

**FACING FACTS:**  
**A Report of**  
**The Civic Committee's Task Force on Illinois State Finance**

The Civic Committee of The Commercial Club of Chicago  
December 2006

*The Commercial Club of Chicago*



**Task Force on State Finance**  
**Civic Committee of The Commercial Club of Chicago**

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## EXECUTIVE SUMMARY

Illinois is headed toward financial implosion.

The State's liabilities and unfunded commitments exceed its assets by over \$100 billion. The State has failed to set aside the amounts necessary to pay employee/retiree pensions and health benefits and to pay amounts currently owed to healthcare providers under Medicaid. The State has also failed to fund K-12 education at the "foundation" level. These liabilities and unfunded commitments are growing rapidly. Yet the State continues to spend or commit to spend billions more than it takes in each year.

In the current fiscal year, FY 2007, the State has discretion over approximately \$28.8 billion of revenue. To fully fund its true costs -- including its increasing obligations -- as well as its unmet commitment to fund K-12 education at the "foundation level," approximately \$5.9 billion more would be required. This annual gap will grow as the cost of pensions and health care rises faster than tax revenues.

Illinois' debt and unrecognized obligations have grown at an enormous rate. In FY 2002, Illinois had about \$8.4 billion in general obligation bonds outstanding. In FY 2003, the State took on an additional \$10 billion in pension debt. Moreover, the State now has \$46 billion of unfunded pension liability. Also, unfunded commitments to cover the health care costs of its employees and retirees are estimated to be in the range of \$48 billion. In addition, the State owes about \$1.7 billion in unpaid Medicaid bills to health care providers.

The total of these debts and unfunded obligations (apart from general obligation bonds) is about \$106 billion – roughly \$8,800 per person for the 12 million residents of the State.

Illinois cannot solve its problems by printing money. Our Executive and Legislative branch leaders in Springfield must (a) cut costs, or (b) increase revenues, or (c) both. If they do not, commitments to State employees will become a huge burden to future generations or will not be kept at all. Illinois may be forced to implement radical service cut-backs; and its ability to refinance its debt may be adversely affected by deteriorating ratings.

Significant cost savings are possible. Retirement and healthcare benefits for State employees are more generous and expensive than those of most of the taxpayers asked to pay for those benefits. By bringing State plans into line with reasonable private and public benchmarks, total State-level costs can be reduced by approximately \$1 billion per year. Substantial savings also can be achieved through more widespread outsourcing and restructuring of State services. The cost of many programs can be reduced through tightening of the rules governing campaign contributions, hiring and contracting.

Although such reforms can and should be undertaken, the resulting savings will not be enough to cover the State's annual costs, including the obligations that are being accumulated. To avoid collapse, a tax increase may be inevitable. The State could increase its income tax rates and expand its sales tax base without jeopardizing its competitive status compared to other Midwestern or urban-industrial states.

But to do nothing more than raise taxes would be disastrous. In particular:

Taxes should *not* be raised unless – simultaneously – the State reduces its costs dramatically. Specifically, it should trim its pension benefits, shift to Defined Contribution Plans for future employees, and align health care benefits of State employees and retirees with relevant private and public sector benchmarks. Other suggested economies are set forth in this Report.

Taxes should *not* be raised for K-12 education unless – simultaneously – major reforms are made to improve school accountability, operations, results and transparency. In Chicago the legislative cap on charter schools should be eliminated. To spend more money on K-12 education without these reforms would waste the money.

Taxes should *not* be raised state-wide to pay for a property tax “swap.” Revenues used to pay for such a “swap” are needed to meet existing commitments. Effective property tax rates in Chicago have declined over the last few years to a level close to the national average. Property taxes provide a more stable, less fluctuating source of funds to support schools than statewide income or sales taxes, which vary with the level of economic activity. Reducing taxes on property – and making up for it by increasing income and sales taxes – would accomplish little of substance. Moreover, the proposed tax “swaps” would shift funding and control of local K-12 education away from local districts and local citizens in the direction of centralized State decision-making.

Taxes should *not* be raised unless the proceeds are used to meet the State's commitments. It would make no sense to launch expensive new programs with new tax dollars, while leaving existing commitments to pensions, health care costs and K-12 education underfunded.

Good government in a democracy involves making hard choices. Citizens who live in Illinois and pay taxes here, and the businesses located here, make hard choices. Their government should do no less.

## INTRODUCTION

The Commercial Club of Chicago is a group of approximately 300 business and civic leaders in the greater Chicago area. The Civic Committee of the Club includes approximately 80 CEOs of Chicago-area companies, firms and not-for-profit entities. Through projects and reports such as the historic Burnham Plan for Chicago in 1909, the Club and its Civic Committee have historically sought to help make Chicago and Northern Illinois a better place to live and conduct business. They have worked to improve the operations of government, expand the economy, improve ground and air transportation facilities, rationalize land use and environmental planning, and improve the schools.

The Civic Committee has not historically been directly involved in State government or its operations. However, because the greater Chicagoland area represents such a large fraction of the State and because the fiscal integrity of Chicago's school system is directly dependent on the State's financial health, the Club decided to evaluate the current state of the State's finances. In the spring of 2006, the Club formed a special task force of members, chaired by W. James Farrell, former Chairman and CEO of Illinois Tool Works. The task force met during the summer and fall of 2006. It consulted with a number of experts in state finance, and drew on the consulting assistance of several of the Club's members.

This is the report of the Civic Committee's task force. Our primary purpose is to set forth the relevant facts so that our members and other readers may better understand the financial position in which the State today finds itself. Our purpose is not to write a financial history of how things came to be this way, nor is it to attach blame. We leave those things to historians and politicians.

Nor do we come to firm ground as to which, if any, reforms should be adopted, or how much could be saved by reforms, or which, if any, tax reform proposals may have greater or lesser merit. Reasonable people will debate the details of such reforms.

But of several things we are sure.

First, Illinois is headed toward financial implosion. It annually spends or makes commitments that vastly exceed its revenues. The total of its debt and unfunded obligations now exceeds \$100 billion.

Second, reforms are possible and expenses can and should be reduced going forward. The disciplines of competitive markets provide a good guide.

Third, if more money is to be spent on K-12 education, we should make sure it is wisely spent. Major reforms are needed to improve school accountability and the transparency of operations and results. Giving parents more and better choices will create powerful incentives for improvement – in charter schools as well as traditional public schools. The legislative cap on the number of charter schools in Chicago should be removed.

Fourth, taxes should not be raised unless – simultaneously – major reforms are implemented to reduce costs, trim benefits, and improve school accountability and choice.

Fifth, whatever one thinks of particular proposals for expense cuts or tax increases, it is fundamentally wrong to ignore the problem of the growing State fiscal deficit, or to try to borrow our way out of it. Today's costs should be borne by today's generation of taxpayers. To ignore the problem and thus impose it on a future generation of taxpayers is the very definition of irresponsibility.

## **I. Despite the Illinois Constitutional Obligation to Adhere to a Balanced Budget, Illinois Today Incurs Costs and Makes or Increases Commitments Each Year That Far Exceed Its Own-Source Annual Revenues**

### **A. Introduction**

The State of Illinois operates under a provision of the State Constitution which requires a “balanced budget” (Illinois State Constitution, Article VIII, Section 2). Under this provision, the Governor is required to propose – and the General Assembly is obligated to pass – a budget for the coming fiscal year in which revenues are adequate to cover expenses.

However, those who craft and approve the State's budget are not required to live by the same realities as the citizens of the State when they prepare their own budgets. One major difference is that the State may borrow to pay current operating expenses. Also, the State does not account for and fully fund all the costs and obligations it takes on during the year.

For these reasons, the budget may appear to be balanced because the State has increased its borrowing or its unfunded obligations, or because the State simply does not recognize on its financial books and records the actual economic obligations which it is incurring.

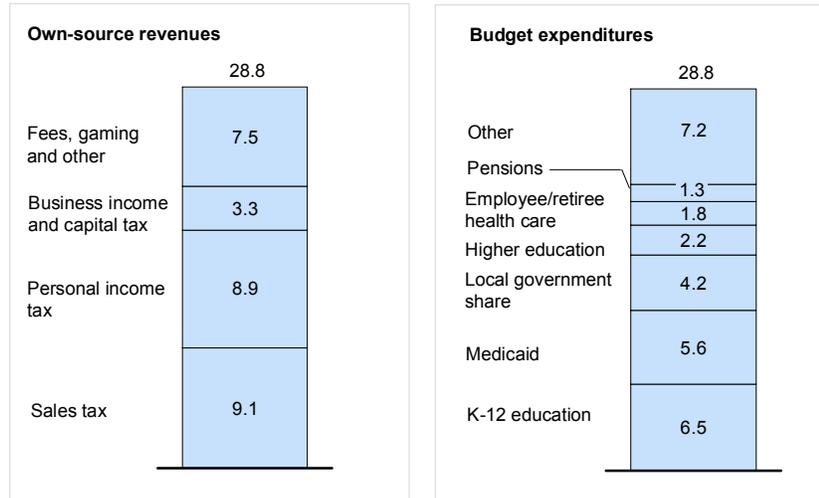
Illinois' own-source revenues and expenses – the portion of the overall budget over which the State has discretion and autonomy – amount to approximately \$28.8 billion in FY 2007 (the fiscal year ending June 30, 2007)<sup>1</sup>.

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<sup>1</sup> Own-source revenues exclude transportation and federal sources and minor sources of revenues of special funds. Budgeted expenditures exclude federal fund spending.

**STATE OF ILLINOIS OWN-SOURCE REVENUE AND EXPENDITURE BUDGET FY2007\***

\$ Billion



\* Own-source revenues exclude transportation and federal sources and minor sources of revenues of special funds. The budgeted expenditures here exclude federal fund spending.

Source: State of Illinois; Taxpayers' Federation of Illinois

But in fact the State's true costs during FY 2007 - including the amounts by which the State's pension, employee/retiree health care and Medicaid commitments are increasing - create a gap between the State's revenues and its costs of approximately \$4.3 billion. If we were to add to these obligations the State's "commitment" (by statute) to fund K-12 education at a minimum "foundation" level, the gap between revenues and costs would enlarge to approximately \$5.9 billion per year<sup>2</sup> -- about 20% of the State's current annual revenues.

<sup>2</sup> Note on calculation of estimated gap (total = \$5.9 billion):

**Pensions:** \$1.1 billion: the difference between the \$1.3 billion payment made in FY 2007 (which is incorporated into the new payment schedule) and the \$2.4 billion payment that should have been made under the COGFA estimate of the new benefit structure, but using the 1995 funding plan (this schedule does not allow the State to take the benefits of the reforms at the front end). Source: Commission on Government Forecasting and Accountability.

