Part 1: The Financial Framework
I. Implement Long-Term Financial Planning and Increase Fiscal Transparency

The first elements of the Financial Framework are implementing long-term financial planning and increasing fiscal transparency. As in 2017, the Tax Policy Task Force calls for the State to adopt measures that would align its financial planning policies with the best practices of other states.

The State continues to employ irresponsible budget practices and has not made significant progress on making its finances more transparent. The State should also make State finances more transparent so that important financial information is easy to find and understand for all interested parties.

Best Practices of Other States

A useful starting point for identifying the best practices that other states employ is the Volcker Alliance’s *Truth and Integrity in State Budgeting* report (issued in 2017). The report evaluates states’ budgeting and transparency practices and focuses on five key elements:

- **Budget Forecasting**;
- **Budget Maneuvers**;
- **Legacy Costs**;
- **Reserve Funds**; and
- **Transparency**.

States are assigned a letter grade (A to D-) based on the scores they receive on subcategory questions (e.g., for budget forecasting, a subcategory question is “Does the state utilize a consensus revenue estimate for the forthcoming fiscal year or biennium in budget and planning documents?”). Illinois’ grades were generally poor, indicating that the State does not typically follow budget and transparency best practices.

### ILLINOIS GRADES

<table>
<thead>
<tr>
<th>Category</th>
<th>Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget Forecasting</td>
<td>D-</td>
</tr>
<tr>
<td>Budget Maneuvers</td>
<td>D-</td>
</tr>
<tr>
<td>Legacy Costs</td>
<td>D-</td>
</tr>
<tr>
<td>Reserve Funds</td>
<td>C</td>
</tr>
<tr>
<td>Transparency</td>
<td>B</td>
</tr>
</tbody>
</table>

**Best Practices: Budget Forecasting**

Many of the budgeting procedures identified as best practices by the Volcker Alliance focus on ensuring that budgets paint an accurate picture of a state’s finances and do so well into the future so that states can plan in advance for changes in revenues and expenditures that will have a major impact on state finances. States are evaluated on whether or not they utilize consensus revenue estimates, if they provide reasonable (and detailed) rationales for their revenue projections, if their budget and planning documents use multi-year revenue and expenditure forecasts, and whether or not the state had to make a material mid-year budget adjustment. Illinois performs poorly in the budget forecasting category and received a D-. 
Florida performed well on the budget forecasting category because it uses consensus revenue forecasting and makes multi-year projections. Florida uses a six-year revenue forecast that is the product of the Revenue Estimating Conference, which includes representatives of the Governor, Senate, House, and the Office of Economic and Demographic Research. This office provides six-year expenditure forecasts as well.  

Illinois, by contrast, does not utilize consensus revenue estimates and tends to rely on estimates from two different bodies: the Governor’s Office of Management and Budget (GOMB) and the Commission on Government Forecasting and Accountability (COGFA). Estimates from both bodies are generally close, but there have been instances in the past where they have been far apart (by as much as $800 million). 

In addition, the State has not consistently used multi-year revenue and expenditure forecasts in its budgeting documents. The GOMB issues one document each year with multi-year projections, but the projections are often obsolete by the time the Governor issues a proposed budget only a few months later. For example, in October 2017, the GOMB released five-year projections that showed projected total resources of $36.2 billion for FY19. By the time the Governor released his proposed budget the following February, the projected total resources for FY19 were $38 billion. Since there was a significant change in projected resources, the resource projections for FY20-FY23 made in October were no longer accurate. Despite the significant change, the State did not publish updated projections for the out years.

**Best Practices: Budget Maneuvers**

The next category that the Volcker Alliance grades states on is budget maneuvers. A basic tenet of responsible budgeting is to use one-time revenues for one-time expenses only rather than using one-time measures to cover recurring expenses to “balance” the budget. States are graded based on whether they avoided budget maneuvers, such as borrowing to pay for recurring expenses, using “scoop and toss” financing, and using proceeds from material, non-recurring asset sales to fund recurring costs. Most states (22) earned an A because they successfully avoided budget maneuvers during the three-year period the report covers; another 15 earned a B because they only had limited reliance on budget maneuvers. Illinois, on the other hand, was rated poorly and earned a D-. Illinois frequently utilizes the types of budget maneuvers that best practice dictates should be avoided. The FY19 enacted budget provides many examples, including relying on $800 million of interfund borrowing and $300 million of anticipated proceeds from the sale of the Thompson Center to balance the budget. (Although the Thompson Center has yet to be sold, the proceeds from the sale have been counted as revenues in enacted budgets for several fiscal years including 2018 and 2019). In addition, although the State has made progress on paying down its unpaid bills, the remaining bill backlog is the legacy of deferring recurring expenditures to the future.
**Best Practices: Legacy Costs**

The third area of analysis is how a state handles its legacy costs, including pension and Other Post-Employment Benefit (OPEB) liabilities. When states weigh the need to fully fund their retirement costs against the need to maintain government services, states sometimes short-change their pension funds in order to achieve a balanced budget, rather than make tough decisions to increase revenues or cut other expenditures. As such, they push retirement costs (plus interest) onto future generations. The Volcker Alliance grades states based on whether they contribute an actuarially determined amount to their pension funds and to public employee OPEB liabilities. Generally, states have mixed records on how they handle legacy costs (only eight states earned an A), but Illinois earned a D+ on how it handles its legacy costs.

Illinois’ pension problems are well known: the State has an extremely low funded ratio with unfunded liabilities totaling approximately $130 billion. The State has a pension payment schedule that was set in statute in 1995, but 24 years into the schedule, the State’s contribution is still not sufficient to keep the unfunded liability from growing. Indeed, the State’s low contributions are responsible for roughly $48 billion in increased unfunded liabilities from FY96-FY17. Eventually, pursuant to the statutory schedule, the contributions will increase to levels high enough to amortize the unfunded liability, but that will not occur for many more years. And when the contribution levels are higher, they increasingly crowd out other needs for government revenues. The State is accruing more and more unfunded liability that must be paid off in the future.

The “Pension Reform” section goes into more detail about solutions for Illinois’ pension problem, but it is clear that the State needs to enact a credible plan to pay down its unfunded liabilities and better address its legacy costs.

**Best Practices: Reserve Funds**

The next area evaluated by the Volcker Alliance report is reserve (or “rainy day”) funds. Reserve funds are important from a budgeting standpoint because they help states weather the ups and downs of the economy and any associated budgetary shocks. These funds make it less likely that states will have to drastically cut services or increase taxes to deal with fiscal downturns. The reserve fund criteria that are evaluated include whether there are formal policies in place governing use and replenishment of a rainy day fund, if its balance is tied to historical trends in volatility (i.e., whether it is large enough to help a state if there is an economic downturn), and whether or not there is money in the fund. Illinois earned a C for its reserve fund, primarily because of its formal policies governing the fund (this grade does not indicate how well it is funded).

Texas serves as a good example for how states should approach reserve funds. Its Economic Stabilization Fund is the largest in the country with $9.7 billion in assets as of June 30, 2016 and is supported by natural resource taxes.

Illinois, on the other hand, has never had a functional rainy day fund. A law was enacted in 2004 to build up a rainy day fund using the existing Budget Stabilization Fund, and the goal was to set aside 5% of General Fund revenues. Deposits were to be made into the fund when revenues grew more than 4% over the prior year and any withdrawals were meant to reduce the need for tax increases or short-term borrowing, maintain the credit rating, and address budgetary shortfalls.
Likely due to the high threshold for requiring deposits into the fund, the balance of the Budget Stabilization Fund has never come close to 5% of General Fund revenues, although there was a balance of approximately $275 million at the end of FY15 (which is far short of the 5% goal). In addition, the entire balance of the fund was used to cover regular operating expenses in FY17. As such, even though the State follows some of the best practices of other states by having a rainy day fund and clearly defining the process for funding and making withdrawals, these processes are not strict enough to ensure that the State has a robust fund.

**Best Practices: Transparency**

The last area of evaluation is transparency, which is key to ensuring that policymakers and citizens can easily access and understand important information about their state’s budget. The Volcker Alliance rates states on whether they have a consolidated website (or set of websites) that provide budgetary data, whether the state makes tables listing outstanding debt and debt service available, whether the state provides a tax expenditure budget, and whether it includes the estimated cost of deferred infrastructure maintenance liability for its capital assets in budget and planning documents. Illinois scored relatively well on this category (earning a B), but other states serve as aspirational examples for transparency in budgeting.

Minnesota and Colorado provide excellent consolidated budget websites that make financial information accessible to citizens, including budget processes, current and previous budgets, budget and economic forecasts, etc. Utah’s website also provides visual representations of budget information, including tax incentives/exceptions and the yearly budget. California and Alaska also serve as positive examples because they disclose infrastructure replacement costs, which most states do not do.

Illinois scores fairly well on transparency, mostly because it has a consolidated website with budget information, and it discloses debt and debt service tables. However, simply making these sorts of documents available does not necessarily make them particularly useful to the public. For example, one way to make finances more transparent would be for budget documents to include a baseline budget, then describe how planned policy changes affected the baseline. New York provides such a comparison in its Detailed General Fund Gap-Closing Plan, which begins by showing the baseline budget gap that exists prior to any changes, then lists the spending and revenue changes the Governor plans to enact to address that gap.
Recommendations for Financial Planning and Increasing Fiscal Transparency

The Civic Committee’s recommendations for improving Illinois’ financial planning processes and transparency are consistent with the best practices outlined in the Volcker Alliance report. Our recommendations include:

- Establishing clear financial objectives and articulating metrics that will illustrate progress towards those goals in both the short and long terms;
- Focusing on long-term (at least five-year) financial projections for revenues and expenditures;
- Reviewing all funds under the control of the State during budget negotiations (including General Funds, Other State Funds, as well as revenue-sharing with local governments);
- Ensuring that expense forecasts accurately and completely reflect the full expected costs of programs;
- Creating consensus revenue forecasts that do not rely on one-time revenues to balance the budget and focus on sustained revenue sources;
- Producing timely financial statements that report revenues and spending (as well as assets and liabilities) that are updated at key points of the budget cycle;
- Including baseline budgets in budget documents that show projected revenues and expenditures absent major policy changes; and
- Publishing the aggregate State pension contribution (from General Funds and Other State Funds) as well as pension contribution benchmarks (e.g., the Normal Cost plus Interest payment) so that stakeholders can evaluate the adequacy of the State’s pension contribution (and how underfunding compared to that benchmark will impact pension liabilities).
II. Eliminate the State’s Structural Budget Deficit and Unpaid Bills, Establish a Reserve Fund, and Implement a New Funding Plan to Pay Down the Approximately $130 Billion in Unfunded Liabilities of the State’s Pension Funds

The second element of the Financial Framework is to stabilize State finances. This includes not only eliminating the structural deficit and unpaid bills, but also establishing a reserve fund and making progress on reducing the State’s unfunded pension liabilities.

In our 2017 report, the Task Force adopted a five-year timeframe for eliminating the structural deficit and unpaid bills, as well as establishing a reserve fund of $4.5 billion, which was estimated to require $10 billion a year in spending cuts and/or revenue increases to achieve.

Since that time, the State has taken action to address some of the most immediate financial problems (e.g., enacting an income tax increase and passing a budget with a reduced structural deficit), but there is still much more to be done in order for the State to reach financial stability. The structural deficit is much smaller than it was, but it has not been eliminated. The State’s bill backlog has only been partially addressed (through issuing bonds), and Illinois still does not have an appropriate reserve fund. In addition, the State needs to create a long-term plan for addressing pension liabilities in a sustainable way.

