EMBARGOED FOR RELEASE UNTIL FRIDAY, MARCH 17, 2006

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CIVIC FEDERATION OPPOSES ILLINOIS FY2007 BUDGET
REJECTS PENSION HOLIDAY, EXPENSIVE NEW INITIATIVES

(CHICAGO) – Citing the fiscally dangerous combination of increasing spending on new programs while underfunding pension obligations, the Civic Federation announced today that it **opposes** Gov. Blagojevich's proposed $45.4 billion FY2007 operating budget. The basis for the Federation's opposition is included in its 54 page analysis of the governor's proposed budget that is being released today.

The Civic Federation renewed its opposition to the state's ill-considered partial pension funding "holiday" in its analysis, calling the budget short-sighted. As a consequence of the state's decision to shortchange its pension funds by $2.3 billion over two years, the funded ratio of the retirement systems is projected to fall to 57.7% in FY 2007 from 60.9% in FY2004. "We are alarmed by the rapid erosion of last year's essential pension reforms with this budget," said Laurence Msall, president of the Civic Federation.

The Civic Federation also expressed disappointment with the $261 million in new and recurring program initiatives included in the budget. "Not only is Illinois not taking care of its current and past spending obligations, it is creating new and potentially larger future obligations," Msall said. "We at the Federation cannot stress enough how important it is for the future of the state of Illinois that current responsibilities be taken care of before shouldering new spending commitments."

The Civic Federation's analysis proposed fiscally sound principles on which the state should base this and future budgets:

- The state of Illinois should fund its retirement systems at the certified contribution amount each year, as established by the 1995 pension funding reform law.
- The state should meet existing obligations before undertaking expensive new programs, particularly those with recurring costs.
- Proceeds from the sale of state of Illinois assets like the student loan portfolio and possibly the state Toll Highway Authority should be applied immediately to reducing ongoing obligations, such as the state's $45 billion in unfunded pension liabilities, before they are used for expensive new recurring programs.
- The state should continue to embrace reforming the management of state operations.

The Civic Federation offered its **support** for some elements of the budget, including exploring privatization of the student loan assets and further use of Shared Service Centers to consolidate and reduce state agencies' administrative functions. The Federation **cautions** that the proceeds from the student loan sale should be used to reduce the unfunded liabilities of the pension program, not pay for continuing operating expenses.

Finally, the Civic Federation urged Gov. Blagojevich to convene a third blue-ribbon **Commission on State Spending** to conduct a comprehensive review of state spending programs and follow up on two earlier commissions on state pension costs that were created by the governor. The ultimate goals of the new commission would be to increase transparency in the budget process and prioritize programs so the public will know whether the state is operating as efficiently and effectively as it could.

The Civic Federation's complete state of Illinois budget analysis, including detailed findings and recommendations, is available today on our website at www.civicfed.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
FY2007 RECOMMENDED OPERATING BUDGET

Analysis and Recommendations

Prepared By
The Civic Federation
March 17, 2006

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EXECUTIVE SUMMARY

The State of Illinois proposes a $45.4 billion operating budget for FY2007. The budget is balanced in part with a $1.1 billion reduction in the State's contribution to its five retirement systems from the certified amount of $2.5 billion. The full text of our analysis follows this summary and is also available on our web site at www.civicfed.org.

Civic Federation Position: Opposition to Budget

The Civic Federation **opposes** Governor Blagojevich's FY2007 $45.4 billion operating budget. It is built on a foundation that shortchanges the State's pension funds by $1.1 billion. This is the second year of an ill-considered $2.3 billion partial pension funding shortfall brokered last year by the Governor and legislative leaders.

At the same time as the budget fails to adequately fund the retirement systems, it proposes over $1.0 billion in increased spending from General Fund revenues. The budget proposes as much as $261 million in new initiatives, many of which represent recurring costs that could expand dramatically in future years. Deferring huge, ongoing pension obligations to pay for expensive new obligations that will entail recurring costs is short-sighted.

The consequences of the partial pension holiday are sobering. The retirement systems' funded ratio is projected to fall to 57.7% in FY2007. Since FY2004, when the State issued $10 billion in pension obligation bonds for the express purpose of reducing the funds' outstanding liabilities, the funded ratio *will have fallen* from 60.9%. Between FY2006 and FY2007, unfunded liabilities will rise from $42.2 billion to $45.8 billion. The gains from the infusion of pension obligation bond funds and the approval of certain sorely needed reforms last year are being eroded.

The Civic Federation does support some elements of the FY2007 State Budget. We are pleased that the budget contains no broad-based income or sales tax increases. Illinois must begin evaluating the performance of the current budget and demonstrates the discipline necessary to fund its constitutionally guaranteed employee pension benefits, before raising new revenues from broad-based sources. We also support exploring the competitive sale of Illinois Designated Account Purchase Program student loan assets and loan transactions and the proposal to implement a Shared Services program to consolidate administrative functions.

The Civic Federation believes that the State of Illinois should base the FY2007 and future budgets on the following fiscally sound principles:

1. The State of Illinois should fund its retirement systems at the certified contribution amount each year as established by the 1995 pension funding reform law.

2. The State should meet existing obligations before undertaking expensive new programs, particularly those with recurring costs.

3. Proceeds from the sale of State of Illinois assets like the student loan portfolio should always be used to reduce ongoing obligations, especially the State's $45 billion in unfunded pension liabilities, before they are used for expensive new recurring programs.

4. The State should continue to embrace reforming the management of State operations.

Highlights of the State of Illinois FY2007 Budget:

- Proposed FY2007 budgeted appropriations will increase by 4.0% from the proposed FY2006 budget of $43.5 billion. General Funds appropriations are projected to increase by 4.6%, a $1.1 billion increase over last year's proposed $25.7 billion.
- Over $261 million in new program initiatives are included in the FY2007 budget. The major new programs include a $1,000 tuition tax credit costing $90 million, a universal preschool program costing $45 million and the All Kids program, a universal health insurance program for disadvantaged children costing $45 million. Most initiatives represent recurring expenditures.
- The budget contains $147.0 million in revenue from new tax treatments: $48 million from eliminating the sales tax exemption for prewritten, licensed software; $44 million from eliminating the underground storage tank tax exemption for fuel transported out of state; $25 million from the repeal of the Retail Rate Law; $10 million from allowing Department of Revenue auditors to verify losses older than 3 years; $10 million from expanding the definition of the U.S. to include the outer continental shelf; and $10 million from increasing the other tobacco products tax from 18% to 30% of the wholesale price.
- The number of full-time equivalent (FTE) positions authorized in FY2007 is projected to increase by 1,146 FTEs from the number of positions that will be filled in FY2006. This will increase the State workforce to 58,490 FTEs.
- The State's contribution to its five retirement systems will be $1.3 billion. This is $1.1 billion less than the total certified amount of $2.5 billion. The General Assembly authorized a two-year partial pension holiday in FY2006 totaling $2.3 billion.
- The funded ratio of the State retirement systems will drop to 57.7% in FY2007, according to projections from the Commission on Government Forecasting and Accountability. Since FY2004, when the State issued $10 billion in pension obligation bonds for the express purpose of reducing the funds' outstanding liabilities, the funded ratio *will have fallen* from 60.9%.
- The State proposes that any revenues derived from the sale of state assets or the 10th casino license be used to reduce pension fund liabilities.

The Civic Federation **supports** some elements of the FY2007 State Budget:

- The budget contains no broad-based income or sales tax increases. Until Illinois begins evaluating the performance of the current budget and demonstrates the discipline necessary to fund its constitutionally guaranteed employee pension benefits, there will be little confidence that promised priorities would actually be addressed by additional tax revenue from broad-based sources.
- We support exploring the competitive sale of Illinois Designated Account Purchase Program student loan assets and loan transactions. This is not a core business of the State and may therefore be a good candidate for privatization. However, we are disappointed that the State has not chosen to achieve savings from the proposed sale by eliminating current staff positions.
- The State proposes the creation of Shared Service Centers to assume responsibility for state agencies' Administrative Services, Grants Management, Customer Service, and Business Portal functions. Staffing reductions achieved by this sound management reform could save up to $100 million per year in the future.

- The Civic Federation agrees with the four findings by the second Blue Ribbon Pension Commission that focus on regularly reviewing pension benefits and on identifying or securing dedicated revenues to fund the retirement systems. We strongly support the concept of directing revenues from asset sales to reducing the unfunded obligations of the pension systems. We think this concept is such a good idea that it should be applied to all asset sales, including the proposed sale of the student loan program.

The Civic Federation offers the following **recommendations** to improve the State's financial management:

- Governor Blagojevich should convene a Blue Ribbon Commission on State Spending to conduct a comprehensive review of State spending programs. The Commission's ultimate goal should be to prioritize those programs. A prioritization review is long overdue given the State's ongoing resource constraints, the administration's pledge to refrain from broad-based tax increases and the public's unwillingness to embrace new taxes or enhanced spending until it gains some confidence that the State is operating as efficiently and effectively as it should.
- We urge the State to reject the ill-considered $1.1 billion partial pension funding holiday approved last year. The State should fund its pension obligations at the full $2.5 billion amount required by the 1995 law.
- The hundreds of millions in dollars in proceeds that may be generated from the privatization of the management of the student loan program should be used to reduce the unfunded liabilities of the State's pension funds, not to pay for expensive new recurring obligations.
- The State should explore opportunities for leasing the management of all or part of the 274-mile Illinois Toll Highway system to private investors. This action could generate up to $15 billion in revenue. Revenues from a privatization effort should be dedicated to reducing the unfunded liabilities of the State's five retirement systems, not to funding costly recurring operating expenses.
- 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 should be required to receive some relevant financial training on an annual basis.
- The State should impose a moratorium on any new employee benefit enhancements until such time as substantial progress has been made on reducing the State's billions of dollars in pension liabilities.
- 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. Stratospheric pension costs pose a serious threat to the financial future of the State of Illinois and its residents, and containing those costs must be a shared, ongoing, focused effort.
- All relevant information about State retirement systems assets and liabilities for the current fiscal year should be provided in the Budget Book and all pension funds should be required to submit annual reports on their activities and financial condition to the Department of Financial and Professional Regulation.
- The Civic Federation urges the State to undertake a study that would determine both the costs and benefits of moving to a Defined Contribution pension plan. We recognize that any move toward a DC plan would be contingent upon financial feasibility and the identification of real, substantial cost savings over time.

OVERVIEW OF ANALYSIS

The Civic Federation recently concluded an analysis of financial issues related to the State of Illinois' proposed FY2007 $45.4 billion operating budget. Our position on the budget as a whole and on particular components of the budget proposal rests on four basic principles:

1. The State of Illinois should fund its retirement systems at the certified contribution amount each year as established by the 1995 pension funding reform law.

2. The State should meet existing obligations before undertaking expensive new programs, particularly those with recurring costs.

3. Proceeds from the sale of State of Illinois assets should be used to reduce ongoing obligations, especially the State's $45 billion in unfunded pension liabilities, before they are used for expensive new obligations that will entail recurring costs.

4. The State should continue to embrace reforming the management of State operations.

The full text of our analysis follows this summary and is also available on our web site at www.civicfed.org.

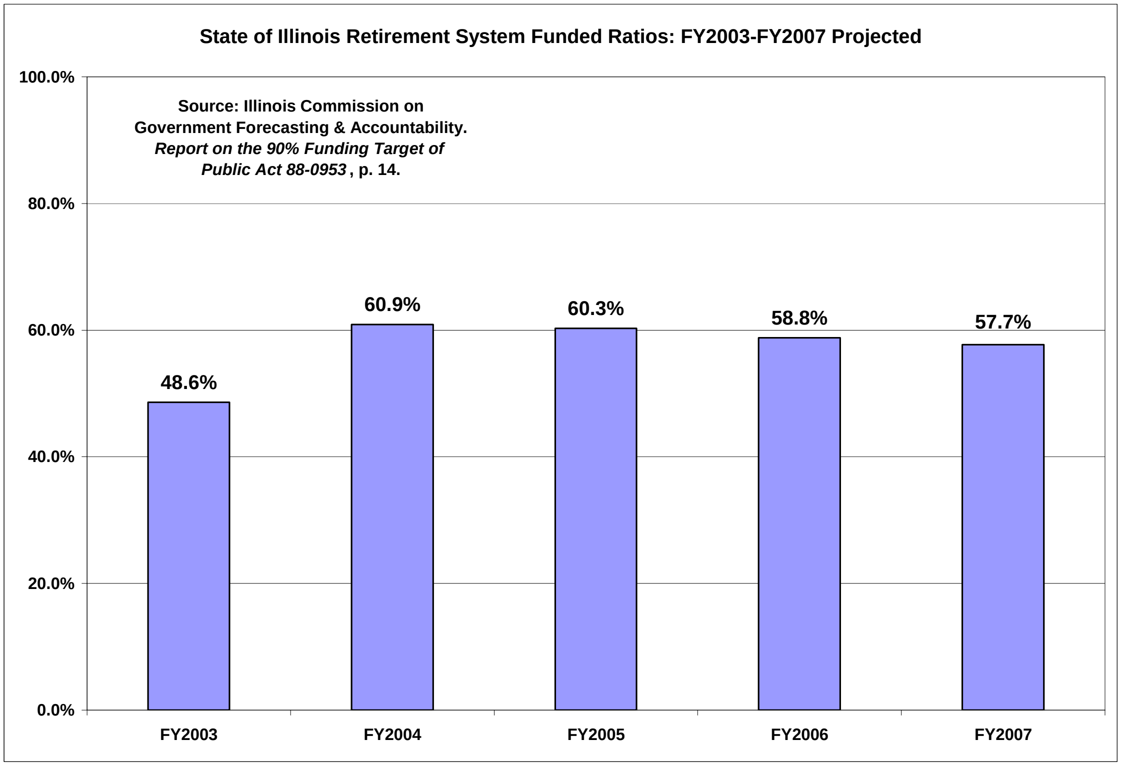
The Civic Federation Opposes the FY2007 State of Illinois Operating Budget

The Civic Federation **opposes** Governor Blagojevich's FY2007 $45.4 billion operating budget. It is built on a foundation that shortchanges the State's pension funds by $1.1 billion. To compound the problem, this is the second year the State has chosen to use this easy short-term fix. Last year, the Governor and General Assembly approved a two-year, $2.3 billion partial pension holiday.

At the same time this budget proposes to underfund the retirement systems, it is proposing hundreds of millions of dollars in expensive new recurring programs. It proposes as much as $261 million in new initiatives, many of which represent recurring costs that could expand dramatically in future years. Deferring huge, ongoing pension obligations to pay for expensive new obligations that will entail recurring costs is short-sighted and jeopardizes the State's long-term fiscal stability.

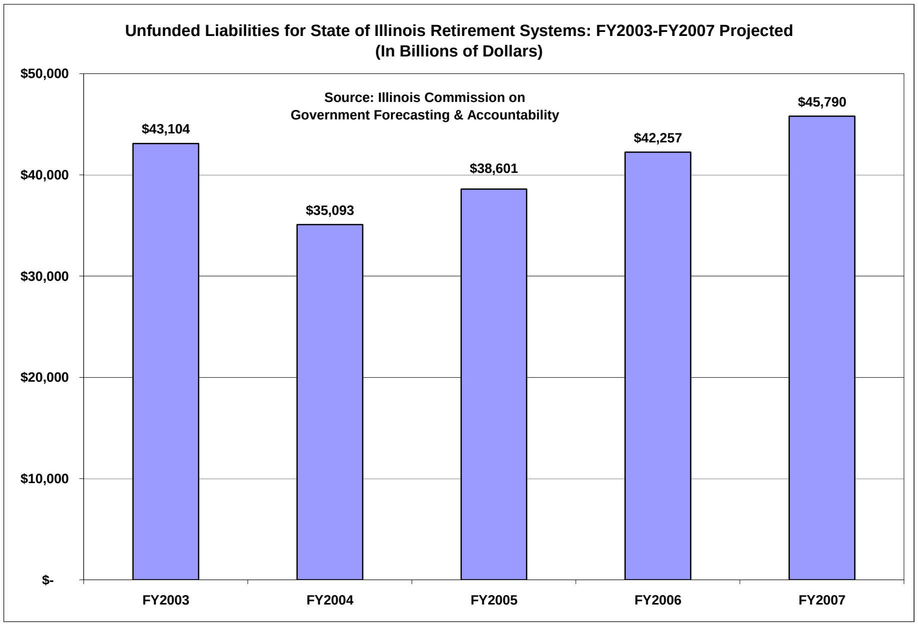
Governor Blagojevich, in concert with the General Assembly, appears to have abandoned his pledge to fix one of the State's longstanding problems, the chronic underfunding of its pension systems. It comes as no surprise, then, that the funded ratio of the five retirement systems will fall to 57.7% in FY2007 and unfunded liabilities will rise to nearly $45.8 billion, according to recent projections from the Commission on Government Forecasting and Accountability.

