

EXECUTIVE SUMMARY

The Civic Federation **CANNOT support** the Chicago Public Schools' (CPS) proposed \$6.8 billion budget for FY2015 because it represents a short-term, short-sighted plan in the midst of a grave and ongoing fiscal crisis. Furthermore, the budget is only balanced by an accounting gimmick. In light of declining enrollment and reduced federal and state funding, the District could have chosen to hold its budget flat, increasing only non-discretionary spending, while it worked to create further cost savings and identify potential recurring funding streams for new programming. Instead, the District has chosen to grow an already massive cost structure by increasing spending on new programs and new schools, while simultaneously cutting existing programs and existing school budgets. By appropriating most of the District's reserves to close the FY2015 budget deficit and by increasing the District's real estate and programming footprint – and not providing equivalent savings or increased revenues to offset all these new costs – CPS is fiscally overcommitting itself. Because of what will be a near complete drawdown of the unrestricted fund balance by the close of the fiscal year, the FY2015 budget also provides no protection for next year's budget. The FY2015 budget exposes all budget items to the risk of even more dramatic and painful cuts in FY2016 when it is increasingly likely that CPS will not find enough revenue to sustain its current levels of spending.

The Civic Federation is **seriously concerned** about the worsening current and long-term fiscal health of CPS. The FY2015 budget only heightens our concern. The CPS FY2015 Proposed Budget – like the FY2009, FY2010, FY2013 and FY2014 budgets – closes a titanic \$876.3 million budget deficit with a near complete drawdown of its unrestricted reserves, funds generated chiefly from a change in the CPS revenue recognition period. Additionally, because the District is using one-time revenue in the form of reserves to pay for ongoing expenditures, CPS will start FY2016 with a budget deficit the size of the reserves appropriated in FY2015.

The Civic Federation offers the following **key findings** on the FY2015 Proposed Budget:

- FY2015 Proposed Budget increases spending by \$444.1 million, or 8.4%, from FY2014 year-end estimates and \$164 million, or 2.9%, from the approved FY2014 budget;
- FY2015 proposed revenues are essentially flat, with a \$2.7 million decrease over FY2014 year-end estimates; and
- CPS closes a projected \$876.3 million projected deficit only through an accounting gimmick.

The Civic Federation has **major concerns** about the CPS FY2015 Proposed Budget:

- Increased spending on new schools and new programs adds to worsening structural deficit;
- Continued inaction on the pension funding crisis and lack of acknowledgement that pension reform is necessary but not sufficient to right the District's fiscal health; and
- Scarcity of appropriation and deficit details continue an ongoing lack of transparency that threatens public trust in the District's ability to be an efficient steward of taxpayer funds.

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

- Ground FY2016 budget in a long-term financial plan;
- Consolidate the Chicago Teachers' Pension Fund with the State Teachers' Retirement System;
- Provide a more transparent single budget document, including a more explicit accounting of where dollars are spent;
- Provide an explanation of how TIF monies can and cannot be used by the District;
- Require Chicago Board of Education participation at public hearings;
- Provide sufficient data on the drivers of the budget deficit; and
- Require consistent financial reporting for charter schools.

CIVIC FEDERATION POSITION

The Civic Federation **CANNOT support** the Chicago Public Schools' (CPS) proposed \$6.8 billion budget for FY2015 because it represents a short-term, short-sighted plan in the midst of a grave and ongoing fiscal crisis. CPS is delaying the inevitable by not addressing this devastating financial reality and the FY2015 budget continues the District's practice of myopic budgeting, with no contingency planning. The budget is balanced only by an accounting gimmick that allows CPS to book more than twelve months of revenue into a single fiscal year. In light of declining enrollment and reduced federal and state funding, the District could have chosen to hold its budget flat, increasing only non-discretionary spending for pensions and contractual obligations, while it worked to create further cost savings and identify potential recurring funding streams for new programming. Instead, the District has chosen to grow an already massive cost structure by increasing discretionary spending on new programs and new schools, while simultaneously cutting existing programs and existing school budgets. By appropriating nearly all of the District's reserves to close the FY2015 budget deficit and by increasing the District's real estate and programming footprint – and not providing equivalent savings or increased recurring revenues to offset all these new costs – CPS is fiscally overcommitting itself. Because of what will be a near complete drawdown of the unrestricted fund balance by the close of the fiscal year, the FY2015 budget also ensures that there will be no protection for next year's budget. All budget items, including schools, will be exposed to the risk of even more dramatic and painful cuts in FY2016 when it is increasingly likely that CPS will not find enough revenue to sustain its current levels of spending.

