracts.[138] The legislation was vetoed by the Governor on July 29, 2011.

The Governor in his budget recommendations for FY2010 and FY2011 proposed shifting more healthcare costs to retirees. The proposals were strongly opposed by Council 31 of the American Federation of State, County and Municipal Employees (AFSCME), the State's largest union, and did not receive support in the General Assembly.[139]

A study for the legislature in May 2011 presented alternatives for new retiree health insurance premium structures based on pension income, years of service and age when benefits began.[140] The study estimated that the State could save between $260 million and $300 million in FY2012 (out of a total cost of $680.6 million) by increasing the share of premiums paid by retirees and their dependents from the current average of roughly 9% to close to 50%.[141] A bill based on the study's recommendations stalled in the Illinois Senate in 2011.[142]

Retirees covered by the Teachers' Retirement Insurance Program (TRIP) are required to pay premiums, but they effectively obtain subsidies if they live out of state. Under Illinois law, TRIP retirees who do not have access to the State's managed care networks—including those who live outside of Illinois—pay half as much in premiums for the traditional health plan.[143] For example, the monthly premium is $326.52 for a TRIP retiree aged 65 or older without Medicare who does not have access to managed care. The premium is $653.03 for the same retiree who does have access to managed care.[144] Only four Illinois counties do not have complete access to managed care.[145]

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[136] For more information on the contract dispute, see the Civic Federation's Institute for Illinois' Fiscal Sustainability blog, "Court Likely to Decide Dispute Over State Employee Health Insurance," July 28, 2011, at http://www.civicfed.org/civic-federation/blog/court-likely-decide-dispute-over-state-employee-health-insurance (last visited on December 7, 2011).
[137] Health Alliance Medical Plans, Inc. v. State of Illinois, No. 2011-MR-250 (Circuit Court of Sangamon County filed June 6, 2011).
[138] 97th Illinois General Assembly, Senate Bill 178.
[139] Council 31 AFSCME, "Some cuts blocked, others approved," May 26, 2010, http://www.afscme31.org/news?id=0070 (last visited on December 7, 2011).
[140] Commission on Government Forecasting and Accountability, *Retiree Healthcare Contributions*, May 17, 2011.
[141] Commission on Government Forecasting and Accountability, *Retiree Healthcare Contributions*, May 17, 2011, pp. 10-14.
[142] 97th Illinois General Assembly, Senate Bill 175.
[143] 5 ILCS 375/6.5(e)(2) and (3).
[144] Teachers' Retirement Insurance Program, *Benefit Choice Options*, Effective July 1, 2011-June 30, 2012, p. 3, http://www2.illinois.gov/cms/Employees/benefits/Insurance/Documents/FY12_trip_Book.pdf (last visited on December 7, 2011).
[145] Teachers' Retirement Insurance Program, *Benefit Choice Options*, Effective July 1, 2011-June 30, 2012, p. 4, http://www2.illinois.gov/cms/Employees/benefits/Insurance/Documents/FY12_trip_Book.pdf (last visited on December 7, 2011).

Civic Federation Recommendations for State Retiree Health Insurance

The Civic Federation supports requiring all State retirees to share the cost of their health insurance premiums. The Federation also supports abolishing any law or rule that allows retirees who live outside Illinois to pay lower premiums than retirees who live in Illinois for the same insurance coverage.

Unlike pension benefits, retiree health benefits are not specifically protected by the Illinois Constitution. Proposed changes would require a change in State law. However, some labor advocates have maintained that any changes in retiree benefits are subject to collective bargaining.[146]

Issue 3: Medicaid

Rising Medicaid costs are a major budgetary problem. General Funds Medicaid expenditures are offset by federal reimbursements, reducing the net effect on the budget by approximately half. Nevertheless, State costs are expected to increase at a rate that far exceeds revenue growth, raising concerns about the program's sustainability.

