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For further information,  
contact **Laurence Msall** at 312.201.9044

## **CIVIC FEDERATION REJECTS LARGEST TAX INCREASE AND LONG-TERM SPENDING EXPANSION IN ILLINOIS HISTORY**

### **Gives Qualified Support for Lottery Sale and Reasonable Revenue Enhancements**

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(CHICAGO) – Facing a continued operating deficit and spiraling pension costs, the State of Illinois cannot afford the massive expansion of its responsibilities proposed by Governor Blagojevich, the Civic Federation concluded today in its 56-page analysis of the proposed \$49.0 billion FY2008 budget.

The Governor's proposed operating budget calls for an extraordinary \$28.4 billion expansion in State revenue over the next four years, funded by a regressive and burdensome gross receipts tax and payroll tax. The Civic Federation urges the General Assembly to **reject** both of these initiatives and focus attention instead on a plan to improve Illinois' core financial structure.

The Federation takes the following positions on the main elements of the Governor's FY2008 budget proposal.

- We **reject** the Governor's massive long-term expansion of spending for health care as unsustainable and unaffordable.
- We **strongly oppose** the unfair and seriously flawed gross receipts tax, which taxes unprofitable and profitable businesses at the same rate and will eventually be passed onto consumers.
- We **do not support** the \$15.9 billion pension obligation bond because the State would still not be providing the full payment of the current pension fund operating costs and it is not tied to pension benefit reforms.
- We **support** the long term lease of the State Lottery only if all proceeds are used to reduce the unfunded liabilities of the pension systems and pension benefit reforms are approved.

The Civic Federation also proposes an alternative source of recurring revenues for critical State priorities and thus **could support** a modest increase in income taxes to fully fund its pension obligations and pay for increases in funding to education and transportation.

- Increase the personal income tax from 3% to 4% and the corporate income tax from 4.8% to 6.4% to provide \$3.75 billion in increased annual revenues.
- The increase in revenues provides:
  - \$1.1 billion for elementary and secondary education and mass transit
  - \$700 million to make the full required pension funding payment
  - \$650 to replace annual Lottery revenues
  - \$1.3 billion for mandated spending increases such as salary adjustments
- The Civic Federation also endorses the Blagojevich administration's effort to consolidate special purpose funds. This is a common sense management proposal that would increase the efficiency of the State's cash management process and put surplus funds to productive use.

The Civic Federation's complete State of Illinois budget analysis, including detailed findings and recommendations, is available today on our website at [www.civiced.org](http://www.civiced.org).

*The Civic Federation is an independent, non-partisan government research organization founded in 1894. The Federation's membership includes business and professional leaders from a wide range of Chicago area corporations, professional service firms and institutions.*



**STATE OF ILLINOIS  
FY2008 RECOMMENDED OPERATING BUDGET**

*Analysis and Recommendations*

**Prepared By  
The Civic Federation  
May 7, 2007**

<b>EXECUTIVE SUMMARY: CIVIC FEDERATION POSITION ON FY2008 ILLINOIS OPERATING BUDGET .....</b>	<b>3</b>
ISSUES THE CIVIC FEDERATION OPPOSES .....	7
ISSUES THE CIVIC FEDERATION SUPPORTS .....	15
CIVIC FEDERATION RECOMMENDATIONS .....	21
<b>ACKNOWLEDGEMENTS .....</b>	<b>24</b>
<b>REVENUES .....</b>	<b>24</b>
<i>PROJECTED V. ESTIMATED FY2007 GENERAL FUND REVENUES.....</i>	<i>27</i>
<i>FOUR-YEAR REVENUE TRENDS.....</i>	<i>28</i>
<i>PROPOSED FY2008 TAX CHANGE: GROSS RECEIPTS TAX .....</i>	<i>30</i>
<i>PROPOSED FY2009 TAX CHANGE: PAYROLL TAX .....</i>	<i>32</i>
<b>APPROPRIATIONS .....</b>	<b>32</b>
<i>FY2007-FY2008 APPROPRIATION TREND .....</i>	<i>32</i>
<i>FY2008 APPROPRIATIONS BY PURPOSE.....</i>	<i>33</i>
<i>FOUR-YEAR APPROPRIATION TREND .....</i>	<i>34</i>
<b>PERSONNEL.....</b>	<b>35</b>
<b>DEBT TRENDS .....</b>	<b>37</b>
STATE OF ILLINOIS GENERAL OBLIGATION DEBT.....	37
GENERAL OBLIGATION DEBT PER CAPITA - EXCLUDING PENSION BONDS.....	39
GENERAL OBLIGATION DEBT PER CAPITA – INCLUDING CURRENT PENSION BOND ISSUE.....	39
GENERAL OBLIGATION DEBT PER CAPITA – INCLUDING PROPOSED \$15.9 BILLION PENSION BOND ISSUE.....	40
BOND RATINGS.....	41
DEBT SERVICE SCHEDULE .....	41
SHORT-TERM DEBT .....	42
<b>STATE OF ILLINOIS EMPLOYEE HEALTH INSURANCE PLANS .....</b>	<b>42</b>
RISING STATE EMPLOYEE HEALTH INSURANCE COSTS .....	43
COSTLY PROVISIONS OF THE STATE GROUP HEALTH INSURANCE PLAN .....	43
ILLINOIS HAS AN EXPENSIVE INDEMNITY PLAN.....	43
ILLINOIS STATE EMPLOYEES PAY A BELOW AVERAGE PERCENTAGE OF PREMIUM COSTS.....	44
ILLINOIS PROVIDES FREE HEALTH CARE FOR RETIREES WITH 20 YEARS OF SERVICE.....	44
<b>STATE OF ILLINOIS RETIREMENT SYSTEMS.....</b>	<b>45</b>
RECENT CHANGES IN PENSION FUNDING: 2003 TO PRESENT .....	45
<i>Issuance of \$10 Billion in Pension Obligation Bonds in 2003.....</i>	<i>45</i>
<i>Governor Blagojevich’s FY2006 Pension Funding Reform Proposals.....</i>	<i>46</i>
<i>The FY2006-FY2007 Partial Pension Holiday .....</i>	<i>47</i>
<i>Governor Blagojevich’s FY2008 Pension Funding Proposal.....</i>	<i>48</i>
<b>CIVIC FEDERATION RECOMMENDATIONS .....</b>	<b>52</b>
IMPLEMENT PENSION BENEFITS REFORMS .....	52
IMPLEMENT EMPLOYEE AND RETIREE HEALTH INSURANCE COST SAVING REFORMS .....	53
<i>Eliminate the costly indemnity plan .....</i>	<i>53</i>
<i>Eliminate free health care for retirees .....</i>	<i>53</i>
<i>Increase employee premium contributions.....</i>	<i>53</i>
IMPLEMENT MODEST REVENUE ENHANCEMENTS TO PAY FOR PENSION LIABILITIES, EDUCATION, AND MASS TRANSIT .....	53
IMPLEMENT METROPOLITAN MAYORS CAUCUS SCHOOL FINANCIAL MANAGEMENT ACCOUNTABILITY REFORMS.....	54
IMPROVE THE STATE’S PERFORMANCE MEASUREMENT SYSTEM .....	55
IMPLEMENT A FORMAL LONG-TERM FINANCIAL PLANNING PROCESS .....	55

## **EXECUTIVE SUMMARY: CIVIC FEDERATION POSITION ON FY2008 ILLINOIS OPERATING BUDGET**

The Civic Federation recently concluded an analysis of financial issues related to the State of Illinois' proposed FY2008 \$49.0 billion operating budget. Our positions on the principal components of the budget follow:

### **Civic Federation Opposes Massive Budget Expansion and Long-Term Borrowing, Offers Qualified Support for Lottery Sale and Reasonable Revenue Enhancements**

Governor Blagojevich has proposed a complex and expansive \$49.0 billion operating budget for FY2008. His budget proposal outlines an untenable four-year spending plan that would dramatically and unaffordably enlarge the scope of the State's responsibilities. This spending proposal is premised on a regressive Gross Receipts Tax that will overburden Illinois businesses and consumers, and a \$15.9 billion pension obligation bond that will allow the State to borrow money while reducing its FY2008 pension payment by \$700 million. Although the Governor is to be commended for recognizing the need to dramatically increase the funding for the State pension system, the Governor's proposal will not fund the pension system's normal operating cost in FY2008 and it offers no reform of the State's ongoing, unaffordable pension liabilities. The Civic Federation calls on the legislature to **reject** both of these initiatives and to focus attention instead on a plan to improve Illinois's core financial structure.

The Governor's FY2008 budget calls for an expensive new universal healthcare coverage program and education spending increases that are in excess of what the State can afford. Even more alarming than the proposed \$2.6 billion spending increase for new programs, however, is that the total cost of the Governor's program expansion to Illinois taxpayers would balloon to as much as \$9.3 billion by FY2011 under the Governor's proposal. In four years the health care component alone is projected by the administration to cost between \$3.7 and \$4.5 billion. Because medical care inflation routinely outpaces the overall rate of inflation,<sup>1</sup> the General Assembly must recognize that even \$4.5 billion may not be sufficient to cover the annual costs of the Governor's proposed healthcare program expansions.

The State is simply not in a strong enough financial position to embark upon so significant and costly an expansion of its Medicaid and related new health insurance responsibilities. According to its most recent audited financial statement, Illinois spent \$2.4 billion more than was available in revenue in FY2006 while failing once again to adequately fund its pensions.<sup>2</sup> Moreover, it is unclear to us or to taxpayers that existing State health insurance programs operate as efficiently and effectively as possible. The Civic Federation's recent examination of the State's existing health insurance program for its employees and retirees suggests that the State has not effectively managed these benefits' costs. The implementation of reasonable State employee and retiree health insurance reforms could save the State between \$297.3 and \$466 million annually, the

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<sup>1</sup> U.S. Bureau of Labor Statistics show that the annual inflation for medical care products and services outpaced all consumer products and services by an average of 1.4 percentage points between 1996 and 2005.

<sup>2</sup> Daniel W. Hynes, *State of Illinois Comprehensive Annual Financial Report 2006*, [http://www.apps.ioc.state.il.us/ioc-pdf/CAFR\\_2006.pdf](http://www.apps.ioc.state.il.us/ioc-pdf/CAFR_2006.pdf), p. 11.

Civic Federation found.<sup>3</sup> If reforms to the State's employee and retiree health insurance programs were implemented, the State could use the savings to fund a reasonable demonstration project in the area of private health insurance for low income individuals.

The Civic Federation **supports** the Governor's proposal to lease the Illinois Lottery and to deposit all proceeds into the State's chronically underfunded pension system, provided that the adoption of this proposal is linked to the implementation of **significant pension benefits reforms**. Such reforms would include a moratorium on new pension benefit enhancements, a higher retirement age for new hires, and the limitation of automatic increases to the lesser of 2% or CPI for new hires. The Civic Federation believes that leasing or selling a non-core government asset in order to improve the financial condition of the State's pension system represents an appropriate use of that asset. We also believe, however, that the benefit levels currently offered to State employees and retirees are unaffordable. The State's pension crisis can only be resolved by addressing both the funding and the expenditure components of the problem. The Civic Federation's support for the Governor's proposal is also contingent upon **all proceeds from the transaction being used to reduce past unfunded liabilities** rather than to avoid paying the pension fund's current annual operating costs. It is imperative that the pension fund's normal costs be paid for out of current revenues.

We **do not support**, however, the Governor's proposal to issue \$15.9 billion in pension obligation debt. According to the revised pension payment schedule that the Governor's proposed FY2008 budget relies upon, most of the State's \$1.9 billion pension payment would be used to pay the debt service on the State's previously issued \$10 billion in pension obligation bonds and the proposed \$15.9 billion in new borrowing. Only \$340 million would be available for the current normal cost of the State pension system. This amount is approximately \$1 billion less than the annual cost of existing employee benefits, which is an operating cost of the State. A massive debt issuance may eventually be an effective component of a plan to address the State's past unfunded liabilities. But the Civic Federation strongly believes that the State should never borrow money to meet current operating expenses.

The Civic Federation has previously supported the State's issuance of pension obligation bonds in order to pay down existing retirement system liabilities. In 2003 we supported the State's \$10 billion bond issue on the condition that all proceeds be used to pay down past unfunded liabilities. We were disappointed, though, when the State immediately used part of those proceeds to reduce its annual payments for its retirement system's operating expenses. Subsequently, the State took a \$2.3 billion partial pension holiday in FY2006 and FY2007. Both of these actions weakened the benefit of the \$10 billion infusion to the pension system's financial health.

If the State is to take the extraordinary action of using debt financing to pay down the State's unfunded pension liabilities, it must ensure that this borrowing improves the long-term financial condition of the State and that it does not merely conceal the unaffordability of State employees' benefits. The justification for such borrowing is the continued need to address decades of underfunding the State's pension system. But going forward, the State must act to control the costs of a benefit system that remains far too expensive. If, as we believe, **the current normal**

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<sup>3</sup> The Civic Federation, "State of Illinois Employee Health Insurance Plans: Analysis and Recommendations for Cost Containment," [http://www.civicfed.org/articles/civicfed\\_245.pdf](http://www.civicfed.org/articles/civicfed_245.pdf) (April 16, 2007).

**cost of the pension system is unaffordable, the State must reduce this expense so that current operating costs can be met with current revenues**, not paid for by borrowing.

In FY2008 the State should make the full \$2.0 billion pension payment required under the 1995 Pension Funding Reform Law in addition to the \$546 million owed for debt service on the 2003 bond issue. If the State leases the lottery and pays all of the proceeds into the pension system, it could modify the existing pension payment schedule to make it more affordable beginning in FY2009, as long as the State only reduces the amortized debt portion of the annual pension payment. The State must show it is willing to make serious pension benefit reforms and that it has the fiscal discipline to stick to the schedule it has set for itself before it considers turning to borrowing again to pay down its unfunded pension liabilities.

*The Civic Federation urges the General Assembly to **approve** the Governor's plan to use lottery lease proceeds to reduce pension liabilities by \$10 billion or more, provided that the plan is linked to substantive pension benefits reforms and that all proceeds are used to reduce the past unfunded liabilities. We **do not support** the Governor's plan to use borrowing in order to meet current State operating expenses. We also call upon the General Assembly to **reject** the dramatic expansion of State responsibilities and the vastly increased spending called for in the Governor's FY2008 budget.*

We also urge the legislature to **reject** the proposal to levy a **gross receipts tax** (GRT) on business with more than \$2 million in annual receipts, in lieu of their paying the current corporate income tax. The gross receipts tax is fundamentally a regressive, seriously flawed tax: 1) it imposes a tax on businesses regardless of profitability or ability to pay, 2) it will increase production cost because of the pyramiding effect, 3) it is ultimately passed on to consumers, and 4) it is not transparent. Even theoretical arguments about the benefits of a GRT's low rate tax application wither in view of the design and application of the GRT proposed for Illinois.

The Civic Federation recognizes that the State's current revenues might be insufficient for the Governor to implement his lottery lease proposal, meet the pension payment schedule required under the 1995 Pension Funding Reform Law, maintain the State's fiscal stability, and fund budgetary priorities that are critical to the long-term economic viability of Illinois. For these reasons, the Civic Federation could support the extraordinary action of increasing existing tax rates in order to stabilize the State's current financial position, increase State revenues in order to pay for the Governor's lottery lease proposal and the State's continuing pension costs, and allow for reasonable spending increases in areas that are traditional core State responsibilities, such as education and public transit.

We estimate that the State would require an additional \$3.75 billion in FY2008 over the previous year's budget to pay for:

- A reasonable funding increase over the State's FY2007 operating budget for mandated or contractual spending increases, inflationary costs, and some additional operating funds. This increase would cost \$1.3 billion.
- The difference between the Governor's proposed FY2008 pension and debt service payment, \$1.9 billion, and the pension and debt service payment that must be made according to the

amended 1995 Pension Funding Reform Law, \$2.6 billion. That difference is roughly \$700 million in FY2008.

- The replacement of annual lottery revenues that are currently used to fund education. Replacing these revenues would cost \$650 million annually. If the General Assembly does not approve the lease of the lottery, this \$650 million should be paid into the pension system in order to reduce past unfunded liabilities.
- Providing a reasonable yet significant funding increase for the critical priorities of elementary and secondary education and mass transit. The Civic Federation's proposal would make \$1.1 billion in new State revenue available annually for these core State needs. New money for schools, however, must be coupled with the adoption of new financial management accountability reforms as proposed by the Metropolitan Mayors Caucus. It should also allow for the expansion of charter schools and other innovative practices in order to improve the cost and quality of our State's educational system.

The Civic Federation feels that a \$3.75 billion total increase in State revenues, a 13.2% increase in General Fund Revenues over FY2007, would be adequate to pay for essential operations of State government, and is sufficiently limited that it will not overburden taxpayers. Our support for such a tax increase would be aimed at stabilizing the State's financial condition. This tax increase would not, however, allow for the type of dramatic and expensive long-term expansion of State responsibilities that the Governor's health insurance proposal entails. Adding billions of dollars in recurring obligations for an expensive new health insurance program is not financially prudent now and not sustainable over the long term. The Governor and the General Assembly must focus on paying for the State's outstanding obligations rather than incurring new ones, and investing in the traditional State priorities of education and transportation.

*To generate the additional revenues required for the funding needs outlined above, the Civic Federation could support increasing the state personal income tax from 3% to 4%, which would generate approximately \$3.2 billion, and increasing the corporate income tax from 4.8% to 6.4%, which would generate approximately \$0.6 billion.*

The Civic Federation would not lightly endorse a general tax increase. We could not support new revenues simply to implement new programs. But we could support reasonable revenue increases that would invest in the future of our children and our infrastructure and that would ensure fiscal stability by establishing a recurring revenue source to replace lottery revenues. The price to be paid for instilling fiscal responsibility and investing in core State priorities would be, in our view, a reasonable one, and the increased revenues should be paid in conjunction with the implementation of comprehensive pension liability and funding reforms.

## Issues the Civic Federation Opposes

The Civic Federation **opposes** the following issues in the FY2008 State of Illinois operating budget.

### The Governor's Dramatic Long-Term Expansion of Spending

The Civic Federation cannot support Governor Blagojevich's proposal to commit State resources to expensive multi-year projects. We do not believe such a long-term expansion of government responsibilities is prudent given Illinois's precarious financial condition. The audited FY2006 financial statement shows that the State currently has a \$2.4 billion operating deficit, \$40.7 billion in unfunded pension liabilities, and an undetermined liability for post-employment benefits that will be identified in the FY2008 financial statements. Future generations may well be saddled with enormous costs that will be difficult bear without dramatic tax increases or the crowding out of other State priorities. The Civic Federation is specifically concerned about three issues:

- 1) The proposed four-year, 215% spending expansion for new programs between FY2008 and FY2011.
- 2) The enormous cost of funding the State's ongoing pension liabilities even if the pension funding reforms are approved.
- 3) The State's inability to control current Medicaid and Group Health Insurance program costs.

### *A 215% Increase in Spending for New Programs by FY2011*

The imposition of a new gross receipts tax (GRT) is being proposed to allow for an enormous long-term expansion of State spending. The Governor initially proposed to boost spending for new initiatives alone, including healthcare, education, and capital program debt service, by as much as 215%, from \$2.6 billion to \$8.2 billion, between FY2008 and FY2011. This GRT and spending proposal, which has been promoted as a means for achieving tax fairness in Illinois, has recently been amended to increase the GRT rates and provide an additional \$1 billion annually for property tax relief. It is not clear to the Civic Federation that generating enormous revenues for new programs has much to do with notions of tax fairness or meeting existing State obligations.

Under the Governor's new social spending proposals, new funding for elementary and secondary education is projected to rise by 100% over a four-year period, from \$1.5 billion in FY2008 to \$3.0 billion in FY2011. Spending for the Governor's new health insurance programs will rise by as much as 969%, depending on how his programs are implemented. This represents an increase from \$374 million in the first year to as much as \$4.0 billion four years later. Finally, the cost of increasing reimbursement rates for Medicaid providers will jump by 431%, from \$90 million to \$478 million. Combined healthcare and education spending will rise by 250% to 291% during this four-year period.

