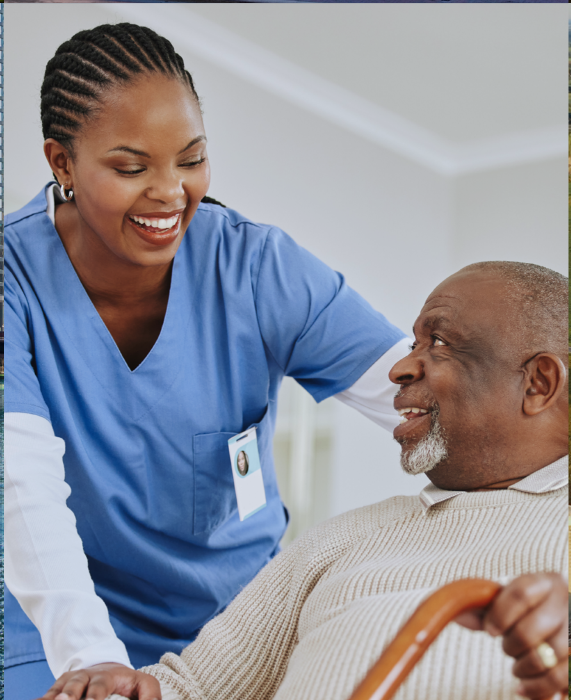
Civic Committee
COMMERCIAL CLUB OF CHICAGO

Securing Illinois' Future

Stabilizing State Finances to Promote Long-Term Growth

FEBRUARY 2023



Civic Committee
COMMERCIAL CLUB OF CHICAGO

The Civic Committee of the Commercial Club of Chicago

The Civic Committee works with business leaders, public officials, and other civic organizations on game-changing initiatives to promote the social and economic well-being of our region. Its mission is to make the Chicago region a better place for everyone to live, work, and do business.

We have a strong history of taking on broad, systemic issues that impact the Chicago region and Illinois and call for a sustained effort. These projects change over time and currently include efforts to:

- Restore the State of Illinois to fiscal stability;
- Improve the educational system in Chicago for all who live here;
- Solidify Chicago's position as a global transportation hub;
- Grow Chicago's position as a top-tier technology ecosystem that promotes inclusive economic growth;
- Foster an inclusive economy by supporting minority owned businesses and tapping into our region's diverse workforce;
- Engage the business community in the public dialogue about public safety.

We also work closely with the organizations we have helped create over our history:

- The Civic Consulting Alliance builds pro bono teams of business experts, government leaders, and its own professional staff to work on transformative public sector challenges, such as reducing crime, increasing the availability of high-quality healthcare, improving the educational system, and promoting economic growth.
- Kids First Chicago is dedicated to ensuring Chicago's public school system provides high quality, accessible options for all Chicago families.
- P33 works with over 1,000 Chicago leaders to turbocharge the Chicago region's tech economy and promote inclusive growth.

Executive Summary

Illinois' finances and the fiscal discipline shown by state leadership have improved in recent years, which has resulted in the State receiving its first two credit rating upgrades in two decades. The purpose of this report from the Civic Committee of the Commercial Club of Chicago is to provide a foundation for further dialogue with the Governor and State legislative leaders to identify and prioritize policies that provide for a stronger, secure future for our State and all who live here.

The report focuses on the importance of establishing a consensus among a wide range of stakeholders on the overarching objectives to guide the long-term financial strategy for the State. We believe that the following Three Pillars are critical to secure Illinois' finances and are the foundation on which a range of potential actions should be evaluated:

PILLAR #1 – PLAN: The State should develop a comprehensive financial plan for addressing its fiscal challenges.

PILLAR #2 – CREDIT RATING: The focus of actions to be implemented should be designed to achieve an AA credit rating for the State in 5 years. 80% of all states have a credit rating of AA or higher. Illinois' current credit rating is BBB+, which is the lowest among all 50 states. We believe that achieving an AA credit rating in 5 years is an ambitious but achievable target. A critical element of achieving an AA credit rating is to implement a new credible funding plan to address the unfunded pension liabilities of the State.

PILLAR #3 –FINANCIAL SUSTAINABILITY: The State should ensure that structural annual budget deficits are eliminated in the foreseeable future.

The report identifies several potential policy actions to address the complex set of fiscal issues facing the State. However, the Civic Committee recognizes that there may be other ways to address these challenges and will support other actions beyond those identified in the report if they are integrated into a comprehensive plan that when taken together will achieve each of the Three Pillars.

The policy actions discussed further in the report are focused on the following:

1. Implement a new accelerated pension funding plan that will save the State approximately $40 billion in pension contributions over the next 22 years and will amortize 100% of the State's pension liabilities, rather than the current target of 90%. The Civic Committee would support a personal and corporate income tax surcharge for 10 years to pay for the accelerated pension funding on the condition that the funds raised in the surcharge are legally obligated to be contributed to the pension funds (in a lockbox-style approach) and incremental funding of the Rainy Day Reserve Fund.
2. Continue the progress on building the State's Rainy Day Reserve Fund to $6 billion within 5 years from the current level of $2 billion to align with credit rating expectations of comparable AA states.
3. Revise certain tax policies to enhance the State's economic competitiveness and raise revenues without making Illinois an outlier compared to most other states.
4. Identify and implement long-term reductions in expenditures in targeted areas to ensure that the comprehensive plan includes expenditure reductions to support strategic incremental investments that are important for the long-term success of the State.

If we are able to achieve the Three Pillars outlined above, the uncertainty that currently exists regarding the State's finances would be eliminated, which will result in higher economic growth for the State, improved competitiveness, and increased jobs for working families. Further, achieving the Three Pillars will lead to a successful State in which:

- Parents will not have to worry about education funding being sacrificed to pay for legacy obligations.
- Residents will be assured that the State will have the resources to provide the government services they rely on.
- Pensioners will not have to worry about whether their retirement income payments are secure.

The Governor and State leadership have created positive momentum in addressing the State's long-standing fiscal issues and they should be commended for their recent actions. By further securing the State's finances in a meaningful manner as outlined in the report, we believe this will benefit all who live in Illinois.

Securing Illinois' Future: Stabilizing State Finances to Promote Long-Term Growth

Illinois has considerable strengths. It is one of the largest and most diverse economies in the United States with a broad mix of industries. The State is also home to a diverse, skilled, and talented workforce. It has more than 200 higher education institutions, including top-ranked public and private research institutions that draw students from all over the world. With five international airports, seven Class I railroads, and the third-largest intermodal port in the world, Illinois is a world-leading transportation hub. Our geography, climate, and other natural assets also give us a tremendous competitive advantage.

Given these unique strengths, Illinois should be the envy of other states. However, the State's fiscal challenges are a risk to Illinois' long-term growth potential, economic health, reputation, and ability to compete with other states and provide the services that those who live here deserve and expect.

The Civic Committee of the Commercial Club has long been involved in state finance, proposing solutions to put the State back on the right fiscal path. We believe Illinois is an excellent place to live, work, and do business, and that if we comprehensively address our fiscal challenges, we will eliminate uncertainty about Illinois' finances, resulting in higher economic growth for the State, improved competitiveness, and increased jobs for working families.

We are optimistic about the State's recent progress in demonstrating improved financial discipline. The Covid-19 pandemic recession in 2020 added severe strain to state and local government budgets, however, the pain was relatively short-lived. The federal government stepped in with significant financial support, and the rapid recovery boosted revenues, and we are now in our best fiscal position in decades.