The Civic Federation is **seriously concerned** about the worsening current and long-term fiscal health of CPS. The FY2015 proposed budget only heightens our concern. The CPS FY2015 Proposed Budget – like the FY2009, FY2010, FY2013, and FY2014 budgets before it – closes a titanic \$876.3 million budget deficit with an almost complete drawdown of its unrestricted reserves, funds generated predominately from a change in the CPS revenue recognition period. The District narrowly avoided complete exhaustion of its unrestricted reserve funds in FY2013 and FY2014. Absent exceedingly large (and unlikely) cost savings over the course of FY2015, it is difficult to see how CPS will again avoid the scheduled near decimation of its unrestricted reserves by the start of FY2016. Additionally, because the District is using one-time revenue in the form of reserves to pay for ongoing expenditures, CPS will start FY2016 with a budget deficit the size of the reserves appropriated in FY2015.

It is important to acknowledge that CPS faces enormous challenges and that some of the factors contributing its fiscal challenges are beyond the District's control, most markedly declining state and federal funding. CPS has only three sources of revenue – federal, state and local – and it only has limited power over the latter due to property tax caps. That said it is equally important to recognize that CPS has played a very real and active role in the decline of its own fiscal health. CPS has made fiscally short-sighted choices in its annual budgets. These include (1) choosing not to make annual contributions to the Chicago Teachers' Pension Fund for nearly ten years and taking a three-year partial pension holiday just after the fund suffered a significant loss of assets in FY2009; (2) choosing not to address the District's monumental structural deficit by developing a long-term, actionable financial plan; (3) choosing to continue to adopt unsustainable fiscal practices like using one-time revenues to pay for ongoing expenditures; and (4) choosing to increase spending to create new programs and open new schools at a time when

it is clear the District does not have the fiscal resources to pay for its existing programs and schools.

In order to understand the District's current financial crisis, it is important to be aware of the overall context of the situation. The key events and factors that have resulted in the ongoing structural deficit faced by CPS are described below.

Short-Sighted Decisions with Long-Term Consequences

CPS has laid the blame for the District's budgetary crisis at the feet of the State of Illinois, citing lack of reforms of the Chicago Teachers' Pension Fund and inadequate funding through General State Aid. There is no doubt that the State had a very significant role in creating the fiscal crisis faced by the District, both through failing over many years to appropriate enough in education funding to fund at the full foundation level and by passing legislation that allowed CPS to skip or short pension payments. However, the District bears the ultimate responsibility for its own fiscal crisis because it has a duty to plan for the long-term impacts of the budget decisions it makes annually. Partial pension contribution holidays provided temporary budget relief for CPS but did nothing to address the growing pension problem. On the contrary, skipping the payments only deepened the very serious pension situation by depriving the pension fund of badly needed contributions for three years. While partial pension holidays successfully delayed many difficult choices for a few years, depriving the pension fund of these payments greatly added to the unfunded liability, increased future payments and exacerbated the pension crisis CPS faces in FY2015 and beyond.