The funded ratio decline is particularly worrisome because it comes after the State issued $10 billion in pension obligation bonds in 2003, and after the State implemented positive pension funding reforms last year that will reduce long-term liabilities from what they otherwise would have been. It is true that between FY2003 and FY2007, the funded ratio for all funds will increase from 48.6% to 57.7%, reflecting that infusion of new dollars. However, since FY2004 the funded ratio has fallen each year. Some of the funded ratio's drop is due to the impact of the Early Retirement Initiative funding fiasco in FY2002, which increased liabilities.[1] But the two-year partial pension holiday has undoubtedly exacerbated the situation.



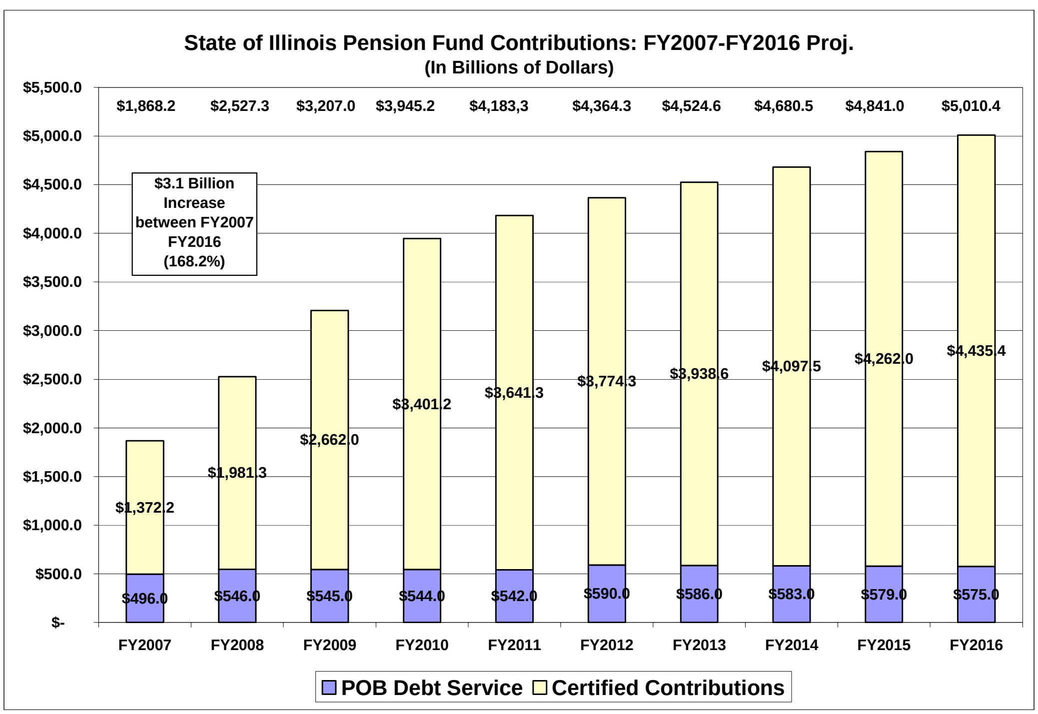
The unfunded liabilities of the State's five pension funds are projected to grow to nearly $45.8 billion in FY2007, according to the Commission on Government Forecasting and Accountability. This is approximately a 6.2%, $2.6 billion increase since FY2003, when unfunded liabilities were $43.1 billion. In short, unfunded liabilities are even greater than they were before the pension obligation bond issue. This can hardly be considered progress.

[1] The original estimated annual cost of amortization of the FY2002 Early Retirement Initiative was $70 million. However, a recalculation has show that there were serious errors in that estimate, and that the actual annual cost will be $382 million. The State has opted to spread out the cost of paying for the ERI over 40 years. These costs are included in the calculation of estimated contributions to the retirement systems over time.



The Pension Funding Crisis is Going to Get Worse

The pension funding crisis isn't going away. In fact, from a budgetary standpoint, it's going to get much worse in the future. Assuming that the State makes the full certified contributions for the next 10 years, the annual required payment in FY2016will have increased by 223.2%. That is a $3.0 billion increase, from $1.4 billion to $4.4 billion. When the debt service payments on the pension obligation bonds are factored in, the amount of increase is $3.1 billion, from $1.9 billion to $5.0 billion.



If State budget appropriations grow at a rate of 5% per year over the next 10 years and the State makes the full certified contributions, the percentage of total appropriations reserved for pensions (including debt service on pension obligation bonds) will rise from 4.1% in FY2007 to 7.1% in FY2016.

State Pension Expenses as a Percentage of Future Operating Budgets

	All Funds	POB Debt Service*	Certified Contributions	Total Pension Expenses	% of Total Budget
FY2007	$ 45,427.7	$ 496.0	$ 1,372.2	$ 1,868.2	4.1%
FY2008	$ 47,699.1	$ 546.0	$ 1,981.3	$ 2,527.3	5.3%
FY2009	$ 50,084.0	$ 545.0	$ 2,662.0	$ 3,207.0	6.4%
FY2010	$ 52,588.2	$ 544.0	$ 3,401.2	$ 3,945.2	7.5%
FY2011	$ 55,217.7	$ 542.0	$ 3,641.3	$ 4,183.3	7.6%
FY2012	$ 57,978.5	$ 590.0	$ 3,774.3	$ 4,364.3	7.5%
FY2013	$ 60,877.5	$ 586.0	$ 3,938.6	$ 4,524.6	7.4%
FY2014	$ 63,921.3	$ 583.0	$ 4,097.5	$ 4,680.5	7.3%
FY2015	$ 67,117.4	$ 579.0	$ 4,262.0	$ 4,841.0	7.2%
FY2016	$ 70,473.3	$ 575.0	$ 4,435.4	5,010.4	7.1%

* Principal + Interest
Assumes 5% appropriation growth per year
Certified Pension Contribution data from Commission on Government Forecasting & Accountability
POB Debt Service figures from FY2007 Illinois State Budget, p. 12-13.

The Civic Federation has consistently supported Governor Blagojevich's efforts to reform the way Illinois funds pensions in order to reduce the staggering unfunded liabilities produced by decades of underfunding. With caveats, we supported the issuance of $10 billion in pension obligation bonds in 2003. We endorsed the Governor's proposed reforms last year. But the administration's abrupt change in direction is exacerbating an already bad situation rather than providing a long-term solution. We must oppose the pension contribution reduction and therefore we must oppose the budget on which it is based.

We recognize that any solution to the pension funding crisis will inflict pain and will require difficult choices. The longer that pain is deferred, the worse the situation will become until the State is forced to take drastic action.

In conclusion, the Civic Federation opposes the FY2007 State operating budget because it fails to adhere to two key fiscal principles:

1. The State of Illinois should fund its retirement systems at the certified contribution amount each year as established by the 1995 pension funding reform law.

2. The State should meet existing obligations before undertaking expensive new programs, particularly those with recurring costs.

Issues that the Civic Federation Supports

While the Civic Federation opposes the Governor's FY2007 operating budget because it is built on a fiscally dangerous foundation, we do support several particular elements that it contains.

No Broad-Based Tax Increases (Income or Sales Taxes)

The Civic Federation is pleased that Governor Blagojevich's proposed FY2007 budget for the State of Illinois does not increase the State's income or sales tax rates.

The Civic Federation supports a regular review of the State's financing and tax structure. But any review of State government operations must include both the revenue and **expenditure** components of the budget. Until Illinois government commits to a realistic plan for evaluating the effectiveness of the current $45 billion operating budget and demonstrates the discipline necessary to adequately fund its constitutionally guaranteed employee pension benefits, neither the general public nor the Civic Federation will have confidence that promised priorities will actually be addressed by additional revenue from sales or income taxes.

Illinois's financial difficulties are historic and have yet to be effectively addressed, as illustrated by the Governor and General Assembly's embrace of a two-year partial pension holiday. Simply raising taxes to generate new revenues without first clearly understanding and prioritizing how the State spends the money it already collects would be an irresponsible and wasteful exercise.

The Civic Federation believes that the State of Illinois must make a comprehensive review of all the programs it currently provides to determine if they operate as efficiently and effectively as possible, or if there are opportunities to eliminate duplicative or wasteful programs. We also think it imperative that the administration, in conjunction with stakeholders, undertake the painful but necessary task of prioritizing programs and services in order to determine what the State can reasonably afford. This is especially true if the Governor or the General Assembly wants to avoid broad-based tax increases to fund recurring cost increases for employee benefits and healthcare.

Even with likely sales and income tax growth, the unchecked pressure of increasing State pension costs will leave the State with no recourse but cost containment and spending reduction strategies in succeeding years. The State will be out of options, that is, unless it resorts to seriously unsound measures: the continued shortchanging of pension funds, the deferral of payments to Medicaid providers for lengthier and lengthier periods, short-term borrowing or desperate searches for one-time budget fixes.

Tax Treatments

While the Civic Federation cannot support any increase in the State's broad-based taxes until the State has clearly and unequivocally demonstrated its commitment to reducing outstanding obligations and prioritizing spending, we do not oppose efforts to modernize the State's antiquated revenue system or to reduce the number of outmoded exemptions that have progressively narrowed the tax base. In our view, the tax changes proposed in this budget are reasonable and defensible on tax policy grounds. Therefore, we do not oppose the enactment of any of the Governor's proposals, including eliminating the sales tax exemption for prewritten, licensed software, repealing the Retail Rate law, allowing Department of Revenue auditors to verify losses older than three years, expanding the definition of the U.S. to include possessions and the outer continental shelf, eliminating the current exemption for gas transported out of state and increasing the other tobacco products tax.

In past years we have had concerns about the ability of the Department of Revenue to implement many of their proposals and have been disappointed by the lack of detail accompanying specific proposals to change the tax system. This year, however, we are satisfied that the Department has responded to our concerns. Department of Revenue Director Brian Hamer and his staff have done a good job in fully informing the public about the nature of the proposed changes, and we commend them for their efforts.

Exploring the Privatization of the Illinois Designated Account Purchase Program (IDAPP)

The State of Illinois proposes exploring the competitive sale of Illinois Designated Account Purchase Program student loan assets and loan transactions, in effect privatizing the management of the student loan portfolio in much the same manner that other states and the federal government have done. Revenue from the sale would be used to fund the proposed $1,000 per student tuition tax credit.

The Civic Federation supports outsourcing the management of non-core government functions provided that there is an identifiable market of qualified vendors and that after privatization the government maintains adequate administrative oversight, ensuring that the program fulfills its goals and operates as required under the terms of agreement. If both of these conditions can be met, we support exploring the possibility of selling this asset. However, we have two concerns with the State's current proposal.

First, the privatization will not lead to a reduction in personnel; current employees will be offered jobs elsewhere in the State bureaucracy.[2] Therefore, no long-term savings will be generated for the Illinois Student Assistance Commission which administers IDAPP. Second, because this asset sale will only bring a one-time windfall of funds, those funds should not be used to pay for a *recurring* expense like the tuition scholarship program. It would be much more appropriate to use those funds to reduce the massive unfunded liabilities of the State's chronically underfunded pension systems.

Shared Services

The State of Illinois has proposed a Shared Services Vision for FY2007. This plan would establish six Shared Service Centers to assume responsibility for state agencies' Administrative Services (e.g., Human Resources, Payroll, Fiscal), Grants Management (e.g. grant application, monitoring, and reporting), Customer Service (e.g. State-wide call center, consolidated front-office service locations) and Business Portal (e.g. business application and authorization) functions. In future years, Information Technology Infrastructure, Fleet, and Facilities

[2] *FY2007 Illinois State Budget*, p. 6-9.

Management may also be brought into the program. This program will generate an estimated savings of $100 million per year, primarily primarily be eliminating administrative and support positions.

The Civic Federation is a strong proponent of bringing business process reforms to bear on government operations. Such reforms can significantly reduce administrative costs and improve efficiency. We have been encouraged by the administration's willingness to employ business process reforms in past years. The Shared Services plan is part of that ongoing process and we strongly support its implementation.

<u>Second Blue Ribbon Commission Pension Funding Reform Proposals Except New Pension Obligation Bonds</u>

The Governor's second Blue Ribbon Commission on Pensions made a number of recommendations. The Civic Federation agrees with the Commission's four findings that focus on identifying or securing dedicated revenues to fund the retirement systems and regularly reviewing pension benefits:

1. The State should dedicate revenues in excess of a targeted percentage of growth toward the additional funding of the pension systems when those targets are met and establish a minimum when they are not met.
2. If the state sells certain assets, 100% of the proceeds should be dedicated toward reducing pension liabilities.
3. The General Assembly should explore new dedicated revenue sources for the retirement systems.
4. The legislature should regularly review the pension systems' provisions regarding benefits and make determinations as needed.

The fifth recommendation, however, proposes that the State consider issuing additional Pension Obligation bonds to further reduce pension costs as long as market conditions are favorable, and as long as POB issuance is part of a broader plan to reduce the retirement systems' unfunded liabilities. Absent any ironclad commitment by the Governor or Legislature to actually fund the retirement systems at their certified level, we are not convinced that issuing additional debt would in fact improve the funding situation. An influx of bond money might unfortunately become an excuse to reduce budgetary contributions to the retirement systems.

Civic Federation Recommendations

The Civic Federation offers the following recommendations regarding ways to improve the State's financial management and fulfill the State's financial obligations:

<u>Fund State Pension Systems at Certified Contribution Amount</u>

The State of Illinois has a responsibility to follow the mandate of the 1995 pension funding reform law. Deviating from the path laid out by that law renders it meaningless. Fixing the pension funding problem requires discipline and sacrifice, even pain. We urge the State to reject the ill-considered $1.1 billion partial pension funding holiday approved last year. The State should fund its pension obligations at the full $2.5 billion amount required by the 1995 law. In short, we do not believe that the State should increase recurring operating expenditures until it pays its existing, constitutionally guaranteed obligations. Each time the State reduces contributions to the retirement systems, it is doing little more than deferring expense to future years.

Retirement System Funding and Governance Reforms

The Civic Federation strongly believes the State of Illinois must continue on the path to comprehensive reform of the way the State funds and governs its retirement systems. Some progress was made last with the approval of certain reforms that will reduce long-term liabilities and curb longstanding abuses. But much more remains to be done.

Impose a Moratorium on New State Employee Pension Enhancements

The Civic Federation believes the time has come to stop expanding employee pension benefits. We call upon the legislature to reject and the Governor to veto any new pension enhancements whether they are funded or not. In addition the State must adopt a moratorium on any new benefit enhancements until such time as substantial progress has been made on reducing the State's billions of dollars in pension liabilities. This moratorium will likely be necessary for at least 10 years, until the FY2002 Early Retirement Initiative is fully paid for.

Require Employees to Increase Pension Contributions by 1%

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. This increase should be required immediately for new hires and non-union employees. Although current contracts prevent this increase from being immediately implemented for employees covered by collective bargaining agreements, the State should, as a matter of policy, require increased contributions in future contracts. Stratospheric pension costs pose a serious threat to the financial future of the State of Illinois and its residents, and containing those costs must be a shared, ongoing, focused effort. We do not believe a single percentage point increase is onerous or unreasonable, especially when balanced against the generous retirement benefits state employees receive.

Study the Costs and Benefits of a Defined Contribution Pension Plan

In reviewing the record of the past thirty years, we have seen no evidence that the General Assembly has the requisite fiscal discipline to transparently execute a well-funded Defined Benefit retirement system. For that reason, we think that a shift to a defined contribution (DC) system must be seriously considered for new hires when such a shift is deemed financially feasible. We understand that transition costs for the shift could be expensive because of the current dramatic underfunding of the retirement systems. However, the Civic Federation urges the Governor and the legislature to undertake a study that will determine both costs and benefits of this option. This study should include consideration of transition funding mechanisms because the cost savings and benefits of a shift to a DC plan in the long term may outweigh short-term expenses. While the Civic Federation opposes the issuance of any new Pension Obligation bonds to fund current or future State of Illinois pension obligations, it may make sense to issue such bonds for the sole purpose of paying the transition costs to a defined contribution plan. This possibility would be contingent, of course, upon financial feasibility and the identification of real, substantial cost savings over time.

The State Should Not Mandate Local Pension Enhancements without Providing Funding

The General Assembly frequently approves legislation increasing the level and scope of local government employee pension benefits. However, no funding is provided for what amounts to yet another costly unfunded mandate for cash-strapped local governments. We believe that the concept of "pay as you go" funding adopted last year for state retirement system funding should be extended to include all State of Illinois actions that financially impact the pension costs of local governments. If the General Assembly sees fit to enhance benefits, it should identify and provide the requisite funding for those enhancements.

