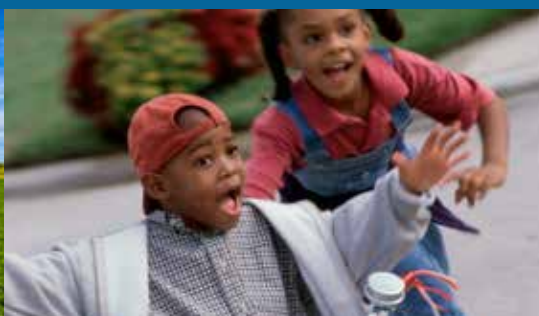


A REPORT OF THE CIVIC COMMITTEE OF THE COMMERCIAL CLUB OF CHICAGO

Bringing Illinois Back: A Framework for our Future



The
Civic Committee
of the Commercial Club of Chicago



The Civic Committee would like to thank PricewaterhouseCoopers LLP for its generous support in the graphic design and production of this report.

Bringing Illinois Back: A Framework for Our Future

With its large, diversified economy, educated workforce, abundant natural resources and prime location, Illinois is the economic engine of the Midwest – with the City of Chicago at its financial and cultural center.

Almost 1/3 of Illinois' adult residents have bachelor's degrees or more (13th highest in the nation), and Illinois' median household income has averaged 4.5% annual growth since 2011 – significantly higher than the national average of 3.1%. Chicago is second only to Boston in its number of universities, and Illinois is home to some of the world's premier research entities – the University of Chicago, Northwestern University, the University of Illinois and Argonne Lab. With its deep roots in the financial services industry, Chicago was recently named among the top five international hubs for financial technology and innovation. Chicago was also designated one of A.T. Kearney's 15 "Global Elite" cities based on its ability to attract and retain global capital, people and ideas, as well as to sustain that performance in the long term.

In addition, Illinois' central location and extensive and diverse transportation network make it the nation's transportation hub. O'Hare Airport is the 4th busiest airport in the world by passenger volume, and 4th busiest in the US by cargo weight. Chicago is the only city served by the six largest North American railroads, and is first in the nation in rail freight volume. Seven interstate highways converge in the metropolitan area, and the region's water system serves as the only connection between the Mississippi waterway and the Great Lakes.

Yet, against this vibrant backdrop, the State of Illinois faces an unprecedented fiscal crisis. Illinois has gone 21 months without a fully enacted State budget. The backlog of unpaid bills has risen to almost \$13 billion – growing by \$500 million each month without a budget. The State's pension funds have amassed \$130 billion in unfunded liabilities, and annual pension costs surpass State spending on K-12 education. Illinois' credit rating, already worst in the nation, is at risk of dropping below investment grade. Several of Illinois' public universities have already been downgraded to "junk" status as they have lost critical State funding to support their operations.

According to published reports:

- More than 1 million Illinois residents have lost access to critical services.
- The State's higher education system has sustained cuts of \$2.3 billion over the last two years, and 130,000 low income college students have lost tuition grants – threatening their ability to participate in the 21st century economy.
- Unpaid health insurance claims for State employees reached \$4.2 billion at the end of February, and continue to accumulate at the rate of \$200 million per month. Payment cycles are extremely long – approaching two years in certain areas.

Equally concerning is the impact of the budget stalemate on Illinois' jobs climate. Increasing uncertainty about the State's fiscal future – as well as the ongoing damage to Illinois' schools, universities and public services – makes Illinois less attractive to businesses considering where to locate or expand jobs, despite all of its other advantages.

As an organization of the region's largest employers, the Civic Committee of the Commercial Club has become increasingly concerned about the deterioration of Illinois' attractiveness as a place to live and work, as well as its reputation among investors. This report lays out our recommendations for bringing Illinois back. While the budget impasse is clearly the most pressing issue facing the State, other aspects of Illinois' job climate are also a cause for concern. In addition to our financial Framework, we include recommendations to improve the effectiveness and efficiency of local governments, school funding reforms and changes to the State's workers' compensation system.

In drafting this report, we observed that Illinois' practices and policies frequently make it an outlier compared to other states:

- **Financial Framework:** Illinois imposes some taxes that most other states do not impose, and, conversely, does not impose some taxes that most other states impose.

- **Local Governments:** Illinois has more local governments than any other state; inadequate reporting requirements fail to provide needed transparency and accountability, and current law creates significant obstacles to local government consolidation.
- **School Funding:** Illinois' current school funding formula creates one of the greatest disparities in the nation between funding for wealthy and poor school districts.
- **Workers' Compensation:** Illinois' workers' compensation provisions do not incorporate the best practices of similar states, such as linking fee schedules to Medicare rates and implementing treatment and return-to-work guidelines.

Illinois' position as an outlier suggests that significant improvement may result from moving to align with the practices of most other states. Our recommendations are frequently based on that principle, and incorporate reasonable, common-sense reforms that have a proven track record.

The report is divided into two major sections:

I. Financial Framework:

This section includes a deep review of Illinois' budgetary and fiscal practices and recommends the adoption of a financial Framework consisting of five key elements.

The State should:

1. Implement long-term financial planning processes and increase fiscal transparency;

2. Eliminate the State's structural budget deficit and unpaid bills, establish a reserve fund, and begin to address the almost \$130 billion in unfunded liabilities of the State's pension funds;
3. Reduce spending across the entire State budget;
4. Reform the tax system to reduce Illinois' negative outlier status and raise revenues, as needed; and
5. Establish goals and metrics to measure the State's progress back to financial solvency.

In addition, this section includes a specific revenue and spending proposal to balance the budget and begin to pay down the State's debts.

II. Additional Reforms to Improve Jobs Climate

Local Governments:

Illinois has more local governments than any other state. These almost 7,000 units have outdated and inconsistent reporting systems and little public oversight, yet they receive significant local and State funds. This section calls for the implementation of reforms that standardize and improve the reporting of accurate financial data, as well as the adoption of measures that encourage local government coordination, consolidation and dissolution.

School Funding:

As with all parts of the State budget, P-12 education has been stressed under the current budget crisis. Yet, the most critical issue in funding P-12 education is the manner in which funds are distributed. Illinois' heavy reliance on local property taxes leads to substantial disparities between the spending in wealthy and poor

school districts. The current model for distributing State aid to school districts fails to adequately counter these disparities. The recent Illinois School Funding Reform Commission Report provided a series of principles that we believe should serve as a framework for the evaluation of all proposed new funding models.

Workers' Compensation:

Despite the 2011 workers' compensation reforms, Illinois continues to have some of the highest workers' compensation costs in the nation. Additional reforms that bring Illinois more in line with the practices of other states are a sensible next step to lower costs and improve the State's business climate, while maintaining the critical role of the workers' compensation system in caring for injured workers. Recommendations include reforms to causation standards, as well as provisions governing medical and indemnity benefits.

While the challenges facing Illinois are considerable, we believe that with the right combination of actions and a focus on what is best for the long-term health of our State, its communities and our fellow citizens, those challenges can be overcome, and Illinois' competitive advantages can once again take center stage.

This report focuses on a set of sensible, balanced reforms that leverage the best practices of other states. They will require some sacrifice from a broad swath of stakeholders across Illinois, but together they form a clear and reasonable path to bring our State and local governments back. However, State leadership must move swiftly to address these issues – the passage of time only increases the massive backlog of bills, puts more public services at risk, and makes the task of bringing Illinois back increasingly difficult.

Part I: Financial Framework

Report of the Tax Policy Task Force

Tax Policy Task Force

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This section summarizes the findings and recommendations of the Civic Committee's Tax Policy Task Force, which was established in the summer of 2015 to examine the fiscal challenges facing the State of Illinois. These recommendations are centered on a Framework of long-term, comprehensive reforms to the State's fiscal policies, which will restore the integrity of the State's budgetary and financial processes.

In addition, given the ongoing budget impasse, a specific revenue and spending proposal has been included in this section's Appendices. This proposal complies with the Framework, but does not include all of its longer-term recommendations, such as a comprehensive review of local revenue-sharing. While these longer-term elements are critical, an immediate plan for addressing the State's budget crisis is the most pressing concern.

The Civic Committee of the Commercial Club of Chicago is a private, not-for-profit organization of senior executives from the region's largest employers, and is committed to improving Chicago and Illinois for those who live, work and conduct business here. Over the last few years, Civic Committee leadership has become increasingly concerned about the deterioration of Illinois' attractiveness as a place to live and work, as well as its reputation among investors.

In late 2014, the Civic Committee conducted a member survey to help guide its policy initiatives around improving Illinois' jobs climate. The results of that survey pointed to widespread concern about the State's tax policies and how they impact Illinois' attractiveness to job creators. While members expressed some concern about the tax rates in place at that time—a 5% individual income tax rate and a 9.5% total corporate income tax rate (both of which were partially rolled back on January 1, 2015), as well as high property and sales tax rates—they were even more concerned about Illinois' fiscal future.

In particular, the *uncertainty* created by State government's lack of responsible, long-term financial planning, and overall poor fiscal health, as well as the prospect of ad hoc, poorly-planned tax increases in the future, will increasingly make Illinois a bad bet for business investment and job creation.

As a result, Civic Committee leadership formed a Tax Policy Task Force ("Task Force") to examine the financial challenges facing Illinois, especially focused on tax and budgetary policies and practices that require improvement or significant change. The Task Force met with legislators, experts from the Federal Reserve Bank, the Taxpayers' Federation of Illinois and the Civic Federation, as well as municipal bond experts, tax policy experts (who produced a proprietary Business Tax Outlier Study comparing Illinois to other states), state budget experts and others.

Based on the work of its Task Force, the Civic Committee has developed a framework for Illinois' future that incorporates the disciplined fiscal practices needed to restore the integrity of the State's budgetary and financial processes.

If fully implemented over a five year period, that framework will:

- Bring the State back to financial solvency while ensuring the provision of critical public services to the State's residents;
- Renew Illinois' position as an attractive place to locate and expand jobs; and

- Turn around Illinois' reputation among investors and the general public.

Our goal in these efforts is to promote economic growth for our State and economic opportunity – and jobs – for its people. We believe that it is important to have specific metrics to evaluate how well the State's fiscal management is serving the ultimate objective of improvement in economic growth and opportunity. Accordingly, measurable goals that serve as targets for the State's financial and economic future are a critical part of the framework. Sustained growth in employment and Gross State Product (GSP) are the most direct measures of economic health and vibrancy, and are included in our target goals. However, other factors are also essential – such as restored confidence in State government's fiscal management and increased certainty about Illinois' financial future. In addition, the most pressing issues currently facing State government are balancing the annual budget, paying off the unpaid bills, establishing a reserve fund, and beginning to address the almost \$130 billion in unfunded liabilities of the State's pension funds.

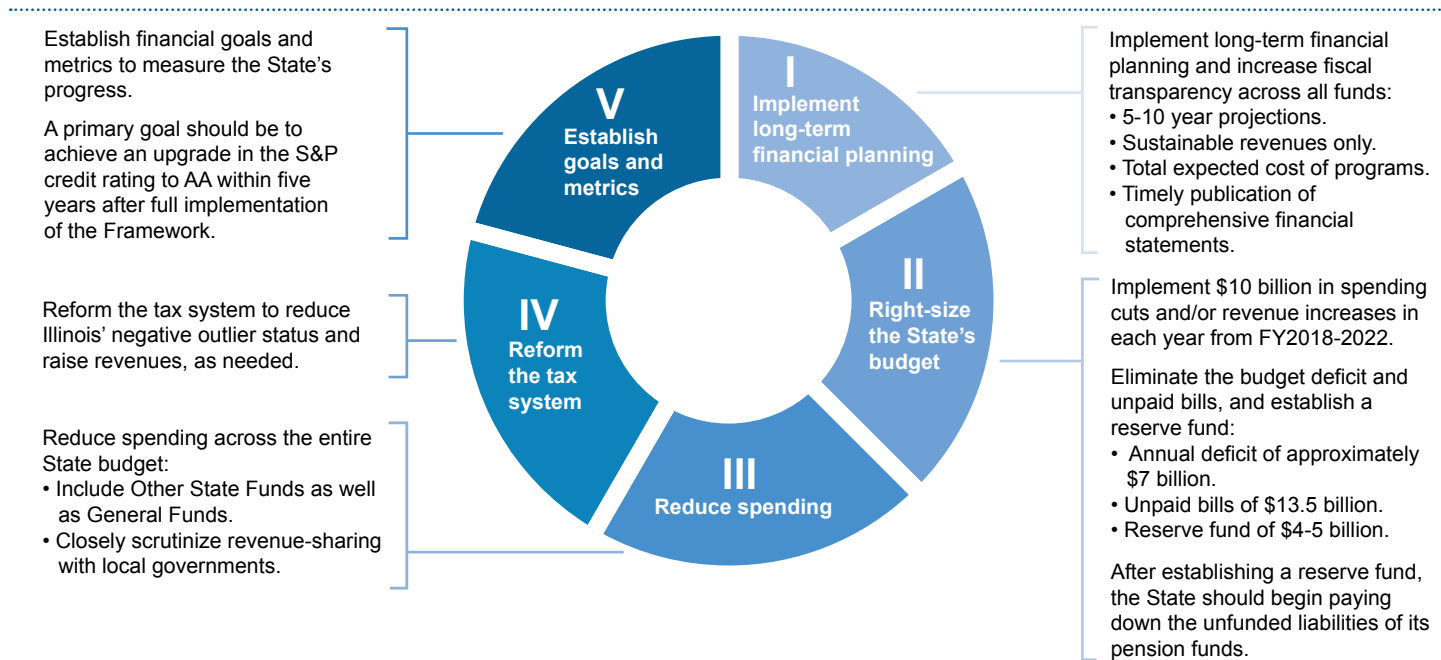
A clear, recognized metric that encompasses all these factors is the State's credit rating. While not a perfect measure, the credit rating consolidates many different fiscal and economic metrics into one aggregate score, and also serves as a measure of fiscal uncertainty. Achieving an upgrade in Illinois' S&P credit rating to AA in five years should be a primary goal. Improvements in the credit rating will demonstrate increased confidence in the State's fiscal management and prospects for economic growth, while future downgrades will demonstrate that State government continues on its current destructive path.

The Civic Committee's framework ("Framework") consists of the five elements described below – all of which together are essential to reducing uncertainty and restoring the State's credit rating, which are essential to achieving sustained economic growth. The issues facing Illinois are closely connected and the five elements of the Framework reflect that interconnectedness.

The State should:

- I. Implement long-term financial planning processes and increase fiscal transparency;
- II. Eliminate the State's structural budget deficit and unpaid bills, establish a reserve fund, and begin to address the almost \$130 billion in unfunded liabilities of the State's pension funds;
- III. Reduce spending across the entire State budget;

Figure 1—Civic Committee Framework



- IV. Reform the tax system to reduce Illinois' negative outlier status and raise revenues, as needed; and
- V. Establish goals and metrics to measure the State's progress back to financial solvency.

It cannot be overemphasized that the individual recommendations which make up these elements form a comprehensive, balanced plan and must be implemented as such if they are to be effective. Selective or piecemeal implementation would likely do more harm than good.

The Framework itself does not include specific spending or revenue proposals—the responsibility for such specific proposals resides with the State's duly-elected legislative and executive leadership. Instead, the Framework recommends a comprehensive set of fiscal policies based on the best practices of economically vibrant states.