Furthermore, up until the District decided that it wanted to piggy-back on the State Teachers' Retirement System reforms passed by the Illinois General Assembly, CPS had not come forth with any idea or plan of its own to address its own fund's massive and growing unfunded liabilities. Both the City of Chicago and Cook County took the initiative to bring together their pension stakeholders to develop pension reform proposals that were presented to the Illinois legislature. CPS, at least publicly, has taken no steps toward actually achieving pension reform and instead places this responsibility on the State. Taking the lead from the City of Chicago and Cook County, it is imperative that CPS aggressively seek legislation to reform and re-establish its retirement system in a manner that is more sustainable in the long-term for both retirees and taxpayers.

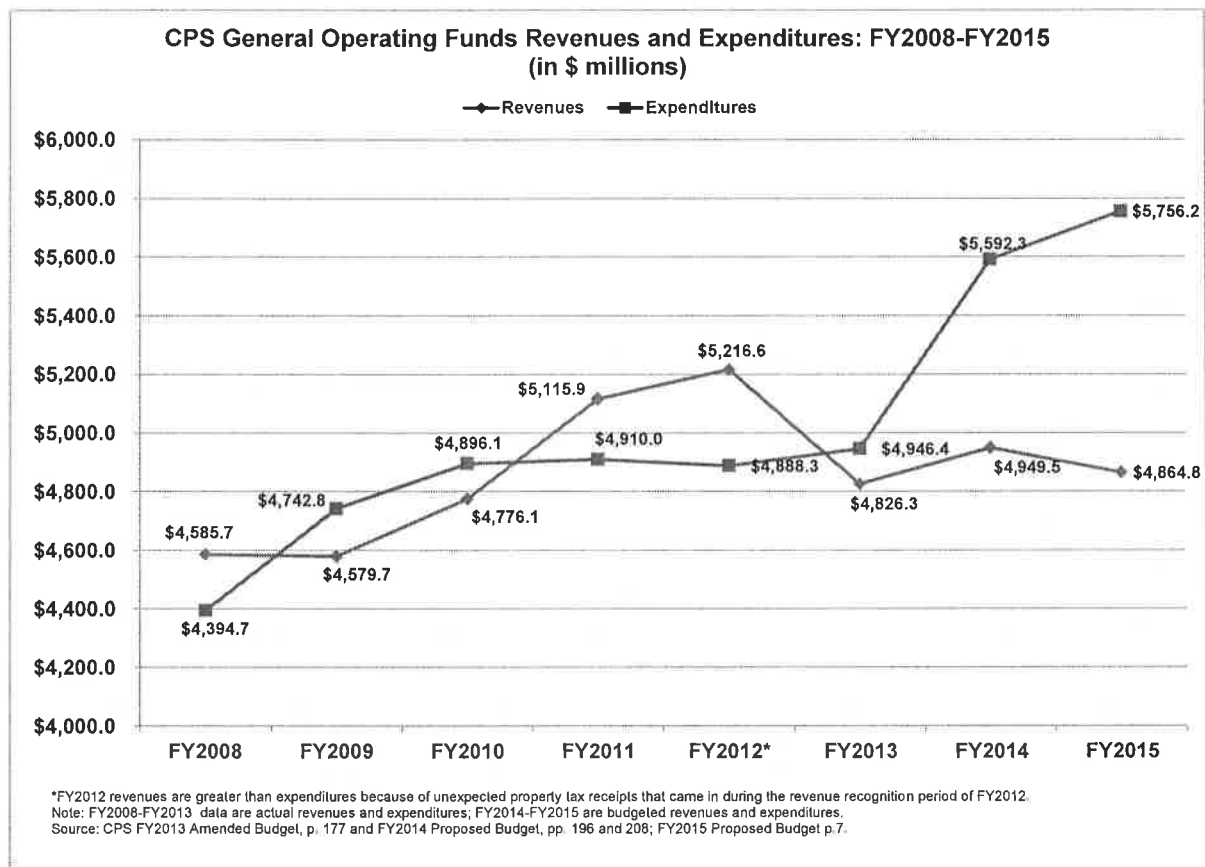
While pension reform is necessary for the District to right its current financial predicament, pension reform alone will not be sufficient to achieve fiscal sustainability. CPS estimates \$250 million in first year savings would be achieved by applying the reform measures that were passed by the Illinois legislature in December 2013 for the Teachers' Retirement System (TRS) to the Chicago Teachers' Pension Fund.¹ Saving a quarter of a billion dollars would clearly greatly improve the CPS budget situation. However, the CPS budget deficit is over three times the size of the savings that could be had from a pension reform package similar to that enacted for TRS. This means that while pension reform is a necessary component of a comprehensive

