



STATE OF ILLINOIS
EXECUTIVE OFFICE OF THE GOVERNOR
GOVERNOR'S OFFICE OF MANAGEMENT AND BUDGET
SPRINGFIELD 62706

BRUCE RAUNER
GOVERNOR

October 12, 2017

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DIRECTOR

EXECUTIVE SUMMARY

- The fiscal year 2018 budget went into effect on July 6, 2017 after the General Assembly overrode Governor Rauner's vetoes of the budget bills.
 - The Governor cited an unbalanced budget at the time of the veto and did not support passage of a state budget that raised taxes without spending controls and structural governmental, economic and fiscal reforms.
 - The Governor's Office of Management and Budget (GOMB) estimates a \$1.7 billion general funds structural deficit.
 - The Governor and some members of the General Assembly put forth proposals that would have reduced general funds spending by an additional \$2 billion had they been enacted. This would have balanced the state budget.
- The Governor has implemented approximately \$150 million in general funds deficit spending reductions to decrease the deficit to \$1.5 billion.
 - The Governor has limited unilateral control to reduce state government spending to close a deficit of this size without legislative action.
- The Governor is pursuing the issuance of \$6 billion in general obligation bonds to pay down a portion of the bill backlog.
 - This issuance, along with interfund borrowing and fund reallocations, is estimated to reduce the bill backlog by approximately 50 percent to \$7.5 billion by the end of fiscal year 2018.
- Without changes to the current trajectory of the state's finances, the projected deficit for fiscal year 2019 is \$2.15 billion and the bill backlog could grow to an estimated \$13.7 billion by the end of fiscal year 2023.
- The Governor remains committed to helping Illinois achieve long-term fiscal stability. He will continue to seek General Assembly support for structural changes that grow the state's economy and bend the cost curve of state government spending.
 - An additional \$5.4 billion in state revenues could be gained over the next five years if Illinois' economy were to grow at the national average.
- With stronger economic growth accompanied by spending controls, Illinois' fiscal position would improve with estimated budget surpluses and reducing the bill backlog to an estimated \$500 million by the end of fiscal year 2023.

Illinois Economic and Fiscal Policy Report

The Governor's Office of Management and Budget (GOMB) is required, pursuant to 20 ILCS 3005/7.3, to annually submit an Economic and Fiscal Policy Report to the General Assembly outlining the long-term economic and fiscal policy objectives of the state, the economic and fiscal policy intentions for the upcoming fiscal year, and the economic and fiscal policy intentions for the subsequent four fiscal years. It must also include fiscal and policy options that GOMB intends to pursue to remedy any budgetary shortfalls in the current year or the five following fiscal years.

This report provides information on national economic conditions, Illinois' economic conditions and forecast, a review of the enacted 2018 budget, five-year budgetary forecast, and policy objectives and intentions. An attachment, the General Funds Financial Walk Down, also provides a five-year projection of revenues, expenditures, any deficits or surpluses, and other liabilities through fiscal year 2023 as well as an agency categorization key for the expenditure categories.

ECONOMIC REVIEW

National Economic Conditions

As the United States moves through its ninth year of economic expansion, the national economy continues to expand at a moderate pace. After growing at a rate of 1.5 percent in calendar year 2016, the U.S. economy, as measured by growth in real Gross Domestic Product (GDP), grew at a rate of 3.1 percent in the second calendar quarter of 2017 after expanding at 1.2 percent in 2017's first quarter.¹ Economic growth in the second quarter of 2017 was a two-year record driven largely by consumer spending and business investment.² While growth in consumer spending had slowed by 1.0 percent in the first quarter of 2017, it picked up in the second quarter, growing 3.3 percent at an annualized rate. The second quarter increase was driven mostly by higher consumption of household furniture and durable household equipment, recreational durable goods and vehicles, and other durable goods.³ This increase in consumption of long-term durable goods points to consumer confidence and the current strength of the economy.

The labor market has continued to tighten in 2017, with unemployment remaining on the downward trend that began in October 2009. The national unemployment rate has remained below 5.0 percent since May 2016.⁴ Lower unemployment and higher consumer confidence are driving up demand for homes. This puts upward pressure on home prices (which have also risen due to a shortage of supply). The median price of homes sold in August 2017 was up 5.6 percent compared to a year earlier. This is more than double the growth in Americans' incomes.⁵

Despite these strong economic indicators, weekly earnings have remained historically low relative to past periods of similar rates of unemployment.⁶ Still, the total net worth of American households is in record territory unadjusted for inflation. Americans have avoided taking on high levels of debt seen prior to the last recession. Household liabilities relative to net worth is at its lowest since 2000 unadjusted for inflation.⁷

A strong economy has translated into more tax revenue for state governments. The U.S. Census Bureau reports tax revenue growth increasing in the first quarter of 2017 compared with the average rate of growth in the prior four calendar quarters. The national average growth rate of state taxes was 3.1

percent in the first quarter of calendar year 2017 compared with an average growth rate of 0.4 percent in the prior four quarters in 2016.⁸

Looking beyond the next year, some economists expect that slower growth in the rate of productivity (output per worker per unit of time) will slow the national economic growth trends. High growth rates of productivity, like those experienced between 1995 and the mid-2000's, tend to follow big technological innovations. The productivity increases during 1995 to the mid-2000's were very high as the economy made huge gains from information technology innovations. Historically, productivity fades until the next big innovation. Since 2007, productivity has returned to the 1973 – 1995 pace.⁹

The size of the working-age population and its educational attainment are important drivers of productivity, economic growth and tax revenues. According to U.S. Census Bureau projections, the size of the national working-age population is expected to grow at just 0.3 percent per year in the next two decades compared with rates between 0.8 percent and 2.0 percent for much of the 20th century.¹⁰ However, the rate at which people older than 25 are attaining a bachelor's degree or higher is accelerating.¹¹ Rising educational attainment, lower productivity and a decelerating working-age population will have a future impact on wage growth. The tax revenue growth impact is unclear.¹²

This report will discuss two economic forecasts provided by IHS Markit (IHS), a national economic forecasting firm. The first scenario is its baseline forecast on the short-term future, which anticipates continued economic expansion, with real GDP growing at annualized rates of 2.1 percent and 2.7 percent in the third and fourth quarters of 2017. The second forecast, a more pessimistic one, includes a chance that the U.S. economy will see negative economic impacts attributable to an anticipated lack of progress on economic, fiscal and monetary policy issues. Under this forecast, a decline in the stock market and feeble economic growth is projected.

According to IHS, the estimated baseline economic forecast projects that the strong consumer spending realized today will remain “a driving force in the economic expansion.” Third quarter real spending growth in 2017 is expected to be 2.5 percent and 2.8 percent in the fourth quarter. Beyond 2017, real consumer spending is expected to grow 2.8 percent in 2018 and 2.6 percent in 2019. Household wealth will continue to improve, riding the wave of a strong stock market, housing market and job market. Residential construction is expected to improve, increasing at a 7.0 percent annualized rate in the final quarter of 2017 due to rising demand for homes, limited supply and rising home prices. Business investment is expected to grow more moderately in the final two quarters of 2017 at 3.5 percent, but investments in software and research and development will help maintain economic growth. Inflation is also projected to pick up in response to dollar depreciation and the rebound in commodity prices. The core personal consumption deflator is projected to increase from a 0.9 percent annualized increase in the second quarter to 1.3 percent in the third quarter and 1.6 percent in the fourth. Finally, the Federal Reserve is expected to reduce its asset holdings and increase the federal funds rate in December 2017.¹³

The pessimistic forecast assumes that political uncertainty surrounding the passage of a federal budget and tax and healthcare reform will damage consumer confidence and in turn consumer spending. Under this pessimistic case, a potential stock market correction is more likely and would lead to a decline in the valuation of the equity market. Real consumer spending growth is lower than the baseline forecast by 0.8 percent in 2018 and by 0.9 percent in 2019, while housing starts are also below the baseline forecast. Despite these hits to the U.S. economy, it is still expected to grow in this pessimistic forecast by 0.8 percent at a potential annualized rate in the fourth quarter of 2018 and the first quarter of 2019.