<b>Proposed New State Social Spending Initiatives</b>			
	<b>First Year Costs (in \$ millions)</b>	<b>FY2011 Costs (in \$ millions)</b>	<b>% Increase</b>
Increased Education Funding	\$1,500	\$3,000	100%
Illinois-Covered Health Insurance	\$374	\$3,200 to \$4,000	755% to 969%
Increased Medicaid Provider Rates	\$90	\$478	431%
<b>Total</b>	<b>\$1,964</b>	<b>\$6,678 to \$7,678</b>	<b>250% to 291%</b>

Source: John Filan, "Investing in Illinois Families," presented to the Civic Federation on March 14, 2007

### *Mounting Costs for Existing State Healthcare Programs*

The State proposes to establish universal health care coverage even as costs for its existing employee and retiree health insurance program and Medicaid are soaring. Between FY1997 and FY2005 (the most recent year for which Illinois Medicaid spending data is available), due to both program expansions and increased medical costs, the State's share of Illinois's total Medicaid spending has risen annually by an average of 6.8% or \$292.4 million. Combining both State and Federal portions, Illinois's total Medicaid spending has increased by an average of 6.9% or \$604.7 million. Today, approximately 2.3 million Illinoisans or roughly 18% of State residents receive health care coverage or pharmacy benefits through medical programs administered by the Department of Healthcare and Family Services.<sup>4</sup>

<b>State of Illinois Medicaid Spending: FY1997 through FY2005</b>					
	<b>State Share</b>	<b>Federal Share</b>	<b>Total</b>	<b>Total \$ Increase Over Previous Year</b>	<b>Total % Increase Over Previous Year</b>
<b>FY1997</b>	\$ 3,485,203,931	\$ 3,546,779,998	\$ 7,031,983,929	--	--
<b>FY1998</b>	\$ 3,497,584,796	\$ 3,573,089,918	\$ 7,070,674,714	\$ 38,690,785.0	0.6%
<b>FY1999</b>	\$ 3,525,354,267	\$ 3,618,617,017	\$ 7,143,971,284	\$ 73,296,570.0	1.0%
<b>FY2000</b>	\$ 4,089,792,922	\$ 4,213,366,638	\$ 8,303,159,560	\$ 1,159,188,276.0	16.2%
<b>FY2001</b>	\$ 4,193,860,911	\$ 4,287,439,965	\$ 8,481,300,876	\$ 178,141,316.0	2.1%
<b>FY2002</b>	\$ 4,728,626,310	\$ 4,836,998,123	\$ 9,565,624,433	\$ 1,084,323,557.0	12.8%
<b>FY2003</b>	\$ 4,793,738,053	\$ 5,245,693,887	\$ 10,039,431,940	\$ 473,807,507.0	5.0%
<b>FY2004</b>	\$ 5,188,976,874	\$ 5,849,671,970	\$ 11,038,648,844	\$ 999,216,904.0	10.0%
<b>FY2005</b>	\$ 5,824,265,539	\$ 6,045,463,843	\$ 11,869,729,382	\$ 831,080,538.0	7.5%
<b>Average Annual Increase</b>	<b>\$ 292,382,701</b>	<b>\$ 312,335,481</b>	<b>\$ 604,718,182</b>	<b>N/A</b>	<b>6.9%</b>

Source: Centers for Medicare & Medicaid Services, CMS-64 Quarterly Expense Reports

Note: Totals include all Medical Assistance Program, Administrative, and SCHIP costs

Over the ten-year period between FY1998 and FY2007, the State's liabilities for its own employee and retiree health insurance program have risen from \$802.8 million to \$1.8 billion, a \$1.0 billion or 131.4% increase. These liabilities have risen at a much faster rate than have the State's total budgetary appropriations. The average rate of increase for budget appropriations between FY1998 and FY2007 was 5.2%, while the average rate of increase for health insurance liabilities was 9.4%. In FY2007 State employee health insurance liabilities represented approximately 3.4% of total State operating budget appropriations, and its employee health care costs of \$1.8 billion exceeded the entire operating budget of \$1.3 billion for the Illinois Department of Children and Family Services. These levels of increase do not give the Civic

<sup>4</sup> See <http://www.hfs.illinois.gov/>.

Federation confidence that the State is well positioned to manage a universal health insurance program even if such a program were affordable for the State at the present time.

The Governor's *Illinois Covered* initiative consists of four different programs:

- *FamilyCare Expansion*, which will expand the existing FamilyCare program to provide health insurance to families of eligible children up to 400 percent of the federal poverty level;
- *Illinois Covered Assist*, which will provide comprehensive healthcare to Illinois residents who live below the poverty level but are otherwise ineligible for Medicaid (\$247 million in FY2008);
- *Illinois Covered Rebate*, which will provide rebates for Illinois residents with incomes between 100% and 400% of the federal poverty level who pay their own health insurance premiums or who contribute part of the premium for their employer-provided health insurance coverage; and
- *Illinois Covered Choice*, which will offer a subsidized insurance product to all Illinois residents with premium assistance for individuals who make 400 percent of the federal poverty level or less (expected to cost \$1.2 billion when implemented in FY2009).

The Governor also proposes increasing by an average of 37% the rates at which Illinois's Medicaid program reimburses medical practitioners. These rate increases, which are to be phased in between FY2008 and FY2011, will eventually cost \$426 million per year. The initial rate increases will cost \$90 million in FY2008.

#### *Governor's Long-Term Spending Plan for Elementary and Secondary Education*

While the Civic Federation could support a tax increase to generate substantial new revenues for education, provided that the new funds were tied to significant financial management accountability reforms, we believe that the Governor's education proposal promises more than the State can currently afford. In addition to the substantial education spending increases included in the FY2008 budget, the Governor has proposed that by FY2011, the State will have raised its education funding levels by \$3.0 billion over FY2007 spending levels.

The FY2008 State budget proposes an increase of \$1.5 billion for PK-12 Education Programs. More than half of the \$1.5 billion, \$800 million, will be used to increase the level of General State Aid provided to school districts by \$686 per student. The Governor's plan also calls for:

- Increasing the state reimbursement rate for teachers and other personnel who serve students with special needs and fully funding other special education programs mandated by the state (i.e., transportation programs);
- Accelerating the implementation of the Preschool for All program begun in FY2007 (\$60 million in FY2008);
- Providing financial incentives to recruit and retain teachers;
- Providing resources to aid underperforming schools (these resources are to be accompanied by accountability measures); and
- Making additional resources available to school districts who face unique challenges.

The Civic Federation could support a significant increase in education funding. We believe that such an increase would constitute a vital investment in the economic and social future of the State. The Civic Federation also believes, however, that the State must prioritize its education spending. While each of the component programs outlined in the Governor's proposal may be worthwhile, **a \$3.0 billion increase in education funding over four years is unrealistic given the State's inability to meet its current outstanding obligations.** Moreover, any substantial education funding increase must be accompanied by significant financial management reforms so that taxpayers can be confident that their money is being used effectively and efficiently. A portion of any new funding should be earmarked for implementing these reforms.

### *Property Tax Relief*

Under the gross receipts tax proposal currently being considered by the General Assembly, \$1 billion in GRT revenues will go toward property tax relief for Illinois businesses and homeowners once the GRT has been fully implemented. This \$1 billion will come from the additional revenue raised by the General Assembly's having increased the Governor's GRT tax rates on both service activities and manufacturing, wholesale, and retail activities. The Civic Federation strongly opposes this proposal. Exacerbating the negative economic impact of a flawed and regressive tax in order to provide very modest property tax relief is an extremely ill-advised tax policy.

According to the current GRT proposal, \$1 billion will be dispersed directly to school districts, and each school district will be required to reduce its operating tax levy by one dollar for every dollar it receives. \$200 million of the \$1 billion available will be set aside for Chicago. The remaining \$800 million will be distributed to Illinois school districts based on two formulae that favor school districts with lower property wealth per pupil. The overall property tax reduction experienced by different cities will vary significantly, but using data from tax year 2005, the Civic Federation estimates that if the property tax relief proposal had been in effect, City of Chicago taxpayers would have owed 6% less for that tax year than they otherwise owed. This proposal brings significantly less property tax relief for residential homestead eligible taxpayers than the renewal of the 7% homestead exemption would bring.

Given the State's numerous outstanding financial obligations and the modest effects of the property tax relief proposed by supporters of the GRT, the State would be better served by focusing its attention on improving its financial structure and producing a more comprehensive reform of the property tax system.

### *New State Social Spending will be Added to Huge Pension Funding Obligations*

The Governor's proposed pension funding proposal will revise the annual payment schedule required by Illinois statute, reducing the FY2008 combined payment for pension obligation bond debt service and pension system costs from \$2.6 billion to \$1.9 billion. Under the Governor's proposal, only \$0.3 billion in operating revenue would be paid into the pension system. This amount falls approximately \$1 billion short of covering the pension system's normal operating costs.

Even if \$15.9 billion in bonded debt were issued to pay down pension liabilities and the Governor's revised pension funding schedule were adopted, the State would still have to pay a

large and steadily increasing sum each year until 2040. According to the revised schedule, in 2011 this amount (which includes all debt service on the pension obligation bonds) would be \$2.2 billion and in FY2016 it would be \$3.6 billion. Adding long-term social program costs to mounting pension costs raises serious concerns about the affordability of the enormous fiscal commitments that the Governor is proposing for Illinois.

*The Civic Federation cannot support the addition of expensive recurring programs because these programs are unaffordable in the long term. The State has repeatedly failed to pay for its existing obligations. Given that the State has proved reluctant to pay even the normal operating cost of its pension system, we are also very concerned about the State's ability to afford current benefit levels over the long term.*

### The Governor's \$15.9 Billion Pension Obligation Bond Issue

The Governor's FY2008 budget would provide the State's five pension plans with \$25.9 billion in new assets. This dramatic increase in the funded ratio would be achieved through two financing mechanisms:

1. The issuance of \$15.9 billion in pension obligation bonds. All proceeds of the bond issue would be paid into the State retirement systems, which would be responsible for investing the assets and achieving a rate of return that exceeds the interest rate paid on the borrowed funds.
2. The long-term lease of the Illinois State Lottery, which is projected to generate at least \$10 billion. All proceeds of the lottery lease transaction would be paid into the State retirement systems. The Governor proposes replacing the \$650 million in annual lottery revenues that currently funds education with revenues generated by the gross receipts tax.

The Civic Federation **opposes** Governor Blagojevich's proposal to issue \$15.9 billion in pension obligation bonds because not all of the proceeds would be used to pay down existing pension liabilities. Under the Governor's revised pension payment schedule, the State's FY2008 pension payment of \$340 million falls far short of the approximately \$1.3 billion "normal" or annual cost of existing employee benefits, which is an operating cost of the State.<sup>5</sup> In FY2008 the State would also pay \$496 million for debt service on the \$10 billion in pension obligation bonds issued in 2003 and \$957 million for its proposed \$15.9 billion pension obligation bond issue. The Civic Federation strongly believes that the State should never borrow money to meet current operating expenses.

The Civic Federation has previously supported issuing pension obligation bonds in order to pay down existing retirement system liabilities. In 2003 we supported the State's \$10 billion bond issue on the condition that all proceeds be used to pay down past unfunded liabilities. We were disappointed when the State immediately used part of those proceeds to reduce its annual payments for its retirement system's operating expenses. Subsequently, the State took a \$2.3 billion partial pension holiday in FY2006 and FY2007. Both of these actions weakened the benefit of the \$10 billion to the pension system's fiscal health.

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<sup>5</sup> For a comparison of the current and revised pension funding schedules, please see the charts on pp. 50-51.

In the future the Civic Federation would consider a proposal to use debt financing to pay down the State's unfunded pension liabilities, but **only** if two conditions were met.

First, the State must pass pension benefit reforms prior to issuing debt. The justification for such borrowing is the continued need to address decades of underfunding the State's pension system. But going forward, the State must also act to control the costs of a State employee benefit system that remains unaffordable. This means that the State must couple new funding with significant reforms that will reduce the systems' long term liabilities by capping benefits for new hires and increasing cost sharing from employees and retirees. Funding reforms like the Governor's proposal cannot put the State on solid financial footing if the General Assembly grants new benefits to retirees or if the State remains burdened by its overly generous retirement plans.

Second, the State, as would be the case for any government proposing borrowing money to improve the financial health of its pension system, must only use the proceeds from any pension bond borrowing to pay down pre-existing liabilities. In other words, the State must use current revenues to pay for the current operating cost of the State's employee benefit programs.

In FY2008, the State should make the full \$2.0 billion pension payment required under the 1995 Pension Funding Reform Law. If the State leases the lottery and uses all of the proceeds to strengthen the pension system, it could modify the existing pension payment schedule in FY2009, so long as the State continues to fully fund the normal cost of the pension system and only reduces the amortized debt portion of the pension payment. Before taking the extraordinary action of borrowing again to pay down its unfunded pension liabilities, the State must show it is willing to make serious pension benefit reforms. We also believe that the State should demonstrate that it has the fiscal discipline to make its scheduled pension payments for several years before proposing another massive debt issuance.

### The Gross Receipts Tax

The Civic Federation **strongly opposes** Governor Blagojevich's gross receipts tax (GRT) proposal. We do not support the dramatic expansion of State government spending that this tax is intended to support, nor do we believe that the GRT is an appropriate or fair tax for Illinois.

The Civic Federation shares the concerns of the business community, newspaper editorial boards, and other State constitutional officers that the GRT is a seriously flawed and regressive tax. Specifically, our concerns about this expansive new tax are as follows:

- The gross receipts tax is an unfair and inequitable tax. It imposes a tax on businesses regardless of profitability or ability to pay, and penalizes businesses that make investments or fund research. It will cause economic disruptions for the numerous businesses that operate at the margins of profitability, jeopardizing their financial sustainability. In short, this tax seriously violates the principle of economic neutrality by causing significant economic distortions in business activity.
- The gross receipts tax causes a "pyramiding" effect. Because every stage of the production process is taxed, products could face as many as six different levels of taxation. This adds substantially to the cost of production and ultimately boosts prices.

- Most taxes are passed along to some degree from business to purchaser. The GRT legislation forbids passing along the cost of the tax to customers, but in most instances this provision will be nearly impossible to enforce. The Civic Federation therefore strongly disagrees with the Governor's claim that the GRT is a business tax, not a consumer tax.
- The GRT is highly susceptible to being passed on because, unlike income taxes or property taxes, it is imposed on the stages of production. The Civic Federation believes that major spending increases should be funded by transparent revenue sources so that taxpayers know exactly what they are paying.
- The Governor's proposal does not eliminate the corporate income tax, which will continue to be imposed on businesses which are exempt from the GRT. The administration has merely asked the General Assembly to find replacement revenues for the corporate income tax by 2011. This proposal therefore differs from the GRT passed in Ohio, which is touted as the model for the Illinois GRT. Ohio completely replaced its corporate income tax with the GRT. Ohio's GRT rate of 0.26% is also significantly lower than the current proposal for Illinois, which would have one of the highest GRT rates in the country.
- The Governor's proposal also fails to eliminate the State's second corporate income tax, the Personal Property Replacement Tax (PPRT). So, all businesses will continue to pay some corporate income taxes, regardless of whether they are subject to the GRT or not.
- The GRT will have a severe impact on industries that operate with long-term contracts, such as the real estate industry. These types of industries typically operate with low profit margins. At minimum, there is a need for transition rules for these industries. Otherwise, their profit margins will shrink dramatically to the detriment of significant sectors of the Illinois economy.

The Governor's charged rhetoric about businesses not paying their "fair share" of taxes concerns us. Businesses already pay a panoply of state and local taxes – the PPRT, insurance taxes, property taxes, utility taxes, the corporate franchise tax, unemployment and worker's compensation taxes, etc. If the Governor truly thinks that the Illinois business community does not pay what the Governor believes is its "fair share," the Governor should have approached and continued to work with the business community to selectively close business tax loopholes that either serve no public policy purpose or have outlived their usefulness. The Civic Federation has supported many of the Governor's proposed "loophole" closings in past years. We believe as a matter of principle that tax exemptions and benefits should be sunsetted and their renewal debated and discussed, not continued indefinitely.

### *The Gross Receipts Tax Proposal*

The FY2008 budget includes a new proposed gross receipts tax that is projected to generate at least \$2.6 billion between January 1, 2008, when the tax would go into effect, and the end of

FY2008 (June 30, 2008). The following fiscal year, when fully operational, the GRT is expected to generate \$7.2 billion.<sup>6</sup>

Under the Governor's proposal, the GRT rate would be 0.85% on all receipts for agriculture, mining, manufacturing, construction, wholesale and retail industries and 1.95% for service related industries and activities. Exemptions would be provided for the following categories of business activity:

- Businesses with \$2 million or less in annual gross receipts (not the first \$1 million of receipts),
- Retail sales of food,
- Retail sales of pharmaceutical drugs,
- Exports,
- Entities receiving federal Medicaid payments from the federal government,
- Insurance premiums, and
- Gaming receipts (there already is a separate gross receipts tax on gaming).

Tax-exempt, charitable, and not-for-profit organizations would also be exempt. Additional revisions that are being proposed by the administration will exempt receipts from securities trading and the sale of capital assets.<sup>7</sup>

The GRT does not eliminate or replace the corporate income tax. It simply provides that the General Assembly must decide upon a replacement source of revenues for the corporate income tax by 2011. The GRT and the corporate income tax will therefore co-exist for a period of time. In FY2008, all Illinois businesses will continue to calculate their liability on profits and will pay corporate income taxes. Those businesses that are subject to the GRT will then be allowed to take a credit against their gross receipts tax liability equal to the amount of the corporate tax liability. Those companies exempt from the GRT, the majority of Illinois businesses, will be subject only to the corporate income tax.<sup>8</sup>

In addition, the GRT proposal does not eliminate the personal property replacement tax (PPRT), essentially a second corporate income tax. All businesses currently obligated to pay the PPRT will continue to pay that tax. The administration has indicated its interest in the future repeal of the PPRT if replacement revenues can be found from another source.<sup>9</sup>

In FY2008 revenues from the gross receipts tax would be used to fund an array of expensive projects: the proposed \$1.5 billion increase in funding for elementary and secondary education, \$650 million to replace annual Lottery receipts, and \$374 million to begin the implementation of the Governor's health insurance program. A surplus of \$47 million would be reserved for the State's budget stabilization Rainy Day Fund.

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<sup>6</sup> The Civic Federation does not have the data necessary to estimate the additional revenue the Governor's revised GRT proposal would generate either in FY2008 or FY2011. The revenue estimates cited are for the Governor's original proposal. The revised GRT proposal currently being considered by the General Assembly increased the rate on manufacturers from 0.5% to 0.85% and services from 1.8% to 1.95%.

<sup>7</sup> Presentation by Illinois Department of Revenue Director Brian Hamer to the Civic Federation, March 30, 2007.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid.

Proposed Uses for Gross Receipts Tax Revenue in FY2008	
Increased P-12 Education Funding	\$1.5 billion
Offset to Lottery Revenues	\$650 million
Health Insurance Programs	\$374 million
Increased Medicaid Provider Rates	\$90 million
Healthcare System Improvement	\$16 million
Capital Program	\$12 million
Rainy Day Fund (Net Surplus)	\$47 million
<b>Total</b>	<b>\$2.6 billion</b>

Note: The chart does not include any money that might be spent on property tax relief in FY2008. That figure is unavailable at the time of printing.

## Issues the Civic Federation Supports

The Civic Federation supports several components of Governor Blagojevich's FY2008 operating budget, including the long-term lease of the lottery and the consolidation of special purpose funds. We also support reasonable revenue enhancements to pay for core State responsibilities, such as pensions, education, and mass transit.

### Governor's Illinois State Lottery Proposal

The Governor proposes entering into a long-term concession lease of the Illinois Lottery and is currently qualifying potential bidders. The State expects that the lease of the Illinois Lottery, which is the nation's 11<sup>th</sup> largest and has annual revenues exceeding \$2 billion, will generate \$10 billion in immediate cash. The State has pledged to immediately transfer these proceeds to the State retirement systems. Other important details about the lease of the lottery, including the level of oversight that the State will retain and the length of the lease, are not yet available.

### Support for the Long-Term Lease of the Illinois State Lottery

The Civic Federation **supports** Governor Blagojevich's proposal to put approximately \$10 billion in proceeds from the lease of the lottery into the State's five pension systems. We believe that this proposal is an appropriate means to reduce the past unfunded liabilities of the State's chronically underfunded pension system. If implemented, this component of the Governor's pension funding plan will immediately increase the financial health of the State's chronically underfunded pension systems, reducing the pension funds' unfunded liabilities from \$40.7 billion to \$30.7 billion.

The Civic Federation, however, can only support the Governor's proposal if the General Assembly couples this new funding with significant pension benefit reforms. We believe that funding reforms alone cannot put the State on solid financial footing if the State remains burdened by the cost of its overly generous retirement plans.

In evaluating alternative service delivery proposals advanced by state or local governments, the Civic Federation uses the following criteria:

- Privatization efforts, i.e., the transfer of service delivery responsibilities to the private sector, should be focused on non-essential services or programs.
- Revenues from commercialization efforts such as asset sales or leases should **not** be used for recurring expenditures. These revenues should be used to reduce existing obligations, such as long-term debt or unfunded pension obligations.
- Transferring responsibility for service delivery to a private firm or nonprofit organization can be beneficial **only** if there is a marketplace of competitive, qualified vendors or service providers and strong, sustained management oversight by the government.

The State's proposal for a long-term lease of the Lottery meets several of the Civic Federation criteria. In our view:

- The Lottery is a non-essential or non-core function of the State government and therefore a good candidate for privatization.
- The proceeds of the Lottery lease will be used to reduce an existing obligation - unfunded retirement system liabilities - not for recurring expenditures. Civic Federation support for this transaction is contingent upon all proceeds of the transaction being used to reduce **past unfunded pension liabilities**. Therefore, whether the State obtains \$10 billion for a long-term lease or more, every penny must be used to reduce past liabilities, and none of it may be used to pay for the \$2.6 billion pension payment that the State must make in FY2008 under the 1995 Pension Funding Reform Law.