However, the Framework does evaluate the magnitude of the fiscal challenge facing the State of Illinois. To reach fiscal sustainability, the State will have to identify a total of \$10 billion in expenditure reductions/revenue increases for each of the years from FY2018-FY2022. Based on discussions with budget experts, it appears that expenditure reductions will account for, at most, \$2 billion of this \$10 billion requirement. The remaining \$8 billion will have to come from revenue increases.

In addition, while the Framework itself does not include specific revenue or spending recommendations, the Civic Committee has developed a specific revenue and spending proposal that draws heavily from the

best practices described in the Framework. This specific proposal was developed in response to the State's continuing budget impasse, which is worsening the State's fiscal situation and negatively impacting Illinois' citizens, as well as the State's jobs climate. The proposal is included in the Appendices of this section and identifies \$10 billion in annual revenue increases/expenditure reductions.

The Framework does not specifically address the State's capital budget. Nevertheless, ongoing capital investments are essential to maintaining the State's infrastructure and preserving Illinois' position as the nation's transportation hub. Upgrades in the credit rating will lower the State's costs for financing its capital programs by reducing the current interest rate "risk premium" for Illinois' general obligation bonds. Reducing the costs of borrowing for capital projects will be critical in the future, since Illinois has "a significant backlog of overdue maintenance across our infrastructure network," as was noted in the American Society of Civil Engineers 2014 Illinois Report Card. According to the 2012 State Budget Crisis Task Force "Illinois Report," addressing this backlog and overall poor condition of Illinois' infrastructure will require an estimated \$340 billion in capital investment over the next 20-30 years, the bulk of which would be for maintaining, rehabilitating, and replacing roads and bridges (an estimated \$171.4 billion over 30 years). Developing a strong State capital budget in the near future will be critical to promoting economic growth.

Illinois' Current Performance

Illinois is a large and populous state with many inherent advantages. It is home to the City of Chicago, the nation's third largest city and the primary economic driver for the Midwest. Other strategic advantages include the State's location, extensive and diverse transportation network, vast freshwater resources and educated workforce.

Yet despite these advantages, Illinois has struggled in recent years, and now compares unfavorably to other states on many important measures.

- In a recent poll of registered voters conducted by the Paul Simon Institute of Public Policy, 84% said that the State was headed in the wrong direction, and nearly half said they would like to leave Illinois.
- Illinois has experienced three straight years of population loss, resulting in a total population decline of approximately 78,000 people. Only three other states (Connecticut, Vermont, and West Virginia) have seen three straight years of population decline.¹
- Some of Illinois' population decline can be attributed to net *outmigration*.² Data from the Census Bureau shows that from 2010-2016, Illinois experienced net outmigration of approximately 362,000 people.³
- A state's credit rating serves as a useful proxy for evaluating its fiscal health and budgetary practices; Illinois' credit rating is the *worst in the nation*. In addition, the current interest rate "risk premium," as determined by the municipal bond market for State of Illinois general obligation bonds, is the highest of any of the 50 states and increases Illinois' cost of borrowing (as well as the borrowing cost for local governments and universities across the State).
- Illinois' performance on key employment metrics continues to rank in the bottom half of all states.⁴ For example, Illinois is:
 - 37th out of the 50 states for employment growth.
 - 43rd out of the 50 states for unemployment rate.

Civic Committee Framework

It is no wonder that many of Illinois' residents would like to leave the State, or that job creators and investors view opportunities in Illinois with skepticism. Illinois is frequently cited as an example of irresponsible fiscal practices, as well as public policies that appear hostile to job creators.

The elements of the Civic Committee's Framework include substantial changes to Illinois' current practices and policies based on the models and best

practices of successful states. The description of each Framework element below includes a discussion of the current state of affairs in Illinois, as well as the Framework's recommendations.

I. Implement long-term financial planning and increase fiscal transparency

Today, the State's financial planning is incomplete and focused on the near-term. General Funds budget projections include only about half of the State's spending, and historically have extended only three years into the future (the most recent projections extend five years into the future and are summarized in Figure 2).

In addition, short-sighted budgetary practices—such as the use of one-time revenues, sweeps from funds outside of General Funds and borrowing for current operations, as well as the intentional underestimation of the cost of certain programs (which has contributed to the State's rapidly growing pile of unpaid bills)—are used to mask annual deficits and "balance" the State's budget. These practices have allowed Illinois' leadership to avoid making tough choices in the past, instead pushing costs off to the future and driving the State to its current fiscal crisis.

Going forward, the State must implement a long-term planning process that reflects the best practices of fiscally responsible states, and must significantly improve transparency regarding the State's financial condition. Best practices include:

- Clear financial objectives—and metrics to measure progress in reaching those objectives.
- A focus on long-term (5-10 years) financial projections.
- A broad view of all funds under the control of the State (including Other State Funds, as well as revenue-sharing with local governments).
- Expenditure forecasts that reflect the total expected costs of programs (so that service providers can be paid in full and on time).
- Consensus revenue forecasting that reflects only sustainable revenues (no borrowing or one-time revenue sources).
- Publication of 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.
- Timely publication of comprehensive financial statements (reporting revenues and spending, as

well as assets and liabilities) to track progress against the plan and allow for mid-course corrections when necessary.

II. Eliminate the budget deficit and unpaid bills, establish a reserve fund, and begin to address the almost \$130 billion in unfunded liabilities of the State's pension funds

To reach financial solvency over a five-year period, the State will need to right-size its budget by eliminating the structural budget deficit, providing for the amortization of overdue bills over five years (which could be achieved through issuing bonds), and establishing a reserve fund.

As shown in Figure 2, Illinois' chronic budget deficits are expected to continue into the foreseeable future and the level of unpaid bills is expected to grow if existing revenue and spending structures remain in place. As a result, it is estimated that the State will have a budget deficit of approximately \$7 billion in each year from

Figure 2—Baseline General Funds Budget (\$ Billions)

FY2017 projected bill backlog: \$13.5 billion

Fiscal Year:	2018	2019	2020	2021	2022
Total General Funds Revenue	\$32.1	\$32.9	\$33.7	\$34.5	\$35.3
Total General Funds Spending	\$39.8	\$40.3	\$40.6	\$41.6	\$42.5
Surplus/Deficit	\$7.7	\$7.4	\$6.9	\$7.1	\$7.2

Note: Estimates include the Fund for the Advancement of Education and the Commitment to Human Services Fund. These baseline projections were developed using the most recent 5-year projections from the Governor's Office of Management and Budget (GOMB) with the following adjustments:

- Total General Funds Revenues and Total General Funds Expenditures are both reduced to reflect a change to the "offset" methodology that accounts for what Illinois owes for Medicare premiums under the Medicaid program.
- Total General Funds Revenues are reduced to reflect the most recent 3-year revenue projections published by the Commission on Government Forecasting and Accountability (COGFA) in March of 2017. Current estimates have lowered projections for individual and corporate income tax revenues (based on lower-than-expected receipts in FY2017), as well as additional reductions to projected federal sources (based on lower-than-expected State spending that is reimbursable by the federal government).
- Total General Funds Expenditures are also reduced to reflect the decrease in reimbursable spending.

FY2018-FY2022.⁵ Given these projections, the State will need to identify about \$7 billion in spending cuts and/or revenue increases just to eliminate this annual deficit.⁶

However, the State will need to do more than simply eliminate its structural budget deficit.

As a result of previous budget deficits, the State is expected to have \$13.5 billion in unpaid bills at the end of FY2017.⁷ These bills must also be paid off if Illinois is to return to fiscal solvency.

In addition, the State must follow the best practices of other states and establish a reserve fund as a cushion against future budgetary shocks or fluctuations. Such a reserve fund would require an additional \$4-5 billion, depending on total State revenues and expenditures.

Therefore, to return to financial solvency within a five-year timeframe, the State must:

- Eliminate its annual deficit of approximately \$7 billion;
- Pay off its \$13.5 billion in unpaid bills; and
- Establish a reserve fund of approximately \$4-5 billion.⁸

To achieve this goal, the State will need to identify about *\$10 billion in spending cuts and/or revenue increases each year from FY2018-FY2022.*

After the unpaid bills have been paid off and a reserve fund established, the State should begin to pay down the almost \$130 billion in unfunded liabilities of its pension funds.

III. Reduce spending across the entire State budget

State government should intensify its pursuit of opportunities for reducing spending by improving the efficiency of service provision and redirecting resources toward the State's highest-priority programs.

- In the short-term, these opportunities will be focused on the General Funds budget, because that spending is frequently scrutinized and well-understood. However, opportunities for expenditure reductions in the General Funds budget are limited by the non-discretionary nature of some expenditures (e.g., debt service) and constitutional constraints on others (e.g., pension contributions and retiree health care spending).
- In the longer-term, State government should widen its "frame" beyond the General Funds budget, and conduct a thorough review of spending from Other State Funds, as well as revenue-sharing with local governments.⁹
- Efforts to reduce spending should be carefully considered and thoughtfully implemented. The negative impacts of recent reductions in State funding for K-12 education and higher education illustrate the damage caused by untargeted, across-the-board cuts.

The full range of options for reducing the State's annual **pension contributions** – within constitutional constraints – should be explored. As required pension contributions have grown to about 25% of State-source General revenue,¹⁰ they have already crowded out spending on P-12 education, human services, higher education and other programs that rely on General Funds – forcing

painful trade-offs.¹¹ Recent proposals for reducing pension contributions include:

- Funding reforms that would curb late-career salary spiking, reallocate some pension costs for high-salaried employees, smooth the impact of assumption changes, and base the funding formula on total payroll;
- The creation of a voluntary Tier 3 hybrid defined benefit/defined contribution plan for new employees;
- The “consideration model” proposed by Senate President John Cullerton, which would require Tier 1 members of the State’s pension systems (excluding judges) and the Chicago Teachers’ Pension Fund to choose between their current 3% compound cost of living adjustments and having future pay raises counted toward pensionable salary.

However, any projected savings associated with reforms that could be subject to litigation under the State’s constitution should not be counted against future State budgets until the Illinois Supreme Court has confirmed their constitutionality.

Group health insurance programs for current State employees also offer opportunities for savings. The State has proposed the establishment of a multi-tiered system that offers plans with different combinations of monthly premiums vs. plan benefits (deductibles, co-payments, etc.). These plans are all intended to increase participant contributions to a 40/60 split (employee/employer) of healthcare costs. However, the State is currently prevented from implementing these changes due to pending litigation.

Additional cost-savings proposals include:

- **Procurement reforms** and other **operational cost savings**;
- Additional **Medicaid reforms**; and
- Implementation of the **Community Reinvestment Program** for non-Medicaid-eligible seniors.

The State also should widen its budgetary “frame” and conduct a thorough review of spending from Other State Funds as well as local revenue-sharing.

- Current budget negotiations focus on General Funds, and ignore nearly half of total State spending. The portion of the State’s total budget that is subject to intense public scrutiny and negotiation should be expanded so that spending can be prioritized across the entire budget (including Other State Funds) and opportunities for efficiencies and savings outside the General Funds can be identified and implemented.

- As discussed in a later section of this report, Illinois has almost 7,000 local units of government – more than any other state in the nation. The current lack of transparency into their revenue and spending strongly suggests that there are opportunities for improving the effectiveness and efficiency of service provision at the local level, including through shared services, joint purchasing, and consolidation.¹²

Greater transparency will be absolutely critical to the State’s effort to improve efficiency and reduce costs in a balanced and thoughtful manner. The negative impact of recent reductions in State funding for K-12 education and higher education have demonstrated the harm that can be done by across-the-board cuts.

- From 2010-2016, the General Assembly did not appropriate sufficient funds to support “formula” grants, which are intended to maintain a base level of per pupil funding across the State. The formula grants were pro-rated by the same percentage in all school districts, which disproportionately affected poorer districts that receive more State aid dollars per pupil.
- According to the Illinois Board of Higher Education, State funding for higher education (excluding pension contributions) has been on the decline since 2002 as a result of State government’s worsening fiscal condition. The budget impasse magnified that decline – the stop gap budgets for FY2016 and FY2017 cut State support of higher education by more than half – and has had a devastating impact on Illinois’ public universities and low-income students who rely on the State’s MAP grants.

IV. Reform the tax system to reduce Illinois’ negative outlier status and raise revenues, as needed

Job creators typically evaluate a state’s tax climate relative to other states. The Census Bureau publishes high-level data on state and local government revenues and expenditures that provides a foundation for such comparisons. The most recent Census Bureau data (from FY2014, when the full income tax rate increases were still in place)¹³ shows that:

- Illinois’ total state and local government revenues as a percentage of Gross State Product (GSP)¹⁴ was below the national average. While Illinois ranked 14th highest out of the 50 states for state and local tax revenues as a percentage of GSP, federal funding¹⁵ and non-tax own-source revenues as a percentage of GSP ranked in the bottom ten states.
- In addition, Illinois’ total state and local government spending as a percentage of GSP was below the

national average. This reflects the ongoing “crowding out” of spending for critical public services by required pension contributions, as employer contributions to public pension funds are not counted as spending by the Census Bureau.

Given Illinois’ relatively high ranking for taxes as a percentage of GSP under the full tax increase, any tax increases should be thoughtfully considered and carefully targeted.

The Task Force devoted substantial attention to Illinois’ current tax system, including discussions with tax experts and analysis of the findings of a proprietary Business Tax Outlier Study (conducted in 2015) comparing Illinois’ tax provisions to other states.

- These efforts were critical to identifying where there might be opportunities to increase State tax revenues (after spending cuts have been implemented), while inflicting as little damage as possible on Illinois’ future economic prospects.¹⁶
- In addition, the Task Force was able to identify instances where Illinois’ tax policies make it an “outlier” that diverges from the best practices of other states. In many of these instances, Illinois could change its policies and improve its attractiveness to job creators with little or no impact on State revenues.

The review of Illinois’ tax system began with the State’s rankings on the Tax Foundation’s annual *State Business Tax Climate Index*.

- Illinois ranked 31st overall out of the 50 states when the full income tax rate increases enacted in 2011 were in place (Illinois’ individual income tax rate was 5%, while the total corporate income tax rate was 9.5%).¹⁷ Illinois’ best ranking was on the individual income tax (11th) and its worst ranking was on the corporate income tax (45th).¹⁸
- With the partial rollback of the income tax rates in 2015, Illinois’ overall ranking improved. At the beginning of FY2017, Illinois’ overall ranking had increased to 23rd out of the 50 states. The ranking on the individual income tax improved only slightly (to 10th), while the ranking on the corporate income tax improved significantly (to 26th).¹⁹
- Illinois received its best ranking on the individual income tax—even when the 5% rate was in place. According to the Tax Foundation, Illinois scores well on this component because it has a single, low tax rate. Illinois performs quite poorly on its other taxes—especially on the corporate tax when the full income tax increase was in place.

This analysis suggests that increases in individual income taxes may offer the best opportunity for raising additional revenues while inflicting the least damage on Illinois’ tax climate.