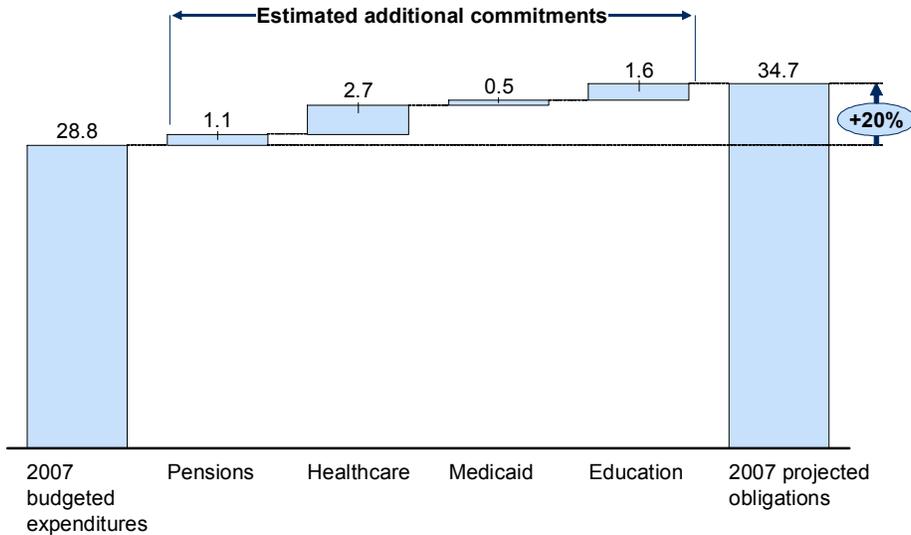
**Health Care:** \$2.7 billion: the midpoint of the estimated range (\$2.2-\$3.2 billion) provided by Aon Consulting as the additional annual expense for retiree health care costs using publicly available data and actuarial assumptions deemed reasonable by other states. The precise value of this estimate as well as the estimate of the State's unfunded liability for retiree health benefits should be determined with actual Illinois participant data and actuarial assumptions as soon as practicable. Source: Aon Consulting.

**Medicaid:** Medicaid bills-on-hand for FY 2006 were estimated to be between \$1.3 and \$1.4 billion. "Bills-on-hand" are those bills that have been verified by the State, but have not yet been paid. The State's bills-on-hand are expected to grow to an estimated \$1.7 billion by the end of FY 2007. The change in bills-on-hand (approximately \$.5 billion) is the estimated Medicaid "gap" in FY 2007. Source: "Illinois' \$3 billion deficit country's largest in 2005," Associated Press, 07/25/06; "Blagojevich signs bill releasing funds for Medicaid debt," *The News-Gazette*, May 20, 2006.

**Education:** \$1.6 billion: additional cost associated with full funding of EFAB recommendation of \$6,405 per pupil. Multiplies difference between EFAB recommendation and actual funding (\$1,071) by 79% of students in the state of Illinois (based on ISBE data, 79% of students are in poor districts that receive "foundation level" funding). Source: Illinois State Board of Education.

**ESTIMATED GAP BETWEEN CURRENT BUDGET AND ACTUAL ANNUAL COSTS AND COMMITMENTS IS \$5.9 BILLION**

\$ Billions



Moreover, the gap is growing. The State's revenues are not growing as fast as its expenses. Overall growth in revenues is at about 4% per year. Personal income tax grows at a rate of about 5%. Sales tax grows at only 4% in part because it excludes services. The direct taxes on utilities, cigarettes and liquor tend to be based on consumption levels rather than monetary levels.

By contrast, absent major changes in the law, expenses are expected to grow over the next three years at a rate of about 7.5% per year. This trend may drop to 6-7% when the ramp up of pension contributions is accomplished by FY 2010.

The impact of the gap is not confined to the State's operating revenue statement. It has an even greater impact on the State's balance sheet.

In FY 2002, the State of Illinois had approximately \$8.4 billion in general obligation bonds outstanding. In FY 2003, the State took on an additional \$10 billion of pension debt (the proceeds of which were placed in the State's pension funds in the early part of FY 2004) – which more than doubled the State's general obligation debt.

In addition, of the total \$108 billion pension liability of the State's five pension funds, today about \$46 billion is unfunded. The State's 58% pension funding ratio is among the lowest in the nation. In addition to this unfunded pension debt, the additional \$10 billion of debt represented by the FY 2003 bonds will have to be paid.

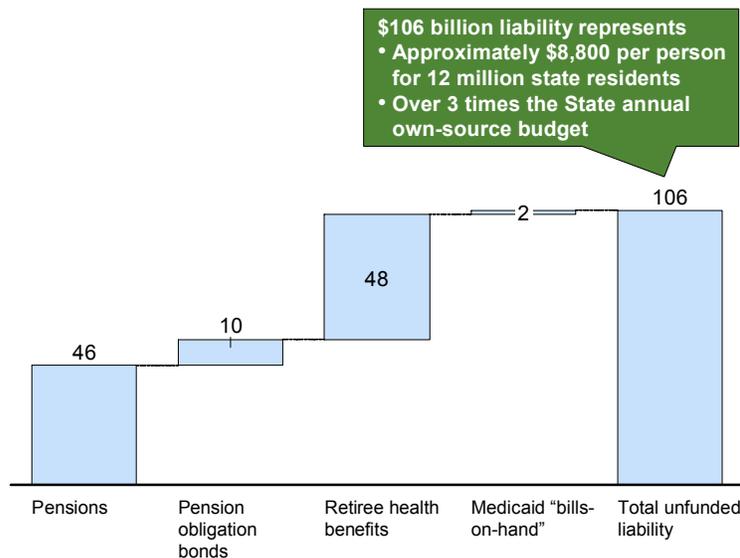
Further, the State has an unfunded commitment to its employees and retirees to cover the cost of their health care insurance. An actuarial estimate of this amount will have to be recognized on the State’s balance sheet for the first time in FY 2008. But apart from the accounting rules, the economic reality is that the State has an estimated \$43-53 billion<sup>3</sup> in unfunded actuarial liabilities today to cover the cost of retiree health benefits.

Finally, the State owes approximately \$1.7 billion in unpaid Medicaid bills to the State’s health care providers.

The total of these unfunded obligations and the \$10 billion of pension-related debt is now about \$106 billion – or roughly \$8,800 per person for the 12 million residents of the State.

**ESTIMATED UNFUNDED LIABILITY IS \$106 BILLION**

\$ Billions



**\$106 billion liability represents**

- Approximately \$8,800 per person for 12 million state residents
- Over 3 times the State annual own-source budget

Source: Commission on Government Forecasting and Accountability; Civic Federation; Aon Consulting; Health Management Associates; Associated Press; The News-Gazette; Chicago Tribune

Politicians and interest groups argue that the State should undertake popular new programs, or expand existing ones – more money for public transportation, or for the environment, or for health or medical care for the aged or for kids, or for pre-school or higher education. But as Illinois political leaders address possible new or increased areas of State expenditures, they must consider obligations the State has already incurred but which are not now funded. Three huge and growing areas of such obligations today are: pensions, health care for employees and retirees, and Medicaid. A fourth area is the “commitment” the State has assumed by state statute to assure that K-12 school districts

<sup>3</sup> For the purposes of this report, the midpoint of the range (\$48 billion) estimated by Aon is used. Aon estimated the unfunded liability associated with retiree health benefits at \$43 to \$53 billion by using publicly available data and actuarial assumptions deemed reasonable by other states. The precise value of the unfunded liability should be determined by the State with actual Illinois participant data and actuarial assumptions as soon as practicable. If Illinois determines not to fund this benefit, the discount rate assumed here is too high and the actual unfunded liability will be higher.

throughout the State have available at least the “foundation level” of adequate financial resources.

## **B. Pensions**

Although the State’s cash contribution to the pension funds in FY 2007 is \$1.3 billion, the State’s actuarially determined cost of pensions for that same year is far higher.

Illinois’ pension benefits, including early retirement subsidies, are more generous than typical private sector plans.

Illinois has a long history of not making contributions out of operating revenues to its five pension plans<sup>4</sup> adequate to cover the increasing pension obligations to its employees. In 1995, the General Assembly enacted Public Law 88-593, which created a 50-year plan to bring pension funding ratios to 90% by the year 2045. Under this plan, payments were supposed to ramp up over the first 15 years and then level out over the remainder of the period. Recent changes in federal law require corporations to fund their plans at 100%, and provide only a seven-year period in which to do this.

Actuaries certify the amount of pension cost each year – i.e., the increasing obligation to pay employees their future pensions. But it is up to the Governor and the Legislature to decide how much actually to pay into the plans. In FY 2003, the State borrowed \$10 billion through long-term bonds, and put that money into the plans. It used this borrowing as an excuse not to make the normal payment out of operating revenues in FY 2004. In FY 2005 the State made a payment of \$1.65 billion – approximately \$300 million less than the certified amount (\$1.95 billion). In FY 2006 the State contributed about \$1.2 billion less than the certified amount (\$2.1 billion). And in FY 2007 it contributed about \$1.1 billion less than the certified amount (\$2.4 billion).

As a result, the “present value” of the unfunded liability has grown dramatically. In FY 2000 the unfunded pension liability was about \$15.5 billion. In FY 2007 it is now about \$45.7 billion. (When one adds in the additional \$10 billion of debt represented by the FY 2003 pension bonds, the total unfunded liability is over \$55 billion.) The \$45.7 billion unfunded obligation – putting to one side for the moment the pension bonds – gives Illinois one of the lowest funding ratios for its state pension plans of any state in the country, and represents an obligation of approximately \$3,800 per person for the 12 million residents of the State.

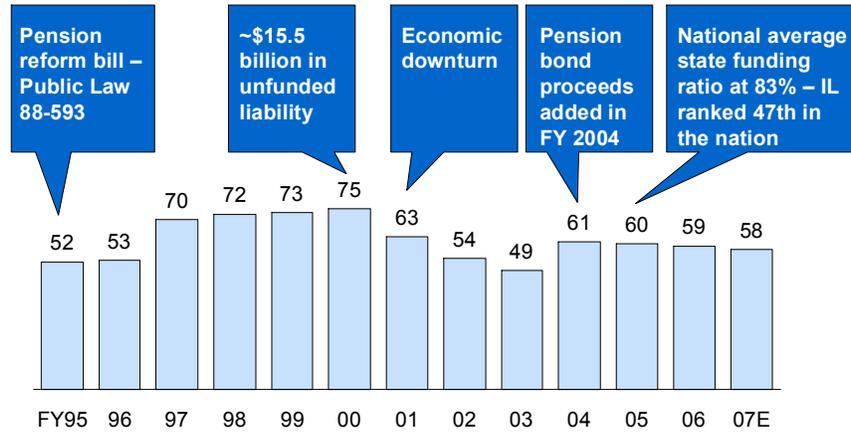
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<sup>4</sup> The State of Illinois funds five retirement systems for employees and retirees: the State Employees Retirement System (SERS), the Teachers’ Retirement System (TRS), the State Universities Retirement System (SURS), the Judges’ Retirement System (JRS) and the General Assembly Retirement System (GRS).

Other plans cover employees of municipal governments and entities. Although these plans are not the subject of this report, it should be noted that many of them are also seriously under-funded.