It is imperative that the State structure a lottery lease contract to provide for continuous and strong management oversight. As the State will continue to own the asset, it must provide guarantees to the public that the lottery will be operated in a fiscally responsible way by a private contractor. This includes regular publicly available reports on the fiscal and administrative status of the lottery as well as the ability to terminate the contract if the concessionaire fails to fulfill contractual terms in an appropriate manner.

In addition, we believe that a lottery contract must include safeguards against and/or limits on aggressive marketing techniques, particularly those campaigns that target disadvantaged communities. Gambling is here to stay, but its social consequences can be extremely negative. We hope that the State will take necessary steps to mitigate its ill effects in the contractual process.

*The Civic Federation believes that the long-term lease of the State Lottery is an appropriate and reasonable measure for improving the financial condition of the State's chronically underfunded pension system. We urge the General Assembly to adopt this proposal, provided that the plan is linked to substantive pension benefits reforms and that all proceeds are used to reduce the past unfunded liabilities.*

#### Implement Pension Benefits Reforms

The State has a pension system it cannot afford. The Civic Federation urges the Governor and General Assembly to couple the lottery lease proposal in the FY2008 budget with several common sense measures that will substantially improve the health the retirement systems and improve accountability of the funds to taxpayers. Specifically, we call for:

*A Moratorium on New Pension Benefits.* The General Assembly has approved the Pay as You Go Act which requires that any State pension enhancements provide for funding. This is a more fiscally responsible approach to pensions than the State has had in the past. But the General Assembly can still sweeten the State's already unaffordable pension plans if it identifies new revenues, potentially leaving taxpayers on the hook for continuously expanding benefits and costs. The State should impose a moratorium on any new employee benefits. Until the pension system has achieved a 90% funded ratio, we call on the legislature to reject and the Governor to veto any new pension enhancements whether they are funded or not.

*A 1% Increase in Employee Contributions.* Employees covered by the state retirement systems contribute a percentage of their compensation for their own pensions and to fund survivor's benefits. For example, members of the State Employees Retirement System (SERS), employees covered by the regular retirement formula are required to make the following contributions:

- Members with Social Security: 3.5% of compensation (pension) + 0.5% (survivors') = 4.0% total
- Members without Social Security: 7.0% of compensation (pension) + 1.0% (survivors') = 8.0% total

The Civic Federation believes all public employees covered by the State's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions.

*Raise the Retirement Age for New Hires.* Members of the state's retirement systems are currently eligible for full retirement benefits when they reach age 60, unlike most private sector retirement systems that make 65 the minimum retirement age for full benefits. The age at which employees become eligible for full benefits should be increased to age 65 for employees with between 8 and 30 years of service, age 62 for employees with between 30 and 35 years of service, or age 60 for employees with 35 or more years of service.

*Fix automatic increases for new hires at the lesser of 2% or CPI.* The current rate of automatic increase for retirement annuities is 3% per year. Other retirement systems index the rate of increase to the CPI, limit the dollar amount of increase, or approve new increases annually. For new hires only, automatic increases should be limited to the lesser of the change in CPI or 2%, and should apply only to the first \$12,000 in annual pension for retirees covered by Social Security and \$24,000 for retirees not covered by Social Security.

*Study the Possibility of Moving to a Defined Contribution Plan for New Hires.* The State should undertake a study that would determine both the costs and benefits of moving to a Defined Contribution pension plan. If the Governor's lottery lease proposal is adopted and the funded ratio of the retirement systems improves dramatically, this option will be more feasible than it has been in the past.

*Require Balance on Pension Boards Between Employees, Management and Taxpayers.* The State should require a balance of employee, management, and taxpayer interests in the governance of its retirement system Boards. Board seats should be set aside for members with professional expertise or certification in financial asset investment, and all members who do not

already possess such expertise should be required to receive some relevant financial training on an annual basis.

### New Recurring Revenues

The Civic Federation supports a reasonable increase in the personal and corporate income taxes to replace Lottery revenues, provide for a modest overall increase in State appropriations, and fund key priorities such as education and mass transit. New moneys for schools, however, should be coupled with the adoption of new financial management accountability reforms as proposed by the Metropolitan Mayors Caucus.

We believe it is reasonable to provide for obligatory annual cost increases in the State budget, such as paying for salary increases and inflationary costs, and to provide some funds for enhancing existing programs. Allowing for a modest 3% increase for these expenses would require approximately \$1.3 billion. Making up the difference between the Governor's proposed FY2008 pension payment and the payment required by the 1995 Pension Funding Reform Law would require approximately \$700 million. Replacing Lottery revenues would require approximately \$650 million per year. A portion of this \$2 billion could be paid for with natural revenue growth, which in FY2008 is expected to be approximately \$370 million for all funds.<sup>10</sup>

To ensure the State's fiscal stability, the Civic Federation also supports investments in areas that are important to furthering the economic growth and viability of Illinois. The two priority concerns in this category are elementary and secondary education and mass transit. The Governor has significantly increased education spending during his first term, although not as much as many education advocates would like. We believe that education should receive more funding, but we also believe that the State must restrict additional funding to affordable targets.

A reasonable increase in the income tax can provide needed dollars that will ease recurring financial pressures on Illinois school districts. However, we caution that any new funding increases for education should be coupled with strong financial management accountability reforms. These reforms should include new guarantees that school district financial information will be transparent and accessible, the implementation of planning processes for school districts, and performance measures that will allow taxpayers to verify that their school districts are being managed efficiently.

Mass transit today faces a crisis situation. The three transit boards under the umbrella of the Regional Transit Authority (RTA) have requested \$225.7 million in new operating funds from the General Assembly this year, as well as increased capital funding.<sup>11</sup> The Civic Federation supports increased public operating funds for the transit boards in order to maintain their viability. We believe that the mass transit systems of northeastern Illinois are critical to the economic sustainability of northeastern Illinois. Allowing them to deteriorate or substantially reduce service would negatively impact the economic and environmental health of the entire region. We were very disappointed that the Governor failed to address this important issue in his FY2008 budget.

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<sup>10</sup> This figure excludes Lottery revenues or gross receipts tax revenues.

<sup>11</sup> *Regional Transit Authority FY2007 Budget: Two-Year Financial Plan and Five-Year Capital Plan*, p. 46.

The Civic Federation believes that the best way to pay for the State's existing obligations and to provide a recurring revenue source for these two top priorities would be a modest increase in the personal income tax, from 3% to 4%, and corporate income tax, from 4.8% to 6.4%.

The average personal income tax in the United States is 5%, well above the Illinois rate of 3%. Consequently, the total personal income tax collected in Illinois as a percentage of total personal income in 2005 was 1.71%, whereas the national average was 2.15%.<sup>12</sup> The corporate income tax is currently slightly lower than in other states. In 2005 the Illinois state corporate tax rate as a percent of taxable income was 7.3% versus 7.8% for the U.S. average. State corporate tax revenues as a percent of Gross State Product in 2005 in Illinois were 0.24% compared to 0.27% nationwide.<sup>13</sup> Given this data, the Civic Federation believes a reasonable increase in income taxes would not impose an undue burden on individual or business taxpayers.

Increasing the individual income tax rate from 3.0% to 4.0% would generate approximately \$3.17 billion. Raising the corporate income tax from 4.8% to 6.4% would generate approximately \$577.0 million. The two tax increases together would yield approximately \$3.75 billion.<sup>14</sup>

In summary, we estimate that the State would require an additional \$3.75 billion in FY2008 over the previous year's budget to pay for:

- A modest funding increase over the State's FY2007 operating budget for mandated or contractual spending increases and some additional operating funds. This increase would cost \$1.3 billion.
- The difference between the Governor's proposed FY2008 pension and debt service payment, \$1.9 billion, and the pension and debt service payment that must be made according to the amended 1995 Pension Funding Reform Law, \$2.6 billion. That difference is \$700 million in FY2008.
- The replacement of annual Lottery revenues that are currently used to fund education. Replacing these costs would cost \$650 million annually. If the General Assembly does not approve the lease of the lottery, this \$650 million should be paid into the pension system in order to reduce past unfunded liabilities.
- Providing a reasonable yet significant funding increase for the critical priorities of elementary and secondary education and mass transit. The Civic Federation's proposal would make \$1.1 billion in new State revenue available for these core State needs.

Finally, the Civic Federation also endorses State efforts to close outdated and economically inefficient corporate tax loopholes. In our past analyses of the State operating budget, we have supported many of these efforts. In FY2007, for example, we supported State efforts to repeal

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<sup>12</sup> Tax Foundation, Taxpayers' Federation of Illinois, US Census Bureau; Bureau of Business and Economic Research; and analysis by McKinsey Consulting. Cited in Civic Committee of the Commercial Club, *Facing Facts: A Report of the Civic Committee's Task Force on Illinois school Finance*, December 2006, p. 34.

<sup>13</sup> Tax Foundation, Taxpayers' Federation of Illinois, US Census Bureau; Bureau of Business and Economic Research; and analysis by McKinsey Consulting. Cited in Civic Committee of the Commercial Club, *Facing Facts: A Report of the Civic Committee's Task Force on Illinois school Finance*, December 2006, p. 35.

<sup>14</sup> These are mathematical extrapolations based on the revenue estimates contained in the FY2008 Illinois State Operating Budget. A more precise estimate would require econometric modeling. See FY2008 Illinois State Operating Budget, p. 2-36.

the Retail Rate law, to allow Department of Revenue auditors to verify losses older than three years, to expand the definition of the U.S. to include possessions and the outer continental shelf, and to eliminate an exemption for gas transported out of state.

### Consolidation of Special Purpose Funds

The vast majority of the State's more than 600 special purpose funds were created to receive earmarked revenues that are only used for a designated purpose. The General Funds, which include the General Fund and the Common Schools Fund, are used for any purpose that the State deems fit. Over time, the number of special purpose funds has increased, consuming ever larger portions of the State budget. In FY2008, these Other State funds, as they are designated in the budget, will constitute 29.2% of the entire State budget or \$14.3 billion. When federal funds are included, the amount rises to \$20.2 billion or 41.2% of the total operating budget.<sup>15</sup> These funds had an aggregate balance exceeding \$3.0 billion at the end of FY2006.

In previous years, the administration has "swept" special purpose funds to transfer revenues to the General Funds. In FY2004 the Blagojevich administration began assessing most "Other" funds a 5% fee to pay for the cost of administrative services, such as legal and accounting services, that are provided by the State and paid for out of the General Revenue Fund. The Civic Federation strongly endorsed this measure,<sup>16</sup> and the General Assembly approved it in statute.<sup>17</sup> Many fee revenues earmarked for special purpose funds in Illinois are deposited to the General Fund in other states.<sup>18</sup>

The FY2008 budget proposes consolidating these funds into the General Fund in order to simplify cash management, expedite bill paying, and simplify the state audit process. This consolidation will proceed in accordance with the recommendations of a collaborative task force involving representatives from both the executive and legislative branches. The Governor also proposes using any excess fund balances to augment the Budget Stabilization Fund and to pay down existing Medicaid liabilities. The State expects to generate \$224 million for the Budget Stabilization Fund and \$276 million for Medicaid liabilities.

The Civic Federation supports the concept of transferring surplus revenues from special purpose funds to General Funds. It is a common budgetary practice across the U.S. to "sweep" funds and transfer surpluses in segregated funds to help close budget gaps. We see no compelling reason that Illinois should not also use surplus funds to provide revenues for essential programs.

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. The General Assembly and the voters are free to reject the administration's policy choices through the legislative and electoral processes.

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<sup>15</sup> *FY2008 Illinois State Budget*, p. 2-35.

<sup>16</sup> The Civic Federation. *FY2004 Illinois State Budget Analysis*, May 20, 2003.

<sup>17</sup> See Sections 8H and 8J of the State Finance Act, 30 ILCS 105/8H-8J.

<sup>18</sup> *FY2006 Illinois State Budget*, p. 3-6.

*The Civic Federation endorses the Blagojevich administration's effort to consolidate special purpose funds. This is a common sense management proposal that would increase the efficiency of the State's cash management process and put surplus funds to productive use.*

## **Civic Federation Recommendations**

The Civic Federation offers a number of recommendations intended to improve the State's financial management practices and reduce costs.

### Implement Pension Benefits Reforms

Pension benefit reforms are essential if the State is to control the costs of a State employee benefit system that remains unaffordable. We urge the Governor and General Assembly to adopt the following common sense proposals that will substantially improve the health the retirement systems and improve accountability of the funds to taxpayers. Adopting these pension benefit reforms are, in our view, a precondition for both the lottery lease and any new state pension borrowing plans:

*A Moratorium on New Pension Benefits.* The General Assembly has approved the Pay as You Go Act which requires that any State pension enhancements provide for funding. This is a more fiscally responsible approach to pensions than the State has had in the past. But the General Assembly can still sweeten the State's already unaffordable pension plans if it identifies new revenues, potentially leaving taxpayers on the hook for continuously expanding benefits and costs. The State should impose a moratorium on **any** new employee benefits. Until the pension system has achieved a 90% funded ratio, we call on the legislature to reject and the Governor to veto any new pension enhancements whether they are funded or not.

*A 1% Increase in Employee Contributions.* Employees covered by the state retirement systems contribute a percentage of their compensation for their own pensions and to fund survivor's benefits. For example, members of the State Employees Retirement System (SERS), employees covered by the regular retirement formula are required to make the following contributions:

- Members with Social Security: 3.5% of compensation (pension) + 0.5% (survivors') = 4.0% total
- Members without Social Security: 7.0% of compensation (pension) + 1.0% (survivors') = 8.0% total

The Civic Federation believes all public employees covered by the State's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions.

*Raise the Retirement Age for New Hires.* Members of the state's retirement systems are currently eligible for full retirement benefits when they reach age 60, unlike most private sector retirement systems that make 65 the minimum retirement age for full benefits. The age at which employees become eligible for full benefits should be increased to age 65 for employees with between 8 and 30 years of service, age 62 for employees with between 30 and 35 years of service, or age 60 for employees with 35 or more years of service.

*Fix automatic increases for new hires at the lesser of 2% or CPI.* The current rate of automatic increase for retirement annuities is 3% per year. Other retirement systems index the rate of increase to the CPI, limit the dollar amount of increase, or approve new increases annually. For new hires only, automatic increases should be limited to the lesser of the change in CPI or 2%, and should apply only to the first \$12,000 in annual pension for retirees covered by Social Security and \$24,000 for retirees not covered by Social Security.

*Require Balance on Pension Boards Between Employees, Management and Taxpayers.* The State should require a balance of employee, management, and taxpayer interests in the governance of its retirement system Boards. Board seats should be set aside for members with professional expertise or certification in financial asset investment, and all members who do not already possess such expertise should be required to receive some relevant financial training on an annual basis.

Additionally, the State should undertake a study that would determine both the costs and benefits of moving to a Defined Contribution pension plan. If the Governor's lottery lease proposal is adopted and the funded ratio of the retirement systems improves dramatically, this option will be more feasible than it has been in the past.

#### Implement Employee and Retiree Health Insurance Cost Saving Reforms

To alleviate the fiscal pressures of mounting employee and retiree health insurance costs for State government employees, State university employees, members of the General Assembly, and judges, the Civic Federation makes the following policy recommendations:<sup>19</sup>

- Eliminate the costly indemnity plan and place enrollees in HMO or OAP plans that cost significantly less. This measure could save the State between **\$176.6** and **\$253.4 million** per year.
- Eliminate free health care for retirees, saving between **\$53.4** and **\$146.0 million per year** in premium costs.
- Increase employee premium contributions, which are low in comparison to employee contribution levels required by other state and local governments and private sector organizations. Bringing employee premium contributions in line with national averages could yield as much as **\$67.3 million** in savings annually.

By implementing all of the Federation's recommendations, the State could reduce its total annual spending on employee and retiree health care by between **\$297.3** and **\$466 million**.

#### Implement Reasonable Revenue Enhancements to Pay for Pension Liabilities, Education, and Mass Transit

Illinois should increase the personal income tax from 3% to 4% and increase the corporate income tax from 4.8% to 6.4% to provide approximately \$3.75 billion in new recurring revenues.

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<sup>19</sup> The Civic Federation, "State of Illinois Employee Health Insurance Plans: Analysis and Recommendations for Cost Containment," [http://www.civiced.org/articles/civiced\\_245.pdf](http://www.civiced.org/articles/civiced_245.pdf) (April 16, 2007).

Increasing the individual income tax rate from 3% to 4% would generate approximately \$3.2 billion. Raising the corporate income tax from 4.8% to 6.4% would generate approximately \$577.0 million. The two income tax increases together would yield approximately \$3.75 billion.<sup>20</sup>

The Civic Federation believes that this modest revenue enhancement would not unduly burden the State's economy. It would provide needed funds to significantly reduce the State's existing pension obligations as well as to provide money for critical investments in education and mass transit. Maintaining education and mass transit funding at reasonable levels are, in our view, necessary prerequisites to ensuring the State's continued economic growth and stability.

#### Implement Metropolitan Mayors Caucus School Financial Management Accountability Reforms

The Metropolitan Mayors Caucus recently released a report entitled "Strengthening the Financial Accountability of Illinois School Districts" that outlined a 10-point plan to ensure that school districts provide citizens with transparent financial documents, implement planning procedures, and strengthen internal controls.<sup>21</sup> The report was prepared by the Civic Federation.

The Metropolitan Mayors Caucus, an organization bringing together 272 northeastern Illinois civic leaders, proposes that this accountability plan be a prerequisite for any new school funding from the State of Illinois. **We strongly agree.**

The Metropolitan Mayors Caucus school financial management accountability plan includes the following proposals:

1. Prepare a user friendly Budget Executive Summary that is posted on the school district Web site.
2. Prepare a full budget document that includes an organizational chart, formal financial policies, a full long term financial plan or a summary thereof, and a full capital improvement plan or a summary thereof.
3. Require that school districts develop and implement publicly reported performance measures for support services and functions.
4. Require that school districts adopt strengthened internal controls, including creating a strong internal auditor function, implementing more rigorous external audit requirements, and requiring the adoption of formal written internal control policies.
5. Require that school districts create formal written financial policies in key policy areas that must be adopted by Boards of Trustees and made publicly available.

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<sup>20</sup> These are mathematical extrapolations based on the revenue estimates contained in the FY2008 Illinois State Operating Budget. A more precise estimate would require econometric modeling. See FY2008 Illinois State Operating Budget, p. 2-36.

<sup>21</sup> Metropolitan Mayors Caucus. *Strengthening the Financial Accountability of Illinois School Districts*. April 2007.

6. Require that school districts develop and implement a long-term financial plan that includes multi-year forecasts of revenues expenditures and debt.
7. Require that school districts adopt, implement, and disclose a multi-year capital improvement plan.
8. Require that all school board members complete at least six hours of training on their financial oversight, accountability, and fiduciary responsibilities.
9. Require that an Office of School District Financial Management Accountability be established within the Illinois State Board of Education (ISBE) to monitor progress made in meeting the reform requirements. ISBE would be empowered to monitor progress, enforce compliance, and impose sanctions for noncompliance including removal of non-complying administrators.
10. Earmark a portion of new school revenues for implementing the financial management accountability reforms. Special funding would be made available for financially distressed school districts to enable them to implement these reforms.

The Metropolitan Mayors Caucus has proposed that the recommendations be implemented by statute and that compliance be monitored by the ISBE. Intergovernmental cooperation is encouraged for small school districts and those districts experiencing fiscal distress to facilitate implementation of the proposed reforms. The reforms proposed should be phased in to allow sufficient time for ISBE to develop accountability, reporting, and oversight mechanisms, and for school districts to comply with the requirements.

## **ACKNOWLEDGEMENTS**

The Civic Federation would like to express its sincere appreciation to State of Illinois Chief Operating Officer John Filan, Governor's Office of Management and Budget (GOMB) Director Ginger Ostro, Illinois Department of Revenue Director Brian Hamer, GOMB Communications Director Becky Carroll and the respective staffs of the Governor's Office of Management and Budget and the Illinois Department of Revenue for their hard work in preparing this budget and their willingness to answer many of our budget and revenue questions.

## **REVENUES**

The FY2008 proposed State operating budget projects a 6.4% increase in total receipts from the originally proposed FY2007 budget. This is a \$3.0 billion increase from the previous fiscal year's receipts of \$46.7 billion. State tax revenues are expected to rise by 17.3% or \$4.1 billion, due in large part to anticipated revenues from the Governor's proposed gross receipts tax (GRT).<sup>22</sup> Other receipts, non-State tax revenues such as fees, lottery revenues, and federal revenues, will drop by 4.8% or \$1.1 billion.