Illinois' Economic Conditions and Forecast

As has been the case for many years, Illinois' economic growth continues to lag the nation, a condition that is expected to continue throughout the five-year forecast horizon absent reforms. U.S. real GDP grew 1.5 percent in 2016 while Illinois' real GDP grew just 0.9 percent.¹⁴ The recovery of employment in Illinois since the recession has also lagged behind the nation. The U.S. experienced a 1.18 percent growth in total nonfarm employment from August 2016 to August 2017¹⁵ while Illinois' total nonfarm employment contracted by 0.57 percent.¹⁶ During the same period, the state did see some gains in higher paying jobs, such as 9,100 added jobs in financial activities, 15,300 in professional and business services and 400 in mining. However, 3,000 jobs in construction and 2,800 jobs in manufacturing were lost over the same period.¹⁷

Barring the passage of meaningful economic and political structural changes, Illinois' anemic employment and economic growth is expected to continue and underperform the nation over the next five years. The table below summarizes the five-year forecast in Illinois for several key state economic variables in both the baseline and pessimistic scenarios. Slower job growth in Illinois will mean slower growth in wages and slower consumption growth. This translates to slower growth in the long run for both income and sales tax revenues collected by the state.

U.S. and Illinois Economic Forecast: Baseline vs. Pessimistic

Variables	Fiscal Year Growth Rate											
	2018 (p)	2018 (b)	2019 (p)	2019 (b)	2020 (p)	2020 (b)	2021 (p)	2021 (b)	2022 (p)	2022 (b)	2023 (p)	2023 (b)
U.S. Real Gross Domestic Product	2.1%	2.5%	1.4%	2.6%	1.8%	2.0%	2.5%	2.1%	2.0%	2.1%	1.8%	2.0%
Illinois Real Gross Domestic Product	1.3%	1.6%	0.8%	1.9%	1.2%	1.4%	1.8%	1.4%	1.3%	1.4%	0.9%	1.1%
Illinois Non-Farm Employment	0.5%	0.7%	0.4%	1.1%	0.3%	0.7%	0.7%	0.4%	0.7%	0.5%	0.5%	0.5%
Illinois Wage Disbursements	2.9%	3.1%	3.9%	4.9%	3.9%	4.7%	4.8%	4.4%	4.6%	4.4%	4.3%	4.4%
Domestic U.S. Corporate Profits	9.0%	11.4%	6.9%	11.3%	9.1%	3.7%	9.9%	6.8%	4.8%	6.1%	3.4%	4.4%
Illinois Retail Sales	3.2%	3.7%	2.5%	3.8%	4.0%	4.4%	3.9%	3.8%	3.7%	3.8%	3.6%	3.7%

Source: (p/pessimistic) IHS's Pessimistic Scenario (recession 10 percent probability) and (b/baseline) IHS's Baseline Scenario.

The impact of the national and state economy on Illinois' budget cannot be understated. With an understanding of the economic challenges facing Illinois and an awareness of the national economic climate, the Governor has proposed budgets to improve Illinois' finances while pursuing structural changes to become more competitive for job growth.

A Review of the Fiscal Year 2018 Enacted Budget

Fiscal year 2018 began on July 1, 2017. In early July, the General Assembly passed a fiscal year 2018 budget package, including appropriations and revenue increases. The Governor vetoed the bills related to the budget package on July 4, 2017, citing imbalances in the fiscal year 2018 general funds budget. The Senate and the House of Representatives overrode the Governor's veto of the budget package, and three budget-related Public Acts went into effect on July 6, 2017 – PA 100-21 (appropriations), PA 100-22 (revenues) and PA 100-23 (the budget implementation statutory changes).

The fiscal year 2018 enacted budget also includes appropriation language to allow state agencies to pay outstanding bills from a prior fiscal year. State agencies have been unable to pay many vendors and providers due to the lack of a full general funds budget in fiscal years 2016 and 2017. However, the fiscal year 2018 enacted appropriations did not include enough funding for agencies to catch up on prior fiscal year expenses owed. The Governor's veto message indicated a budget deficit of \$2 billion based on

preliminary estimates of \$700 million in appropriation shortfalls associated with pension reforms and approximately \$1.3 billion in unpaid bills from fiscal year 2017.

Included in PA 100-22 were increases in the individual income tax rate from 3.75 percent to 4.95 percent and increases in the corporate income tax rate from 5.25 percent to 7.0 percent, effective July 1, 2017. Other changes included revisions to certain tax credits and corporate income tax deductions.

PA 100-23 included several legislative changes enacted by the General Assembly, some of which will affect the state's fiscal year 2018 general funds budget. These items include:

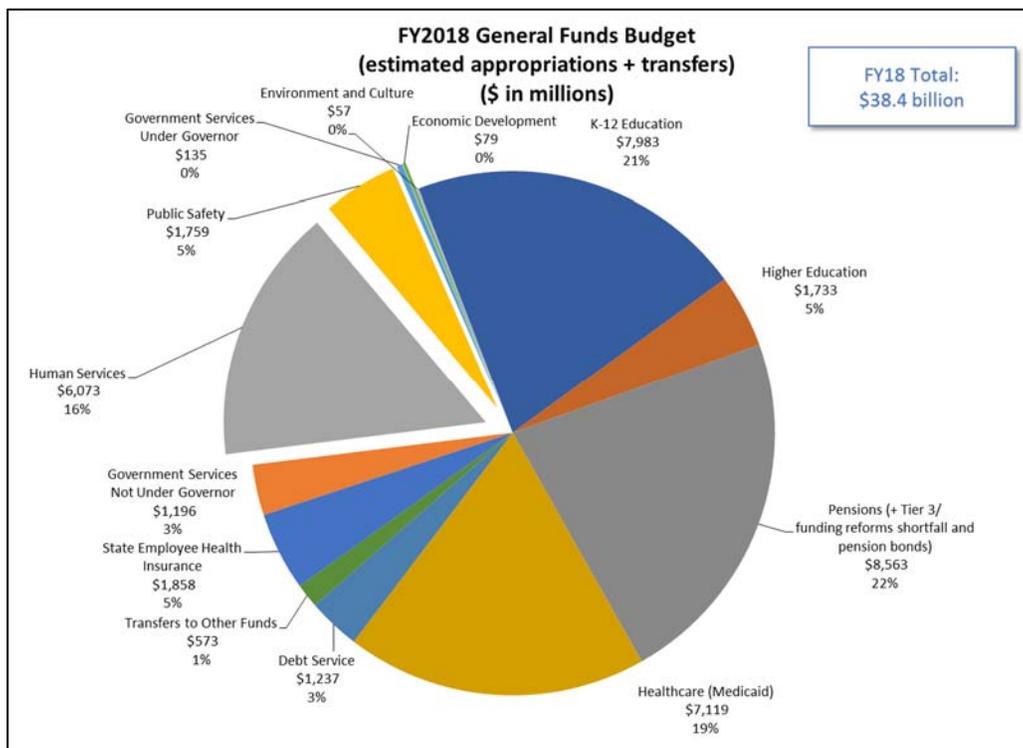
- Pension funding reforms with the expectation that the revisions would reduce the amount of contributions the state is required to make during fiscal year 2018. Final amounts due to the retirement systems will be recertified by the systems by November 1, 2017. In addition, there was a creation of a Tier 3 pension system for new employees in certain state-funded retirement systems.
- For fiscal year 2018, a 10 percent reduction in state income and sales tax revenue sharing with local governments and transit districts. Also, this revenue sharing shifted from a legislative transfer from the General Revenue Fund (GRF) after income and sales taxes are deposited into GRF to a direct deposit into the Local Government Distributive Fund, Public Transportation Fund and Downstate Public Transportation Fund at the time revenues are collected. Local governments are expected to receive their payments from the state more quickly under this structure.
- Authorization for the state to issue up to \$6 billion in Income Tax Proceed Bonds to be used to reduce the state's accumulated unpaid bills by paying state financial commitments incurred prior to July 1, 2017.
- Authorization for the Comptroller to reallocate in fiscal year 2018 up to \$292.8 million from specific funds in the State Treasury to the General Revenue Fund, Budget Stabilization Fund, Healthcare Provider Relief Fund, or Health Insurance Reserve Fund, to enable the Comptroller to reduce the backlog of bills.
- Authorization for the Comptroller to temporarily borrow balances in other state funds for deposit into the general funds or Health Insurance Reserve Fund prior to December 31, 2018 to assist with the liquidity of the funds. Any interfund borrowing is required to be paid back within 24 months of the borrowing under current statute. Outstanding borrowing at any time cannot exceed \$1.2 billion.
- The definition of general funds in the State Budget Law was amended to include an expanded list of the funds, adding the Budget Stabilization Fund, the Commitment to Human Services Fund and the Fund for the Advancement of Education.