Provide Transparent and Frequent Reporting of Pension Fund Information

The FY2007 Budget Book only provides information about the assets and liabilities of the State's retirement systems through FY2005. Traditionally, projections have been provided through the current budget year. This omission is disappointing and is contrary to the transparency of much of the rest of the document.

The public needs full and accurate financial information in order to understand and evaluate the Governor's budget proposals, particularly on an important issue such as pension funding. The Civic Federation recommends that the State fully disclose all relevant financial information about contribution levels and funding status for all retirement systems in the Pension section of future Budget Books. We also call upon the Illinois Department of Financial and Professional Regulation to seek legislative approval for the annual reporting of public pension funds' activities and financial condition, and to extend the law to require disclosure of information by the Chicago Transit Authority Pension system.

Require Balance of Interests in Pension Board Governance

In reviewing public pension board composition in other states, The Civic Federation finds that many jurisdictions require pension governing boards to reflect a balance between employees, management and citizens. Many others also require financial training or expertise for at least some of their trustees.[3] The Civic Federation believes that balance in pension board composition is critically important if Illinois is to confront and more equitably debate the escalating costs of public pensions. Consequently, it recommends the following reforms for public pension fund governance in Illinois, and urges the General Assembly to take legislative action to:

- Balance employee and management representation on pension boards and

[3] For the full Civic Federation report entitled, "Recommendations to Reform Public Pension Boards of Trustees in Illinois," please go to www.civicfed.org.

- Develop a tripartite structure that includes independent citizen representation on pension boards.

Require Financial Expertise on Pension Boards

Public pension boards are charged with making complex financial and investment decisions affecting millions of dollars contributed by employees and taxpayers. This is a weighty fiduciary responsibility that requires a thorough understanding of asset management. It would be prudent to set aside some board seats for members with professional expertise or certification in financial asset investment, and to require all members to receive some basic education on their fiduciary responsibilities. Furthermore, all pension trustees should receive some relevant financial training on an annual basis.

<u>Establish a Governor's Commission to Review and Prioritize State Spending</u>

The Civic Federation recommends that the Governor convene a Blue Ribbon Commission on State Spending. The Commission's purpose would be to comprehensively review State spending programs and identify appropriate performance measures so that the Commission could ultimately prioritize those programs. Programs deemed essential to the well being of Illinoisans should be maintained or even enhanced. Programs that are not essential may require reductions or even elimination. Given the State's ongoing resource constraints, the administration's pledge to refrain from broad-based tax increases and the public's unwillingness to embrace new taxes or enhanced spending until it gains some confidence that the State is operating as efficiently and effectively as it should, we believe that a prioritization review is long overdue. Several states, including Washington and Michigan, have or are in the process of conducting similar prioritization processes.

The framework for a review of State spending should be comprehensive and include the following considerations:

- Cost containment strategies for mandated programs;
- A cap or moratorium on the expansion of State employee benefits;
- No new programs without new revenues or spending cuts; and
- Enhanced accountability for state programs, including publicly announced and updated performance measures.

<u>Explore Privatization of the Illinois State Toll Highway Authority</u>

The State of Illinois should consider leasing the management of all or part of the 274-mile Illinois Toll Highway system to private investors. Some very preliminary estimates about the value of leasing the Tollway indicate that it could generate up to $15 billion in revenue for the State.[4]

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[4] Greg Hinz, *Crain's Chicago Business* on-line edition, "Gov. Looks $15 Billion Gift Horse in the Mouth." posted Jan. 26, 2006.

Operating the Tollway is not a core function of the State and as such is a good candidate for outsourcing. Given the success of the City of Chicago's recent Skyway privatization, the Civic Federation believes that the idea should be seriously explored. As with all one-shot asset sales, we strongly believe that the revenues from a privatization effort should be dedicated to reducing existing liabilities such as the unfunded liabilities of the State's five retirement systems.

ACKNOWLEDGEMENTS

The Civic Federation would like to express its sincere appreciation to Governor's Office of Management and Budget (GOMB) Director John Filan, 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.

The Civic Federation particularly appreciative of the efforts made by Department of Revenue Director Hamer and his staff in providing detailed and thoughtful responses to the Federation's questions and concerns about tax changes proposed in the budget.

FY2007 BUDGET HIGHLIGHTS

Governor Blagojevich proposes a FY2007 operating budget of $45.4 billion, a 4.0% or $1.7 billion increase from FY2006 proposed budget of $43.5 billion. Budget highlights include:

- No increase in general state taxes on sales or income.
- A $1.1 billion reduction from the $2.5 billion amount certified under the 1995 pension funding reform law. This is the second year of a $2.3 billion partial pension holiday approved last year.
- Robust revenue growth. General Fund revenues will increase by 6.3% or $1.6 billion in FY2007. Reflecting the continued economic recovery, actual FY2006 revenues will be $429 million more than originally anticipated.
- Approximately $138 million in new business tax changes, including elimination of the sales tax exemption for licensed pre-written software, repeal of subsidies for alternative energy production and the elimination of an exemption for gas transported out of state.
- An increase from 18% to 30% in the state tax on "other tobacco products" such as cigars and smokeless products, which is expected to generate $10 million;
- Another sweep of Special Purpose funds to transfer $144 million in surpluses to the General Fund.[5]
- A reduction of $1.1 billion to the State's five retirement systems from the certified amount of $2.5 billion.
- A proposal to pay a $1.2 billion backlog in Medicaid bills with the proceeds of the funds sweeps and federal matching funds.[6] Last year, the state took an average of 75 days to pay Medicaid bills; it proposes to reduce that turnaround time to 20 days in FY2007.[7]

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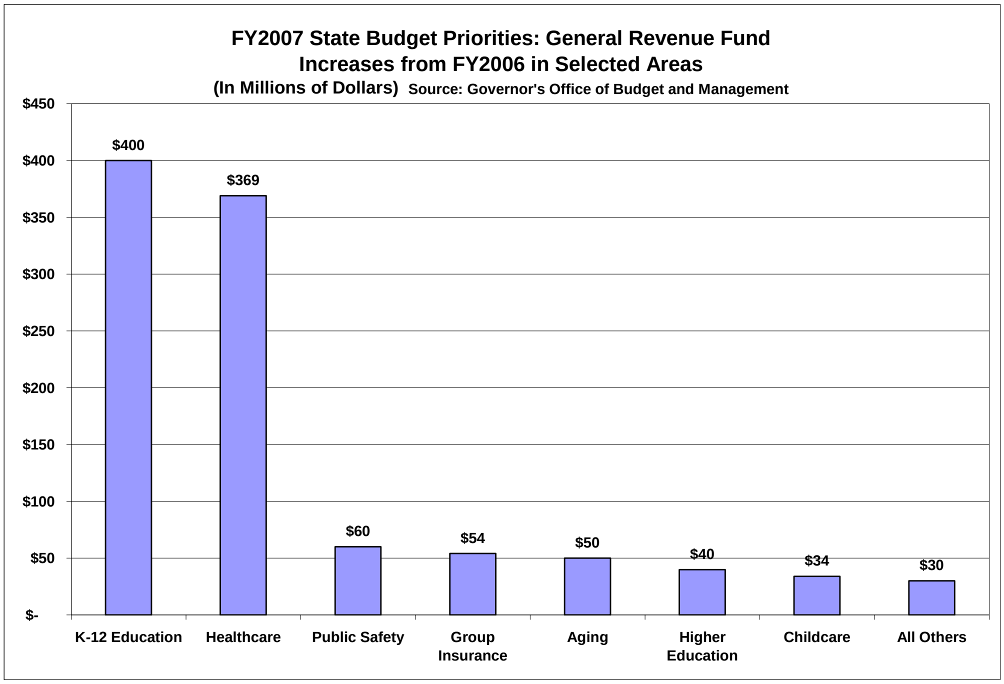
[5] Communication from the Governor's Office of Management and Budget, March 3, 2006.
[6] *Chicago Tribune*, "Campaign: Topinka Says Governor's Plan is Illegal," February 25, 2006.

The total FY2007 budget will be $55.3 billion, up 4.5% or $2.9 billion from FY2006 proposed budget of $52.9 billion. The capital budget is proposed at $9.95 billion.

Budget Increases for Governor's Priorities

The Governor proposes over $1.0 billion in increased spending from General Fund revenues over the amounts enacted in FY2006. He also proposes boosting pension funding by $369 million from General Fund revenues. However, as the administration simultaneously is reducing pension contributions by $1.1 billion in FY2007 from the amount it should be contributing, we did not include this amount in our calculation.



New Program Initiatives

Governor Blagojevich proposes 14 new program initiatives in his FY2007 budget. These programs are expected to cost $261.7 million in FY2007. This amount is included in the $1.0 billion in increased spending referenced in the previous section.

[7] *Chicago Tribune*, "Campaign: Topinka Says Governor's Plan is Illegal," February 25, 2006.

New Spending Initiatives in FY2007 Budget (In Millions of Dollars)	
Program	**Amount**
$1,000 Tuition Tax Credit	$ 90.0
All Kids	$ 45.0
Preschool for All	$ 45.0
Riverfront Development	$ 20.0
Stem Cell Research	$ 15.0
Veteran's Health Care	$ 10.0
Reduce K-12 Class Size	$ 10.0
Sales Tax Rebate for Fuel Efficient Vehicle Purchase	$ 7.5
Thomson Correctional Center	$ 6.5
Two new State Police cadet classes	$ 3.6
More Nursing Faculty	$ 3.3
Southwestern Illinois Correctional Center	$ 1.9
Expanding DNA abilities	$ 1.8
Expediting Business License Processing	$ 1.6
Scholarships for forensic science students	$ 0.5
Expanded Film Tax Credit	N/A
Total	**$ 261.7**

Source: FY2007 Illinois State Budget

Significant Program Funding Changes

The following section provides a brief overview of significant programmatic funding changes contained in the FY2007 budget.

Elementary and Secondary Education

The FY2007 State budget proposes an increase of $452 million over the total enacted appropriation for elementary and secondary education in FY2006. The Governor has not proposed specific spending allocations for particular programs and will work with the General Assembly to allocate funds for an increase in General State Aid and other programs. However, $100 million has been promised to the Chicago Public Schools, the Governor's proposal to provide universal access to preschool for all Illinois children has a $45 million pricetag (per year) and $10 million has been earmarked for class size reduction.[8]

The proposal for universal access to preschool education will be funded by natural revenue growth, some fund transfers, and revenues from two of the proposed corporate tax changes in the FY2007 budget, the repeal of the Retail Rate Law and the extension of the definition of the U.S. to include the outer continental shelf.[9]

[8] *FY2007 Illinois State Budget*, p. 6-2.
[9] Communication from the Governor's Office of Management and Budget, March 3, 2006.

Higher Education

The Governor proposes two major higher education initiatives: a $1,000 tuition tax credit and the privatization of the loan assets and transaction services of the Illinois Designated Account Purchase Program (IDAPP).

College students who maintain a B average and who are enrolled in a degree program will be eligible for a $1,000 ***tuition tax credit*** for their first year of college. In addition students who maintain a B average for their first year of college will also qualify for a tax credit of up to $1,000 for their sophomore year. The administration expects 150,000 students to enroll in the program at an annual cost of $90 million.

The tuition tax credit program will be funded in FY2007 through ***the competitive sale of IDAPP student loan assets and loan transactions***. The State will remain the guarantor of student loans, and financial aid outreach and training programs will remain intact. All current IDAPP employees will be transferred to other agencies and the State vows to maintain loan terms.[10] Currently, loans are being serviced for about 335,000 students. The Illinois Student Assistance Commission believes that the sale will generate several hundred million dollars. However, only $100 million will be appropriated in FY2007 for the higher education college tuition savings tax credit. The remaining proceeds will be used to pay for the credit in succeeding years.[11]

IDAPP was founded in 1977 as a division of the nonprofit Illinois Student Assistance Commission. Its mission is to provide Illinois students with access to educational loan capital. It achieves this goal by purchasing educational loans from Illinois lenders to provide liquidity for the lenders and to encourage market stability and access to educational credit. Many states have similar agencies that help control the costs of student loans because they finance themselves through bonds and direct part of their earnings back toward student aid instead of stockholders.

The current privatization proposal in Illinois and in other states such as Missouri has raised concerns about potential increases in interest rates. A private company focused on meeting shareholder expectations may not be as focused as a government agency on offering incentives such as lower interest rates if students pay off their loans in a timely manner.[12] The State argues that extensive market competition should keep interest rates competitive.[13]

Healthcare Programs

The FY2007 budget includes two major program initiatives, the All Kids program, approved in the fall of 2005, and a new veteran's healthcare program. These programs continue the Governor's priority of expanding healthcare coverage in Illinois. Today, approximately 2 million Illinoisans or roughly 15% of the State's residents receive health care coverage through medical programs administered by the Department of Healthcare and Family Services.[14]

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[10] Information provided by Governor's Office of Management and Budget, February 16, 2006.
[11] Communication from the Governor's Office of Management and Budget, March 3, 2006.
[12] "Loans: Probe Target Insider Deals of Governor," *Chicago Tribune*, March 1, 2005, (Metro).
[13] FY2007 Illinois State Budget, p. 2-4.
[14] See http://www.hfs.illinois.gov/.

The ***All Kids*** program is intended to provide comprehensive health insurance coverage to all Illinois children. All 235,000 uninsured children in the state will be eligible for coverage beginning July 1, 2006. The program will increase children's health coverage by increasing the enrollment of children already eligible for Medicaid and the State Children's Health Insurance Program (SCHIP) and it will give parents with higher incomes who might otherwise be eligible for existing programs the ability to buy health insurance coverage. The Illinois Department of Healthcare and Family Services estimates that the net (or state share) cost of All Kids in the first year of operations will be $45 million.[15]

The Governor proposes a new program in FY2007 that will provide $10 million for comprehensive health coverage for Illinois veterans. Initially, the program will cover veterans below the poverty line who do not live in proximity to a Veterans Administration medical center.[16]

The administration also proposes to establish the Illinois Regenerative Institute of Stem Cell Research. The Institute will initially be funded with a $15 million grant in FY2007. Funding will increase to $100 million over 5 years.[17]

Public Safety

The FY2007 budget includes several new public safety initiatives:

- Opening the Thomson Correctional Center will cost $6.5 million to begin operations. The Center will be a state-of-the-art facility focusing on minimum security prisoners.[18]

- $6.7 million are earmarked for a dedicated methamphetamine prison at the Southwestern Illinois Correctional Center.

- Building the ability for the Illinois State Police to test all DNA cases in-house will cost approximately $2.3 million. $1.8 million of that amount is earmarked for expanding the State's DNA labs and $500,000 will be provided in scholarships for forensic science students, provided that they work for four years for the Illinois State Police.[19]

REVENUES

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[15] Communication from Illinois Department of Healthcare and Family Services, March 2, 2006. Families USA reported in 2005 that the projected cost of the program would be $81 million, $44 million of which were expected to come from state sources. The remaining $37 million was to come from the federal government. See Families USA. "Good for Kids, Good for the Economy: Healthy Coverage for All Kids in Illinois," Publication No. 05-106, 2005, p. 3.

[16] Governor's Office of Management and Budget, "Fiscal Year 2007 Budget in Brief and Historical Overview," February 16, 2005, p. 43.

[17] FY2007 Illinois State Budget, p. 7-44.

[18] FY2007 Illinois State Budget, p. 8-1.

[19] Governor's Office of Management and Budget Briefing, February 16, 2006.

The FY2007 State operating budget projects a 2.3% increase in total receipts from the originally proposed FY2006 budget. This is a $1.0 billion increase from the previous fiscal year's receipts of $45.6 billion. State tax revenues are expected to rise by a robust 8.9% or $1.9 billion while other receipts such as fees and lottery revenues will drop by 12.7% or $1.3 billion.