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<sup>22</sup> These figures reflect the revenue that would be generated under the Governor's original GRT proposal. An amended version of the proposal that increases the tax rates proposed by the Governor is currently under consideration by the General Assembly. For a discussion of the differences between the original and amended GRT proposals, please see page 30.

The FY2008 State budget proposes a gross receipts tax, a significant new revenue source that is projected to generate \$2.6 billion between January 1, 2008, when the tax would go into effect, and the end of FY2008 (June 30, 2008). Under the Governor's proposal, the GRT would impose a 0.5% tax on all receipts for companies "engaged in agriculture, mining, manufacturing, construction, wholesale and retail activities."<sup>23</sup> The GRT would also tax service industries, which are currently not assessed a sales tax in Illinois. The tax rate for service industries would be 1.8% on all receipts. All Illinois companies whose annual receipts total less than \$1 million would be exempted from the GRT.

An amended GRT proposal is currently being considered by the General Assembly. The amended proposal increases the tax rate on wholesale, retail, and manufacturing activities to 0.85% and increases the tax rate on services to 1.95%. The amended proposal also exempts Illinois companies whose annual receipts total less than \$2 million. For a complete description of the amended proposal, please see page 30. All revenue tables below reflect GRT revenue projections made under the Governor's original proposal. Updated revenue projections based on the amended proposal's tax rates and exemptions were not available at the time of this report's publication.

Projections for elastic revenues in Illinois reflect concern that the U.S. economy's growth will slow as fiscal year 2008 begins. The state anticipates, though, that the effects of the slow down on Illinois's economy will lag behind the effects on other states' economies because the onset of Illinois's economic gains lagged behind the onset of national growth. Net personal income tax revenues are expected to continue to grow at a strong 7.1% rate in FY2008, but net corporate income taxes are projected to increase by only 2.7% in FY2008. By comparison, between FY2006 and FY2007, projected corporate income tax revenue increased by 45.4%.

There are three components of the sale tax base: 1) sales taxes from vehicle purchases, 2) motor fuel, and 3) retail sales. The State forecasts sales tax revenues by making its own projections through econometric modeling. It also contracts with two national firms, Economy.com and Global Insight, who provide independently generated economic forecasts. These forecasts are then reviewed by the Council of Economic Advisors (a group of private and public sector finance experts appointed by the Governor), the Governor's Office of Management and Budget, the Department of Revenue, and the Department of Employment Security.

Overall, sales tax revenues are expected to increase by a modest 3.5%, as compared to a projected 7.9% growth rate between FY2006 and FY2007. Retail sales are the main sales tax driver, accounting for 70% of total sales tax revenue. Growth in this sector is projected to be slightly less than 3.5% in FY2008 compared to 4.5% in FY2007. The slowdown is attributed to a weakening of household credit conditions, which will negatively impact demand for large durable goods, and also to the dissipation of wealth gains that had accompanied the strong housing market of the previous several years. Based on the recommendation of the Council of Economic Advisors, the FY2008 sales tax revenue projections track more closely with the lower of the two forecasts produced by Global Insight and Economy.com. Global Insight projects only 3.0% retail sales growth, while Economy.com projects 5.0% growth. Vehicle sales are expected to fall by 1.8% in FY2008 (sales taxes from motor vehicles account for 20% of all sales tax

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<sup>23</sup> FY2008 State of Illinois Budget, p. 5-18.

receipts), and revenue from motor fuel sales is projected to be flat at \$1.45 billion (sales taxes from motor fuel account for roughly 10% of all sales tax receipts).<sup>24</sup>

Riverboat gaming taxes and fees are expected to rise by 5.0%, increasing from \$802 million in FY2007 to \$842 million in FY2008. The temporary gaming tax increase approved in 2003 that increased the staggered rate structure to a high of 70% on adjusted gross receipts over \$250 million expired in 2005. The gaming tax rate then reverted to the previous rate structure, which ranges from 15% to 50% of adjusted gross receipts.

<b>Illinois State Revenues for All Funds: FY2007-FY2008</b>				
<b>(\$ millions)</b>				
	<b>Projected FY2007</b>	<b>Projected FY2008</b>	<b>\$ change FY07-FY08</b>	<b>% change FY07-FY08</b>
<b>STATE TAXES</b>				
Income Taxes (Net)	\$ 10,572	\$ 11,252	\$ 680	6.4%
Personal	\$ 8,884	\$ 9,519	\$ 635	7.1%
Corporate	\$ 1,688	\$ 1,733	\$ 45	2.7%
Sales Taxes	\$ 7,751	\$ 8,022	\$ 271	3.5%
Gross Receipts Taxes	\$ -	\$ 2,626	\$ 2,626	100.0%
Motor Fuel Tax	\$ 1,462	\$ 1,452	\$ (10)	-0.7%
Public Utility Tax	\$ 1,333	\$ 1,884	\$ 551	41.3%
Cigarette Taxes	\$ 623	\$ 618	\$ (5)	-0.8%
Liquor Taxes	\$ 152	\$ 154	\$ 2	1.3%
Inheritance Tax	\$ 255	\$ 255	\$ -	0.0%
Insurance Taxes/Fees	\$ 477	\$ 413	\$ (64)	-13.4%
Corporate Franchise Taxes/Fees	\$ 200	\$ 197	\$ (3)	-1.5%
Riverboat Gaming Taxes/Fees	\$ 802	\$ 842	\$ 40	5.0%
<b>Subtotal State Taxes</b>	<b>\$ 23,627</b>	<b>\$ 27,715</b>	<b>\$ 4,088</b>	<b>17.3%</b>
<b>OTHER RECEIPTS</b>				
Motor Vehicle/Operators License Fees	\$ 1,173	\$ 1,282	\$ 109	9.3%
Interest Income	\$ 141	\$ 185	\$ 44	31.2%
Revolving Fund Receipts	\$ 563	\$ 683	\$ 120	21.3%
Lottery	\$ 1,050	\$ -	\$ (1,050)	-100.0%
Assessment Funds Receipts	\$ 808	\$ 804	\$ (4)	-0.5%
Intergovernmental Payments	\$ 1,357	\$ 1,275	\$ (82)	-6.0%
Group Insurance Receipts	\$ 1,701	\$ 1,396	\$ (305)	-17.9%
Tobacco Settlement Receipts	\$ 295	\$ 288	\$ (7)	-2.4%
Other Taxes, Fees, Earnings & Net Transfers	\$ 2,440	\$ 3,043	\$ 603	24.7%
<b>Subtotal Other Receipts</b>	<b>\$ 9,528</b>	<b>\$ 8,956</b>	<b>\$ (572)</b>	<b>-6.0%</b>
Federal Receipts	\$ 13,544	\$ 13,019	\$ (525)	-3.9%
<b>GRAND TOTAL</b>	<b>\$ 46,707</b>	<b>\$ 49,698</b>	<b>\$ 2,991</b>	<b>6.4%</b>

Source: FY2007 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 2-34  
 FY2008 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 2-36

The next exhibit shows projected changes in **General Funds receipts** between FY2007 and FY2008. The State expects General Fund revenues to rise by 11.4%, from \$28.3 billion to \$31.6 billion, a \$3.2 billion increase. Base revenues from state sources are projected to rise by 4.9%, increasing from \$28.0 billion to \$29.4 billion. The proposed gross receipts tax would generate \$2.6 billion in FY2008. Revenues from the GRT are tallied under "Recurring Revenues and

<sup>24</sup> Ibid., pp. 5-7, 5-9, and 5-10.

Transfers” in the chart below and were calculated using the tax rates originally proposed by the Governor.

<b>Illinois State Revenues for General Funds: FY2007-FY2008 (\$ millions)</b>				
	<b>Proj. FY2007</b>	<b>Proj. FY2008</b>	<b>\$ change FY07-FY08</b>	<b>% change FY07-FY08</b>
<b>BASE REVENUES</b>				
<b>STATE SOURCES</b>				
Income Taxes (Net)	\$ 10,572	\$ 11,252	\$ 680	6.4%
Personal	\$ 8,884	\$ 9,519	\$ 635	7.1%
Corporate	\$ 1,688	\$ 1,733	\$ 45	2.7%
Sales Taxes	\$ 7,280	\$ 7,577	\$ 297	4.1%
Public Utility Taxes	\$ 1,075	\$ 1,105	\$ 30	2.8%
Cigarette Taxes	\$ 350	\$ 350	\$ -	0.0%
Liquor Taxes	\$ 152	\$ 154	\$ 2	1.3%
Inheritance Taxes	\$ 255	\$ 255	\$ -	0.0%
Insurance Taxes & Fees	\$ 322	\$ 317	\$ (5)	-1.6%
Corporate Franchise Fees & Taxes	\$ 196	\$ 187	\$ (9)	-4.6%
Interest on State Funds & Investments	\$ 125	\$ 185	\$ 60	48.0%
Cook County Intergov. Transfer	\$ 309	\$ 287	\$ (22)	-7.1%
Other State Sources	\$ 540	\$ 480	\$ (60)	-11.1%
Transfers-In			\$ -	
Lottery	\$ 650	\$ 650	\$ -	0.0%
Riverboat Gaming Taxes	\$ 692	\$ 692	\$ -	0.0%
Other Transfers	\$ 679	\$ 813	\$ 134	19.7%
<b>Subtotal State Sources</b>	<b>\$ 23,197</b>	<b>\$ 24,304</b>	<b>\$ 1,107</b>	<b>4.8%</b>
Federal Sources	\$ 4,835	\$ 5,089	\$ 254	5.3%
<b>TOTAL BASE REVENUES</b>	<b>\$ 28,032</b>	<b>\$ 29,393</b>	<b>\$ 1,361</b>	<b>4.9%</b>
			\$ -	
<b>Reduction to Base Revenues</b>				
Tax Credits	\$ (100)	\$ -	\$ 100	100.0%
Offset of Lottery Revenue	\$ -	\$ (650)	\$ (650)	-100.0%
			\$ -	
<b>Increases to Base Revenues</b>				
Recurring Revenues and Transfers	\$ 306	\$ 2,836	\$ 2,530	100.0%
Multi-Year Revenues	\$ 100	\$ -	\$ (100)	-100.0%
<b>Total Adjusting Sources</b>	<b>\$ 306</b>	<b>\$ 2,186</b>	<b>\$ 1,880</b>	<b>100.0%</b>
			\$ -	
<b>TOTAL REVENUES</b>	<b>\$ 28,338</b>	<b>\$ 31,579</b>	<b>\$ 3,241</b>	<b>11.4%</b>
Pension Obligation Bonds	\$ -	\$ -	\$ -	
Short-Term Borrowing	\$ -	\$ -	\$ -	
<b>TOTAL RECEIPTS</b>	<b>\$ 28,338</b>	<b>\$ 31,579</b>	<b>\$ 3,241</b>	<b>11.4%</b>

Source: FY2008 State Budget, Table II-B General Funds Revenues by Source, p. 2-37  
FY2007 State Budget, Table II-B General Funds Revenues by Source, p. 2-35

### ***Projected v. Estimated FY2007 General Fund Revenues***

The State originally projected that General Fund revenues in FY2007 would be \$28.3 billion. Net of \$900 million in short-term borrowing, the estimate of General Fund FY2007 revenues has been revised to total \$28.5 billion. This represents a \$0.2 billion or 0.5% increase in revenues.

Illinois State Revenues for General Funds FY07 Projected v. FY07 Estimated (\$ millions)				
	Proj. FY2007	Est. FY2007	\$ difference	% difference
<b>BASE REVENUES</b>				
<b>STATE SOURCES</b>				
Income Taxes (Net)	\$ 10,572	\$ 10,818	\$ 246	2.3%
Personal	\$ 8,884	\$ 9,130	\$ 246	2.8%
Corporate	\$ 1,688	\$ 1,688	\$ -	0.0%
Sales Taxes	\$ 7,280	\$ 7,356	\$ 76	1.0%
Public Utility Taxes	\$ 1,075	\$ 1,110	\$ 35	3.3%
Cigarette Taxes	\$ 350	\$ 350	\$ -	0.0%
Liquor Taxes	\$ 152	\$ 153	\$ 1	0.7%
Inheritance Taxes	\$ 255	\$ 255	\$ -	0.0%
Insurance Taxes & Fees	\$ 322	\$ 322	\$ -	0.0%
Corporate Franchise Fees & Taxes	\$ 196	\$ 186	\$ (10)	-5.1%
Interest on State Funds & Investments	\$ 125	\$ 185	\$ 60	48.0%
Cook County Intergov. Transfer	\$ 309	\$ 307	\$ (2)	-0.6%
Other State Sources	\$ 540	\$ 475	\$ (65)	-12.0%
Transfers-In				
Lottery	\$ 650	\$ 631	\$ (19)	-2.9%
Riverboat Gaming Taxes	\$ 692	\$ 692	\$ -	0.0%
Other Transfers	\$ 679	\$ 850	\$ 171	25.2%
<b>Subtotal State Sources</b>	<b>\$ 23,197</b>	<b>\$ 23,690</b>	<b>\$ 493</b>	<b>2.1%</b>
Federal Sources	\$ 4,835	\$ 4,803	\$ (32)	-0.7%
<b>TOTAL BASE REVENUES</b>	<b>\$ 28,032</b>	<b>\$ 28,493</b>	<b>\$ 461</b>	<b>1.6%</b>
<b>Reduction to Base Revenues</b>				
Tax Credit	\$ (100)	\$ -	\$ 100	100.0%
<b>Increases to Base Revenues</b>				
Recurring Revenues and Transfers	\$ 306	\$ -	\$ (306)	-100.0%
Multi-Year Revenues	\$ 100	\$ -	\$ (100)	-100.0%
<b>Total Adjusting Sources</b>	<b>\$ 306</b>	<b>\$ -</b>	<b>\$ (306)</b>	<b>-100.0%</b>
<b>Short Term Borrowing</b>	<b>\$ -</b>	<b>\$ 900</b>	<b>\$ 900</b>	<b>100.0%</b>
<b>TOTAL REVENUES</b>	<b>\$ 28,338</b>	<b>\$ 29,393</b>	<b>\$ 1,055</b>	<b>3.7%</b>

Source: FY2008 State Budget, Table II-B General Funds Revenues by Source, p. 2-37

FY2007 State Budget, Table II-B General Funds Revenues by Source, p. 2-35

#### ***Four-Year Revenue Trends***

The next two exhibits show three-year revenue trends for all funds and for General Funds alone. In order to provide an accurate comparison, the figures presented are the originally proposed revenues for each fiscal year. Comparable data are not available before FY2005 because that was the first year in which operating and capital budgets were separated. From FY2005 to FY2008, total receipts for all funds are expected to increase by 16.2% while the State's own source tax revenues will rise by 38.1%.

<b>Illinois State Revenues for All Funds: FY2005-FY2008</b>						
<b>(\$ millions)</b>						
	<b>Proj.</b>	<b>Proj.</b>	<b>Proj.</b>	<b>Proj.</b>	<b>\$ change</b>	<b>% change</b>
	<b>FY2005</b>	<b>FY2006</b>	<b>FY2007</b>	<b>FY2008</b>	<b>FY05-FY08</b>	<b>FY05-FY08</b>
<b>STATE TAXES</b>						
Income Taxes (Net)	\$ 8,075	\$ 9,283	\$ 10,572	\$ 11,252	\$ 3,177	39.3%
Personal	\$ 7,285	\$ 8,120	\$ 8,884	\$ 9,519	\$ 2,234	30.7%
Corporate	\$ 790	\$ 1,161	\$ 1,688	\$ 1,733	\$ 943	119.4%
Sales Taxes	\$ 6,957	\$ 7,362	\$ 7,751	\$ 8,022	\$ 1,065	15.3%
Gross Receipts Tax	\$ -	\$ -	\$ -	\$ 2,626	\$ 2,626	100.0%
Motor Fuel Tax	\$ 1,484	\$ 1,450	\$ 1,462	\$ 1,452	\$ (32)	-2.2%
Public Utility Tax	\$ 1,102	\$ 1,218	\$ 1,333	\$ 1,884	\$ 782	71.0%
Cigarette Taxes	\$ 693	\$ 620	\$ 623	\$ 618	\$ (75)	-10.8%
Liquor Taxes	\$ 123	\$ 146	\$ 152	\$ 154	\$ 31	25.2%
Inheritance Tax	\$ 240	\$ 255	\$ 255	\$ 255	\$ 15	6.3%
Insurance Taxes/Fees	\$ 459	\$ 453	\$ 477	\$ 413	\$ (46)	-10.0%
Corporate Franchise Taxes/Fees	\$ 175	\$ 194	\$ 200	\$ 197	\$ 22	12.6%
Riverboat Gaming Taxes/Fees	\$ 758	\$ 710	\$ 802	\$ 842	\$ 84	11.1%
<b>Subtotal State Taxes</b>	<b>\$ 20,066</b>	<b>\$ 21,689</b>	<b>\$ 23,627</b>	<b>\$ 27,715</b>	<b>\$ 7,649</b>	<b>38.1%</b>
<b>OTHER RECEIPTS</b>						
Motor Vehicle/Operators License Fees	\$ 1,315	\$ 1,171	\$ 1,173	\$ 1,282	\$ (33)	-2.5%
Interest Income	\$ 63	\$ 70	\$ 141	\$ 185	\$ 122	193.7%
Revolving Fund Receipts	\$ 387	\$ 514	\$ 563	\$ 683	\$ 296	76.5%
Lottery	\$ 884	\$ 924	\$ 1,050	\$ -	\$ (884)	-100.0%
Assessment Funds Receipts	\$ 1,190	\$ 635	\$ 808	\$ 804	\$ (386)	-32.4%
Intergovernmental Payments	\$ 1,559	\$ 1,409	\$ 1,357	\$ 1,275	\$ (284)	-18.2%
Group Insurance Receipts	\$ 1,573	\$ 1,756	\$ 1,701	\$ 1,396	\$ (177)	-11.3%
Tobacco Settlement Receipts	\$ 271	\$ 283	\$ 295	\$ 288	\$ 17	6.3%
Other Taxes,Fees,Earnings & Net Transfers	\$ 1,978	\$ 4,151	\$ 2,440	\$ 3,043	\$ 1,065	53.8%
Riverboat License Sale	\$ 350	\$ -	\$ -	\$ -	\$ (350)	-100.0%
<b>Subtotal Other Receipts</b>	<b>\$ 9,570</b>	<b>\$ 10,913</b>	<b>\$ 9,528</b>	<b>\$ 8,956</b>	<b>\$ (614)</b>	<b>-6.4%</b>
Federal Receipts	\$ 13,143	\$ 13,040	\$ 13,544	\$ 13,019	\$ (124)	-0.9%
<b>GRAND TOTAL</b>	<b>\$ 42,779</b>	<b>\$ 45,642</b>	<b>\$ 46,699</b>	<b>\$ 49,698</b>	<b>\$ 6,919</b>	<b>16.2%</b>

Note: Due to rounding, the FY2008 Grand Total exceeds the sum of the revenues as listed in this table.

Source: FY2008 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 2-36

FY2007 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 2-34

FY2006 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 1-27

FY2005 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 1-37

General Fund base revenues, including state own source tax revenues and federal intergovernmental aid, are projected to increase by 16.1% between FY2005 and FY2008, from \$25.3 billion to \$29.4 billion. Total General Fund receipts from all sources will increase by 20.9% or \$5.5 billion, from \$26.1 billion to \$31.6 billion.

