CIVIC FEDERATION BRIEFING:

FY2005 ILLINOIS STATE BUDGET

July 30, 2004

Earlier this week, the General Assembly approved a final State of Illinois FY2005 operating budget totaling $43.1 billion. The budget now awaits final action by the Governor. The challenge this year was how to eliminate a projected deficit of $2.3 billion. The Governor's proposed $10.1 billion capital budget will not be considered until the legislature's fall veto session.

Over the next few months, most local governments will release their FY2005 budgets. The City of Chicago released its Preliminary Budget Estimates today, the Chicago Public Schools (CPS) budget will be issued in early August and the City Colleges of Chicago budget likely will be released at the end of August. The CPS budget release, which usually occurs in June, was delayed this year because of the late resolution of the Illinois State budget.

CIVIC FEDERATION REVIEW OF THE FINAL STATE BUDGET

Governor Blagojevich originally announced his operating budget on February 18th. Disputes between the Governor and the legislature over the budget led to a stalemate and postponed final consideration until two months longer than the legislature's originally scheduled adjournment date of May 21st. The impasse was the longest in 30 years. In order to finalize the budget deal, legislative leaders required formal memoranda of understanding with the Governor. They also restructured several oversight panels dealing with issues such as state health insurance and contracts to increase legislative leverage in future dealings with the administration.

The budget ultimately approved by the General Assembly is $400 million less than Governor's original proposal of $43.5 billion and approximately $2 billion or 5% more than the FY2004 budget of $41.1 billion. It includes a $389 million increase in funding for elementary and secondary education. The Chicago Public Schools will receive approximately $72.4 million of that amount in new monies.

Civic Federation staff has prepared a review of the major issues as contained in the final version of the State budget. The issues are listed in the text below as well as a table in the attachment that accompanies this memorandum.

Positive Directions: No Broad-Based Tax Increases, Spending Cuts, Rejection of Most Business Tax Changes

Broad Based Tax Increases: The budget contains **no income or sales tax increases**. The Civic Federation believes that any broad-based tax increases at this time could seriously jeopardize efforts to attract and maintain businesses and jobs in Illinois.

Spending Reductions: The final budget includes **spending cuts of approximately $1.3 billion**. Reductions of 4% across the board were made in non-education, non-healthcare programs to realize these savings. The Civic Federation had proposed that cuts of as much as $1.2 billion be enacted. *No major service disruptions are expected even with the deeper spending cuts.*

Headcount Reductions: The Governor proposes to continue to reduce **the number of State employees**. A non-pension severance plan for employees will be offered on a first-come, first-served basis. It will be limited to 3,000 employees and is expected to save $81 million. This is projected to reduce the number of State employees to 60,000, the lowest level since 1972.

Business Tax Changes: A total of $400 million in new revenues were proposed by the Governor in the FY2005 budget from 12 changes in business sales and income taxes. While they were presented in the budget as mere "loophole closings," many of the proposals appeared to represent fundamental changes in the State's corporate sales and income tax structure. The Civic Federation believed that these changes would require much more public disclosure to measure their economic impact and the validity of their assumed revenue benefits. We were particularly concerned about three of the more complex proposals: Using Straight Line Instead of Accelerated Depreciation, Extending the Sales Tax to Licensed Software, and Applying a Destination Apportionment Rule to Service Companies.

The legislature approved four of the proposed **changes in business tax treatments** representing approximately $150 million in tax increases.[1] The changes are contained in Senate Bill 2207, Amendment Number 1. In addition, the Illinois Department of Revenue has sent a letter to the General Assembly agreeing not to extend the sales tax to licensed software through 2005 by administrative rule (the Governor's original budget had proposed extending the sales tax to licensed software).

> **1) Expanding the Definition of Business Income**. This legislation expands the definition of business income to include all income considered apportionable business income under the U.S. Constitution, net of allocable deductions. Taxpayers recognizing nonbusiness income from the disposition of business assets will be required to recapture as business income all expenses deducted in the year of the nonbusiness treatment and the two preceding tax years. The original proposal required recapture of those expenses deducted in prior years without limitation. This proposal is estimated to raise $29 million annually.
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> **2) Requiring compliance with federal tax shelter enforcement.** This legislation mandates that taxpayers disclose federally listed and reportable transactions on state tax returns annually. Tax shelter promoters would be required to register and keep lists of investors in these types of tax shelters. Penalties would be increased for promoters and investors in abusive tax shelters. The legislation also includes an amnesty or voluntary compliance provision which would allow taxpayers to come forward and pay taxes and interest due resulting from tax avoidance transactions. The amnesty program will be

[1] Information on business tax changes was derived from Garland Allen and Michael Lovett, "Fiscal 2005 Illinois Budget Would Raise Some Taxes, Reduce Others," State Tax Notes, July 29, 2004. For more detailed information on these tax changes, please see this report.

offered between October 15, 2004 and January 31, 2005 and is projected to raise $100 million in FY2005.

3) 80/20 Income Tax Changes. Legislation was passed that amends the Illinois Income Tax Act to require that taxpayers add back to their federal taxable income interest or intangible expenses provided to foreign persons who would be included as part of the same unitary business group except for the fact that 80% or more of their total business activity was conducted outside the U.S. The legislation drops the original proposal to extend the definition of the United States to include territories and possessions such as Puerto Rico. This proposal is projected to raise $15 million.