Additionally, on August 31, 2017, the Governor signed Public Act 100-65 into law, which provides for an evidence-based method of allocating funding among the State's school districts.

Over 75 percent of the Fiscal Year 2018 Budget is “Locked” Into Law and Limits the Governor’s Ability to Unilaterally Close the \$1.7 Billion Deficit

In August 2017, GOMB completed its review of the enacted budget and projected a \$1.7 billion general funds deficit as described below. The Governor has limited unilateral control to reduce spending to address a budget deficit of this magnitude. More than 75 percent of the general funds budget – or over \$30 billion – for state fiscal year 2018 is “locked” into place, and largely outside the Governor’s control. This portion of the budget is dictated by state and federal laws and rules, collective bargaining agreements (CBA) and federal consent decrees. For example, approximately 50 percent of the fiscal year 2018 budget is for spending items that are significantly driven by laws and CBAs such as pensions, Medicaid, debt service transfers, statutory transfers-out, and state employees’ group health insurance. In addition, approximately 25 percent of the enacted budget is for K-12 education and higher education which are governed by independent boards.

Within the remaining 25 percent of the budget, the Governor’s ability to reduce spending is also limited due to other factors. Within the largest segment, Human Services, approximately 85 percent of the Department of Human Services’ budget is for spending items for compliance with federal consent decrees, entitlements, Medicaid and maintenance of effort (MOE) spending requirements for federal programs. In addition, nearly 100 percent of the Department of Children and Family Services budget is subject to a consent decree. Furthermore, approximately \$1.2 billion or 90 percent of the government services spending category (not including group health insurance) is for the legislative and judicial agencies, other constitutional offices and subsidies to other non-state pensions and retiree healthcare (Chicago Public Schools, Teacher’s Retirement Insurance Program and College Insurance Program). This significant portion of the budget is also outside the control of the Governor.



As a result, the Governor determined that the estimated general funds deficit of \$1.7 billion requires legislative actions to successfully close the deficit. However, the Governor did implement approximately \$150 million in general funds deficit spending reductions. The Governor's actions reduce the general funds deficit to \$1.5 billion, and include:

- Keeping many state programs at or below fiscal year 2017 levels thereby limiting increases in state spending;
- Taking 5 percent reductions in many programs that were not reduced by the General Assembly as the enacted budget included 5 percent reductions in most areas of state government; and
- Maintaining a process for six-month redeterminations on child care eligibility, while allowing child care program participation to increase to assist parents at up to 185 percent of the federal poverty level and parents pursuing educational opportunities.

Fiscal Year 2018 Operating Deficit Exceeds Preliminary General Assembly Projections

The \$1.7 billion budget deficit inherited by Governor Rauner (before the \$150 million in Governor's directed deficit spending reductions) is based on different assumptions than legislative budget estimates of a \$350 million surplus¹⁸, including:

- Current fiscal year 2018 general funds revenue estimates are over \$500 million lower than the enacted budget assumption. This is due primarily to lower revenue collections in fiscal year 2017 that depressed the revenue base for fiscal year 2018.
- Unlike the Governor's proposal, the General Assembly allowed pension systems to set their own implementation date for Tier 3 (new hire) reforms. The General Assembly also did not statutorily "lock in" fiscal year 2018 pension payment reductions and overestimated savings from other pension funding changes. This resulted in a total loss of spending reductions of \$585 million.
- The budget plan did not account for estimated debt service costs on the legislatively authorized \$6 billion general obligation bonds to address a portion of the state's bill backlog, an estimated cost of \$535 million.
- The budget plan did not account for the impact of one-time transfers out of the General Revenue Fund for local government income/sales tax revenue sharing as part of the transition to direct deposit of revenues, an estimated cost of \$216 million.
- The General Assembly budget plan includes an estimated \$261 million spending reduction for undefined "Adjustments." The Governor's implementation of the budget targets \$150 million in deficit spending reductions.

A Balanced Budget Could Have Been Achieved

There were many budget savings proposals put forward by the Governor and the General Assembly this past legislative session that were not included in the enacted budget. A balanced budget for fiscal year 2018 could have been achieved if approximately \$2 billion in general funds savings initiatives were included in the budget package that was enacted:

- \$500 million in reduced pension payments by requiring a specific implementation date in fiscal year 2018 for Tier 3 and by locking in the payment reductions in statute;
- \$200 million for two other pension funding reforms that were included in the Governor’s budget proposal;
- \$600 million in savings to government group health insurance programs;
- \$525 million in savings for Medicaid reforms;
- \$150 million in savings similar to the deficit spending reductions implemented by the Governor;
- \$60 million reduction of debt service costs from authorizing a lower cost revenue bond issuance for the \$6 billion in backlog borrowing instead of requiring lower-rated General Obligation bonds; and
- \$45 million in lower late interest payments due to the General Assembly not appropriating approximately \$1.2 billion for unpaid bills from fiscal year 2017.

In addition, the General Assembly could have passed the “consideration” model for pensions that received bipartisan support in the General Assembly and passed the Senate this past spring. This would have resulted in significant savings in future fiscal years.

Fiscal Year 2018 Budget Outlook

GOMB estimates that under current statutes, total general funds base revenues for fiscal year 2018 will total \$35,899 million. The general funds’ “Big Three” revenue sources (individual income tax, corporate income tax and sales tax) are estimated to total \$27,102 million. The estimate reflects the direct deposit of the revenue sharing portion of income and sales tax revenues for local governments (totaling \$1,558 million) prior to the deposit of those sources into the general funds. The base general funds revenue estimates do not include any potential one-time revenues from authorized fund reallocations and interfund borrowing. Fiscal year 2018 estimated base general funds receipts for federal sources total \$3,556 million based on appropriations that are expected to generate federal match if payments are released timely. The base fiscal year 2018 estimate does not reflect the impact of borrowing under PA 100-23 on federal receipts as discussed below.

Fiscal year 2018 estimated base general funds spending in the walk down totals \$37,403 million. This assumes spending from enacted appropriations, but also assumes the estimated impact of continuing appropriations for payments to the state retirement systems for fiscal year 2018 estimated to be \$585 million above enacted appropriations. The spending estimate also reflects the impact of approximately \$150 million in general funds deficit spending reductions as directed by the Governor.

GOMB estimates fiscal year 2018 spending will exceed current resource projections by \$1,504 million, reflecting the structural deficit of the general funds budget. However, several other items will have a one-time impact on the deficit on a reporting basis in fiscal year 2018.

Backlog Borrowing and One-time Impacts on the Fiscal Year 2018 Budget Results. While there is a forecasted general funds operating deficit of \$1.5 billion for fiscal year 2018, several items are expected

to have an impact on the budget during fiscal year 2018. This will change the fiscal year 2018 budget results on a reporting basis from a deficit to a surplus.

Fiscal year 2018 spending could increase if additional appropriations are enacted for payments for fiscal year 2017 bills brought forward into fiscal year 2018. The amount of fiscal year 2017 liabilities carried forward into fiscal year 2018 is estimated to total approximately \$2.8 billion. Estimates of fiscal year 2017 carryover by major agencies are listed in the table below. While the fiscal year 2017 group health insurance obligations will be addressed directly by the planned backlog borrowing, the remaining \$1.2 billion would need to be appropriated for the state to fund its commitments.

Fiscal Year 2017 Estimated Carryover Liabilities*
(\$ in millions)

Agency	Estimated Carryover of Fiscal Year 2017 Liabilities
Group Health Insurance ¹ (Central Management Services)	\$1,600
Corrections	\$499
Healthcare and Family Services (HPRF² fund deposit)	\$445
Human Services	\$118
Central Management Services (non-GHI)	\$40
State Police	\$27
All Other Agencies	<u>\$73</u>
Total	\$2,802

* The amounts listed here reflect estimates of fiscal year 2017 services/commitments that remained unpaid after any available fiscal year 2017 appropriations were utilized. The amounts have not been adjusted down for any fiscal year 2018 appropriations that may have been used to make the payments. With the exception of the Healthcare and Family Services appropriation for a fund deposit, the fiscal year 2017 liabilities are already factored into the current bill backlog estimates.

¹ The fiscal year 2017 General Revenue Fund (GRF) group health insurance costs are expected to be addressed through the issuance of bonds authorized in PA 100-23 of which a portion is expected to be deposited into the Health Insurance Reserve Fund outside of the general funds. If so, CMS would not need an appropriation from GRF during fiscal year 2018 for the fiscal year 2017 liabilities.