General Funds costs for Medicaid are projected to increase by more than 40% to $12.1 billion in FY2017 from $8.6 billion in FY2012.[147] If Medicaid appropriations increase by only 2% a year, the backlog of unpaid Medicaid bills could reach $21.0 billion by the end of FY2017.[148]

Governor Quinn's three-year budget projections, issued on January 3, 2012, do not show any increase in annual General Funds Medicaid appropriations from FY2012 through FY2015.[149] The flat projection of $6.6 billion is particularly unrealistic in light of the program's underfunding by roughly $1.5 billion in FY2012. In a report that accompanied the three-year projections, the Governor acknowledged the problem and stated that further cuts to the program will be necessary.[150] The report did not suggest how those reductions could be achieved.

Reducing expenditures in an entitlement program such as Medicaid requires reductions in eligibility, benefits or reimbursement rates paid to medical service providers. In attempting to control Medicaid costs, however, states face restrictions on program reductions. Certain coverage is mandated by the federal government. As a condition of continued participation in the Medicaid program, national healthcare reform legislation enacted in 2010 generally required that states not tighten existing eligibility requirements.[151] Several states that have tried to reduce Medicaid costs

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[146] Henry Bayer, "Don't Let Gov. Quinn Shift Health Costs," *Letter to the Editor*, Springfield Journal-Register, May 10, 2010.

[147] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

[148] Illinois Department of Healthcare and Family Services, *Five Year Medical Assistance Budget Outlook*, January 2012.

[149] Governor's Office of Management and Budget, *Three Year Budget Projection (General Funds), FY13-FY15*, January 3, 2012.

[150] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report*, January 3, 2012, p. 2.

[151] The Patient Protection and Affordable Care Act, P.L. 111-148, as amended by the Health Care and Education Reconciliation Act of 2010, P.L. 111-151, together known as the Affordable Care Act, Section 2001(b). The requirement specifies that existing coverage must remain in place until an insurance exchange established by a state under the Act is determined to be fully operational, which is likely to be January 2014.

by cutting rates paid to healthcare providers have faced lawsuits, charging that they are not complying with federal law requiring rates that are adequate to assure access to healthcare.[152]

Recent cost-cutting efforts by Governor Quinn's administration have met resistance from the General Assembly. The General Assembly rejected the Governor's FY2012 budget proposal to reduce reimbursement rates for hospitals and other healthcare providers by 6%. The legislature also rejected the Governor's proposal to eliminate Illinois Cares Rx, a prescription drug program for seniors for which the State is not reimbursed by the federal government. Instead, spending on the program was cut in half by restricting income standards for eligibility.[153] Because the enacted General Funds Medicaid appropriation for FY2012 is well below the anticipated cost, bills are expected to pile up and healthcare providers will have to wait longer to be paid.

Significant reforms to the Illinois Medicaid program were enacted in January 2011, but they are not expected to reduce costs substantially in the short term.[154] The legislation addressed two of the program's major shortcomings: inadequate use of managed care and overuse of institutional care for the elderly and disabled. [155] The legislation required that half of all Medicaid recipients be enrolled in coordinated or managed care programs by January 1, 2015. The legislation also supported the concept of shifting more long-term care to community settings, although it did not set specific goals for relocating residents.

Illinois launched its first experiment with mandatory Health Maintenance Organization (HMO) coverage of Medicaid recipients in May 2011. The pilot program in the Chicago suburbs covers approximately 40,000 elderly and disabled people, the most expensive categories of Medicaid recipients.

In a recent analysis, the Illinois Department of Healthcare and Family Services predicted five-year savings of $350 million from coordinated care, beginning in FY2013.[156] This estimate includes federal reimbursements, meaning that net State savings would be approximately half as much after the reduction in federal revenues. Most of the savings are expected in later years, after coordinated-care networks are well established.