¹ David Vitale and Barbara Byrd-Bennett, "Op-Ed: CPS wants pension reform in Springfield this year", *Chicago Tribune*, March 7, 2014.

multi-year plan to begin to right-size the District’s enormous cost structure, it is not sufficient on its own. Other cost-savings, spending reductions and revenue enhancements will all be necessary to fully tackle the \$1 billion and growing projected deficits for FY2016 and beyond.

Worsening Structural Deficit

Since at least FY2009, CPS has failed to consistently match recurring expenditures to recurring revenues. This mismatch has resulted in a growing gap between the spending the District engages in and the revenues it collects. This gap can be seen in the graph below, which maps operating revenues against expenditures for FY2008-FY2015.



In order to better understand the development of the District’s structural deficit, it is important to detail the **revenue streams and economic occurrences** over which CPS exercises little-to-no control and the **key events** in the District’s financial decision-making, over which it exercises maximum control.

Revenue Streams and Economic Occurrences

CPS has three revenue sources: local, state and federal. Most local revenue comes from property tax receipts. The majority of state and federal revenue comes in the form of grants, which are

based upon a number of factors including enrollment numbers and the percentage of the District's students qualified as low-income.

Federal Revenue

The District's federal revenue has declined for three reasons. First, CPS has seen enrollment decline over the last several years and some federal funding is tied to student enrollment. Secondly, the District's funding for low-income students has declined because the number of students in poverty nationwide has increased. Lastly, the scheduled decline of federal funding is related to the ratcheting down of American Recovery and Reinvestment Act (ARRA), or federal stimulus, funding.

State Revenue

Reduction in State Pension Contributions

The State of Illinois has reduced its "employer contribution" to the Chicago Teachers' Pension Fund in recent years. The State had traditionally contributed roughly \$65 million² each year to the Teachers' Pension Fund despite 40 ILCS 5/17-127, which declares the General Assembly's "goal and intention" to contribute an amount equivalent to 20% or 30% of the contribution it makes to the downstate Teachers' Retirement System. The State employer contribution then decreased from \$65 million in FY2009 to \$32.5 million in FY2010. In FY2011 the State appropriated \$32.5 million for the Teachers' Fund, but designated it specifically for retiree healthcare costs paid out of the fund. There was no State "employer contribution" in FY2012-FY2014.³ In FY2015, the State appropriated an additional \$50 million to the Chicago Teachers' Pension Fund, approximately 6% of the State's "goal and intention."

Stagnant Level of General State Aid

Public Act 90-548 created the Illinois Education Funding Advisory Board (EFAB) in 1997. As stated in 105 ILCS 5/18-8.05(M), the statutory charge of the EFAB is to "make recommendations [to the General Assembly] for the foundation level...and supplemental general State aid grant level." The majority of the State revenue received by CPS comes from the General State Aid (GSA) grant program. GSA is composed of two parts: a per-pupil formula grant and a supplemental GSA grant. The per-pupil formula grant is based upon the foundation level, whereas the supplemental grant (formerly referred to as the poverty grant) provides additional funding based on a district's percentage of low-income students. The GSA distribution to school districts is based on a number of factors, including local property tax capacity. The formula assumes that school districts will levy for all available local property taxes first before the State provides additional funding to reach the foundation level. Even though the EFAB has made recommendations to increase the statutory funding level, the foundation level has remained at \$6,119 per student since FY2010. Furthermore, the statewide appropriation has been insufficient since FY2012 to pay for the full foundation level, resulting in a prorated amount of the funding: in FY2015, State grants will be made at 90% of the foundation level.