Reflecting continued improvements in the national and state economy, elastic revenues will increase. Net personal income tax revenues are expected to rise by 9.4%, net corporate income taxes by 45.4% and sales taxes by 5.3%. Riverboat gaming taxes and fees are expected to rise by 13.0%. 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 and reverted to the previous rate structure, which ranges from 15% to 50% of adjusted gross receipts. The temporarily increased admissions tax structure also fell back to $3 for admissions over one million and $2 for admissions under one million visitors.[20]

The sharp increase in corporate income tax receipts is related to two factors. First, corporate profits in Illinois have experienced double digit growth since 2003. Corporate profits tax liability is projected to grow by 30% in FY2006 according to the State's economic analysts. Second, the Department of Revenue's recently acquired expanded audit capacity will help increase the amount of corporate income taxes collected. However, the rate of growth in corporate profits is expected to slow down in 2007. Economy.com forecasts a 6.2% increase in corporate profits tax liability in FY2007 because increased labor and investment costs are expected to shrink profit margins.[21]

There are three components of the sale tax base: sales taxes from vehicle purchases, motor fuel and retail sales. Illinois is the only Midwestern state and one of only fourteen in the nation in which sales tax collections in 2005 exceeded the national average. Sales taxes from retail purchases constitute 70% of the sales tax base. Most estimates of retail sales growth in 2007 are positive, reflecting continued optimism about the economy. Forecasts range from Economy.com's projection of 5.3% (up from 4.9% in 2006) to Global Insight's 3.9%. Sales taxes from motor vehicles, which account for 20% of all receipts, are expected to increase only slightly, by 1.8%. The projected low rate of growth is attributed to a small expected increase in vehicle sales in FY2007. Sales tax revenue from motor fuel purchases increased in the aftermath of Hurricane Katrina and the resultant shortfalls in supply, but has stabilized since then. The prognosis is for flat revenues from this source in FY2007 as gasoline and diesel prices fall.[22]

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[20] 230 ILCS 10/12.
[21] *FY2007 Illinois State Budget, pp. 5-8 and 5-9.*
[22] *FY2007* Illinois State Budget, pp. 5-10 and 5-11.

ILLINOIS STATE REVENUES: ALL FUNDS FY06-FY07 (In Millions of Dollars)				
	Prop. FY2006	Prop. FY2007	$ CHG FY06-FY07	% CHG FY06-FY07
STATE TAXES				
Income Taxes (Net)	$ 9,283	$ 10,572	$ 1,289	13.9%
Personal	$ 8,120	$ 8,884	$ 764	9.4%
Corporate	$ 1,161	$ 1,688	$ 527	45.4%
Sales Taxes	$ 7,362	$ 7,751	$ 389	5.3%
Motor Fuel Tax	$ 1,450	$ 1,462	$ 12	0.8%
Public Utility Tax	$ 1,218	$ 1,333	$ 115	9.4%
Cigarette Taxes	$ 620	$ 623	$ 3	0.5%
Liquor Taxes	$ 146	$ 152	$ 6	4.1%
Inheritance Tax	$ 255	$ 255	$ -	0.0%
Insurance Taxes/Fees	$ 453	$ 477	$ 24	5.3%
Corporate Franchise Taxes/Fees	$ 194	$ 200	$ 6	3.1%
Riverboat Gaming Taxes/Fees	$ 710	$ 802	$ 92	13.0%
Subtotal State Taxes	**$ 21,689**	**$ 23,627**	**$ 1,938**	**8.9%**
OTHER RECEIPTS				
Motor Vehicle/Operators License Fees	$ 1,171	$ 1,173	$ 2	0.2%
Interest Income	$ 70	$ 141	$ 71	101.4%
Revolving Fund Receipts	$ 514	$ 563	$ 49	9.5%
Lottery	$ 924	$ 1,050	$ 126	13.6%
Assessment Funds Receipts	$ 635	$ 808	$ 173	27.2%
Intergovernmental Payments	$ 1,409	$ 1,357	$ (52)	-3.7%
Group Insurance Receipts	$ 1,756	$ 1,701	$ (55)	-3.1%
Tobacco Settlement Receipts	$ 283	$ 295	$ 12	4.2%
Other Taxes,Fees,Earnings & Net Transfers	$ 4,151	$ 2,440	$ (1,711)	-41.2%
Subtotal Other Receipts	**$ 10,913**	**$ 9,528**	**$ (1,385)**	**-12.7%**
Federal Receipts	$ 13,040	$ 13,544	$ 504	3.9%
GRAND TOTAL	**$ 45,642**	**$ 46,707**	**$ 1,065**	**2.3%**

Source: FY2007 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 2-34.
Source: FY2006 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 1-27.

The next exhibit shows projected changes in **General Funds receipts** between FY2006 and FY2007. The State expects General Fund revenues to rise by 6.3%, from $26.6 billion to $28.3 billion, an approximately $1.7 billion increase. Base revenues from state sources are projected to rise by 6.1%, increasing from $26.4 billion to $28.0 billion.

ILLINOIS STATE REVENUES GENERAL FUNDS FY2006-FY2007 (In Millions of Dollars)	Prop. FY2006	Prop. FY2007	$ CHG FY06-FY07	% CHG FY06-FY07
BASE REVENUES				
STATE SOURCES				
Income Taxes (Net)	$ 9,281	$ 10,572	$ 1,291	13.9%
Personal	$ 8,120	$ 8,884	$ 764	9.4%
Corporate	$ 1,161	$ 1,688	$ 527	45.4%
Sales Taxes	$ 6,778	$ 7,280	$ 502	7.4%
Public Utility Taxes	$ 1,096	$ 1,075	$ (21)	-1.9%
Cigarette Taxes	$ 400	$ 350	$ (50)	-12.5%
Liquor Taxes	$ 146	$ 152	$ 6	4.1%
Inheritance Taxes	$ 255	$ 255	$ -	0.0%
Insurance Taxes & Fees	$ 366	$ 322	$ (44)	-12.0%
Corporate Franchise Fees & Taxes	$ 194	$ 196	$ 2	1.0%
Interest on State Funds & Investments	$ 45	$ 125	$ 80	177.8%
Cook County Intergov. Transfer	$ 340	$ 309	$ (31)	-9.1%
Other State Sources	$ 436	$ 540	$ 104	23.9%
Transfers-In			$ -	
Lottery	$ 628	$ 650	$ 22	3.5%
Riverboat Gaming Taxes	$ 696	$ 692	$ (4)	-0.6%
Other Transfers	$ 916	$ 679	$ (237)	-25.9%
Subtotal State Sources	**$ 21,577**	**$ 23,197**	**$ 1,620**	**7.5%**
Federal Sources	$ 4,834	$ 4,835	$ 1	0.0%
TOTAL BASE REVENUES	**$ 26,411**	**$ 28,032**	**$ 1,621**	**6.1%**
			$ -	
Reduction to Base Revenues			$ -	
Tax Credits	$ -	$ (100)	$ (100)	100.0%
			$ -	
Increases to Base Revenues			$ -	
Recurring Revenues and Transfers	$ 255	$ 306	$ 51	100.0%
Multi-Year Revenues	$ -	$ 100	$ 100	100.0%
Total Adjusting Sources	**$ 255**	**$ 306**	**$ 51**	**100.0%**
TOTAL REVENUES	**$ 26,666**	**$ 28,338**	**$ 1,672**	**6.3%**
Pension Obligation Bonds	$ -	$ -	$ -	
Short-Term Borrowing	$ -	$ -	$ -	
TOTAL RECEIPTS	**$ 26,666**	**$ 28,338**	**$ 1,672**	**6.3%**

Source: FY2007 State Budget, Table II-B General Funds Revenues by Source, p. 2-35.
FY2006 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 1-27.

Projected v. Estimated FY2006 General Fund Revenues

The State originally projected that General Fund revenues in FY2006 would be $26.6 billion. However, due to an improving economy and corresponding increases in elastic revenues such as income and sales taxes, the estimate of General Fund FY2006 revenues has been revised to total $27.0 billion. This represents a $429 million or 1.6% increase in revenues.

ILLINOIS STATE REVENUES: GENERAL FUNDS FY06 Projected v. FY06 Estimated (In Millions of Dollars)				
	Prop. FY2006	Est. FY2006	$ DIFF	% DIFF
BASE REVENUES				
STATE SOURCES				
Income Taxes (Net)	$ 9,281	$ 9,949	$ 668	7.2%
Personal	$ 8,120	$ 8,461	$ 341	4.2%
Corporate	$ 1,161	$ 1,488	$ 327	28.2%
Sales Taxes	$ 6,778	$ 6,950	$ 172	2.5%
Public Utility Taxes	$ 1,096	$ 1,081	$ (15)	-1.4%
Cigarette Taxes	$ 400	$ 400	$ -	0.0%
Liquor Taxes	$ 146	$ 151	$ 5	3.4%
Inheritance Taxes	$ 255	$ 285	$ 30	11.8%
Insurance Taxes & Fees	$ 366	$ 320	$ (46)	-12.6%
Corporate Franchise Fees & Taxes	$ 194	$ 191	$ (3)	-1.5%
Interest on State Funds & Investments	$ 45	$ 98	$ 53	117.8%
Cook County Intergov. Transfer	$ 340	$ 350	$ 10	2.9%
Other State Sources	$ 436	$ 523	$ 87	20.0%
Transfers-In			$ -	
Lottery	$ 628	$ 636	$ 8	1.3%
Riverboat Gaming Taxes	$ 696	$ 678	$ (18)	-2.6%
Other Transfers	$ 916	$ 771	$ (145)	-15.8%
Subtotal State Sources	**$ 21,577**	**$ 22,383**	**$ 806**	**3.7%**
Federal Sources	$ 4,834	$ 4,712	$ (122)	-2.5%
TOTAL BASE REVENUES	**$ 26,411**	**$ 27,095**	**$ 684**	**2.6%**
Increases to Base Revenues				
Recurring Revenues and Transfers	$ 255			
Total Adjusting Sources	**$ 255**			
TOTAL REVENUES	**$ 26,666**	**$ 27,095**	**$ 429**	**1.6%**

Source: FY2007 State Budget, Table II-B General Funds Revenues by Source, p. 2-35.
FY2006 State Budget, Table II-A: All Appropriated Funds Revenues by Source, p. 1-28.

3-Year Revenue Trends

The next two exhibits show three-year revenue trends for all funds and for General Fund alone. In order to provide an accurate comparison, the figures presented are for the originally proposed revenues per fiscal year. Comparable data are not available before FY2005 because of the separation of the operating and capital budgets. From FY2005 to FY2007, total receipts for all funds are expected to increase by 9.2% while the State's own source tax revenues will rise by 17.7%.

ILLINOIS STATE REVENUES: ALL FUNDS FY05-FY07 (In Millions of Dollars)					
	Prop. FY2005	Prop. FY2006	Prop. FY2007	$ CHG FY05-FY07	% CHG FY05-FY07
STATE TAXES					
Income Taxes (Net)	$ 8,075	$ 9,283	$ 10,572	$ 2,497	30.9%
Personal	$ 7,285	$ 8,120	$ 8,884	$ 1,599	21.9%
Corporate	$ 790	$ 1,161	$ 1,688	$ 898	113.7%
Sales Taxes	$ 6,957	$ 7,362	$ 7,751	$ 794	11.4%
Motor Fuel Tax	$ 1,484	$ 1,450	$ 1,462	$ (22)	-1.5%
Public Utility Tax	$ 1,102	$ 1,218	$ 1,333	$ 231	21.0%
Cigarette Taxes	$ 693	$ 620	$ 623	$ (70)	-10.1%
Liquor Taxes	$ 123	$ 146	$ 152	$ 29	23.6%
Inheritance Tax	$ 240	$ 255	$ 255	$ 15	6.3%
Insurance Taxes/Fees	$ 459	$ 453	$ 477	$ 18	3.9%
Corporate Franchise Taxes/Fees	$ 175	$ 194	$ 200	$ 25	14.3%
Riverboat Gaming Taxes/Fees	$ 758	$ 710	$ 802	$ 44	5.8%
Subtotal State Taxes	**$ 20,066**	**$ 21,689**	**$ 23,627**	**$ 3,561**	**17.7%**
OTHER RECEIPTS					
Motor Vehicle/Operators License Fees	$ 1,315	$ 1,171	$ 1,173	$ (142)	-10.8%
Interest Income	$ 63	$ 70	$ 141	$ 78	123.8%
Revolving Fund Receipts	$ 387	$ 514	$ 563	$ 176	45.5%
Lottery	$ 884	$ 924	$ 1,050	$ 166	18.8%
Assessment Funds Receipts	$ 1,190	$ 635	$ 808	$ (382)	-32.1%
Intergovernmental Payments	$ 1,559	$ 1,409	$ 1,357	$ (202)	-13.0%
Group Insurance Receipts	$ 1,573	$ 1,756	$ 1,701	$ 128	8.1%
Tobacco Settlement Receipts	$ 271	$ 283	$ 295	$ 24	8.9%
Other Taxes,Fees,Earnings & Net Transfers	$ 1,978	$ 4,151	$ 2,440	$ 462	23.4%
Riverboat License Sale	$ 350	$ -	$ -	$ (350)	-100.0%
Subtotal Other Receipts	**$ 9,570**	**$ 10,913**	**$ 9,528**	**$ (42)**	**-0.4%**
Federal Receipts	$ 13,143	$ 13,040	$ 13,544	$ 401	3.1%
GRAND TOTAL	**$ 42,779**	**$ 45,642**	**$ 46,707**	**$ 3,928**	**9.2%**

Source: 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 10.7% between FY2005 and FY2007, from $25.3 billion to $28.0 billion. Total General Fund receipts from all sources are expected to increase by 8.5% or $2.2 billion, from $26.1 billion to $28.3 billion.

ILLINOIS STATE REVENUES GENERAL FUNDS FY2005-FY2007 (In Millions of Dollars)					
	Prop. FY2005	Prop. FY2006	Prop. FY2007	$ CHG FY05-FY07	% CHG FY05-FY07
BASE REVENUES					
STATE SOURCES					
Income Taxes (Net)	$ 8,075	$ 9,281	$ 10,572	$ 2,497	30.9%
Personal	$ 7,285	$ 8,120	$ 8,884	$ 1,599	21.9%
Corporate	$ 790	$ 1,161	$ 1,688	$ 898	113.7%
Sales Taxes	$ 6,425	$ 6,778	$ 7,280	$ 855	13.3%
Public Utility Taxes	$ 1,102	$ 1,096	$ 1,075	$ (27)	-2.5%
Cigarette Taxes	$ 400	$ 400	$ 350	$ (50)	-12.5%
Liquor Taxes	$ 123	$ 146	$ 152	$ 29	23.6%
Inheritance Taxes	$ 240	$ 255	$ 255	$ 15	6.3%
Insurance Taxes & Fees	$ 347	$ 366	$ 322	$ (25)	-7.2%
Corporate Franchise Fees & Taxes	$ 175	$ 194	$ 196	$ 21	12.0%
Interest on State Funds & Investments	$ 45	$ 45	$ 125	$ 80	177.8%
Cook County Intergov. Transfer	$ 450	$ 340	$ 309	$ (141)	-31.3%
Other State Sources	$ 729	$ 436	$ 540	$ (189)	-25.9%
Transfers-In				$ -	#DIV/0!
Lottery	$ 563	$ 628	$ 650	$ 87	15.5%
Riverboat Gaming Taxes	$ 647	$ 696	$ 692	$ 45	7.0%
Other Transfers	$ 870	$ 916	$ 679	$ (191)	-22.0%
10th Riverboat License	$ 350				
Subtotal State Sources	**$ 20,541**	**$ 21,577**	**$ 23,197**	**$ 2,656**	**12.9%**
Federal Sources	$ 4,772	$ 4,834	$ 4,835	$ 63	1.3%
TOTAL BASE REVENUES	**$ 25,313**	**$ 26,411**	**$ 28,032**	**$ 2,719**	**10.7%**
Reduction to Base Revenues					
Tax Credits	$ -	$ -	$ (100)	$ (100)	100.0%
Increases to Base Revenues					
Recurring Revenues and Transfers	$ 634	$ 255	$ 306	$ (328)	100.0%
Multi-Year Revenues	$ -	$ -	$ 100	$ 100	100.0%
One-Time Revenues	$ 169	$ -	$ -	$ -	100.0%
Total Adjusting Sources	**$ 803**	**$ 255**	**$ 306**	**$ (497)**	**100.0%**
GRAND TOTAL	**$ 26,116**	**$ 26,666**	**$ 28,338**	**$ 2,222**	**8.5%**

Source: 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 FY2007 Tax Changes

The FY2007 State budget proposes several revenue enhancements totaling approximately $147.0 million. They are listed in the exhibit below and information is provided about these changes in the budget on pages 5-17 and 5-18. All of these changes except the proposal to permit auditors to verify losses older than three years and the other tobacco products tax increase have been previously proposed by Governor Blagojevich and rejected by the General Assembly.

FY2007 Revenue Changes in State Budget (In Millions)	
Revenue Change	**Revenues Generated**
Collect Sales Tax on Prewritten Licensed Software	$ 48.0
Eliminate Disparity in Tax Treatment for Gas Stored in Illinois	$ 44.0
Repeal Retail Rate Law	$ 25.0
Permit audit to verify losses older than 3 years	$ 10.0
Increase Other Tobacco Products Tax	$ 10.0
Include Outer Continental Shelf in Illinois' Definition of the U.S.	$ 10.0
GRAND TOTAL	**$ 147.0**

Collect Sales Tax on Prewritten Licensed Software: $48 million

This proposal makes all prewritten, licensed software purchased or used in Illinois subject to the state sales tax, including electronically downloaded and licensed software. Put another way, this proposal aims to eliminate the current exemption for licensed, prewritten software. Custom software remains exempted from the tax extension, along with software used to run exempt machinery. That portion of prewritten software that requires customization is exempt if it is separately invoiced. Customized or modified licensed software will be taxed only on the prewritten portion of the transaction. Regarding prewritten software delivered electronically to a company's out of state offices, only the portion used in Illinois will be taxed.