The Illinois Department of Human Services (DHS) said in November 2011 that it will close up to four of its eight state-operated residential centers for the developmentally disabled in the next two and a half years and relocate at least 600 residents by the end of FY2014.[157] This plan is in line with the department's strategic plan for the developmentally disabled, which calls for an acceleration of the State's placement of residents in community care settings to meet national

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[152] Christine Vestal, "Medicaid: a year of excruciating decisions," *Stateline*, January 11, 2012, http://www.stateline.org/live/details/story?contentId=624072 (last visited on January 11, 2011).
[153] Eligibility standards for Illinois Cares Rx may be tightened because spending on the program is not federally reimbursed.
[154] Public Act 96-1501.
[155] For more information about the State's Medicaid program, see the Civic Federation, *Illinois Medicaid Program: An Issue Brief*, May 22, 2009, http://www.civicfed.org/iifs/publications/illinois-medicaid-program-issue-brief (last visited on January 9, 2012).
[156] Illinois Department of Healthcare and Family Services, *Five-Year Medical Assistance Budget Outlook*, January 2012.
[157] Illinois Department of Human Services, *Governor Quinn's Rebalancing Initiative*, November 2011, http://www.ilga.gov/commission/cgfa2006/upload/GovernorsDDandMHCRebalancingInitiative.pdf (last visited on January 13, 2012).

benchmarks.[158] Two of the nine state psychiatric hospitals are also expected to be closed by the end of FY2014. DHS expects substantial savings after facilities are closed. On January 19, 2012, the Governor said that the Jacksonville Developmental Center will be closed by October 2012 and the Tinley Park Mental Health Center will be closed by July 2012.[159]

The State recently settled three federal lawsuits filed in 2005 and 2007 by institutionalized individuals who sought placement in community settings. The consent decree in Williams v. Quinn, approved in September 2010, requires that individuals who wish to move from private State-funded Institutions for Mental Diseases (IMDs) be placed in the most integrated community-based settings appropriate to their needs within five years of the approval of an implementation plan.[160] The consent decree in Ligas v. Hamos, approved in June 2011, requires that developmentally disabled individuals who wish to move from Medicaid-funded private nursing homes be placed in the most integrated community-based settings appropriate to their needs within six years.[161] The consent decree in Colbert v. Quinn, approved in December 2011, requires the State to provide housing assistance within two and a half years for more than 1,000 physically and mentally disabled individuals who wish to move from Medicaid-funded nursing homes in Cook County.[162]

The most expensive optional service in Illinois' Medicaid program is pharmacy benefits, which cost $932.4 million in FY2010.[163] There is general agreement that effectively run prescription drug programs prevent hospitalization and use of other more expensive medical services.[164] Governor Quinn's Taxpayer Action Board concluded in June 2009 that the State had been effective in controlling some of its prescription drug costs.[165]

The Illinois Department of Healthcare and Family Services has recently taken additional steps to limit spending on prescription drugs. In May 2011, the department significantly restricted patient access to certain mental health-related drugs, requiring doctors to obtain prior approval from Medicaid officials before prescribing the medications.[166] The action, designed to promote use of generic drugs, was expected to save $90 million a year.[167]