² A contribution of \$65 million has not represented 20% of TRS funding since 1996.

³ In FY2012-FY2014 the State made only the nominal statutorily required contribution related to a benefit enhancement granted in the 1990s.

Local Revenue

Property Tax

As the District only has three sources of income, the downward trend related to state and federal revenue has put increased pressure on local revenue. That said, because of the Property Tax Extension Limitation Law, also known as tax caps, CPS can only levy for increases based on a measure of the Consumer Price Index (CPI). However, the tax cap also allows the tax rate calculated on the value of existing property to be applied to new property and expiring TIF increment, generating additional revenue. As a result of the District's limited revenue options, CPS has increased its property tax levy to the maximum amount allowed under the State tax cap law and has levied to capture the growth from all new property in FY2015 as well as for expiring TIF increment. However, even maximizing the amount of local revenue available will only generate approximately \$40 million, which does not begin to address the projected \$876.3 million FY2015 deficit.

Tax Increment Financing (TIF)

It is a common misconception that TIF diverts property tax revenues from CPS. It is therefore important to briefly address the effects of TIF, what TIF monies are available to CPS and how those monies can be used.⁴

PTELL took effect in 1994, limiting the maximum growth in the CPS levy. Prior to 1994, the District's tax extension (the total amount of property tax revenue that a unit of local government is authorized to receive) was limited by a maximum rate for each property tax fund. The fund rate limits still exist, but the tax cap law, not rate limits, has been the operative limit on CPS tax increases since 1994. The limiting effect of the tax cap has also meant that since 1994, tax increment financing has not diverted property tax revenue from CPS. CPS receives the full extension to which it is entitled by the tax cap law. The effect of TIF is to raise tax rates for all property taxpayers, not to divert revenue from local governments.

CPS can capture revenue from expiring TIF districts in two ways: (1) by levying for expiring TIF increment and (2) by receiving their proportionate share of the distribution of any remaining revenue in the TIF district when it is dissolved. Levying for expiring TIF increment generates extra revenue without increasing taxpayer burden. The year after a TIF district expires or is dissolved, a government that overlaps the TIF district is allowed to apply its tax rate⁵ to the increment EAV in order to generate additional revenue for the government that would have previously gone to the TIF district. This increases the amount of money the government is able to access through its aggregate extension without increasing the taxes paid by taxpayers because the taxpayer previously paid the revenue to the TIF district and now pays it to the overlapping government instead.

⁴ For a more in-depth discussion on the effects of TIF, refer to the Civic Federation's updated property tax primer, *The Cook County Property Tax Extension Process: a Primer on Levies, Tax Caps, Tax Bills and the Effects of Tax Increment Financing Districts*, available at www.civicfed.org

⁵ Calculated without including the increment equalized assessed value (EAV) in the tax base EAV, making the tax rate higher.

When TIF districts are allowed to expire, any remaining revenue in the TIF districts' accounts is distributed to all overlapping governments based on their portion of the overall tax bill. This is a one-time distribution, not an ongoing source of revenue.

Chicago Teachers' Pension Fund Investment Losses

When rates of return are positive and meet the fund's expected rate of return, investment income usually represents the majority of a pension fund's total income. This is true for a mature pension plan that has been in existence for a while. Employee and employer contribution amounts are relatively stable from year to year, but investment income can fluctuate widely. Multi-year investment gains or losses that deviate substantially from the assumed rate of return have a major impact on fund assets.

The strong investment market of the late 1990s produced several years of significant gains for pension funds. Likewise, the market decline of 2000-2002 created significant losses for the funds and the steep decline in equity markets beginning in 2008 resulted in negative returns for the Chicago Teachers' Pension Fund. Poor investment returns in FY2008 and FY2009 and later FY2012 reduced the funding level of the fund and increased the unfunded liability which the District must amortize with its annual contributions to reach 90% funded by the end of 2059. To put it in context, approximately \$400 million of the District's current pension payment goes to paying down the fund's unfunded liability.