² Healthcare Provider Relief Fund (HPRF). A deposit from GRF to HPRF was not included in the fiscal year 2017 appropriations and is needed to fund projected Medicaid liabilities.

The Governor is moving forward with issuing up to \$6 billion in general obligation bonds to be used to pay a portion of the financial commitments incurred prior to July 1, 2017. Up to an estimated \$3 billion of the backlog borrowing proceeds will be deposited into the General Revenue Fund to pay accumulated Medicaid and other interest-accruing bills. The balance is expected to go directly to the Health Insurance Reserve Fund for state employees' group health insurance bills. This deposit of bond proceeds will appear to reduce the deficit on a reporting basis. GOMB estimates the utilization of a portion of the bonds to pay Medicaid bills could generate additional federal revenues of at least \$1.1 billion over current federal revenue estimates as the Comptroller is able to release more in Medicaid payments than was expected in the baseline forecast.

Additionally, GOMB estimates that approximately \$850 million in fund reallocations and interfund borrowing could be receipted in fiscal year 2018 under the authorization in PA 100-23. As of September

30, 2017, \$126 million of fund reallocations had been transferred to the General Revenue Fund and \$150 million from interfund borrowing was deposited into the General Revenue Fund by the Comptroller. These revenues will be reported in such a manner as to reduce the fiscal year 2018 deficit in final fiscal year 2018 budget reports.

In total, these changes (including the assumption that \$1.2 billion in additional appropriations are enacted and agencies voucher payments for old bills), are expected to result in a reported budget surplus of \$2,246 million in fiscal year 2018 and a reduction in backlog of the bills at the Comptroller's office.

Five Year Budgetary Forecast

Pursuant to 20 ILCS 3005/7.3, attached to this report is a financial walk down of the budgetary outlook for fiscal year 2018 through fiscal year 2023. The revenues included in the walk down include the 6.67 percent (or 2/30th) portion of individual income taxes and the share of corporate income taxes that are deposited into the Fund for the Advancement of Education (FAE) and the Commitment to Human Services Fund (CHSF) due to the new definition of the general funds beginning in fiscal year 2018.

The projections used for fiscal year 2018 and the five subsequent fiscal years assume moderate natural growth in revenues under existing law driven by the blended economic forecast scenario, increases in pension payments (which beginning in fiscal year 2020 reflect reductions in payments due to the implementation of Tier 3), projected debt service amounts, and moderate increases in other spending. All projections assume no significant reforms or spending controls aside from what is in current statute.

Estimated Resources. As noted earlier, GOMB estimates that under current statutes, general funds base revenues for fiscal year 2018 will total \$35,899 million. The base general funds revenue estimates do not include any potential one-time revenues from authorized fund reallocations and interfund borrowing.

Revenue estimates going forward are based on projections provided by the Illinois Department of Revenue (IDOR) economists blending the IHS's baseline forecast and pessimistic forecast. While it is impossible to definitively predict a recession at any point in the five-year forecast horizon, the IDOR economists incorporated IHS' potential risk for a recession into the revenue forecast. The possibility of a recession translates into a forecast in which individual income tax receipts grow approximately 2.2 percent in fiscal year 2019 and then grow at closer to 4.0 percent after that. Corporate income tax receipts are expected to grow on a steady pace from the lower taxable base level seen in fiscal year 2017.

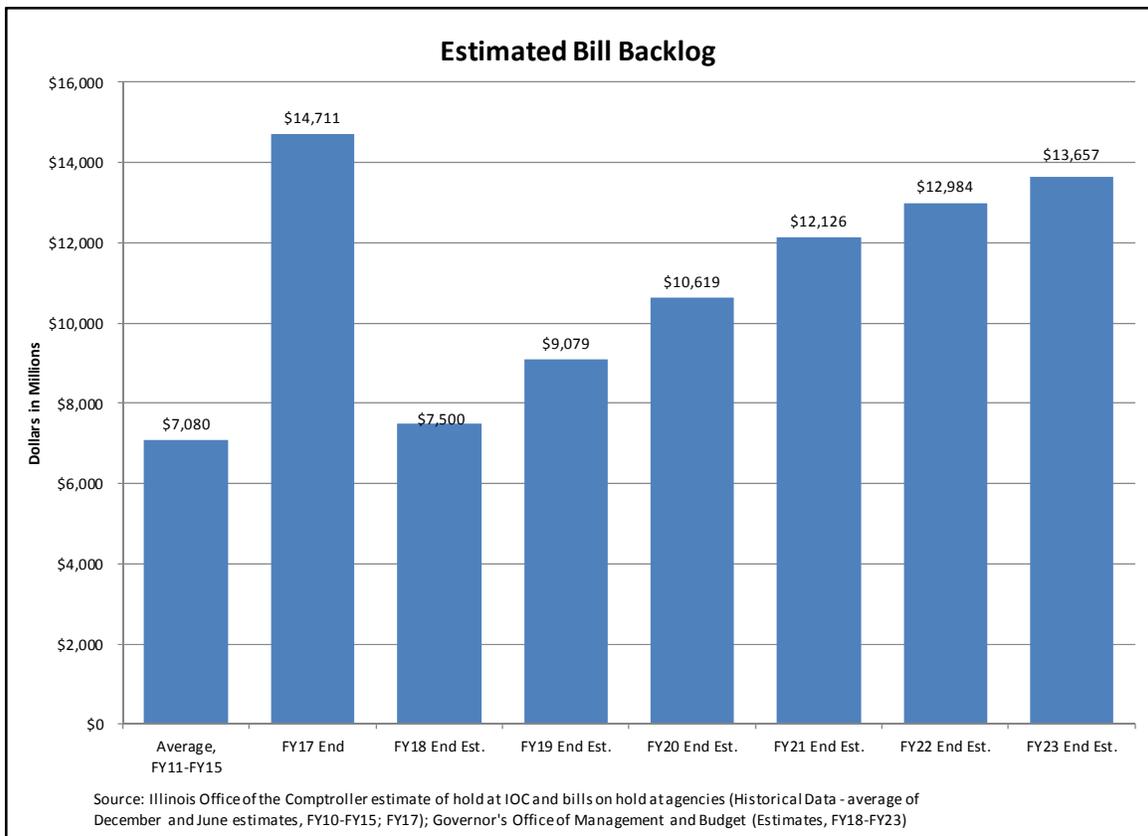
The diversion rate of 9.8 percent of total individual income tax revenues in fiscal year 2018 to the Income Tax Refund Fund is assumed to increase to 10 percent in fiscal year 2018 and the remainder of the forecast. The corporate income tax forecast assumes a refund fund diversion rate of 17.5 percent in fiscal year 2018 that will fall to 17.0 percent in fiscal year 2019, before declining to 14.5 percent in fiscal year 2020 and then to 14.0 percent for the remainder of the forecast.

Fiscal year 2018 estimated base general funds receipts for federal sources total \$3,556 million based on appropriations that are expected to generate federal match if payments are released timely. Federal reimbursements for Medicaid spending are returned to the same fund that was used for the original expenditure. It is assumed that the Department of Healthcare and Family Services will continue to maximize the use of non-general funds for Medicaid spending, which will reduce federal receipts into the general funds. Growth in federal revenues is projected to show only moderate growth over the forecast horizon.

Estimated Expenditures. Fiscal year 2018 estimated base general funds spending in the financial walk down totals \$37,403 million. This assumes spending from enacted appropriations, but also the estimated impact of continuing appropriations for payments to the state retirement systems for fiscal year 2018 of \$585 million above enacted appropriations. Future-year spending estimates are based on moderate growth rates in the various categories of state spending from fiscal year 2018 appropriations, without significant changes to programs.

GOMB estimates fiscal year 2018 spending will exceed current resource projections by \$1,504 million. This reflects the structural deficit of the general funds budget after factoring in the deficit spending reductions directed by the Governor.

GOMB estimates that with borrowing and other measures in fiscal year 2018, the state’s bill backlog will fall from approximately \$15.1 billion at the end of September 2017 to an estimated \$7.5 billion at the end of fiscal year 2018. The estimated end of fiscal year 2018 backlog would be closer to the average backlog levels from fiscal year 2010 to fiscal year 2015. However, because there is an estimated structural deficit over the term of the forecast as depicted in the financial walk down, there are not further expected reductions in the state’s backlog over the next few years. Without changes to the current trajectory of the state’s finances, the backlog will continue to grow over the near-term. The Governor does not believe this is an acceptable path for Illinois and its taxpayers as he advocates for economic and fiscal policies aimed to grow the economy and the implementation of spending controls to address these deficits.