<b>Illinois State Revenues for General Funds: FY2005-FY2008 (\$ millions)</b>						
	<b>Proj. FY2005</b>	<b>Proj. FY2006</b>	<b>Proj. FY2007</b>	<b>Proj. FY2008</b>	<b>\$ change FY05-FY08</b>	<b>% change FY05-FY08</b>
<b>BASE REVENUES</b>						
<b>STATE SOURCES</b>						
Income Taxes (Net)	\$ 8,075	\$ 9,281	\$ 10,572	\$ 11,252	\$ 3,177	39.3%
Personal	\$ 7,285	\$ 8,120	\$ 8,884	\$ 9,519	\$ 2,234	30.7%
Corporate	\$ 790	\$ 1,161	\$ 1,688	\$ 1,733	\$ 943	119.4%
Sales Taxes	\$ 6,425	\$ 6,778	\$ 7,280	\$ 7,577	\$ 1,152	17.9%
Public Utility Taxes	\$ 1,102	\$ 1,096	\$ 1,075	\$ 1,105	\$ 3	0.3%
Cigarette Taxes	\$ 400	\$ 400	\$ 350	\$ 350	\$ (50)	-12.5%
Liquor Taxes	\$ 123	\$ 146	\$ 152	\$ 154	\$ 31	25.2%
Inheritance Taxes	\$ 240	\$ 255	\$ 255	\$ 255	\$ 15	6.3%
Insurance Taxes & Fees	\$ 347	\$ 366	\$ 322	\$ 317	\$ (30)	-8.6%
Corporate Franchise Fees & Taxes	\$ 175	\$ 194	\$ 196	\$ 187	\$ 12	6.9%
Interest on State Funds & Investments	\$ 45	\$ 45	\$ 125	\$ 185	\$ 140	311.1%
Cook County Intergov. Transfer	\$ 450	\$ 340	\$ 309	\$ 287	\$ (163)	-36.2%
Other State Sources	\$ 729	\$ 436	\$ 540	\$ 480	\$ (249)	-34.2%
Transfers-In						
Lottery	\$ 563	\$ 628	\$ 650	\$ 650	\$ 87	15.5%
Riverboat Gaming Taxes	\$ 647	\$ 696	\$ 692	\$ 692	\$ 45	7.0%
Other Transfers	\$ 870	\$ 916	\$ 679	\$ 813	\$ (57)	-6.6%
10th Riverboat License	\$ 350	\$ -	\$ -	\$ -	\$ (350)	-100.0%
<b>Subtotal State Sources</b>	<b>\$ 20,541</b>	<b>\$ 21,577</b>	<b>\$ 23,197</b>	<b>\$ 24,304</b>	<b>\$ 3,763</b>	<b>18.3%</b>
Federal Sources	\$ 4,772	\$ 4,834	\$ 4,835	\$ 5,089	\$ 317	6.6%
<b>TOTAL BASE REVENUES</b>	<b>\$ 25,313</b>	<b>\$ 26,411</b>	<b>\$ 28,032</b>	<b>\$ 29,393</b>	<b>\$ 4,080</b>	<b>16.1%</b>
<b>Reduction to Base Revenues</b>						
Tax Credits	\$ -	\$ -	\$ (100)	\$ -	\$ -	0.0%
Offset of Lottery Revenue	\$ -	\$ -	\$ -	\$ (650)	\$ (650)	-100.0%
<b>Increases to Base Revenues</b>						
Recurring Revenues and Transfers	\$ 634	\$ 255	\$ 306	\$ 2,836	\$ 2,202	347.3%
Multi-Year Revenues	\$ -	\$ -	\$ 100	\$ -	\$ -	0.0%
One-Time Revenues	\$ 169	\$ -	\$ -	\$ -	\$ (169)	-100.0%
<b>Total Adjusting Sources</b>	<b>\$ 803</b>	<b>\$ 255</b>	<b>\$ 306</b>	<b>\$ 2,186</b>	<b>\$ 1,383</b>	<b>172.2%</b>
<b>GRAND TOTAL</b>	<b>\$ 26,116</b>	<b>\$ 26,666</b>	<b>\$ 28,338</b>	<b>\$ 31,579</b>	<b>\$ 5,463</b>	<b>20.9%</b>

Source: FY2008 State Budget, Table II-B General Funds Revenues by Source, p. 2-37  
FY2007 State Budget, Table II-B General Funds Revenues by Source, p. 2-35  
FY2006 State Budget, Table II-B General Funds Revenues by Source, p. 1-28  
FY2005 State Budget, Table II-B General Funds Revenues by Source, p. 1-38

### ***Proposed FY2008 Tax Change: Gross Receipts Tax***

The FY2008 State budget proposes a gross receipts tax (GRT), a significant new revenue source was originally projected to generate \$2.6 billion between January 1, 2008, when the tax would go into effect, and June 30, 2008, the end of the fiscal year. A description of the original GRT proposal is provided on page 5-18 of the budget.

The GRT proposal under consideration at the time of this report's publication has been amended to increase the tax rates. This amended proposal is described below. A revised estimate of the revenues that the GRT would generate in FY2008, however, was not available at the time of printing.

Under the revised proposal, the Gross Receipts Tax rate would be 0.85% on all receipts for agriculture, mining, manufacturing, construction, wholesale and retail activities, and 1.95% for service-related industries and activities. Exemptions would be provided for the following categories of business activity:

- Businesses with \$2 million or less in annual gross receipts (but not the first \$2 million of receipts),
- Retail sales of food,
- Retail sales of pharmaceutical drugs,
- Exports,
- Entities receiving federal Medicaid payments from the federal government,
- Insurance premiums, and
- Gaming receipts (there already is a separate gross receipts tax on gaming)

Tax-exempt, charitable, and not-for-profit organizations would also be exempt. Additional revisions that are being proposed by the administration would exempt receipts from securities trading and the sale of capital assets.<sup>25</sup>

The GRT does not eliminate or replace the corporate income tax. It simply provides that the General Assembly must designate replacement revenues for the corporate income tax by 2011. The GRT and the corporate income tax will therefore co-exist for a period of time. In FY2008 all Illinois businesses will calculate their liability on profits and will corporate income taxes. Businesses subject to the GRT will then take a credit against their GRT liability equal to the amount of the corporate tax liability.<sup>26</sup> Those companies exempt from the GRT, the majority of Illinois businesses, will be subject only to the corporate income tax.

In addition, the GRT proposal does not eliminate the personal property replacement tax (PPRT), essentially a second corporate income tax. All businesses currently obligated to pay the PPRT will continue to pay that tax. The administration has indicated its interest in the future repeal of the PPRT if replacement revenues can be found from another source.<sup>27</sup>

In FY2008 the revenues from the gross receipts will be used to fund several projects: the proposed \$1.5 billion increase in funding for elementary and secondary education, \$654 million to replace annual lottery receipts and \$374 million for health insurance cost. A surplus of \$47 million would be reserved for the State's budget stabilization Rainy Day Fund.

<b>Proposed Uses for Gross Receipts Tax Revenue in FY2008</b>	
<b>Increased P-12 Education Funding</b>	\$1.5 billion
<b>Offset to Lottery Revenues</b>	\$650 million
<b>Health Insurance Programs</b>	\$374 million
<b>Increased Medicaid Provider Rates</b>	\$90 million
<b>Healthcare System Improvement</b>	\$16 million
<b>Capital Program</b>	\$12 million
<b>Rainy Day Fund (Net Surplus)</b>	\$47 million
<b>Total</b>	<b>\$2.6 billion</b>

<sup>25</sup> Presentation by Illinois Department of Revenue Director Brian Hamer to the Civic Federation, March 30, 2007.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

The current GRT proposal being considered by the General Assembly also provides for \$1 billion in property tax relief for Illinois businesses and homeowners by reducing the operating tax levy for all Illinois school districts. The funds will be dispersed directly to school districts, and each school district will be required to make a dollar-for-dollar reduction in its operating tax levy.

\$200 million of the \$1 billion available will be set aside for Chicago. The remaining \$800 million will be distributed to Illinois school districts based on two formulae that favor school districts with lower property wealth per pupil. The overall property tax reduction experienced by different cities will vary significantly.

***Proposed FY2009 Tax Change: Payroll Tax***

The Governor’s FY2008 budget also proposes that, beginning in FY2009, a payroll tax will be assessed in order to help pay for the Governor’s proposed expansion of Illinois’s health care programs. The Governor proposes levying a payroll fee of 3% on all businesses who employ 10 or more employees and who pay less than 4% of their payroll for healthcare costs. The State estimates that this tax will generate approximately \$1.1 billion per year.

**APPROPRIATIONS**

The Governor’s FY2008 operating budget recommends a total appropriation of \$49.1 billion, an increase of \$3.6 billion, or 8.0%, over the FY2007 originally proposed appropriation of \$45.4 billion. This total includes \$28.9 billion in the General Funds, \$14.3 billion in Other State Funds, and nearly \$5.9 billion in Federal Funds.

***FY2007-FY2008 Appropriation Trend***

In FY2008, proposed General Funds appropriations will increase by 12.2% over the previous year, while Other State Funds appropriations will rise by 1.5%, or approximately \$207.7 million.

The largest fund group in the budget is the General Funds, which represent 58.8% of total recommended appropriations. “Other State Funds” includes a wide range of funds, such as highway funds and other special state funds. The primary purpose of these funds is to receive either tax revenue distributions or specific revenues such as permit and license fees, which are reserved for specific projects. These funds represent 29.2% of the total State operating budget proposal for FY2008.

<b>State of Illinois Appropriations by Fund: FY2007-FY2008</b>				
<b>(\$ thousands)</b>				
	<b>FY2007 Prop.</b>	<b>FY2008 Prop.</b>	<b>\$ change</b>	<b>% change</b>
General Funds	\$ 25,711,790	\$ 28,858,988	\$ 3,147,198	12.2%
Other Funds	\$ 14,125,477	\$ 14,333,216	\$ 207,739	1.5%
Federal Funds	\$ 5,590,405	\$ 5,867,905	\$ 277,500	5.0%
<b>Total</b>	<b>\$ 45,427,672</b>	<b>\$ 49,060,109</b>	<b>\$ 3,632,437</b>	<b>8.0%</b>

Source: FY2008 Illinois State Budget, p. 2-35

The next exhibit shows changes in proposed appropriations between FY2007 and FY2008 for major program areas in the State budget. Spending for agencies under the Governor, the largest appropriation category, will increase by 4.8% or \$1.6 billion to \$34.4 billion. Appropriations for elementary and secondary education, the next largest category, will increase by 15.6%, from \$8.8 billion to \$11.1 billion.

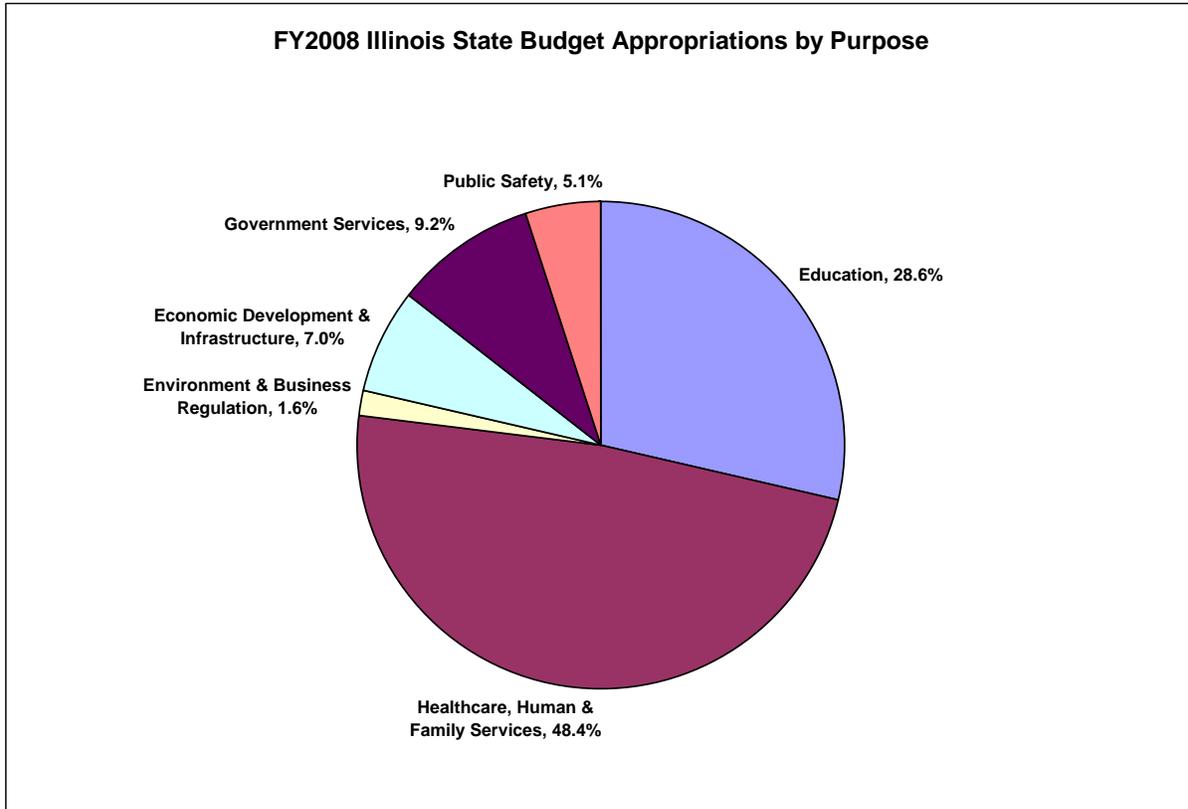
State of Illinois Recommended Appropriations: FY2007-FY2008				
(\$ thousands)				
Type	FY2007 Recommended Appropriation	FY2008 Recommended Appropriation	\$ change FY2007-FY2008	% change FY2007-FY2008
<b>LEGISLATIVE AGENCIES</b>				
<b>Legislative Agencies Total</b>	\$ 93,415	\$ 99,221	\$ 5,806	6.2%
General Funds	\$ 76,498	\$ 79,011	\$ 2,513	3.3%
Other State Funds	\$ 16,917	\$ 20,210	\$ 3,293	19.5%
<b>JUDICIAL AGENCIES</b>				
<b>Judicial Agencies Total</b>	\$ 386,765	\$ 400,953	\$ 14,188	3.7%
General Funds	\$ 360,199	\$ 374,018	\$ 13,819	3.8%
Other State Funds	\$ 24,141	\$ 24,710	\$ 569	2.4%
Federal Funds	\$ 2,425	\$ 2,225	\$ (200)	-8.2%
<b>ELECTED OFFICIALS AND ELECTIONS</b>				
<b>Elected Officials And Elections Total</b>	\$ 2,441,453	\$ 2,387,938	\$ (53,515)	-2.2%
General Funds	\$ 318,378	\$ 325,296	\$ 6,918	2.2%
Other State Funds	\$ 2,110,767	\$ 2,052,218	\$ (58,549)	-2.8%
Federal Funds	\$ 12,308	\$ 10,424	\$ (1,884)	-15.3%
<b>AGENCIES UNDER THE GOVERNOR</b>				
<b>Governor's Agencies Total</b>	\$ 32,868,191	\$ 34,446,846	\$ 1,578,655	4.8%
General Funds	\$ 15,361,506	\$ 16,442,928	\$ 1,081,422	7.0%
Other State Funds	\$ 14,374,002	\$ 14,722,971	\$ 348,969	2.4%
Federal Funds	\$ 3,132,682	\$ 3,280,947	\$ 148,265	4.7%
<b>ELEMENTARY AND SECONDARY EDUCATION</b>				
<b>Elementary and Secondary Education</b>	\$ 9,619,466	\$ 11,120,785	\$ 1,501,319	15.6%
General Funds	\$ 7,402,217	\$ 8,909,168	\$ 1,506,951	20.4%
Other State Funds	\$ 43,542	\$ 44,517	\$ 975	2.2%
Federal Funds	\$ 2,173,707	\$ 2,167,100	\$ (6,607)	-0.3%
<b>HIGHER EDUCATION<sup>3</sup></b>				
<b>Higher Education Total</b>	\$ 2,741,437	\$ 2,924,214	\$ 182,777	6.7%
General Funds	\$ 2,215,435	\$ 2,264,567	\$ 49,132	2.2%
Other State Funds	\$ 254,524	\$ 252,438	\$ (2,086)	-0.8%
Federal Funds	\$ 271,477	\$ 407,209	\$ 135,732	50.0%
<b>Revolving Funds</b>	\$ (2,693,785)	\$ (2,783,848)	\$ (90,063)	3.3%
<b>Governor's Operating Initiatives</b>	\$ (29,271)	\$ -	\$ 29,271	100.0%
<b>Governor's Illinois Covered Initiative</b>	\$ -	\$ 358,000	\$ 358,000	100.0%
<b>Governor's Healthcare Improvements</b>	\$ -	\$ 16,000	\$ 16,000	100.0%
<b>Medical Practitioner Rate Increases</b>	\$ -	\$ 90,000	\$ 90,000	100.0%
<b>TOTAL</b>				
General Funds	\$ 25,711,790	\$ 28,858,988	\$ 3,147,198	12.2%
Other State Funds	\$ 14,125,477	\$ 14,333,216	\$ 207,739	1.5%
Federal Funds	\$ 5,590,405	\$ 5,867,905	\$ 277,500	5.0%
<b>GRAND TOTAL</b>	\$ 45,427,672	\$ 49,060,109	\$ 3,632,437	8.0%

Sources: State of Illinois FY2007 Budget, pp. 2-23 to 2-32, State of Illinois FY2008 Budget, pp. 2-27 to 2-35

### ***FY2008 Appropriations by Purpose***

The following exhibit shows how FY2008 appropriations are apportioned. Healthcare, Human, and Family Service programs will require 48.4% of the \$49.1 billion FY2008 operating budget.

Spending for elementary, secondary, and higher education is the second largest category, consuming 28.6% of all appropriations.



Source: FY2008 State of Illinois Budget, p. 2-13

### ***Four-Year Appropriation Trend***

The next section presents an analysis of four-year appropriation trends between FY2005 and FY2008. In order to provide an accurate comparison, the figures presented are for the originally proposed revenues per fiscal year. Data comparable to that presented in FY2008 are not available before FY2005 because FY2005 was the first year in which operating and capital budgets were published separately.

Proposed operating budget appropriations are expected to increase by 12.8% between FY2005 and FY2008. This represents a \$5.6 billion increase from \$43.5 billion to \$49.1 billion. General Fund appropriations will rise by \$4.9 billion, or 20.5%, while Other Funds will increase by \$526.6 million, or 3.8%. Agencies under the control of the Governor, which will account for 70.2% of all operations spending, will rise by 16.8%, from \$29.5 billion to \$34.4 billion. Appropriations for Elementary and Secondary Education are expected to increase by 25.6% or \$2.3 billion.

State of Illinois Recommended Appropriations: FY2005-FY2008 (\$ thousands)				
Type	FY2005 Recommended Appropriation	FY2008 Recommended Appropriation	\$ change FY2005-FY2008	% change FY2005-FY2008
<b>LEGISLATIVE AGENCIES</b>				
<b>Legislative Agencies Total</b>	<b>\$ 82,813</b>	<b>\$ 99,221</b>	<b>\$ 16,408</b>	<b>19.8%</b>
General Funds	\$ 70,587	\$ 79,011	\$ 8,424	11.9%
Other State Funds	\$ 16,105	\$ 20,210	\$ 4,105	25.5%
<b>JUDICIAL AGENCIES</b>				
<b>Judicial Agencies Total</b>	<b>\$ 376,938</b>	<b>\$ 400,953</b>	<b>\$ 24,015</b>	<b>6.4%</b>
General Funds	\$ 376,727	\$ 374,018	\$ (2,709)	-0.7%
Other State Funds	\$ 24,581	\$ 24,710	\$ 129	0.5%
Federal Funds	\$ 3,450	\$ 2,225	\$ (1,225)	-35.5%
<b>ELECTED OFFICIALS AND ELECTIONS</b>				
<b>Elected Officials And Elections Total</b>	<b>\$ 2,241,158</b>	<b>\$ 2,387,938</b>	<b>\$ 146,780</b>	<b>6.5%</b>
General Funds	\$ 250,812	\$ 325,296	\$ 74,484	29.7%
Other State Funds	\$ 1,976,650	\$ 2,052,218	\$ 75,568	3.8%
Federal Funds	\$ 13,697	\$ 10,424	\$ (3,273)	-23.9%
<b>AGENCIES UNDER THE GOVERNOR</b>				
<b>Governor's Agencies Total</b>	<b>\$ 29,503,571</b>	<b>\$ 34,446,846</b>	<b>\$ 4,943,275</b>	<b>16.8%</b>
General Funds	\$ 14,520,013	\$ 16,442,928	\$ 1,922,915	13.2%
Other State Funds	\$ 11,786,000	\$ 14,722,971	\$ 2,936,971	24.9%
Federal Funds	\$ 3,216,449	\$ 3,280,947	\$ 64,498	2.0%
<b>ELEMENTARY AND SECONDARY EDUCATION<sup>2</sup></b>				
<b>Elementary and Secondary Education</b>	<b>\$ 8,853,413</b>	<b>\$ 11,120,785</b>	<b>\$ 2,267,372</b>	<b>25.6%</b>
General Funds	\$ 6,563,064	\$ 8,909,168	\$ 2,346,104	35.7%
Other State Funds	\$ 73,699	\$ 44,517	\$ (29,182)	-39.6%
Federal Funds	\$ 2,216,650	\$ 2,167,100	\$ (49,550)	-2.2%
<b>HIGHER EDUCATION<sup>3</sup></b>				
<b>Higher Education Total</b>	<b>\$ 2,607,177</b>	<b>\$ 2,924,214</b>	<b>\$ 317,037</b>	<b>12.2%</b>
General Funds	\$ 2,260,700	\$ 2,264,567	\$ 3,867	0.2%
Other State Funds	\$ 54,713	\$ 252,438	\$ 197,725	361.4%
Federal Funds	\$ 291,765	\$ 407,209	\$ 115,444	39.6%
<b>Revolving Funds</b>	<b>\$ (2,418,096)</b>	<b>\$ (2,783,848)</b>	<b>\$ (365,752)</b>	<b>15.1%</b>
<b>Governor's Initiatives</b>	<b>\$ (211,300)</b>	<b>\$ -</b>	<b>\$ 211,300</b>	<b>100.0%</b>
<b>Governor's Illinois Covered Initiative</b>	<b>\$ -</b>	<b>\$ 358,000</b>	<b>\$ 358,000</b>	<b>100.0%</b>
<b>Governor's Healthcare Improvements</b>	<b>\$ -</b>	<b>\$ 16,000</b>	<b>\$ 16,000</b>	<b>100.0%</b>
<b>Medical Practitioner Rate Increases</b>	<b>\$ -</b>	<b>\$ 90,000</b>	<b>\$ 90,000</b>	<b>100.0%</b>
<b>TOTAL</b>				
General Funds	\$ 23,955,768	\$ 28,858,988	\$ 4,903,220	20.5%
Other State Funds	\$ 13,806,584	\$ 14,333,216	\$ 526,632	3.8%
Federal Funds	\$ 5,742,010	\$ 5,867,905	\$ 125,895	2.2%
<b>GRAND TOTAL</b>	<b>\$ 43,504,362</b>	<b>\$ 49,060,109</b>	<b>\$ 5,555,747</b>	<b>12.8%</b>

Sources: State of Illinois FY2005 Budget, P. 1-27 to 1-34, State of Illinois FY2008 Budget, pp.2-27 to 2-35

## PERSONNEL

The Governor's FY2008 budget recommends filling 58,834 full-time equivalent (FTE) positions. This is a 0.2%, 100 position decrease from the number of positions authorized in FY2007. Since FY2005, the number of FTEs authorized will have increased by 3.7% or 2,110 positions, from 56,724 to 58,834.