## ILLINOIS' PENSION FUNDING RATIO, 1995 TO 2007E

Percent

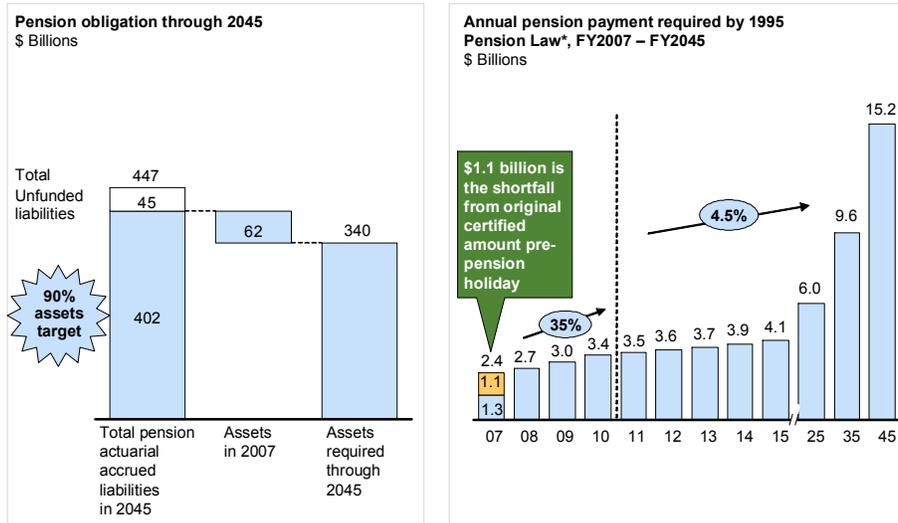


Source: Civic Federation's Issue Brief on The State of Illinois Retirement Systems (with reference to Standard & Poor's report: Rising U.S. Unfunded Pension Liabilities are Causing Budgetary Stress, February 22, 2006); Commission on Government Forecasting and Accountability

As another result, the amount which the State should pay each year not only to cover the increased liability for that year, but also to “catch up” for past failures to make adequate payments, will rise quickly to \$3.4 billion per year by FY 2010 -- three years from now -- and these annual amounts will continue to grow each year after that. Unless the State’s flows of revenues and expenses change, the annual pension contribution will rise from less than 5% now to almost 9% of the State’s revenues in FY 2009 – and to 11% in FY 2010.

This means that very soon, the State’s annual pension costs – whatever the State does about funding to cover those costs – will rise to a level approximately \$2 billion more than the level of current annual funding. The level of these required annual payments will continue to rise. In the absence of significant reforms, the State’s total pension liabilities can be expected to increase to around \$450 billion by 2045. To achieve the 90% funding ratio target established in the State’s 1995 Pension Law, annual contributions will continue to grow – to perhaps as much as \$15 billion per year by 2045.

**FUNDING AND ASSET APPRECIATION OF \$340 BILLION IS REQUIRED TO MEET TARGET OF 90% FUNDING RATIO BY 2045**



\* COGFA estimation post-pension holiday with new benefits structure under old 1995 funding plan; debt services for \$10 billion pension obligation bond are not included  
Source: Commission on Government Forecasting and Accountability

**C. Employee/Retiree Health Care**

In FY 2007 Illinois will pay about \$1.8 billion in costs to cover health insurance for employees and retirees. These costs are incurred on a pay-as-you-go basis, rather than through accrual accounting. In contrast to the way the State funds pensions, there is no trust fund set up to fund the increasing health care costs associated with either current employees or retirees.

This cost is growing at a rate of about 14% per year (from 2000-2007). The state revenue growth is only about 4% per year. Thus, these health insurance costs will continue to eat up an increasing share of the State’s revenues.

The State’s health insurance programs are very generous compared to those of private sector employees. The State offers both (a) “quality care” plans and (b) “managed care” plans, which are less expensive. Under “quality care” plans, covered parties may go to any doctor at any time for service. The annual premiums for a family under the “quality care” plans are about \$16,000 (the State subsidizes, on average, 81% of this cost). By contrast, the annual premiums for a family under the “managed care” alternative are less -- about \$11,000 (the State subsidizes, on average, 85% of this cost).

An expensive feature of the State’s program is that retired State employees and their families are allowed to stay in the health-care plan during the post-retirement period. They qualify for a partial subsidy after only eight years of service to the State, and they receive a full subsidy after 20 years of service. Illinois State employees can become “annuitants” who are eligible for these benefits at the age of 55. Thus, Illinois has large numbers of retirees in their 50’s and early 60’s who are not yet eligible for

Medicare, but who are eligible for state coverage. The annual premium under the “quality care” plans for a retiree who is not yet eligible for Medicare is about \$9,000; a retiree who is eligible for Medicare costs the state only about \$4,000 under the “quality care” plans. In addition, many retirees have qualified for other post-employment benefits – e.g., dental and vision.

## RETIREE HEALTH BENEFIT OVERVIEW

	Illinois State	Corporate benchmark
<b>Employer subsidy</b>	<ul style="list-style-type: none"> <li>• Generally 80% to 100%</li> <li>• 100% with 20 years service</li> </ul>	<ul style="list-style-type: none"> <li>• Generally 40% to 80%</li> <li>• Sometimes 100% with 30 years service</li> </ul>
<b>Plan composition</b>	<ul style="list-style-type: none"> <li>• 73% state quality care</li> <li>• 27% state managed care</li> </ul>	<ul style="list-style-type: none"> <li>• 15% indemnity plans</li> <li>• 85% managed care plans</li> </ul>
<b>Annual premium</b>	Single/family/retiree* <ul style="list-style-type: none"> <li>• Quality care • \$7,100/\$15,600/\$9,100</li> <li>• Managed care • \$4,700/\$11,400/\$6,900</li> </ul>	Single/family <ul style="list-style-type: none"> <li>• Not available</li> <li>• \$4,100/\$11,300</li> </ul>

\*Non-Medicare eligible (younger than 65)

Note: Illinois State data based on forecasted 2006 weighted average premium and employer subsidy data published by the Commission on Government Forecasting and Accountability

Source: Commission on Government Forecasting and Accountability: “Liabilities of the State Employees Group Insurance Program” (2006 and 2007), “Funding and Plan Design Summary of the State Employees Group Insurance Program”; Kaiser Family Foundation “Employer Health Benefits 2006 Annual Survey” (“large firm” data for HMO annual premiums; conventional indemnity premium data is not provided); AON Consulting

The State subsidizes an average of 80-100% of the cost of coverage under these health care plans (the percentage varies depending on the plan, and whether the coverage is for a single employee, a family or a retiree) -- which is more generous than most private sector employers. The State’s plans are also somewhat more generous with respect to co-pays and annual deductibles.

The biggest difference is that the State has allowed far higher percentages of employees and retirees to stay under the “quality care” plans than under the less-expensive “managed care” plans. Most active and retired private-sector employees are enrolled in “managed care” plans. The difference in annual costs to the State per family in these two kinds of plans is over \$4,000 per year.

The difference is most apparent with respect to retirees. About 73% of Illinois’ retired employees are covered by “quality care” plans – which enable them to go to any doctor, any time (with no diminution in benefits). The annual premium for a retiree who is not eligible for Medicare is about \$9,000 under the “quality care” plans and about \$7,000 under the “managed care” plans. By contrast, most retirees of private-sector firms do not have the option of choosing a more-expensive indemnity plan.

Illinois has not set aside trust funds for these health insurance costs for employees and retirees (as it has for pension costs), but has paid for them on a pay-as-you-go basis. However, under GASB Statement 45, Illinois and other states will have to recognize

these obligations on their financial statements commencing with the fiscal year ending in mid-2008 – the fiscal year after the current one. In particular, they will have to recognize the actuarial cost each year as an expense and report a liability on the balance sheet equal to the cumulative difference between the cost and actual contributions made; they will also have to report their estimate of the total current value of the future benefit costs already earned in a footnote. This will put the states in the same position as private-sector companies, which have had to report such expenses and liabilities under FASB 106 since the early 1990's.

GASB 45 does not compel states to fund these obligations, but it places significant pressure on them to do so. States which fund the costs will be permitted to use a discount rate (based on today's market rates) of approximately 8% to estimate the "present value" of the obligation for costing purposes. States which do not fund the costs will be required to use something like a 4% rate – which will produce a much higher "present value," liability, and cost determination.

Under these new requirements, the annual accounting expense Illinois will be required to accrue for annual health care costs is estimated to be in the range of \$4 to \$5 billion – or approximately \$2.2 to \$3.2 billion<sup>5</sup> more than the current FY 2007 level of expenditures for retiree health care costs.

Illinois will also be required to set up a liability on its balance sheet for the cumulative difference between the actuarial costs and actual contributions made. If Illinois continues to fund these health care costs on a pay-as-you-go basis, the amount of the actuarial liability is estimated to be in the range of \$43 to \$53<sup>6</sup> billion. All or part of this liability will appear as a footnote on the State's financial statements starting in FY 2008; and it will continue to grow each year unless Illinois adequately funds this obligation.

#### **D. Medicaid**

Medicaid is the federal-state program which funds health care providers (hospitals, long-term care providers, physicians, etc.) to cover the health care costs of low-income and other eligible individuals (the elderly, blind, disabled, and children and others in low-income families). Over 2 million Illinoisans are enrolled in Medicaid, which makes payments to about 200 hospitals, 1,100 nursing homes, 2,500 pharmacies, and 30,000 physicians each year. The program is administered by the states, and the Federal matching rate is, at a minimum, a 50/50 split between the states and the Federal Government. Poorer states receive a larger Federal match, but due to Illinois' relatively high per capita income, Illinois does not qualify for a greater match rate.

Illinois' share of these Medicaid costs in FY 2007 is estimated to be \$5.6 billion. The amount appropriated does not cover the actual cost since Medicaid is one area where

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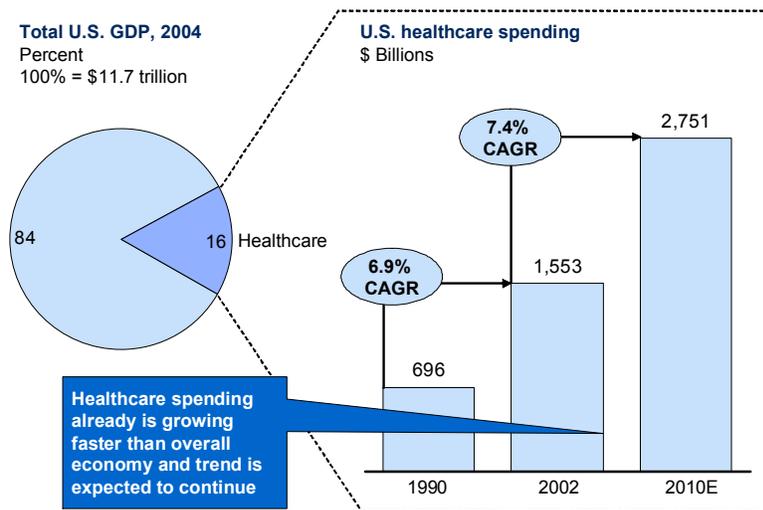
<sup>5</sup> For the purposes of this report, the midpoint (\$2.7 billion) of the estimated range of increase in annual expense is used.

<sup>6</sup> For the purposes of this report, the midpoint (\$48 billion) of the estimated range of the actuarial liability is used.

the State can pay prior period expenses out of current appropriations. The FY 2007 gap is estimated to be about \$500 million, while the accrued liability to-date is estimated to be about \$1.7 billion.

This element of the State’s cost structure -- like health care costs throughout the country -- is growing rapidly. Underlying growth in health care costs (projected at approximately 7.5% annually from 2002 to 2010) combined with large exposure to the growing aging population suggests that the program will continue to grow at a rapid pace going forward – perhaps in the range of 9.0% per year.