POLICY OBJECTIVES AND INTENTIONS

This five-year forecast, based on the current trajectory of Illinois' economy and spending, projects budget shortfalls for fiscal years 2018-2023. Governor Rauner's fiscal year 2018 budget proposal outlined several transformations to bend the cost curve of spending for the high-growth areas of the state's budget and included other spending control initiatives. The Governor also sought the General Assembly's support of a package of structural changes to address Illinois' financial and economic challenges. His proposals were driven by his goals of ending deficit spending; improving fiscal management of state government; and restoring Illinois' economic competitiveness through economic and political structural changes. His goals remain the same today.

During the budget impasse, the Governor publicly expressed his willingness to consider proposals to increase revenue if the General Assembly supported meaningful structural changes necessary to improve Illinois' economy. The fiscal year 2018 budget enacted by the General Assembly over the Governor's veto was out of balance and perpetuated status quo policies of deficit budget spending. Additionally, the fiscal year 2018 budget established permanent increases in the individual and corporate income tax rates. Structural changes supported by the Governor for property tax relief, lowering workers' compensation costs, enacting term limits and creating fair maps through an independent redistricting process were not enacted.

Governor Rauner's resolve to pursue structural changes critical to helping Illinois adequately address its escalating fiscal and economic problems has not diminished. The Governor will continue to seek the support of the General Assembly to control state government spending through enactment of balanced budgets and structural changes to grow the state's economy. To achieve long-term fiscal stability, Illinois' economy must grow at a faster rate than state government spending.

The Governor supports spending allocations to fund core priorities to:

- invest in our future workforce through pre-K through 12 education;
- protect our children;
- serve those most in need;
- provide compassionate care through community-based services;
- reform our criminal justice system; and
- focus on programs that serve the entire state.

Improve Illinois' Economy

The Governor is committed to work with the General Assembly to enact changes to improve Illinois' economy to generate new and better jobs for all residents. Significant economic improvement is more likely to occur if meaningful changes to the state's economic and political policies are enacted that would boost Illinois' economic competitiveness to attract and retain businesses. Illinois' reliance on tax hikes and fee increases to pay for unsustainable levels of spending and poor fiscal management policies contributes to the state's current financial instability.

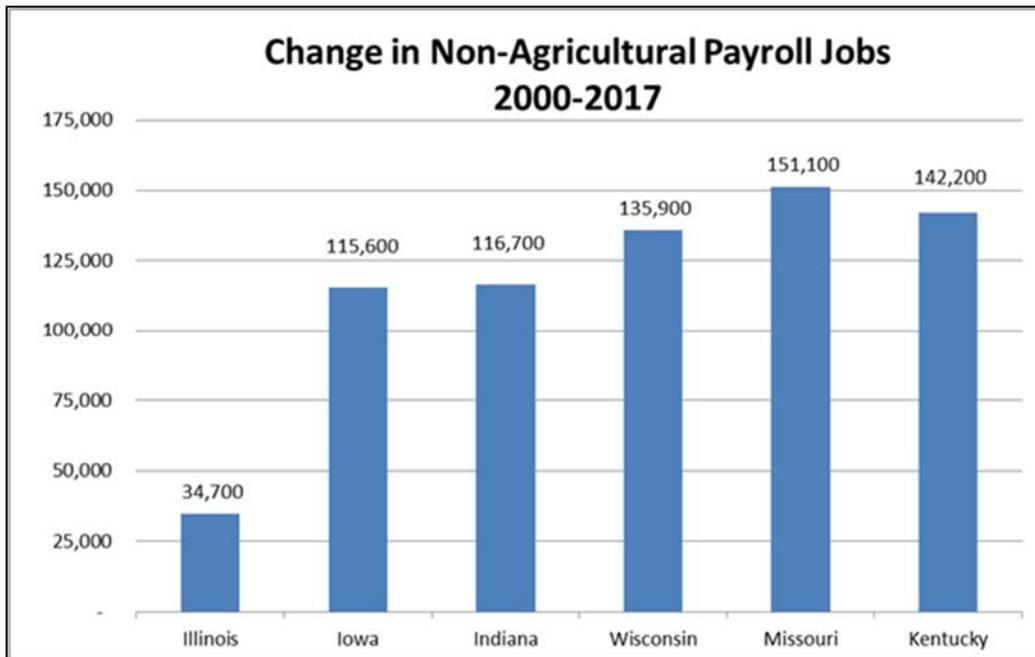
Illinois' fiscal and economic policies factor prominently in the state's negative reputation with businesses. High property taxes, a burdensome regulatory environment, and employer-unfriendly legal and judicial system further erode Illinois' ability to compete with other states for business attraction and expansion.

The inability to attract and retain businesses is also apparent in Illinois' continuing underperformance in job creation over the last two decades, both as compared to the national level and to our neighboring states. In January 2000, Illinois' non-agricultural job total was 6,009,100. As of August 2017, the preliminary estimate for the number of jobs increased to 6,043,800. **Over nearly an 18-year period, Illinois added only 34,700 jobs—a 0.6 percent increase. At the national level, 15,683,000 new jobs were created during the same time period – a 12.0 percent increase.** The following chart shows that each of Illinois' neighboring states have added an average of 132,300 jobs, or more than three times the number added in Illinois during this same time period.

**Non-Agricultural Payroll Jobs
(Seasonally Adjusted)**

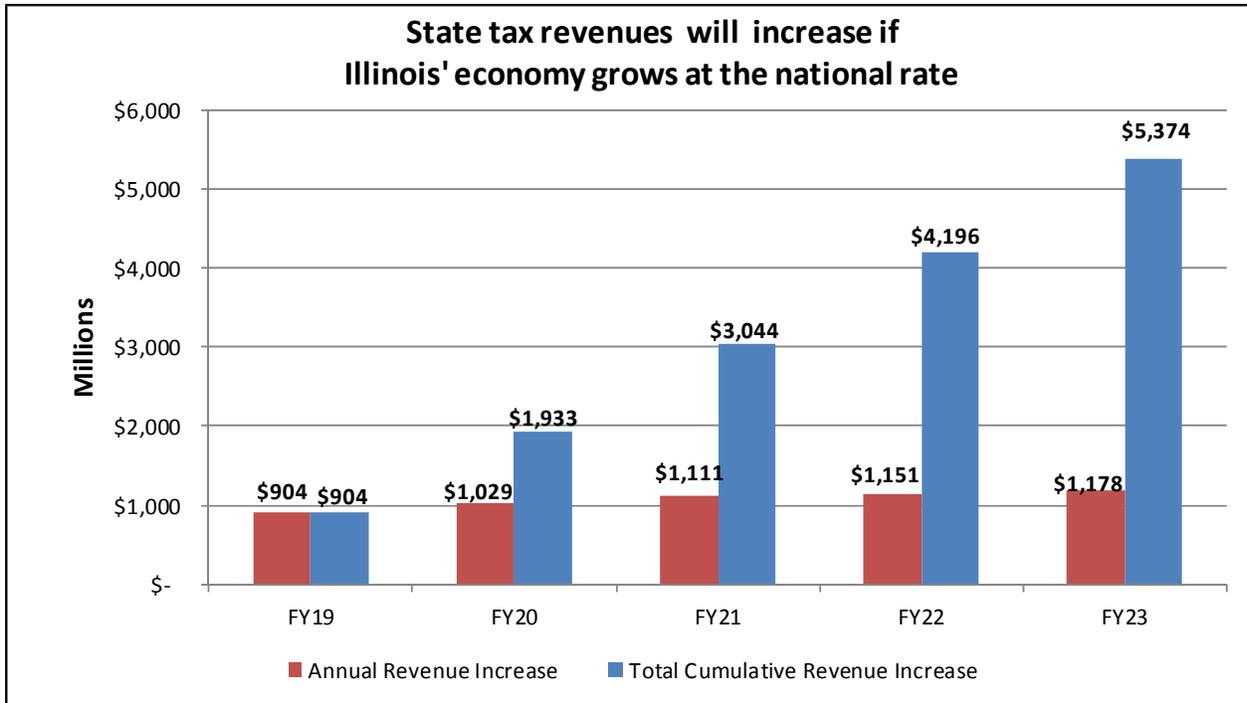
Date	Nation	Illinois
January 2000	131,009,000	6,009,100
August 2017	146,692,000	6,043,800
Difference Jan-00 to Aug-17	15,683,000	34,700
% Difference Jan-00 to Aug-17	12.0%	0.6%

Source: Bureau of Labor Statistics, Current Employment Statistics



Source: Bureau of Labor Statistics, Current Employment Statistics, January 2000 – August 2017

Significant additional state revenues could be attained if Illinois improved its economic growth to just the national average. As illustrated in the chart below, according to IDOR an additional \$5.4 billion in state revenues could be gained over the next five years if the Illinois economy were to grow at the national average.