In order to address all of these components, the State will now need to identify $8 billion a year in spending cuts or revenue increases.

At the end of five years, some of the goals outlined in this Framework will have been achieved, including eliminating the bill backlog and establishing a reasonable reserve fund. At that time, the State should consider rolling back the recommended tax increases or evaluate its top fiscal priorities and allocate these resources to the most pressing needs. In particular, the State should ensure that it has a balanced budget incorporating all funds, education is adequately funded, pension contributions are sufficient, and state services are at an appropriate level.

It should be noted that the Financial Framework does not specifically address the State’s capital needs and budget because funding for capital comes primarily from funding sources that are not included in the General Funds budget. However, the Civic Committee recognizes that infrastructure will require significant investment in the coming years and that ongoing capital investment is critical to maintaining the State’s infrastructure and preserving Illinois’ position as a key transportation hub.

The Illinois Department of Transportation estimates that additional revenues of $1.7 billion each year are needed simply to maintain existing highway and transit infrastructure. In addition, the Regional Transportation Authority (RTA) estimates it will need $38 billion over 10 years to bring the mass transit system in the Chicago metropolitan region into a state of good repair. However, the State’s history of
 episodic capital plans and reliance on unsustainable revenues (such as gaming, liquor taxes, etc.) has not been adequate to support the ongoing capital and infrastructure needs of the State.

The State of Illinois needs to make new investments to maintain and improve our transportation network and spur economic growth. Any revenues identified for transportation should be sustainable, user-fee based, able to support all modes of transportation, and, importantly, invested transparently and efficiently based on data.

**Eliminate the Structural Budget Deficit and Unpaid Bills**

Despite a balanced budget amendment, the State has passed budgets with significant structural deficits for many years. At the time *Bringing Illinois Back* was published, baseline budget projections (that is, what the State’s budget was projected to be absent any major policy changes) showed structural deficits of roughly $7 billion a year from FY18-FY22.63

The structural deficit was significantly reduced when the legislature passed the FY18 budget and enacted rate increases for the personal and corporate income tax. These increases brought in roughly $4.7 billion in additional revenue in FY18,64 but it was not enough to balance the FY18 budget. Two other measures provided significant one-time revenues to the general funds: proceeds from bonds that were sold to pay down the bill backlog (approximately $2.5 billion) and an increase in federal match revenues from using those bond proceeds to pay prior year Medicaid bills ($1.2 billion).65

The enacted FY19 budget was “balanced” through the use of one-time revenue sources, pre-booking savings that have not yet materialized, and under-appropriating costs that are likely to occur during the fiscal year.66 However, as noted in State bond disclosure documents and the recently released five-year projections from the GOMB, the structural deficit for FY19 is more than $1 billion.67 As indicated in the chart below, the GOMB projects structural deficits as much as $3.4 billion over the next five years.

**Table 1: Baseline General Funds Budget ($ Millions)**68

<table>
<thead>
<tr>
<th>FISCAL YEAR</th>
<th>ESTIMATED 2019</th>
<th>PROJECTED 2020</th>
<th>PROJECTED 2021</th>
<th>PROJECTED 2022</th>
<th>PROJECTED 2023</th>
<th>PROJECTED 2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total General Funds Revenue</td>
<td>$37,985</td>
<td>$37,874</td>
<td>$38,451</td>
<td>$39,409</td>
<td>$40,501</td>
<td>$41,496</td>
</tr>
<tr>
<td>Total General Funds Expenditures</td>
<td>$39,029</td>
<td>$40,637</td>
<td>$41,885</td>
<td>$42,685</td>
<td>$43,700</td>
<td>$44,771</td>
</tr>
<tr>
<td>Surplus/(Deficit)</td>
<td>($1,044)</td>
<td>($2,763)</td>
<td>($3,434)</td>
<td>($3,276)</td>
<td>($3,199)</td>
<td>($3,275)</td>
</tr>
</tbody>
</table>

*Source: Governor’s Office of Management and Budget, “General Funds Financial Walk Down FY19-FY24.”*
The projected structural deficits are higher than the GOMB previously predicted (the five-year projections released in October 2017 estimated deficits peaking at roughly $1.5 billion) for a few key reasons. First, the new projections build the probability of a recession into their revenue estimates. As described in the Illinois Economic and Fiscal Policy Report accompanying the General Funds projections, the GOMB selected a pessimistic economic scenario to underlie revenue projections due to their view that a recession is likely to occur in the next few years. As a result, key State source revenues such as the personal income tax are expected to grow slowly in the near term (FY20 and FY21) and grow more quickly thereafter.

Second, the new projections include a more complete and realistic accounting of General Funds expenditures and revenues. For example, the new projections remove proceeds from the sale of the Thompson Center from the FY19 revenue estimate and reduce the amount of interfund borrowing from $800 million to $400 million. In addition, costs that were not included in the enacted FY19 budget that will surface in FY19 and beyond (e.g., debt service for bonds used to finance the pension buyout programs and American Federation of State, County and Municipal Employees (AFSCME) step increases that the State will be required to pay) are reflected in the five-year projections.

Given these revenue projections, the State will have to identify as much as $3.4 billion in spending cuts or revenue increases each year over the next five years just to cover the structural deficit. However, as noted above, eliminating the structural budget deficit is not the only financial pressure facing the State. After years of running budget deficits (and two years of not having a budget in place), the State accumulated a bill backlog totaling $16.7 billion. After the State sold bonds and used the proceeds to pay down some of these overdue bills, the backlog was substantially reduced. The GOMB estimates that by the end of the fiscal year it will stand at roughly $7.8 billion.

If the remaining unpaid bills are amortized over the next five years, the State will need to identify an additional $1.5 billion each year.

Establish a Reserve Fund

Another key step for the State to take in order to stabilize its finances is to establish a reserve fund. Having a reasonable reserve fund would cushion against future budgetary shocks or fluctuations and make it easier for the State to weather economic downturns. It is a best practice for states to have a reserve fund, and credit rating agencies take them into account when assessing a state’s credit worthiness.

For the State to create a $4-5 billion reserve fund (large enough to cover 8% of State revenues), the State would need an additional $1 billion a year over the next five years in either spending cuts or revenue increases.
Address the State’s Unfunded Pension Liabilities

The last major step the State needs to take to get back on the path to fiscal stability is to address its unfunded pension liabilities. The Civic Committee recommends adopting a new pension funding plan that meet the following criteria:

- Structure contributions in a budget sustainable manner (e.g., will not significantly worsen crowding out);
- Increase pension contributions up front so that contributions reach the “tread water” level faster than under the current schedule; and
- Provide a plan to amortize the remaining unfunded liability after the funds reach 90% funded.

The plan is discussed in greater detail in the “Pension Reform” section, and it will require an additional $2 billion a year until the pension systems are 90% funded.

Summary of the Gap

In order for the State to eliminate the structural deficit and unpaid bills, establish a reserve fund, and implement the new pension funding plan, it will require approximately $8 billion a year of additional operating profit for the State over the next five years.

Table 2: Summary of the Gap ($ Millions)

<table>
<thead>
<tr>
<th>FISCAL YEAR</th>
<th>PROJECTED 2020</th>
<th>PROJECTED 2021</th>
<th>PROJECTED 2022</th>
<th>PROJECTED 2023</th>
<th>PROJECTED 2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Deficit</td>
<td>$2,763</td>
<td>$3,434</td>
<td>$3,276</td>
<td>$3,199</td>
<td>$3,275</td>
</tr>
<tr>
<td>Pay Down the Bill Backlog</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Establish a Reserve Fund</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Incremental Pension Funding</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>TOTAL GAP</td>
<td>$7,263</td>
<td>$7,934</td>
<td>$7,776</td>
<td>$7,699</td>
<td>$7,775</td>
</tr>
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</table>
Figure A below shows several policy options that could be implemented to reach this goal.

**Figure A: Elements of a Solution**

- **SPENDING REDUCTIONS**
  - Create a New Retiree Healthcare Plan for New Employees
  - Implement Healthcare Plan Reforms for Current Employees (up to $500 million)
  - Implement Constitutional Pension Reforms
  - Reduce State Spending (general funds and other state funds) through operational improvements ($1 billion)
  - Implement “2+2” Plan ($500 million)

- **REVENUE INCREASES**
  - Increase the Personal Income Tax by 1 PPT: $3.7 billion
  - Eliminate the exclusion of retirement income from the income tax base and increase the value of 65+ Exemption from $1,000 to $15,000 ($1.9 billion)
  - Tax consumer services ($500 million)
  - Increase the Corporate Income Tax by 1 PPT: $300 million

- **TAX REFORMS**
  - Implement tax reforms to enhance Illinois’ competitive position and eliminate the state’s negative outlier status, including:
    - Eliminate the estate tax ($290 million)
    - Eliminate the franchise tax ($205 million)
**Pension Reform**

The challenges facing Illinois' public pension systems – massive unfunded liabilities, extremely low funded ratios, and annual contributions that are crowding out other State spending – are significant and well known. Across all five pension systems, unfunded liabilities total roughly $130 billion, and the funded ratio is only 40%. In addition, pension contributions currently account for nearly 20% of the General Funds budget, a share that will almost certainly increase as the State's statutorily required pension contributions continue to grow over the next 26 years.

It is clear that the State needs to make changes to its public pensions, but options to reduce the unfunded liability are limited due to the Illinois Supreme Court's 2015 decision on pension reform. Accordingly, future reforms should focus on creating a credible plan for paying down the unfunded liabilities of Illinois' pension systems, while also mitigating the negative impact of pension contributions on the provision of government services.

This analysis will describe several options for addressing the State's pensions, including reforms to reduce the unfunded liabilities, options to pay down the existing unfunded liabilities, and the evaluation and implementation of possible changes to pension governance. Given the current level of unfunded liabilities and the level to which pension payments are crowding out critical services in the State budget, policymakers should implement a responsible, long-term solution that begins to pay down the unfunded liability faster than the current contribution schedule and structures payments in a more sustainable manner.

**Illinois' Statutory Pension Contribution Schedule**

The State makes pension contributions according to a schedule enacted in 1995. After an initial 15 year phase-in period that has since ended, the law required that the State's pension contributions be made at a level percent of payroll until 90% funding is achieved in 2045. The structure of the contribution schedule is such that contributions started out lower and will increase each year until 2045, effectively deferring amortization of the unfunded liability to the future. Since the schedule delays amortization of the unfunded liability, contributions are currently too low to keep the unfunded liability from growing (the unfunded liability is projected to increase at the end of FY19; it is expected to grow until it peaks at approximately $144 billion at the end of FY28).

In order to keep unfunded liabilities from growing, contributions would need to equal the “Normal Cost plus Interest,” or the cost of benefits earned in a given year plus the “interest” on any unfunded liabilities (the plan's discount rate times the unfunded liability). If the State does not cover the “Normal Cost plus Interest” with its annual contribution, the unpaid interest is then added to the total unfunded liability. Since the statutory contribution schedule was enacted in 1995, over 20 years ago, the State's pension payments have not been sufficient to keep unfunded liabilities from growing and are responsible for roughly $48 billion of the total increase in unfunded liabilities from FY96-FY17.

However, the State needs to do more than just keep the unfunded liability from growing; it needs to make payments to amortize the approximately $130 billion in unfunded...
liabilities. There are accounting standards for disclosing the contribution necessary to cover normal costs plus a payment to amortize unfunded liabilities over a certain time frame (the “Actuarially Determined Contribution” or ADC), but Illinois’ statutory contributions are much lower than the ADCs calculated by the State’s pension systems. If the State’s contributions equaled the ADC (as calculated and reported by each of the pension systems), it would have required an additional $4 billion contribution from the State for FY19.