**HEALTHCARE SPENDING IS EXPECTED TO GROW AT AN ANNUAL RATE OF APPROXIMATELY 7.5% FROM 2002 TO 2010**

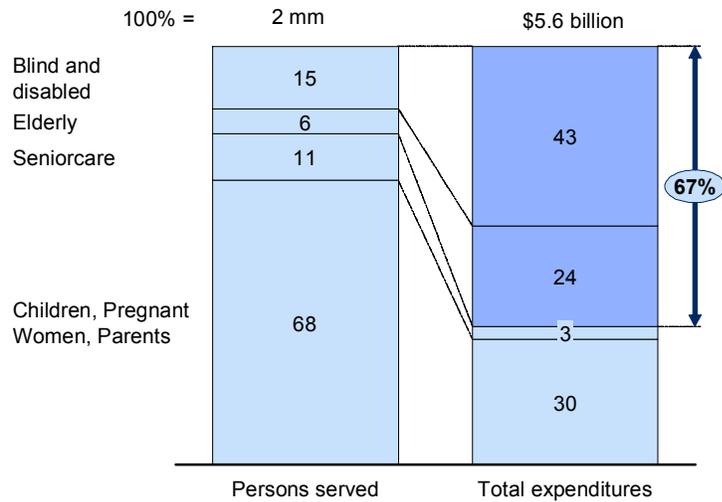


Source: CMS, Office of the Actuary; Global Insight; McKinsey analysis

A small portion of the enrollees drive a large amount of the total cost. Adults (non-elderly) and children are the vast majority of the enrollee base (68%), but account for only about 30% of total costs. The elderly and disabled, though only a minority of the enrolled population, account for the bulk of Medicaid spending in Illinois.

**THE MAJORITY OF EXPENDITURES ARE USED TO TREAT A SMALL PERCENTAGE OF ENROLLEES**

Percent

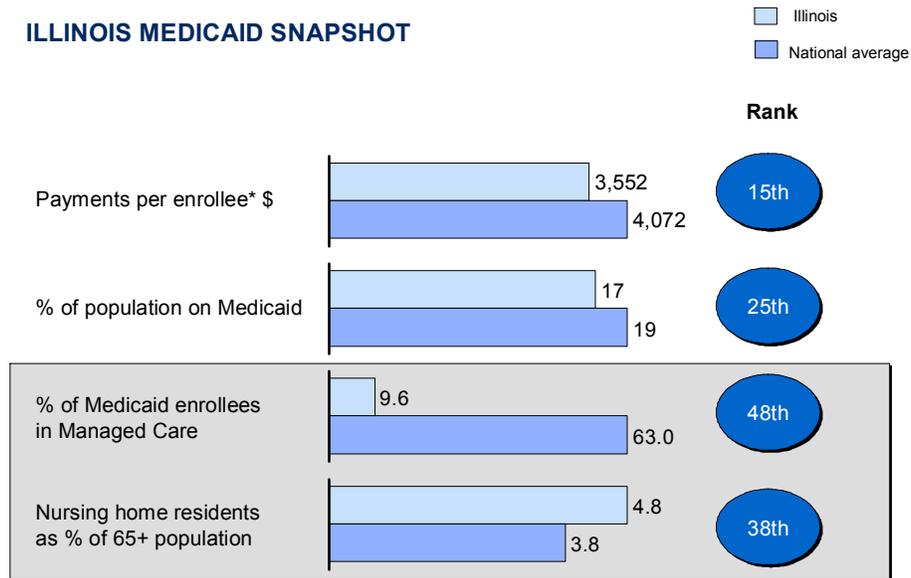


Source: Illinois Medicaid: A Primer; 2003 statistics

The number of enrollees tends to increase when the economy slows or contracts, which leads to worse budget problems at the state level when recessions occur. Also, as health care costs have continued to climb, employer-sponsored coverage has declined over the past several years.

A high-level snap shot comparing the Illinois Medicaid system to that of other states suggests that Illinois is spending less than average per Medicaid enrollee, but is not taking advantage of potential savings from switching enrollees to “managed care” plans or to less expensive patient care settings.

## ILLINOIS MEDICAID SNAPSHOT



\* Ranked from lowest spending to highest spending  
 Source: Kaiser Family Foundation; McKinsey analysis

Because increasing Medicaid costs have not been covered by revenues, the State has simply ignored the problem by not funding the increased obligations -- or, more precisely, by paying the bills rather than funding the growing obligations. It has also paid its bills more slowly, in effect increasing its borrowings from service providers.

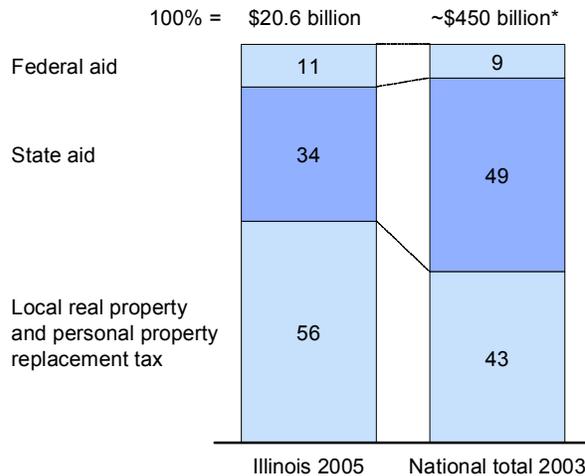
### E. K-12 Education

K-12 education in Illinois today is financed by a combination of local real property and personal property replacement taxes<sup>7</sup> (55.5%), state aid (33.8%), and federal aid (10.7%). 65% of state aid is allotted through the General State Aid (GSA) formula; categorical grants for programs such as special education and pupil transportation make up an additional 24%, with other grants making up the remainder. Over the last 15 years, state spending for K-12 education on a per pupil basis has increased on average 4.7% (nominal) – and 1.8% (real) – per year.

<sup>7</sup> The Corporate Personal Property Replacement Tax is a tax imposed by State government, but this report follows the convention established by public documents and reports CPPRT revenue as part of local tax revenue.

## K-12 SCHOOL FUNDING BY SOURCE

Percent



\* \$410 billion in 2001; estimated annual growth rate of 5% yields \$450 billion in 2003 and \$500 billion in 2005  
 Source: ISBE Annual Report 2005; Data reported by states to the U.S. Department of Education, National Center for Education Statistics, Common Core Data (CCD), "National Public Education Financial Survey," 2002-2003; ECS 2001-2002 finance report

Because there are wide disparities in the local property tax base throughout Illinois, the State – through the General State Aid (GSA) formula – “equalizes” resources among districts, in theory to assure that every district will have no less than the “foundation level” of per pupil expenditures. The “foundation level” per pupil is supposed to reflect the cost of providing a basic educational program in a high-performing efficient school. In 1997 the Legislature created the Educational Funding Advisory Board (EFAB) to set the “foundation levels.”

Once EFAB determines the “foundation level,” the State then determines how much each school district should be able to collect, based on the assessed valuation of property within the district and a “formula” tax rate. If (using these assumptions) the “available local resources” per pupil are lower than the “foundation level,” then the State is supposed to make up the difference. The poorest districts (those where available local resources are less than 93% of the “foundation level”) get the most state money per pupil. Districts between 93% and 175% of “foundation level” get less; and the wealthier districts -- over 175% of the “foundation level” -- get a small flat grant per pupil.

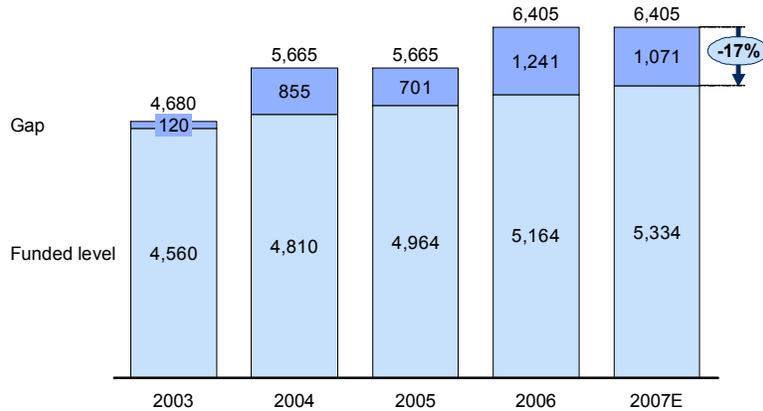
Until FY 2002 the Illinois Legislature fully funded the “foundation level” grants as defined in the 1997 statute. That is, the State gave local districts what it was supposed to give them to enable them to have at least the “foundation level” of resources per pupil. In 2003 the “foundation level” was set at \$4,680 per pupil; but the Legislature only funded \$4,560.

In FY 2004 and 2005 the “foundation level” was determined by EFAB to be \$5,665 per pupil. But the Legislature appropriated only \$4,810 in 2004 and \$4,964 in 2005.

In FY 2006 the “foundation level” was determined to be \$6,405; but the Legislature appropriated only \$5,164. The gap in 2006 is thus approximately \$1,240 per pupil.

**PER PUPIL FUNDING GAPS HAVE GROWN FROM 3% to 17% OF THE FOUNDATIONAL LEVEL**

Dollar per pupil

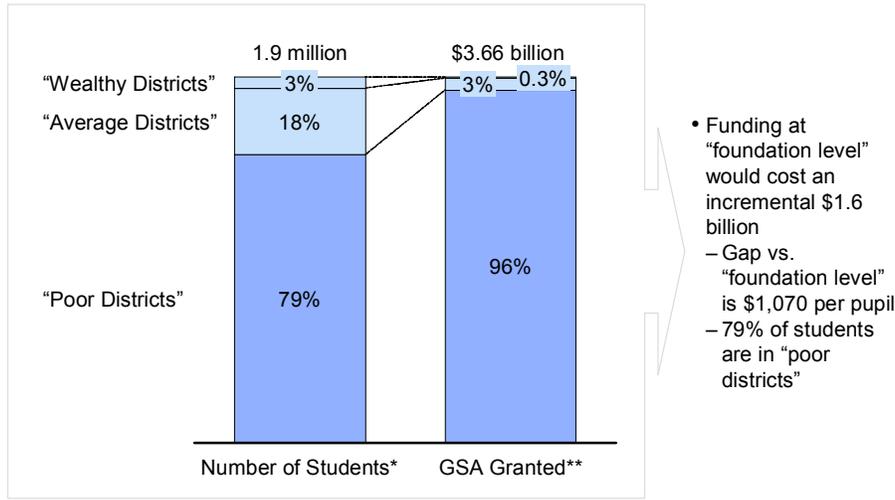


Source: Educational Funding Advisory Board, Illinois State Board of Education

The needs and/or demands of the State’s schools for more money are great. Schools would like to have money for capital construction, and/or more in the form of categorical grants. But the strongest case for more money is that the State should bring every school district up to the EFAB-determined “foundation level.” While the State has increased its funding level every year, the EFAB-determined “foundation level” has increased more quickly due to changes in the methodology used for calculating the “foundation level.” The additional funds would go to “poor” districts to bring them up to the “foundation level,” but all districts would continue to receive a minimum of \$218 per student. This would cost the State approximately \$1.6 billion more in FY 2007.

## ALLOCATION OF GSA ACROSS 3 TIERS, 2006

\$ Billions; percent; students



- Funding at "foundation level" would cost an incremental \$1.6 billion
- Gap vs. "foundation level" is \$1,070 per pupil
- 79% of students are in "poor districts"

Source: Illinois State Board of Education; McKinsey analysis

If the State were to bring every school district up to the EFAB "foundation level," that would mean about \$400 million more annually in State GSA money for Chicago public schools.