The definition of prewritten computer software in the proposal and on which the tax is imposed, as well as the multiple points of use provisions in the proposed law are based on the Streamlined Sales Tax Project model. Under the proposal, the tax would be apportioned in instances of multiple points of use.

The proposal would impose sales tax on the transfer of prewritten computer software as well. "Transfer" is defined in legislation as the transfer of the right to use or possess prewritten computer software regardless of whether that right is combined with the title to or ownership of the software. It includes, but is not limited to a transfer by sale, lease, license or rental.

In addition, tax payment would be required on the prewritten base on which modified software is built.

The proposal includes an exemption for manufacturers and the telecommunications industry. The exemption is justified on the grounds that these industries are subject to other state taxes.[23]

Eliminate Disparity in Tax Treatment for Gas Stored in Illinois: $44 Million

Fuel from Illinois refineries and pipelines that is used in-state is currently subject to a 1.1 cent per gallon storage tank fee and fee. The funds are used to pay for the clean up of spills. Fuel from in-state refineries that is moved out of state is currently exempt from the tax.

[23] Information provided by the Illinois Department of Revenue, March 10, 2006.

This proposal would repeal the exemption for fuel exported out of state and reduce the aggregate rate of the tax to 1.0 cents per gallon. The aggregated tax would generate up to $69 million per year, of which $44 million would result from repeal of the exemption. Twenty five million dollars of the revenues generated would be reserved to fund the State's federally mandated vehicle emissions testing and underground storage tank inspection programs and the remainder would be deposited in the General Revenue Fund.[24]

Repeal Retail Rate Law: $25 Million

This proposal would repeal the State's unique Retail Rate Law, which subsidizes the production of electricity from alternative energy sources such as methane.

The Retail Rate Law, which is administered by the Illinois Commerce Commission, was enacted in 1987 to encourage the development of alternate energy production facilities.[25] The Law provides that companies certified as Qualified Solid Waste Energy Facilities (QSWEFs) are entitled to enter into 10-year contracts with utilities companies. The utilities must purchase electricity from the QSWEF at a rate that is equivalent to "the average cost per kilowatt-hour paid from time to time by the unit of local government in which the electricity generating facilities are located."[26] The retail rate is much higher than the wholesale rate the utilities would normally pay for electricity.[27] In return for purchasing the electricity from the QSWEF, the utility receives State tax credits:

> …in an amount equal to the difference between the "retail rate" paid to the QSWEF and the "avoided cost" were the utility to generate such electricity itself. The QSWEF then must reimburse the State for the value of the issued tax credits after retirement of the debt incurred to finance its construction.[28]

Permit Auditors to Verify Losses Older than 3 Years: $10 Million

This proposal would allow Illinois Department of Revenue auditors to verify losses older than 3 years. Currently, taxpayers can carry losses forward for 12 years, but IDOR auditors can only look back 3 years to verify the losses.

Increase Other Tobacco Products Tax: $10 Million

The Governor proposes to increase the State tax on other tobacco products such as cigars and smokeless tobacco from 18% to 30% of the wholesale price, that is the distributor's cost price for the products. In FY2004, $18.4 million was collected from this tax, according to the Legislative Research Unit.

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[24] Information provided by Illinois Department of Revenue, March 10, 2006.
[25] 220 ILCS 5/8-403.1(a) (West 2000).
[26] 220 ILCS 5/8-403.1(c) (West 2000).
[27] CGE Ford Heights v. Miller, 306 Ill. App. 3d 431, 433, 714 N.E.2d 35 (1999).
[28] 220 ILCS 5/8-403.1(d) (West 2000).

Include Outer Continental Shelf in Illinois' Definition of the United States: $10 million

The State proposes that Illinois treat U.S. territories and the Outer Continental Shelf as part of the United States. Currently, Illinois defines the "United States" as excluding U.S. territories and possessions, in the same manner as federal Internal Revenue Service rules. The Department defends this proposal as preventing situations in which corporations do not account for activity in subsidiaries located outside the 50 states and the District of Columbia, thereby reducing income subject to Illinois tax. An example of the "problem" cited in the FY2007 Budget (p. 5-17) is oil production from the Outer Continental Shelf being placed in a separate subsidiary, thereby reducing Illinois tax liability. A similar proposal was floated in FY2005.

APPROPRIATIONS

The Governor's FY2007 operating budget recommends a total appropriation of $45.4 billion, an increase of $1.7 billion, or 4.0%, over the FY2006 originally proposed appropriation of $43.6 billion. This total includes $25.7 billion in the General Funds, $14.1 billion in Other State Funds, and nearly $5.6 billion in Federal Funds.

FY2006-FY2007 Appropriation Trend

In FY2007, proposed General Funds appropriations increased by 4.6% over the previous year, while Other State Funds appropriations rose by 5.1%, or approximately $679.6 million.

The largest fund group in the budget is the General Funds which represent 56.6% of total recommended appropriations. "Other State Funds" includes a wide range of funds, including 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 then dedicated to specific projects. These funds represent 31.1% of the total State operating budget proposal for FY2007.

State of Illinois Appropriations by Fund: FY2006-FY2007				
	FY2006 Prop.	FY2007 Prop.	$ CHG	% CHG
General Funds	$ 24,571,059	$ 25,711,790	$ 1,140,731	4.6%
Other Funds	$ 13,445,878	$ 14,125,477	$ 679,599	5.1%
Federal Funds	$ 5,652,497	$ 5,590,405	$ (62,092)	-1.1%
Total	**$ 43,669,434**	**$ 45,427,672**	**$ 1,758,238**	**4.0%**

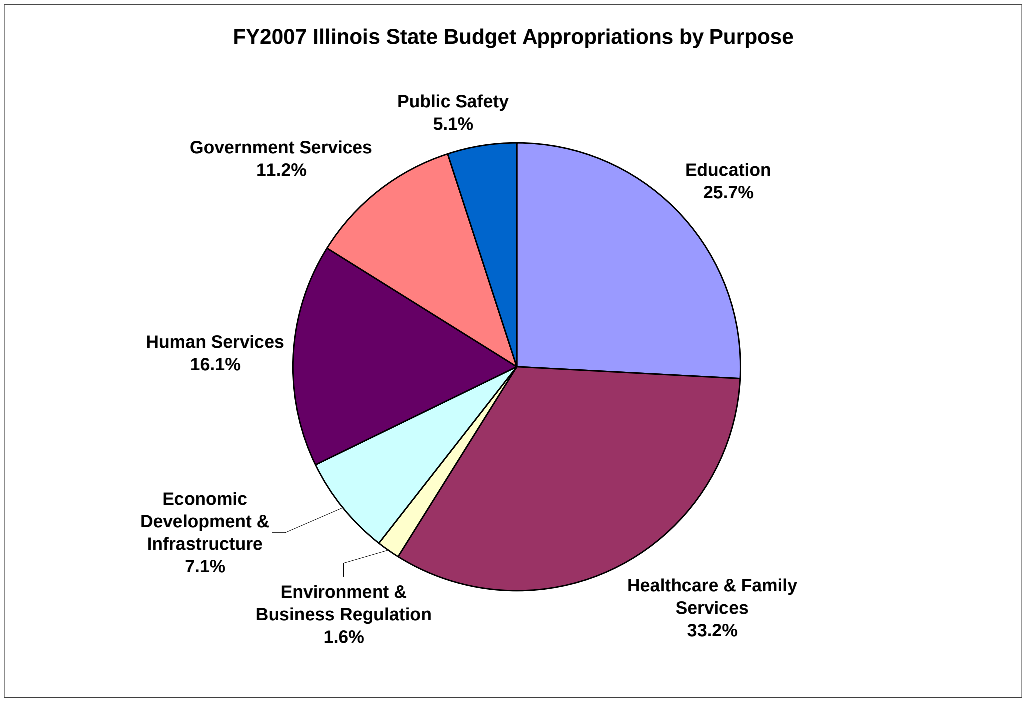
The next exhibit shows changes in proposed appropriations for major program areas in the State budget. Spending for agencies under the Governor, the largest appropriation category will increase by 3.3% or $1.0 billion to $32.8 billion. Appropriations for elementary and secondary education, the next largest category, will increase by 8.6%, from $8.8 billion to $9.6 billion.

STATE OF ILLINOIS FY2006-FY2007 APPROPRIATIONS (in thousands of dollars)				
Type	FY2006 Recommended Appropriation	FY2007 Recommended Appropriation	Appropriation $ change 2006 to 2007	Appropriation % change 2006 to 2007
LEGISLATIVE AGENCIES				
Legislative Agencies Total	**$ 87,971**	**$ 93,415**	**$ 5,444**	**6.2%**
General Funds	$ 72,136	$ 76,498	$ 4,362	6.0%
Other State Funds	$ 15,835	$ 16,917	$ 1,082	6.8%
JUDICIAL AGENCIES				
Judicial Agencies Total	**$ 417,057**	**$ 386,765**	**$ (30,292)**	**-7.3%**
General Funds	$ 390,405	$ 360,199	$ (30,206)	-7.7%
Other State Funds	$ 23,202	$ 24,141	$ 939	4.0%
Federal Funds	$ 3,450	$ 2,425	$ (1,025)	-29.7%
ELECTED OFFICIALS AND ELECTIONS				
Elected Officials And Elections Total	**$ 2,358,987**	**$ 2,441,453**	**$ 82,466**	**3.5%**
General Funds	$ 268,030	$ 318,378	$ 50,348	18.8%
Other State Funds	$ 2,079,064	$ 2,110,767	$ 31,703	1.5%
Federal Funds	$ 11,893	$ 12,308	$ 415	3.5%
AGENCIES UNDER THE GOVERNOR				
Governor's Agencies Total	**$ 31,812,177**	**$ 32,868,191**	**$ 1,056,014**	**3.3%**
General Funds	$ 14,956,143	$ 15,361,506	$ 405,363	2.7%
Other State Funds	$ 13,640,864	$ 14,374,002	$ 733,138	5.4%
Federal Funds	$ 3,215,170	$ 3,132,682	$ (82,488)	-2.6%
ELEMENTARY AND SECONDARY EDUCATION				
Elementary and Secondary Education	**$ 8,860,821**	**$ 9,619,466**	**$ 758,645**	**8.6%**
General Funds	$ 6,680,324	$ 7,402,217	$ 721,893	10.8%
Other State Funds	$ 26,373	$ 43,542	$ 17,169	65.1%
Federal Funds	$ 2,154,125	$ 2,173,707	$ 19,582	0.9%
HIGHER EDUCATION[3]				
Higher Education Total	**$ 2,626,746**	**$ 2,741,437**	**$ 114,691**	**4.4%**
General Funds	$ 2,204,022	$ 2,215,435	$ 11,413	0.5%
Other State Funds	$ 154,865	$ 254,524	$ 99,659	64.4%
Federal Funds	$ 267,859	$ 271,477	$ 3,618	1.4%
Revolving Funds	**$ (2,494,323)**	**$ (2,693,785)**	**$ (199,462)**	**8.0%**
Governor's Initiatives		**$ (29,271)**	**$ (29,271)**	
TOTAL				
General Funds	**$ 24,571,059**	**$ 25,711,790**	**$ 1,140,731**	**4.6%**
Other State Funds	**$ 13,445,878**	**$ 14,125,477**	**$ 679,599**	**5.1%**
Federal Funds	**$ 5,652,497**	**$ 5,590,405**	**$ (62,092)**	**-1.1%**
GRAND TOTAL	**$ 43,669,434**	**$ 45,427,672**	**$ 1,758,238**	**4.0%**

Sources: State of Illinois FY2006 Budget, P. 1-15 to 1-26, State of Illinois FY2007 Budget, pp. 2-23 to 2-32

FY2007 Appropriations by Purpose

The following exhibit shows how FY2007 appropriations are earmarked. Healthcare and Family Service programs will require 33.2% of the $45.4 billion FY2007 operating budget. Education spending for elementary and secondary education as well as higher education is the second largest category, consuming 25.7% of all appropriations. The third largest spending category will be Human Services programs at 16.1% of all appropriations.



3-Year Appropriation Trend

The next section presents an analysis of 3-year appropriation trends between FY2005 and FY2007. In order to provide an accurate comparison, the figures presented are for the originally proposed revenues per fiscal year; comparable data are not available before FY2005 because of the separation of the operating and capital budgets.

Proposed operating budget appropriations are expected to increase by 4.4% between FY2005 and FY2007. This represents a $1.9 billion increase from $43.5 billion to $45.4 billion. General Fund appropriations will rise by $1.7 billion, or 7.3%, while Other Funds will increase by $319 million, or 2.3%. Agencies under the control of the Governor, which will account for 72.4% of all operations spending, will rise by 11.4%, from $29.5 billion to $32.8 billion. Appropriations for Elementary and Secondary Education are expected to increase by 8.7% or $766.0 million.

STATE OF ILLINOIS FY2005-FY2007 APPROPRIATIONS (in thousands of dollars)				
Type	FY2005 Recommended Appropriation	FY2007 Recommended Appropriation	Appropriation $ change 2005 to 2007	Appropriation % change 2005 to 2007
LEGISLATIVE AGENCIES				
Legislative Agencies Total	**$ 82,813**	**$ 93,415**	**$ 10,602**	**12.8%**
General Funds	$ 70,587	$ 76,498	$ 5,911	8.4%
Other State Funds	$ 16,105	$ 16,917	$ 812	5.0%
JUDICIAL AGENCIES				
Judicial Agencies Total	**$ 376,938**	**$ 386,765**	**$ 9,827**	**2.6%**
General Funds	$ 376,727	$ 360,199	$ (16,528)	-4.4%
Other State Funds	$ 24,581	$ 24,141	$ (440)	-1.8%
Federal Funds	$ 3,450	$ 2,425	$ (1,025)	-29.7%
ELECTED OFFICIALS AND ELECTIONS				
Elected Officials And Elections Total	**$ 2,241,158**	**$ 2,441,453**	**$ 200,295**	**8.9%**
General Funds	$ 250,812	$ 318,378	$ 67,566	26.9%
Other State Funds	$ 1,976,650	$ 2,110,767	$ 134,117	6.8%
Federal Funds	$ 13,697	$ 12,308	$ (1,389)	-10.1%
AGENCIES UNDER THE GOVERNOR				
Governor's Agencies Total	**$ 29,503,571**	**$ 32,868,191**	**$ 3,364,620**	**11.4%**
General Funds	$ 14,520,013	$ 15,361,506	$ 841,493	5.8%
Other State Funds	$ 11,786,000	$ 14,374,002	$ 2,588,002	22.0%
Federal Funds	$ 3,216,449	$ 3,132,682	$ (83,767)	-2.6%
ELEMENTARY AND SECONDARY EDUCATION[2]				
Elementary and Secondary Education	**$ 8,853,413**	**$ 9,619,466**	**$ 766,053**	**8.7%**
General Funds	$ 6,563,064	$ 7,402,217	$ 839,153	12.8%
Other State Funds	$ 73,699	$ 43,542	$ (30,157)	-40.9%
Federal Funds	$ 2,216,650	$ 2,173,707	$ (42,943)	-1.9%
HIGHER EDUCATION[3]				
Higher Education Total	**$ 2,607,177**	**$ 2,741,437**	**$ 134,260**	**5.1%**
General Funds	$ 2,260,700	$ 2,215,435	$ (45,265)	-2.0%
Other State Funds	$ 54,713	$ 254,524	$ 199,811	365.2%
Federal Funds	$ 291,765	$ 271,477	$ (20,288)	-7.0%
Revolving Funds	**$ (2,418,096)**	**$ (2,693,785)**	**$ (275,689)**	**11.4%**
Governor's Initiatives	**$ (211,300)**	**$ (29,271)**	**$ (29,271)**	**13.9%**
TOTAL				
General Funds	**$ 23,955,768**	**$ 25,711,790**	**$ 1,756,022**	**7.3%**
Other State Funds	**$ 13,806,584**	**$ 14,125,477**	**$ 318,893**	**2.3%**
Federal Funds	**$ 5,742,010**	**$ 5,590,405**	**$ (151,605)**	**-2.6%**
GRAND TOTAL	**$ 43,504,362**	**$ 45,427,672**	**$ 1,923,310**	**4.4%**

Sources: State of Illinois FY2005 Budget, P. 1-27 to 1-34, State of Illinois FY2007 Budget, pp. 2-23 to 2-32

PERSONNEL

The Governor's FY2007 budget recommends filling 58,490 full-time equivalent (FTE) positions. This is a 0.1%, 49 position decrease from the number of positions authorized in FY2006. Since FY2005, the number of FTEs authorized will have increased by 3.1%, from 56,724 to 58,490.