Key Events in CPS Fiscal Management

State-Sanctioned Pension Payment Holidays

The State of Illinois has played a real and active role in the fiscal crisis faced by CPS. The State passed two separate laws: one that allowed CPS to skip payments for a time and another that reduced the statutorily required payments for another spate of time. In 1995 the State enacted PA 89-15, which allowed the District to forgo pension payments as long as the pension fund was 90% funded or better. For almost ten years, from FY1995 to FY2005, CPS made no payments into its pension fund. Failure to pay the normal cost,⁶ even when pension fund was well funded contributed to a dramatic decline in funded ratio. While PA 89-15 gave CPS the option to forgo pension payments, it did not require the District to do so. Furthermore, the legislation did not prevent the District from developing a long-term plan with contingencies that might have helped to mitigate fund asset losses.

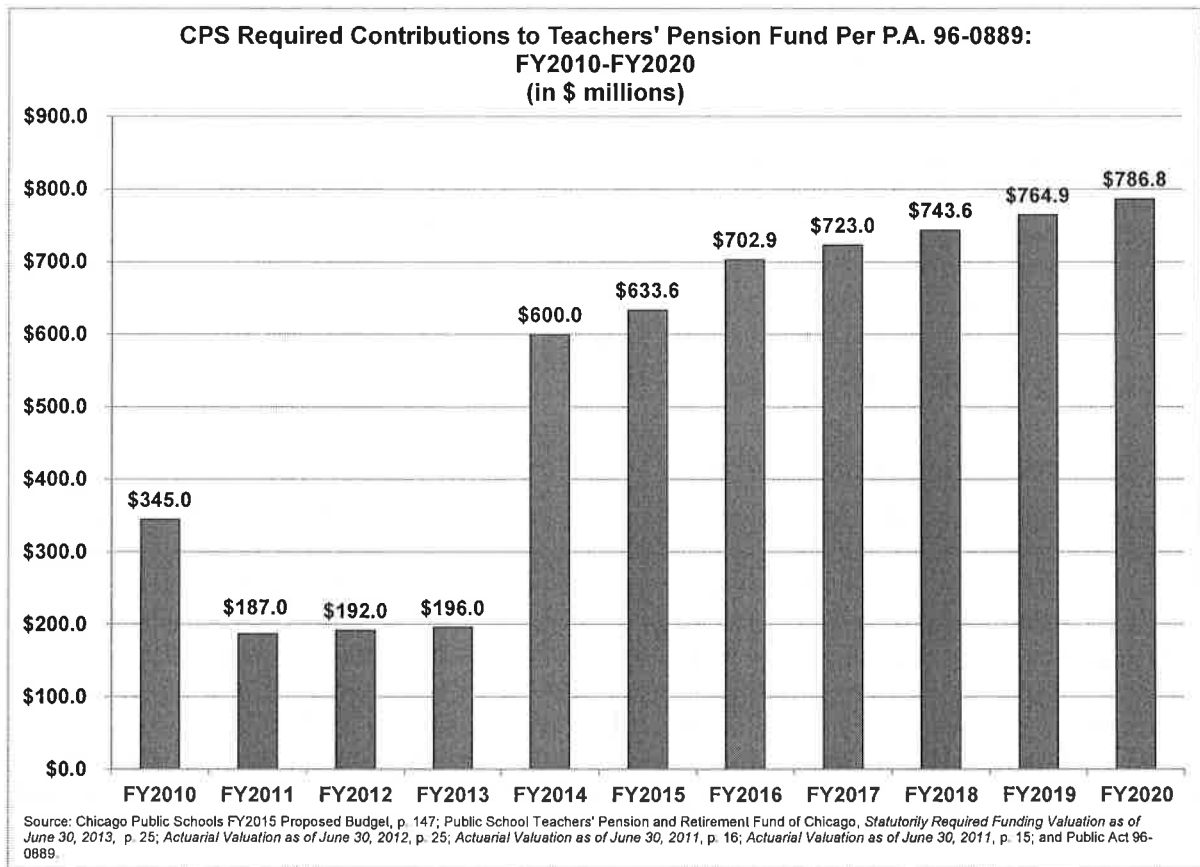
Partial Pension Contribution Holiday

In April 2010, at the urging of prior CPS officials, Illinois enacted a three-year reduction in statutory pension contributions for CPS in Public Act 96-0889. The law also created a different level of pension benefits for new employees. The partial pension contribution holiday reduced the CPS required employer pension contributions for FY2011, FY2012 and FY2013 to an amount estimated to be equivalent to the normal cost, which only added to growing unfunded

⁶ Normal cost is the portion of the cost of projected pension benefits allocated to the current plan year.

liability. The law also delayed the year that the pension fund must reach a 90% funded ratio from 2045 to the end of 2059.

Prior to the passage of P.A. 96-0889, the FY2011 CPS required pension contribution was calculated to be \$586.9 million, or almost double the FY2010 amount. The partial pension holiday provided substantial budgetary relief by reducing the District's required FY2011 contribution to \$187.0 million, which was \$158.0 million, or 45.8%, less than the prior year contribution. The partial pension contribution holiday expired in FY2014 and the District's pension payment increased by \$404.0 million, or 206.1%, from \$196.0 million in FY2013 to \$600.0 million. The CPS pension payments will continue to rise in future years, reaching \$786.8 million in FY2020.



Increasing Spending without Securing New or Increasing Ongoing Revenue Streams