Apart from the benefit that Chicago would receive if the State were to bring all school districts up to the EFAB "foundation level," Chicago has an additional argument for more state money based on fairness. The State of Illinois has assumed responsibility for all the pension costs for teachers throughout the State except in Chicago. In Chicago, the pension costs for teachers are the responsibility of CPS. Thus, Chicago taxpayers contribute through their taxes to the costs of teachers' pensions throughout the State – and they also are responsible for the cost of CPS teachers' pensions<sup>8</sup>.

This inequity is historical – not logical. The State, recognizing this inequity, has made some payments to CPS – but these fall short of the funding level which the State gives to the downstate teachers' pension plans. Chicago now receives about \$75 million per year for pensions from the State. If CPS teachers' pensions were funded by the State, like other school districts, that amount would rise to approximately \$150 million in 2007.

### F. Summary

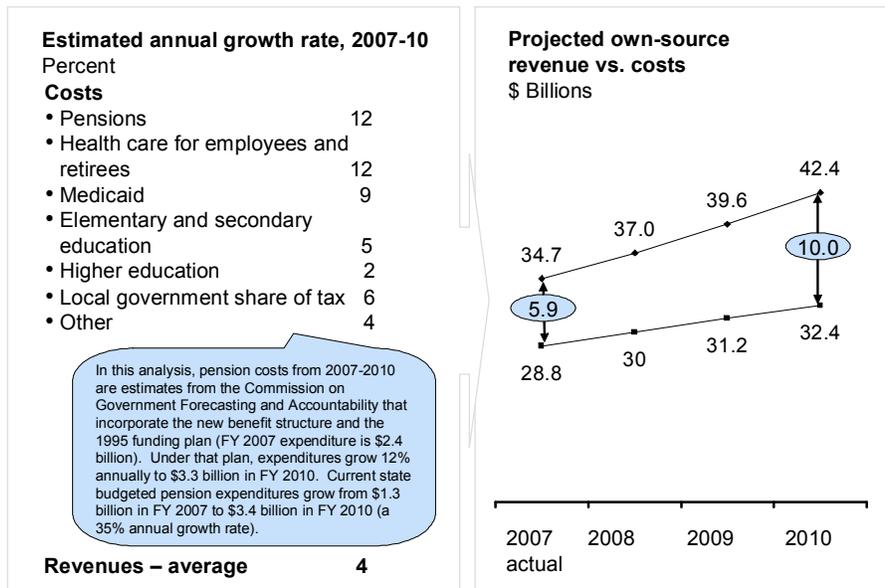
If one recognizes the actual increasing costs of State commitments made in the areas of pensions, health care for employees and retirees, and Medicaid – and if one were to include funding of the "commitment" the State has made to bring funding for K-12 education to the "foundation level," then the next State of Illinois budget would show a

<sup>8</sup> Although the focus of this report is on State finance issues, it should be noted that the Chicago Teachers' Retirement plan ratio of actuarial assets to liabilities for FY 2005 was only 79.0%.

huge growth in costs – from \$28.8 billion to \$34.7 billion – or approximately \$5.9 billion (see exhibit, p. 10).

Moreover, unless trends change, the gap between state revenues and costs will continue to grow. Driven by the rapid increases in the cost of health care benefits and Medicaid, State costs may be expected to grow at an average of 6.9%<sup>9</sup> per year in the near future, while revenues are expected to grow at approximately 4% per year. Thus, the gap between what the State is generating in revenues and its costs -- including growth in unfunded commitments -- will probably grow by 2010 to approximately \$9-10 billion per year.

**GAP IS EXPECTED TO WIDEN TO \$9-10 BILLION BY 2010**



Source: Taxpayers' Federation of Illinois; Commission on Government Forecasting and Accountability

**II. Reforms and Efficiencies Would Enable the State to Reduce These and Other Costs, But Not Enough to Eliminate the Gap Between Revenues and Costs**

**A. Introduction**

Program reforms and expense reductions should occur even if there were no budget deficit. The costs of state government in Illinois and many other states are out of control. The disciplines of competitive markets do not restrain and control costs in either state or municipal governments the way they do in the private sector. It is the responsibility of State officials to use their budget and executive authority to see that

<sup>9</sup> The 6.9% growth rate in costs cited here assumes that the State contributes an additional \$1.1 billion to pension funds in FY 2007; the 7.5% growth rate cited earlier in this report (p. 10) does not assume this additional contribution.

costs are controlled, and that benefit levels for State employees do not exceed those generally available in the private sector. The competitive yardstick of reasonableness should apply to public employees as well as private sector employees who help pay the State's bills through their taxes.

We have not undertaken a general review of all categories of State expenditures, but have instead focused on areas where the costs of the State's commitments have not been fully recognized or funded. Our principal conclusion is that existing realities should be recognized – that commitments already made should be funded – that the growth in pension and health care obligations today are *current* costs – and that they should be borne by today's taxpayers, rather than deferred to the future. But we also believe that the upward trends in cost growth can and should be slowed. Before the patient can be made well, at least the present bleeding should be stopped. The State's budget is today hemorrhaging. If this does not stop, the burdens transferred to future generations of taxpayers will be enormously increased – beyond those identified here – and the State will be faced with the choice of radical service cuts or huge tax increases that would make Illinois uncompetitive.

## **B. Pensions**

One way to reduce pension costs is to make the plans less generous. While the State Constitution may protect the accrued benefits of present retirees and existing employees whose rights are accrued (Illinois State Constitution, Article XIII, Section 5), the State can reduce the pension costs of future employees and presently non-vested employees. However, because of the influence of State employee unions and the fact that members of the State Legislature and Executive branches participate in the pension programs, the same market disciplines that exist in the private sector do not exist in state government.

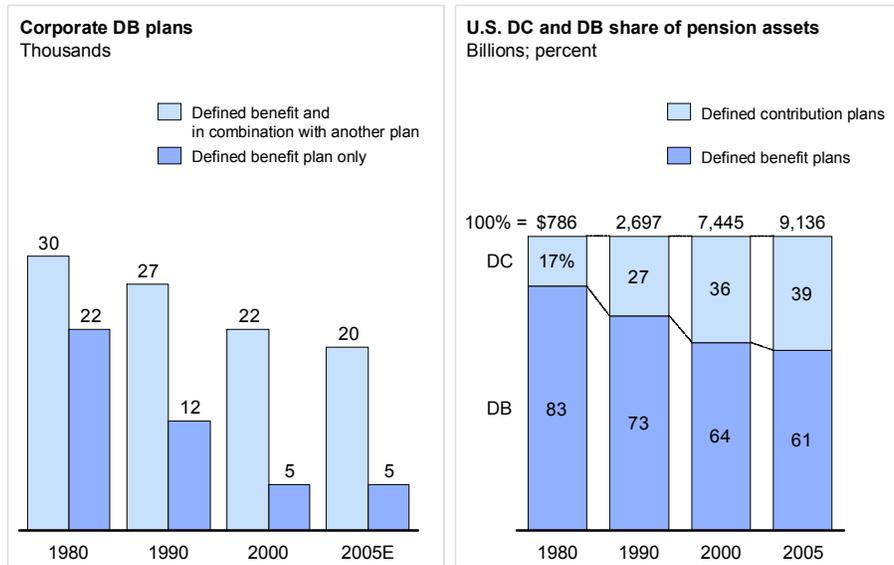
The recent report of the Governor's Pension Commission set forth ways to reform the pension plans and reduce pension costs. The Governor proposed, and the General Assembly approved, a few of the Commission's recommendations, including capping end-of-year salary increases and requiring funding for enhanced pension benefits. However, many of the Commission's recommendations have not been adopted, including increasing the minimum age for new employees to receive full benefits to 65 years of age with 8 years of service (this proposal was estimated by the Commission to save \$11.51 billion in State contributions to the pension funds and reduce accrued liabilities in the year 2045 by \$30.90 billion) and limiting automatic annual pension increases for new hires only (this proposal was estimated by the Commission to save \$4.76 billion in State contributions to the pension funds and reduce accrued liabilities in the year 2045 by \$74.20 billion).

Another way for Illinois to reduce its exposure to the growth in unfunded pension deficits would be to convert future employees and presently non-vested employees to Defined Contribution Plans, which is what many private-sector employers have done. During a transition, there would inevitably be problems – including issues with respect to

funding the present pension plans. We do not attempt here to quantify the costs of such a transition or the savings that would be generated going forward -- those would vary considerably depending on how the plan change was implemented -- but such a shift should reduce costs and growth in unfunded liabilities in the future.

Defined Contribution Plans have been widely adopted in the private sector to avoid the predicament created by unfunded Defined Benefit Plans.

**PRIVATE COMPANIES ARE MOVING AWAY FROM DB PLANS**



Source: Federal Reserve; McKinsey analysis

These Defined Contribution plans shift investment risk and longevity/mortality risk to the employees. They also make it impossible for the State to defer funding since the money transfers to the employee the year the benefit is earned. In addition, such plans allow for job mobility, enabling State employees to roll investments into a new plan in the event of a job change.

## DIFFERENCES BETWEEN THE 2 MAJOR TYPES OF PENSION PLANS

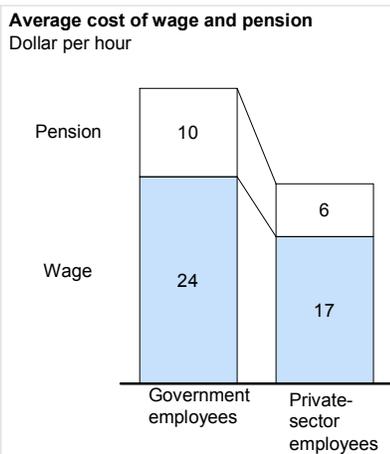
	Defined benefit plan (state employees)	Defined contribution plan
<b>Plan participation</b>	<ul style="list-style-type: none"> <li>Automatic for eligible employees</li> </ul>	<ul style="list-style-type: none"> <li>Elective</li> </ul>
<b>Benefit determination</b>	<ul style="list-style-type: none"> <li>Employer promises an annual pension benefits determined by a formula                             <ul style="list-style-type: none"> <li>– Multiplier (1.5%-2%) x final 3/5 year average pay x years of service</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Determined by level of employer and employee's contribution, and investment return on the contributions; investment decision is solely made by employees</li> </ul>
<b>Employee contributions</b>	<ul style="list-style-type: none"> <li>National average of 5% with social security</li> <li>National average of 8.4% without social security</li> </ul>	<ul style="list-style-type: none"> <li>Limited to \$15,000 in pretax contribution in 2006; \$20,000 for those who will be age 50 or older at year-end</li> </ul>
<b>Asset allocations</b>	<ul style="list-style-type: none"> <li>Determined by employer</li> </ul>	<ul style="list-style-type: none"> <li>Determined by employee</li> </ul>
<b>Withdrawals at 65</b>	<ul style="list-style-type: none"> <li>Annuity or lump sum</li> </ul>	<ul style="list-style-type: none"> <li>Lump sum</li> </ul>
<b>Rollovers before 65</b>	<ul style="list-style-type: none"> <li>Typically not permitted</li> </ul>	<ul style="list-style-type: none"> <li>Almost always permitted</li> </ul>

Source: Profit sharing/401(k) Council of America; National Association of State Retirement Administration; McKinsey analysis; Aon Consulting

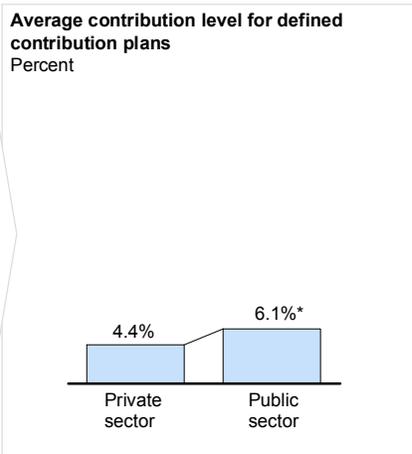
State pension levels tend to be more generous than those of the private sector. It is sometimes suggested that extra-generous pensions are needed to make up for lower wages and salaries; but public sector wages may not in fact be lower. In any event, switching to a Defined Contribution Plan would help reduce or control the level of state costs.