Since the State’s contributions have been actuarially insufficient to date, pension contributions in the final years of the contribution schedule will be much higher as a result. Back-loading pension contributions in this manner will make it increasingly difficult for the State to make its required contributions and still provide necessary government services, as it increases the likelihood of pension contributions growing at a faster rate than the State budget. Even the current contribution level ($7.5 billion from the General Funds in FY19) is crowding out State spending, accounting for nearly 20% of all General Funds expenditures.

Under the current schedule, required pension contributions are projected to grow at a compound annual growth rate of approximately 3.3% a year until 2045 (with the final contribution projected to peak at $19.5 billion), which is faster than the likely growth of the rest of the State budget over that same time frame. As such, pension contributions will become a larger percentage of the State budget, crowding out will worsen, and it will be increasingly difficult for the State to make its required pension contributions and still maintain essential services.

Yet, despite the astronomical contributions scheduled for the end of the pension schedule, the State’s existing plan will never fully amortize the unfunded liabilities of the pension systems. The pension funding schedule aims for 90% funding rather than 100%, and while 90% funded is considered healthy for a pension system, there will still be unfunded liabilities the State must eventually pay. The longer the State delays in paying off the remaining unfunded liabilities, the more expensive it will be to do so as the interest on the unfunded liabilities grows. The State should amortize all of its unfunded liabilities so that it will only have to pay the normal cost of pensions going forward.

Previous Pension Reform Efforts

In May 2015, the Illinois Supreme Court ruled that the pension reform bill passed in 2013 to address the State’s pension problems (Public Act 98-0599) was unconstitutional. The provisions of the bill included capping the 3% automatic compounded benefit increases, increasing retirement ages, and limiting the final average pay used to calculate pension benefits. The Illinois Supreme Court ruled unanimously that the law violated the pension protection clause of the Illinois Constitution, which states that pension benefits cannot be “diminished or impaired.” In addition, the court stated that benefits that are promised to employees on their first day of work cannot later be reduced during the term of their employment, only increased. This decision severely limits potential reforms to pension benefits and suggests that only reforms to benefits for new employees or reforms that allow for voluntary changes will pass constitutional muster.
The State already has enacted new employee benefit reforms with the establishment of the Tier 2 pension system, which requires a higher retirement age, a change in the calculation of final average salary, a cap on pensionable earnings, and a reduction in the automatic cost of living adjustment.

The State also authorized an optional Tier 3 plan in its FY18 budget, which would allow new employees to opt-in to a hybrid pension plan with a defined benefit and defined contribution component (similar to a 401(k) plan). After the new Tier 3 plan is enacted, the responsibility for paying the cost of pensions going forward will fall on local employers rather than the State (except for existing Tier 1 and Tier 2 employees). The State would see some savings eventually from the Tier 3 plan requiring local employers to pay the cost of pensions, but it is unclear how much money it will save or when those savings will materialize (estimates are further complicated due to the pension-related provisions in the new Evidence-Based School Funding Formula). It is estimated that the pension plans will not be able to enact Tier 3 until FY20 at the earliest.

There have also been a number of smaller scale pension reforms that have been enacted. Most recently in the FY19 Budget Implementation Act (BIMP), the State authorized buyout programs that could save the State approximately $400 million (although no actuarial analysis of either program was released prior to the savings being taken in the FY19 budget). The buyout programs consist of two pieces:

- **Tier 1 buyout for vested, inactive members**: The State would offer inactive members with vested benefits 60% of the net present value of their pensions.

- **3% Automatic Annual Increase buyout**
  - Retiring Tier 1 members could choose to keep their automatic increases at 3% a year, or they could accept a lower 1.5% annual increase in exchange for a lump sum payment of 70% of the difference between what they would have gotten with 3% increases and what they will now get with 1.5% increases.

However, since the savings from the buyout programs rely on people opting in, the ultimate projected savings is not clear. In addition, projections do not take into account the cost of issuing bonds to pay for the buyout programs, so the savings would be reduced. Recent projections from the GOMB show that the cost of debt service for issuing bonds to pay for the buyout will cost the State nearly $100 million a year from FY20-FY24.

**Opportunities for Future Reforms**

With the Illinois Supreme Court ruling that benefits cannot be changed for current employees and the less expensive Tier 2 system already in place for all new employees, there are not many options left for pension reform that would produce significant savings (particularly because 70% of liabilities are attributable to current retirees). The potential reform options described below will first focus on reform options to reduce the unfunded liability, then on creating a credible plan to pay down the unfunded liability. In addition, we will discuss reform options for pension plan governance, as well as options for addressing the unfunded liabilities of local pension plans.
Reforms to Reduce the Unfunded Liability

One reform that is often discussed is the “consideration model” proposed by Senate President Cullerton. This model would ask Tier 1 employees to choose between having their future pay increases included in the calculation of their pension benefits or maintaining the automatic 3% compounded cost of living adjustment. However, as many have noted, there is no guarantee that this plan would survive a constitutional challenge since it may be interpreted as asking Tier 1 employees to choose between two forms of benefit diminishment. Proponents argue that this model will survive a constitutional challenge since future pay increases are not guaranteed.

Some also have proposed a type of pension reform that has been successfully implemented in the private sector, a “hard freeze.” A hard freeze would end benefit accruals for active employees in the pension plans, which would eliminate future normal costs and reduce the current liability for active employees (this is the equivalent of terminating all workers and workers would only get what is earned to date). The reduction in current liability would be the result of eliminating future pay increases from the calculation of accrued pension benefits; pension benefits would instead be based on current pay. However, since the majority of the State’s pension liabilities (70%) are attributable to members who are already retired, a hard freeze would only reduce the unfunded liability by an estimated $9 billion. It is also likely that a hard freeze would be challenged pursuant to the Illinois Constitution’s pension protection clause.

Finally, another potential reform is a constitutional amendment to the pension protection clause. Passing a constitutional amendment is frequently brought up as the solution that will solve the State’s pension problems since it would allow the State to reduce the benefits it is obligated to pay out. However, passing a constitutional amendment is a difficult process: the amendment must pass with a three-fifths majority in both the House and Senate before it is voted on by residents in the next general election, where either three-fifths of those voting on the amendment or a majority of those voting in the general election must vote to approve it.

Depending on what form the amendment took, the State could be empowered to make benefit changes for Tier 1 members, including current employees and retirees. The majority of the current liability for the State’s pension plans is attributable to current retirees ($148 billion of $212 billion or 70%, of total liabilities for the three largest plans).

Options for Paying Down Pension Liabilities

Given the limited options for reducing the unfunded liability without a constitutional amendment and the time it would take to pass an amendment and implement it should it pass, the State should immediately focus on instituting a credible plan for paying down the unfunded liability. Several options for how the State might address its pension liabilities and their pros and cons are listed below.

It should be noted that projections for all scenarios only include the “big three” plans (TRS, SERS, and SURS). They presume future experience will match assumptions embedded in these projections, including meeting the assumed asset returns (7.00% for TRS and SERS, 7.25% for SURS). Real dollar contributions are discounted using a growth rate of 2.5% per year. Contribution estimates...
are for the *entire* State contribution, not just the portion paid out of the General Funds.

**Status Quo: Following the Statutory Pension Schedule**

The first option is to continue to follow the statutory pension contribution schedule. One positive aspect of the statutory schedule is that it clearly lays out a plan for reaching 90% funding by 2045. If the State makes contributions as scheduled (and all other assumptions are met), the State will meet this goal.

However, in our view, the Status Quo funding schedule does not represent a credible plan for paying down the State's unfunded liabilities. The current pension contribution schedule was set up in a way that shifted costs to the future and despite contributions already consuming a significant amount of the general funds budget (roughly 20% for FY19), the statutorily required contribution will be more than double its current level in nominal dollars by the final year of the schedule ($19.5 billion or approximately $10 billion in 2018 dollars). Unless the State’s budget (specifically revenue) grows at the same rate or more, it will become increasingly difficult to make the statutorily required pension contributions without severely cutting services, significantly raising taxes, or some combination of both.

In addition, through the first 24 years of the statutory contribution schedule (i.e., FY96-FY19), contributions have not been sufficient to keep the unfunded liability from growing. As such, the State has essentially dug itself deeper throughout the life of the pension payment schedule and due to its structure, will continue to do so for another 10 years. The State’s “plan” for paying down the unfunded liabilities of the pension funds actually makes the problem worse while pushing off an even heavier future price. It also contributes to Illinois having one of the worst-funded pension systems in the country, behind only Kentucky and New Jersey.90

**Addressing the State’s Pensions Through Supplemental Contributions**

The second option the State could pursue to fund its pensions is to make supplemental pension contributions on top of what is required by statute. Putting additional money towards pensions immediately would speed up the timeline for reaching key funding benchmarks – including the “tread water” level and the State’s own goal of 90% funded – thereby removing a key roadblock to fiscal stability sooner. In addition, putting more money towards pensions now would likely reduce the total amount of interest the State would have to pay on the unfunded liability in the long run.91

It is important to note that in order for these payments to accelerate the timeline for reaching 90%, they would need to be kept in a separate fund. Due to the structure of the current funding schedule, making additional contributions to the pension funds directly would lead to a decrease in required contributions in future years.92 Alternatively, the State could take a potentially simpler approach and amend the funding law so that any supplemental contributions would not change the rest of the contribution schedule.

The main argument in favor of making supplemental pension contributions is that it helps get the State to a “tread water” level much faster than under the current pension schedule (contributions are not currently projected to reach “tread water” levels for approximately 10 years), and it significantly accelerates the timeline for reaching 90% funded.
A Civic Committee analysis of the three major pension systems (TRS, SERS, SURS) suggests that an additional $2 billion a year made as a supplemental contribution would get the State's contributions above the level necessary to tread water quickly (unfunded liabilities would peak at the end of FY20). It would also reduce the projected time it takes to reach 90% funded by six years. If the State made $4 billion supplemental contributions, it would exceed the tread water payment level immediately and would reduce the projected timeline for reaching 90% funded by 11 years. With supplemental pension contributions of $2 billion a year, the pension funds are projected to reach 90% funded by 2039; with $4 billion supplemental contributions, the funds are projected to reach 90% by 2034.

When discussing potential changes to the State's pension schedule, it is useful to compare how much money the State will have to put towards pension contributions under each scenario (the “total contribution”). Since the funding scenarios discussed throughout this analysis have different funding targets (e.g., 90% vs. 100%) and different target years to reach those funding goals, we define the total contribution as the sum of State pension contributions from FY20 until FY65.

If the State's goal is to reach 90% funded, there will still be an unfunded liability that the State must pay interest on going forward; any State contributions after reaching 90% funded must equal the Normal Cost plus Interest to remain at 90%. By contrast, if the State changed its funding target to 100%, any contributions after reaching 100% would not include interest since there would no longer be any unfunded liability. The difference in post-funding target contributions can be significant, and therefore, should be taken into account when evaluating the total costs borne by the State under each scenario.

The potential reduction in the State's total pension contributions from making supplemental payments until it gets to 90% funded is enormous. If the State follows its current pension schedule, its projected contributions in inflation-adjusted dollars will total roughly $263 billion; with $4 billion in supplemental contributions, the State's total contribution will be approximately $40 billion less, totaling approximately $224 billion. Supplemental contributions of $2 billion would reduce the State's total contribution by approximately $25 billion to approximately $238 billion.