In early 2013 CPS announced that starting in the fall of 2013, full-day kindergarten would be available district-wide to all 30,400 kindergarten-age children.⁷ This enhanced program, because of greater staffing needs, cost the District \$15 million more in FY2014 than in FY2013. In FY2014 the District funded the increase in spending by cutting costs in central office spending,

⁷ CPS FY2014 Approved Budget, p. 2.

reducing overtime for some non-teaching positions, and renegotiating heat and electrical contracts.⁸ Full-day kindergarten, as an ongoing program, now represents an ongoing expenditure that does not have a new or enhanced ongoing revenue stream tied to it. In addition, in FY2015 the District is planning to hire 84 art teachers and 84 physical education teachers. This new program is being mostly funded through TIF surplus, which by definition is a one-time revenue source. Thus, the new art and PE teachers are now proposed to be an ongoing expenditure without a matching ongoing revenue source. It is important to note that the Civic Federation is not critiquing programs or policy objectives, but rather the District's ongoing practice of increasing its cost structure without finding matching recurring revenues to support the increased costs over the long term. Additionally, in its FY2015 budget, CPS includes over \$400 million in increased spending from FY2014 year-end estimates, most of which cannot be tied to specific programs or schools because of a dearth of appropriation data in the budget book. As this increased spending is tied to a decline in revenues, rather than an increase, it too represents the District's decision to increase its programming and real estate footprint without finding dedicated revenue streams to support these increases. While new programs that carry out the District's policy objectives are no doubt worthwhile, failing to match ongoing expenditures with ongoing revenues worsens the District's already grave structural deficit and prohibits a stable provision of funding year-to-year to existing schools and programs. Absent an increase in the size of the CPS revenue pie, the budgets for existing programs and schools have to be cut to free up funding for new programs and schools. Once the District exhausts its store of budget gimmicks, all programs and schools will at-risk of termination because of the District's inability to continue to finance them.

⁸ Becky Vevea. "Mayor expands full-day kindergarten to all Chicago Public Schools." *WBEZ Chicago*. February 25, 2013. <http://www.wbez.org/news/mayor-expands-full-day-kindergarten-all-chicago-public-schools-105748> (last visited July 18, 2014).