<b>State of Illinois Employees: FY2005-FY2008</b>						
<b>Purpose</b>	<b>FY2005 Actual</b>	<b>FY2006 Actual</b>	<b>FY2007 Authorized</b>	<b>FY2008 Authorized</b>	<b>FY05-FY08 # Change</b>	<b>FY05-FY08 % Change</b>
Human Services	19,752	19,940	20,688	20,952	1,200	6.1%
Public Safety	18,015	17,702	18,062	17,851	-164	-0.9%
Econ Dev/Infrastructure	8,651	8,461	8,719	8,589	-62	-0.7%
Government Services	3,960	4,078	4,506	4,417	457	11.5%
Environ/Business Reg	4,157	4,154	4,373	4,398	241	5.8%
Healthcare/Family Services	2,189	2,313	2,586	2,627	438	20.0%
<b>TOTAL</b>	<b>56,724</b>	<b>56,648</b>	<b>58,934</b>	<b>58,834</b>	<b>2,110</b>	<b>3.7%</b>

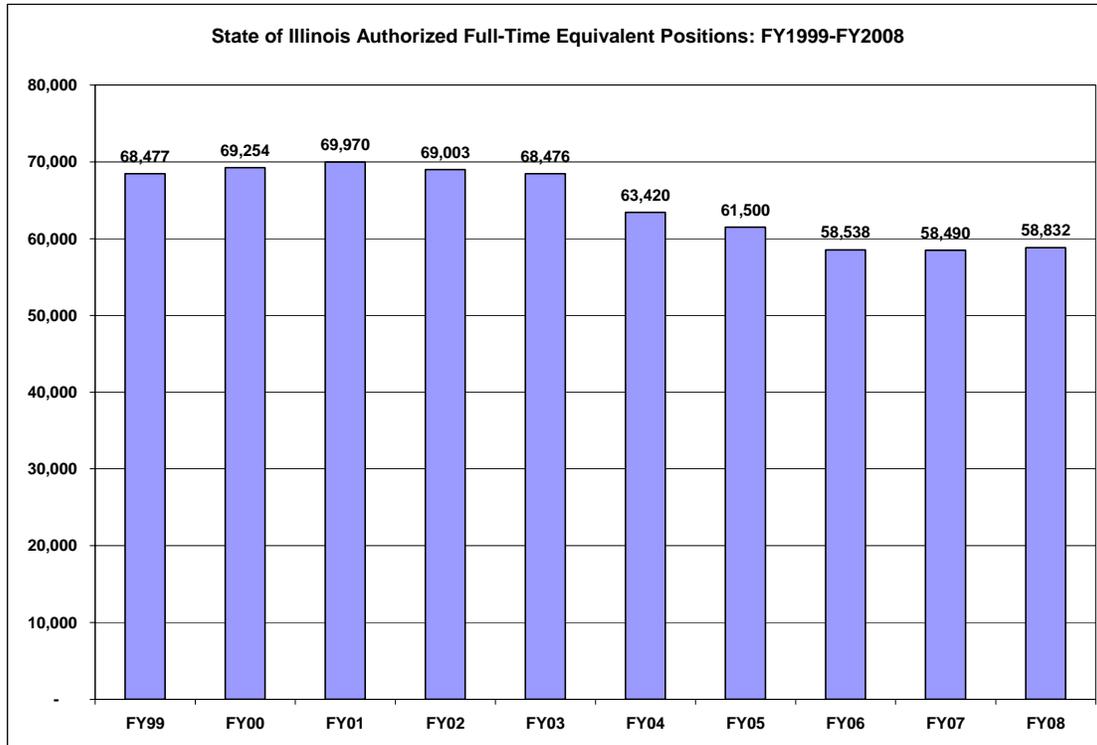
Source: State of Illinois FY2008 State Budget, p. 2-16

The State does not necessarily fill all of the positions that are authorized in a budget. In FY2007, it is estimated that 57,637 of the 58,934 positions authorized were actually filled. Comparing the FY2007 estimate with the FY2008 personnel authorization shows that, if all of the authorized positions were filled, the number of FTEs would rise by 2.1% or 1,197 positions.

<b>State of Illinois Employees: FY2007 Estimated and FY2008 Authorized</b>				
<b>Purpose</b>	<b>FY2007 Estimated</b>	<b>FY2008 Authorized</b>	<b>FY07-FY08 # change</b>	<b>FY07-FY08 % change</b>
Human Services	20,302	20,952	650	3.2%
Public Safety	17,647	17,851	204	1.2%
Econ Dev/Infrastructure	8,566	8,589	23	0.3%
Government Services	4,286	4,417	131	3.1%
Environ/Business Reg	4,332	4,398	66	1.5%
Healthcare/Family Services	2,504	2,627	123	4.9%
<b>TOTAL</b>	<b>57,637</b>	<b>58,834</b>	<b>1,197</b>	<b>2.1%</b>

Source: State of Illinois FY2008 State Budget, p. 2-16

The next exhibit shows changes in the number of authorized full-time equivalent positions in the 10-year period between FY1999 and FY2008. During that period, the number of FTEs has fallen by 14.1% or 9,645 positions. Since FY2001, the number of positions has declined by 15.9% or 11,138 FTEs.



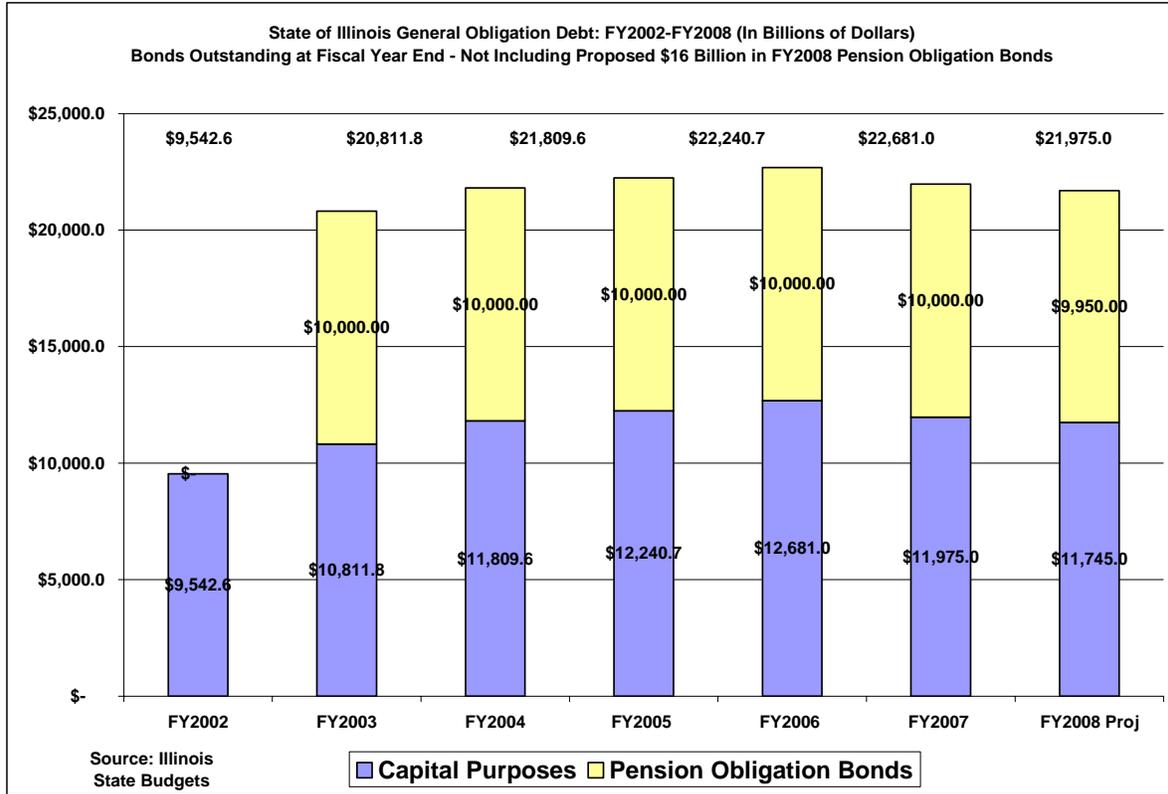
Source: State of Illinois Budgets, FY1999-FY2008

## DEBT TRENDS

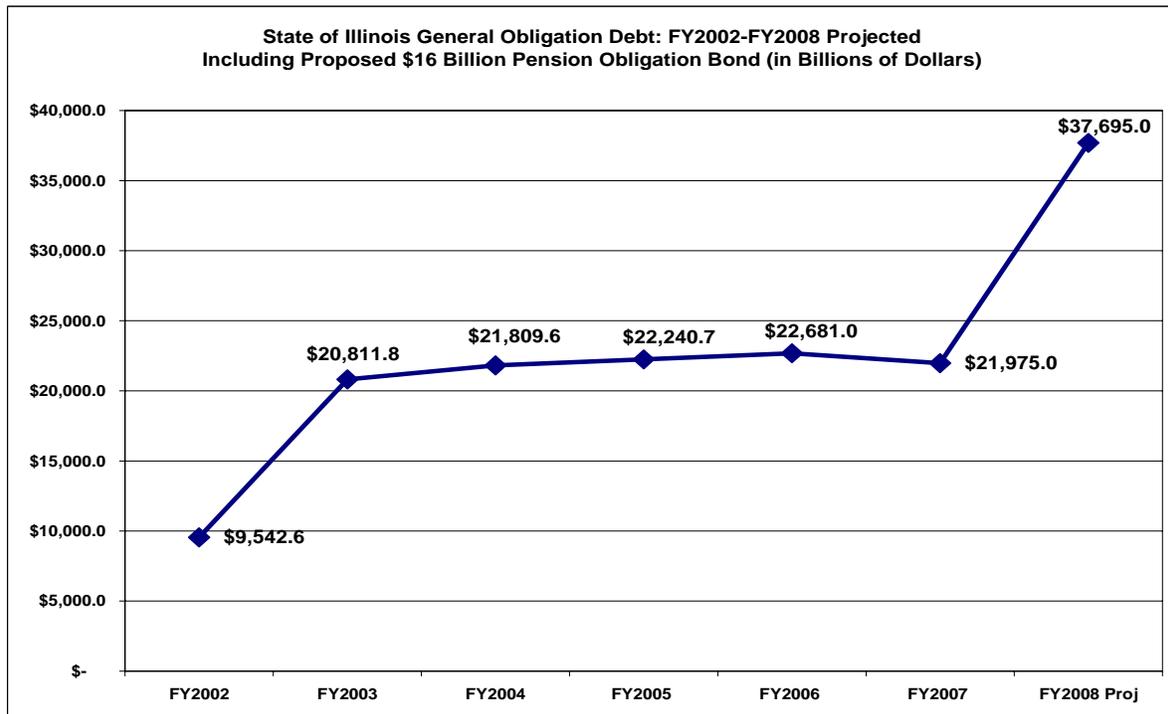
This section of the analysis examines trends in long- and short-term debt issued by the State of Illinois, as well as bond ratings and an overview of the debt service schedule.

### State of Illinois General Obligation Debt

The State of Illinois estimates that it will have \$21.9 billion in general obligation (GO) debt outstanding in FY2008. Of that amount, \$9.9 billion is from the 2003 pension obligation bond issue and \$11.7 billion is from three different types of capital purpose general obligation debt: GO capital debt, Build Illinois debt, and Civic Center debt. The total amount of GO debt outstanding will rise by 127.3% or \$12.1 billion between FY2002 and FY2008.

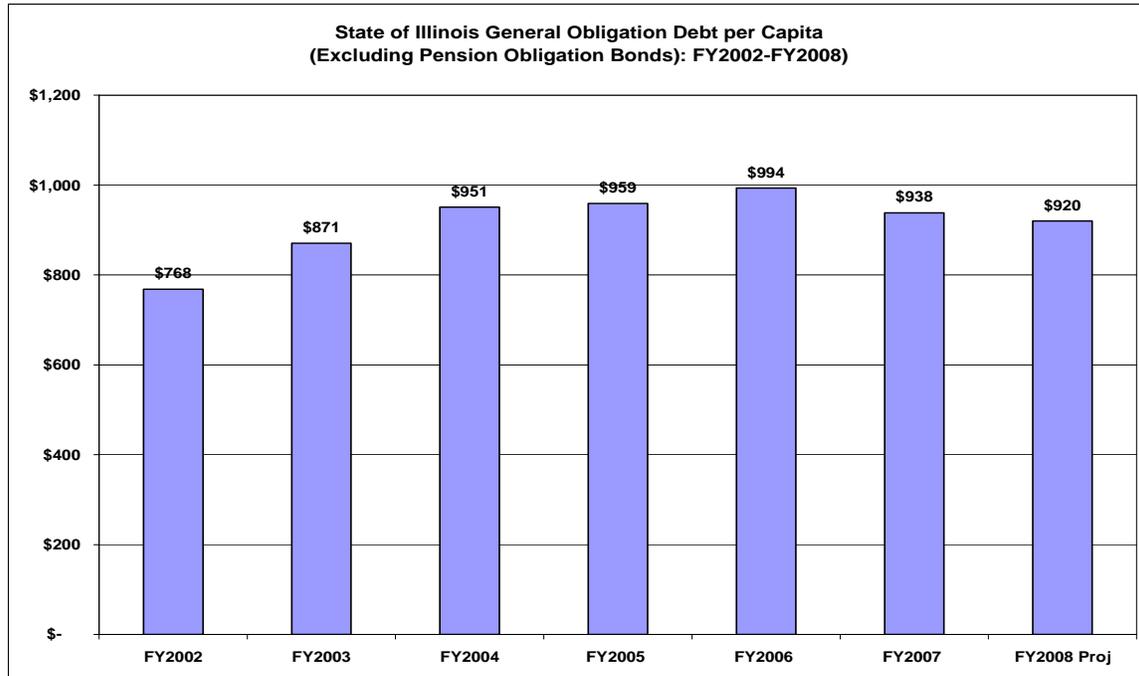


The State of Illinois has proposed to issue an additional \$15.9 billion in GO bonds in order to increase the assets of the State's pension systems. If approved, total GO debt would increase by 71.5% between FY2007 and FY2008, from \$21.9 billion to \$37.7 billion.



## General Obligation Debt Per Capita - Excluding Pension Bonds

Illinois State General Obligation bond debt per capita<sup>28</sup> (excluding the existing pension obligation debt) is shown in the following exhibit. Between FY2002 and FY2008, GO debt per capita for capital purposes is projected to increase by 19.7%, from \$768 to \$920.

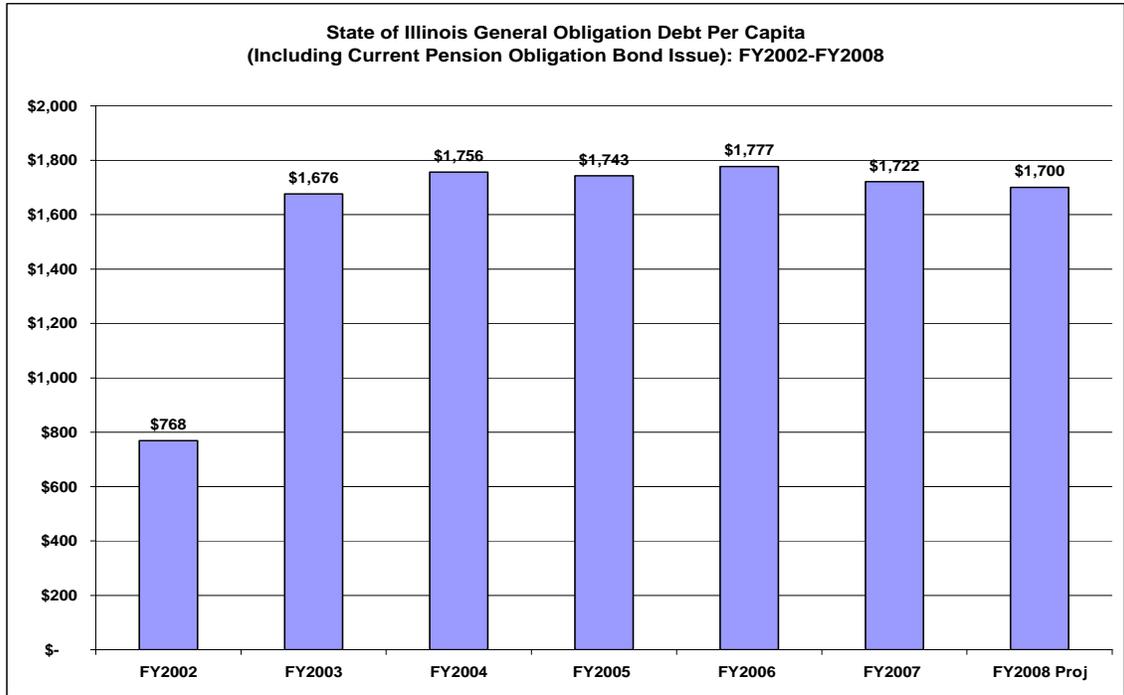


## General Obligation Debt Per Capita – Including Current Pension Bond Issue

The next exhibit shows estimates for total GO debt per capita, including both capital debt and existing pension obligation debt.<sup>29</sup> Between FY2002 and FY2008, GO debt per capita is projected to increase by 121.1%, from \$768 to \$1,700.

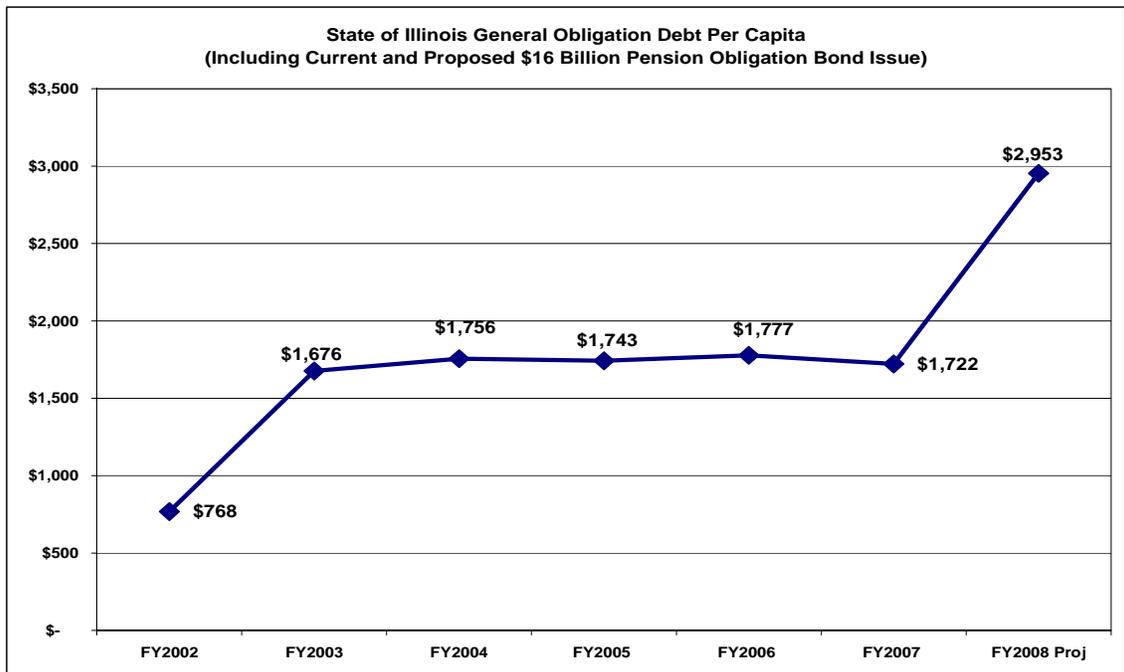
<sup>28</sup> Per capita figures were derived from the United State Bureau of the Census for 2000 and 2005 (projections).