The challenge with making supplemental contributions, of course, is finding the money to pay for them, especially since required contributions will be increasing steadily over the life of the pension payment schedule. Crowding out is already an issue at the current contribution level; it would be difficult to make supplemental contributions without additional sacrifice, whether through cutting services, raising taxes, or both.

**Extend the Pension Contribution Schedule**

The third option for addressing pension funding is to extend the current pension schedule beyond 2045 while keeping the underlying funding mechanism in place. Extending the pension schedule would give the State more time to pay down the unfunded liabilities, allowing it to reduce yearly contribution levels and alleviate further crowding out in the near term. However, extending the schedule and taking more time to reach 90% funding significantly increases the State's total pension contribution in the long run, exposes the funds to greater risk during market downturns, and would make it so the State's unfunded liability is higher in all years than it would be under the current schedule.
Analysis of the three largest pension systems shows that if the State extended its pension schedule by 10 years to 2055 (keeping the 90% funded target), the total pension contribution for FY20 would decrease by roughly $1.3 billion. Extending the schedule by 20 years to 2065 and keeping the 90% target would reduce the required FY20 contribution by roughly $2 billion. In the near term, the State would benefit from the reduction in required contributions, as it would free up some money in the short term to spend on government services rather than on legacy debt.

However, the reductions in required contributions do not represent “savings” in any way – the unfunded liability would increase as a result of lower contributions, and the interest that accrues on those liabilities eventually must be paid off. Delaying the timeline for amortizing the unfunded liability significantly increases the total contributions the State must make until it reaches 90% funded. Extending the schedule to 2055 (while also targeting 90%) would increase the State's total contributions by approximately $42 billion to $305 billion (in 2018 dollars); extending the schedule to 2065 (while also targeting 90%) would increase the State's total contribution by $91 billion to $354 billion (in 2018 dollars).

Restructure the Pension Contribution Schedule

A final option for the State is to restructure the statutory pension contribution schedule. However, given the State’s history of underfunding its pensions, any plan that only extends the time frame for reaching its funding target (e.g., keeping the same funding mechanism but giving the State more time to meet the funding target) is likely to be met with criticism from bond rating agencies, investors, and the general public. Given that the State's bond rating is the lowest in the nation and one level above junk, any new plan should be credible, achievable, and demonstrate that the State is making progress on funding its pensions. As such, we have identified criteria which we believe should be met by any new pension funding plan. It should:

- Structure contributions in a budget sustainable manner (i.e., will not significantly worsen crowding out);
- Increase pension contributions up front so that contributions reach the “tread water” level faster than under the current schedule; and
- Provide a plan to amortize the remaining unfunded liability after the funds reach 90% funded.

“2+2” Plan

We have identified a funding plan that meets these criteria by blending attributes from the different funding options described thus far. Broadly, this funding scenario would set a new yearly contribution schedule (the “baseline contributions”) with a lower growth rate so that contributions are more budget sustainable than the current schedule. In addition, it would require fixed supplemental $2 billion contributions (“supplemental contributions”) each year (in nominal dollars) until the pension funds reach 90% funding, which puts more money into the funds up front and gets the State to a “tread water” level faster than the current contribution schedule. Lastly, this plan provides a path to full funding – targeting a 100% funded ratio by amortizing the remaining unfunded liability over 10 additional years (i.e., after the plans reach 90% funded, which the current contribution schedule does not do).
Similar to the supplemental contribution options described earlier (the $2 billion or $4 billion on top of the current contribution schedule), the main challenge with this scenario is identifying the additional $2 billion to contribute to the pension plans each year. However, the baseline contribution for FY20 under the “2+2” Plan will be roughly $500 million less than the projected FY20 contribution under the Status Quo. Therefore, an additional $2 billion a year in nominal dollars should be more manageable. Several policy options that could produce the required $2 billion a year are described throughout this report.

This proposal would restructure the contribution schedule so that the State’s baseline contributions would grow at 2% each year (compared to an average 3.3% each year under the current schedule). In this schedule, the FY20 payment would be set to be 2% higher than the FY19 payment, which would continue until the plans are 90% funded. In addition to this regular payment, the State would make supplemental $2 billion contributions each year until the pension funds reached 90% funded. Once the pension plans reach the 90% funded target, the “2+2” Plan provides for the amortization of the remaining unfunded liabilities. The remaining liability would be paid down over 10 years, and the pension plans would reach 100% funded by 2055.

**Figure B: Yearly Pension Contribution Comparison: Status Quo Contribution Schedule vs. the “2+2” Plan**
Figure B shows a comparison of pension contributions in nominal dollars under the status quo (current pension schedule) and the “2+2” Plan. (The bars for the “2+2” Plan represent the baseline contribution levels; the line for the “2+2” Plan represents the yearly baseline contribution level plus the supplemental $2 billion contribution.)

As shown in Figure B, yearly pension contributions for the “2+2” Plan are initially higher than the yearly contributions under the Status Quo. As such, the State’s contribution is projected to reach the level necessary to tread water a full five years sooner under the “2+2” Plan than under the Status Quo contribution schedule (FY23 vs. FY28). In addition, the fact that yearly contributions under the “2+2” Plan are lower than the Status Quo in FY33 and beyond make the “2+2” Plan a more budget-sustainable option in the long term.

The benefits of increasing contributions up front are shown in Figure C below. Not only are the State’s pension funds projected to reach the “tread water” level faster, but under the “2+2” Plan, the unfunded liability is projected to peak at a lower level than under the Status Quo pension schedule. It would remain lower than the projected unfunded liability for the Status Quo pension schedule for all years.

Figure C: Unfunded Liability Comparison, Status Quo Contribution Schedule vs. “2+2” Plan
In addition to comparing the cost of the State’s yearly pension contributions and unfunded liabilities, it is important to analyze how altering yearly contributions will affect the total cost of the State’s pension contributions over time. Table 3 below shows a comparison of the total cost of the State’s pension contributions for three time frames: FY20-FY45 (when both scenarios are projected to reach approximately 90% funded), FY46-FY55 (when the Status Quo scenario maintains 90% funded and the “2+2” Plan amortizes the remaining unfunded liability), and FY56-FY65 (when the Status Quo is still maintaining 90% and the “2+2” Plan has no remaining unfunded liability).

Table 3: Comparison of Total State Contributions and Unfunded Liability, Status Quo vs. the “2+2” Plan ($ Billions).

<table>
<thead>
<tr>
<th></th>
<th>STATUS QUO CONTRIBUTION SCHEDULE</th>
<th>“2+2” PLAN</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Funded Ratio (at FY End)</td>
<td>Total Contribution (Real Dollars)</td>
</tr>
<tr>
<td>FY20-FY45</td>
<td>90%</td>
<td>$241.9</td>
</tr>
<tr>
<td>FY46-FY55</td>
<td>90%</td>
<td>$13.0</td>
</tr>
<tr>
<td>FY56-FY65</td>
<td>90%</td>
<td>$8.6</td>
</tr>
<tr>
<td>Total (FY20-FY65)</td>
<td>90%</td>
<td>$263.5</td>
</tr>
</tbody>
</table>

Note: Forecasts presume all assumptions as of June 30, 2017 will be realized, including asset return assumptions of 7.00% (TRS and SERS) or 7.25% (SURS). Real dollar totals are based on a 2.5% inflation assumption.
As Table 3 illustrates, there are benefits to restructuring the contribution schedule so that the full unfunded liability is amortized, and more money goes into the pension systems up front:

- The “2+2” Plan would get the State to better than 90% funded by 2045 (the target under the Status Quo) for approximately $6 billion less in total State contributions.

- While amortizing the remaining unfunded liability (“2+2” Plan) would cost the State more than maintaining a 90% funded ratio from FY46-FY55 (Status Quo), the projected savings compared to the Status Quo after the “2+2” Plan has eliminated all unfunded liability (FY56-FY65) is approximately $7 billion.

- The total financial benefit to the State would be approximately $46 billion: total contributions from FY20-FY65 would be approximately $8.6 billion less compared to the Status Quo, as well as the elimination of the $37.7 billion in projected unfunded liability in FY65 under the Status Quo.

The “2+2” Plan meets the three criteria we have identified as necessary for any new pension plan: contributions are structured in a more budget sustainable manner, payments are increased up front so that the State gets to tread water faster than the current schedule, and the proposal provides a plan to amortize the full unfunded liability. In addition to meeting these criteria, the “2+2” Plan also provides a likely reduction in the total State contribution to the pension systems over the next 46 years, saving a projected $8.6 billion.

Adjusting some of the levers of this plan, particularly the growth rate for baseline contributions, could give the State more options for a pension funding plan that would still meet the three criteria we have outlined. For example, if the baseline contribution growth rate were 1% instead of 2%:

- Contributions would be lower than under the Status Quo (and the “2+2” Plan), making them more budget sustainable);
- The State would reach the contribution level necessary to tread water one year faster than under the Status Quo (FY27 vs. FY28); and
- The unfunded liability would be fully amortized, with the pension plans reaching 100% funded in FY62.

However, making adjustments such as slowing the growth rate for baseline contributions changes the projected timeline and cost for reaching key funding goals compared to the “2+2” Plan. For example, slowing the baseline contribution growth rate to 1% instead of 2% would delay the time frame for reaching 90% funded by approximately eight years (the “2+2” Plan would reach 93% funded by FY2045, vs. 90% funded by FY2053 with 1% baseline contribution growth) and would add approximately $24 billion to the total cost of State contributions from FY20-FY65 (total contributions under the “2+2” Plan would total approximately $255 billion compared to approximately $279 billion if baseline contributions grew at 1% a year).

The State could also consider pension contribution schedules that flatten out yearly contributions so they don't go above a certain level or would gradually phase contributions down to avoid a “cliff” where payments drop substantially after a funding target is met. No matter how the State decides to restructure its pension ramp, it is critical that the State focuses on options that put more money in up front (in order to begin reducing unfunded liabilities sooner than the Status Quo schedule) and adhere to the other key principles (budget sustainability and fully amortizing the unfunded liability) we have identified.
Governance of Pension Funds

A third area of reform that the State should pursue is evaluating the governance of State and local pension funds and making improvements to governance where evidence indicates it is necessary.

State and local pension funds are not subject to the strict requirements of the Employee Retirement Income Security Act (ERISA) to which private pensions must adhere, and research shows that most pension funds do not voluntarily follow many best practices in pension fund governance. There is some evidence that pension plans that do employ best practices in transparency (reporting financial, actuarial, statistical, and investment information) are shown to be more likely to have higher investment returns.97 Conversely, poor governance produces lower investment results and lower levels of plan funding. For example, one study demonstrated that the presence of plan participants, either active or retired, on a pension fund board is correlated with lower levels of pension plan funding.98 Furthermore, many plans have significant leeway to employ practices that intuitively suggest lower investment returns and funding ratios will result. For example, plans are allowed to choose investments that offer “collateral benefits” (e.g., promoting local economic activity or avoiding undesirable investments like tobacco, firearms, etc.) regardless of whether they are sound investments on their other merits. Some plans are also not required to use reasonable actuarial factors in critical plan calculations.99

The Center for Municipal Finance at the University of Chicago has identified the relationship between pension fund governance and investment returns and funding ratios as an important topic ripe for academic research and plans to study the issue further. We support ongoing efforts to ascertain the link between good governance and strong pension results and to implement changes accordingly.