## SETTING UP THE RIGHT CONTRIBUTION LEVEL WILL ALIGN PUBLIC-SECTOR EMPLOYEES' COMPENSATION WITH THEIR PRIVATE SECTOR COUNTERPARTS

Public sector employees have been receiving higher benefits . . .



. . . defined contribution plans should benchmark with private sector standards



\* Average employer contribution rate for 7 states with public defined contribution plans, including Michigan, Ohio, Alaska, Florida, Montana, South Carolina, Colorado

Source: Bureau of Labor Statistics; EBRI; Various states retirement systems; McKinsey analysis; U.S. Chamber of Commerce; Aon Consulting

Some states have already begun to make the transition. Alaska, for example, has replaced a statewide defined benefit plan with a defined contribution plan for public employees and teachers hired after July 1, 2006.

In addition to migrating new hires and non-vested employees to a Defined Contribution Plan, the State should pursue initiatives to trim the cost of its existing Defined Benefit Plans, including those set forth in the recent report of the Governor's Pension Commission.

One possibility would be to increase individual contributions to the State's existing plans to match national benchmarks. In the Illinois State Employees Retirement Systems, members with Social Security are now required to contribute only 4% of their compensation to the pension funds, and members without Social Security are required to contribute 8%. These contribution levels are lower than the national averages of 5% and 8.6% respectively.

We believe that management of the State's pension funds could also be improved. Asset allocations should be in line with industry best practices; and the best asset managers should be selected for each asset class. News reports suggest that asset managers may have been selected in the past with a view toward political considerations – including political contributions – rather than investment performance. This should stop.

### **C. Employee/Retiree Health Care**

As shown above (*supra*, at pp. 14-16), the State's health insurance programs are more generous than those of most private sector employees. Moreover, the State subsidizes more of the cost of coverage under these plans than most private sector employers. The State's plans are also somewhat more generous with respect to co-pays and annual deductibles; and the State also allows far higher percentages of employees and retirees to stay under the "quality care" plans than under the less-expensive "managed care" plans. Most active and retired private-sector employees are enrolled in "managed care" plans.

The difference is most apparent with respect to retirees. About 73% of Illinois' retired employees are covered by "quality care" plans – which enable them to go to any doctor, any time (without any diminution in benefits). Most retirees of private-sector firms do not have this option. Also, State employees may retire after only 20 years of service with 100% State subsidy.

## EMPLOYEE AND RETIREE HEALTH BENEFIT OVERVIEW

	Illinois State	Corporate benchmark
<b>Plan composition</b>	<ul style="list-style-type: none"> <li>• Employees                             <ul style="list-style-type: none"> <li>– 35% state quality care</li> <li>– 65% state managed care</li> </ul> </li> <li>• Retirees                             <ul style="list-style-type: none"> <li>– 73% state quality care</li> <li>– 27% state managed care</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Employees                             <ul style="list-style-type: none"> <li>– 3% indemnity</li> <li>– 97% managed care</li> </ul> </li> <li>• Retirees                             <ul style="list-style-type: none"> <li>– 15% indemnity</li> <li>– 85% managed care</li> </ul> </li> </ul>
<b>Annual premium</b>	Single/family/retiree*	Single/family
• <b>Quality care</b>	• \$7,100/\$15,600/\$9,100	• Not available
• <b>Managed care</b>	• \$4,700/\$11,400/\$6,900	• \$4,100/\$11,300
<b>Employer subsidy</b>	<ul style="list-style-type: none"> <li>• Employees (single/family)                             <ul style="list-style-type: none"> <li>– 91/81% quality care</li> <li>– 91/85% managed care</li> </ul> </li> <li>• Retirees up to 100% depending on years of service</li> </ul>	<ul style="list-style-type: none"> <li>• Employees (single/family)                             <ul style="list-style-type: none"> <li>– Not available</li> <li>– 84/77% managed care</li> </ul> </li> <li>• Retirees over 65, average 60%</li> </ul>

**State plans are also more generous in terms of co-pays, annual deductibles, out-of-pocket max and prescription drug co-pay**

\*Non-Medicare eligible

Source: Commission on Government Forecasting and Accountability: "Liabilities of the State Employees' Group Insurance Program" (2006 and 2007) and "Funding and Plan Design Summary of the State Employees' Group Insurance Program", Kaiser Family Foundation "Employer Health Benefits 2006 Annual Survey" (premiums and employer subsidies for conventional indemnity insurance are not provided), AON Consulting

The most obvious way to cut expenses is to end the rights of employees and retirees to use the expensive “quality care” plan, and require them to shift to “managed care.” This could be done by ending the “quality care” option altogether or in part by eliminating the generous subsidy of the premiums for that option. The current cost difference between these two types of plans is about \$2,400 per single employee, \$4,200 per family, and \$2,200 per retiree (non-Medicare eligible). The transition could be managed through reducing the subsidy for “quality care” and creating incentives for participants to switch to the lower-cost option.

A second measure would be to require longer service and greater age as conditions to the right of retirees to health insurance during retirement. Today, only 20 years of service is required to obtain a full state subsidy. The state could require a longer time period – for example, 25 years. It could also require that employees be at least a certain age before becoming eligible for such a benefit – for example, age 60.

A third measure would require retirees to start paying more of the cost of their annual health care premiums – perhaps 25%. In the private sector, retirees are typically required to pay about 40% of their health care premiums.

Retirees may argue that their right to “free” health care insurance is protected by law or contract. Though the matter is not free from doubt, it appears that the State – like private employers – can change its policy with respect to employees and retirees whose rights have vested. The State clearly can change its policy prospectively with regard to *new* employees and those whose rights have not yet vested.

A fourth measure would be to require both employees and retirees to make co-payments comparable to those that exist in private-sector plans. Such “cost sharing” both shifts part of the burden of the cost from the State to the participant, and also discourages

wasteful use of the health care resources by the participant. This practice can save in the range of 10% of the costs incurred in “managed care” plans. Also, cost-sharing would reduce over-utilization of medical services.

We believe all these measures could yield major annual cost savings – perhaps initially in the range of \$200 million or more per year, increasing in later years.

#### **D. Medicaid**

This is not the place for a comprehensive evaluation of ways to reform Illinois’ Medicaid system. But we do suggest that such opportunities exist, and that significant cost savings may be achievable without serious detriment to those who most need Medicaid protection.

Illinois has some control over who is enrolled in Medicaid. It may, for example, reduce optional coverage – e.g., parents, or children above a certain age. Likewise, the State has some control over the level of coverage it provides participants, and over State optional benefits like nursing home care. Better case management and disease management programs may ensure that high-risk patients get the right care at the right time, without unnecessary costs. The elderly may receive better care – or at least care which is not lower in quality – at home or in assisted-living facilities, rather than nursing homes.

Perhaps the best opportunity for Illinois to reduce or control Medicaid expenses would be to shift to risk-based “managed care” programs, comparable to the health-care benefits provided by many companies in the private sector. Most states have done this already. About 63% of the recipients of Medicaid nationally are in managed care programs – the majority of which are risk-based managed care programs. Only seven states have fewer than 50% of their Medicaid enrollees in managed care. Illinois is clearly an outlier – it has fewer than 10%. Many risk-based managed care models have emerged for the costly elderly and disabled populations as well.

This reform would require an agreement with the Federal Government in the form of a waiver which operates like a block grant. But if managed correctly, this reform could help stabilize complicated Medicaid revenue streams and significantly increase predictability.

Moving to a managed care system by itself could save the State initially in the range of \$100 million per year. The other initiatives identified above could increase the total savings to approximately \$200 million per year, increasing in later years.

#### **E. K-12 Education**

The opportunities to reform and improve public education in Illinois are incalculable. In Chicago the public schools operate as a virtual monopoly. In the suburbs and other areas of the State, families often have the ability to select the school

districts where they will live, and this ability to make choices creates some of the competitive incentives that exist in the private sector. Families in these areas also have a greater ability to influence the management of the schools and generate a sense of accountability through direct participation and intervention. In Chicago these competitive incentives and the accountability that comes through citizen participation are much reduced (see the Civic Committee's report on the performance of Chicago's public schools and students: *Left Behind: A Report of the Education Committee*, Civic Committee of The Commercial Club of Chicago, July 2003).

The most encouraging development in public education in Chicago in recent years has been the growth in the number of charter schools, located primarily in the poorest areas of the City. The charter schools, which are open by lottery to children without prior testing, consistently out-perform their neighborhood "comparison" public schools (see, for example, *Chicago Public Schools Charter Schools Performance Report 2004-2005*).

Chicago's charter schools generally attract teachers who are better qualified, often work longer hours and receive less pay, and yet produce better results than teachers in the schools from which their students have transferred. Thousands of economically disadvantaged minority parents have recognized the superiority of the charters and have lined up to enroll their children, creating long waiting lists.

In 2004 Mayor Daley and the Chicago Public School System announced a major new initiative to create 100 new schools by 2010 – most of them charter and contract schools. These schools are more innovative and free from many of the bureaucratic impediments and restrictions that have plagued traditional urban public schools. The business community in Chicago has supported Mayor Daley's initiative, and within the past two-and-a-half years has helped support and fund the creation of 35 new "Renaissance 2010" schools, virtually all of which have been located in the poorest areas of the City.

Offering all Chicago parents and families more and better choices as to where their children go to school will help make *all* schools better – not just the new charter and contract schools, but the traditional public schools as well. Incentives to improve performance will be strengthened, and "accountability" will be fostered. More choices and competition should also help constrain the growth of costs in the future.

However, Illinois law now caps at 30 the number of charters that may be granted in Chicago. Chicago has used or committed all 30 of these charters. Most of the charters available to suburban and downstate communities remain unused.

Any additional funding for schools should be conditioned on greater accountability and transparency, and on eliminating the cap on the number of Chicago's charter schools.

Transparency includes timely public disclosure of the academic qualifications of each teacher, hired, tenured, terminated or retained, as well as the academic success of their students. Taxpayers, voters and parents deserve information adequate to determine whether our schools are competing effectively for talent, and whether teachers are promoted and retained on the basis of performance.

Chicago's schools may need more money – but they need even more the incentives to improve performance that will come with more and better choices. Although the effects of generations of poverty and discrimination on academic achievement are formidable, Chicago's charter schools have proven that these effects need not be irreversible.

Without the improved incentives that come with competition and choice, spending more money on the existing schools – organized and managed as they now are – would produce little if any lasting benefit.