<sup>29</sup> State of Illinois. FY2006 Operating Budget, page 10-10. For FY2007, a 0.4% population increase was calculated based on the average annual population increase.

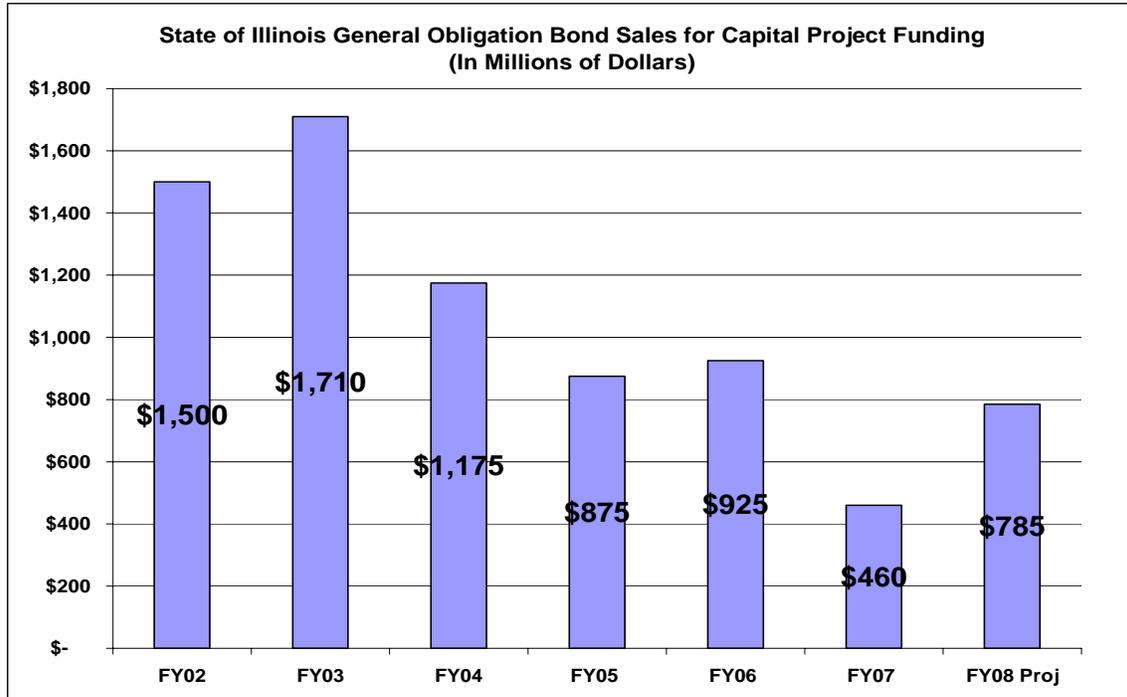


**General Obligation Debt Per Capita – Including Proposed \$15.9 Billion Pension Bond Issue**

The next exhibit shows estimates for what total GO debt per capita would be for capital purposes and pension obligation debt if the Governor’s proposed FY2008 \$15.9 billion pension obligation bond issue were approved by the General Assembly. Between FY2002 and FY2008, GO debt per capita would be projected to increase by 284.3% from \$768 to \$2,953. The increase between FY2007 and FY2008 would be 71.5%, from \$1,722 to \$2,953.



The State of Illinois' capital program is financed primarily through the issuance of general obligation bonds.<sup>30</sup> The exhibit below shows historical and projected bond sales.<sup>31</sup> It excludes sales for refunding purposes and the pension obligation bonds. As the exhibit shows, bond sales will increase sharply from \$460 million in FY2007 to \$785 million in FY2008. That is a 70.6% increase.



### Bond Ratings

The State of Illinois' general obligation bond ratings are:<sup>32</sup>

Moody's	Aa3
Standard & Poor's	AA
Fitch Ratings	AA

### Debt Service Schedule

A debt service schedule sets forth the principal and interest amounts due for outstanding bonds. The State projects declining total debt service payments for principal and interest between FY2006 and FY2034, from \$1.9 billion to \$1.2 billion. However, Pension Obligation Bond debt service payments are backloaded and will increase from \$546 million in FY2007 to over \$1.1 billion in FY2033. During the period between FY2007 and FY2033, the State of Illinois will pay a total of \$20.4 billion in debt service for the \$10 billion pension obligation bond issue and \$21.3 billion for all capital projects debt service.<sup>33</sup>

<sup>30</sup> A small portion of the capital program is financed through the sale of Build Illinois bonds.

<sup>31</sup> State of Illinois. FY2008 Operating Budget, p. 12-1

<sup>32</sup> State of Illinois. FY2008 Operating Budget, page 12-3.

<sup>33</sup> State of Illinois FY2008 Operating Budget, p. 12-10.

## Short-Term Debt

Short-term debt is a financial obligation that must be satisfied within one year. An increasing trend in short-term debt may be a warning sign of future financial difficulties. It is a measure of budgetary solvency, a government's ability to generate enough revenue over the course of a normal budgetary period to meet its expenditures and prevent deficits. The State of Illinois Short Term Borrowing Act governs the State's ability to access short-term capital.

The State may issue short-term debt certificates based upon revenue anticipation or shortfall and failure in revenues. However, the State may borrow only up to five percent of State appropriations for any fiscal year in anticipation of revenues collected for that fiscal year that will repay the borrowing by the close of that year. The State may borrow up to fifteen percent of the state's appropriations for any fiscal year due to revenue shortfalls. Revenue shortfall borrowing must be repaid within one year.<sup>34</sup>

The following exhibit shows the number of certificates as well as the issuance and retirement dates from July of 2002 through February 2007. No certificate issuance was reported between August of 1995 and July of 2002. The March of 2005 issuance represents borrowing for Medicaid related purposes. The amount of State short-term debt rose to \$1.5 billion in May 2003, then declined to \$765 million in March 2005 before increasing to \$1.0 billion later that year. In February 2007, the last date for which information is available, short-term debt was \$900 million. The current short-term is expected to be repaid on June 7, 2007.<sup>35</sup>

ILLINOIS SHORT-TERM DEBT FY02-FY07			
Certificates Issues	Certificates Retired	Approx. Months	Amount (\$ mil)
July 2002	June 2003	11	\$ 1,000
May 2003	May 2004	12	\$ 1,500
June 2004	October 2004	4	\$ 850
March 2005	June 2006	3	\$ 765
November 2005	June 2006	7	\$ 1,000
February 2007	June 2007	4	\$ 900

Source: FY2008 Illinois State Budget, Page 12-3

## STATE OF ILLINOIS EMPLOYEE HEALTH INSURANCE PLANS

The Civic Federation recently completed research on the State of Illinois's employee health insurance program. The research was published in a separate report. The findings of that report are presented below.

The State of Illinois Group Insurance Program offers three different health insurance plan types to employees, retirees, and dependents of the State government, State universities, the General Assembly, and judges. The plan types are:

<sup>34</sup> State of Illinois FY2006 Operating Budget, page 10-3.

<sup>35</sup> Ibid.

- A self insured indemnity plan, commonly called a fee-for-service or traditional plan (the Quality Care Health Plan),
- A modified preferred provider plan (the Open Access Plan or OAP), and
- Various health maintenance organization (HMOs).

There are over 346,000 employees, retirees, and their dependents enrolled in the State's three health insurance plans.

<b>State of Illinois Group Health Insurance: Percent of Participants Who Are Retirees or Their Dependents: FY2006</b>				
	<b>Employees + Dependents</b>	<b>Retirees + Dependents</b>	<b>Total</b>	<b>Retirees as % of Total</b>
Indemnity Plan	61,452	73,470	<b>134,922</b>	54.5%
OAP Plan	25,943	3,445	<b>29,388</b>	11.7%
HMO Plans	155,381	26,394	<b>181,775</b>	14.5%
<b>Total</b>	<b>242,776</b>	<b>103,309</b>	<b>346,085</b>	<b>29.9%</b>

Source: Colm Brewer, Illinois Department of Healthcare and Family Services, September 8, 2006.

### **Rising State Employee Health Insurance Costs**

Between FY1998 and FY2007, Illinois State health insurance liabilities are expected to rise from \$802.8 million to \$1.8 billion, a \$1.0 billion or 131.4% increase.

These liabilities have risen at a much faster rate than State of Illinois total budgetary appropriations. The average rate of increase for budget appropriations between FY1998 and FY2007 was 5.2%, while the average rate of increase for health insurance liabilities was 9.4%.

In FY2007 State employee health insurance liabilities represented approximately 3.4% of total State operating budget appropriations. The State's employee health care costs of \$1.8 billion exceed the entire operating budget of \$1.3 billion for the Illinois Department of Children and Family Services, and is nearly as large as the \$2.1 billion operating budget of the Illinois Department of Transportation.

### **Costly Provisions of the State Group Health Insurance Plan**

Three features of the State of Illinois Group Health Insurance plan drive State health insurance costs: an expensive indemnity plan, employee contribution to premiums which are lower than national private sector averages, and the provision of free health insurance to many retired employees.

### **Illinois has an Expensive Indemnity Plan**

The average cost per participant in the State's indemnity plan is expected to be 51.3% higher than the cost for HMO coverage and 31.1% higher than the cost for the OAP plans in FY2006. In FY2007 the cost differential is projected to widen, with indemnity plan average participant costs 57.4% higher than costs for HMO coverage and 35.3% higher than for OAP coverage.<sup>36</sup>

<sup>36</sup> Commission on Government Forecasting and Accountability, *Fiscal Year 2007 Liabilities of the State Employees' Group Insurance Program*, 2006, p. 9.

<b>Estimated Average Annual Cost Per Participant</b>			
<b>Plan</b>	<b>FY2006 Average Cost</b>	<b>FY2007 Average Cost</b>	<b>% CHG</b>
<b>Indemnity</b>	\$5,512	\$6,128	11.2%
<b>HMO</b>	\$3,634	\$3,893	7.1%
<b>OAP</b>	\$4,203	\$4,527	7.7%

Source: Commission on Governmental Forecasting and Accountability  
FY2007 Liabilities of the State Employees' Group Insurance Program, p. 9.

The cost of the indemnity plan is significant because the State estimates that 39.0% or 134,922 of its 346,085 total enrollees in the group health insurance plans were in the indemnity plan in 2006. Approximately 71.1% of all State retirees select the indemnity plan. The high rate of enrollment in the Illinois indemnity plan contrasts significantly with a Kaiser Foundation Survey that found that only 4% of all covered workers in firms and governments with over 5,000 employees are enrolled in indemnity plans.<sup>37</sup>

### **Illinois State Employees Pay a Below Average Percentage of Premium Costs**

Illinois employees and retirees paid lower percentages of total premium costs than public and private employees in large (over 200 workers) firms nationwide according to the Kaiser Foundation's 2006 survey. They also paid less for family coverage in the HMO and OAP plans than the average paid by employees of other state and local governments surveyed by the Kaiser Foundation. Relatively low employee contributions to premiums mean that the State of Illinois must shoulder a greater share of total health insurance costs than do other public and private organizations. This contributes to the State's escalating health insurance liabilities.

<b>Annual Premium Contributions by Employees as a Percentage of Total Premiums</b>					
	<b>Kaiser Survey All Large Plans Average</b>	<b>Kaiser Survey State/Local Govt Average</b>	<b>Illinois</b>	<b>Illinois Premium % compared to All Plans</b>	<b>Illinois Premium % compared to Govt. Average</b>
<b>Single</b>					
HMO	15.6%	10.0%	5.4% to 11.6%	below	similar
OAP (HMO/PPO Hybrid)	15.6% to 16.4%	6.0% to 10.0%	6.2% to 9.0%	below	similar
Indemnity	14.1%	n/a	7.6% to 9.6%	below	n/a
<b>Family</b>					
HMO	22.9%	17.0%	12.3% to 16.3%	below	below
OAP (HMO/PPO Hybrid)	22.4% to 22.9%	17.0% to 18.0%	14.6% to 15.7%	below	below
Indemnity	21.2%	n/a	17.1% to 18.0%	below	n/a

Source: Kaiser Family Foundation and State of Illinois Benefit Choice Options FY2006. Kaiser Survey indemnity data from 2005.

### **Illinois Provides Free Health Care for Retirees with 20 Years of Service**

State of Illinois retirees with more than 20 years of service do not have to contribute to their health care premiums. Illinois is one of only fifteen states that currently provide free health care insurance for some or all retirees over 65 with Medicare coverage. Of the 75,040 Illinois retirees

<sup>37</sup> Kaiser Family Foundation and Health Research and Educational Trust, *Employer Health Benefits 2006 Annual Survey* (Menlo Park, CA: Henry J. Kaiser Family Foundation, 2006), V-3. See also Appendix A of this report.

reported in FY2006, 92.7% or 69,896 retirees receive free health insurance, according to the Illinois Department of Healthcare and Family Services.<sup>38</sup> The cost of this subsidy to the State is estimated to be as much as \$356.1 million in FY2006.<sup>39</sup>

## STATE OF ILLINOIS RETIREMENT SYSTEMS

The State of Illinois funds five retirement systems for employees and retirees: the State Employees Retirement System (SERS), the Teachers' Retirement Employment Retirement System (TRS), the State Universities Retirement System (SURS), the Judges' Retirement System (JRS) and the General Assembly Retirement System (GRS). A total of 677,738 individuals are currently enrolled in these five systems.

MEMBERS OF ILLINOIS RETIREMENT SYSTEMS			
Pension Fund	Members	Annuitants	Total
Teachers	250,540	85,153	335,693
University	153,475	41,638	195,113
State Employees	89,735	54,678	144,413
Judges	947	912	1,859
General Assembly	265	395	660
<b>Total</b>	<b>494,962</b>	<b>182,776</b>	<b>677,738</b>

Source: FY2008 Illinois State Budget, p. 4-1.

### Recent Changes in Pension Funding: 2003 to Present

Since 2003, several changes have been made regarding how the State's retirement systems are funded.

#### *Issuance of \$10 Billion in Pension Obligation Bonds in 2003*

In his first year in office, Governor Blagojevich championed Public Act 93-0002, which authorized the issuance of \$10 billion of pension obligation bonds. The proceeds of these bonds were to be used to boost the pension funds' assets and reduce future unfunded liabilities.

Initially, the funds' managers and the Governor's financial team estimated that the pension funds would earn investment income at the traditional long-term actuarial rate of 8.5% and that the pension bond proceeds would earn at least that rate over the thirty-year life of the bonds. The financial team forecast that economic savings would result from issuing the \$10 billion in bonds at the then-current market rate of approximately 5.8%, as long as the funds earned a long-term actuarial rate of 8.0%. In fact, the bonds were ultimately issued at an interest rate of 5.05% while the pension funds' actuaries ultimately projected an 8.5% expected rate of return for the entire asset portfolio. The State estimated that it would realize \$860 million in additional

<sup>38</sup> Information provided by the Illinois Department of Healthcare and Family Services.

<sup>39</sup> These estimates assume that 92.7% of the retirees enrolled in each of the different type of State health insurance program do not pay for the cost of their insurance. More precise calculations were not possible because the Illinois Department of Healthcare and Family Services did not provide a breakdown of the percentages per health insurance plan of enrollees who do not pay for health insurance.

“savings” from these favorable rates. In the FY2005 budget, the State proposed to capture \$215 million, or 25% of the increase, reserving the remainder for capture in future years. The \$215 million “savings” was used as the basis for reducing the State’s pension contribution by a like amount in FY2005.

*Governor Blagojevich’s FY2006 Pension Funding Reform Proposals*

Governor Blagojevich proposed a number of pension funding reform proposals in the FY2006 State of Illinois Budget. These proposals were all originally recommended by the Governor’s Blue Ribbon Pension Commission, which is composed of representatives from the General Assembly, business, labor, and civic groups. The Governor accepted all but two of the Commission’s recommendations:

- Requiring employees to increase the percentage of salary they pay into the retirement systems by 1%, and
- Considering shifting to a defined contribution (DC) Plan at some point in the future.

The General Assembly approved a few of the Governor’s proposed reforms with some modifications. The most significant proposals enacted into law were capping end-of-year salary increases, eliminating the State Universities Retirement Systems money purchase option for new hires, limiting eligibility for alternative formulas, and requiring funding for enhanced benefits. The legislators rejected proposals to:

- Change the eligibility for full benefits to age 65, with between 8 and 30 years of service; age 62 with 30 to 35 years of service; or age 60 with 35 years or more of service.
- Limit automatic benefit increases for new hires to the lesser of the change in CPI or 3% and apply increases only to the first \$12,000 in annual pension for retirees covered by Social Security and \$24,000 for retirees not covered by Social Security.

New proposals approved by the legislature and signed into law by the Governor enacted a two-year deferral of \$2.3 billion in pension contributions, created a second Blue Ribbon Task Force to further study pension reform, created a cost neutral early retirement program, and eliminated lump sum awards for unearned sick pay.

The exhibit below presents a comparison of the Governor’s FY2006 original pension funding proposals, as well as new proposals that were advanced during the legislative session, and the final action taken by the General Assembly.

<b>PENSION FUNDING REFORMS</b>	
<b>GOVERNOR'S ORIGINAL PROPOSALS</b>	<b>FINAL BUDGET APPROVED</b>
Cap End of Year Salary Increases to 3%	6% annual Cap Adopted
Eliminate SURS Money Purchase Option (New Hires)	Approved
Recalculate Money Purchase Interest Rate to Reflect Long-Term Rate of Return, not 9%	Authorized Comptroller to set rate
No New Benefits w/o Funding	Approved
Limit Alternative Formula Benefits (New Hires)	Approved
Limit Automatic Increases to CPI	Not Approved
Change Retirement Age (New Hires)	Not Approved
<b>New Proposals</b>	
Defer Pension Contributions by \$2.3 Billion over 2 Years	Approved
Create Task Force to Study Pension Reform	Approved
Create Cost Neutral Early Retirement Program Paid for by Local Employers/Beneficiaries	Approved
Eliminate Lump Sum Awards for Unearned Sick Pay to Boost Pensions	Approved

*The FY2006-FY2007 Partial Pension Holiday*

The General Assembly approved legislation (P.A. 94-0004) in FY2006 authorizing reductions in the State contributions from the originally certified amounts to the five State retirement systems in both FY2006 and FY2007 totaling \$2.3 billion. In accordance with that statute, the State contributed nearly \$1.4 billion to the state's retirement funds in FY2007, which is \$1.1 billion less than the certified contribution amount. The exhibit below shows the difference between the certified amount for each State pension fund and the amount that was appropriated in FY2006 and FY2007.

<b>FY2006 &amp; FY2007 CERTIFIED CONTRIBUTIONS VS. FINAL GENERAL ASSEMBLY APPROPRIATIONS (In Millions of Dollars)</b>								
System	FY2006			FY2007			Total 2-Year Contributions	Total Reduction
	Certified Contributions	P.A. 94-0004	Difference	Certified Contributions	P.A. 94-0004	Difference		
TRS	\$ 1,058.5	\$ 531.8	\$ 526.7	\$ 1,233.1	\$ 735.5	\$ 497.6	\$ 2,291.6	\$ 1,024.3
SERS	\$ 690.3	\$ 203.8	\$ 486.5	\$ 832.0	\$ 344.2	\$ 487.8	\$ 1,522.3	\$ 974.3
SURS	\$ 324.9	\$ 166.6	\$ 158.3	\$ 391.9	\$ 252.1	\$ 139.8	\$ 716.8	\$ 298.1
JRS	\$ 38.0	\$ 29.2	\$ 8.8	\$ 44.5	\$ 35.2	\$ 9.3	\$ 82.5	\$ 18.1
GARS	\$ 5.5	\$ 4.2	\$ 1.3	\$ 6.3	\$ 5.2	\$ 1.1	\$ 11.8	\$ 2.4
<b>Total</b>	<b>\$ 2,117.2</b>	<b>\$ 935.6</b>	<b>\$ 1,181.6</b>	<b>\$ 2,507.8</b>	<b>\$ 1,372.2</b>	<b>\$ 1,135.6</b>	<b>\$ 4,625.0</b>	<b>\$ 2,317.2</b>

Source: Commission on Government Forecasting and Accountability. Report on the 90% Funding Target of Public Act 88-0593.

The Commission on Governmental Forecasting and Accountability estimated that the final pension program approved for FY2006 would cost the State an additional \$4.7 billion and reduce actuarial liabilities by \$38.6 billion over 40 years. The retirement systems' actuaries estimated that \$6.8 billion more would be incurred in costs and the liabilities would be reduced by \$44.6 billion.