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[158] Illinois Department of Human Services, Strategic Plan FY2011-FY2017, July 2010, pp. 7-8, http://www.dhs.state.il.us/OneNetLibrary/27897/documents/DD%20Reports/StrategicPlan2011to2017.pdf (last visited on January 13, 2012).
[159] Illinois Governor's Office, "Governor Quinn Announces Active Community Care Transition Plan," *news release*, January 19, 2012.
[160] Illinois Department of Human Services, *Entered Williams Consent Decree*, http://www.dhs.state.il.us/page.aspx?item=51836 (last visited on January 14, 2012). The implementation plan was approved on June 28, 2011. State spending for individuals aged 22 to 64 in IMDs is not reimbursed by the federal government. IMDs are nursing facilities in which more than half of the residents have serious mental illness.
[161] Illinois Department of Human Services, *Overview of the Ligas v. Hamos Lawsuit*, http://www.dhs.state.il.us/page.aspx?item=58321 (last visited on January 14, 2012).
[162] Carla K. Johnson, "Judge OKs deal on disabled in nursing homes," *Southtown Star*, December 20, 2011.
[163] Illinois Department of Healthcare and Family Services, *Optional populations current enrollment and liability & Optional services for mandatory adult populations*, Attachment 1, Medicaid Advisory Committee Meeting Minutes, March 18, 2011. The number includes only General Funds and related pharmacy costs.
[164] For more information about the prescription drugs in the State's Medicaid program, see the Civic Federation, *Illinois Medicaid Program: An Issue Brief*, May 22, 2009, pp. 18-19, http://www.civicfed.org/iifs/publications/illinois-medicaid-program-issue-brief (last visited on January 9, 2012).
[165] State of Illinois Taxpayer Action Board, *Final Report*, June 2009, p. 40.
[166] Illinois Department of Healthcare and Family Services, *Informational Notice Re: Preferred Drug List Changes for Atypical Antipsychotics, Anticonvulsants, Antidepressants—SSRIs, Antidepressants—Other, and Stimulants/ADHD Agents*, April 18, 2011.
[167] John Keilman, "Illinois limits psychiatric drugs for Medicaid patients," *Chicago Tribune*, September 7, 2011.

In July 2011, HFS proposed a reduction in reimbursement rates paid to pharmacists that was expected to save $42 million a year.[168] However, the rule faced intense opposition from pharmacists.[169] A revised version of the rule, approved by the General Assembly's Joint Committee on Administrative rules on January 10, 2012, includes an increase in the dispensing fee for generic drugs by 38.0% to $6.35 from $4.60.[170] The dispensing fee is the flat fee paid to pharmacies for dispensing a drug. Despite the increased dispensing fee, HFS maintains that annual savings will still total $42 million, apparently due to an anticipated increase in sales of lower-cost generic drugs.[171]

Civic Federation Recommendations for Medicaid

The State should move aggressively to implement the significant reform legislation passed in January 2011 by enrolling Medicaid recipients in coordinated or managed care networks and moving residents from State centers for the developmentally disabled to community settings. The State should continue its efforts to control prescription drug costs, the most expensive optional medical service provided under the Medicaid program.

Short-term savings on Medicaid should come from programs that are not eligible for federal reimbursement. One such program the State cannot afford to continue and must eliminate is Illinois Cares Rx, a prescription drug program that supplements coverage for seniors in Medicare Part D.

Issue 4: Borrowing for Operations and Unpaid Bills

The State of Illinois has dealt with its recent budget problems by delaying payment of bills to vendors and transfers to local governments. The total backlog of bills owed by the State including General Funds bills, Medicaid and group health insurance claims and unpaid business tax refunds is expected to total $9.2 billion by the end of FY2012. It would cost the State approximately $8.2 billion to pay off the obligations, after accounting for Medicaid reimbursements from the federal government and the portion of the business tax refunds not paid for from the General Funds.

The Civic Federation's five-year projections suggest the State's total unpaid bills—including both General Funds bills and bills outside of the General Funds—are predicted to increase from $9.2 billion at the end of FY2012 to $34.8 billion at the end of FY2017.

Governor Pat Quinn has proposed in his Economic and Fiscal Policy Report issued on January 3, 2012 that borrowing be used to pay down the bill backlog.[172] The Governor's report did not provide the terms of the borrowing, such as the repayment schedule and total estimated debt