State of Illinois Employees: FY2005-FY2007					
Purpose	**FY2005 Actual**	**FY2006 Authorized**	**FY2007 Authorized**	**FY05-FY07 CHG**	**FY05-FY07 % CHG**
Human Services	19,752	20,749	20,447	695	3.5%
Public Safety	18,015	17,882	18,062	47	0.3%
Econ Dev/Infrastructure	8,651	8,990	8,717	66	0.8%
Government Services	3,960	4,173	4,376	416	10.5%
Environ/Business Reg	4,157	4,416	4,358	201	4.8%
Healthcare/Family Services	2,189	2,329	2,530	341	15.6%
TOTAL	**56,724**	**58,539**	**58,490**	**1766**	**3.1%**

Source: State of Illinois FY2007 State Budget, p. 2-15.

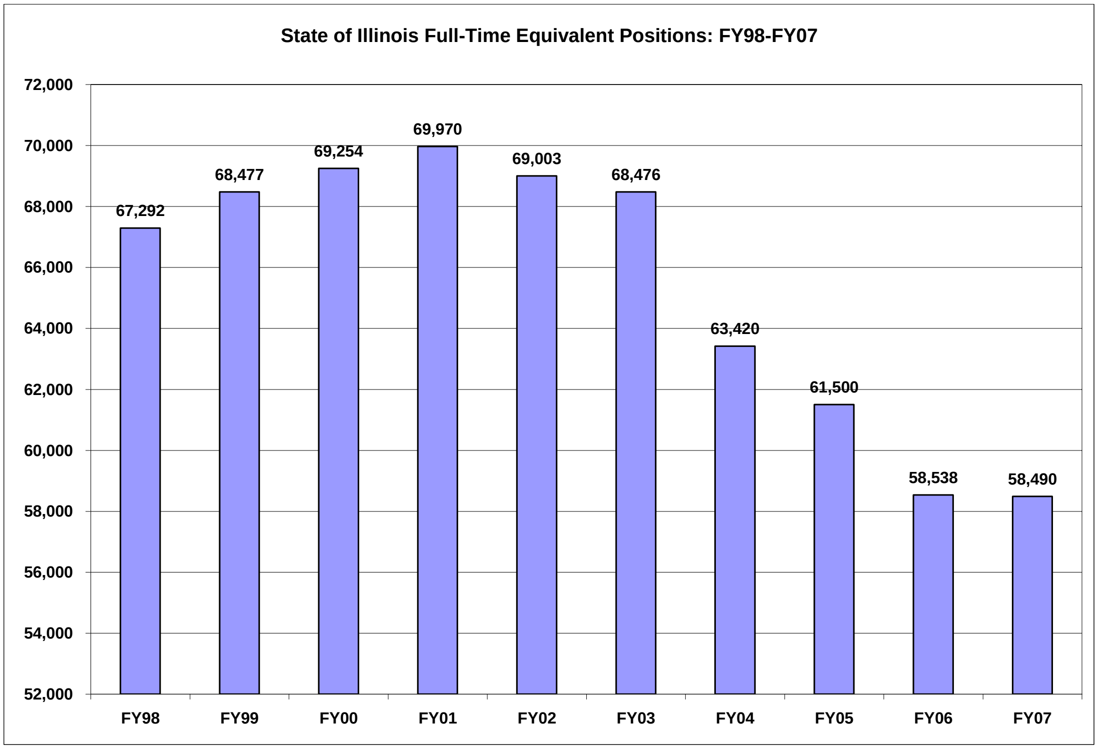
The State does not necessarily fill all of the positions that are authorized in a budget. In FY2006, it is estimated that 57,344 of the 58,539 positions authorized will actually be filled. Comparing the FY2006 estimate with the FY2007 personnel authorization shows that the number of FTEs is expected to rise by 2.0% or 1,146 positions. Some of the increase is due to the terms of a court judgment which requires that several hundred technology programmers be shifted from a contractual to full-time basis. The State anticipates that total headcount at the conclusion of FY2007 will be less than 58,000 FTEs.[29]

State of Illinois Employees: FY2006 Est - FY2007 Authorized				
Purpose	**FY2006 Est.**	**FY2007 Authorized**	**FY06-FY07 CHG**	**FY06-FY07 % CHG**
Human Services	20,007	20,447	440	2.2%
Public Safety	17,769	18,062	293	1.6%
Econ Dev/Infrastructure	8,645	8,717	72	0.8%
Government Services	4,173	4,376	203	4.9%
Environ/Business Reg	4,249	4,358	109	2.6%
Healthcare/Family Services	2,501	2,530	29	1.2%
TOTAL	**57,344**	**58,490**	**1146**	**2.0%**

Source: State of Illinois FY2007 State Budget, p. 2-15.

The next exhibit shows changes in the number of authorized full-time equivalent positions in the 10-year period between FY1998 and FY2007. During that period, the number of FTEs has fallen by 13.1% or 8,802 positions. Since FY2001, the number of positions has declined by 16.4% or 11,480 FTEs.

[29] Briefing on the State of Illinois FY2007 Budget by the Governor's Office of Management and Budget, February 16, 2006.



SHARED SERVICES

The Governor's Office of Management and Budget (GOMB) has set forth a Shared Services Vision that calls for six Shared Service Centers to assume responsibility for state agencies' Administrative Services (e.g., Human Resources, Payroll, Fiscal), Grants Management (e.g. grant application, monitoring, and reporting), Customer Service (e.g. State-wide call center, consolidated front-office service locations), and Business Portal (e.g. business application and authorization) functions. The Shared Services Vision also identifies Information Technology Infrastructure, Fleet, and Facilities Management as areas that have been addressed by previous initiatives, but that might be made more efficient and cost-effective under the shared services organizational structure.[30]

The GOMB's initiative proposes to:

- allow agencies to concentrate on their core missions,
- provide state employees with a more efficient, accessible, and user-friendly HR system,
- produce substantial savings in line with those realized by business and governments who have made similar commitments to administrative reorganization, and
- increase the transparency of state budgeting processes and state spending.

According to a state-commissioned Deloitte study, "six Shared Service Centers with common and standardized processes" will replace 104 Fiscal Systems, 38 Human Resource Systems, nine Payroll Systems, and 100 "1-800" Customer Numbers.[31] Deloitte's 2003 cross-industry shared

[30] FY2007. State of Illinois. Operating Budget, page 3-5.
[31] FY2007. State of Illinois. Operating Budget, pages 3-2 and 3-4.

services survey reported an average annual return on investment of approximately 20%, and indicates that the reorganization project pays for itself within approximately three years.[32] The Governor has estimated that the shared services plan will save Illinois $100 million per year and will "cut the number of employees providing those service in half, to 2,000 or fewer."[33]

The Shared Services plan is intended to make budget planning and state spending more transparent for both public officials and state citizens by integrating the reporting systems of Accounts Payable, General Accounting, Travel Vouchers, Purchasing, Accounts Receivable, Fixed Assets, Grants, Inventory Accounting and GAAP reporting. In addition to improving the state's ability to control costs and plan budgets, the integration of these reporting systems will allow for year-round auditing, enabling both officials and citizens to better track how public funds are being used.[34] The integration of reporting systems should also enable the state to institute useful and non-burdensome performance measures.

System implementation is projected to begin in the latter half of FY2008, and system stabilization is projected to have been achieved by FY2011.[35]

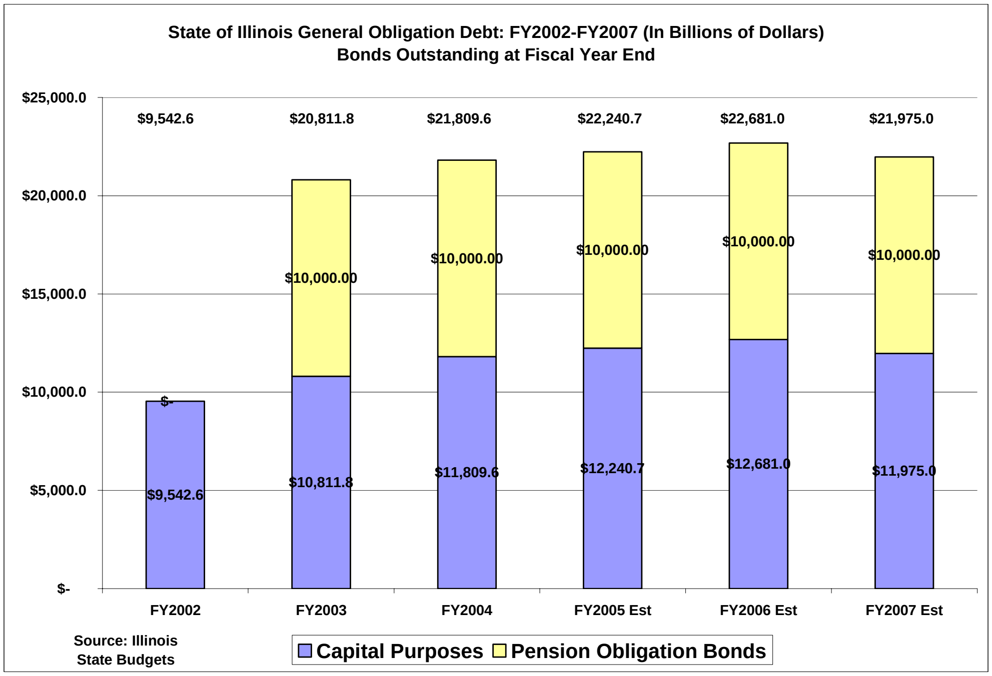
DEBT TRENDS

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

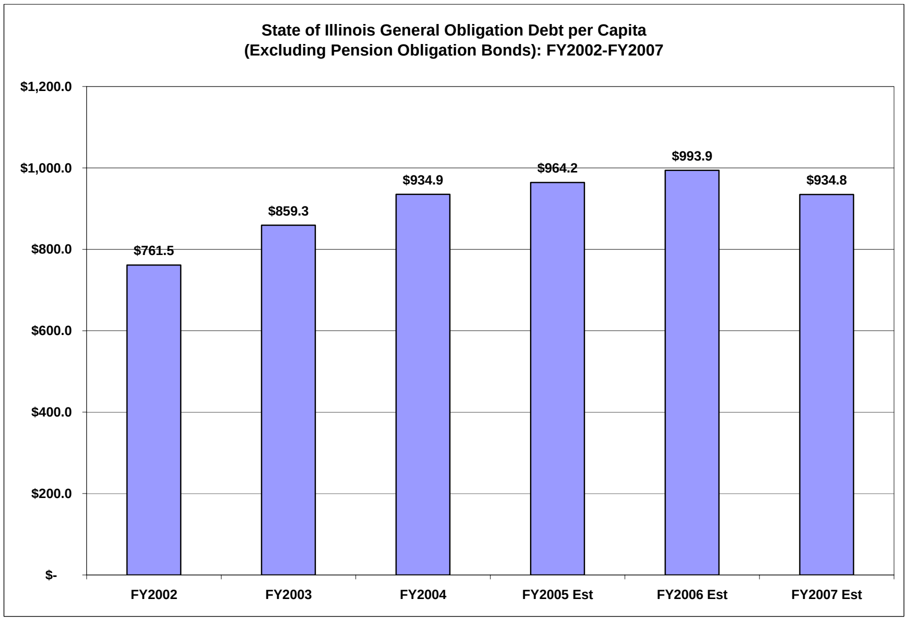
The State of Illinois estimates that it will have $21.9 billion in general obligation (G.O.) debt outstanding in FY2007. Of that amount, $10.0 billion is from the 2003 pension obligation bond issue and $11.9 billion from three different types of capital purpose general obligation debt: G.O capital debt, Build Illinois debt and Civic Center debt. The total amount of G.O. debt outstanding will rise by 130.1% or $12.4 billion between FY2002 and FY2007.

[32] FY2007. State of Illinois. Operating Budget, page 3-3.
[33] Wills, Christopher. "Blagojevich proposes long list of programs in election-year budget." *The Chicago Tribune*. On-line edition. February 15, 2006.
[34] FY2007. State of Illinois. Operating Budget, page 3-7.
[35] FY2007. State of Illinois. Operating Budget, page 3-8.



General Obligation Debt Per Capita - Excluding Pension Bonds

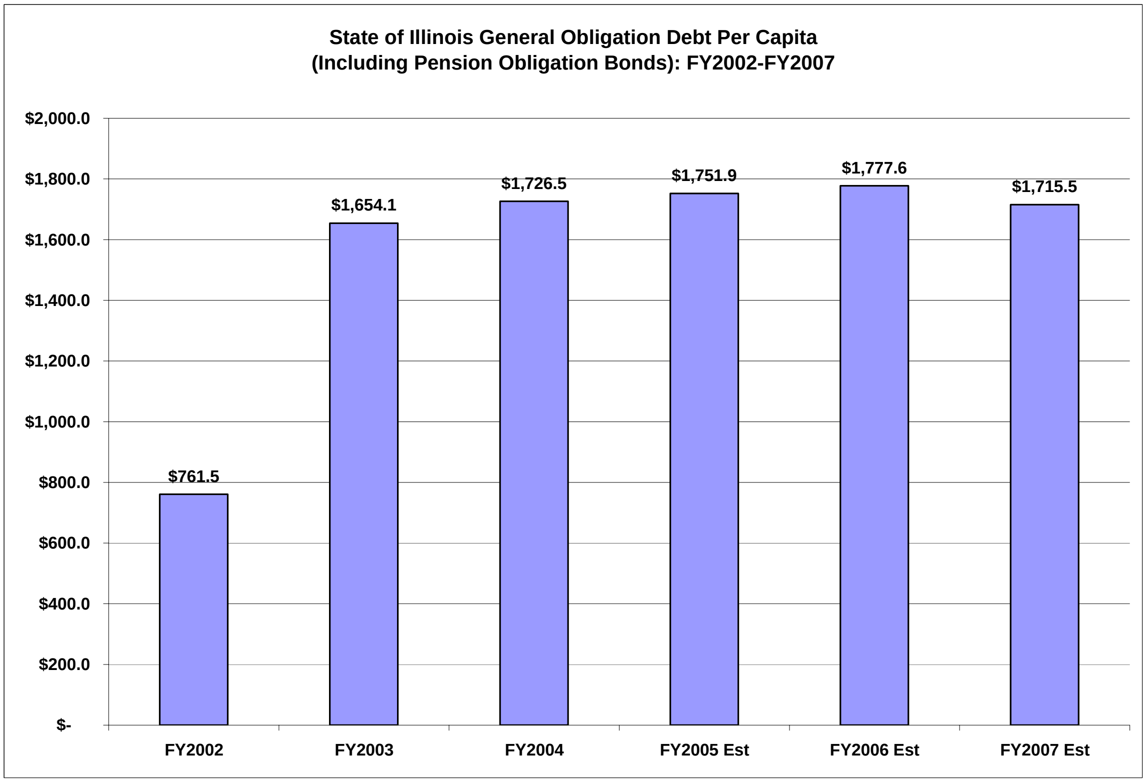
Illinois State General Obligation bond debt per capita[36] (excluding the Pension Obligation bonds) is shown in the following exhibit. Between FY2002 and FY2007, G.O. debt per capita for capital purposes is projected to increase by 22.8%, from $762 to $935.



[36] Per capita figures were derived from the State of Illinois FY2006 Operating Budget, p. 10-10 for fiscal years 2002 through 2006; for FY2007, a 0.4% population increase was calculated based on the average annual population increase.