In addition, based on the findings of the 2015 Business Tax Outlier Study and discussions with tax experts, the Task Force identified the following tax provisions and administrative practices that are anti-competitive and make Illinois a negative outlier compared to other states:

- Illinois is an outlier in that it imposes some taxes that most other states do not impose:
 - Franchise tax (the majority of states do not impose a franchise tax, including all of Illinois’ neighbors).
 - Estate tax²⁰ (In 2015, Illinois was one of only 19 states that still imposed an estate or inheritance tax).
- Illinois is an outlier in that it *does not* impose some taxes that other states impose:
 - Individual income tax on retirement income. Of the states that impose an individual income tax, only three completely exempt all retirement income. Any retirement income stream is completely tax-exempt in Illinois, irrespective of the age or income of the individual earning the income stream (e.g., income from inherited IRAs is not taxed, regardless of the age of the beneficiary).
 - Sales tax on certain consumer services.
- Illinois is an outlier in that it imposes sales tax on more production-related business inputs than other states.
- Illinois’ fees for starting an LLC are among the highest in the nation.²¹
- Illinois is falling behind other states in the way that it implements corporate tax credits. Illinois does not have a system in place to formally evaluate credits to gauge their effectiveness. In addition, the State is relatively inflexible in allowing businesses to monetize the tax credits they have earned, and has automatic sunset provisions.
- In the past, the State has been reluctant to provide timely advice to business taxpayers through letter rulings, which would improve compliance, and has a penalty structure that may discourage them from coming forward if they find that they have made an error.²²
- The Illinois False Claims Act allows private parties to assert a tax liability against business taxpayers; most states have excluded all tax laws from the provisions of their False Claims Act.

The tax policies described below reflect these findings as well as the Task Force’s more detailed discussions with tax experts. The policies are focused on generating the revenues needed to restore the State to financial solvency and shifting the tax burden onto higher income tax payers (within the constraints of the constitutionally-mandated flat income tax rate),²³ while at the same time enhancing the State’s competitive position and avoiding a tax policy or rate that would be viewed as an “outlier” among other states.²⁴

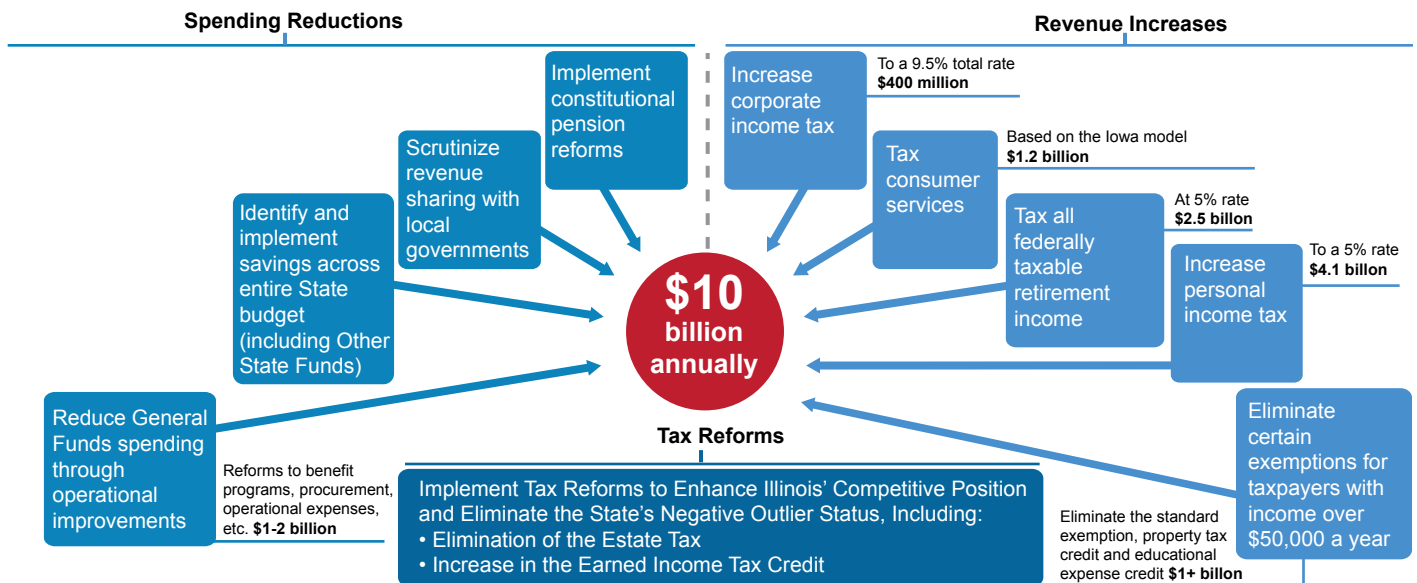
*It is important to note that the numeric examples used to quantify the effect of specific tax changes are provided only to give a sense of their relative impact, not to make specific recommendations.*²⁵

Tax policies impacting individuals (and, in some cases, small businesses) could include:

- Increasing the individual income tax rate.
 - Each .25% increase in the rate raises an additional \$830 million
 - Increasing the rate to 5.0% would raise an additional \$4.1 billion
- Applying the individual income tax rate to retirement income.
 - Taxing retirement income (excluding Social Security benefits) of individuals with an AGI of more than \$50,000 at 5% would raise an additional \$1.5 billion

- Taxing all federally taxable retirement income (including Social Security benefits subject to federal taxation) of individuals with an AGI of more than \$50,000 at 5% would raise an additional \$2 billion
- Taxing all federally taxable retirement income (including Social Security benefits subject to federal taxation) at 5% would raise an additional \$2.5 billion
- Eliminating certain tax benefits (e.g., standard exemption and property tax credit) for higher income taxpayers.
 - Eliminating the standard exemption, property tax credit and education expense credit for individuals with an AGI of more than \$50,000 would raise more than \$1 billion (depending on the individual income tax rate, which would impact the savings from eliminating the standard exemption).
- Increasing the Earned Income Tax Credit (EITC) for low income residents.
 - Increasing the EITC to 15% of the federal EITC would cost the State approximately \$130 million
- Eliminating the estate tax.
 - Eliminating the estate tax would cost the state \$320 million
- Expanding the sales tax to specified consumer services.

Figure 3—Sample Elements of a Solution



- Expanding the sales tax to cover a similar set of services as those taxed in Wisconsin would raise an additional \$500 million after full implementation²⁶
- Expanding the sales tax to cover a similar set of services as those taxed in Iowa would raise an additional \$1.2 billion after full implementation

Tax policies impacting businesses could include:

- Increasing the base corporate income tax rate²⁷
 - Increasing the rate to 7.0% would raise an additional \$400 million²⁸
- Developing metrics to evaluate the effectiveness of tax incentives.
- Eliminating the corporate franchise tax.
 - Eliminating the corporate franchise tax would cost the State \$170 million
- Lowering the LLC fee.
 - Lowering the LLC fee would cost the State \$20 million²⁹
- Reforming various business tax provisions and administrative practices that are burdensome, anti-competitive and do not generate significant tax revenues for the State.

Because of Illinois' high reliance on taxes as a source of state and local revenue, all tax increases should be thoughtfully considered and carefully targeted in order to inflict as little damage as possible on the State's future economic prospects.

Given the range of Framework elements available to craft a solution, a variety of different plans could be developed that reach the State's goals. The specific combination of elements in a given plan will determine the impact on key groups of stakeholders:

- Wage earners will be primarily impacted by increases in personal income tax rates, although Illinois' personal income tax compares relatively favorably to other states.
- Low-income families will be positively impacted by an increase in the Earned Income Tax Credit.
- Corporations will bear the burden of higher corporate tax rates.
- Retirees, who currently pay no personal income tax, will be affected by the imposition of a tax on retirement

income. Illinois is currently one of only three states that exempts all retirement income from taxation.

- Consumers will pay sales taxes on a broader range of goods and services if certain consumer services are taxed. Illinois currently taxes fewer services than other states.
- Local governments that impose sales taxes will benefit from the expansion of the sales tax base.
- Property owners will not be impacted directly by the elements included in the Framework. Property taxes are a local source of revenue, and Illinois already has higher per capita tax collections than the national average. However, to the extent that local governments are affected by State spending reductions, they may turn to property taxes to ameliorate those reductions.

All Illinois citizens will benefit from the implementation of a Framework of reforms that provides a clear path toward fiscal solvency and future success for the State of Illinois.

V. Establish financial goals and metrics to measure the State's progress

The final element of the Framework includes identifying a set of goals and metrics as target goals for growth are included as part of the recommended long-term goals. The Civic Committee recommends the goals and metrics listed below to serve in that role.

As noted earlier, the most direct measures of the strength and vibrancy of Illinois' economy are metrics related to job creation and economic growth; target goals for growth are included as part of the recommended long-term goals. However, goals regarding State government's fiscal practices, as well as confidence in Illinois' economic future, are also critical to measuring progress.

Therefore, a key goal should be to achieve an upgrade in the State's S&P credit rating to AA within five years after full implementation of the Framework. The Civic Committee selected the credit rating upgrade as a key goal both because it serves as a measure of uncertainty about the State's fiscal and economic future, and because it consolidates many different metrics into one aggregate score for each state. The S&P credit rating includes:

- 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).

While not a perfect measure, a state's credit rating serves as a useful proxy for evaluating its overall fiscal health and budgetary practices; improvements to Illinois' credit rating will be a key measure of the State's success in moving towards fiscal solvency.

Short-term goals (next fiscal year after full implementation of the Framework)

- Implementation of a long-term financial planning process that is transparent, implements best practices and includes the entire State budget.
- A structurally balanced annual budget and the amortization of the State's unpaid bills.
- Actuarially determined funding of the State's pension systems.
- Meaningful expense reductions based on a comprehensive review of spending across the entire State budget, including the spending of local government units that receive a significant portion of their revenues from the State.
- Reform of tax provisions and practices that make Illinois an outlier compared to other states.

Long-term goals (within five years after full implementation of the Framework)

- S&P credit rating of AA.
- 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.
- Establishment of a reserve fund that equals more than 8% of revenues/expenditures.³⁰
- Reduction in outstanding debt (excluding unfunded obligations) to less than \$2,000 per capita.³¹

Conclusion

The Framework developed by the Civic Committee should serve as a guide for the necessary fiscal reforms to:

- Bring the State back to financial solvency while ensuring the provision of critical public services to the State's residents;
- Renew Illinois' position as an attractive place to locate and expand jobs; and
- Turn around Illinois' reputation among investors and the general public.

In the near term, the State's leadership must address the enormous fiscal challenge facing Illinois. To reach fiscal sustainability, the State will have to identify a total of \$10 billion in revenue increases/expenditure reductions for each of the years from FY2018-FY2022. The Task Force's findings suggest that expenditure reductions will account for around \$2 billion, and revenue increases will be required for the remaining \$8 billion. The following Appendices describe the Civic Committee's recommendations for reaching this goal.

While the challenges facing Illinois are considerable, we believe that with the right combination of actions and a focus on what is best for the long-term health of our State, its communities and our fellow citizens, those challenges can be overcome and Illinois can once again be a vibrant and attractive place to live and work.

Notes

- 1 "National, State, and Puerto Rico Commonwealth Totals Datasets: Population, population change, and estimated components of population change: April 1, 2010 to July 1, 2016," US Census Bureau.
- 2 Net migration is calculated as the number of people migrating to a state minus the number of people migrating from a state. Net migration data from the Census Bureau accounts for both international and domestic migration.
- 3 "National, State, and Puerto Rico Commonwealth Totals Datasets: Population, population change, and estimated components of population change: April 1, 2010 to July 1, 2016," US Census Bureau.
- 4 Employment growth is based on Civic Committee calculations using November 2015 and November 2016 numbers. Unemployment rankings are based off of state unemployment rates for November 2016. Original data from "Table 3. Civilian labor force and unemployment by state and selected area, seasonally adjusted" and "State and Area Employment, Hours, and Earnings," Bureau of Labor Statistics.
- 5 Civic Committee calculations. Based on the Governor's Office of Management & Budget (GOMB) "General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down (FY2018-2022), November 15, 2016, and the Commission on Government Forecasting and Accountability (COGFA) "3-Year Budget Forecast FY2018-FY2020," March 2017.
- 6 It is important to note that these expected budget deficits are based on the State's current statutory schedule for making required contributions to its pension funds. The current statutory schedule assumes that no reforms are made to the benefit structure of the pension plans (which would lower the State's required contributions) and that the discount rates currently used by the pension funds remain in place (in recent years, those discount rates have been lowered as a result of changes in the markets; additional revisions downward would increase the State's required pension contributions).
- 7 Governor's Office of Management and Budget's General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down (FY2018-FY2022), November 15, 2016. However, if revenues continue to underperform projections, the bill backlog could increase to over \$15 billion by the end of FY2017 (See "Revenue Underperformance Adds to the Difficulty of Balancing Illinois' Budget," The Civic Federation, March 10, 2017).