<b>Estimated Impact of P.A. 94-0004</b>						
<b>Total Projected State Contributions for FY2006-FY2045</b>						
<b>Prepared by CGFA (\$Millions)</b>						
<b>State Contributions</b>	<b>TRS</b>	<b>SERS</b>	<b>SURS</b>	<b>JRS</b>	<b>GARS</b>	<b>TOTAL</b>
<b>Pre P.A. 94-0004</b>	\$ 160,302	\$ 68,065	\$ 61,184	\$ 6,538	\$ 862	\$ 296,951
<b>P.A. 94-0004</b>	\$ 155,507	\$ 78,068	\$ 60,531	\$ 6,654	\$ 877	\$ 301,637
<b>Difference</b>	\$ (4,795)	\$ 10,003	\$ (653)	\$ 116	\$ 15	\$ 4,686
<b>FY2045 Liability Reduction</b>	\$ 26,265	\$ 667	\$ 11,690	\$ -	\$ -	\$ 38,622

Source: Commission on Government Forecasting and Accountability. August 2005.

<b>Estimated Impact of P.A. 94-0004</b>						
<b>Total Projected State Contributions for FY2006-FY2045</b>						
<b>Prepared by Retirement Systems (\$Millions)</b>						
<b>State Contributions</b>	<b>TRS</b>	<b>SERS</b>	<b>SURS</b>	<b>JRS</b>	<b>GARS</b>	<b>TOTAL</b>
<b>Pre P.A. 94-0004</b>	\$ 156,715	\$ 65,340	\$ 60,688	\$ 6,538	\$ 862	\$ 290,143
<b>P.A. 94-0004</b>	\$ 152,550	\$ 75,928	\$ 60,914	\$ 6,654	\$ 877	\$ 296,923
<b>Difference</b>	\$ (4,165)	\$ 10,588	\$ 226	\$ 116	\$ 15	\$ 6,780
<b>FY2045 Liability Reduction</b>	\$ 34,322	\$ 675	\$ 9,655	\$ -	\$ -	\$ 44,652

Source: Commission on Government Forecasting and Accountability. August 2005.

### *Governor Blagojevich's FY2008 Pension Funding Proposal*

The Governor's FY2008 budget would provide the State's five pension plans with \$25.9 billion in new assets.<sup>40</sup> The State's pension systems would have an 83.0% funded ratio in FY2008, 34 years ahead of the current 50-year funding schedule, if this proposal were adopted.<sup>41</sup> Under the Governor's proposal, this sharp increase in the funded ratio would be achieved through two financing mechanisms:

1. The long-term lease of the Illinois Lottery. The State proposes entering into a long-term concession lease of the Illinois Lottery and is currently qualifying potential bidders. The State expects that the lease of the Illinois Lottery, which is the nation's 11<sup>th</sup> largest and has annual revenues exceeding \$2 billion, will generate \$10 billion in cash. The State has pledged to immediately transfer these proceeds to the State retirement systems. Other important details about the lease of the lottery, including the level of oversight that the State will retain and the length of the lease, are not yet available.
2. The issuance of \$15.9 billion in pension obligation bonds. All proceeds of the bond issue will be paid into the State retirement systems.

<sup>40</sup> The funded ratio figures provided by the State are estimates. The Commission on Government Forecasting and Accountability has estimated the State retirement systems' funded ratio in FY2006 as 58.8%, but this figure was only a projection. See Government Forecasting and Accountability. *Report on the Financial Condition of the Illinois Public Retirement Systems*, August 2006, p. 8.

<sup>41</sup> Presentation by John Filan, Chief Operating Officer, State of Illinois, to the Civic Federation, March 14, 2007, p. 25.

The structure of the pension obligation bond issue will resemble the previous POB transaction in 2003. Debt service payments will be supported by deductions from the unfunded liability payments that would have been necessary if the bonds were not issued. The State hopes to complete the POB transaction around June 7, 2007 in order to take advantage of favorable market conditions.

The State believes it can secure long-term taxable interest rates that are within 0.5% of the low long-term rate of 5.05% at which its \$10 billion pension obligation bonds were issued in 2003. The State also believes it can invest this \$15.9 billion and achieve a rate of return that significantly exceeds the bond interest rate. Pension investments had an annual rate of return of 14.3% between 2003 and 2006. The bond interest rate would also be lower than the 8.5% interest rate at which the State currently pays down its unfunded pension liabilities.<sup>42</sup>

If both financial transactions are undertaken, according to the Governor's revised pension payment schedule, the State of Illinois would reach the 90% funded ratio five years ahead of the schedule established by the 1995 pension funding reform law (P.A. 88-593) and will save roughly \$60 billion in payments over time. The State's pension payment schedule will be restructured so that the FY2008 payment would be \$1.9 billion (the amount contributed in FY2007), and the total annual pension and debt service payment would increase by \$280 million per year thereafter.<sup>43</sup> Until at least FY2011, the portion of the State pension payment that would be paid into the State retirement system would not be adequate to pay for the normal operating cost of the system. The State's calculations, of course, assume that there are no further increase in benefits, pension payment reductions, or subsequent substantive changes to the law.

The two exhibits that follows show:

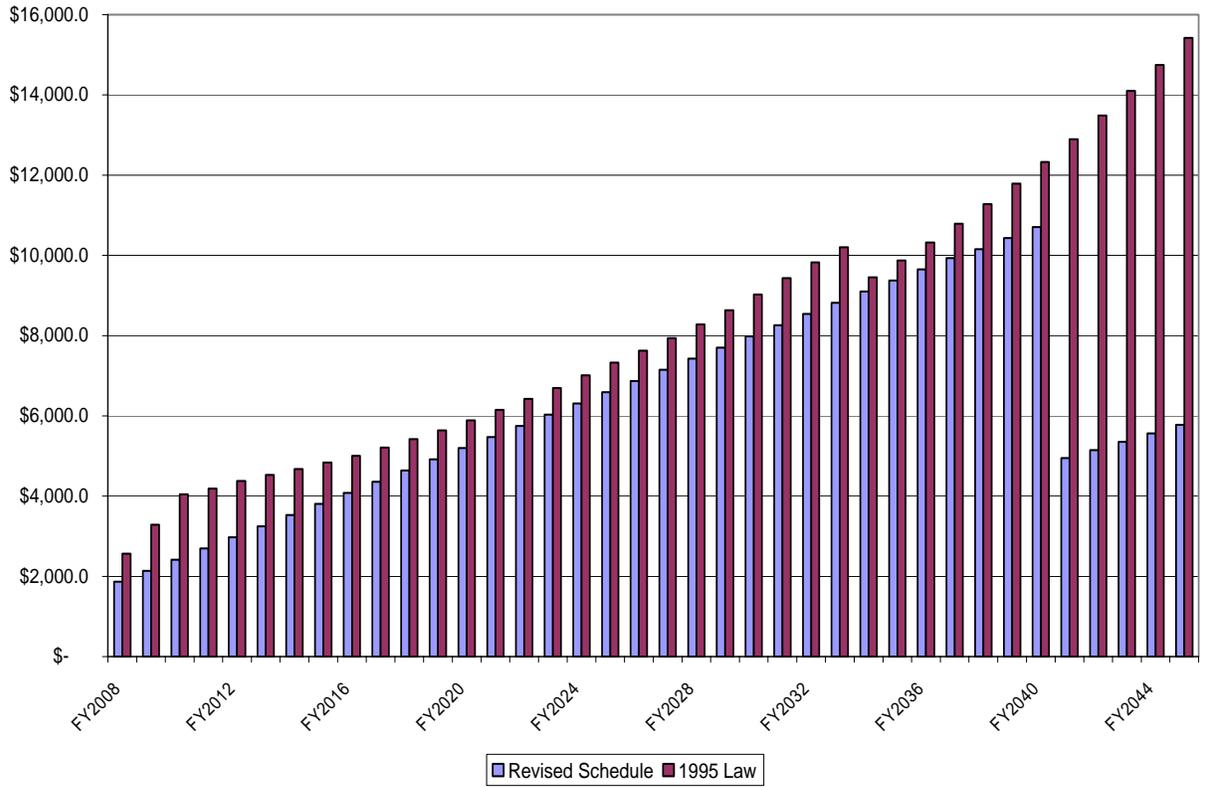
- The differences in the State's scheduled payments to the pension funds under the 1995 law as amended versus the proposed schedule under the Governor's FY2008 funding reform proposal.
- A comparison of payments and funded ratios under the revised schedule versus the requirements of the 1995 funding reform law as amended.

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<sup>42</sup> *FY2008 Illinois State Budget*, p. 4-3 and 4-4.

<sup>43</sup> *FY2008 Illinois State Budget*, p. 4-5.

**Revised Pension Payment Schedule v. 1995 Pension Funding Reform Law Payment Schedule**



Note: Payments include contributions to all five pension systems and debt service on all relevant POBs.

**Revised Pension Payment Schedule  
v. 1995 Pension Funding Reform Law Payment Schedule  
(in millions)**

	Revised Schedule		1995 Reform Schedule	
	Total Payment	Funded Ratio	Total Payment	Funded Ratio
FY2008	\$ 1,868.4	82.07%	\$ 2,564.9	58.94%
FY2009	\$ 2,139.0	81.06%	\$ 3,284.0	59.00%
FY2010	\$ 2,416.4	80.22%	\$ 4,042.1	59.55%
FY2011	\$ 2,694.4	79.52%	\$ 4,183.7	60.08%
FY2012	\$ 2,972.8	78.92%	\$ 4,378.4	60.56%
FY2013	\$ 3,250.6	78.44%	\$ 4,526.0	61.01%
FY2014	\$ 3,527.9	78.07%	\$ 4,679.3	61.43%
FY2015	\$ 3,805.2	77.84%	\$ 4,840.0	61.86%
FY2016	\$ 4,083.6	77.68%	\$ 5,008.8	62.27%
FY2017	\$ 4,361.3	77.61%	\$ 5,210.4	62.66%
FY2018	\$ 4,639.0	77.62%	\$ 5,420.0	63.05%
FY2019	\$ 4,916.7	77.70%	\$ 5,638.4	63.43%
FY2020	\$ 5,195.9	77.81%	\$ 5,890.6	63.82%
FY2021	\$ 5,474.5	77.96%	\$ 6,151.1	64.22%
FY2022	\$ 5,753.4	78.13%	\$ 6,420.5	64.62%
FY2023	\$ 6,031.8	78.37%	\$ 6,698.7	65.07%
FY2024	\$ 6,310.6	78.66%	\$ 7,011.9	65.55%
FY2025	\$ 6,589.3	78.98%	\$ 7,328.8	66.07%
FY2026	\$ 6,868.3	79.33%	\$ 7,628.8	66.63%
FY2027	\$ 7,146.7	79.73%	\$ 7,939.6	67.23%
FY2028	\$ 7,425.5	80.16%	\$ 8,277.0	67.87%
FY2029	\$ 7,704.2	80.61%	\$ 8,633.4	68.56%
FY2030	\$ 7,983.2	81.09%	\$ 9,027.5	69.31%
FY2031	\$ 8,262.1	81.60%	\$ 9,432.6	70.12%
FY2032	\$ 8,540.8	82.14%	\$ 9,825.3	71.00%
FY2033	\$ 8,819.4	82.71%	\$ 10,206.8	71.94%
FY2034	\$ 9,096.7	83.31%	\$ 9,454.8	72.96%
FY2035	\$ 9,374.3	83.96%	\$ 9,878.3	74.05%
FY2036	\$ 9,651.7	84.66%	\$ 10,322.3	75.23%
FY2037	\$ 9,929.4	85.38%	\$ 10,788.0	76.50%
FY2038	\$ 10,155.5	86.89%	\$ 11,276.7	77.85%
FY2039	\$ 10,433.0	88.42%	\$ 11,790.0	79.28%
FY2040	\$ 10,710.5	90.00%	\$ 12,328.0	80.81%
FY2041	\$ 4,948.0	90.00%	\$ 12,891.9	82.44%
FY2042	\$ 5,148.0	90.00%	\$ 13,482.2	84.17%
FY2043	\$ 5,353.0	90.00%	\$ 14,099.7	86.01%
FY2044	\$ 5,562.5	90.00%	\$ 14,746.0	87.95%
FY2045	\$ 5,774.5	90.00%	\$ 15,421.7	90.00%
<b>Total</b>	<b>\$ 234,918.1</b>		<b>\$ 310,728.2</b>	

Note: Payments include contributions to all five pension systems and debt service to relevant POBs.

Source: Governor's Office of Management and Budget

## CIVIC FEDERATION RECOMMENDATIONS

The Civic Federation offers a number of recommendations intended to improve the State's financial management practices and reduce costs.

### **Implement Pension Benefits Reforms**

We urge the Governor and General Assembly to adopt the following common sense proposals that will substantially improve the health the retirement systems and improve accountability of the funds to taxpayers:

*A Moratorium on New Pension Benefits.* The General Assembly has approved the Pay as You Go Act which requires that any State pension enhancements provide for funding. This is a more fiscally responsible approach to pensions than the State has had in the past. But the General Assembly can still sweeten the State's already unaffordable pension plans if it identifies new revenues, potentially leaving taxpayers on the hook for continuously expanding benefits and costs. The State should impose a moratorium on any new employee benefits. Until the pension system has achieved a 90% funded ratio, we call on the legislature to reject and the Governor to veto any new pension enhancements whether they are funded or not.

*A 1% Increase in Employee Contributions.* Employees covered by the state retirement systems contribute a percentage of their compensation for their own pensions and to fund survivor's benefits. For example, members of the State Employees Retirement System (SERS), employees covered by the regular retirement formula are required to make the following contributions:

- Members with Social Security: 3.5% of compensation (pension) + 0.5% (survivors') = 4.0% total
- Members without Social Security: 7.0% of compensation (pension) + 1.0% (survivors') = 8.0% total

The Civic Federation believes all public employees covered by the State's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions.

*Raise the Retirement Age for New Hires.* Members of the state's retirement systems are currently eligible for full retirement benefits when they reach age 60, unlike most private sector retirement systems that make 65 the minimum retirement age for full benefits. The age at which employees become eligible for full benefits should be increased to age 65 for employees with between 8 and 30 years of service, age 62 for employees with between 30 and 35 years of service, or age 60 for employees with 35 or more years of service.

*Fix automatic increases for new hires at the lesser of 2% or CPI.* The current rate of automatic increase for retirement annuities is 3% per year. Other retirement systems index the rate of increase to the CPI, limit the dollar amount of increase, or approve new increases annually. For new hires only, automatic increases should be limited to the lesser of the change in CPI or 2%,

and should apply only to the first \$12,000 in annual pension for retirees covered by Social Security and \$24,000 for retirees not covered by Social Security.

*Require Balance on Pension Boards Between Employees, Management and Taxpayers.* The State should require a balance of employee, management, and taxpayer interests in the governance of its retirement system Boards. Board seats should be set aside for members with professional expertise or certification in financial asset investment, and all members who do not already possess such expertise should be required to receive some relevant financial training on an annual basis.

*Study the Possibility of Moving to a Defined Contribution Plan for New Hires.* The State should undertake a study that would determine both the costs and benefits of moving to a Defined Contribution pension plan. If the Governor's funding reforms are adopted and the funded ratio of the retirement systems improves dramatically, this option will be more feasible than it has been in the past.

### **Implement Employee and Retiree Health Insurance Cost Saving Reforms**

To alleviate the fiscal pressures of mounting employee and retiree health insurance costs for State government employees, State university employees, members of the General Assembly, and judges, the Civic Federation makes the following policy recommendations:<sup>44</sup>

*Eliminate the costly indemnity plan* and place enrollees in HMO or OAP plans that cost significantly less. This measure could save the State between **\$176.6** and **\$253.4 million** per year.

*Eliminate free health care for retirees*, saving between **\$53.4** and **\$146.0 million per year** in premium costs.

*Increase employee premium contributions*, which are low in comparison to employee contribution levels required by other state and local governments and private sector organizations. Bringing employee premium contributions in line with national averages could yield as much as **\$67.3 million** in savings annually.

By implementing all of the Federation's recommendations, the State could reduce its total annual spending on employee and retiree health care by between **\$297.3** and **\$466 million**.

### **Implement Modest Revenue Enhancements to Pay for Pension Liabilities, Education, and Mass Transit**

Illinois should increase the personal income tax from 3% to 4% and increase the corporate income tax from 4.8% to 6.4% to provide approximately \$3.75 billion in new recurring revenues.

Increasing the individual income tax rate from 3% to 4% would generate approximately \$3.2 billion. Raising the corporate income tax from 4.8% to 6.4% would generate approximately

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<sup>44</sup> The Civic Federation, "State of Illinois Employee Health Insurance Plans: Analysis and Recommendations for Cost Containment," [http://www.civicfed.org/articles/civicfed\\_245.pdf](http://www.civicfed.org/articles/civicfed_245.pdf) (April 16, 2007).

\$577.0 million. The two income tax increases together would yield approximately \$3.75 billion.<sup>45</sup>

The Civic Federation believes that these modest revenue enhancements would not unduly burden the State's economy. They would provide needed funds to significantly reduce the State's existing pension obligations as well as to provide money for critical investments in education and mass transit. Maintaining education and mass transit funding at reasonable levels are, in our view, necessary prerequisites to ensuring the State's continued economic growth and stability.

### **Implement Metropolitan Mayors Caucus School Financial Management Accountability Reforms**

The Metropolitan Mayors Caucus recently released a report entitled "Strengthening the Financial Accountability of Illinois School Districts" that outlined a 10-point plan to ensure that school districts provide citizens with transparent financial documents, implement planning procedures, and strengthen internal controls.<sup>46</sup> The report was prepared by the Civic Federation.

The Metropolitan Mayors Caucus, an organization bringing together 272 northeastern Illinois civic leaders, proposes that this accountability plan be a prerequisite for any new school funding from the State of Illinois. **We strongly agree.**

The Metropolitan Mayors Caucus school financial management accountability plan includes the following proposals:

1. Prepare a user friendly Budget Executive Summary that is posted on the school district Web site.
2. Prepare a full budget document that includes an organizational chart, formal financial policies, a full long term financial plan or a summary thereof, and a full capital improvement plan or a summary thereof.
3. Require that school districts develop and implement publicly reported performance measures for support services and functions.
4. Require that school districts adopt strengthened internal controls, including creating a strong internal auditor function, implementing more rigorous external audit requirements, and requiring the adoption of formal written internal control policies.
5. Require that school districts create formal written financial policies in key policy areas that must be adopted by Boards of Trustees and made publicly available.

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<sup>45</sup> These are mathematical extrapolations based on the revenue estimates contained in the FY2008 Illinois State Operating Budget. A more precise estimate would require econometric modeling. See FY2008 Illinois State Operating Budget, p. 2-36.

<sup>46</sup> Metropolitan Mayors Caucus. *Strengthening the Financial Accountability of Illinois School Districts*. April 2007.

6. Require that school districts develop and implement a long-term financial plan that includes multi-year forecasts of revenues expenditures and debt.
7. Require that school districts adopt, implement, and disclose a multi-year capital improvement plan.
8. Require that all school board members complete at least six hours of training on their financial oversight, accountability, and fiduciary responsibilities.
9. Require that an Office of School District Financial Management Accountability be established within the Illinois State Board of Education (ISBE) to monitor progress made in meeting the reform requirements. ISBE would be empowered to monitor progress, enforce compliance, and impose sanctions for noncompliance including removal of non-complying administrators.
10. Earmark a portion of new school revenues for implementing the financial management accountability reforms. Special funding would be made available for financially distressed school districts to enable them to implement these reforms.

The Metropolitan Mayors Caucus has proposed that the recommendations should be implemented by statute and that compliance be monitored by the ISBE. Intergovernmental cooperation is encouraged for small school districts and those districts experiencing fiscal distress to facilitate implementation of the proposed reforms. The reforms proposed should be phased in to allow sufficient time for ISBE to develop accountability, reporting, and oversight mechanisms, and for school districts to comply with the requirements.

### **Improve the State's Performance Measurement System**

The FY2008 Illinois State Budget includes five years of performance metrics for each agency. However, most of these metrics are workload measures, that is, counts of the number or percentage of activities undertaken or services delivered. These are important statistics. But they provide no information about the goals the statistics are measuring, which makes it impossible to determine if agencies are meeting, exceeding, or falling short of program and policy objectives. In addition, there are no efficiency, effectiveness, or service quality measures that would permit a focused evaluation of how well agencies and programs are meeting stated objectives.

A sound financial planning process involves tracking and improving productivity among the State's agencies. Given the administration's continued focus on improving management efficiency, the Civic Federation urges the State to enhance the quality and effectiveness of the performance data collected, presented, and utilized. Optimally, this would include efficiency, effectiveness, and service quality measures as relates to the attainment of stated objectives.

### **Implement a Formal Long-Term Financial Planning Process**

The National Advisory Council on State and Local Budgeting (NACSLB) and the Government Finance Officers Association (GFOA) both recommend that all governments formally adopt a

long-term financial plan as a key component of a sound budget process.<sup>47</sup> The State of Illinois currently employs many of the techniques of a long-term financial planning process internally, including the projection of multi-year revenue trends and modeling of various revenue and expenditure options. However, the State does not develop a formal plan that is shared with and/or reviewed by key policymakers and stakeholders. The Civic Federation recommends that the State develop and implement a formal long-term financial planning process.

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<sup>47</sup> See National Advisory Council on State and Local Budgeting and Government Finance Officers Association