Source: Illinois Department of Revenue

Pay Down Backlog of Bills and Prevent Future Backlogs

Decades of deficit spending, refusing to enact structural changes, and deferring present liabilities to future years resulted in a bill backlog exceeding \$14 billion at the end of fiscal year 2017. Proceeds from the \$6 billion bond sale authorized by the General Assembly will help pay down a significant portion of the bill backlog and accelerate payments to vendors. Selling bonds to pay Illinois’ debt is a short-term solution at best, and does not address the real problem: how to prevent a recurrence of a bill backlog.

The Governor’s long-term objective is to prevent the bill backlog from recurring through enacting balanced budgets and structural changes while making significant, but common-sense changes to current policies for management of accounts payable. Illinois’ excessive statutory 9 or 12 percent annual late payment interest penalties have significantly added to our financial liability. The late payment penalty applicable to future bills should be reduced and tied to the economy. For example, the interest rate could be set using the rate of 5-year U.S. Treasuries as reported by the federal government, plus 100 basis points (a full percent).

Consensus Model of Revenue and Spending Forecasts

Governor Rauner strongly supports reforms to make changes to Illinois’ framework governing the state’s expenditure of public funds.

The Illinois Constitution and state budget laws require a balanced budget. The Governor may not propose expenditures that exceed funds estimated to be available for the fiscal year covered by the proposed budget. The General Assembly is similarly constrained—appropriations for expenditures for a fiscal year may not exceed funds estimated to be available in that year. Obviously, there are weaknesses between Illinois’ constitutional and statutory balanced budget requirements evidenced by Illinois’ long standing practice of deficit spending.

As noted by Moody's Investors Service in its recent analysis of Illinois' credit rating, "Constitutional budget-balancing requirements are not enforced or meaningful. In practice, these provisions have served only as very loose guidelines. The state's shortcomings in these respects have contributed materially to its credit deterioration in recent years."¹⁹

Legislation to strengthen the controls in the budgetary process to improve revenue and spending projections are needed to ensure the state's budget is balanced. Budget discussions are typically conducted at the leadership level of the Governor and General Assembly, with minimal input from rank-and-file legislators and revenue experts. Opportunities for public access to the process are also limited, particularly during the final weeks of the legislative session.

The Governor recommends the creation of a new consensus revenue forecasting forum and process. This best practice is recommended by national experts and has been adopted by almost one-half of the other states. Under this model, many states project spending trends as well as revenues.

Revenue and spending estimates should be approved periodically by the consensus forum and aligned with critical dates during the budget cycle to provide more accurate and current estimates. These estimates should be required to be incorporated into the Governor's budget proposal and the appropriations bills before they are enacted by the General Assembly.

Provisions in Illinois law allowing deferral of payment of some bills to future years also need to be examined. Best practices of other states should be reviewed and considered as part of the forum's process for estimated spending to minimize liabilities carried forward to future fiscal years. The consensus process will allow policy makers to focus on what is best for our citizens by allocating resources to the state's priorities while minimizing the risk of inaccurate revenue and spending projections.

In addition, the best practice "consensus" model allows economic and other experts to participate in the legislative process. It further increases transparency through public hearings, comments and online posting of proposed and final forecasts.

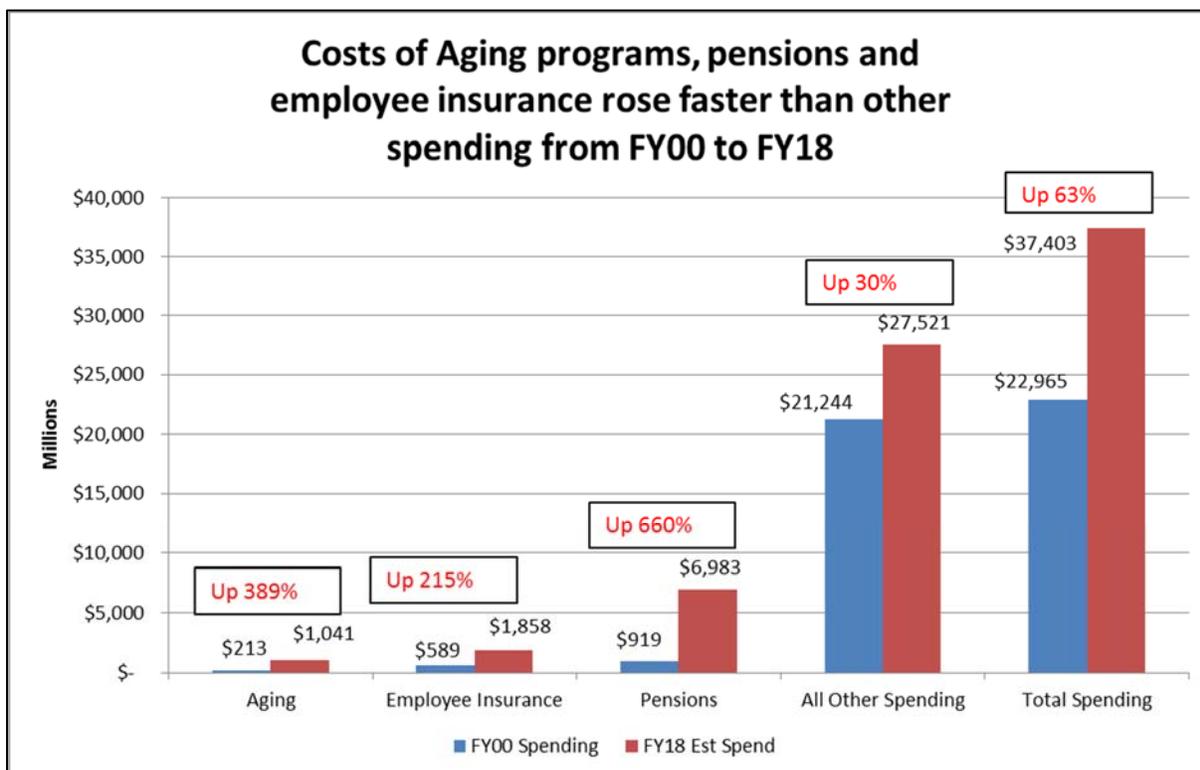
Enhance the Budget Stabilization ('Rainy Day') Fund

Once the bill backlog has been brought under control, Governor Rauner believes action must be taken to achieve and maintain an adequate cash balance in our 'rainy day' fund. The balance in the Budget Stabilization Fund, the state's 'rainy day fund', has been less than \$300 million for many years. Illinois had one of the lowest rainy day fund balances (1 percent of expenditures) of any state in the nation in 2016. By comparison, both Indiana and Minnesota had rainy day fund balances exceeding 9 percent of expenditures in 2016.²⁰

Instead of devoting above-trend growth in revenues to permanent increases in operating spending as we have done in the past, Illinois should responsibly set aside that extra money to pay down bills, and then save for years in which revenues may drop below trend growth levels. A rainy day fund must maintain a sufficient cash balance enabling government to manage during difficult economic times that may adversely impact government operations—particularly the ability to deliver critical government services to vulnerable members of our population. The most likely result of not maintaining a sufficient rainy day cash balance is program cuts, tax hikes or fee increases. The Governor supports the recent bipartisan efforts that would implement these concepts and encourages continued collaboration to enact a true rainy day fund.

Reforms to Reduce Illinois' Highest Cost Drivers

Since fiscal year 2000, Illinois' expenditures for pensions, state employees' group health insurance, and Aging programs have risen significantly faster than all other spending items in the budget. Without meaningful reforms, these high-cost drivers will stay on this trajectory and continue to increase far beyond the growth in inflation and total spending. As mentioned earlier, general funds spending cost control initiatives have been introduced by the Governor as well as proposed by the General Assembly totaling approximately \$2 billion. These initiatives could have closed the fiscal year 2018 deficit and improved the future budget outlook.