General Obligation Debt Per Capita - Including Pension Bonds

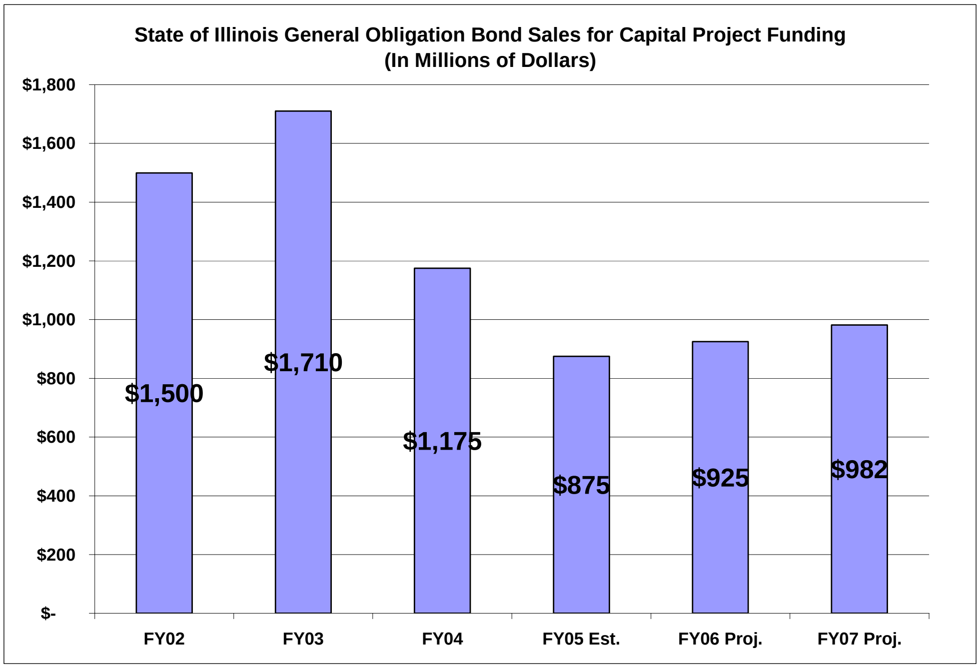
The next exhibit shows estimates for total General Obligation debt per capita for capital purposes as well as Pension Obligation debt. [37] Between FY2002 and FY2007, General Obligation debt per capita is projected to increase by 125.3% from $762 to $1,715. Approximately 50% of the debt per capita in fiscal years 2003 through 2005 is due to Pension Obligation debt issuance.



The State of Illinois' capital program is financed primarily through the issuance of general obligation bonds.[38] The exhibit below shows historical and projected bond sales.[39] It excludes sales for refunding purposes and the pension obligation bonds. As the exhibit shows, bond sales will increase modestly in FY2007 from $925 million to $982 million.

[37] 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.

[38] A small portion of the capital program is financed through the sale of Build Illinois bonds.
[39] State of Illinois. FY2007 Operating Budget, p. 12-1



Bond Ratings

The State of Illinois' general obligation bond ratings are: [40]

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

Both Moody's and Fitch reduced the State's bond rating in May 2003 citing factors such as weakened economy, decline in pension fund conditions,[41] debt burden and debt service structure.[42] Previously, Moody's had rated the State's G.O. debt as Aa2 and Fitch had given an AA+ rating. [43] At that time, Standard & Poor's rating carried a negative outlook while Fitch and Moody's ratings outlooks were stable. In August 2005, Standard & Poor's changed their outlook from negative to stable; the factors cited were restraint in spending, conservative base revenue forecasts and pension reform measures undertaken.[44]

Debt Service Schedule

A debt service schedule sets forth the principal and interest amounts due for bonds outstanding. The State projects declining total debt service payments for principal and interest between

[40] State of Illinois. FY2007 Operating Budget, page 12-3.
[41] State of Illinois. FY2006 Capital Budget, page 49.
[42] Yvette Shields. "Borrowing, Illinois Style: Partisans Split Over State's New Approach." The Bond Buyer March 2004:
[43] "State of Illinois. FY2005 Recommended Operating Budget: Analysis and Recommendations." May 3, 2005. The Civic Federation. www.civicfed.org. Page 55.
[44] State of Illinois FY2007 Budget, p. 12-3.

FY2006 and FY2033, from $1.9 billion to $1.2 billion. However, Pension Obligation Bond debt service payments are backloaded and will increase from $496 million in FY2006 to over $1.1 billion in FY2033. During the period between FY2006 and FY2033, the State of Illinois will pay a total of $20.9 billion in debt service for the $10 billion Pension Obligation bond issue and $21.8 billion for all capital projects debt service.[45]

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, that is, 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 of Illinois 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 which 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. [46]

The following exhibit shows the amount of certificates as well as the issuance and retirement dates from July of 2002 through November of 2005. 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 remained flat at $1.0 billion between FY2002 and FY2006, after declining to $765 million.

ILLINOIS SHORT-TERM DEBT FY02-FY06

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

Source: FY2007 Illinois State Budget, Page 12-3

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 666,952 individuals are currently enrolled in these five systems.

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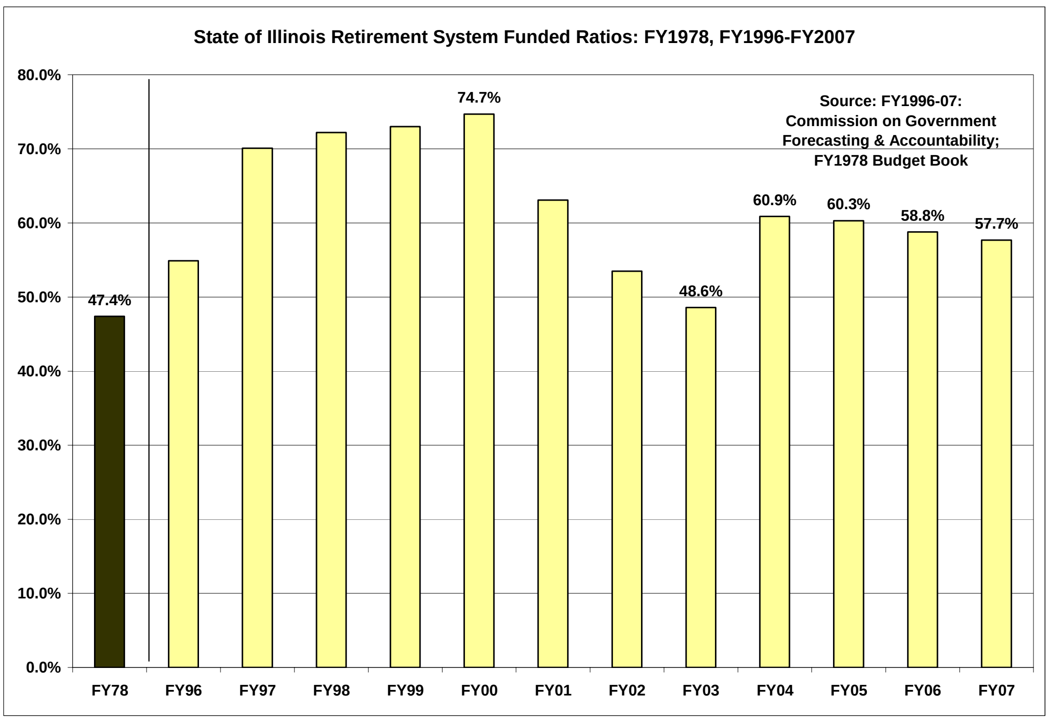
[45] State of Illinois FY2007 Operating Budget, p. 12-13.
[46] State of Illinois FY2006 Operating Budget, page 10-3.

MEMBERS OF ILLINOIS RETIREMENT SYSTEMS			
Pension Fund	**Members**	**Annuitants**	**Total**
Teachers	245,925	82,491	328,416
University	149,951	39,800	189,751
State Employees	91,423	54,828	146,251
Judges	962	900	1,862
General Assembly	275	397	672
Total	**488,536**	**178,416**	**666,952**

Source: FY2007 Illinois State Budget, p. 4-1.

The exhibit that follows shows historic funding ratios for the State of Illinois' five retirement systems. It compares the funded ratio for FY1978, which was 47.4%, to a 12-year trend from FY1996-FY2007. After passage of the 1995 funding reform law, funded ratios rose to a high of 74.7% in FY2000 before falling once again. The funded ratio rose from 48.6% in FY2003 to 60.9% the following year after the issuance of $10.0 billion in Pension Obligation bonds. However, since then, the funded ratio has dropped each year, according to calculations from the Commission on Government Forecasting and Accountability that consider the impact of pension funding reforms, benefit increases and the two-year partial pension holiday in FY2006-FY2007. In FY2007, to, the funded ratio will fall to 57.7%.



Pension Obligation Bonds

In 2003, Governor Blagojevich signed Public Act 093-0002 authorizing the issuance of $10 billion of Pension Obligation Bonds. The proceeds of these bonds were to be used to fund current and future unfunded liabilities of the State's five pension funds.

The Civic Federation has traditionally cautioned governments against using long-term debt to address budget shortfalls. However, the Federation recognized the extraordinarily difficult financial position of Illinois and most other state governments. As a result of the dire budget conditions of the State, past funding inadequacies, and historically low interest rates, The Civic Federation supported this proposal.

While supportive of the Governor's proposal, The Civic Federation strongly warned against the practice of debt financing to correct ordinary budget shortfalls or to fund normal operations, which would traditionally include current pension obligations. The Federation also offered the following concerns and suggestions:

- The General Assembly and the public at large should be aware that this financial strategy would not eliminate all the problems associated with the funding of State pensions.
- We strongly encouraged the General Assembly to be mindful of the benefit levels granted to employees.
- In the future, the State should also consider authorizing cost effective, contemporary borrowing techniques such as variable rate obligations.

The Governor'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 8 years or more of service; age 62 with 30 years or more 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.

PENSION FUNDING REFORMS	
GOVERNOR'S ORIGINAL PROPOSALS	**FINAL BUDGET APPROVED**
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
New Proposals	
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

Pension Fund Indicators

The Civic Federation used three measures to present a multi-year evaluation of the fiscal health of the State of Illinois pension funds: funded ratios, the value of unfunded liabilities and pension fund contributions as a percentage of General Fund resources.

Funded Ratios

Five years of information on actual and projected funded ratios for the State's pension funds are illustrated in the following exhibit. The ratios were calculated by the Commission on Government Forecasting and Accountability. The FY2003 figures do not include proceeds of the $10 billion Pension Obligation bond issue.[47]

Between FY2003 and FY2007, the funded ratio for all funds will increase from 48.6% to 57.7%. However, the funded ratio has fallen each year since FY2004; in that year the funded ratio increased dramatically because of the infusion of the proceeds of the $10 billion Pension Obligation bonds. Between FY2006 and FY2007:

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[47] According to a recent report by Standard & Poor's, Illinois's funded ratio was the 47th lowest in the nation, above West Virginia, Rhode Island, Oklahoma and possibly Connecticut. See Standard & Poor's, "Rising U.S. Unfunded Pension Liabilities are Causing Budgetary Stress," February 22, 2006.

- The projected funded ratio for the State Employees' Retirement System will decline from 52.6% to 51.4%;
- The projected funded ratio for the Teachers' Retirement System will fall from 59.5% to 58.6%;
- The State Universities Retirement System projected ratio will decline from 63.9% to 62.5%;
- The Judges' Retirement System projected ratio will decrease from 44.7% to 43.4%; and
- The General Assembly Retirement System will remain constant at 37.2%.

ILLINOIS STATE RETIREMENT SYSTEMS FUNDED RATIOS					
	FY2003*	FY2004	FY2005	FY2006 Estimate	FY2007 Estimate
State Employees' Retirement System	42.6%	54.2%	54.4%	52.6%	51.4%
Teachers' Retirement System-Downstate	49.3%	61.9%	60.8%	59.5%	58.6%
State Universities Retirement System	53.9%	66.0%	65.6%	63.9%	62.5%
Judges' Retirement System	30.7%	46.2%	45.7%	44.7%	43.4%
General Assembly Retirement System	25.3%	40.1%	39.1%	37.2%	37.2%
ALL STATE RETIREMENT SYSTEMS	**48.6%**	**60.9%**	**60.3%**	**58.8%**	**57.7%**

*Does not includes proceeds of Pension Obligation Bonds on a pro forma basis.
Source: Commission on Government Forecasting and Accountability. *Report on the 90% Funding Target of Public Act 88-0593*, January 2006, pp. 7-21.

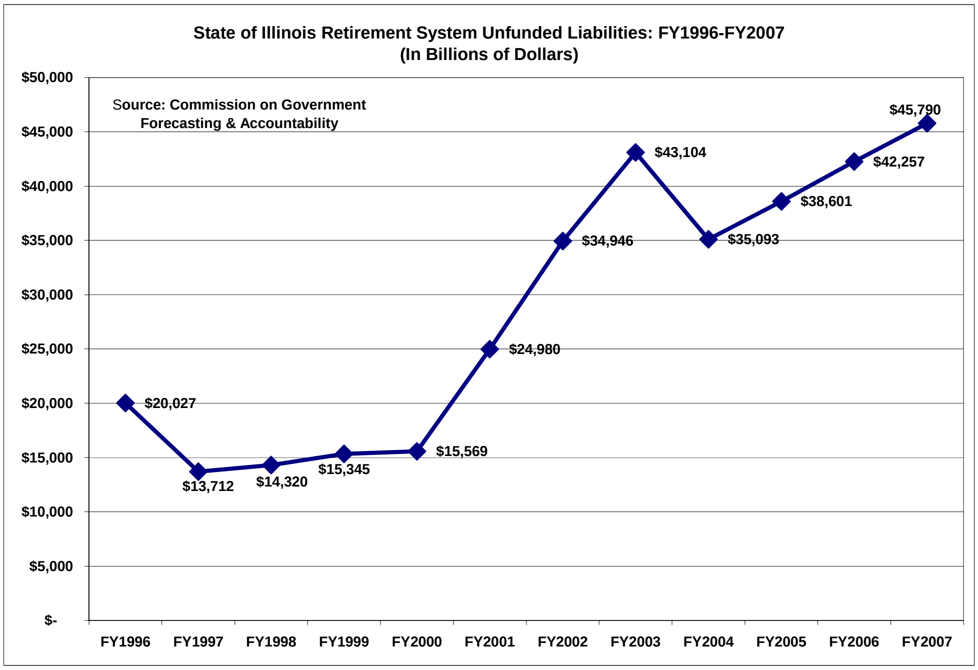
Unfunded Liabilities

In previous years, the Budget Book included pension fund information through the current fiscal year. However, in FY2007, the Book only provides pension fund information through FY2005. The Commission on Government Forecasting and Accountability has provided funded ratio calculations in its *Report on the 90% Funding Target of Public Act 88-0593*. According to the Commission, the unfunded liabilities of the State's five pension funds are projected to be nearly $45.8 billion in FY2007. This is approximately a 6.2%, $2.6 billion increase over FY2003, when unfunded liabilities were $43.1 billion.

STATE PUBLIC EMPLOYEE RETIREMENT SYSTEMS UNFUNDED LIABILITIES (FY03-FY07) - $ Millions							
RETIREMENT SYSTEM	**FY2003**	**FY2004 Estimate**	**FY2005 Estimate**	**FY2006 Estimate**	**FY2007 Estimate**	**$ CHG FY03-FY07**	**% CHG FY03-FY07**
State Employees'	$ 10,091.9	$ 8,452.5	$ 8,810.5	$ 9,586.0	$ 10,328.0	$ 236.1	2.3%
Teachers' Retirement	$ 23,808.6	$ 19,402.8	$ 21,989.8	$ 24,117.6	$ 26,207.3	$ 2,398.7	10.1%
State Universities	$ 8,310.4	$ 6,495.3	$ 6,999.6	$ 7,698.7	$ 8,337.1	$ 26.7	0.3%
Judges'	$ 746.1	$ 621.5	$ 671.5	$ 718.9	$ 774.2	$ 28.1	3.8%
General Assembly	$ 146.5	$ 124.4	$ 129.6	$ 135.6	$ 143.8	$ (2.7)	-1.8%
TOTAL	**$ 43,103.8**	**$ 35,096.5**	**$ 38,601.1**	**$ 42,256.8**	**$ 45,790.4**	**$ 2,686.6**	**6.2%**

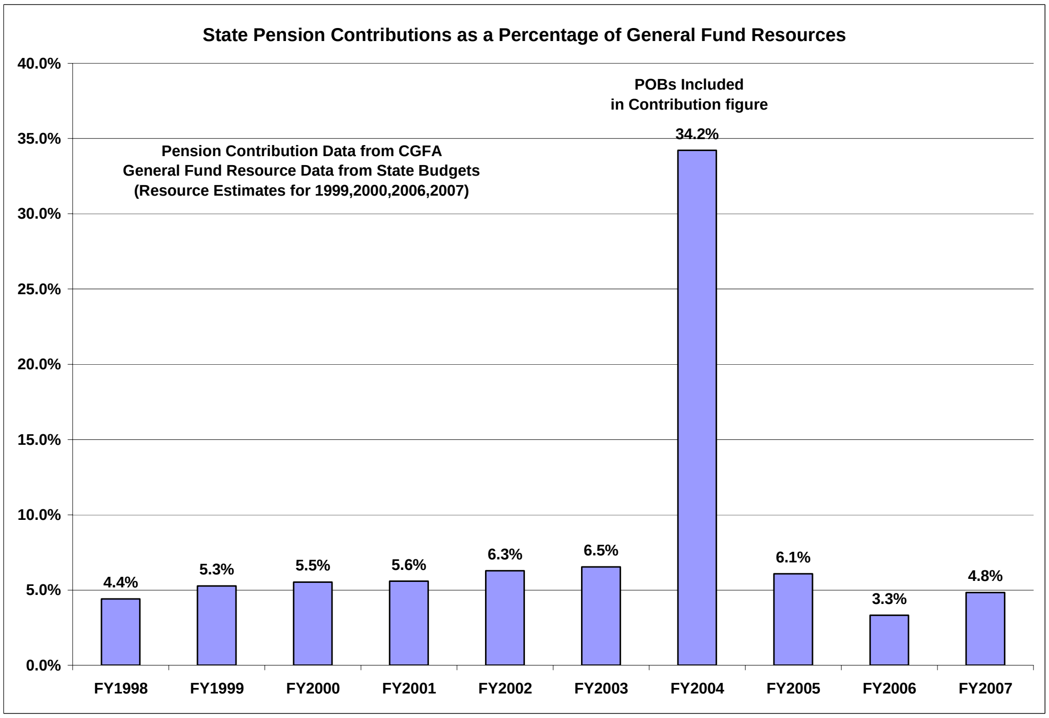
Source: Commission on Government Forecasting and Accountability.
FY2003 calculations do not include proceeds of the Pension Obligation bonds.