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- 8 To get the highest score on the reserve fund component of Standard & Poors' credit rating factors, a state must have a formal budget-based reserve fund that is > 8% relative to revenue or spending. S&P looks at the reserve fund as a percentage of general state government funds (including all general and special state funds, but not federal funds). As for whether a state is assessed on its reserve fund relative to revenue or spending, S&P will look at how an individual state's reserve fund policy is set up as a starting point. However, for most states, the distinction is not relevant. In FY2018, total Illinois' appropriated funds revenues totaled \$63.7 billion – including \$19.4 billion in federal receipts. Therefore, general state government funds in 2018 are about \$44 billion. Assuming a conservative 3% growth rate, revenues would grow to roughly \$50 billion by 2022. Using \$50 billion, an 8% reserve fund would be approximately \$4 billion. However, assuming that part of the State's solution to covering its deficit and paying off unpaid bills is through revenue increases (which would increase the level of general state government revenues) and that revenues and expenditures will be aligned, we estimate the reserve requirement would be between \$4-5 billion in 2022.
- 9 "Fund Transfers—Hidden State Spending," Tax Facts, November/December 2013, Taxpayers' Federation of Illinois.
- 10 Civic Committee calculations. Based on the Governor's Office of Management and Budget's General Funds/Fund for the Advancement of Education/Commitment to Human Services Fund Financial Walk Down (FY2018-FY2022), November 15, 2016.
- 11 However, according to analysis by the Fiscal Futures Project ("Why Ignore over Half of the Illinois State Budget Picture," July 2011), some of the reductions in General Funds spending were offset by additional spending from Other State Funds. The increasing share of Other State Fund spending for such categories as Medicaid and Human Services is not transparent given the State's current narrow budget frame.
- 12 "Delivering Efficient, Effective and Streamlined Government to Illinois Taxpayers," the final report submitted by the Task Force on Local Government Consolidation and Unfunded Mandates includes a number of case studies describing how local governments have achieved such efficiencies.
- 13 Based on Civic Committee calculations; original data from "State and Local Government Finances by Level of Government and by State: 2014," US Census Bureau. Note: the temporary tax increase that increased the individual income tax to 5% and the total corporate income tax rate to 9.5% was in effect in 2014.
- 14 This measure accounts for each state's size and wealth.
- 15 Of particular note is Illinois' relatively low federal match on its Medicaid spending for low-income residents who were eligible for Medicaid before the recent expansion under the Affordable Care Act. According to analysis by the Taxpayers' Federation of Illinois, the State's federal match (FMAP) for these "old eligibles" is below the national average and significantly below the match for surrounding states—leaving Illinois taxpayers to make up the difference. ("Federal Medical Assistance Plan (FMAP). Is Illinois Treated Fairly?" Tax Facts November/December 2012, Taxpayers' Federation of Illinois.)
- 16 Property taxes are not discussed in this summary, although they are analyzed in the Business Tax Outlier Study. In Illinois, local governments assess property taxes, and they are not a source of revenue for the State. In addition, Illinois is already a high property tax state—both in terms of its dependence upon, and its level of, property taxation. The Business Tax Outlier Study includes steps that the State could take to improve and simplify Illinois' property tax system.
- 17 Illinois' total corporate income tax rate consists of two distinct parts. The first is the base rate, which goes into the State's coffers. The second is a 2.5% surcharge – the Corporate Personal Property Replacement Tax (CPPRT)—which is collected by the State but distributed to local governments as replacement revenue for a local tax on business personal property that was abolished in the 1970 Illinois Constitution. Illinois stands out among the states because its corporate income tax includes this 2.5% surcharge. Increases in the corporate tax rate apply to the base rate only. After the 2011 tax increase, the base corporate income tax rate was increased to 7.0%, which brought the total corporate income tax rate to 9.5%. That 9.5% rate made Illinois an outlier, as it was one of only eight states with a total business income tax rate of 9% or more.
- 18 The Tax Foundation made changes to its methodology for evaluating a state's business tax climate before publishing its 2017 *Index*. To achieve comparability across tax years, the Tax Foundation recalculated rankings from previous years (2014-2016) using the new methodology, and reported those updated rankings in the 2017 *Index* report. Those updated rankings for 2015 are used in this document for purposes of comparability with the 2017 rankings.
- 19 Much of the improvement in Illinois' ranking on the corporate income tax rate was the result of the partial rollback of the corporate income tax rate and the reinstatement of the use of net operating losses to reduce taxable income. Other changes also contributed to the improvement, including the policy actions of other states (the ranking is relative).
- 20 While the estate tax is imposed on the estates of individual when they die, it may have an impact on some businesses, especially farms and small businesses, if those business assets are included in the estate.
- 21 "Illinois needs a makeover to attract small businesses: Here's where to start," Elliot Richardson, August 13, 2014, Crain's Chicago Business.
- 22 The Council on State Taxation (COST) ranked Illinois highly in the "Transparency in Tax Guidance and Rulings" category of its recent report, "The Best and Worst of State Tax Administration." This suggests that perhaps Illinois has improved some of its administrative practices since the Business Tax Outlier Study was completed, or that COST's methodology only counts the existence of certain processes in its rankings, and not necessarily how well they function.
- 23 While some believe that a graduated income tax should be part of a comprehensive solution to the State's fiscal crisis, the Task Force did not consider that option. Moving to a graduated income tax would require a change to the Illinois Constitution, which would take years to achieve. Given the State's precarious fiscal condition, the Task Force focused on recommendations that could be implemented without a change to the Constitution.
- 24 For example, the 2011 income tax increases included an increase in the base corporate income tax rate to 7.0% (a total corporate tax rate of 9.5%) and the suspension of the use of Net Operating Losses. These changes drove the State's ranking on the Tax Foundation's Business Tax Climate Index down to 45th out of the 50 states. Going forward, increases to the corporate income tax rate should be implemented carefully and the use of Net Operating Losses should not be suspended.
- 25 Annual revenue impact estimates included in examples were provided by the Legislative Working Group and follow-up with legislative staff. Where possible, revenue estimates have been updated to reflect new projections based on the Senate package of reforms and the Commission on Government Forecasting and Accountability (COGFA) "3-Year Budget Forecast FY2018-FY2020," March 2017.
- 26 Civic Committee calculations (based on COGFA estimates) adjusted the total impact of implementing a sales tax for specific consumer goods downward to account for the federal ban on the taxation of internet services, one of the services included in the "Wisconsin Model" (see "The Internet Tax Freedom Act: In Brief," Jeffrey M. Stupak, Congressional Research Service, p.2, April 13, 2016). The original estimate from COGFA assumes a 90% compliance rate in the first full year of implementation. COGFA based its compliance rate assumptions on discussions with the NCSL (National Conference of State Legislatures).
- 27 Illinois' total corporate income tax rate consists of two distinct parts. The first is the base rate, which goes into the State's coffers. The second is a 2.5% surcharge – the Corporate Personal Property Replacement Tax (CPPRT) —which is collected by the State but distributed to local governments as replacement revenue for a local tax on business personal property that was abolished in the 1970 Illinois Constitution. Illinois stands out among the states because its corporate income tax includes this 2.5% surcharge. Increases in the corporate tax rate apply to the base rate only. After the 2011 tax increase, the base corporate income tax rate was increased to 7.0%, which brought the total corporate income tax rate to 9.5%. That 9.5% rate made Illinois an outlier, as it was one of only eight states with a total business income tax rate of 9% or more.
- 28 Increasing the corporate income tax rates to these levels would maintain the current corporate-to-individual income tax ratio of 7-to-5 if the individual income tax rate was increased to 4.5% or 5.0%. However, increasing the rate to 7.0% would make Illinois an outlier because its total rate would reach 9.5%.
- 29 There are a range of options for improving Illinois' attractiveness to small businesses. A recommendation for lowering the initial fee is included in this report, but other recommendations to reduce annual fees are also under consideration. Lawmakers should develop a proposal to improve the State's attractiveness to small businesses that includes best practices from the range of recommendations that are being discussed.
- 30 Establishing a reserve balance of more than 8% of revenue/spending is a benchmark used by credit rating agencies to indicate a state's ability to deal well with economic stress.
- 31 Standard & Poor's assigns its second highest ranking for debt burden to states that have a debt per capita of \$500-\$2000.

Appendix A

Civic Committee Proposal – EXPENDITURE REDUCTIONS

As explained in the Framework, the State must identify \$10 billion in expenditure reductions/revenue increases for each year from FY2018-FY2022 if it is to return to fiscal sustainability.

Before enacting a significant tax increase, State government must first reduce spending by improving the efficiency of service provision and redirecting resources toward the State's highest-priority programs. Therefore, our proposal begins with opportunities for expenditure reductions. Once these opportunities have been exhausted, the remaining gap will have to be addressed through revenue increases (described in Appendix B).

We focus on expenditure reductions from the General Funds budget because this spending has been historically scrutinized and is well-understood. However, as noted in the Framework, the State must expand its “frame”

and undertake a thorough review of spending from Other State Funds, as well as local-revenue sharing, to identify additional opportunities to improve efficiency and effectiveness.

The scope of the Tax Policy Task Force's work precluded a detailed analysis of State spending. However, budget experts who met with the Task Force provided their perspectives on reducing General Funds spending, and additional recommendations came from:

- Various Working Group discussions of potential reductions;
- The Senate’s “grand bargain;” and
- Governor Rauner’s 2018 Operating Budget Book

The list below is a compilation of those recommendations, and includes ranges of expected savings assuming full implementation in FY2018.

Provision	FY2018 Savings
<p>Pension reform</p> <p>Funding reforms:</p> <ul style="list-style-type: none"> For members of TRS (Teachers' Retirement System) and SURS (State Universities Retirement System): <ul style="list-style-type: none"> Anti-spiking provisions for end-of-career salary increases. High-end salary provisions; if a member's salary is more than the Governor's salary, the local employer must make an additional pension contribution to cover this incremental cost. 5-year smoothing for changes in actuarial assumptions. Including all payroll in the calculation of State pension contributions (the current calculation uses pensionable payroll). <p>Tier 3 Optional Hybrid Plan:</p> <ul style="list-style-type: none"> New employees in TRS, SURS or SERS (State Employees' Retirement System) who do not participate in Social Security would be offered a Tier 3 hybrid plan as an alternative to Tier 2. Hybrid plan includes a small defined-benefit plan that mimics the structure of Social Security and a defined contribution plan. New employees in TRS or SURS, regardless of whether they choose Tier 2 or Tier 3, would have their complete pension costs paid for by their local employer. <p>Consideration Model:</p> <ul style="list-style-type: none"> Tier 1 employees are required to make a choice between maintaining their current 3% compounded COLA or having future salary increases count toward pensionable salary. 	<p>Estimated savings from funding reforms = \$750 million</p> <p>Estimated savings from Tier 3 = \$500 million</p> <p>Savings from the consideration model are not included as that reform will likely be challenged on constitutional grounds</p>

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Provision	FY2018 Savings
<p>Closing GARS to future members of the General Assembly</p> <p>Note: Any package of pension reforms that is enacted will require actuarial analysis of all components together to determine the impact on FY2018 pension contributions, as well as the impact on future pension contributions and unfunded liabilities.</p>	
<p>Group health insurance reform</p> <p>Participants choose between:</p> <ul style="list-style-type: none"> Increased premiums to maintain current benefits. Reduced benefits to maintain current premiums. 	\$300 - 500 million
<p>Procurement reform</p> <p>(In addition to reductions in the State's General Funds expenditures, the procurement reforms would also drive expenditure reductions for higher education institutions.)</p>	\$85 - 100 million
<p>Across-the-board cuts to operational spending</p>	\$250 - 400 million
<p>Community Reinvestment Program reforms</p> <p>Participants in the community care program who are not eligible for Medicaid would be served using a modified package of available services and supports.</p>	\$120 million
<p>Elimination of the State subsidy to TRIP and CCIP (retiree health care programs for downstate teachers and community college employees).</p> <p>However, because of the Supreme Court decision protecting retiree health care benefits, the State would need to confirm that elimination of the State subsidy (which would lead to either reduced benefits or higher retiree contributions) does not violate that protection.</p>	\$120 million
<p>Medicaid reforms</p> <p>While the State enacted Medicaid reforms as part of the stop-gap budget, additional opportunities for savings remain.</p>	\$100 million
<p>Criminal justice reforms</p> <p>However, savings tend to be incremental until reforms lead to facility closures.</p>	\$250 million
TOTAL ESTIMATED EXPENDITURE REDUCTIONS	\$2.5 - 2.8 BILLION

(Note: The chart above provides working estimates of the impact of each provision. More precise estimates should be developed by the Governor's Office of Management and Budget, the Commission on Government Forecasting and Accountability, and other State agencies.)

As noted earlier, these provisions are a compilation of opportunities for expenditure reductions in the General Funds budget. Based on the estimated savings from each reform, implementing all the provisions together will reduce expenditures by \$2.5 – 2.8 billion.

The reliance on savings associated with pension reform is concerning. It appears that some of the reforms may shift costs out to the future, rather than eliminating them (such as 5-year smoothing and total payroll provisions). This would continue the State’s practice of “kicking the can down the road” when dealing with its pension costs. It will be critical that an actuarial analysis be conducted for any package of pension reforms under serious consideration; some of the reforms may overlap, and adding up the sum of individual reform impacts may overstate the impact of the package.

Some of the expenditure reductions described above may be offset by necessary increases in other spending:

- **School funding:** As discussed in the school funding section of this report, moving Illinois school districts to “adequacy” will require a \$350 million year-over-year increase in K-12 education expenditures in each of the next 10 years.

- **Pension parity:** Moving toward true pension parity between Chicago Public Schools and all other Illinois school districts will require a significant payment toward Chicago teachers’ pensions in FY2018, with increasing contributions in the future.
- **Capital:** While not directly addressed in this report, Illinois needs ongoing, predictable capital investments that will also add to the State’s overall level of expenditures.

As a result of concerns about the true magnitude of possible expenditure reductions, as well as increases in other spending, it is very likely that net expenditure reductions may reach, at most, \$2 billion in each of the years from FY2018-2022. Therefore, revenue increases of at least \$8 billion will be necessary if the State is to return to solid fiscal sustainability.

Appendix B

Civic Committee Proposal – REVENUE INCREASES

As explained in the Framework, the State must identify \$10 billion in expenditure reductions/revenue increases for each year from FY2018-FY2022 if it is to return to fiscal sustainability. Appendix A includes a compilation of opportunities for expenditure reductions. If they are implemented and produce the expected savings, they will total around \$2 billion. This would leave an additional \$8 billion that the State must address through revenue increases.

(Significant additional cost savings opportunities should be identified once the State's budget "frame" is expanded to include Other State Funds, as well as revenue-sharing with local governments. But identifying these savings opportunities will require a longer-term investment in carefully scrutinizing and evaluating spending outside the General Funds. In the short-term, savings from the General Funds budget should be the focus.)

However, based on the concerns described in Appendix A, it is very possible that savings will total less than \$2 billion, or that expected increases in other areas of the State's budget (such as increased funding for P-12 education) may offset a good part of the reductions. In addition, recent revenue updates from the Commission on Government Forecasting and Accountability suggest that projected

baseline revenues may not meet expectations. Therefore, the provisions included in this Appendix to increase revenues overshoot the \$8 billion mark and net almost \$9 billion. This net increase is the result of some provisions that increase tax revenues by almost \$10 billion, and other provisions that increase tax expenditures by close to \$1 billion. If the new revenue requirement falls closer to \$8 billion, these tax revenue provisions should be modified – for example, by increasing the income threshold for the elimination of the standard exemption, property tax credit, and education expense credit.

The provisions described below reflect the Framework's emphasis on reforms that will make Illinois' tax climate more attractive relative to other states – or at least avoid making it less attractive. For example, the recommendation to tax retirement income raises significant revenues by imposing a tax that most other states already impose. Recommended changes to tax expenditures also reflect the Framework, such as the recommendations to eliminate the estate tax and corporate franchise tax, as most other states have already eliminated these taxes.

Note: The provisions highlighted in orange generally impact individuals; the provisions in blue generally impact businesses; and the provisions highlighted in green impact both.

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Provision	FY2018 Revenue Impact (First full year of implementation)
Increase personal income tax rate to 5%. (Currently 3.75%)	\$4.1 billion*
Tax all federally taxable retirement income. (Including Social Security benefits subject to federal taxation)	\$2.5 billion
For individuals with AGI over \$50,000, eliminate: <ul style="list-style-type: none"> Standard exemption. Property tax credit. Education expense credit. 	\$1.3 billion
Expand sales tax to consumer services based on Iowa model.	\$1.2 billion**
Increase total corporate income tax rate to 9.5%. (Currently 7.75%)	\$400 million*
Increase annual corporate filing fee to match LLC fee (\$250).***	\$60 million
Decouple from the federal Domestic Activities Production Deduction.	\$100 million
TOTAL NEW TAX REVENUES	\$9.7 billion

*Based on analysis from the Commission on Government Forecasting and Accountability (COGFA) "3-Year Budget Forecast FY2018-2020," March 2017, p. 16.

**Analysis from the Commission for Government Forecasting and Accountability assumes three years to reach full implementation of sales taxes on consumer services; this estimate is for FY2020 – the first full year of implementation.

*** The difference between the current \$75 corporate fee and the \$250 LLC fee may have been justified when LLCs were first introduced, because they are not subject to the franchise tax. However, if the franchise tax is repealed, it is reasonable to increase the corporate annual filing fee to \$250 so that it is aligned with the LLC fee.