Source: Illinois Office of the Comptroller and Governor's Office of Management and Budget

Note: General Funds Spending

Additional Pension Reforms Are Needed

Pension debt is one of Illinois' most pressing fiscal problems. The unfunded liabilities of the state's pension systems continue to increase concurrently with the escalation of the state's pension payment obligations. It is well documented that Illinois' pension systems are among the worst funded in the nation.

In 2016, Illinois had per capita pension debt of \$15,672. This was the highest in the United States, significantly higher than U.S. average per capita pension debt of \$4,024 and the U.S. mean per capita pension debt of \$2,446.²¹

Changes to Illinois' pension laws are needed to reduce budget pressures from our enormous and growing pension burden and ensure long-term viability of Illinois' public pension systems. Without reform, Illinois pension payments will continue to balloon, diverting more and more available resources from other critical government services.

The General Assembly's recent enactment of Tier 3 reforms and some of the funding changes proposed by the Governor are positive developments but additional reforms are needed. The Governor continues to support adoption of the "consideration" model that has received bipartisan support in the General Assembly and passed the Senate this past spring. The cornerstone of the consideration model is the state's ability to offer employees a choice in selecting pension benefits—they may opt to either receive more generous annual cost-of-living increases or to count pay raises in calculating retirement benefits.

Previous efforts to implement major pension changes have been ruled unconstitutional by Illinois courts. Governor Rauner believes the magnitude of the problem warrants continued efforts to find a reform solution that will result in significant savings and pass constitutional muster.

Reducing State Employees' Group Health Insurance Costs

Illinois' state employees' group health insurance program is one of the most expensive programs in the country and the cost is growing at an unsustainable rate. Illinois now offers a "platinum plus" state employee group health insurance plan as defined by the Affordable Care Act. Compared to the average cost for private sector companies in Illinois, Illinois pays \$6,270 more per employee with family coverage each year for healthcare alone. On average, the net cost per employee per year in Illinois is \$19,695 compared to \$13,425 for Illinois private-sector companies and \$12,815 for Midwest private-sector companies.²²

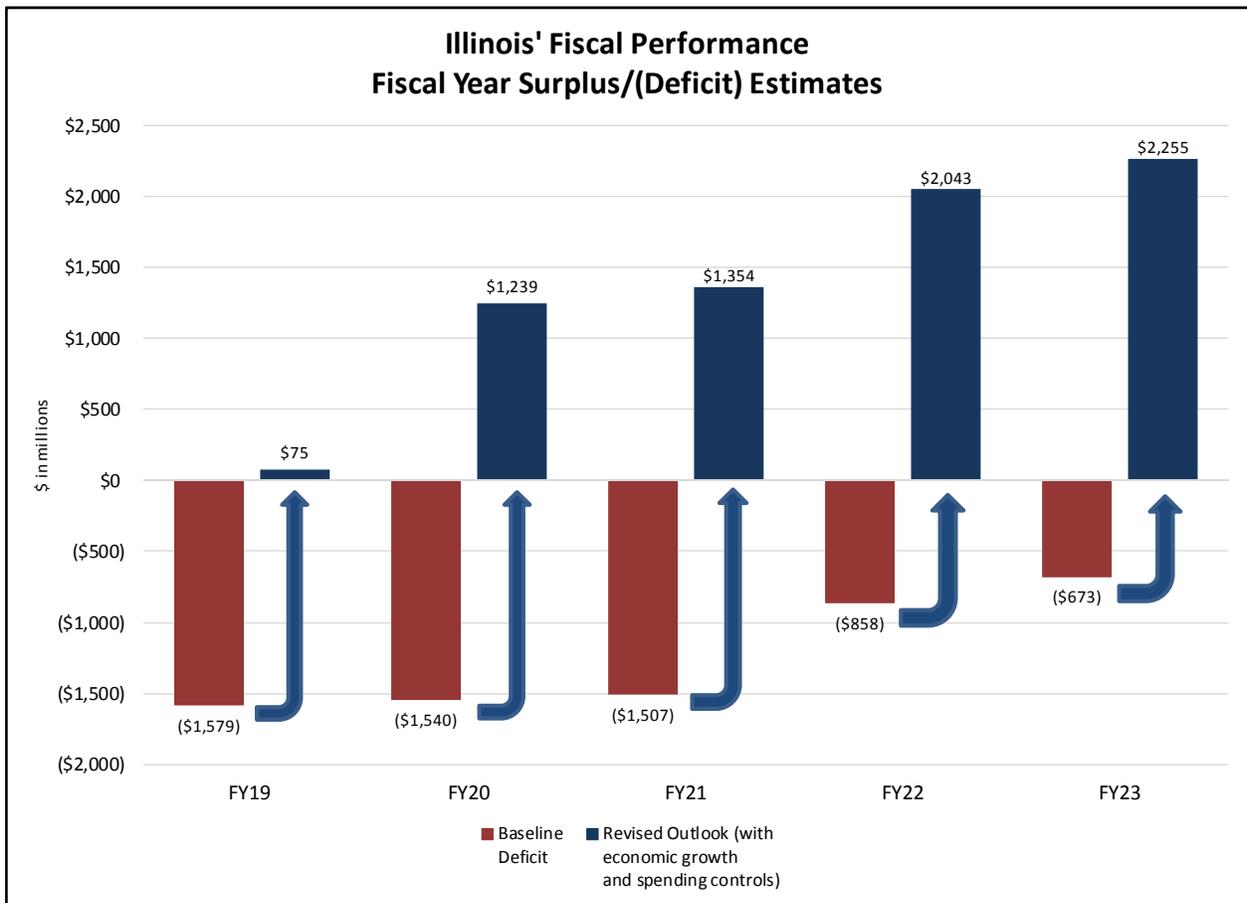
Governor Rauner continues to support changes to the state employees' group health insurance program as the current program is unaffordable. The most critical change would allow Illinois to offer less costly programs-- while ensuring the coverage meets quality parameters defined by the federal Affordable Care Act—resulting in significant cost savings. Additional changes that would reduce costs include establishing a more equitable cost-sharing formula in relation to the benefits to be provided under the plan, particularly with respect to dependent coverage, and development of cost reduction incentives tied to employee participation in wellness programs.

Revised Outlook

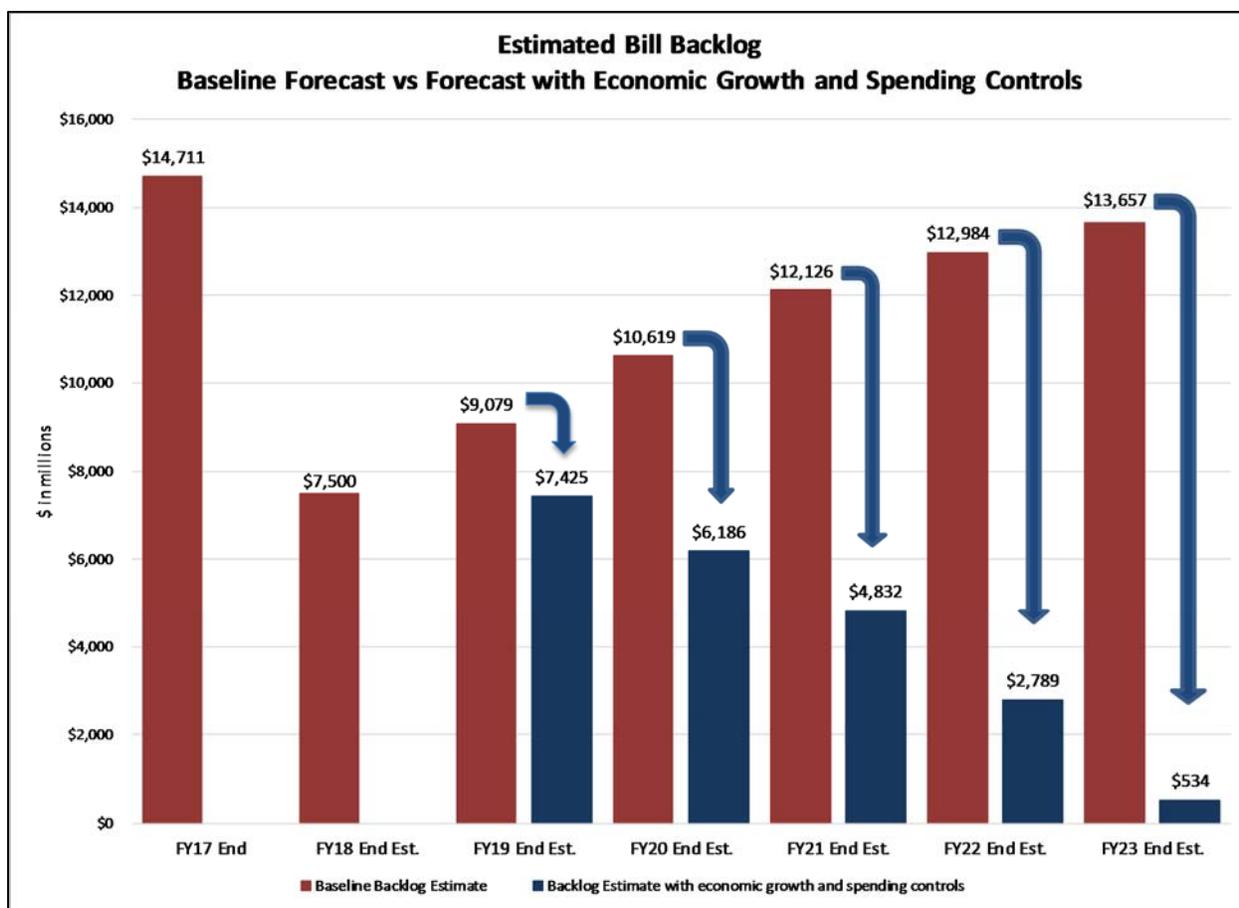
With the policy objectives outlined above, taking the steps to improve the state's economic climate and controlling the costs of government, the outlook for the state's budget can change dramatically from the baseline forecast. The graph and table below show how stronger economic growth and controls to state spending in the areas discussed above can have a significant impact in reducing Illinois' base structural deficit. The table below shows the impact of potential estimates for additional revenue collections that could be realized from stronger economic growth, and potential savings from base spending of \$1,750 million a year. With these changes, Illinois' outlook would move to a surplus for each fiscal year.