## **F. Summary**

Units of government – like families – often are presented budget problems and hard choices. They cannot overcome these unless they face hard facts. Budget deficits cannot be wished away. To ignore them is irresponsible.

Illinois has huge embedded deficits. It takes in revenues annually that are far less than the amount of its annual costs – including the additional obligations it currently generates.

The only ways to deal with a deficit are to reduce costs – or raise more money – or both.

Illinois can and should reduce its costs through reforming its programs (pensions, health benefit programs, Medicaid) and in other ways. And it may be able to reduce the costs of government operations generally, though not without opposition from interest groups who have a greater interest in employee compensation and benefits than in expense controls. For the reasons set forth above, we think total annual cost savings in the range of \$1.0 billion should be achievable.

But the fiscal hole that Illinois has dug for itself is so large that we do not believe it is practically possible to dig out of it solely through budgetary reforms and expense reductions. Additionally, we do not believe that “one-shot” sales of State assets, such as the lottery, or the expansion of gaming are workable long-term solutions to the State's budgetary problems.

The alternatives seem clear.

First, we can criticize the political leaders who created this mess, and hope the budget problems somehow disappear. This course would in some ways be more satisfying, but it ignores an unpleasant reality and might well disable us from having any voice in shaping the reforms that are necessary.

The other alternative, albeit painful, is to recognize that increased revenues – higher taxes – are probably unavoidable, at least if Illinois is to avoid radical reductions in state services and possibly even bankruptcy. If taxes must be raised, it would be better for business people and citizens groups to have some voice in the choices that must be made – and, perhaps even more important, the ability to insist that taxes should not be

the *sole* solution. It would be little short of tragic if the business community and civic groups throughout the State – by remaining silent -- lost the opportunity to insist that if there must be tax increases, then – as a *quid pro quo* – the expensive benefits programs which have led to the budget crisis must also be fundamentally reformed, and that the cap on charter schools in Chicago should be lifted.

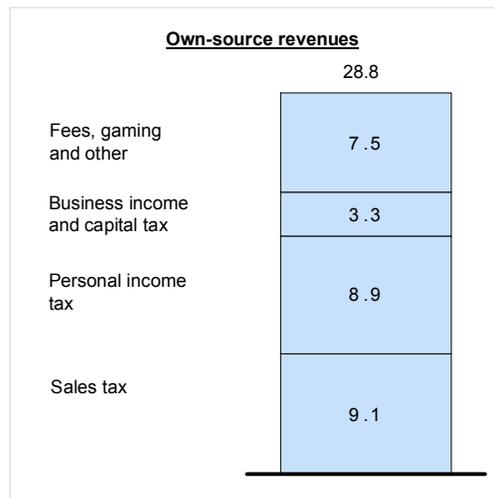
### III. Recent Proposals for Statewide Tax Increases

#### A. Current Illinois Tax Environment

The State’s revenue system currently generates about \$28.8 billion annually.

#### STATE OF ILLINOIS FY 2007 OWN-SOURCE REVENUES

\$ Billion



\* Own-source revenue includes general funds excluding transportation funding and the large portions of specialty funds, incl. some transfers from investment fund  
 Source: State of Illinois; Taxpayers' Federation of Illinois

Three taxes provide the largest part of the State’s revenue:

1. The **personal income tax**, now constitutionally-mandated to be “flat” (Illinois State Constitution, Article IX, Section 3), is currently set at a rate of 3.0%. An increase of 1.0% would yield approximately \$2.9 billion.

2. The **corporate income tax** is now set at a flat rate of 4.8%, with a 2.5% personal property replacement tax (the corporate personal property replacement tax is imposed on corporations to replace the personal property tax, which was constitutionally abolished in 1979). An increase of 1.0% in this tax rate would yield about \$300 million.

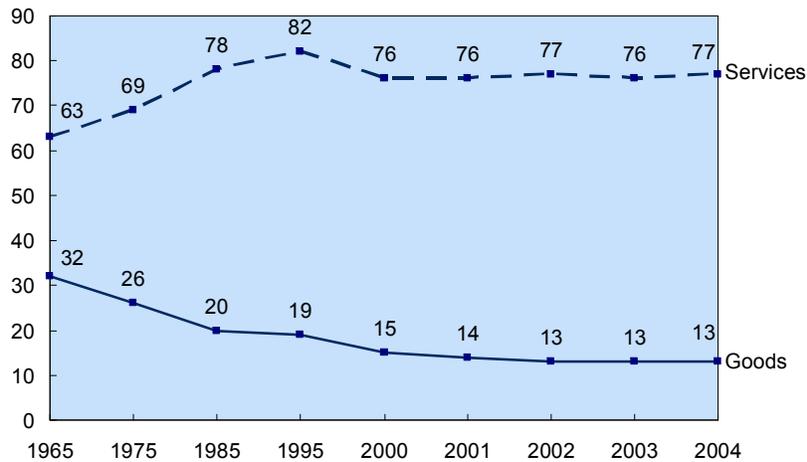
3. The **state sales tax** generates revenue for both state and local governments. The combined state-local tax rate is now 6.25% -- with 5.0% allocated to the state, and

1.25% allocated to local governments. An increase in the sales tax rate of 1.0% would yield about \$1.4 billion.

Localities are allowed to levy additional sales tax. As a result, the current total sales tax in Chicago (Cook County) is 9.0% -- and the average statewide in Illinois is 7.55%.

The sales tax applies, with some exceptions, only to consumer goods. It does not apply to food or services. In 1965, goods represented 32% of the state economy; in 2004, goods represented only 13% of the economy. In 1965, services represented 63% of the state economy; in 2004, services had grown to 77% of the economy. The levying of the sales tax on only consumer goods has thus led to a disconnect between the current tax structure and underlying state economic activity. In order to increase revenue through this tax, the state might either increase the tax *rate* – or extend its application to *services* – or both.

#### GOODS AND SERVICE SECTORS AS A PERCENTAGE OF THE TOTAL ILLINOIS ECONOMY

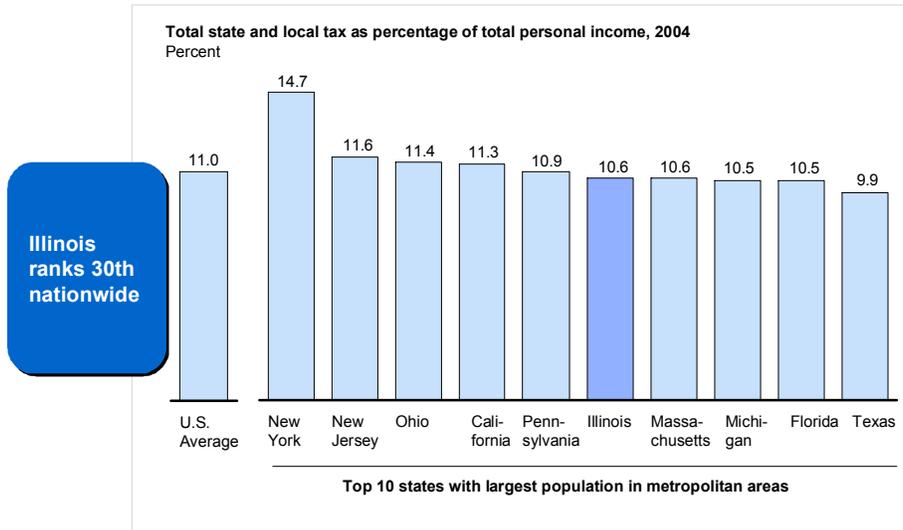


Source: Center for Tax and Budget Accountability

#### B. Illinois' Competitive Position Vis-à-vis Other States

In evaluating the tax environment in Illinois, one may compare Illinois to other states nationwide or to other states that also have a large population living in metropolitan areas. In terms of total state and local tax burden, as defined by taxes as a percentage of total personal income, Illinois is below the national average and ranks sixth in the top 10 states with the largest population in metropolitan areas.

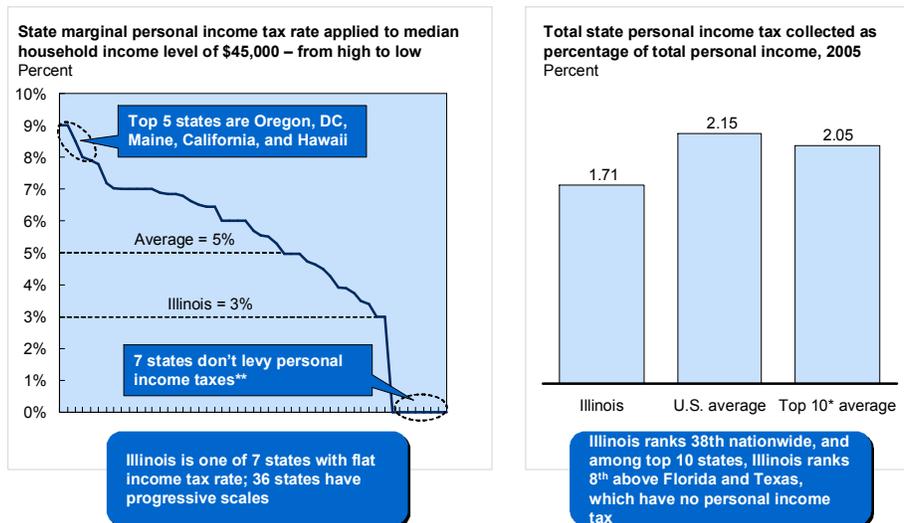
## TOTAL STATE AND LOCAL TAX COMPARISON



Note: Comparison includes taxes but excludes certain fees, etc. that vary between states  
Source: U.S. Census; Federation of Tax Administrators; Economy.com; McKinsey analysis

Illinois' flat personal income tax rate of 3% is at the low end nationally; and the personal income tax burden, again as a percentage of total personal income, is below the national average and the average of the top 10 states with the largest population in metropolitan areas.

## PERSONAL INCOME TAX COMPARISON



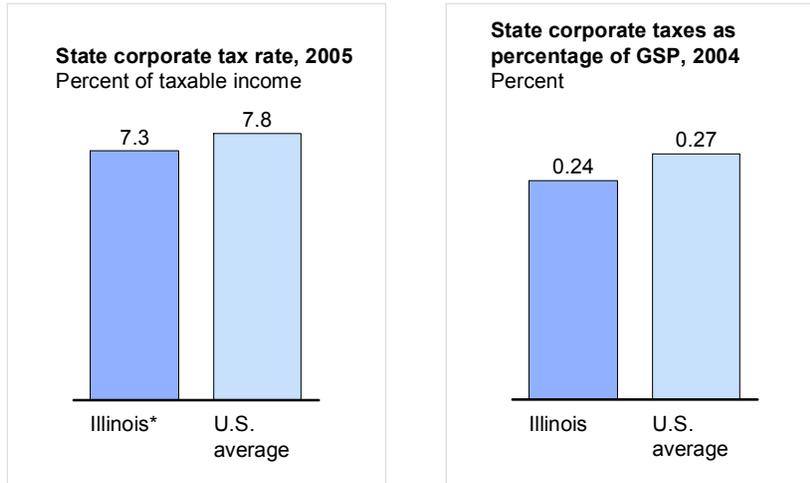
\* 10 states with largest population in metropolitan areas

\*\* 7 states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming

Source: Tax Foundation; Taxpayer's Federation of Illinois; US Census; Bureau of Business & Economic Research; McKinsey analysis

The corporate income tax rate and burden in Illinois (as measured by corporate income taxes as a percentage of Gross State Product) are also slightly lower than the national average.