[168] 35 Ill. Reg. 12600, July 29, 2011.
[169] Chris Wetterich, "Illinois Pharmacists question Medicaid rate changes," *Rockford Register Star*, August 8, 2011.
[170] Communication between the Civic Federation and the Joint Committee on Administrative Rules, January 12, 2012. The increase is effective on February 1, 2012, but it is repealed at the end of FY2014 if generic dispensing rates do not increase by 2%. The dispensing fee is $3.40 for brand-name drugs.
[171] Email communication between the Civic Federation and the Illinois Department of Healthcare and Family Services, January 20, 2012.
[172] Governor's Office of Management and Budget, *Illinois' Economic and Fiscal Policy Report*, January 3, 2012, pp. 2-3, http://www2.illinois.gov/budget/Documents/2012%20Economic%20and%20Fiscal%20Policy%20Report.pdf (last visited January 10, 2012). The report estimates obligations on hand as of December 2011 at $7 billion, including $3.5 billion in unpaid bills held by the Illinois State Comptroller, $2 billion in unpaid Medicaid bills, $500 million in tax refunds owed to businesses and $1 billion in unpaid group health insurance bills.

service costs. The three-year budget projections that accompanied the report did not account for the costs of repaying such borrowing.

Although borrowing for operations sometimes appears to be an attractive solution to fiscal problems, Illinois' reliance on borrowing is one of the factors that has made it difficult for the State to balance its annual operating budget. Borrowing for operations effectively pushes current operating costs into future years. It also complicates future budgets because it is a one-time revenue source that allows the State to spend more in the current fiscal year than is supported by ongoing revenues in subsequent years.

The State borrowed a total of $10.7 billion between FY2009 and FY2011 to pay for operations.[173] The largest portion of the borrowing was the sale of $7.2 billion in Pension Obligation Bonds (POBs) to pay for the State's General Funds contributions to its retirement systems in FY2010 and FY2011. The debt service on the POBs alone increased total General Funds expenditures by more than $1 billion annual through FY2019.

As shown in the Civic Federation's five-year projections, the State faces significant budget imbalances in the coming years, complicated in FY2015 and beyond after the State's temporary income tax increases partially sunsets. It is apparent from these projections that the State cannot afford the additional debt service that would be necessary to repay the Governor's proposed borrowing plan without significant reductions to other State operating expenditures or additional revenues.

Any additional borrowing for operations will add to the State's already unaffordable debt service payments as it prepares for the partial sunset of the income tax rate increases. The State cannot afford any additional borrowing for operations or to pay down its backlog of bills. A vendor payment program has been set up by the State to help ease the financial burden on State vendors with assistance from private lenders. The State should attempt to improve this program to offer better assurance of timely payments to lenders, accessibility to vendors and transparency to taxpayers.

Civic Federation Recommendation on Borrowing for Operations and Unpaid Bills
The Civic Federation opposes any additional borrowing by the State of Illinois to support its ongoing operations or to pay down its backlog of bills because it cannot afford any additional debt service. Borrowing for operations generates one-time revenues that increase future spending pressures. The Federation supports the State's efforts to ease the burden on vendors through an improved and cost-effective vendor payment program.

Issue 5: State Employee Salaries

Between FY2001 and FY2011, the number of full-time equivalent positions in agencies under the Governor's control declined from 69,970 to 55,332.[174] This represents a decline of 20.9% in the number of positions that the State is authorized to fund to carry out operations and services.

[173] Institute for Illinois Fiscal Sustainability at the Civic Federation, *State of Illinois Enacted Budget FY2012: A Review of the Operating and Capital Budgets Enacted for the Current Fiscal Year*, September 26, 2011, p. 39.
[174] The decrease was largely due to the Early Retirement Initiative offered by the State in 2002. For more information about changes in employment level, see Illinois State Comptroller's Office, *Fiscal Focus*, January 2008, pp. 1-4.