Report Objectives

The Governor and State legislative leaders should be commended for the leadership they have shown in implementing improved fiscal policies in Illinois. They have prioritized contributing to the State's "rainy day" fund, made additional pension payments on top of the statutorily required amount, and repaid billions of dollars in borrowing, including long-standing bill backlog debts. Credit rating agencies responded positively, awarding Illinois its first rating upgrades in two decades.

The purpose of this report is to provide a foundation for further dialogue with the Governor and State legislative leaders to identify and prioritize policies that provide for a stronger, secure future for our State. By stabilizing State finances, we believe this can promote long-term economic growth, which will benefit all who live and conduct business in Illinois.

This report focuses on Three Pillars that we believe are critical to secure Illinois' finances. We believe that there is a range of potential actions that the State could take to achieve the goals outlined in the Three Pillars. **Our report identifies one set of potential actions to consider, however, we recognize there are other approaches and actions that the State could implement. Importantly, we want to confirm that the Civic Committee can support other actions beyond those identified in this report as long as they are integrated into a comprehensive plan that when taken together will achieve each of the Three Pillars.**

PART I

THREE PILLARS TO SECURE ILLINOIS' FINANCES

The approach to solving the complex set of issues around Illinois' finances requires that a consensus be developed among a wide range of stakeholders on the overarching objectives to guide the long-term financial strategy for the State.

We believe that the following Three Pillars are the foundation on which a range of potential actions should be evaluated. These Pillars are the "North Star" to guide the discussion among stakeholders on prioritizing a set of long-range solutions to secure State finances:

PILLAR #1 – PLAN: The State should develop a comprehensive financial plan for addressing its fiscal challenges.

PILLAR #2 – CREDIT RATING: The focus of actions to be implemented should be designed to achieve an AA credit rating for the State in 5 years, which will require a new pension funding plan.

PILLAR #3 – FINANCIAL SUSTAINABILITY: The State should ensure financial sustainability by eliminating structural budget deficits for the foreseeable future.

Each of the Three Pillars is discussed further in the following sections of Part I of this report.

Pillar #1 – Plan: The State should develop a comprehensive financial plan for addressing its fiscal challenges.

The fiscal challenges facing the State were not created overnight. They resulted from decades of poor fiscal decisions, including enacting a 50-year pension payment ramp that underfunded the pension system for decades, pension holidays, annual budget deficits, and accumulating $17 billion in unpaid bills when the State went without a budget for two years.

A comprehensive fiscal plan is the starting point for solving the State's financial issues. To be successful, a comprehensive fiscal plan needs to include:

- A prioritized set of fiscal policy actions that will need to be implemented on a multi-year basis focused around achieving Pillars #2 (an AA credit rating) and #3 (financial sustainability).
- An analysis of current tax policies to ensure that current and proposed actions do not make Illinois an "outlier" relative to other states.
- An objective assessment of the benefits to be delivered to a wide range of stakeholders in the State in return for the costs of implementing new actions to secure Illinois' finances.

This report includes potential actions to be included in a comprehensive financial plan. While this report can be used as a reference point for considerations by State leadership, we also would support the establishment of a "Blue Ribbon Panel" composed of a diverse group of individuals appointed by the Governor from business, labor, nonprofits, academia, and other important constituent groups to develop a comprehensive financial plan with the specific actions that can most effectively solve Illinois' long-standing financial issues. It is important to note that we believe that the content of any report completed by a Blue Ribbon Panel should identify, at a minimum, a set of actions that when taken collectively, result in a credible plan to achieve each of the Three Pillars within the defined time periods. A Blue Ribbon Panel could also complete an analysis of various tax policies of Illinois to identify opportunities to reduce outlier status in Illinois and improve the State's competitiveness. We fully appreciate that an outside panel could complicate an already complex process, but we genuinely believe that incorporating broader input will lead to more creative and enduring solutions to secure the future of Illinois.

Pillar #2 – Credit Rating: The focus of actions to be implemented should be designed to achieve an AA credit rating for the State in 5 years, which will require a new pension funding plan.

The credit rating is a useful, widely recognized, and objective measure of a State's fiscal health. It reflects a variety of factors, including the strength of the economy, the amount of debt and unfunded pension obligations, the level of budget reserves and liquidity, and the governmental framework for oversight of financial matters of the State.

Despite recent upgrades of two levels total, Illinois' current credit rating is the lowest among all 50 states at BBB+. 80% of all states have a credit rating of AA or higher.[1] It is important to recognize the Governor and State legislative leaders for the actions they have taken over the past year, but further work is required to achieve longer-term solutions. We believe it is vital for the State to continue to build on this momentum of the past year.

There is a path available for the State to achieve an AA credit rating in 5 years. It will require difficult decisions to prioritize a number of actions, including additional deposits into the Budget Stabilization Fund ("Rainy Day Fund"), managing the level of expenditures annually within existing structural revenues, and various other policy actions consistent with other states that have successfully upgraded their credit rating. Critically, it must include adopting a credible new pension funding plan which fully funds all liabilities.

A state that achieves an AA credit rating is one that demonstrates a track record of strong fiscal management and a low risk of defaulting on its debt obligations. A state with an AA credit rating is one in which:

- Parents will not have to worry about education funding being sacrificed to pay for legacy obligations
- Residents will be assured that the State will have the resources to provide the government services they rely on
- Pensioners will not have to worry about whether their retirement income payments are secure
- Jobs and opportunities are plentiful because of increased levels of investments by companies operating in Illinois.

Above all, by achieving an AA credit rating, Illinois will be stronger and more secure in the future.

Reaching AA in 5 years is an ambitious but achievable target. We are confident that the Governor and State leadership can implement fiscal policies to reach that target. A more detailed description of potential actions to achieve an AA credit rating is included in Part 2 of this report.

Pillar #3 – Financial Sustainability: The State should ensure financial sustainability by eliminating structural budget deficits for the foreseeable future.

In well-managed states, budgets are structurally balanced, meaning that recurring revenues are sufficient to cover recurring expenditures. They meet their financial obligations without having to borrow or rely on one-time budget measures. Structural balance is critical to achieving a higher credit rating.

While Illinois has a long track record of running budget deficits and balancing budgets using one-time maneuvers such as interfund borrowing, the Governor and State leadership have shown discipline around managing the results of the General Funds budget. To their credit, there have been surpluses in the State's General Funds for three consecutive fiscal years as the State has benefited from increased revenues and federal Covid support. The State has also paid down debt and set up the future by making supplemental pension payments and contributing to the Budget Stabilization Fund. In its second upgrade to Illinois' credit rating in less than a year, S&P specifically highlighted, "...continued timely budget adoption and elimination of the bill backlog, as well as recent surplus revenues being used to promote what we view as longer-term financial stability... "[2] as factors contributing to the upgrade.