Provision	FY2018 Revenue Impact (First full year of implementation)
Eliminate the estate tax.	(\$320 million)
Increase the Earned Income Tax Credit (EITC): <ul style="list-style-type: none"> To 15% of the federal EITC. (Currently 10% of the federal EITC)	(\$130 million)
Create a new tax credit of up to \$250 for educators who use personal funds to purchase supplies.	(\$20 million)
Eliminate the corporate franchise tax.	(\$170 million)
Reinstate the Research and Development Credit.	(\$70 million)
Add to the current Manufacturing Machinery & Equipment sales tax exemption: <ul style="list-style-type: none"> Manufacturer's Purchase Credit (MPC). Graphic Arts sales tax exemption. 	(\$70 million)
Reduce Limited Liability Company (LLC) fees.	(\$20 million)
Extend the sunset date for: <ul style="list-style-type: none"> Film Tax Credit. Live Theater tax credit. 	-
Exempt State taxes from the Illinois False Claims Act.	-
TOTAL NEW TAX EXPENDITURES	(\$800 million)

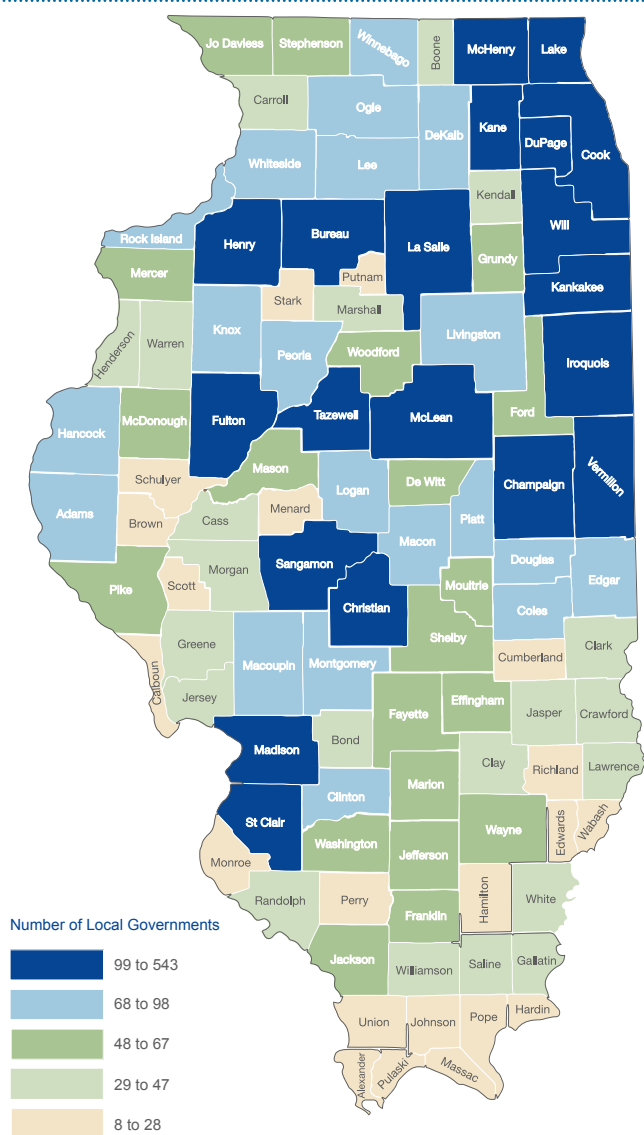
(Note: The charts above provide working estimates of the impact of these provisions and have been updated where possible to reflect new projections based on the Senate package of reforms as well as the Commission on Government Forecasting and Accountability (COGFA) "3-Year Budget Forecast FY2018-FY2020," March 2017. There will be timing issues associated with the changes in tax rates; this analysis assumes a full year's worth of revenue. More precise estimates should be developed by the Governor's Office of Management and Budget, the Commission on Government Forecasting and Accountability, and other State agencies.)

Part II: Additional Reforms to Improve the Jobs Climate

Local Government Consolidation

According to the U.S. Census Bureau, Illinois has almost 7,000 local units of government, more than any other state in the nation. The map below, from the 2007 Census of Governments, illustrates the number of local governments operating in each of the State's counties. Cook County has the highest number of local governments (543); Hardin County has the lowest (8).

2007 Census of Governments: The Many Layers of Illinois Government



Source: U.S. Department of Commerce, U.S. Census Bureau.

Although the fiscal condition of Illinois' local governments was not the focus of the Tax Policy Task Force's work, it became clear during this effort that, while many local governments have challenges identifying sufficient revenues to meet the critical needs of their residents, significant local government reforms will be needed to restore the integrity of budgetary and financial processes across all of Illinois' units of government.

Other groups have also identified the need for reform. Early in his administration, Governor Rauner established the Task Force on Local Government Consolidation and Unfunded Mandates, which presented its final report in December of 2015. The Center for Governmental Studies at Northern Illinois University was a major contributor to the report, and continues to provide policy analysis and recommendations in this area. An earlier effort, the Local Government Consolidation Commission, was established by the General Assembly in 2011 and presented its recommendations in early 2014.

A common theme across all of this work is that the large number of governments in Illinois, as well as outdated and inconsistent reporting systems and processes, reduces transparency and public oversight. Without public oversight, opportunities for improving the efficiency and effectiveness of local government will be missed or ignored. Instead, redundancies and duplicative services, as well as high overhead costs, increase the cost of government and reduce its effectiveness.

While removing statutory impediments to local government consolidation is an important step toward addressing this problem, it is not a panacea. Simply reducing the number of governments will not necessarily reduce costs, and many expense reductions are possible without consolidation – through intergovernmental collaboration, joint purchasing, shared services, etc. Examples of savings achieved through consolidation and through collaboration are provided below.

Transparency and Accountability

The 2015 report of the Task Force on Local Government Consolidation and Unfunded Mandates ("2015 Task Force report") begins with a list of the local governments representing the Wheaton neighborhood of Lieutenant Governor Evelyn Sanguinetti, who chaired the Task Force. These governments, which receive a portion of local

property taxes, as well as other revenue sources (such as sales taxes and user fees), are listed below:¹

1. DuPage County
2. DuPage County Forest Preserve District
3. DuPage County Airport Authority
4. Milton Township
5. Milton Township Road District
6. City of Wheaton
7. Wheaton Park District
8. Wheaton Mosquito Abatement District
9. Wheaton Sanitary District
10. Wheaton-Warrenville Unit School District 200
11. College of DuPage
12. DuPage Housing Authority
13. DuPage Water Commission
14. Regional Transportation Authority
15. Metra
16. Pace

The division of responsibility across multiple local units in this manner constrains government's ability to prioritize and make critical trade-offs. Each government may prioritize programs under its own authority, but no mechanism exists to do so across governments – limiting efforts to improve effectiveness and efficiency.

The large number of governments also makes it difficult for residents to ascertain what services each government provides. In addition, while the tax burden associated with all local governments together is significant, individual governments often take only a small percentage of overall taxes, so the burden associated with each does not seem high.

Accountability is also limited by inadequate information – financial reporting for local governments is neither complete nor reliable.² Many local governments are not required to file an annual audit due to their small size or other characteristics, and those that do report use different accounting methods, inconsistent terminology, etc. As a result, Illinois residents and policymakers do not have the information necessary to judge the adequacy of local government revenues or the effectiveness and efficiency of local government spending.

Costs Borne by Local Taxpayers

The lack of transparency into the finances and operations of Illinois' thousands of local governments shields them from public pressure to deliver services in the most effective and efficient manner. The resulting inefficiency has been blamed for Illinois' local tax rates, which are some of the highest in the nation.

Property taxes are the primary source of revenue for most local governments in Illinois; Illinois has the highest average effective residential property tax rate of any of our neighboring states and the third highest rate in the nation. However, this average masks significant variation in rates across the State – in particular a disparity between well-off and poor communities. Analysis from the Civic Federation, which estimates effective tax rates for Chicago and 28 other selected municipalities in northeastern Illinois,³ highlights this disparity.

In tax year 2014, Oak Brook, Lake Forest, and Glenview had low effective residential property tax rates of 1.12%, 1.61%, and 1.79%, respectively. On the other end of the spectrum, Harvey had an effective residential property tax rate of 7.71%, while Chicago Heights had a 5.59% rate. Chicago's 1.56% residential rate fell at the low end of the range.

Cook County's classification system, which shifts much of the property tax burden off of homeowners and onto commercial and industrial property, made the variance even greater for commercial property tax rates. Commercial properties in Oak Brook and Lake Forest, which are outside Cook County, had the same effective tax rates as residential properties – 1.12% and 1.61%. But Chicago's effective commercial tax rate was 4.18%, while Glenview's was 5.53%. Harvey and Chicago Heights had even higher effective commercial tax rates – 19.20% and 14.64%, respectively.

Commercial property tax rates are an important factor for businesses considering where to locate – property taxes are, by far, the largest component of total state and local taxes paid by businesses. According to "Total State and Local Business Taxes," prepared by Ernst & Young LLP, property taxes accounted for 42% of total state and local taxes paid by Illinois businesses in FY2015. In comparison, corporate income taxes made up only 13% of the total.

In addition, **locally-imposed sales taxes** are the major contributor to Illinois' higher-than-average total sales tax rate – 10th highest in the country and higher than our neighboring states. The total sales tax rate includes both the State's portion and local sales taxes. If only the State portion is considered – 5% – Illinois' state sales tax

rate is below the national average. But local sales taxes drive the total rate up substantially. For example, the City of Chicago now has the highest total sales tax rate of any major U.S. city – 10.25%. But less than half of that (only 5%) goes to the State; the remaining 5.25% goes to local governments.

Local governments are also the recipients of significant revenues from **State-imposed taxes**:

- All Personal Property Replacement Tax revenues (including revenues from the 2.5% surcharge on the State's corporate income tax) – which totaled around \$1.4 billion for FY2016 – are distributed to local governments based on their share of personal property tax collections in the late 1970s.⁴
- A fixed portion of personal and corporate income taxes are collected by the State but transferred to local governments through a line item in the State's operating budget. These transfers total around \$1.3 billion annually and are distributed on a per capita basis to municipalities and counties.

Without complete and reliable information on local government finances, Illinois taxpayers may not realize how many of their tax dollars are spent at the local level. Just as importantly, they may not understand the budget pressures facing local governments. For example, most Illinois taxpayers are probably unaware of the magnitude of required annual pension contributions for their local police and fire departments. Moreover, many local governments have serious financial challenges providing critical services to their residents.

The lack of transparency also hampers State efforts to improve efficiency and effectiveness, or to target resources toward communities with the highest need. For example, if State government considers changing the methodology for revenue-sharing, it may be challenging to predict the fiscal impact on individual local governments.

Local Government Consolidation: Obstacles and Success Stories

The 2015 Task Force report describes a number of significant obstacles to local government consolidation, including:

- Issues with existing consolidation-related laws, which are narrowly crafted to apply to only a single township or government unit, and not to the whole State;
- The absence of statutory processes for citizens to initiate a consolidation, or particularly burdensome requirements that make such efforts virtually impossible; and

- Cultural, political and technical obstacles, such as the perceived loss of local identity and the cost of standardizing systems.

The report also provides case studies of successful consolidation efforts, including the two examples below:

(Note: the DuPage County ACT Initiative and the consolidation of Evanston Township into the City of Evanston were both enabled by State legislation that applied narrowly to their specific circumstances.)

- **DuPage County ACT Initiative (Accountability/Consolidation/Transparency)**

Implemented to improve the efficiency and operations of county government departments, as well as two dozen independently administered agencies whose boards are appointed by the county. Estimated savings to taxpayers over three years are more than \$100 million.

The Initiative's reforms have included:

- Creating a transparency portal to increase public access to agency information;
- Putting in place standardized procurement and ethics policies;
- Implementing shared services and cooperative purchasing agreements; and
- Dissolving and consolidating local governments.

- **Evanston Township Consolidation into the City of Evanston**

Evanston was one of 20 coterminous townships in Illinois, where the city and township share the same borders. Evanston's successful 2014 referendum for consolidation was only the third time in Illinois history that voters had decided to dissolve a township, and the first time since 1932. It is estimated to have saved more than \$1 million for FY2015 in reduced payroll and administrative costs.

Key components of the process:

- In March of 2012, a non-binding advisory referendum was held to identify support for the consolidation, and was approved by 66% of Evanston voters.
- In August of 2013, Governor Quinn signed Public Act 98-0127, which allowed the consolidation of Evanston Township by binding referendum.
- In March of 2014, a binding referendum was passed by 64% of Evanston voters.

As a result of these successes, the 2015 Task Force report includes a number of recommendations to reduce obstacles to local government consolidation, including:

- Empowering Illinois' citizens to consolidate or dissolve local governments via referendum;
- Expanding DuPage County's consolidation program to all 102 counties; and
- Allowing all townships in the State to consolidate with coterminous municipalities via referendum.

Collaboration

The 2015 Task Force report also describes successful collaboration efforts between independent local governments, such as shared services and joint purchasing agreements. These examples demonstrate that consolidation is not necessary to achieve some improvements in the efficiency and effectiveness of local governments. Two examples are provided below:

• GovIT Consortium

In 2012, 14 communities in Chicago's northern suburbs hired a consultant to perform an IT assessment of their current condition and opportunities for improvement. One of the consultant's recommendations was to consider a shared services environment for cost-savings and improved services.

- Five core communities – Glenview, Buffalo Grove, Lincolnshire, Lake Bluff, and Kenilworth – eventually transitioned their IT services to a common provider in 2014.
- By the fall of 2015, they created an IT Consortium (GovIT Consortium) with formal bylaws and membership agreements.
- The shared environment has allowed access to specialists that would have been unaffordable for individual communities (such as cyber security specialists).
- It also leverages economies of scale to purchase software licensing and agreements, and lowers costs for shared offsite backup, email archiving, and staff time.
- Some of the communities have invested their savings in upgrading systems. For example, Buffalo Grove has saved \$240,000 per year by no longer having in-house IT staff, and is reinvesting that money into updating its IT systems.

• Municipal Partnering Initiative

Public works departments from 14 local governments in DuPage County participate in the DuPage Region Municipal Partnering Initiative, a joint bid process that is intended to control costs. Projects have included cold patch, sewer lining, hydrant painting, tree maintenance and water meter testing.

- Six communities lead the bidding process; bid documents are standardized; and at the end of each contract period, there is an evaluation of the process and identification of opportunities to improve.
- Joint bidding has allowed small communities to leverage economies of scale.
- Staff costs related to duplicative bidding processes have been reduced, and staff have learned about alternative project methods.
- Bids now have improved technical specifications and the process has made budgeting for projects easier.
- Contracts have lowered costs or eliminated annual increases. For example, the sewer lining contract for four communities in 2014 saved more than \$89,000 over 2013 costs.

To encourage and incentivize collaboration among local governments, the 2015 Task Force report recommends preserving the State's Intergovernmental Cooperation Act, which encourages local governments to coordinate service offerings through intergovernmental agreements. It also recommends empowering State agencies to incentivize local governmental collaboration when allocating discretionary State and federal funds to local governments.

Conclusion

Addressing the fiscal sustainability of Illinois' public sector ultimately requires reforms at the local government level, as well as the State. However, the lack of comprehensive information about the finances and operations of Illinois' thousands of local governments will make it very difficult to make informed choices. Local government reporting reforms, like those recommended by the Center for Governmental Studies at Northern Illinois University, must be pursued. These include:

- Requiring all local governments – including school districts, housing authorities, community colleges and drainage districts – to report full and accurate financial data to a single State repository of local government data;

- Requiring all local governments to report information in a standardized, consistent manner; and
- Providing local officials with the tools, training and other supports to meet these new requirements.

Implementing these reforms will allow for a clear and comprehensive look at the revenue and spending of Illinois' local governments. This will help residents understand the budgetary pressures facing their local governments and how their tax dollars are being spent, and will aid policymakers in future efforts to improve efficiency and effectiveness.

In addition, the State should implement the consolidation-related recommendations of the Task Force on Local Government Consolidation and Unfunded Mandates, including:

- Empowering Illinois citizens to consolidate or dissolve local governments via referendum;
- Expanding DuPage County's consolidation program to all 102 counties;
- Allowing all townships in the State to consolidate with coterminous municipalities via referendum;
- Protecting the Intergovernmental Cooperation Act to preserve the ability of local governments to coordinate; and
- Empowering State agencies to incentivize local government consolidation and cooperation.

While the recommendations around unfunded mandates are not considered here, the 2015 Task Force report includes many sensible ideas for reducing the current obstacles to government consolidation and encouraging collaboration among local governments to reduce costs and improve service delivery.