The State's fiscal problems cannot be solved simply by reducing employee salaries.[175] The State of Illinois spends a relatively small proportion of its budget on salaries because many State services are not performed by State employees. State government in Illinois provides many services through funding for local governments, health care providers and human services providers, rather than having State employees provide those services. Salaries and wages in agencies under the Governor were estimated at roughly 10% of General Funds expenditures in FY2011.[176] In contrast, the City of Chicago has recently spent 72% of its Corporate Fund on salaries and wages.[177]

The State's current contract with its largest union, Council 31 of the American Federation of State, County and Municipal Employees (AFSCME), calls for increases of 1.25% on January 1, 2012 and 2% on February 1, 2012. On July 1, 2011, Governor Quinn cancelled all scheduled FY2012 raises for employees in 14 agencies, citing inadequate appropriations by the General Assembly.[178]

The current AFSCME contract expires at the end of FY2012 and the State has begun negotiations on a new contract. As the State faces an unprecedented backlog of unpaid bills just to pay the current costs of government operations, it cannot afford additional personnel costs.

Civic Federation Recommendation on State Employee Salaries

Given fiscal realities in the State of Illinois, there is no room for bargaining unit increases in FY2013 or in the foreseeable future. The Civic Federation urges the Governor to keep the State's dire financial condition in mind as new collective bargaining agreements, effective in FY2013, are negotiated.

Issue 6: Retirement Income

Illinois has a narrower income tax base than most states due to its exclusion of most retirement income from taxation. Among the 41 states with individual income taxes, Illinois is one of only three that broadly exempt retirement income from taxation.[179] Illinois excludes from taxation virtually all retirement income, including Social Security benefits, government disability payments and income from qualified employee benefit plans and Individual Retirement Accounts.[180]

The exemption of retirement income is the second most expensive tax expenditure offered by the State of Illinois.[181] According to the Illinois State Comptroller's Office, the cost to the State of not

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[175] Pension and health insurance costs are addressed in separate recommendations.

[176] Institute for Illinois' Fiscal Sustainability at the Civic Federation, *State of Illinois FY2012Recommended Operating and Capital Budgets: Analysis and Recommendations*. May 9, 2011, p.49.

[177] City of Chicago, *Annual Financial Analysis*, July 29, 2011, p. 13.

[178] Doug Finke, Quinn cancels $76 million in state employee raises," *State Journal-Register*, July 1, 2011. A raise of 2% was scheduled for July 1, 2011.

[179]Ronald Snell, National Conference of State Legislatures, *State Personal Income Taxes on Pensions & Retirement Income: Tax Year 2010*, February 2011. Ten states offer exclusions for all state and local government pension income: Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, New York and Pennsylvania. Two of the ten—Kansas and Massachusetts—do not exclude any private-sector income. Louisiana, Michigan and New York cap the private-sector exclusion. Alabama excludes income from defined benefit plans and Hawaii excludes income from contributory plans. Of the remaining three, Illinois and Mississippi exclude income from all plans defined by the Internal Revenue Service as qualified plans and Pennsylvania allows a full exclusion.

[180] Illinois Department of Revenue, *Publication 120: Retirement Income*, October 2005. A qualified employee benefit plan is defined in Internal Revenue Code Sections 402 through 408.

[181] Illinois State Comptroller, *Fiscal Year 2010 Tax Expenditure Report*, August 2011, p. 7. A tax expenditure is defined as any exemption, exclusion, deduction, allowance, credit, preferential tax rate, abatement or other device that reduces the amount of tax revenue that would otherwise accrue to the State. The most expensive tax expenditure is the reduced sales tax rate on food and drugs, which cost an estimated $1.5 billion in FY2010.

taxing retirement income that is taxable by the federal government was $1.1 billion in FY2010. That figure was based on an individual tax rate of 3%; the cost would be higher based on the current rate of 5%.

No federal income tax is owed on Social Security benefits if the combined total of half of the benefits plus all other income is $25,000 or less for single filers and $32,000 or less for joint filers.[182] If the combined total is above those levels, generally up to 50% of the benefits are federally taxable. However, up to 85% of the benefits are federally taxable if the combined total of half of the benefits plus all other income is more than $34,000 for single filers and $44,000 for joint filers.