And there is more good news ahead. Estimates released by the Governor's Office of Management and Budget (GOMB) in November 2022 showed baseline revenues for FY23 coming in about $3.7 billion higher than originally projected.[3] As of the end of the lame duck session in early January, much of this surplus was spoken for: in addition to supplemental appropriations, the Governor signed into law bills which repaid the remaining $1.4 billion owed on its Unemployment Trust Fund (UTF) loan from the federal government,[4] made an $850 million deposit into the Budget Stabilization Fund, and created a $400 million Large Business Attraction Fund.[5] The five-year projections show a small surplus for the next fiscal year, but deficits are projected to return in FY25 and get as high as $800 million in FY28.[6]

Achieving a consistent pattern of balancing the State's budget and eliminating structural budget deficits is not an easy task and requires a balance of policy prioritization to meet the needs of Illinois residents, managing the level of expenditures with an appropriate focus on efficiency and effectiveness, and creating an environment in which tax revenues are sufficient to meet the obligations for annual services and payment of existing obligations.

Achieving structural balance and ensuring ongoing financial sustainability will be positive for local governments as well. Local governments receive funding from several State sources, including the Local Government Distributive Fund (LGDF), and that funding has been cut in the past when the State faced budget deficits. If the State's budget is balanced in a sustainable way, local governments will not have to worry that their funding will be on the chopping block every year.

The State cannot rely on tax increases alone to achieve Pillar #3. There is a need to focus on managing costs in a prudent manner where possible, while also making incremental investments in high-priority initiatives that are critical to the long-term success of the State, such as K-12 education and public safety. The process of completing a comprehensive financial plan (Pillar #1) should include more extensive work to identify opportunities for implementing improved cost disciplines to help pay for the investments called for in this report.

PART II

POLICY CONSIDERATIONS

1. Implement a new accelerated pension funding plan that will save the State approximately $40 billion in pension contributions over the next 22 years and will amortize 100% of the State's pension liabilities, rather than the current target of 90%.

A critical element of any comprehensive financial plan to achieve an AA credit rating in 5 years is to modify the current statutory pension funding plan. The unfunded pension obligations that currently exist, when combined with the existing funding plan, are significant contributors to the reason why Illinois has the lowest credit rating among all 50 states. Therefore, we propose that a new funding plan be established as part of the new comprehensive financial plan. This funding plan represents a meaningful indication that the state is willing and able to repay its pension debt in line with its peers.

Illinois' pension challenges are well-known: massive unfunded liabilities (approximately $139 billion at the end of FY22), a very low funded ratio of 44%,[7] and ever-increasing required pension contributions that make up approximately 21% of the General Funds budget.[8] In addition, despite the substantial contributions that will be required toward the end of the contribution schedule, the State will not fully amortize the liabilities of the pension systems. Instead, the funding schedule only aims for 90% funded, and the State will have to pay interest on the remaining 10% in perpetuity. Illinois' very poor performance on pension metrics – including its funded ratio, unfunded liabilities as a percent of personal income, and unfunded liabilities per capita – are a major drag on Illinois' credit rating.

In recent decades, Illinois attempted to reform the pension system. In 2010, the State established Tier 2 for pensions, which offers lower benefit levels for employees hired after January 1, 2011.[9] In 2013, Public Act 98-0599 was signed into law, capping the 3% automatic compounded cost of living adjustments (COLAs), increasing retirement ages, and limiting the final average pay used to calculate pension benefits.[10] However, the Illinois Supreme Court declared benefit reforms for existing employees unconstitutional, which substantially narrowed the scope for potential future reforms. In short, the court ruled that the Illinois Constitution requires the state to meet its obligations.

Our approach in this report is based on the conclusion that we must accept the Illinois Supreme Court's rulings on pension reforms and should instead focus on how to most effectively fund the plans to secure the payments to current and future retirees and minimize costs to the State over time.

Illinois' Current Statutory Funding Schedule

Illinois makes its pension contributions according to a schedule enacted in 1995, which established a 50-year timeline for funding pensions. After an initial 15-year phase-in period (during which pension contributions were kept artificially low), the law requires the State to make contributions at a level percent of payroll until the systems are 90% funded in 2045.

Before considering what this structure means financially, it is important to note that the design of the funding schedule itself is a major limiting factor when it comes to the State's credit rating. Illinois' statutory funding schedule is far outside the norm of how most pension systems are funded: Illinois is the only state with a 90% funding target (instead of 100%),[11] and the 50-year timeframe for achieving that target is far beyond the median amortization period for public pension plans, which was 22 years as of FY19.[12]

The financial impacts of the statutory funding schedule are also considerable. Because of this contribution structure, Illinois' pension contributions have been well short of the "normal cost plus interest" (the payment necessary to keep the unfunded liability from growing) for most of the life of the statutory schedule. By design, pension contributions are highest in the later years of the pension schedule to pay down remaining liabilities and are projected to reach $18.2 billion by 2045,[13] which could make the share of the General Funds budget going toward pensions, including contributions and debt service, more than 25%.[14]

Pension contributions are projected to grow by an average of 2.4% annually from 2023-2045,[15] but that figure could change depending on factors that impact pension liabilities, like investment returns and demographic experience. As such, there is a risk that sticking to the current schedule will cause increased pressure on the State budget in future years and may worsen the crowd-out of other government spending. **From a budgeting perspective, we do not believe the Status Quo funding plan is sustainable.**

Finally, it is important to note that the difference between required statutory pension contributions and benchmark funding amounts calculated using standard actuarial practices is considered as part of Illinois' structural budget gap. In the most recent rating upgrade from S&P, analysts note, "the statutory funding policy framework requiring contributions sized to achieve a 90% funded ratio in 2045 has led to persistent underfunding that does not meet S&P Global Ratings' static funding measurement. In our view, this creates an annual near-10% structural gap in the budget."[16] In other words, even if the State balances its budget, it will not be considered balanced because State budgets only account for the statutorily required pension contributions, not an actuarially-determined pension contribution level.[17]