Notes

- 1 "Delivering Efficient, Effective, and Streamlined Government to Illinois Taxpayers," Final Report submitted by: Task Force on Local Government Consolidation and Unfunded Mandates, December 17, 2015, p. 6.
- 2 According to recent analysis by the Center for Governmental Studies at Northern Illinois University, "Illinois does not have a universally accepted count of the number of local governments operating in the state, let alone a comprehensive record of total government taxes, other income [e.g., user fees], expenditures, and debt." ("The Big Unknown: How Much Money Do Illinois' Local Governments Spend Annually?" Shannon Sohl, Policy Profiles, September 2016.)
- 3 "Estimated Effective Property Tax Rates 2005-2014: Selected Municipalities in Northeastern Illinois," Civic Federation, December 28, 2016. Note: the Civic Federation analysis does not include the impact of homestead exemptions.
- 4 The 2.5% surcharge also increases Illinois' corporate tax rate. If only the 5.25% that makes up State receipts is considered, Illinois' corporate income tax rate is competitive with other states.

P-12 School Funding Reform

The quality of a state's P-12 education system is a critical factor when businesses are considering where to locate or expand jobs. The Illinois State Board of Education's 2016 School Report Card indicates that:

- Only 1 out of every 3 elementary school children in Illinois performs on grade level and is ready for the next level; and
- Less than half of Illinois high school students are "college ready" based on their scores on the ACT.

These poor results are highly correlated with poverty, and are concentrated in school districts that serve predominantly low-income students. In 2016, 50% of Illinois' students were identified as living in low-income households.¹

According to the most recent National Report Card on school funding, Illinois ranks 15th among the 50 states on average public spending per pupil.² But this average masks significant inequities – analysis from The Education Trust shows that Illinois' highest-poverty districts receive almost 20% less in State and local revenues per pupil than the State's lowest-poverty districts.³ Much of this disparity is due to Illinois' reliance on local property taxes to fund schools.⁴ In addition, the current model for distributing State aid to school districts fails to adequately counter differences in local property wealth, and does not keep up with rising education costs – leading to growing inequity over time.

In developing its recommendations for addressing the State's fiscal challenges, the Tax Policy Task Force reviewed the State's operating budget for opportunities for expenditure reduction. During this review, it became clear that State funding for P-12 education does not present such an opportunity. In fact, State funding for education must increase substantially – and the current formula for distributing State aid must be significantly improved – to ensure that all Illinois schoolchildren receive an adequate education.⁵

Current State Aid for Education

The current model for distributing State aid to school districts is divided into multiple streams of funding, including:

- *Formula grant*

Based on a minimum per pupil funding level – the "foundation level" – that is supposed to reflect the cost of educating a basic student (no special needs, not low-income, etc.). The current statutory foundation level is \$6119. After taking into account local resources from property taxes, the State's formula grant is intended to bring per pupil funding up to the foundation level.

- *Low-income grant*

Provides additional funding to meet the needs of students from low-income households, as well as the higher costs associated with larger concentrations of low-income students. Because of the inclusion of low-income concentration in the calculation, the low-income grant that individual school districts receive can range from \$355 per low-income student to \$2994 per low-income student.⁶

- *Mandated categorical grants*

Provide additional funding for transportation, students requiring special education, etc.

This model has significant flaws, including the following:

- Differences in local property wealth are only considered when calculating one of the funding streams – the formula grant. Accordingly, low property-wealth districts receive State funding at the same rate as high property-wealth districts for many streams of education funding, even though wealthier districts have a greater ability to pay.
- No mechanism exists to prioritize funding for the poorest school districts if the State's overall P-12 education appropriation is insufficient to fund the statutory foundation level. In fact, poor districts suffer the largest cuts on a dollar basis. For example, from 2010-2016, the General Assembly did not appropriate sufficient funds to support the \$6119 statutory foundation level. Formula grants across the State were pro-rated by the same percentage, which disproportionately affected poorer districts that receive more State aid dollars per pupil.

- Differences among school districts in the cost of educating students – as a result of different student demographics – are hidden by multiple funding streams and distribution methodologies. This reduces transparency, and makes it difficult to predict the impact of changing State demographics or changes to the funding formula.

As a result, the highest-poverty districts in Illinois receive only 81¢ for every \$1 of per pupil revenue that goes to the lowest-poverty districts. By comparison, Ohio provides 22% **more** per pupil state and local funding for its highest-poverty districts than it does for its lowest-poverty districts.⁷

Reforming State Aid for Education

In July of 2016, Governor Rauner created the Illinois School Funding Reform Commission to provide a framework for reforming the current school funding formula. The Commission presented its report in February of 2017, which included a framework intended to guide future reform legislation. Key elements of that framework include:

- Establishing an integrated adequacy target for each school district – a per pupil funding level that reflects the unique needs of a district’s student population, including students with disabilities, students who are English Language Learners, students from low-income families, and students who live in areas of concentrated poverty. (Early childhood funding and transportation funding remain outside the integrated formula.)
- Distributing State funds using a model that takes into account local available resources – with special consideration for districts that have low property wealth and high taxes, but, despite their effort, are still not adequately funded.
- Maintaining the current per pupil State funding level in each district through a “Hold Harmless” provision.
- Increasing funding for district-authorized charter schools to make it equitable, on a per-pupil basis, with the funds allocated to district-managed public schools.
- Ensuring that those districts that are currently farthest away from their adequacy target will receive the greatest benefit from any formula change, as well as any additional resources, until all districts have reached their adequacy targets.

- Ensuring that children who attend schools with the largest gap between their adequacy target and current funding levels see reductions in State funding only after districts at or above their adequacy targets lose funding.

The framework addresses the greatest flaws in the current model by: 1) establishing transparent district-specific targets for per pupil spending based on student demographics; 2) moving most funding streams into an integrated formula that takes into account differences in local property wealth; and 3) directing new State funding to the most needy districts first, while protecting them from funding cuts.

How much will it cost for all districts to reach their adequacy targets? The Commission estimated that it will require an additional \$3.5 billion. The State currently spends about \$7.5 billion on elementary and secondary education,⁸ with another \$4 billion for the annual pension contribution to the Teachers’ Retirement System. *Therefore, the State will have to increase its non-pension-related spending on education by almost 50 percent in order for all Illinois school districts to reach their adequacy targets.*

Given the size of the funding increase necessary to reach adequacy, the Commission suggested that the total increase could be phased in over the next decade – with an additional \$350 million added to the previous year’s funding in each of the next 10 years (i.e., \$350 million more in the first year, \$700 million more in the second year, \$1.05 billion more in the third year, and so on). The Commission’s framework ensures that these additional funds are targeted first to school districts that are farthest way from their adequacy target.

Current Reform Proposals: The Evidence-Based Model

The Evidence-Based Model (EBM) has been proposed as a new funding model that complies with the Commission’s framework. The EBM first calculates a per pupil adequacy target for each school district based on its unique student demographics and teaching strategies that have been proven by research to improve student outcomes.

- The calculation starts with a base per pupil spending level, which includes the basic elements of an elementary, middle or high school (e.g., 1 teacher per 25 students in 4th and 5th grade, 1 principal and 1 librarian per 450 students in elementary school, etc.).

- Depending on each school district's percentage of low-income students, English-language learners, etc., the model then adds the cost of proven strategies for supporting these students. For example, special education teachers and aides, reading intervention specialists, extended school days, and academic summer school are all costed out by the model.
- As a result, a unique per pupil adequacy target is calculated for each school district.

The EBM then calculates how much each district should contribute in per pupil funding based on its property wealth (local capacity). The combination of local capacity and current State funding is compared to the adequacy target to determine each school district's current percent of adequacy.

The percent of adequacy determines priority in receiving additional State resources. The EBM creates a tiered distribution system, which ensures that school districts with the lowest percent of adequacy are first in line for new State funding, and receive the greatest share of that funding. (However, all school districts receive at least as much in per pupil State funding as in the previous year because of a "Hold Harmless" provision.) In addition, if the General Assembly underfunds education in the future, reductions are targeted first at well-off school districts that can more easily sustain cuts.

The principles underlying the Evidence-Based Model – calculation of a unique adequacy target for each school district based on student demographics, accounting for local resources and differentiating what each district is expected to contribute, as well as a distribution system that ensures State money goes to the neediest districts – are sound and comply with the Commission's framework.

However, before any new funding model is put in place, it will be critical that an analysis comparing the State funding that districts receive before and after a possible change is developed, published, and vetted by school districts and other stakeholders. Given the complexity of school funding in Illinois, such vetting is the only way to identify and address any unintended consequences of the model's provisions and to build the political support to make the change. In addition, district examples will highlight the impact of specific model provisions – such as the treatment of districts subject to the PTELL, the inclusion or exclusion of TIFs in the calculation of local property wealth, the inclusion of poverty concentration in

the adequacy target, and the metrics used for counting the number of students requiring special supports – that are difficult to evaluate conceptually.

Pension Parity

The Commission's report included some discussion of other issues that impact the State's efforts to reach adequate school funding. One such issue is the State's required annual contributions for teacher pensions, which totaled about \$4 billion in FY2017. The Commission also acknowledged the unique burden borne by Chicago Public Schools (CPS) in that it is the only school district in Illinois that pays the employer's share of its teacher pension costs. (The \$4 billion State payment in FY2017 was for the employer's share of teacher pension costs outside of Chicago.) As a result Chicago taxpayers support their own teacher pensions through local property taxes, and support teacher pensions across Illinois through state-imposed taxes.

Annual pension contributions include both "normal costs," the cost associated with pension benefits earned in a given year, and a payment to amortize any unfunded liabilities. Some stakeholders have recommended that the State assume responsibility for the unfunded liability of Chicago's teacher pensions, and leave CPS to continue to pay the normal cost. At the same time, they recommend that the normal cost for teacher pensions outside of Chicago become the responsibility of each local school district, with the State maintaining responsibility for the unfunded liabilities. These changes would rationalize teacher pension funding in Illinois at a time when significant reforms are being considered to the State's school funding formula. However, such reform will take time and further study to implement. In the meantime, the State should provide additional annual funding to CPS that is sufficient to cover the normal cost of its teacher pensions.

In order for Illinois to prosper, we must ensure that all children in the State receive an adequate education, but the current funding system is failing too many of our students. Reforming the school funding formula, ensuring pension parity, and addressing the need for additional State education funding should be included as part of a comprehensive reform to right-size the State budget and ensure the provision of critical public services to all Illinois residents.

BRINGING ILLINOIS BACK: A FRAMEWORK FOR OUR FUTURE
A REPORT OF THE CIVIC COMMITTEE OF THE COMMERCIAL CLUB OF CHICAGO

Notes

- 1 Low-income criteria: receive or live in households that receive public aid from SNAP (Supplemental Nutrition Assistance Program) or TANF (Temporary Assistance for Needy Families); are classified as homeless, migrant, runaway, Head Start, or foster children; or live in a household where the household income meets USDA guidelines to receive free or reduced-price meals.
- 2 "Is School Funding Fair? A National Report Card," January 2017, Baker et al, p. 4. The funding level analysis uses a regression model to predict an average per-pupil funding level for each state while holding other variables constant. This analysis controls for characteristics that vary across states – such as student poverty, regional wage variation and population density – by determining the per-pupil funding level in each state if these variables are set to the national average.
- 3 "Funding Gaps 2015," March 2015, The Education Trust, p. 4. To measure disparities in state and local revenues based on the level of district poverty, all districts in the state are first sorted by the percent of students who live below the poverty line. Districts are then divided into quartiles, which have approximately the same number of students in each quartile, and the average state and local revenues per student are calculated across all districts in each quartile. This analysis uses the difference in average state and local revenues per student between the highest and lowest poverty quartiles. Specific Illinois data is from "The State of Funding Equity in Illinois," and is included on a graph in the "Funding Gaps 2015" report (p. 4).
- 4 Efforts to combine school districts, as part of broader efforts to encourage consolidation among Illinois' thousands of local governments, could equalize some of the property wealth disparities among school districts and also enable some overhead cost reductions.
- 5 A discussion of the necessary increase is included in the Appendices of the Financial Framework.
- 6 School districts with 0-15% of their student population designated as low-income receive a supplemental grant of \$355 per low-income student. School districts with more than 15% of their student population designated as low-income receive a supplemental grant per low income student based on the following formula: $\$294.25 + \$2,700 \times (\text{Concentration } \%)^2$. The squared term in the formula drives the significant difference in the per pupil grant depending on the concentration of low-income students. At 100% low-income concentration, a school district would receive \$2994 per low-income student.
- 7 "Funding Gaps 2015," March 2015, The Education Trust, p. 4.
- 8 Estimated 2017 spending on K-12 education from the General Funds Budget with the inclusion of the Fund for the Advancement of Education.

Workers' Compensation Reforms

Workers' compensation insurance covers the cost of medical care and rehabilitation for employees injured on the job, and compensates them for lost wages. In return, the employee gives up the right to sue the employer for injuries caused by the employer's negligence. Workers' compensation costs are one of many factors that influence business decisions to locate or expand in a particular state; Illinois' relatively high costs are often cited as a negative for the State's business climate. Fortunately, there are opportunities for Illinois to improve outcomes for injured workers and reduce its workers' compensation costs by moving to align with the best practices of other states

In 2011, the General Assembly passed a package of reforms that made significant changes to Illinois' workers' compensation system. In addition to other changes, the reforms:

- Reduced medical fee schedule rates by 30% across-the-board;
- Limited workers' choice of medical providers by creating a preferred provider program;
- Set utilization review standards based on recognized treatment guidelines and evidence-based medicine;
- Introduced the American Medical Association's "Guide for the Evaluation of Permanent Impairment" as a factor for determining the level of impairment;
- Set limits on carpal tunnel permanency at 15% loss of use of a hand (up to 30% loss of use in certain cases); and
- Established a cap on wage differential benefits – at age 67 or 5 years of benefits, whichever comes later.

The National Council on Compensation Insurance (NCCI) files advisory "manual" rates for workers' compensation insurers in Illinois. According to the NCCI, the cumulative impact of its recommended rate level changes for Illinois since the 2011 reforms has been a recommended rate **reduction** of 28.7%.

The insurance premium paid by an individual employer is based on the manual rate for the relevant industry, as well as other factors – such as experience modification factors, premium reductions on policies carrying deductible features, etc. According to published reports, some Illinois employers believe that they have not benefited

from reductions in their insurance premiums that are commensurate with NCCI's recommendations.