Civic Federation Recommendations on Retirement Income

The Civic Federation supports broadening the individual income tax in Illinois to include federally taxable portions of retirement and Social Security income. This policy would provide additional revenue stability and reduce preferential treatment of retired taxpayers that the State can no longer afford, while protecting the lowest-income individuals.

Issue 7: State Cigarette Tax

Governor Pat Quinn's FY2010 budget recommendation proposed an increase in the State tax on cigarettes in two stages: from 98 cents per pack to $1.48 per pack in FY2010 and to $1.98 per pack in FY2011.[183] This proposal was expected to raise $175 million during the first year after it was enacted. The General Assembly did not support the increase.

At 98 cents per pack, Illinois ranks 32nd of all 50 states in the amount of excise taxes charged on cigarettes. New York charges the highest rate at $4.35 per pack and Virginia the lowest at 30 cents per pack.[184] The federal government and local governments also levy excise taxes on cigarettes in Illinois. According to the American Lung Association, the average retail price of a pack of cigarettes in Illinois is $6.07, but the cost to the State's economy is $21.99 per pack after accounting for losses in workplace productivity, direct healthcare expenditures and premature deaths related to smoking.[185]

Regarding elasticity of demand, the State estimates that for every one percentage point increase in the retail price of cigarettes there will be a corresponding 0.92% decline in consumer demand.[186] The current $.98 per pack tax brings in approximately $355 million per year in State revenues. Based on these elasticity assumptions, the State could expect revenues to increase by approximately $307.2 million annually from a $1 per pack increase in the State cigarette tax.

Civic Federation Recommendation for the State Cigarette Tax

The Civic Federation supports increasing the State tax on cigarettes from the current rate of 98 cents per pack to $1.98 per pack in FY2013 to reduce the State's budget deficit and to fund public health expenses in future years.

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182 Internal Revenue Service, *Publication 915: Social Security and Equivalent Railroad Retirement Benefits*, January 4, 2012, pp. 1-10.

183 Illinois State FY2010 Budget, p. 5-10.

184 Orzechowski & Walker, Tax Burden on Tobacco, 2010.

185 American Lung Association, Smoking Cessation: The Economic Benefits, Illinois Facts, http://www.lungusa.org/stop-smoking/tobacco-control-advocacy/reports-resources/cessation-economic-benefits/states/illinois.html (last visited January 17, 2012)

186 Illinois Department of Revenue Fiscal Note on SB0044, March 20, 2009.

Issue 8: Statutory Transfers Out

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

In its first annual report, the Governor's Budgeting for Results Commission recommended that all statutory transfers be evaluated for history, intent and current need in the areas funded.[187] The goal is to ensure that State resources deliver the greatest possible value to taxpayers. The report suggested that funding provided for ongoing State operations through statutory transfers out of General Funds should be largely eliminated, excluding transfers for debt service, local government revenue sharing, payments to revolving funds and cash flow transfers. Instead, ongoing State operations historically funded by statutory transfers should be reviewed annually as part of the State's General Funds appropriations process.

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

Civic Federation Recommendation for Statutory Transfers Out

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

Issue 9: Special Fund Sweeps

The State of Illinois has more than 600 Special Funds that operate outside the General Funds. In the past, the Civic Federation has supported the concept of transferring surplus revenues from special purpose funds to General Funds but has warned of reliance on these balances as a one-time revenue source. It is a common budgetary practice to "sweep" funds, transferring surpluses to General Funds to help close budget gaps.

Considering the ongoing budgetary imbalance in the State's General Funds and growing backlog of unpaid bills, balances in the Special Funds should not be overlooked. In most cases, segregating revenues into special-purpose funds is a practice that should only be adopted for certain high-priority or mandated programs. Unless there is a compelling reason, the State should be afforded maximum flexibility in allocating resources as needed to meet policy priorities.