Accelerated Funding Plan

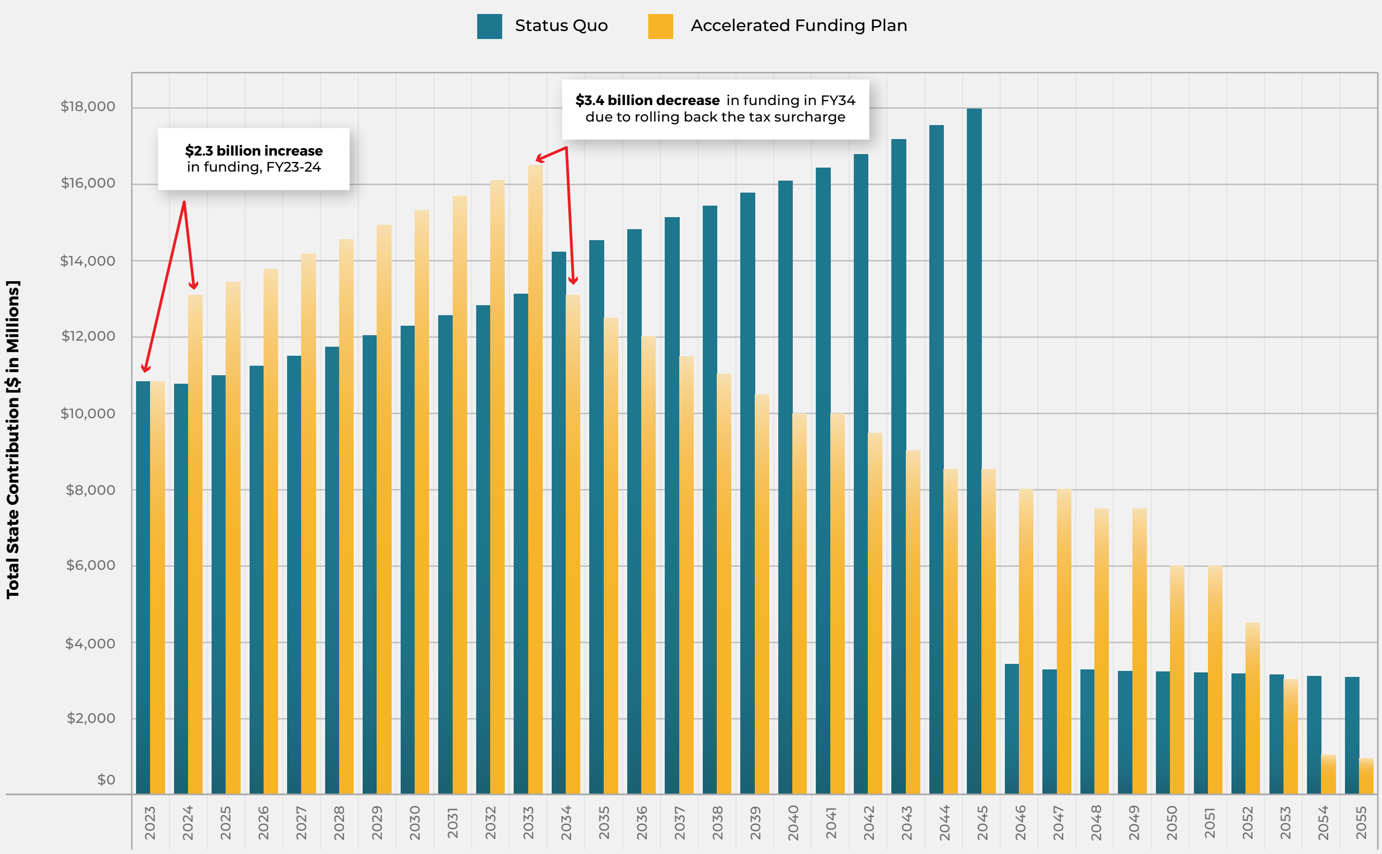
We propose the State adopt a new pension funding plan that will pay down debt faster than the current contribution schedule, reduce total contributions to the State over time, and provide budget relief by reducing required contributions in the future. In addition, it will fully fund 100% of the State's pension liabilities rather than stopping at 90%. Having a credible plan to fully fund the plans over no more than a 30-year period is an essential element to achieving an AA credit rating.

The new payment plan outlined in this report ("Accelerated Funding Plan") would add incremental pension contributions to the Status Quo payment schedule, beginning with $2.3 billion in additional contributions in FY24. The incremental amount would grow each year through FY33 (based on projected revenue growth), then in FY34, contributions would decrease by that incremental amount. Thereafter, contributions would decrease each year by an amount that would still get the pension systems to 100% funded by 2053.

The Accelerated Funding Plan outlined in this report is projected to save the State $37 billion in pension contributions over the next 22 years.

The graph below shows a comparison of pension contributions for the Accelerated Funding Plan scenario vs. the Status Quo.

Figure 1: Pension Contribution Comparison, Accelerated Funding Plan vs. Status Quo

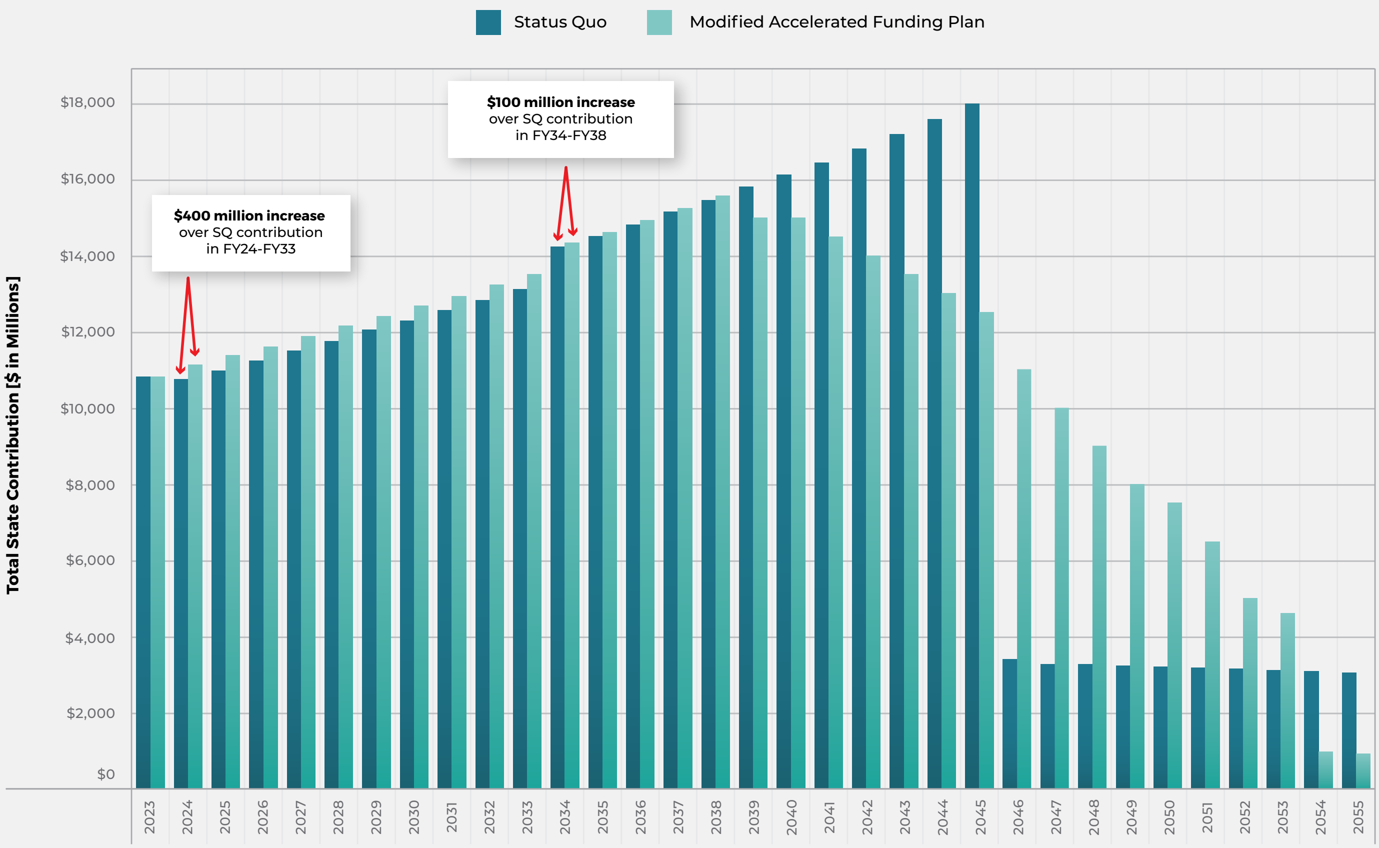


Modified Accelerated Funding Plan

We fully recognize that paying more today to save money in the future presents challenges as to how to pay for this level of incremental pension contributions. So, if this funding is deemed politically impossible, the State could add contributions beyond the current pension funding ramp and still make some progress. For example, if the State made incremental contributions of $400 million from FY24-FY33, incremental contributions of $100 million from FY34-FY38, and decreased contributions thereafter, the pension funds could reach 100% funded by 2053. The nominal contribution savings compared to the Status Quo would still be $16 billion and the State would eliminate the remaining unfunded liability as it would in the other scenario.