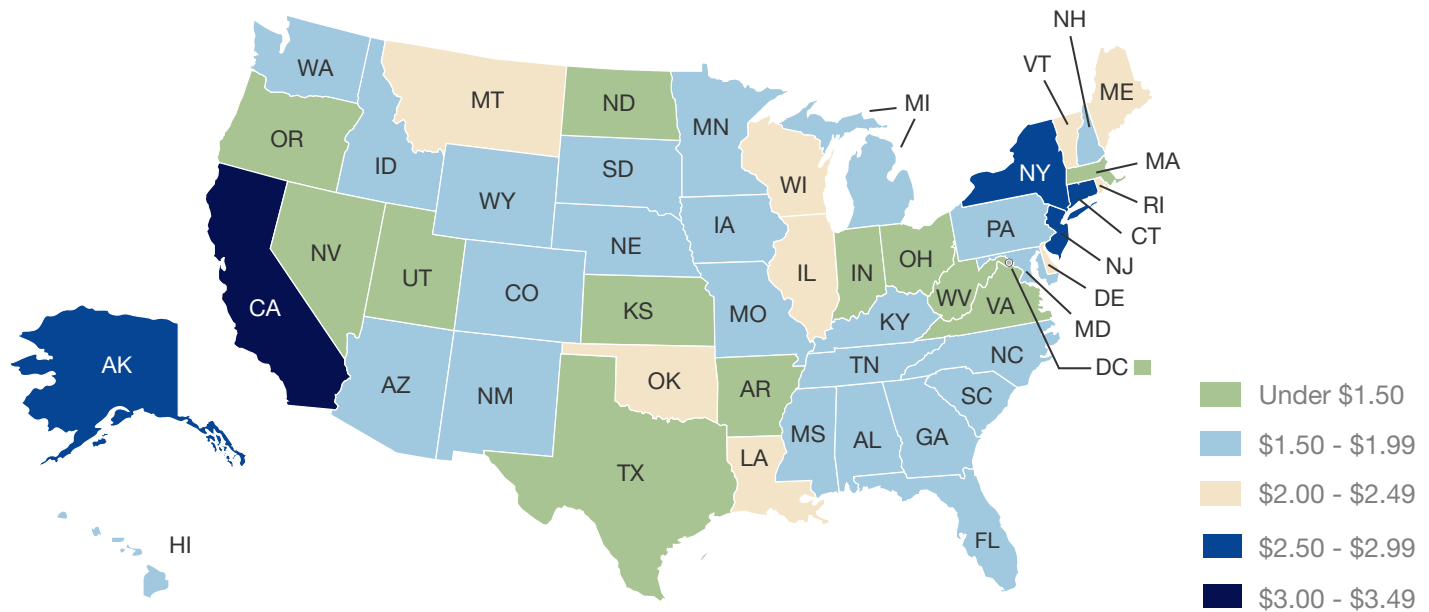
In addition, the most recent "Workers' Compensation Insurance Oversight Report," published by Illinois' Department of Insurance, reports improvements in the profitability of Illinois' workers' compensation market. According to that report, workers' compensation market profitability in Illinois has increased from losses of 10.8% in 2010 (before the reforms) to profits of 10.8% in 2014. As of 2013 and 2014, profitability in Illinois matched nationwide profitability in the worker's compensation market.

An additional issue has been raised regarding the impact of the 2011 reforms on injured workers' access to certain types of medical care. The 30% cut in medical fee schedule rates reduced workers' compensation rates for evaluation and management services (office visits) below prices paid by group health insurance and Medicare rates – creating access-to-care problems for injured workers. The Workers' Compensation Act authorizes the increase of fee schedule amounts if there is a significant limitation on injured workers' access to medical care, and the fee schedule amounts for office visits were increased for treatment on or after July 16, 2014. Earlier access-to-care issues also led to increases in fee schedule amounts for the Rehabilitation Institute of Chicago (effective March 27, 2012).

NCCI's recommended rate reductions demonstrate that workers' compensation costs in Illinois have declined as a result of the 2011 reforms – both in absolute terms and relative to other states. In 2010, before the reforms, Illinois' average rate was 49% above the median US state. In 2016, Illinois was 21% above the median, an improvement of almost 20% relative to other states – many of which also enacted workers' compensation reforms. However, despite this improvement, Illinois' workers' compensation rates continue to rank among the highest in the nation.

Figure 1 compares 2016 workers' compensation premium rate indices across states after controlling for differences in industry mix (Illinois' premium rate index reflects the rate reductions recommended by NCCI). California has the highest premium rates, at \$3.24 per \$100 of payroll; North Dakota has the lowest at \$0.89 (with Indiana following close behind). Illinois (\$2.23) and Wisconsin (\$2.06) have the highest rates in the Midwest.

Figure 1: 2016 Workers' Compensation Premium Index Rates (Per \$100 of Payroll)



Source: 2016 Oregon Workers' Compensation Premium Rate Ranking Study, Oregon Department of Consumer and Business Services, October 2016.

Note: The Oregon study is designed to produce a comparison of premium rates for a comparable set of risk classifications across all states. The 2016 study collected average manual rates (rates for expected claim costs plus factors for insurer expense and profit) as of January 1, 2016 for 54 occupational classes in each state. Each state's average manual rate per \$100 of payroll was then calculated by weighting those rates by the Oregon payroll in each of those classes. Using the Oregon payroll for all states adjusts for different industry mixes across states. (This calculation does not include other factors that would impact the insurance premium paid by an individual employer, such as experience modification factors, premium reductions associated with deductibles, etc.)

The index for Illinois was developed using the National Council on Compensation Insurance (NCCI) advisory rates.

Workers' compensation insurance is intended to cover injuries that employees sustain in the workplace or anywhere else while the employee is acting in the "course and scope" of employment. State standards determining whether a given claim is work-related – and therefore compensable under workers' compensation – often describe certain exceptions. These exceptions may include injuries incurred during social/recreational activities, injuries incurred while coming and going (during the worker's normal commute), and injuries incurred while intoxicated. In addition, states apply **causation standards** to determine whether the work injury is the cause of the medical condition requiring care – as described below, such standards are particularly important when a pre-existing condition or disability contributes to the medical condition.

Once a claim has been determined to fall under a state's workers' compensation system, there are two major drivers of costs per claim.

- **Medical care** costs, which reflect the price and utilization of medical services for injured workers; and
- The cost of **indemnity benefits**, which are intended to compensate workers for lost wages. These include

temporary disability benefits paid while workers are recovering from injuries, as well as permanent disability benefits paid if injuries cause permanent impairment.

Causation

Causation standards vary from state to state and may address the following issues:

- **Causation threshold:** If a pre-existing condition or disability contributed to the work-related injury, is there a causation threshold that must be met for the claim to be covered under workers' compensation?
- **Apportionment:** If a pre-existing condition or disability contributed to the work-related injury, are there provisions that apportion workers' compensation benefits based on the portion due to the new injury?

Standards based on a fixed threshold or apportionment become particularly important in the case of pre-existing conditions or disabilities that are aggravated by an injury at work. For example, if a worker has a pre-existing knee condition from running marathons and injures that knee at work, will his or her claim be covered by workers' compensation?

In Illinois, employment need only be a cause of the medical condition or injury for which compensation is being sought. Once that standard has been met, no further causation threshold or apportionment is applied. Therefore, the claim described above would fall completely under the employer's workers' compensation insurance.

Florida applies a much more stringent "major contributing cause" standard. If a work-related injury combines with a pre-existing condition:

...the employer must pay compensation or benefits required by this chapter only to the extent that the injury arising out of and in the course of employment is and remains more than 50 percent responsible for the injury as compared to all other causes combined...Major contributing cause must be demonstrated by medical evidence only. [Florida Statute §440.09 (1b)]

Claims that fail to meet this threshold are not covered by workers' compensation, and must be addressed through employee health care insurance. In Florida, the claim described above would likely not fall under the employer's workers' compensation insurance.

The State of Wisconsin recently enacted a set of workers' compensation reforms (2015 Wisconsin Act 180) that included provisions for the apportionment of permanent disability costs:

Lastly, the Act specifies that liability is reduced when a combination of an injury in the course of employment and other factors cause a permanent disability. If this combination of causes is certified by the care provider, the employer pays only the percentage of the permanent disability that was caused by the accidental injury that occurred in the course of employment. This is commonly referred to as "apportionment." [Wisconsin Legislative Council Act Memo, 2015 Wisconsin Act 180, Worker's Compensation]

In Wisconsin, if the claim described above includes permanent disability of the injured knee, the employer would be responsible to compensate the worker only for the portion of the disability that is attributable to the work injury.

Medical Costs

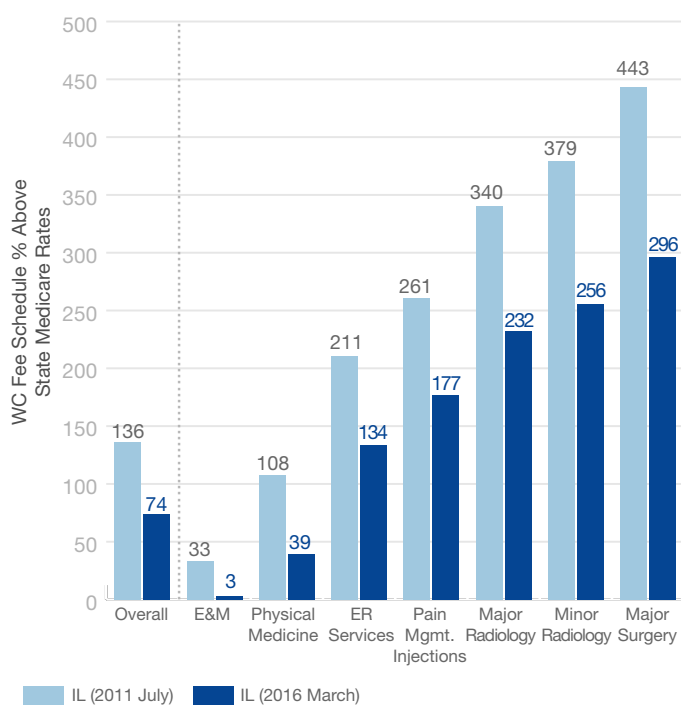
According to the Workers Compensation Research Institute (WCRI),¹ which evaluates the cost of Illinois' claims with more than seven days of lost time versus 17 comparison states, average medical payments per claim

in Illinois are 18% higher than the median state. Before the 2011 reforms – which included a 30% across-the-board rate reduction for medical providers – average medical payments per claim in Illinois were 40% higher than the median state.

Although average hospital payments per claim in Illinois are now comparable to WCRI's comparison states, non-hospital payments per claim remain significantly higher than average. Non-hospital payments include payments to physicians, chiropractors, and physical/occupational therapists for professional services, as well as payments to ambulatory surgery centers. These relatively high costs are the result of both **higher prices** and **higher utilization**.

Most states regulate prices for professional services through medical fee schedules, which set the maximum allowable fees for workers' compensation claims. Many states link their fee schedules to Medicare rate calculations, but Illinois does not. **Figure 2** compares Illinois' workers' compensation rates for professional services with state Medicare rates – both for 2011 (before the 30% across-the-board rate reduction) and for 2016.

Figure 2: Workers' Compensation Fee Schedule Rates: Percent Above Medicare Rates



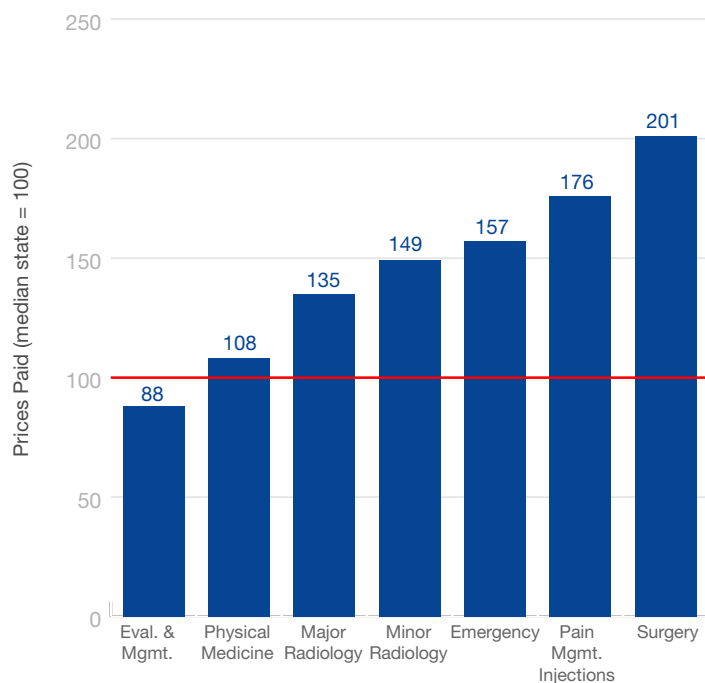
Source: *Compscope Medical Benchmarks for Illinois, 17th Edition*, p. 23. Evelina Radeva. Workers Compensation Research Institute. October 2016.

Note: The 2016 rates for evaluation and management services include the rate increase that was effective as of July 16, 2014.

Although the disparity between workers’ compensation and Medicare rates has been reduced since the 2011 reforms, rates for workers’ compensation services remain significantly higher (except for evaluation and management services). In addition, the size of the disparity varies widely by type of service. This variance is important when considering possible reforms; across-the-board cuts may reduce the fees for some services below Medicare rates, while leaving others significantly higher than Medicare rates.

Figure 3 compares actual prices paid for professional services in Illinois vs. the median comparison state using a price index for commonly billed professional services (median state = 100). Prices paid for all types of professional services in Illinois are higher than average (except for evaluation and management).

Figure 3: Actual Prices Paid for Professional Services in Illinois vs. Median Comparison State



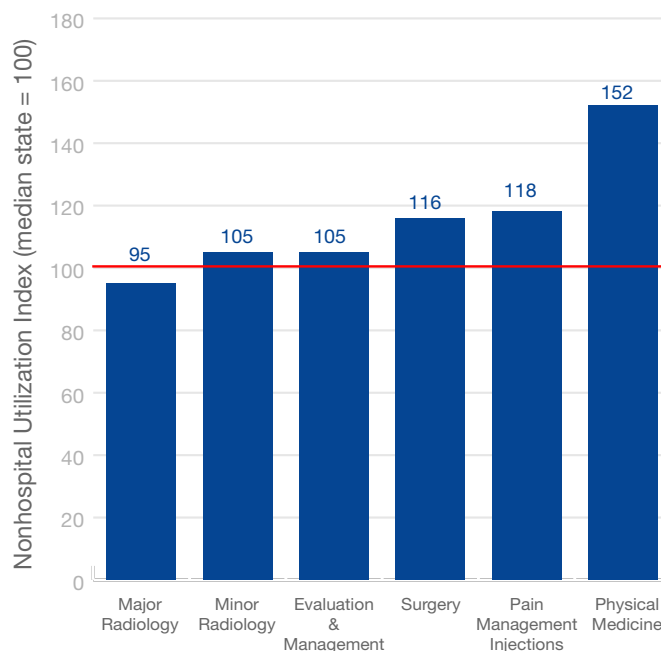
Source: *Compscope Medical Benchmarks for Illinois, 17th Edition*, p. 24. Evelina Radeva. Workers Compensation Research Institute. October 2016.

As noted earlier, a state’s workers’ compensation medical costs reflect not only the prices paid for medical services, but also the utilization of services. To control costs, some states restrict the number of visits/services a claimant may

receive for certain services through treatment guidelines or specific limits. Commonly limited services include chiropractic care, physical therapy and occupational care. Illinois does not impose prospective limits, although employers can seek a utilization review to determine whether or not services are necessary, and limit care based on that review.

Figure 4 compares Illinois’ utilization of non-hospital, professional services versus WCRI’s comparison states using a utilization index with the median state set at 100 – the value shown by the red line.