Local Government Pension Liabilities

Illinois’ pension troubles are not limited to the State pension funds as local government pension funds (e.g., local police and fire pensions) face significant challenges as well. One high-profile example is the City of Harvey, which had State funds withheld and diverted to its pension funds by the Comptroller earlier this year due to its failure to make required pension payments. Yet, Harvey is not alone in its pension challenges. An analysis of the more than 600 police and fire pension funds across the State show that most police and fire pension funds are underfunded, with an average 60% funded ratio. However, approximately 29% of these funds had a funded ratio less than 50%, and only 9% of the funds had a funded ratio above 80%.100

Some argue that local governments do not have the capacity to deal with underfunded pensions on their own since property taxes in some jurisdictions are high and already going mostly toward pensions. (For example, approximately 69% of property tax revenues in the City of Galesburg are projected to go towards pensions in FY19.101) Rather than leave local funds to fend for themselves, some have called for the State to take on the responsibility for the unfunded liabilities and
governance of the local pension funds. If the State took on the unfunded liabilities of all the pension funds in the State (e.g. the local police and fire plans, the City of Chicago plans, the Cook County plan, and the Illinois Municipal Retirement System) it would increase the unfunded liabilities by approximately $60 billion,\(^\text{102}\) bringing the unfunded liability to approximately $190 billion.

However, taking on the unfunded liabilities for all local pension funds has complexities that should be considered. First, there is an issue of fairness – should taxpayers statewide have to pay to fund pensions in other localities whose underfunding may be due to financial mismanagement? Second, if the State assumed local pension liabilities, it would preclude the possibility of those liabilities being restructured or discharged if the municipality declared bankruptcy. (Note: while municipalities are currently prohibited from declaring bankruptcy under Illinois law, the State could change the law to authorize municipal bankruptcy. States, however, are not permitted to declare bankruptcy.)

The issue of the State potentially assuming unfunded liabilities for local pension funds is complex and merits further study. Before any decision is made on absorbing the unfunded liabilities of local pension funds, a comprehensive actuarial analysis should be performed, and a thorough study of governance changes that would be needed at the state and local levels should be undertaken.
III. Scrutinize the Entire State Budget for Spending Reductions

In order to achieve the required additional $8 billion each year to get the State back on sound financial footing, there will need to be expenditure reductions in addition to new revenues.

A closer evaluation of the General Funds budget suggests that additional savings opportunities may be limited. Many of the savings proposed by the Governor’s Office and/or the General Assembly in the past are based on very optimistic assumptions and often do not materialize as expected. It is clear that there needs to be a comprehensive assessment of all State expenditures (including the General Funds and Other State Funds) to identify areas where additional savings can be achieved, either through cuts or reorganizing.

Savings in the Enacted FY19 Budget

The enacted FY19 budget appears balanced at first glance, but it relies on one-time revenues (including $800 million from interfund borrowing and $300 million from the sale of the Thompson Center) and counts savings that have not yet materialized. Proposed pension reforms are an area in which the State frequently assumes savings in the budget before those savings have actually materialized. Higher education is one area of the budget where there have been significant cuts in recent years, including in the FY19 budget.

Pension Reforms

The FY19 budget assumed roughly $400 million in savings from pension reforms. Provisions include.103

- Tier 1 buyout for vested, inactive members:
  - The State would offer inactive members with vested benefits 60% of the net present value of their pensions
  - Estimated savings are roughly $40 million

- 3% Automatic Annual Increase buyout:
  - Retiring Tier 1 members could choose to keep their automatic increases at 3% a year, or they could accept a lower 1.5% annual increase in exchange for a lump sum payment of 70% of the difference between what they would have gotten with 3% increases and what they will now get with 1.5% increases
  - Estimated savings are $382 million

- Reduction of the “spiking cap” from 6% to 3%:
  - Requires local employers to pick up the increased cost of pensions if they are due to a salary increase of more than 3% at the end of an employee’s career
  - Estimated savings are $22 million

There are several reasons the State should not count savings from these pension reforms immediately.
First, regarding the buyout provisions, although it is reasonable to assume that some members of the pension systems will find this option attractive and will choose to participate, the fact remains that savings hinge entirely on how many people opt in. The State assumed participation based on a similar program in Missouri and projected Illinois’ savings using the same 22% take-up rate Missouri initially saw. It is likely that the State will achieve some savings if and when the programs are implemented, but the State cannot guarantee that they will be to the level of what is assumed in the enacted FY19 budget.

An additional concern with counting pension buyout savings now is that the timing of implementation is such that a significant portion of savings will not occur immediately. First, the State will need to issue bonds to pay for the buyout, the timing of which has not been determined. Additionally, as described in the FY19 Budget Implementation Act (“BIMP”), which authorized the pension buyout programs, members may opt into the buyout programs until June 30, 2021. Given the nearly three-year window of time over which the buyout program could take place, it does not make sense to count all of the savings from the programs upfront.

Lastly, even if all assumptions are met and the timing works such that these reforms produce savings in FY19, there will be costs associated with these buyout programs that are not included. Future debt service on the bonds used to pay for the buyouts (and the costs associated with issuing those bonds) will reduce the net savings to the State.

Potential Areas of Future Savings

After years of budget issues, it appears that the State has utilized many sources of General Funds savings; however, our analysis indicates that the State Employee Group Insurance Program (SEGIP) is one area for significant General Funds savings. We also continue to believe that the State should conduct a comprehensive analysis of both General Funds and Other State Funds to determine what savings might exist in funds that typically are not scrutinized during the budget process. Additionally, the State should continue to pursue local government consolidation measures in order to reduce the cost of government and achieve savings through more efficient governance, which could in turn reduce the yearly cost of State transfers to local governments and would benefit State taxpayers by reducing their local tax burden.

General Funds Savings: State Employees’ Group Insurance Program (SEGIP)

The State Employees’ Group Insurance Program (SEGIP) provides medical, dental, vision, and life insurance coverage to the following (and their dependents):

- Active State employees;
- Elected State officials (legislators and judges); and
- State university employees.

SEGIP also provides retiree healthcare benefits for members of the State’s five pension plans (and their dependents) EXCEPT:

- Teachers who receive benefits through the Teachers’ Retirement Insurance Program (TRIP); and
- Community college workers who receive benefits through the College Insurance Program (CIP).
SEGIP participants have their choice of medical plans, including HMOs, Open Access Plans (OAPs), and the State’s self-insured plan (QCHP). Medicare-eligible retirees and their Medicare-eligible dependents must enroll in Medicare Advantage HMO and PPO plans.

In FY18, costs associated with SEGIP totaled approximately $3.1 billion, including $335 million in interest payments from overdue FY16/FY17 bills that were paid in FY18. Excluding interest payments, total SEGIP costs were close to $2.8 billion, with medical care coverage accounting for about 85% of the total ($2.4 billion).

**SEGIP and the Previously Proposed FY19 Budget**

A package of reforms to the existing medical plans offered to SEGIP enrollees (excluding the Medicare Advantage plans) have been proposed to create a multi-tier system of “metal” plans – Platinum, Gold, Silver, and Bronze – for the QCHP, HMO, and OAP plans. The tiers would be defined by a balance between increased premiums and/or increased out-of-pocket costs (co-payments, deductibles, etc.):

- Platinum plans would require significant increases to the current employee premium contribution;
- Silver plans would keep the employee premium contribution at the current level but have higher out-of-pocket costs;
- Gold plans would split the difference between the Platinum and Silver plans; and
- Bronze plans would have no employee premium contribution but much higher out-of-pocket costs.

Each of these plans would increase employee contributions toward their own healthcare costs, whether by higher premiums or higher out-of-pocket costs.

Successful implementation of the reforms, which was assumed in the former Governor’s FY19 Proposed Budget, was expected to reduce FY19 General Funds expenditures on group health insurance by about $470 million. These reform provisions were included in contract negotiations with the American Federation of State, County and Municipal Employees (AFSCME) union; however, those negotiations were at a stalemate and the subject of litigation. (The Governor also requested that the General Assembly change the statute that requires negotiating health benefits for public workers through collective bargaining but was unsuccessful). In addition, the FY19 Proposed Budget included a shift of $105 million in group health insurance costs for State university workers to the universities that employ them. That proposed cost shift was rejected by the General Assembly.

As a result, the FY19 Enacted Budget does not include either the “metal” tier reforms or the cost shift and appropriates $2 billion in General Funds for group health insurance – the FY19 Proposed Budget appropriated only $1.45 billion. We believe healthcare plan reforms that align the State’s plans better with what is offered in the private sector should be pursued.

**Retiree Healthcare under SEGIP**

As described above, the State requires Medicare-eligible retirees and their Medicare-eligible dependents to enroll in Medicare Advantage plans which are offered by private companies that contract with the federal government to provide Medicare benefits.
This requirement went into effect in FY14; prior to that, Medicare-eligible retirees were offered the same plans as other SEGIP enrollees.

Retiree healthcare benefits are similar to pension benefits in that future benefits are earned through current service (i.e., the 5% retiree healthcare premium subsidy that is earned for each year of service). Therefore, similar to the treatment of pension benefits, the State is required to report the present value of future employer-provided retiree healthcare benefits that are attributable to previous service – the accrued Other Post-Employment Benefits (OPEB) liability. The State does not pre-fund its OPEB liability in the same way that it pre-funds its pension liability; retiree healthcare benefits are funded on a pay-as-you-go basis. As a result, the unfunded OPEB liability is equal to the accrued OPEB liability.

The Governmental Accounting Standards Board requires that OPEB liabilities be reported and that OPEB programs funded on a pay-as-you-go basis (like Illinois) use a discount rate that is consistent with an index of high-quality 20-year general obligation bonds. The discount rate used for the State’s accrued OPEB liability as of June 30, 2016 was 2.85%, and the accrued OPEB liability was reported as $42 billion.\textsuperscript{110}

Retiree Healthcare Reforms and the Kanerva Decision

Opportunities for reducing the cost of retiree healthcare fall into two broad categories – changes to the medical plan(s) offered to retirees and changes to the State’s subsidy of retiree healthcare premiums. The successful shift of Medicare-eligible retirees into Medicare Advantage plans falls into the former category while the Kanerva decision, described below, relates to the latter cost category.

SEGIP enrollees who retired after January 1, 1998 are subject to a statutory provision that the State provide a 5% healthcare premium subsidy for each year of creditable service (i.e., retirees with 20 years of creditable service receive a 100% premium subsidy). SEGIP members who retired before January 1, 1998 are eligible for single coverage at no cost to the member.\textsuperscript{111}

In June of 2012, during the Quinn administration, the State enacted Public Act 97-695, which eliminated the statutory provisions regarding State subsidies of retiree healthcare premiums. Public Act 97-695 gave the Illinois Department of Central Management Services (CMS) the authority to determine how much retirees would contribute toward their premiums.

During the subsequent collective bargaining negotiations, the State negotiated new retiree healthcare provisions with its largest union, AFSCME, which took effect in FY14:\textsuperscript{112}

\begin{itemize}
\item The contract included the requirement that, in FY14, Medicare-eligible retirees contribute 1% of their pension benefit toward their healthcare premium; non-Medicare-eligible retirees were required to contribute 2% of their pension benefit toward their healthcare premium;
\item In FY15, those amounts increased to 2% and 4%; and
\item The contract also included the agreement to move Medicare-eligible retirees into Medicare Advantage plans.
\end{itemize}

Governor Quinn’s administration estimated that, over the course of the two-year contract, increasing retiree premiums would generate $128 million in savings, and the switch to Medicare Advantage would generate savings
of $232 million. State retirees challenged the law in four separate lawsuits that were consolidated and became known as the Kanerva litigation after Roger Kanerva, the lead plaintiff in one of the cases.\textsuperscript{113}

In July 2014, the Illinois Supreme Court held that the State’s subsidies toward the cost of retiree healthcare coverage are subject to constitutional protection, which the legislature may not diminish or impair. As a result of that ruling, the required increased contributions from retirees toward their healthcare premiums imposed by the Quinn administration no longer applied after September 2014.