Instead of sweeping excess balances in FY2011, the State authorized borrowing up to nearly $1 billion from the Special Funds to help close the State's budget gap and relieve cash flow

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[187] State of Illinois, *Budgeting for Results Commission Report*, November 2, 2011, p. 11.

pressures.[188] Under the interfund borrowing law, loans from these funds must be paid back within 18 months. The State borrowed a total of $496 million in FY2011 under this authorization, of which $487 million remained outstanding at the close of the fiscal year.[189] The State is required to repay $347 million of the interfund borrowing in FY2012 and $139 million in FY2013. Although the practice of interfund borrowing provided temporary relief for ongoing cash flow issues, the repayment of the loans pushed current obligations into future fiscal years and widened projected budget gaps in FY2012 and FY2013.

Sweeping excess funds from Special Funds also relieves cash flow problems but does not create spending pressures due to required repayments in future fiscal years. Between FY2003 and FY2010 the State was able to sweep a total of $1.2 billion into General Funds from Special Funds.[190] As a one-time revenue source, fund sweeps do run the risk of creating future budget gaps if equivalent amounts are not available in future fiscal years. However, due to Illinois' ongoing backlog of unpaid bills and projected budget deficits, the State should allocate all available resources to ease the delay in payments to vendors and balance its budget.

Civic Federation Recommendation for Fund Sweeps

The Civic Federation opposes interfund borrowing not repaid within the same fiscal year because it pushes current operating expenses into future years. Instead, the State should sweep any available surpluses in Special Funds into the General Funds to pay down its backlog of bills and ease cash flow issues. The Civic Federation also recommends that the State's Special Funds be consolidated and/or eliminated except in cases of high priority or mandated expenses.

Issue 10: Economic Development Incentives

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

Even though it faced insufficient revenues to balance its FY2012 budget or to pay down its substantial backlog of unpaid bills, the State still enacted additional tax incentives, also known as tax expenditures, in the fall 2011 veto session.[191] The tax expenditure package began as a reaction to requests from CME Group and Sears Corporation, which sought tax reductions in exchange for staying in Illinois. As negotiations on the package proceeded, it was expanded to include the renewal of many other tax credits for business and benefits for individuals, including the working poor.[192] The final legislation is estimated to reduce State resources by at least $261.4 million in FY2013 and $371.6 million in FY2014.

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[188] Public Act 96-0958.

[189] Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012*, August 2011, p. 195.

[190] Commission on Government Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2012*, August 2011, p. 194.

[191] Pubic Acts 97-0636, 97-0652.

[192] See the revenue discussion in the Five-Year Projections section on page 29 for more details on the tax expenditures enacted in the veto session.

In FY2010, the most recent year for which data are available, the State spent a total of $313.6 million on tax incentives for businesses.[193] According to 2009 Illinois Department of Revenue data, only 0.7% of the more than 450,000 corporations filing taxes in Illinois take advantage of these tax incentives.[194]

A transparent economic development policy would effectively curb economic brinksmanship by Illinois businesses by creating a predictable process for applying for and earning tax incentives. Such a policy would also help decide which tax incentives are most beneficial to the State.

The Government Finance Officers Association (GFOA) recommends that governments create an economic development policy that includes goals and objectives, a list of financial incentive tools and their limitations, an evaluation process applied to all approved incentives, performance standards and a process for monitoring and compliance. It is also important that the State communicate its policy to the public, along with complete data on companies that benefit from incentives and costs and benefits to the State.[195]

Civic Federation Recommendation on Economic Development Incentives

The Civic Federation recommends that the State of Illinois develop a comprehensive economic development incentive policy to curb economic brinksmanship by Illinois businesses and allow the State to monitor the relative effectiveness of various incentive programs. Such a policy should be in place before the State renews, expands or creates any economic development incentives.

[193] Illinois State Comptroller, *Fiscal Year 2010 Tax Expenditure Report*, August 2011, p. 5.
[194] Illinois Department of Revenue, *Business Income Taxes in Illinois*, July 19, 2011.
[195] Government Finance Officers Association, *Best Practices: Developing an Economic Development Incentives Policy*, October 17, 2008.