The next exhibit presents a 12-year trend of unfunded liabilities in the State's five retirement systems. It shows that since FY1996, unfunded liabilities have grown by 128.6% or $25.7 billion. This represents an increase from $20.0 billion to nearly $45.8 billion.



Pension Contributions as a Percentage of General Fund Resources

Pension fund contributions as a percentage of General Fund resources (revenues and other financing sources) rose from 4.4% in FY1998 to 6.5% in FY2003 before falling to a projected 4.8% in F2007. The 34.2% ratio in FY2004 is an anomaly – it can be attributed to the $9.1 billion total contribution to the State's retirement systems that year that included the proceeds of the Pension Obligation bonds.



The FY2007 Budget Proposal for the Retirement Systems

The General Assembly approved legislation (P.A. 94-0004) last year authorizing reductions in the State contributions from the originally certified amounts to the five State retirement systems in FY2006 and FY2007 totaling $2.3 billion. In accordance with that statute, the Governor proposes to contribute nearly $1.4 billion to the state's retirement funds in FY2007, which is $1.1 billion less than the certified contribution amount. The administration also proposes that any revenues derived from the sale of state assets or the 10th casino license be used to reduce pension fund liabilities. The exhibit below shows the difference between the certified amount for each State pension fund and the amount to be appropriated in FY2006 and FY2007.

FY2006 & FY2007 CERTIFED CONTRIBUTIONS
VS. FINAL GENERAL ASSEMBLY APPROPRIATIONS
(In Millions of Dollars)

	FY2006			FY2007				
System	Certified Contributions	P.A. 94-0004	Difference	Certified Contributions	P.A. 94-0004	Difference	Total 2-Year Contributions	Total Reduction
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
Total	**$ 2,117.2**	**$ 935.6**	**$ 1,181.6**	**$ 2,507.8**	**$ 1,372.2**	**$ 1,135.6**	**$ 4,625.0**	**$ 2,317.2**

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

Financial Impact of Pension Funding Changes to FY2045

The actuaries of the General Assembly's Commission on Government Forecasting and Accountability (CGFA) and the five retirement systems have each prepared estimates of the long-term economic impact of the FY2006 pension funding reforms. The results of those analyses are shown below.

The CGFA estimates that the final pension program approved for FY2006 will cost the State an additional $4.7 billion and reduce actuarial liabilities by $38.6 billion over 40 years. The retirement systems' actuaries estimate that $6.8 billion more in costs will be incurred and the liabilities will be reduced by $44.6 billion. The State originally projected that pension liabilities would be reduced by approximately $55.0 billion if all of the Governor's proposed reforms were adopted.

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

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

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

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

Second Blue Ribbon Task Force Recommendations

The second Blue Ribbon Task Force on Pensions created by P.A. 94-0004 included representatives from the General Assembly, the state retirement systems, organized labor and government. The Commission made five principal recommendations:

1. The State should dedicate revenues in excess of a targeted percentage of growth toward the additional funding of the pension systems when those targets are met and establish a minimum when they are not met.
2. If the state sells certain assets, 100% of the proceeds should be dedicated toward reducing pension liabilities.
3. The General Assembly should consider the issuance of Pension Obligation bonds as quickly as practicable to help further reduce pension costs as long as there are favorable market conditions and the issuance of POBs is part of a broader plan to reduce the retirement systems' unfunded liabilities.
4. The General Assembly should explore new dedicated revenue sources for the retirement systems.
5. The legislature should regularly review the pension systems' provisions regarding benefits and make determinations as needed.

CIVIC FEDERATION RECOMMENDATIONS

The Civic Federation offers the following recommendations regarding ways to improve the State's financial management and fulfill the State's financial obligations:

Fund State Pension Systems at Certified Contribution Amount

The State of Illinois has a responsibility to follow the mandate of the 1995 pension funding reform law. Deviating from the path laid out by that law renders it meaningless. Fixing the pension funding problem requires discipline and sacrifice, even pain. We urge the State to reject the ill-considered $1.1 billion partial pension funding holiday approved last year. The State should fund its pension obligations at the full $2.5 billion amount required by the 1995 law.

Impose a Moratorium on New State Employee Pension Enhancements

The Civic Federation believes that the time has come to stop expanding employee pension benefits. Therefore, we call on the legislature to reject and the Governor to veto any new pension enhancements whether they are funded or not. In addition, the State must adopt a moratorium on any new benefit enhancements until such time as substantial progress has been made on reducing the State's billions of dollars in pension liabilities and will likely require waiting at least 10 years until the FY2002 Early Retirement Initiative fiasco is full paid for.

Require Employees to Increase Pension Contributions by 1%

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. This increase should be required immediately for new hires and non-union employees. Although current contracts prevent this increase from being implemented immediately for employees covered by collective bargaining agreements, the State should, as a matter of policy, require increased contributions in future contracts. Stratospheric pension costs pose a serious threat to the financial future of the State of Illinois and its residents, and containing those costs must be a shared, ongoing, focused effort. We do not believe a single percentage point increase is onerous or unreasonable, especially when balanced against the generous retirement benefits state employees receive.

Study the Costs and Benefits of a Defined Contribution Pension Plan

The first Blue Ribbon Pension Commission recommended that once the State stabilizes the funding of its pension system, it should consider replacing all or part of its Defined Benefit pension plans for new hires with defined contribution (DC) Plans. DC plans, which are the predominant form of retirement benefit provided to the average American worker, can significantly reduce unfunded liabilities over time and offer employees greater flexibility as they change jobs.

In reviewing the record of the past thirty years, we have seen no evidence that the General Assembly has the requisite fiscal discipline to transparently execute a well funded defined benefit retirement system. For that reason, we think that a shift to a defined contribution system must be seriously considered for new hires when it is financially feasible. We understand that the transition costs for the shift could be expensive because of the current dramatic underfunding of the retirement systems. However, the Civic Federation urges the Governor and the legislature to undertake a study of this option to determine both costs and benefits. This study should include consideration of transition funding mechanisms because the cost savings and benefits of a shift to a DC plan in the long term may outweigh short-term expenses. While the Civic Federation opposes the issuance of any new Pension Obligation bonds to fund current or future State of Illinois pension obligations, there may be the potential for issuing such bonds for the sole purpose of funding the transition costs to a defined contribution plan. This would, of course, be contingent upon financial feasibility and the identification of real, substantial cost savings over time.

The State Should Not Mandate Local Pension Enhancements without Providing Funding

The General Assembly frequently approves legislation increasing the level and scope of local government employee pension benefits. However, no funding is provided for what amounts to yet another costly unfunded mandate for cash-strapped local governments. We believe that the concept of "pay as you go" funding should be extended to include State of Illinois actions that financially impact the pension costs of local governments. If the General Assembly sees fit to enhance benefits, it should identify and provide the requisite funding for those enhancements.

Provide Transparent and Frequent Reporting of Pension Fund Information.

The FY2007 Budget Book only provides information about the assets and liabilities of the State's retirement systems through FY2005. Traditionally, projections have been provided through the current budget year. This omission is disappointing and in contrast to the transparency of much of the rest of the document.

The public needs full and accurate financial information in order to understand and evaluate the Governor's budget proposals, particularly on an important issue such as pension funding. The Civic Federation recommends that the State fully disclose all relevant financial information about contribution levels for all retirement systems in the Pension section of future Budget Books.

In addition, the Civic Federation believes that the State of Illinois should increase requirements for the public disclosure of pension fund information. Currently, state statute requires that all of the over 600 public pension systems in Illinois prepare and file a biennial report with the Division of Insurance in the Department of Financial and Professional Regulation on their activities and financial condition.[48] In the interest of providing full and transparent information about the assets and liabilities of these constitutionally guaranteed benefits, we believe that reporting should be required on an annual basis and the law extended to require disclosure of information by the Chicago Transit Authority Pension system.

Reform Pension Board Composition to Provide Balance of Interests

The membership of four of the five State Pension Boards of Trustees contains a majority of employee and retirees. Employees and annuitants are currently in the minority on the State Universities Retirement System Board; however, while state statute requires four of the nine

[48] 40 ILCS 5/2A of the Illinois Pension Code.

members to be annuitants or actives, the governor is empowered to shift that balance by appointing other board members who “may, but need not, be participants or annuitants of the System.”[49] These five discretionary appointees currently include the president of the Service Employees International Union Local 73, so it can be argued that the majority of the SURS Board represents the interests of the employees. All seven of the General Assembly’s pension board members are beneficiaries.

Illinois State Public Pension Boards of Trustees Composition	
Fund	**Employees and Retirees less than 50% of Board?**
General Assembly Retirement System	No, 7 out of 7
State Employees Retirement System	No, 4 out of 7
State Universities Retirement System	Yes, 4 out of 9, but variable**
Teachers Retirement System	No, 6 out of 11
Judges Retirement System	No, 4 out of 5

**State statute allows the Governor discretion to shift the balance of representation by appointing additional active
Source: Illinois Pension Code, 40 ILCS 5

The Civic Federation believes that the proper role of a pension board is to safeguard the assets of the fund and to balance the interests of employees and retirees who receive benefits and taxpayers who pay for pension benefits. All of these parties have an interest in the management of the fund. However, the tilt toward employees on four of the five State pension boards raises questions about how objective the Board can be in its work. In our view, a pension board should:

- Balance employee and management representation on pension boards; and
- Develop a tripartite structure that includes citizen representation on pension boards.

We urge the State of Illinois to seek reform of its Pension Fund governing structures to ensure greater balance of interests.

Require Financial Expertise on Pension Boards

Public pension boards are charged with making complex financial and investment decisions affecting millions of dollars contributed by employees and taxpayers. This is a weighty fiduciary responsibility that requires a thorough understanding of asset management. It would be prudent to set aside some board seats for members with professional expertise or certification in financial asset investment, and to require all members to receive some basic education on their fiduciary responsibilities.

Although some Illinois funds require their comptroller or financial officer to sit on the pension board ex officio, only one Illinois state public pension fund, the Teachers Retirement System, explicitly requires inclusion of at least two independent citizen board members with financial experience.[50] The Civic Federation urges The Illinois General Assembly should pass legislation

[49] 40 ILCS 5-15-159
[50] 40 ILCS 5/16-164: “The Governor shall appoint 2 members as trustees in each even-numbered year who shall hold office for a term of 4 years. Each such appointee shall reside in and be a taxpayer in the territory covered by

to require the membership of public pension boards to include financial experts with experience in investing or managing large asset portfolios. Furthermore, all pension trustees should receive some relevant financial training on an annual basis.

Use Proceeds from Student Loan Program Privatization to Reduce Pension Liabilities

The State of Illinois proposes the competitive sale of IDAPP student loan assets and loan transactions, in effect privatizing the management of the student loan portfolio in much the same manner as other states and the federal government have done. Revenue from the sale would be used to fund the proposed $1,000 per student tuition tax credit.

The Civic Federation supports the State exploring the possibility of selling the assets and transactions of the Illinois Designated Account Purchase Program. We support the outsourcing of management functions for non-core functions of government with certain conditions. There must be an identifiable market of qualified vendors in the marketplace. The government must maintain adequate administrative oversight of the program after privatization to ensure that it fulfills its goals and operates as required under terms of the contract.

Because the proposed sale of the student loan portfolio will bring a one-time windfall of funds, those funds should not be used to pay for a recurring expense like the tuition scholarship program. A much more appropriate use of the funds would be to help reduce the massive unfunded liabilities of the State's chronically underfunded pension systems.

Establish a Governor's Commission to Review and Prioritize State Spending

The Civic Federation recommends that the Governor convene a Commission on State Spending. The purpose of this Commission would be to conduct a comprehensive review of State spending programs with the ultimate goal of prioritizing State programs. Those programs that are deemed to be essential to the well being of Illinoisans should be maintained or even enhanced. Those programs that are not essential may require reductions or even elimination. Given the State's ongoing resource constraints, the administration's pledge to refrain from broad-based tax increases and the public's unwillingness to embrace new taxes or enhanced spending without at least some confidence that the State is operating as efficiently and effectively as it should, we believe that a prioritization review is long overdue. Many states, including Washington and Michigan, have or are in the process of conducting similar prioritization processes.

The framework for a review of State spending should be comprehensive and include the following considerations:

- Cost containment strategies must be considered for mandated programs;
- There must be a cap or moratorium on the expansion of State employee benefits until the State can demonstrate it can control those costs;

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this system, shall be interested in public school welfare, and experienced and competent in financial and business management."

- The State should not implement new programs without new revenues or spending cuts;
- There must be enhanced accountability for state programs. Providing accountability is key to gain public trust about the need for and continuation of programs.

Consider Privatization of the Illinois Toll Highway

State Senator Jeff Schoenberg (D-Evanston) has proposed that Illinois lease all or part of the 274-mile Illinois Tollway to private investors. This initiative seeks to capitalize on momentum generated by Chicago Mayor Richard Daley's 2004 agreement to lease the Chicago Skyway for $1.83 billion over 99 years and Indiana Governor Mitch Daniels's recently completed agreement to lease the 157-mile Indiana Toll Road for $3.85 billion over 75 years. Some very preliminary estimates about the value of leasing the Tollway are that it could generate up to $15 billion in revenue for the State.[51]

While specific arrangements may be different, it is likely than a Tollway privatization arrangement would operate in much the same manner as the recent Chicago Skyway privatization agreement. In that case, the City will mandate standards for operation and maintenance, assume responsibility for public safety and enforce compliance with safety standards. The concessionaire is responsible for all operating and maintenance costs of the Toll Highway and has the right to all toll and concession revenue. The City and Cintra Macquarie, the Skyway lessor, have agreed to include a specified toll rate schedule. The private operator will have the right to raise tolls up the limits prescribed by the City in the Concession Agreement.[52]

Crain's Chicago Business reports that Governor Blagojevich has two primary concerns over the privatization proposal:

1. As per the Chicago Skyway agreement, a private Tollway operator would want the possibility of raising tolls, something likely to anger the driving public.

2. Privatizing the Tollway would require a complex and expensive retirement, or defeasement, of existing debt. The Tollway is in the midst of a massive reconstruction project, so this process is no small undertaking.

The City of Chicago addressed the toll hike issue by limiting the amount of future toll increases. Regarding the retirement of existing debt, it is possible to address the issue by phasing in a lease agreement.

Senator Schoenberg has said the proceeds from any privatization deal should go exclusively toward leveraging the $3 billion in federal transportation funds now awaiting a matching state contribution and reducing the State's unfunded pension liabilities."[53]

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[51] Greg Hinz, *Crain's Chicago Business* on-line edition, "Gov. Looks $15 Billion Gift Horse in the Mouth." posted Jan. 26, 2006.
[52] Information provided by City of Chicago, October 2004.
[53] Jeff Schoenberg's website, www.jschoenberg.org.

Clearly, there are many issues that would need to be addressed if management of the Illinois Toll Highway system was to be privatized. However, given the success of the City of Chicago's Skyway privatization, the Civic Federation believes that the idea should be seriously explored. Operating the Tollway is not a core function of the State. As such, it is a good candidate for outsourcing. As with all one-shot asset sales, we strongly believe that the revenues from a privatization effort should be dedicated to reducing the existing liabilities such as the unfunded liabilities of the State's five retirement systems.

Improve Performance Measure System

The FY2007 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; this makes it impossible to determine if agencies are meeting, exceeding or falling short of program and policy goals. 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 goals.

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 the inclusion of stated goals as well as efficiency, effectiveness and service quality measures.

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.[54] 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.

[54] See National Advisory Council on State and Local Budgeting and Government Finance Officers Association