For FY19, retired SEGIP enrollees are projected to pay only 6.3\% of their healthcare costs.\textsuperscript{114}

However, the Supreme Court decision did not impact the shift of Medicare-eligible retirees and their Medicare-eligible dependents into Medicare Advantage plans. Currently, SEGIP enrollees who become eligible for Medicare (and whose covered dependents are also Medicare-eligible) must enroll in a Medicare Advantage plan if they wish to remain in SEGIP; they are not given the option of remaining in one of the other SEGIP plans.

Potential Cost Savings: Implement a New Retiree Healthcare Plan

The Kanerva decision does not apply to new employees. There is no prohibition against establishing a new retiree healthcare plan that would change the retiree healthcare premium subsidy for future hires. Such a change would not affect the State’s current OPEB liability (because the OPEB liability is based on previous service), but would limit its growth in the future.

Under the current system, the State is taking on approximately $70,000 in promised retirement healthcare benefits for each new hire, on average.\textsuperscript{115} (As an average, this figure factors in employees who will not be owed benefits in retirement, as well as those who will be owed benefits, so the value of promised benefits owed to each person covered by SEGIP at retirement is higher than the $70,000 average.)

These costs are driven in part by the structure of the premium subsidy and the fact that the State assumes payment for 5\% of a retiree’s healthcare premium for every year of service. Recent analysis by the Pew Charitable Trusts demonstrates that the primary driver for variation in OPEB liabilities between states is how they structure their contribution toward retiree healthcare benefits;\textsuperscript{116}

\begin{itemize}
  \item States that provide a monthly contribution equal to a flat percentage of the premium report the largest liabilities and costs that automatically increase as plan premiums increase. Illinois is one of these states;
  \item States with fixed-dollar premium subsidies provide a smaller benefit and report lower liabilities. Their exposure to healthcare cost inflation is also lower because a fixed-dollar subsidy does not rise with the plan premiums; and
  \item States that only provide access to a retiree healthcare plan, with no subsidy, have the lowest liabilities as a percentage of personal income. Although these plans do not make an explicit monthly premium contribution to retirees, many offer retirees a reduced premium through a group rate, which is an implicit subsidy.
\end{itemize}

In order to limit the future growth in its OPEB liability (and reduce the average $70,000 in promised SEGIP retirement benefits associated with each new hire), Illinois should implement a new retiree healthcare plan for future hires as soon as possible. The plan should move away from a fixed percent of premium subsidy and provide either a fixed-dollar premium subsidy or
no subsidy but allow continued access to a group medical plan.

**Potential Cost Savings: Remaining Avenues for Healthcare Benefit Reform in the Context of Kanerva**

Although the *Kanerva* case provides clear protection of the **premium subsidy** for current retirees, it leaves room for the State to change the **healthcare plans** that the premium subsidy supports. The State may also be able to make prospective changes to the premium subsidy for current employees, but doing so would be difficult to reconcile with other decisions interpreting the pension protection clause.

The State Employees Group Insurance Act gives the State the power to determine and modify the healthcare plans it offers its employees and retirees. It does not, however, spell out the level of benefits that must be included in employee healthcare plans. This is in contrast to the premium subsidy, which is a benefit promised in statute. Accordingly, even though the State cannot change the premium subsidy for current annuitants, the State has the power to make changes to plan design without it being considered a “diminishment or impairment” of benefits under the pension protection clause. Savings could be achieved through changes to healthcare plan design for both current employees and retirees (subject to collective bargaining agreements).

In addition to the creation of a new retiree healthcare plan that would change the premium subsidy for new employees, the State should explore the possibility of making changes to the premium subsidy that current employees earn. Other cases involving the pension protection clause have held that an employee’s rights are governed by the provisions in effect when they entered the system, but statements in the *Kanerva* case emphasized that previous changes had been made in 1997 and 1998 to the premium subsidy for current employees who had not yet retired. In addition, the inherent ambiguity of healthcare compared to pension costs (e.g., pension costs are based on a formula and healthcare benefits are frequently negotiated) suggests that prospective changes to the premium subsidy would not be a diminishment of benefits. Such a change might also generate significant savings for the State.

**Scrutiny of Other State Funds**

One of the major impediments to identifying savings in the State budget is that only about half of the budget is part of budget negotiations and scrutinized closely each year. Typically, budget discussions and negotiations focus on the General Funds; Other State Funds receive little scrutiny by comparison.

The narrow focus on the General Funds budget can be misleading when analyzing total programmatic spending. Key programs, such as Medicaid, receive funding from several sources, including General Funds, federal funds, and Other State Funds. Therefore, looking only at the General Funds portion of Medicaid funding will give an incomplete picture of actual programmatic spending; a reduction in General Funds Medicaid spending could represent an actual cut to the program, or it could merely be a shift in where funding comes from.

In addition, ignoring Other State Funds in budget debates and negotiations allows some significant budgetary choices to be made with little scrutiny. Some important programmatic areas, such as transportation, get the bulk of their funding from sources outside the General Funds. If the State increased the scope of the budget to include All Funds, there would be increased discussion and
scrutiny of spending priorities in these types of programs.

The Fiscal Futures Project at the University of Illinois' Institute for Government and Public Affairs has created an All Funds budget model that aggregates General Funds and Other State Funds into a smaller number of revenue and spending categories. The Fiscal Futures Project's model groups revenue and spending by State function using “fundamental, time-consistent criteria,” allowing for comparison of actual revenues and spending over time.

When the Fiscal Futures Project first conceived the All Funds Budget, the process for aggregating spending and revenue data was manual and time-intensive. More recently, however, the process has become fairly automated. They receive data automatically from the Comptroller's office, which is then run through a computer program to group spending and revenue into programmatic categories. If the State decided to require that the budget process include All Funds, there would be a relatively inexpensive and straightforward implementation process. We urge State leadership to take action to improve budget transparency and require budget documents to include the Fiscal Futures Project's All Funds Budget and undertake a comprehensive review of the State budget.

**Consolidation of Local Governments**

According to the 2012 Census of Governments, Illinois is home to nearly 7,000 units of local government. Revenues for these local governments are nearly as much as the State's General Fund revenues and totaled approximately $30 billion in FY16. (General Fund revenues are projected to be approximately $38.5 billion for FY19.)

For many of these local units of government, public oversight is difficult due to the sheer number of governments in a given area (e.g., there are 536 local governments in Cook County), as well as outdated and inconsistent financial reporting processes. As a result, it is difficult to ensure that government services are being provided efficiently and at the lowest possible cost to taxpayers.

Reducing the number of local governments in Illinois would have an indirect impact on State finances since most local government revenue comes from locally-imposed property taxes. However, local governments are recipients of revenues from some State-imposed taxes, including income taxes and sales taxes. Reducing the cost of local governments through consolidation could reduce the need for revenue, leading to reduced property tax levies or reductions in transfers to local governments from the State.

The Local Government Consolidation section in Part 2 of this report provides details about the cost of local government in Illinois, as well as opportunities for achieving efficiency through consolidation. Although it is difficult to quantify precisely how much taxpayers could save by consolidating governments, the magnitude of potential savings is significant: a 10% reduction in the cost of local government would save Illinois taxpayers $3 billion. We continue to support consolidation efforts (including enabling legislation) and encourage shared services between units of government.
IV. Reform the Tax System to Reduce Illinois' Negative Outlier Status and Raise Revenues, as Needed

One of the key components of the Financial Framework is reforming the tax system to reduce Illinois’ negative outlier status and raise revenues, as needed. A state's tax system is an important consideration for job creators deciding where to locate or expand their businesses; as such, it is critical that Illinois’ tax system is carefully designed so that it raises sufficient revenue to provide necessary services without making the State an outlier.

The Tax Policy Task Force conducted a thorough review of Illinois’ tax system, consulting with tax policy experts and reviewing the findings of a proprietary Business Tax Outlier study (prepared for the Civic Committee in 2015), which compared Illinois’ tax provisions to other states. A key finding of this review was that Illinois’ combined state and local revenues as a percentage of its Gross State Product (GSP) was relatively low, but its combined state and local taxes as a percentage of GSP was relatively high.\(^\text{125}\)

This is due to the fact that Illinois cannot access some streams of revenue that other states have access to (including higher levels of federal funding,\(^\text{126}\) as well as other own-source revenues from state enterprises such as public hospital systems), so the State relies more heavily on taxes for revenue. Recognizing that the State has limited options for non-tax own-source revenues and already relies heavily on taxes, the Task Force emphasized that any tax increases must be carefully considered and thoughtfully targeted.

In *Bringing Illinois Back*, the Tax Policy Task Force presented several tax policy options that would raise needed revenues for the State without contributing to Illinois’ negative outlier status. These options included:

- Increasing the personal income tax rate;
- Increasing the corporate income tax rate;
- Including consumer services in the sales tax base;
- Ending the exclusion of retirement income from the personal income tax base; and
- Means-testing tax exemptions by phasing them out at higher income levels.

In addition to providing options for raising additional revenue, the Civic Committee identified reforms that would enhance Illinois’ competitive position and reduce the State’s negative outlier status, including:

- Eliminating the Estate Tax;
- Eliminating the Corporate Franchise Tax;
- Lowering the LLC fee; and
- Reforming burdensome administrative practices and business tax provisions.
Changes to Illinois’ Tax System

Since Bringing Illinois Back was published, there have been several changes to the State’s tax system. These changes include:

- Increasing the personal income tax rate from 3.75% to 4.95%;
- Increasing the corporate income tax base rate from 5.25% to 7%;
- Increasing the Earned Income Credit for low-income taxpayers from 10% to 14% of the value of the federal EITC;
- Phasing out personal exemptions and some tax credits for high-income taxpayers;
- Reducing LLC fees;
- Reinstating the Research and Development Tax Credit;
- Adding the Graphic Arts Sales Tax Exemption to the Manufacturing Machinery and Equipment Exemption;
- Increasing the value of the K-12 Education Expense Credit;
- Adding an Instructional Materials and Supplies Credit; and
- Decoupling from the federal Domestic Production Activities Deduction.

Many of these changes were recommended as options by the Task Force and had a positive impact on State finances. However, the State has not fully resolved most of its financial issues: Illinois is still running annual deficits, the bill backlog is projected to be approximately $7.8 billion at the end of FY19, and the State has not established an appropriate reserve fund.

While there is room for spending reductions in the General Funds budget and in Other State Funds (as detailed in the “Scrutinize the Entire State Budget for Spending Reductions” section), the State will need additional revenue to address its financial challenges. Some of the additional revenue need can be met by aligning Illinois’ tax system with tax policies in other states (such as ending the exclusion of retirement income from the income tax base and taxing consumer services), but the State’s financial challenges are such that the State must consider other revenue options as well.

Illinois is a high-tax state: analysis from the Taxpayers’ Federation of Illinois estimates that Illinois’ state and local taxes rank 11th highest out of all states when adjusting for today’s higher income tax rates. The State must remain mindful about which revenue options it pursues so it does not excessively increase Illinois’ negative outlier status and damage the State’s economy.