Illinois Could Move From Deficit to Surplus with Economic Growth and Spending Controls
(\$ in millions)

	Baseline Deficit	Economy Driven Revenue Growth	Potential Spending Reductions	Revised Outlook (with economic growth and spending controls)
FY19	(\$1,579)	\$904	\$750	\$75
FY20	(\$1,540)	\$1,029	\$1,750	\$1,239
FY21	(\$1,507)	\$1,111	\$1,750	\$1,354
FY22	(\$858)	\$1,151	\$1,750	\$2,043
FY23	(\$673)	\$1,178	\$1,750	\$2,255



If Illinois starts to show surpluses in fiscal year 2019, the state can make meaningful reductions in the backlog of bills, reducing the backlog significantly, and perhaps increasing the balance in the Budget Stabilization fund by the end of fiscal year 2023, the end of this report's fiscal outlook horizon.



In summary, Illinois cannot afford to continue status quo economic and fiscal policies. The state’s fiscal trajectory is unsustainable and the General Assembly and the Governor must take responsible actions to improve our economic conditions so that Illinois can:

- resolve its structural budget imbalance for the long term;
- pay off the bill backlog and prevent a recurrence in the future;
- improve long-term liability funding ratios; and
- ensure adequate funding for core priorities.

Footnotes and References:

¹ For annual economic growth, see: “Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product.” *Bureau of Economic Analysis*. 30 August, 2017.

<https://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1&reqid=9&step=3&isuri=1&904=2015&903=1&906=a&905=2017&910=x&911=0>
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² Leubsdorf, Ben. “U.S. GDP Growth Revised Up to 3% Second Quarter.” *The Wall Street Journal*. 30 August 2017.

³ “Table 2.3.1 Percent Change From Preceding Period in Real Personal Consumption.” *Bureau of Economic Analysis*. 28 September 2017.

⁴ “Labor Force Statistics from the Current Population Survey.” *Bureau of Labor Statistics*. 29 September 2017. <https://data.bls.gov/timeseries/LNS14000000>

⁵ Kusisto, Laura and Josh Mitchell. “Existing-Home Sales Tumble for Third Straight Month.” *The Wall Street Journal*. 20 September 2017. <https://www.wsj.com/articles/u-s-existing-home-sales-fell-in-august-1505916634>

⁶ “Does ageing explain America’s disappointing wage growth?” *Economist*. 24 August 2017. <https://www.economist.com/news/finance-and-economics/21727098-economists-debate-effects-baby-boomer-retirements-does-ageing-explain?zid=293&ah=e50f636873b42369614615ba3c16df4a>

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- ⁷ Morath, Eric. "Fed Says Total U.S. Household Net Worth Rose in Second Quarter." *The Wall Street Journal*. 21 September 2017. <https://www.wsj.com/articles/fed-says-total-u-s-household-net-worth-rose-in-second-quarter-1506011666>
- ⁸ U.S. Census Bureau data summarized by The Nelson A. Rockefeller Institute of Government, State Revenue Report (Table 4), September 2017, No 108. http://www.rockinst.org/pdf/government_finance/state_revenue_report/2017-09-19-srr_108.pdf
- ⁹ "Nonfarm Business Sector: Real Output Per Hour of All Persons." *Federal Reserve Bank of St. Louis Economic Data*. 7 September 2017. <https://fred.stlouisfed.org/series/PRS85006092>
- ¹⁰ Passel, Jeffrey S. and D'Vera Cohn. "Immigration projected to drive growth in U.S. working-age population through at least 2035." *Covering President Trump in a Polarized Media Environment*. 8 March 2017. <http://www.pewresearch.org/fact-tank/2017/03/08/immigration-projected-to-drive-growth-in-u-s-working-age-population-through-at-least-2035/>
- ¹¹ "Figure 1: Population Age 25 and Over by Educational Attainment: 1940-2016." *United States Census Bureau*. 29 March 2017. <https://www.census.gov/library/visualizations/time-series/demo/cps-historical-time-series.html>
- ¹² For analysis on the effect of increasing education on wage growth, see Hershbein, Brad et al. "Increasing education: What it will and will not do." *Brookings Institute*. 31 March 2015. <https://www.brookings.edu/blog/up-front/2015/03/31/increasing-education-what-it-will-and-will-not-do-for-earnings-and-earnings-inequality/>
- For analysis on the effect of slower population growth and productivity on economic growth, see Glassman, Jim. "Will a Shrinking Workforce Curtail Growth?" *JPMorgan*. 11 August 2015. <https://commercial.jporganchase.com/country/US/EN/commercial-banking/executive-connect/shrinking-workforce-growth>
- ¹³ IHS Markit US Forecast, September 2017
- ¹⁴ For U.S. real GDP growth, see "Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product." *Bureau of Economic Analysis*. 28 September 2017. <https://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&904=2012&903=1&906=a&905=2017&910=x&911=0>
- For Illinois real GDP growth, see "Real GDP in chained dollars." *Bureau of Economic Analysis*. 11 May 2017. <https://www.bea.gov/itable/iTable.cfm?ReqID=70&step=1#reqid=70&step=10&isuri=1&7003=900&7035=-1&7004=naics&7005=-1&7006=17000&7036=-1&7001=1900&7002=1&7090=70&7007=2016,2015,2014,2013,2012&7093=percentchange>
- ¹⁵ "Labor Force Statistics from the Current Population Survey." *Bureau of Labor Statistics*. 2 October 2017. <https://data.bls.gov/cgi-bin/surveymost>
- ¹⁶ "Local Area Unemployment Statistics." *Bureau of Labor Statistics*. 2 October 2017. https://data.bls.gov/timeseries/LASST170000000000005?amp%253bdata_tool=XGtable&output_view=data&include_graphs=true
- ¹⁷ "Current Employment Statistics." *Illinois Department of Employment Security*. <http://www.ides.illinois.gov/LMI/Pages/CES.aspx>
- ¹⁸ Commission on Government Forecasting and Accountability's "General Funds – Budget Plan FY 2018" summary of budget assumptions in the Fiscal Year 2018 Budget Summary. <http://cgfa.ilga.gov/Upload/FY2018BudgetSummary.pdf>
- ¹⁹ Moody's Investors Service, Credit Opinions 20 July 2017.
- ²⁰ National Association of State Budget Officers, The Fiscal Survey of States, Spring 2017, Table 29, Rainy Day Fund Balances and Rainy Day Fund Balances as a Percentage of Expenditure.
- ²¹ Moody's Investors Service, 2017.
- ²² CMS State Group Health Insurance Overview.