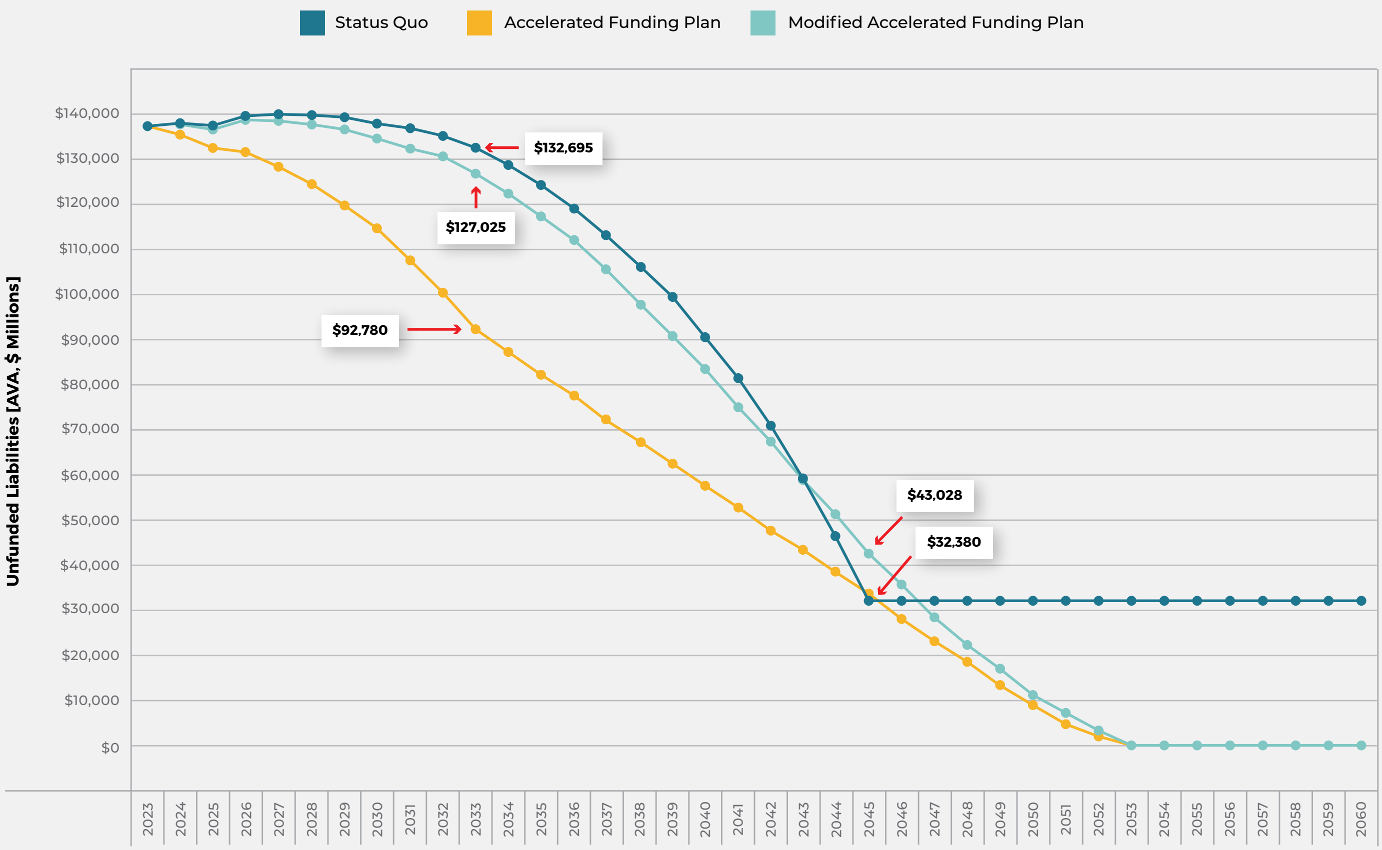
The graph below shows a comparison of pension contributions for the Modified Accelerated Funding Plan vs. the Status Quo.

Figure 2: Pension Contribution Comparison, Modified Accelerated Funding Plan vs. Status Quo



The graph below shows the projected unfunded liability balance for the Status Quo, Accelerated Funding Plan, and Modified Accelerated Funding Plan for 2023-2060.

Figure 3: Unfunded Liability Comparison, Accelerated Funding Plan and Modified Accelerated Funding Plan vs. Status Quo



We believe that implementing a new funding schedule that provides a sustainable, credible plan for fully funding the State's pension systems will be received well by the credit rating agencies. It will make it easier for the State to continue meeting its obligations and will demonstrate a commitment to tackling the State's largest financial challenge.

As part of that credible plan, we think it is important for the State to make a strong pledge to fund incremental pension payments through a dedicated source. As described in the "Revise tax policy..." section below, **we would support a personal and corporate income tax surcharge if funds raised in the surcharge are legally obligated to be contributed to the pension funds (in a lockbox-style approach) and incremental funding of the Rainy Day Reserve Fund.** But regardless of where the funding comes from, Illinois must demonstrate that it is serious and disciplined about reducing unfunded pension liabilities by implementing a new payment plan that fully funds its pensions in a reasonable timeframe.

Pension Governance

We also believe it is important to examine and improve State and Local pension plan governance. One area in particular the State should focus on is professionalizing investment functions of the pension plans. We believe that if the State required those who are making investment decisions for State and Local pension plans to have professional experience in investment, finance, or another related field, the pension plans would yield higher investment returns. Then, if the plans yield higher returns, the State and local governments across the State would not have to make as high of contributions to the pension plans as they do now.

2. Continue the progress on building the State's Rainy Day Reserve Fund to $6 billion within 5 years from the current level of $2 billion to align with credit rating expectations of comparable AA states.

State revenues are affected by economic conditions and are subject to volatility throughout the business cycle. The degree of volatility depends on a state's tax structure and the magnitude of changes in economic conditions, but revenue shortfalls due to external factors are inevitable.

Because it is difficult to predict the timing and size of revenue shortfalls, states must maintain reserve funds. S&P recommends reserve funds to be at least 8% of total revenues or expenditures on an annual basis (note: this applies to all non-federal revenues and expenditures, not just general funds).[18] In addition, best practices for reserve funds include policies for acceptable use (e.g., only during economic downturns or natural disasters) and replenishment after funds are used.[19] Credit ratings explicitly take into account whether states have a properly-sized reserve target relative to the size of their budget and whether they have guardrails to ensure appropriate uses and procedures for replenishment. Illinois has neither.