Our analysis indicates that the personal income tax may offer the best opportunity for raising additional revenues while inflicting the least damage possible on the State’s tax climate. According to the Tax Foundation’s 2019 State Business Tax Climate Index, Illinois ranks favorably compared to other states on its personal income tax. With the current 4.95% tax rate in place, Illinois’ personal income tax ranked 13th out of all states. By contrast, the State ranked much lower on other tax types: 39th for the corporate income tax, 36th for sales taxes, 45th for property taxes, and 42nd for unemployment insurance taxes. It is likely that a personal income tax increase would not substantially change Illinois’ ranking relative to other states. The estimated revenue impact of increasing the personal income tax is substantial. A full percentage point increase, which would raise the tax rate to 5.95%, would bring in an additional $3.7 billion a year.
However, recognizing the impact of an increase in the personal income tax rate, the State should also consider measures to provide tax relief to low-income families. For example, one way to achieve this goal would be to increase the value of the State’s Earned Income Tax Credit.

With an increase in the personal income tax, the State would also need to consider an increase in the corporate income tax. The State has historically maintained a ratio between the personal income tax rate and the corporate income tax base rate (in recent years, this ratio has been 7:5), but due to the State’s combined corporate income tax rate being relatively high compared to other states, the State should consider a smaller increase. The estimated revenue impact of increasing the corporate income tax base rate by one percentage point to 8% would be approximately $300 million.

In addition to ensuring that revenues (combined with spending reductions) are sufficient to fund necessary State services, the Civic Committee urges State leadership to adopt tax policies that will reduce Illinois’ negative outlier status. Several policy recommendations that fall under this category are described below.

**Reforms to Reduce Illinois’ Outlier Status**

Despite the recent changes made to the State’s tax system, there are still a number of ways in which Illinois is an outlier compared to other states:

- Other states levy taxes that Illinois does not;
- Illinois imposes some taxes that other states do not; and
- Illinois has burdensome administrative procedures.

**Taxes Other States Levy that Illinois Does Not**

Illinois is an outlier because it does not levy some taxes that other states do, including applying the personal income tax to retirement income and extending the sales tax to consumer services.

**Extending the Personal Income Tax to Retirement Income**

Illinois is one of only three states that has a personal income tax and completely excludes retirement income from taxation. The structure of this exclusion is broad and inefficient; all retirement income (including pensions, IRAs, 401(k)s, Social Security, etc.) is excluded from taxation regardless of the age or income of the taxpayer.

The retirement income exclusion is one of the State’s largest tax expenditures and costs the State billions in foregone revenue each year. Additionally, the portion of income exempt from taxation under the retirement income exclusion is growing much faster than taxable income in Illinois: the value of excluded income grew by 51% from 2007-2015, compared to 18% growth in the value of taxable income during the same time period.

This exclusion is often discussed as a measure to protect low-income seniors, but in 2015, only about 13% of the value of the retirement income exclusion was associated with seniors with incomes of $50,000 or less. The remaining 87% benefited taxpayers who were younger, richer, or both. Additionally, the retirement income exclusion does not protect low-income seniors who have to work, since their wage income is fully taxable.
Traditional analysis of taxing retirement income in Illinois generally assumes any tax break for seniors will be attached to retirement income specifically (e.g., there would still be an unlimited retirement income exclusion but only for those with Adjusted Gross Income less than $100,000). However, after thorough analysis of other states’ retirement income tax provisions, there are other approaches that Illinois could consider that would cost less than the current retirement income exclusion and would more precisely target tax relief to low-income seniors than today’s unlimited exclusion.

Broadly, these approaches can be separated into three categories:

- Provisions that limit the type of retirement income that is excluded from taxation;
- Provisions that limit the amount of retirement income that is excluded from taxation; and
- Provisions that do not provide tax relief based on the type of income, but instead provide tax breaks based on age and/or income requirements.

The Civic Committee recommends a policy approach in line with the third category above: eliminating the blanket exclusion for retirement income and providing tax relief to seniors by increasing the value of the 65 and over exemption. Providing tax relief through the 65 and over exemption provides the following advantages:

- **Tax relief would be tied to age.** The current retirement income exclusion has no age requirement, so a younger person who inherits an IRA, for example, can take distributions from it without paying taxes.

- **It reduces the inequity between working seniors and retired seniors.** As described above, seniors who work to supplement their retirement income currently must pay full taxes on their wages. Structuring tax relief so that it applies to all types of income would allow seniors to exempt wage income from taxation as well.

- **Implementation would be simple.** The 65 and over exemption already exists; the legislature would only need to increase the value.

If the State were to eliminate the retirement income exclusion and increase the 65 and over exemption to $15,000, it would bring in as much as **$1.9 billion a year** at a 5.95% tax rate.135 (This estimate is based on 2015 tax data and is therefore likely to be conservative; when evaluated using today’s larger tax base, the revenue impact is likely to be significantly greater.)

There are several different variations of this policy proposal that would affect the revenue estimate above, namely the State could increase or decrease the value of the 65 and over exemption. For example, increasing the value of the 65 and over exemption to $20,000 would decrease projected revenues to $1.6 billion.

The State should extend the personal income tax to retirement income by eliminating its retirement income exclusion and increasing the value of its 65 and over exemption. Doing so would reduce Illinois’ status as an outlier, raise much-needed revenue, and provide more targeted tax relief to seniors.
Taxes on Consumer Services

Illinois’ state and local sales tax rates are frequently cited as some of the highest in the nation. According to recent analysis by the Tax Foundation, Illinois’ combined State and average local rate is 8.7%, making it the 7th highest in the country. However, Illinois’ sales tax revenues as a percentage of GSP are relatively low compared to other states with a sales tax; by that metric, Illinois’ sales tax revenues ranked 34th lowest among all states in FY16. It is important to note that in addition to general sales taxes, Illinois levies excise taxes on certain goods and services, including on tobacco products, hotels, and various utilities. If excise taxes are accounted for in the ranking of state and local sales taxes as a percentage of GSP, Illinois’ ranking climbs to 25th.

The fact that Illinois has relatively low state and local sales tax revenues despite relatively high tax rates is likely due to a few different factors that narrow the State’s sales tax base. The first factor is Illinois’ use of excise taxes on certain goods and services, including on tobacco products, hotels, and various utilities. If excise taxes are accounted for in the ranking of state and local sales taxes as a percentage of GSP, Illinois’ ranking climbs to 25th.

States with a sales tax tend to include most goods but few services in their sales tax base, despite the shift to a more service-based economy. Very few states could be described as having a broad-based sales tax on services, but Illinois stands out because it taxes even fewer services than most. According to a 2017 survey of states by the Federation of Tax Administrators, Illinois taxed 29 out of 176 services they track; the number of services taxed by the median state is 60. By taxing fewer services than most states, Illinois’ tax base is much narrower, making it an outlier.

To bring its sales tax system more in line with other states, Illinois should extend the sales tax to include more services, focusing on consumer services to avoid taxing business-to-business transactions. In 2017, the Commission on Government Forecasting and Accountability (COGFA) produced estimates for how much revenue the State could expect if it taxed services like neighboring states. The revenue estimates at full compliance range from $179 million (taxing six additional services currently taxed by Kentucky) to $1.2 billion (taxing 81 additional services that are currently taxed by Iowa).

Recognizing that the mix of services taxed in other states may or may not make sense for Illinois, the Task Force recommends identifying a set of services to tax that would bring in an additional $500 million in revenue.

Taxes Illinois Imposes That Other States Do Not Impose

Two examples of taxes that Illinois imposes that most other states do not are the Franchise Tax and the Estate Tax.

Capital-Based Portion of the Franchise Tax

Illinois’ Franchise Tax is levied on corporations doing business in the State. Broadly, there are two components: registration/filing fees on corporations, as well as a capital-based tax.

The fee portion includes the fees that corporations pay when they initially form or register, their annual report fee, and reinstatement fees. All states require corporations to file and pay an annual fee for the privilege of doing business.

The tax portion is made up of three components: the initial franchise tax (imposed when a corporation begins doing business in Illinois), the annual franchise tax (an annual
tax of 0.1% on paid-in capital),\textsuperscript{146} and an additional franchise tax (imposed whenever events trigger an increase in the corporation's paid-in capital).\textsuperscript{147} According to the Tax Foundation, only 16 states have a capital-based tax, and two of those states are in the process of phasing it out.\textsuperscript{148}

The fact that Illinois has a Franchise Tax makes it a negative outlier, but there are business-related concerns about the Franchise Tax that the State should consider as well. For example, the method for calculating the Franchise Tax in Illinois is complicated and burdensome and can lead to tax pyramiding. Tax pyramiding, in turn, can negatively impact business formation, expansion, and investment.\textsuperscript{149}

The Franchise Tax (including both the tax and fee portion) is expected to bring in approximately $205 million for FY19.\textsuperscript{150}

Since it discourages business formation and investment and makes Illinois an outlier, the capital-based tax portion of the Franchise Tax should be repealed by the State. However, the State should continue to charge corporations filing and registration fees (since that is standard practice for other states) and should set these fees at a level that is competitive with other states. This would lessen the budget impact of repealing the Franchise Tax entirely and would not make Illinois an outlier.

\textit{Estate Tax}

There are two types of taxes triggered by a person's death: an estate tax, which is imposed on the net value of an estate before it is distributed to inheritors, and an inheritance tax, which is paid by heirs or beneficiaries upon receipt of a bequest.

Illinois is one of only 13 states that has an estate tax (six others have an inheritance tax), making it an outlier. It applies to estates valued at more than $4,000,000 and taxes assets at graduated rates ranging from 0% to 16% (only the state of Washington has a higher top marginal rate on its estate tax at 20%).\textsuperscript{151} The Estate Tax is projected to bring in roughly $290 million for FY19.\textsuperscript{152}

The federal government has had an estate tax in place since 1916,\textsuperscript{153} enacted against the backdrop of rising concentration of wealth, and progressives advocating for estate and inheritance taxes as tools to address income inequality.\textsuperscript{154} At that time, many states also had estate or inheritance taxes, but more states enacted them after a federal tax credit for state estate taxes was created (1924) and later increased (1926). Initially, the credit was capped at 25% of federal estate tax liability; Congress later increased the credit to 80% of the federal estate tax liability.\textsuperscript{155}

States that already had estate and inheritance taxes responded by modifying them to take better advantage of the credit. States frequently designed their estate taxes as “pick-up taxes,” where the amount of state tax liability was equal to the maximum value of the federal credit.\textsuperscript{156} These pick-up taxes captured tax revenue that, absent a state level estate tax, simply would have gone to the federal government. As a result, they did not increase a taxpayer's overall tax liabilities. Instead, they merely shifted tax revenue from the federal government to state governments.

This changed when the federal tax credit for state estate taxes was phased out with the passage of the Economic Growth Tax Relief Reconciliation Act (EGTRRA) in 2001; the tax credit was completely eliminated by 2005. After the credit's elimination, state estate and inheritance taxes imposed an additional tax burden on estates. As a result, many states repealed their estate taxes or had their estate
taxes effectively zeroed out if their statute was directly tied to the federal credit.\textsuperscript{157}

The fact that Illinois has an estate tax after most other states repealed them makes it an outlier. While it may make policy sense for a \textbf{federal} estate tax to exist as a tool to raise revenues in a progressive way, the lack of estate taxes in most states has created a competitive tax environment in which states that still have an estate tax are at a disadvantage. The existence of Illinois' estate tax provides an incentive for the State's wealthiest residents to move to another state (and stop paying other taxes and otherwise contribute to the State's economy) or shift their assets and investments to other states so that they will not be subject to the Illinois estate tax.