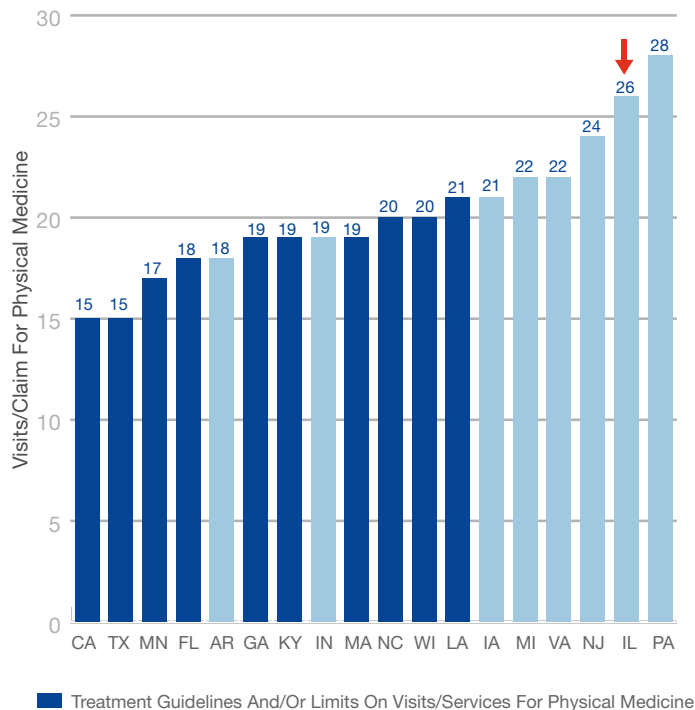
Figure 4: Utilization of Professional Services in Illinois vs. Comparison States



Source: *Compscope Medical Benchmarks for Illinois, 17th Edition*, p. 31. Evelina Radeva. Workers Compensation Research Institute. October 2016.

Illinois has the highest utilization of all the comparison states, largely driven by very high utilization of physical medicine. Illinois’ utilization of physical medicine is 52% higher than the median state; for pain management injections and surgery, Illinois’ utilization is 18% and 16% higher, respectively. **Figure 5** illustrates the key driver of higher utilization of physical medicine in Illinois relative to comparison states – the number of visits per claim.

Figure 5: Average Visits/Claim for Physical Medicine in Illinois vs. Comparison States



Source: *Compscope Medical Benchmarks for Illinois, 17th Edition*, p. 32. Evelina Radeva. Workers Compensation Research Institute. October 2016.

States have different regulations with regard to physical medicine services. The states with dark blue bars in Figure 5 have implemented treatment guidelines and/or limits on visits or services for physical medicine, and tend to have lower utilization. For example:

- California limits physical therapy to 24 visits per claim unless there is a need for post-surgical rehab.²
- Texas uses evidence-based medical treatment guidelines. Treatments and services exceeding or not addressed by the treatment guidelines require pre-authorization.³
- North Carolina allows up to 30 visits, but then requires pre-authorization from the payer.⁴

According to WCRI, the states with the highest number of physical medicine visits per claim – Iowa, Michigan, Virginia, New Jersey, Illinois, and Pennsylvania – do not apply treatment guidelines or visit limits, although they may have utilization review programs.⁵

Although Illinois' workers' compensation provisions that impact medical costs are not currently aligned with the practices of many other states, some efforts have already been made to implement reforms. As discussed

previously, the most significant provision in the 2011 workers' compensation reforms was a 30% reduction in the fee schedule rates for all medical services, which significantly reduced Illinois' medical costs per claim. In addition, Illinois' utilization review provisions have been an important first step in addressing utilization.

Indemnity Costs

In addition to paying for medical care for injured workers, workers' compensation also provides indemnity benefits. These benefits are intended to compensate workers for lost wages, and include **temporary disability** benefits for workers who are recovering from injuries, as well as **permanent disability** benefits for workers whose injuries cause permanent impairment. Illinois' average indemnity costs per claim are higher than WCRI's median comparison state.

Most states tie indemnity benefits directly to wages – weekly benefits are calculated as a fixed percentage of workers' pre-injury wages, subject to minimum and maximum limits. According to WCRI, the variation in average indemnity costs across states reflects a combination of factors,⁶ including:

- Average weekly benefit amounts;
- Duration of benefits; and
- Benefits for permanent disabilities.

Illinois relatively high indemnity costs are attributable to all three of these factors.

Temporary disability benefits

Temporary total disability (TTD) benefits are paid when a worker is unable to return to any work (or is released to light duty work, but whose employer cannot accommodate him or her).⁷ In Illinois, weekly TTD payments are calculated as two-thirds (66 2/3%) of the worker's average weekly wage,⁸ subject to minimum and maximum limits.

These temporary disability benefits are paid until the injured worker has either recovered completely or reached maximum medical improvement (MMI) – the point at which the injured worker's condition has stabilized and no further recovery or improvement is expected even with additional medical intervention. Once the worker has reached MMI, an assessment can be made of any permanent impairment.

High costs for temporary disability benefits are one of the key factors in Illinois' relatively high indemnity costs. According to WCRI, the key contributing factors are:

- *Higher average TTD weekly benefit amounts.*

As noted above, TTD weekly benefit amounts are based on the worker's pre-injury average weekly wage, subject to a maximum. Relatively high average wage levels in Illinois are one factor contributing to higher TTD benefits. However, even after adjusting for differences in wage levels, the average TTD benefit in Illinois remains higher than other states. In Illinois, the maximum TTD benefit is set at 133 1/3% of the statewide average weekly wage. In most other states, the maximum is 100% of the statewide average weekly wage. The higher maximum in Illinois drives the higher average benefit, even after adjusting for wage levels.⁹

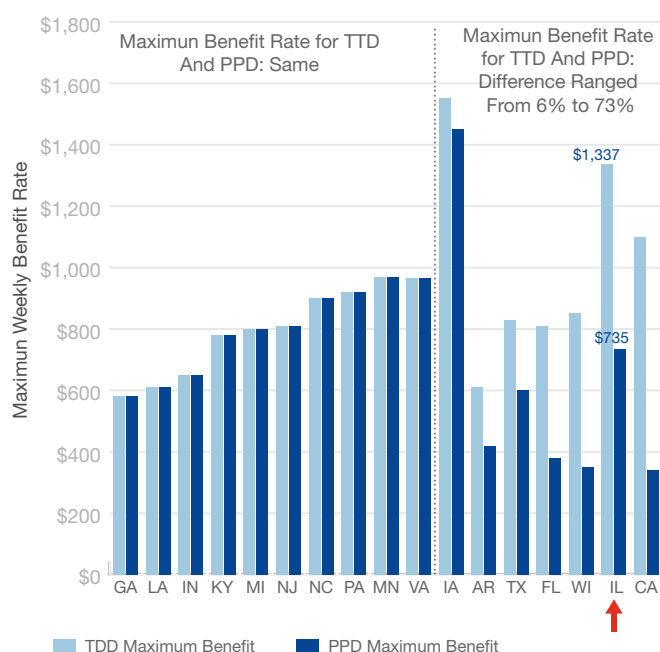
- *Longer duration of temporary disability benefits.*

On average, Illinois workers stay away from work for 19 weeks compared with 13 weeks in the average comparison state. Illinois does not have limits on the duration of temporary disability benefits, while some WCRI comparison states have statutory caps on temporary disability payments and allow termination or modification of TTD benefits without a formal hearing.

In addition to the lack of limits on benefit duration, WCRI's analysis highlights another factor that may be extending the duration of temporary disability in Illinois.

Figure 6 illustrates the maximum weekly benefit levels for temporary benefits vs. permanent benefits for Illinois and comparison states.

Figure 6: Maximum Weekly Benefit Rate for Temporary Disability vs. Permanent Disability



Generally speaking, both temporary and permanent disability payments are tied to weekly wages, subject to minimum and maximum limits. In most comparison states, the maximum is the same for both types of payment.

However, some states have different maximums for temporary and permanent disability benefits; Illinois has one of the largest gaps between the two. In 2014, the maximum weekly amount for permanent partial disability (PPD) benefits was set at \$735. The maximum weekly amount for temporary total disability (TTD) benefits was equal to 133 1/3% of the statewide average weekly wage, or \$1337 – almost twice as much as the PPD maximum.

Permanent disability benefits

If a job-related injury results in some permanent physical loss, the injured worker will also receive permanent disability benefits. A worker who is rendered permanently and totally disabled will receive permanent total disability (PTD) benefits, equal to two-thirds (66 2/3%) of his or her average weekly pre-injury wage (subject to minimum and maximum limits), for life.

A worker who sustains some permanent loss of function will receive permanent partial disability (PPD) benefits. According to WCRI, a PPD benefit in Illinois is viewed as a settlement after the worker completes medical treatment and is at maximum medical improvement. More than 40% of claims with more than seven days of lost time include PPD benefit payments – with the majority paid out as lump sum payments (that may include a settlement for future medical payments) with no weekly PPD benefits. The average PPD benefit payment per claim in Illinois is in the higher group of comparison states.

There are four different types of PPD benefits in Illinois:

1. *Wage differential*

If the employee obtains a new job that pays less than the pre-injury wage, he or she may be entitled to a wage differential award for 5 years or until age 67, whichever is later.

2. *Schedule injuries*

State law includes a schedule, which sets a value on certain body parts expressed as a number of weeks of compensation. The value of an injury is determined by applying a percentage of loss of the injured body part, and then multiplying the number of weeks by 60% of the employee's average weekly wage.

3. *Non-schedule injuries (person as a whole)*

If the condition is not listed on the schedule of injuries, the employee may be entitled to benefits for loss of “the person as a whole.” This is a similar calculation as for scheduled injuries; the “person as a whole” maximum value is 500 weeks.

4. *Disfigurement*

An employee who suffers a serious and permanent disfigurement to the head, face, neck, chest above the armpits, arm, hand, or leg below the knee may be entitled to benefits based on the value of the disfigurement. This is a similar calculation as for scheduled injuries; the disfigurement maximum is 162 weeks.

PPD benefits are subject to minimums and maximums. Benefits for scheduled injuries, person as a whole injuries and disfigurement are subject to a maximum average weekly wage that is significantly lower than the maximum for temporary disability benefits. As noted earlier, this difference in maximums may contribute to the relatively long duration of temporary disability in Illinois.

A key element in determining PPD benefits is the extent of the loss of use of a body part due to an injury; states differ in their provisions regarding this determination. States such as Indiana, Texas and Florida base PPD benefits on medical impairment only. Illinois bases the determination on five factors (one of these factors may not be the sole determinant):

1. Medical impairment report using the American Medical Association’s “Guide for the Evaluation of Permanent Impairment;”
2. Occupation of the injured employee;
3. Age of the employee at the time of the injury;
4. Employee’s future earning capacity; and
5. Evidence of disability corroborated by the treating medical records.

Although Illinois’ workers’ compensation provisions regarding indemnity benefits are not currently aligned with the practices of other states, efforts have been made to implement reforms. For example, before the 2011 workers’ compensation reforms, impairment ratings by physicians were not admissible as evidence in the final determination of PPD benefits. (The inclusion of impairment ratings is intended to standardize the approach for evaluating

permanent impairment, and lower the average PPD benefit payment if the rating is applied in the majority of cases.)

In addition, the 2011 reforms capped the duration of wage differential benefits for PPD at 5 years after the date of the award, or age 67, whichever is later. Previously, those benefits were paid for life. The 2011 reforms also set maximum benefits for carpal tunnel at 15% loss of the use of the hand, unless there is clear and convincing evidence of more disability, with an upper limit at 30% loss of use.

Additional Reforms

Despite the 2011 workers’ compensation reforms, Illinois continues to have some of the highest workers’ compensation costs in the nation. Additional reforms that bring Illinois more in line with the practices of other states are a sensible next step to lower costs and improve the State’s business climate, while improving outcomes for injured workers.

Clear causation standards should be established for cases where a pre-existing condition or injury contributes to the injured worker’s medical condition. Other states have established thresholds (such as Florida’s “major contributing cause” threshold) or provisions for apportioning permanent disability benefits (such as Wisconsin’s new law). Illinois should do the same.

Even after a 30% reduction in fee schedule rates for medical services, Illinois’ medical costs per claim are still high relative to other states. This is the result of both higher prices – particularly for professional services – and higher utilization.

- Illinois should follow the practice of other states and tie its medical fee schedule to Medicare rates. Setting the workers’ compensation fee schedule at 150% of Medicare rates (close to the national average of 155%) would rationalize the current fee schedule and move Illinois to the middle of states. During the implementation of these changes to the medical fee schedule, special care should be taken to identify and ameliorate any access-to-care issues that arise for injured workers.
- In addition, Illinois should adopt limits on utilization for certain medical services (particularly physical medicine) and follow the best practices of other states by establishing evidence-based treatment guidelines for the most common work-related injuries.

There are a number of options for addressing Illinois' relatively high costs for indemnity benefits. The duration of temporary disability is a key contributor to relatively high temporary disability costs. Best practices from other states for reducing the average length of temporary disability, such as return-to-work guidelines, should be explored and adopted. (The evidence-based treatment guidelines described above should help also reduce the duration of temporary disability.)

Illinois has already made an important improvement to the determination of permanent partial disability benefits with the inclusion of the AMA Guides to determine impairment.

- A number of additional reforms have been suggested in this area to give the impairment report more weight (if it exists) – many other states rely solely on medical impairment reports in assessing permanent disability.
- At the same time, not all workers' compensation claims require an impairment report, especially given its expense. The law should be clarified to acknowledge that an AMA report is not mandatory to determine permanent partial disability.

Finally, a number of reforms have been proposed regarding scheduled and "person as a whole" injuries.

- These include clarifying language that the shoulder is part of the arm and the hip is part of the leg (so that these injuries will be included on the schedule rather than treated as "person as a whole" injuries).
- In addition, a "person as a whole" credit, similar to the mechanism for scheduled injuries (which subjects a worker to a cap on awards and credits prior awards against future awards to prevent double recovery),¹⁰ should be established.

These and other more granular reforms in the State's provisions governing permanent partial disability benefits should be considered and implemented.

Reforming the State's workers' compensation provisions to align with the provisions in other states will move Illinois' workers' compensation costs toward the middle of states. These measured, sensible changes will preserve the role of workers' compensation in caring for workers who are injured on the job, while removing a frequently-cited impediment for businesses considering where to locate or expand jobs.

Notes

- 1 WCRI's analysis of 18 comparison/study states (including Illinois) uses data from 25 data sources, including national and regional insurers, claims administration organizations, state funds and self-insured employers. According to WCRI, the data collected in the Detailed Benchmark/Evaluation database includes 57% of Illinois claims (40 to 76 percent of the claims from each state). Workers' compensation claims can take years to develop; much of the WCRI data is reported for 2012/15 (injury year/evaluation year). WCRI analysis focuses on claims with more than 7 days of lost time; these claims account for most of the cost of a state's workers' compensation system. The WCRI analysis generally adjusts for injury and industry mix across states, and for average wage levels. By controlling for these factors, the WCRI analysis focuses on the impact of the provisions of each state's workers' compensation system.
- 2 *Workers' Compensation Laws as of January 1, 2016*, p. 25. Workers Compensation Research Institute, May 2016.
- 3 *Ibid*, p. 26.
- 4 *Workers' Compensation Medical Cost Containment: A National Inventory*, 2015, p. 56. Ramona P. Tanabe, Workers Compensation Research Institute, April 2015.
- 5 *Compscope Medical Benchmarks for Illinois, 17th Edition*, p. 32. Evelina Radeva. Workers Compensation Research Institute. October 2016.
- 6 Indemnity costs are adjusted for differences across states in wages and injury/industry mix in WCRI's analysis.
- 7 Recovering workers who can return to light-duty work at lower wages receive temporary partial disability (TPD) benefits to offset the lower wages.
- 8 Workers' compensation benefits are not taxable under state or federal law.
- 9 In Illinois, only 1.6% of claims analyzed by WCRI had TTD benefits that were constrained by the maximum. In the typical state, 11% of claims were constrained.
- 10 If a given body part is injured more than once, the total compensation can't exceed 100% of the loss of that body part (e.g., if an initial injury is deemed to have caused 60% loss of an arm, subsequent compensation for later injuries of that same arm could not exceed the remaining 40%).

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