While Illinois has had a reserve fund (the Budget Stabilization Fund) since 2001, it has never been funded adequately and has frequently been used as a working cash fund.[20] In 2004, the legislature created a target balance of 5% of General Funds revenue,[21] but deposits into the fund were only triggered when projected revenue growth reached 4% or higher for two or more consecutive years.[22] As such, the State has never met the threshold for requiring a deposit. In addition, since the legalization of adult-use cannabis in 2020, a portion of revenues have been dedicated to the Budget Stabilization Fund, but to date deposits from this source have not been substantial (transfers only totaled $25.6 million for FY22).[23]

The Covid-19 pandemic and recession made clear how important it is to maintain adequate reserve funds. In the aftermath of the Great Recession, most states used the economic expansion to build their rainy day funds to record levels, so they were relatively well-positioned to handle Covid-19's shock to state finances.[24] By contrast, Illinois did not use the post-Great Recession expansion to build its reserve fund, and only had a $60,000 balance at the beginning of the pandemic.[25] As a result, Illinois was required to borrow money from the Federal Reserve's Municipal Liquidity Facility to keep the State running while other states were able to tap into their reserves as necessary.

The State turned a corner on its Budget Stabilization funding in the FY23 budget when it allocated funding to bring the fund's balance over $1 billion for the first time and required monthly deposits of $3.75 million ($45 million annually) going forward. Then, due to higher-than-expected FY23 revenues, the legislature appropriated another $850 million towards the reserve fund in the second FY23 Budget Implementation Act (BIMP), which will bring the total balance to approximately $1.9 billion.[26]

The recent focus on funding the reserve fund has been important to Illinois' credit rating upgrades. The State's progress in this area is good news, but $1.9 billion is only a third of S&P's 8% target (about $6 billion)[27] and is well below the balances of other states. (As a percentage of general fund spending, the median rainy day fund balance stood at 10.3% in fiscal 2021 and 11.6% in fiscal 2022, and is expected to rise to 11.9% in fiscal 2023.)[28] And if the State only makes $75 million in deposits each year (the required $45 million contributions each year plus approximately $30 million in cannabis tax revenue), it will take 45 years to reach the 8% goal.

To continue progress on building the Budget Stabilization Fund, Illinois should adopt a target balance and create a framework for use and replenishment of the fund. Specifically, the State should:

- Increase the target size of the reserve fund to 8% of general State revenues and expenditures, which is the criteria for the highest budget reserve ranking by S&P. Accounting for budget growth through FY28, the target balance would be about $6 billion.
- Determine a reasonable timeline for reaching the target balance (e.g., between 5 and 7 years).
- Clearly lay out criteria for acceptable use of the fund (e.g., only during economic downturns, natural disasters, etc.).
- Ensure the deposit and withdrawal structure tracks with the business cycle. Broadly, this means requiring deposits during economic expansions and allowing withdrawals during contractions.
- Taken together, developing a realistic plan to fully fund pensions and establishing an adequate Rainy Day fund and associated fiscal policies will be credit-positive under any circumstances and accelerate Illinois moving much closer to an AA credit rating.

3. Revise certain tax policies to enhance the State's competitiveness and raise revenues without making Illinois an outlier compared to other states.

As discussed earlier in the report, an integral part of achieving the Three Pillars is to develop a comprehensive plan that balances revenue increases with prudent expenditure reductions. The process of completing a comprehensive financial plan should include more extensive work to identify opportunities for implementing improved cost disciplines to help pay for the investments called for in this report.

To achieve the Three Pillars, we believe that the State should consider various options for raising additional revenues that can be dedicated to these investments since expense reductions alone will not be sufficient to fully fund these increased investments, such as the Accelerated Funding Plan.

Potential New Revenue – Income Taxes

The personal income tax offers two opportunities for adjustments without making Illinois an outlier as compared to most other states: increasing the tax rate and expanding the tax base.

Increasing the personal income tax rate would likely not have a major effect on the State's tax competitiveness. According to the Tax Foundation's 2022 State Business Tax Climate Index, Illinois' personal income tax ranks 13th, meaning Illinois' flat personal income tax with a 4.95% rate compares favorably to most other states. The Index prioritizes low, flat income tax rates (or the absence of a personal income tax) in its scoring, but it is not the only factor considered. Indiana, for example, which has a lower state income tax rate than Illinois at 3.23%, ranked 15th.[29] This suggests other factors have enough influence such that there is room to increase the State's income tax rate without substantially changing Illinois' position relative to other states.

If the State were to implement a personal income tax surcharge of 0.5%, there should be a comparable increase in the corporate income tax rate as well. Historically, there has been a 7 to 5 ratio between the corporate and personal income tax rate, and they are typically changed proportionally.[30] Taken together, tax revenues would increase by $2.9 billion annually with these changes.

The Civic Committee would support a personal income tax surcharge for 10 years of 0.5% and a corporate income tax surcharge of 0.7% for 10 years (a so-called "Personal and Corporate Income Tax Surcharge") under the following conditions:

- The Personal and Corporate Income Tax Surcharge integrates into a comprehensive financial plan to achieve Pillar #2 (an AA credit rating) and Pillar #3 (financial sustainability).
- The State adopts a new pension funding plan similar to the Accelerated Funding Plan which provides for incremental funding above the status quo amount for 10 years.
- The funds raised through the Personal and Corporate Income Tax Surcharge are legally obligated to the pension funds (in a lockbox-style approach) and incremental funding of the Rainy Day Reserve Fund.

Providing a dedicated funding source for pensions would be credit-positive, as it would ensure the State's efforts on accelerating pension funding were institutionalized and sustainable. A legally binding mechanism to use proceeds of a tax surcharge for pensions would provide a more immediate positive impact on its credit rating; absent a legal requirement, the State would need to demonstrate its commitment to additional pension funding over several years.

An alternative to implementing a Personal and Corporate Income Tax Surcharge is to expand the tax base to include retirement income. A change of this nature would not make Illinois an outlier compared with most other states. Illinois is one of three states (Mississippi, Pennsylvania, and Illinois) with a personal income tax that completely excludes retirement income from the tax base, which results in billions of dollars in foregone revenue for the State each year. In addition to its cost, however, it is also a poorly targeted tax break. Tax relief is not tied to age, actual retirement status, or income level at all – it is solely based on the type of income a person receives (e.g., Social Security, distributions from an inherited IRA, pensions, etc.) and is unlimited. By contrast, low-income seniors who cannot afford to retire and must work are fully taxed on their wages. The State could increase revenue considerably by expanding the income tax base to include retirement income while also implementing policies to target tax relief to low-income seniors. If the State taxed all retirement income on returns reporting AGI of $100,000 or more, we project it would bring in $1.8 billion annually.

Potential New Revenue - Expand the Sales Tax to Services

Illinois' sales tax presents an interesting puzzle: despite having the 15th highest tax rates in the country, its sales tax receipts are comparatively low.[31] While some of the difference has to do with how Illinois taxes various things (e.g., Illinois has separate taxes on utilities rather than applying its sales tax to utilities as some other states do), this discrepancy is also driven by the fact that Illinois generally excludes services from taxation.

Even though Illinois does not tax most services, its economy is service based. Services account for the vast majority of economic activity in the State, comprising about 80% of economic activity in 2013.[32]

Most states do not have broad-based sales taxes on services, but Illinois is well below the average in terms of the number of services it taxes. According to a survey by the Federation of Tax Administrators, the median number of services taxed by states was 60 while Illinois only taxed 29.[33]

The revenue impact of expanding the sales tax to services would depend on which services the State chose to tax. 2017 estimates from the Commission on Government Forecasting and Accountability (CGFA) projected that Illinois could bring in approximately $1.2 billion if it taxed the same set of services taxed by Iowa.[34] A later look at sales taxes on services by the Taxpayer's Federation of Illinois produced a comparable revenue estimate.[35] It is clear that Illinois could substantially increase revenues by better aligning its sales tax to today's service-based economy.