A working paper from the National Bureau of Economic Research supports this concern about Illinois' competitiveness. The study looked at federal estate tax returns across all states over an 18-year period and showed that there is a relationship between a state's effective estate and inheritance tax rates and the number of federal estate tax returns filed in that state.\textsuperscript{158} For every one percentage point increase in the effective estate and inheritance tax rate for a state, the number of federal estate tax returns filed in the state declined by 1.4\% to 2.7\% (depending on the model used). The number of returns for the highest wealth estates ($5 million or more) were even more sensitive to estate and inheritance effective tax rates: for a one percentage point increase in a state's effective estate and inheritance tax rate, the number of returns in this wealth category declined by nearly 4\%.\textsuperscript{159} It is unclear if the reduction in federal estate tax returns filed in a given state is due to high wealth individuals actually moving out of state or merely changing their reported state of residence.\textsuperscript{160} Regardless of whether or not these changes are due to actual migration, this study provides evidence of behavioral responses to state tax policy by high-wealth individuals.

The migration of high-wealth individuals to other states may have negative effects on philanthropy. A study of migration to and from New Jersey from 1999-2008 showed how changes in the migration patterns of high-wealth households can impact a state's capacity for charitable giving. From 1999-2003, the net effect of migration into New Jersey resulted in a substantial increase in household wealth and charitable capacity. From 2004-2008, the migration flow was reversed: fewer high-wealth households migrated to New Jersey, and there was a moderate uptick in the number of high-wealth households leaving the state. (Note: the study does not address reasons why this migration flow was reversed). The resulting change in estimated charitable giving capacity (based on the wealth of migrating households) was a reduction of approximately $2 billion.\textsuperscript{161}

Since most other states no longer have an estate or inheritance tax, the existence of an estate tax in Illinois creates an incentive for high-wealth residents to move out of state or otherwise modify their behavior to avoid the tax. The potential negative consequences of Illinois' wealthiest residents leaving the State outweigh the benefits of having an estate tax in place. Illinois should repeal its estate tax so that it removes the additional incentive for high-wealth individuals to move out of state and aligns its tax policy more closely with other states.
**Burdensome Administrative Practices**

Illinois has a history of burdensome administrative practices that made it an outlier compared to other states. Many of the issues we raised in *Bringing Illinois Back* have improved, including how the State provides advice to business taxpayers and its implementation of corporate tax credits.

However, there are still some issues that remain a concern, including the Illinois False Claims Act. Under this law, private parties are allowed to assert a tax liability against business taxpayers. Most other states have excluded all tax laws from their False Claims Acts, and Illinois is an outlier because it does not have such an exclusion.

Illinois' tax penalty structure also makes it an outlier. Penalties are imposed to incentivize compliance and timely payment, and Illinois’ financial penalties are higher than many of its peers. In addition, according to the 2015 *Business Tax Outlier Study*, Illinois' tax penalty structure may discourage voluntary compliance due to the fact that penalties are imposed even when taxpayers self-identify errors on previous returns. Taxpayers also face increased penalties if they disagree with the Illinois Department of Revenue and exercise their right to contest an assessment of additional tax liability, unlike most other states.\(^{162}\)

To make Illinois’ administrative practices less burdensome, the General Assembly should amend the False Claims Act to exclude tax laws. In addition, it should reduce the penalties listed in the Uniform Penalty and Interest Act to align them more with the tax penalty structures in other states. Addressing these administrative issues would not be costly to the State but would go a long way toward improving the tax and business climate.
V. Establish Goals and Metrics to Measure the State’s Progress

The final element of the Financial Framework is to establish goals and metrics to measure the State’s progress. The original goals and metrics have largely remained unchanged; it is still a goal to achieve an S&P credit rating of AA, as well as achieve several additional short- and long-term goals.

The goal of the Tax Policy Task Force is to take a holistic approach to improving the State’s finances and business climate. Our Framework provides a blueprint for the policy changes necessary to bring Illinois back to financial solvency; together, our recommendations provide a comprehensive plan that will improve Illinois’ economic performance, reduce uncertainty, and move the State towards a AA credit rating.

**Short-Term Goals**

In the near term (in the next fiscal year after full implementation of the Framework), the State should focus on making changes that will lay the groundwork for improving Illinois’ financial standing and eventually achieving an increase in the State’s credit rating.

These goals include:

- Implementation of a long-term financial planning process that is transparent, implements best practices, and includes the entire State budget;
- Immediate increases to pension funding to accelerate the time frame for reaching the “tread water” level and stopping the growth in the State’s unfunded pension liabilities;
- Meaningful expense reductions based on a comprehensive review of spending across the entire State budget; and
- Reform of tax provisions and practices that make Illinois an outlier compared to other states.

Since 2017, there has been very limited progress on achieving the short-term goals outlined in the Framework. The State has reduced the structural budget deficit, but it has not been fully eliminated, nor has it fully addressed amortization of the unpaid bills. The State also reformed some tax practices that made Illinois an outlier compared to other states, but there are several reforms that remain unaddressed. The State has not made progress on implementing transparent long-term financial planning processes, making contributions to the State’s pension systems that are sufficient to keep the unfunded liability from growing, or making meaningful expense reductions across the entire State budget.
## Long-Term Goals

We have identified several long-term goals (to be achieved within five years of full implementation of the Framework), which set targets for economic performance. These goals include:

- Sustained achievement of the median level of performance among the 50 states for employment growth, GSP growth, and unemployment rate;
- Achievement of “Top 10” performance among all 50 states for per capita income;
- Elimination of the State’s unpaid bills; and
- Establishment of a reserve fund that equals more than 8% of revenues/expenditures.

Although it has only been a year and a half since *Bringing Illinois Back* was published (and, therefore, it is too soon to judge how Illinois is doing with respect to long-term goals), we can look at Illinois’ recent performance to see if the State is on track to meet its long-term goals. The State has improved its position relative to other states on its unemployment rate and remained in the same position for per capita personal income, but its position has declined relative to other states on employment growth and GSP growth. For example, Illinois is:

- 34th out of the 50 states for unemployment rate (previously 43rd).
- 36th out of the 50 states for employment growth (previously 37th).
- 41st out of the 50 states for GSP growth (previously 18th); and
- 15th out of the 50 states for per capita personal income (previously 15th).

In addition, the State has not fully eliminated the bill backlog, established a reserve fund, or reduced outstanding debt.

## S&P Credit Rating

An additional long-term goal identified by the Task Force is to achieve an upgrade in the State’s S&P credit rating to AA. The credit rating was selected as a metric not only because it affects the State’s costs in issuing bonds, but, more fundamentally, because it encompasses many of the economic indicators and measures of government management that the Task Force identified as important to improving Illinois’ overall financial status.

Some of the metrics built into the S&P credit rating include:

- Debt and liability metrics (including pension liabilities);
- Budgetary performance metrics (including the level of reserves);
- Economic indicators (including Gross State Product and income per capita);
- Government framework measures (including whether the state has a balanced budget amendment); and
- Financial management measures (including measures around budget forecasting).

The five elements of the Financial Framework represent a comprehensive set of actions that will improve Illinois’ standing on many of these metrics and will advance the goal of reaching a AA credit rating. As specific policy proposals are made to address the State’s financial issues, the Task Force will evaluate them together as part of a comprehensive plan to determine whether that set of actions will move the State toward AA.

### Issues the State Must Address to Improve the Credit Rating

There are four areas that are continually mentioned as negatives by credit rating
agencies when they review Illinois’ credit: the lack of a structurally balanced budget, the bill backlog, pension liabilities, and the lack of a rainy day fund.

**Lack of a Structurally Balanced Budget**

Despite the State’s balanced budget amendment, Illinois has had significant structural deficits for years. When * Bringing Illinois Back* was originally released, the projected structural deficit (assuming no major policy changes) was approximately $7 billion a year. Since the personal income tax and corporate income tax rates were increased, the structural deficit has been significantly reduced. As such, the gap between revenues and expenditures for FY19 was small enough that a combination of premature savings assumptions, one-time revenues, and interfund borrowing were enough to “balance” the enacted FY19 budget and show a small surplus. However, recent projections from the GOMB show that the deficit is actually more than $1 billion.

**Bill Backlog**

The bill backlog is another factor that has a negative impact on the State’s credit rating, primarily because the State does not have a plan in place to eliminate it. After issuing bonds last year to pay down part of the backlog, the State has not taken steps to address the remaining unpaid bills, which are expected to total $7.8 billion at the end of FY19. Amortizing the remaining unpaid bills over the next five years will put additional strain on the State budget. The State needs to enact a plan to eliminate the bill backlog and then budget for the additional funding needed.

**Pension Liabilities**

The State's pension liabilities are another drag on its credit rating. Although there is a statutory contribution schedule in place, it is not seen as a credible funding plan because it does not aim for 100% funding and it increases contributions in the later years of the schedule to a degree that makes it unlikely the State could ever pay them. Additionally, the State's current pension contributions are not sufficient to keep the unfunded liability from growing. In order to demonstrate that the State is serious about addressing its pension problems, it needs to re-evaluate the contribution schedule (whether through making supplemental contributions, changing the payment schedule, etc.) so that it represents a credible plan to pay down its unfunded pension liabilities.

**Lack of a Rainy Day Fund**

Lastly, Illinois needs to establish a robust reserve fund in order to provide sufficient funds to operate State government should there be an economic downturn or some other budgetary shock. A healthy reserve fund (as determined by S&P) should be at least 8% of general revenues; as such, Illinois should aim to have a reserve fund of $4-5 billion. This could be achieved in five years if the State budgeted $1 billion a year; in the meantime, making significant contributions to the rainy day fund would demonstrate to the rating agencies that Illinois is taking steps to improve its financial management practices.
Illinois has a long road ahead to improve its financial situation enough to achieve an upgrade in its credit rating to AA. As specific policy proposals are made to address Illinois’ finances, the State should ensure that it evaluates them as part of a set of actions that would advance the goal of a credit rating upgrade. Any plan the State advances should lay the groundwork for financial solvency, improving Illinois’ overall financial status and, as a result, put the State’s credit rating on an upward trajectory.

Financial Impact of Improving the Credit Rating

Achieving AA status is important for Illinois because the rating encompasses a number of meaningful financial fundamentals that the State must achieve. The rating serves as a single, objectively evaluated measure of Illinois’ progress towards achieving sound financial footing.

Additionally, an upgrade in the State’s credit rating is important because Illinois’ near-junk ratings increase the costs of borrowing to levels far higher than peer states. Illinois’ bonds are riskier, so the State has to pay much higher interest rates than it would if its credit rating were better. In addition, the State’s low rating impacts all bond-issuing entities (such as local governments, universities, and school districts) in the State.

In April of 2018, State of Illinois General Obligation (GO) Bonds were trading at approximately 215 basis points over the AAA Municipal Market Data (MMD) Curve, which is a benchmark yield curve for AAA-rated GO bonds. More recently, that spread has narrowed to about 185 basis points. Nonetheless, the State of Wisconsin’s GO bonds (rated Aa1/AA/AA+ by Moody’s, S&P, and Fitch, respectively) are currently trading at about 10 basis points over the AAA MMD. If Illinois takes the steps necessary to improve its finances and return to its previous AA status, its bonds may trade as much as 175 basis points lower than currently. On a hypothetical $500 million serial issue with equal principal amortization over a 25-year period, that could amount to more than $113 million in debt service savings over the life of the bond issue.165