4) Watercraft Use Tax. This proposal eliminates the sales tax exemption for the acquisition of luxury watercraft by gift, transfer, prize or non-retail purchase. This proposal is expected to generate $6 million annually.

Employee Pension Contributions: The State's **pick-up of union employee pension contributions** will be eliminated, for a projected savings of $60 million. The employees will pick up the pension contribution costs in two phases, in 2005 and 2006. The Civic Federation supported this measure last year and again this year.

Agency Consolidation: The legislature approved the Governor's plans to **merge various agencies and functions** for a projected savings of $125 million. The Civic Federation supports efforts to improve efficiency by streamlining and reorganizing State government.

<u>Disappointments:</u>

Failure to Fully Fund State Pension Systems: *The Governor originally proposed reducing pension funding by $527 million from the $1.95 billion amount originally certified by the state retirement systems to approximately $1.4 billion.* The reason for the reduction was twofold: 1) The State proposed to budget only $70 million for the annual cost of the FY2002 Early Retirement Initiative even though revised estimates of the ERI's cost had increased to $380 million and 2) The State allocated $215 million in "savings" to the retirement systems accrued from the favorable interest rate on the bonds and the actuarially determined 8.5% rate of return on major fund assets. The Governor correspondingly proposed to reduce the State's appropriation to the retirement funds by that $215 million amount.

The General Assembly decided to appropriate only $1.64 billion of the $1.95 billion amount certified by the state pension systems. Payments for the $310 million in FY2002 Early Retirement Initiative will be stretched out over a 41-year period. The $215 million in "savings" from investment returns were allocated to the pension funds in the budget.

*The Civic Federation **<u>strongly opposed</u>** the State's reduction of its certified funding contribution to the historically underfunded pension funds.* We were disappointed that the Governor's budget reduced pension contributions by $527 million. The General Assembly's position moves appropriately to allocate "savings" from investment returns to reducing state pension liabilities. However, it still falls short by failing to fund the pension funds at the certified level.

Civic Federation support for the $10 billion pension obligation bond issue in 2003 was contingent upon the State moving to correct its under funding problem. This appropriation reduction, while reducing the operating budget deficit in the short-term, does not deal with the State's longer-term problem of the historic underfunding of the State's pension funds. Instead, it repeats the pattern that created the State pension crisis.

We **oppose** stretching out payments for the 2002 Early Retirement Initiative over a 40-year period. This is nothing but a return to traditional policies of deferring obligations.

Structural Reforms: The Legislature did not consider the Governor's **structural reforms**: 1) to pay vendors within 60 days; 2) to require the legislature to identify spending cuts or revenues for budget changes they propose, and 3) increase the size of the State's Rainy Day Fund. *The Civic Federation strongly supported these common-sense measures.*

FOR ADDITIONAL INFORMATION, PLEASE CONTACT THE CIVIC FEDERATION STAFF AT 312-201-9066 OR VISIT OUR WEB SITE AT WWW.CIVICFED.ORG.

STATUS OF MAJOR FY2005 STATE BUDGET ISSUES

Governor's Original Budget	Civic Federation Position	Final Budget Approved by Legislature
No increase in sales or income tax	No increase in sales or income tax	No increase in sales or income tax
$400 million in new funding for education	Supported idea of fulfilling State's primary responsibility to fund education but cautioned that deficit might require scaleback of proposal	*A $389 million increase for schools* $230 million for General State Aid, which will increase per pupil spending by $154 to $4,964 $30 million more for early childhood education $95 million more for mandated programs such as special education $12 million more for Average Daily Attendance grants $10 million more for transition assistance $2 million more for Bilingual Education
Spending Cuts: Total agency budget reductions of $860 million	Proposed a total of $1.189 billion in cuts; included $690 million in cuts that would be necessary to fund pension contributions at certified level	Total agency budget reductions of $1.3 billion (4% cuts in non-targeted areas)
Pensions: Reduction of $527 million from $1.95 billion amount certified by pension systems	Strong opposition. State should fulfill its pension funding commitments.	Funded Pension Funds at $1.64 billion; opted not to fund $310 million in FY2002 Early Retirement Initiative costs from the State Employees Retirement Fund. Did allocate $215 million in "savings" from investment returns.
Business Taxes: Proposed raising $400 million in new revenues from significant changes in business sales and income tax treatments	Concerned about lack of information, possible economic impact. Urged GA not to approve 3 of the more complex tax changes: using straight line instead of accelerated accelerated depreciation, extending the sales tax to licensed software & applying a destination apportionment rule to service companies	Business Tax Changes Approved: 1) Expanding the Definition of Business Income ($29 m. in revenue projected) 2) Compliance with federal tax shelter enforcement ($100 m. projected) 3) 80/20 Income Tax Changes ($15 m. projected) 4) Luxury Watercraft Use Tax ($6 million projected)
Close St. Charles & Vandalia Prisons	No Position	Prisons to remain open; Facilities closing commission formed to deal with prison overcapacity issue
Agency and Functional Consolidations, Mergers and Reorganizations	Support	Yes
Fiscal Reform Proposals: 1) Balanced Budget Act 2) Responsible Spending Act 3) On-Time Bill Payment Act	Support	No; legislature did not consider
Elimination of pension "pick-up" for union employees. Projected to save $60 million.	Support	Yes; included in union contract