To bring in considerable revenue without making the State an outlier, Illinois should extend the sales tax to include more services, focusing on consumer services to avoid taxing business-to-business transactions.

Revenue estimates for potential options:

- Adopt the "Iowa Model," which would tax an additional 81 services: $1.2 billion
- Adopt an adjusted[36] "Wisconsin Model," which would tax an additional 13 services: $500 million

Tax Policy Changes to Enhance Illinois' Competitiveness

Finally, we should consider tax policy changes to make our tax system more competitive with other states. While credit ratings do not directly evaluate which types of taxes a state has (just whether states have diversified tax revenues and whether they have the flexibility to adjust taxes, as needed), we believe Illinois should examine its tax policies in the context of competitiveness to make it a more attractive location for businesses and individuals. Making ourselves more attractive will, in turn, create more opportunities for Illinoisans and set the stage for long-term economic growth.

We have identified two policies the State should consider repealing: the Corporate Franchise Tax and the Estate Tax.

Resume Repeal of the Corporate Franchise Tax

Franchise taxes typically refer to a tax on a corporation's net worth or capital value. In Illinois, the Corporate Franchise tax is levied on paid-in capital, which "refers to the funds raised when a corporation issues stock plus any additions to capital, such as land granted by the government to the corporation or subsequent investments by shareholders."[37] It is composed of three pieces: an initial tax of .1% when the corporation first registers with the State, an annual tax of .1%, and an additional tax of .15% any time there are increases to paid-in capital. As a tax on paid-in capital, it can also lead to tax pyramiding and may disincentivize investment in Illinois.[38]

The structure and administration of the Corporate Franchise Tax also makes it burdensome to comply with. According to the Taxpayers' Federation of Illinois, because the tax is not based on any standard measure of corporate value (e.g., net worth), corporations must maintain separate records and calculations from other taxes they owe solely for paying this tax. And, because the tax is administered by the Secretary of State (not the Department of Revenue), corporations must deal with separate filings, due dates, and administration than the other taxes they pay.[39]

Most states do not have a franchise tax, and many states have repealed or have begun to repeal their franchise taxes in recent years, including Illinois.[40] In 2019, Public Act 101-0009 was signed into law, which was set to phase out the Franchise Tax over a period of four years. However, when the State was faced with budget challenges in 2021, the phase out process of the Franchise Tax was frozen and the dates for proceeding to the next stages of the phase out were repealed, leaving the Franchise Tax in place.

We strongly urge the State to repeal the Corporate Franchise Tax fully. We estimate the budget impact of full repeal would be approximately $267 million.

Repeal the Estate Tax

The Estate Tax is a tax levied on the total value of a person's estate when they pass away (compared to an inheritance tax, which is levied on the portion of an estate given to an inheritor). In Illinois, estates valued at $4 million or more are subject to the Estate Tax at graduated rates ranging from .8% to 16%.[41] This Estate Tax in Illinois is on top of the federal Estate Tax amount owed, although the federal Estate Tax provides for a significantly higher level of asset value exemption before taxes are incurred.

State level estate taxes used to be quite common, but today Illinois is one of only 13 states with an estate tax (six others have inheritance taxes).[42] One key reason states backed away from estate taxes was a change in the federal tax code in the early 2000s, which repealed a tax credit for up to 80% of estate taxes paid to states. The credit incentivized states to increase their estate taxes to the maximum covered by the credit, since the overall estate tax liability wouldn't change, it would just go to a state rather than the federal government. Once the credit was fully repealed, the incentive structure was reversed, as states did not want to impose additional state tax liability on estates when some states did not have estate taxes at all.[43]

Illinois is an outlier for having an Estate Tax in place. Because there are numerous states that do not have estate taxes, there is an incentive for wealthy individuals to move (or move their assets) to a state that does not have an estate tax before they die. We believe the State should fully repeal the Estate Tax to better align its tax structure with other states. The estimated budget impact of repealing the Estate Tax in FY23 is about $410 million.

If full repeal of the Estate Tax is not politically possible, the State could also consider changing the exemption level (which determines at what value estates are subject to the tax) to align with federal policy. Currently, Illinois exempts estates worth less than $4 million while the federal government exempts estates valued at less than about $12 million. If the State moved to align the State's exemption level with the federal exemption level (as Connecticut has done recently),[44] it would make it so that estates with no federal liability would not have to pay separate state-level estate taxes.

4. Identify and implement long-term reductions in expenditures in targeted areas to ensure that the comprehensive plan includes expenditure reductions to support strategic investments that are important for the long-term success of the State.

An important source of funds to provide for increased payments into pension plans and the Rainy Day Fund is to consider where opportunities are available for long-term reductions in expenditures in targeted areas. We believe that an element of a credible plan for solving the State's financial issues is implementing a blend of revenue increases and expenditure reductions. In the context of a $113 billion all-funds budget, (of which an annual general fund expenditure budget is $47 billion), there are various opportunities to be explored for efficiency reductions and changes in cost structures in the future. These include but are not limited to Other Post-Employment Benefits (OPEB), expenditures that come from outside the general funds, and implementing efficiency targets for State spending.

Other Post-Employment Benefits

Long-term liabilities are a significant drag on Illinois' financial health. In addition to pensions, Illinois faces substantial liabilities from OPEB, which include medical, dental, and vision coverage for retirees.

Illinois OPEB liabilities are substantial: as of June 30, 2021, the State's OPEB liability, which reflects the present value of accrued retiree benefits, totaled $56.7 billion.[45] Unlike with pension liabilities (which also reflect the present value of accrued benefits), the State does not pre-fund OPEB. Instead, it funds benefits on a pay-as-you-go basis, meaning the State pays for the benefits when they come due. This pay-as-you-go structure subjects the State to the risk of budget pressures due to accelerating retiree healthcare costs, as it cannot rely on investments to fund part of the benefits.

Retirees also contribute very little to their own healthcare: in FY23, retirees are projected to cover only 6.6% of their healthcare costs.[46] A key reason why retirees contribute such a small amount to their healthcare in retirement is that the State provides a health insurance premium subsidy for retirees equal to five percent for every year of service. As such, a retiree with 20 years of service would receive a premium subsidy of 100% and have their entire health insurance premium paid for by the State.

This is an expensive benefit to provide. According to an actuarial valuation of the Illinois State Employees Group Insurance Program (SEGIP), the State's accrued liability for active participants at the end of FY21 was roughly $13.6 billion. With about 111,000 active members, this represents an average OPEB liability of $122,000 per active employee.[47]

Research from the Pew Charitable Trusts and the MacArthur Foundation shows states that tie their healthcare subsidies to the cost of premiums, as Illinois does, tend to have the highest OPEB liabilities. This is because healthcare premium costs are outside the state's control; if premiums rise, states must either increase their OPEB spending, reduce their contributions, or change the benefit structure of healthcare plans. By contrast, states that do not offer healthcare coverage at all or that offer access to healthcare plans for retirees with no subsidy tend to have the lowest OPEB liabilities. States that offer fixed dollar subsidies for retirees tend to end up in the middle.[48]

Illinois is barred from changing its retiree healthcare subsidy for current employees due to the Kanerva v. Weems decision, but the State could enact a new retiree healthcare plan for new employees, and we believe the State should do so as soon as possible. (Note that such a change would not impact current employees or OPEB liabilities since they're based on previous service, but it would help reduce growth in future liability). The new plan should move away from the existing premium-tied subsidy to a fixed dollar premium subsidy allowing for continued access to the State's healthcare coverage options. This will help the State slow the growth of future OPEB liabilities, which will reduce the pressure on future state budgets.

Implementing a new retiree healthcare plan that changes the trajectory of future OPEB costs would be credit positive. The financial benefits to the State would take many years to manifest but taking action now to control costs in the future would demonstrate the State's commitment to long-term fiscal health.

Expenditures from Outside the General Funds

A key barrier to identifying expenditure reductions is that budget discussions tend to focus on only a portion of the budget: the General Funds. For FY23, the General Funds budget was estimated to only account for about 40% of the entire $113 billion budget, meaning that the majority of State expenditures come from outside the General Fund.[49]

The narrow focus on the General Funds portion of the budget can be misleading when looking at overall spending on various programmatic areas. Several key priorities, such as education and Medicaid, receive funding from many sources, including Other State Funds and Federal Funds in addition to the General Funds. If the State focuses solely on the General Funds portion of funding when analyzing programmatic spending, it will be incomplete and misleading. For example, if there were a reduction in General Funds appropriations for Medicaid, it could represent an actual cut to the program, or it could mean there was a shift in where the funding came.

The concentration on the General Funds during budget negotiations also allows the State to make significant budgetary decisions without much scrutiny. For example, transportation is primarily funded by Other State Funds and Federal Funds, so there has historically been little public negotiation and debate over transportation projects. This represents billions of dollars in spending that does not receive a high degree of scrutiny.

In order to show Illinois residents a complete picture of expenditures, the State should adopt an all-funds model for its yearly budget negotiations. To do so, the GOMB and other State agencies could use the model developed by the Fiscal Futures Project at the University of Illinois' Institute for Government and Public Affairs. Their model aggregates spending from more than 700 State funds to transparently report spending by consistent and meaningful categories.[50] This would give government leaders and citizens alike the ability to monitor State spending and allow for a comprehensive review of the State budget. We believe that increased transparency and analysis in these areas will lead to identifying further opportunities for expenditure reductions in the future.

Efficiency Targets

Another opportunity for reducing expenditures is for the State to set expenditure management targets for State spending. Businesses commonly set targets for spending reductions that can be covered by increases in productivity and efficiency in operations. The State could set a target for expense management (e.g., aiming to reduce agency expenses by 2-3%) in order to ensure continual review of expenditures.

Strategic Investments

The process of identifying opportunities for expenditure reductions is also critical to allow for strategic incremental investments that are important for the long-term success of the State. For example, we encourage the State to meet its commitment to increase K-12 education funding by $350 million each year, particularly as federal Covid-19 aid for schools winds down. Other areas need to be considered, such as public safety. These strategic investments should be prioritized and integrated into the development of the comprehensive financial plan for the State.

Local Government Finance

As described above, no matter which tactics the State uses to get there, we believe achieving the Three Pillars is critical and will put the State on secure footing for the future. However, we would be remiss not to mention that local government financial issues are a risk to the State as well and should be an area of future study. Two critical issues facing local governments are pension liabilities and high property tax burdens. These issues are intertwined: one of the reasons property taxes are so high in Illinois is because they're going to fund pension liabilities.

In the City of Chicago, a staggering 80% of the property tax levy went to pensions in 2022. However, despite so much of the City's property taxes being dedicated to pensions, its pension systems are woefully underfunded. As of December 2021, the pension fund for firefighters was 20.9% funded, for municipal employees it was funded at 23.4%, for police at 23.5%, and 45.9% for laborers.[51]

Chicago is one example of many local governments dealing with this challenge. We believe it is important to take stock of local government finances across the State and determine solutions to address local pensions, education funding, and other root causes of Illinois' high property taxes.

Reasons for Hope

The path to an AA credit rating from our current BBB+ may seem daunting, but a handful of other states have achieved increases of similar magnitude before, including California (previously BBB, now AA-), Louisiana (previously BBB+, now AA-), and Massachusetts (previously BBB, now AA).[52]

California, which was assigned a BBB rating in 2003 (the lowest of all states at the time) and now has an AA- rating,[53] may be a particularly useful case to consider. When California's rating was lowered to BBB in 2003, some contributing factors were political dysfunction, the requirement that the budget be passed with a two-thirds majority (a threshold so high the legislature was unable to pass one), as well as a budget deficit that was more than 50% of anticipated general funds revenues.[54] It earned upgrades in 2004 (A) and 2006 (A+) after improving its liquidity and experiencing economic improvement,[55] but was downgraded again in the aftermath of the Great Recession in 2009 (A) and 2010 (A-).[56] The state then earned upgrades in 2013 (A), 2014 (A+), and 2015 (AA-) because of a demonstrated emphasis on structural budget alignment, the retirement of debt, and sizable deposits into a rainy day fund voted into law by California residents.[57]

While Illinois' circumstances are not exactly the same as California's, its experience shows that a state can move up from the bottom of state credit rating rankings through fiscal discipline and focusing on fundamentals like balanced budgets and retirement of debt. California serves as an example of a state that had substantial financial challenges turning things around and making remarkable progress. It shows there is a path forward for Illinois.

With two credit rating upgrades in one year, Illinois has already started down the right path. We are optimistic about Illinois' ability to capitalize on this momentum and continue the progress – it just requires strong leadership, a credible plan, and a commitment to prioritize the actions necessary to achieve this goal. Given the progress shown by our State leadership in recent years, we are confident it can be achieved.

CONCLUSION

After weathering the unprecedented challenges caused by the Covid-19 pandemic, the State has prudently taken advantage of federal aid and higher-than-expected revenues to stabilize its finances. Illinois is in the best financial position it has been in for decades, a fact that has been acknowledged through credit rating upgrades from all three major rating agencies. Yet the job is not done: the State must repair the cracks in its fiscal foundation to ensure financial stability and long-term economic growth in Illinois.

We believe our framework and recommendations represent a clear path forward, but understand the challenge of enacting many significant changes all at once in the current political environment. However, instead of meeting this challenge with inaction as has historically been the case with taking on difficult challenges in Illinois, we encourage the State to adopt policies that may be more politically pragmatic if they will help move the needle in the short-term.

Now more than ever it is crucial to build on our positive momentum. We believe that if Illinois achieves the Three Pillars outlined in this report, it will secure Illinois' future and lay a foundation for long-term growth. It will also signal to individuals and businesses that Illinois has turned a corner on its finances and demonstrate a fact we know to be true – that Illinois is a wonderful place to live, work, and do business.

ENDNOTES

Endnotes

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14 The Governor's proposed FY23 budget includes estimates of the share of the General Funds budget going to pensions (both contributions and debt service). This estimate, which does not incorporate investment results from FY22, was approximately 25%. Given the FY22 investment results underperforming, and all contributions from FY24-FY45 increasing as a result, the share of the budget going to pensions in 2045 is likely to exceed 25%. Source: Governor's Office of Management and Budget, "Illinois State Budget: Fiscal Year 2023,"p. 50. https://budget.illinois.gov/content/dam/soi/en/web/budget/documents/budget-book/fy2023-budget-book/fiscal-year-2023-operating-budget.pdf, p. 50.

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