### CORPORATE INCOME TAX COMPARISON



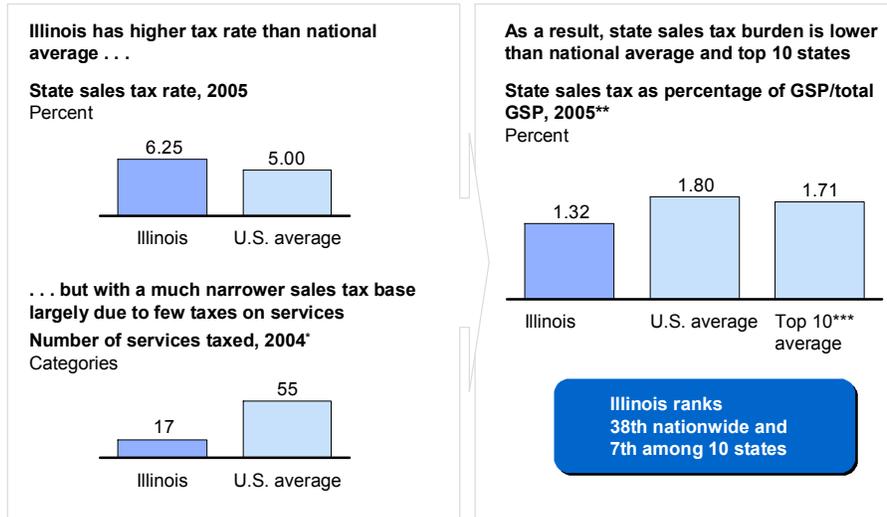
\* Illinois rate includes corporate income tax of 4.8% and replacement tax of 2.5%

Note: Comparison excludes fees, etc that vary between states

Source: Tax Foundation; US Census; McKinsey analysis

Despite a sales tax *rate* that is significantly higher than the national average (6.25% versus 5.0%), Illinois has a lower sales tax *burden* than the national average and the top 10 states with the largest population in metropolitan areas. A much narrower tax base, with few taxes on services, produces this result.

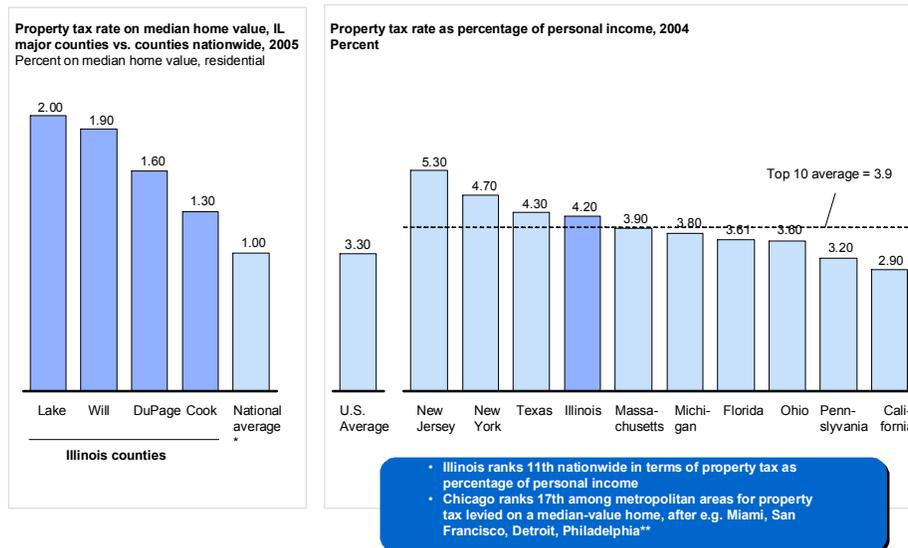
## STATE SALES TAX COMPARISON



\* Based on nationwide survey conducted by Federation of Tax administrators  
 \*\* State sales tax includes general sales tax and GRT revenues  
 \*\*\* 10 states with largest population in metropolitan areas  
 Source: Federation of Tax Administrators; Tax Foundation; Taxpayer's Federation of Illinois; US Census; McKinsey analysis

The Illinois property tax burden is at the high end compared to the national average, but is not an outlier among the top 10 states with the largest population in metropolitan areas.

## PROPERTY TAX COMPARISON



\* Sample of 770 counties  
 \*\* For non-elderly taxpayers, based on a study conducted by Minnesota Taxpayer's Association in 2005  
 Source: Tax Foundation; Federation of Tax Administrators; U.S. Census; McKinsey analysis

Based on these comparisons, Illinois appears to be reasonably competitive nationally in terms of tax environment. While the property tax burden is relatively high

in Illinois compared to other states, the relatively low personal and corporate income tax burden and sales tax burden offset the property tax burden and place Illinois at a slightly favorable competitive position nationally.

### **C. The Proposal to Reduce Property Taxes and Increase Income or Sales Taxes to Make Up the Short-Fall – i.e. the Proposed “Tax Swap”**

The three tax reform plans summarized in the next section of this report all include some version of a “tax swap” – reducing local property taxes, upon which the schools are now heavily dependent, and replacing those revenues with state revenues. This in effect would “swap” property taxes for some combination of increased income or sales taxes, or a new gross receipts tax.

The two tax reform proposals sponsored at different times by the Cook County Assessor would reduce that portion of local property taxes which now funds K-12 education by about 25%, and replace those funds with increases in statewide taxes (approximately \$4.5 - 4.9 billion). The third major tax reform proposal, House Bill 750, also provides property tax relief, though only about half of what is proposed by the Assessor (\$2.7 billion).

Proponents of a “tax swap” believe that Illinois property taxes are “too high” from a tax policy standpoint. They argue that these taxes render Illinois non-competitive in comparison with other states. Proponents also point out that Illinois’ property taxes are higher than the national “median;” as the previous analysis showed, Illinois ranks 11<sup>th</sup> nationwide in terms of property taxes as a percentage of personal income. However, when compared to other states with a large population in metropolitan areas (such as New Jersey, New York and Texas), Illinois is not an outlier among the top 10 such states.

In terms of *total* state and local tax burden, Illinois is below the national average and ranks sixth among the top 10 states with the largest population in metropolitan areas. Illinois simply tends to rely more heavily on property taxes, and less heavily on sales taxes and personal and corporate income taxes than other states.

Aside from such national comparisons of relative tax burden, Illinois’ current tax structure can be evaluated in the context of economically “optimal” tax policy. The proper objective of an economically optimal tax policy is to structure taxes in a way that minimizes the impact of the tax on what would otherwise be the optimal allocation of economic resources. This approach was first explained by economist Frank Ramsey in the 1920’s (Ramsey, Frank P. “A Contribution to the Theory of Taxation.” *Economic Journal* 37 (1927): 47-61).

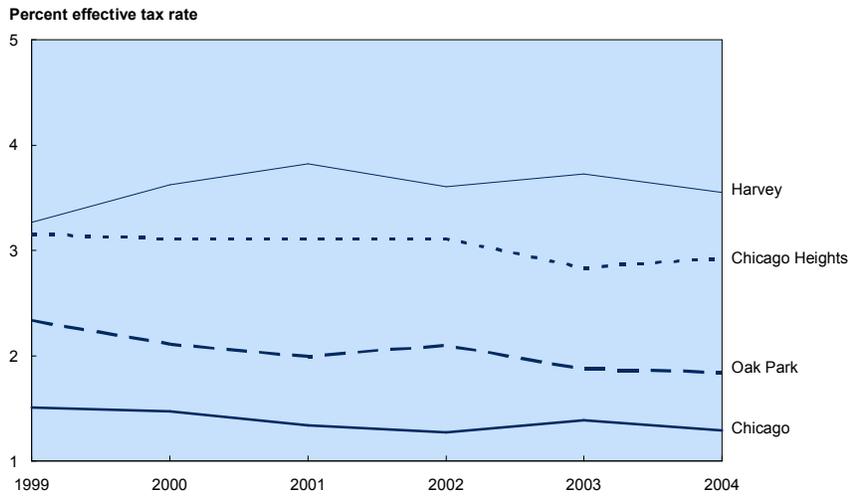
Under the Ramsey approach, tax rates on the sale of goods, for example, should be inversely proportional to the elasticity of demand for the good (loosely defined as how sensitive the demand for a product is relative to changes in price). Goods for which demand is relatively inelastic should have a higher tax rate since changing their prices does not create as much distortion. Conversely, lower tax rates should be set on price-

elastic goods since small price changes may create large distortions in the quantity demanded.

When one evaluates property tax rates using this approach, it is clear that “high” taxes on real property tend to make owning property more expensive and therefore relatively unattractive. But if the taxes are roughly comparable throughout the area where a particular private or commercial owner wishes to be located, it is far from clear that “high” property taxes applied *generally* are any more disruptive of the optimal allocation of economic resources than other “high” taxes. However, if taxes are not comparable throughout a given area, differences in tax burden may “distort” economic decisions – leading private and commercial owners to locate in relatively “low-tax” areas and avoid relatively “high-tax” areas.

A comparison of effective tax rates (defined as taxes paid expressed as a percent of the market value of the property) for residential, commercial and industrial properties in selected cities in Cook County illustrates the problem. It should be noted that the effective tax rate on residential properties is significantly lower than that on commercial and industrial properties in Cook County, on average. The classification system in Cook County gives residential property taxpayers (assessed at only 16% of fair cash value) a break at the expense of commercial and industrial property taxpayers, which are assessed at higher percentages (38% and 36%, respectively).

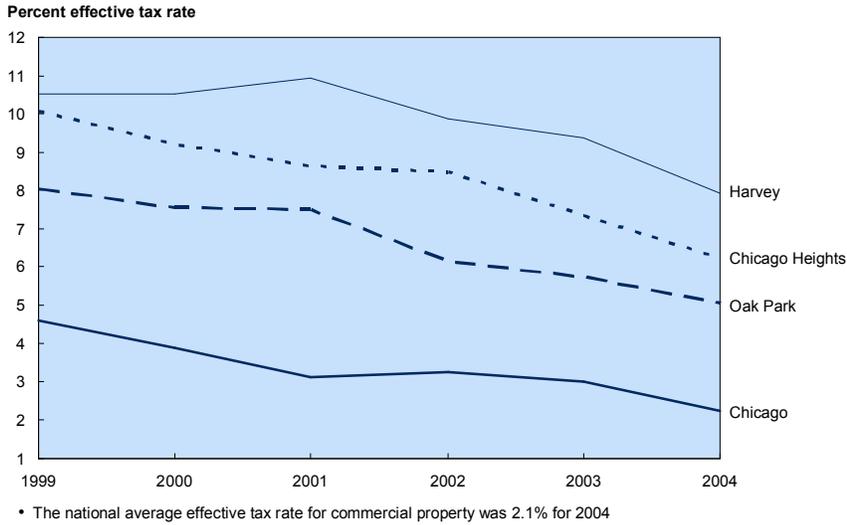
**COOK COUNTY EFFECTIVE TAX RATES FROM CIVIC FEDERATION STUDY RESIDENTIAL – SELECTED CITIES**



- The national average effective tax rate for residential property was 1.45% for 2004
- The effective tax rates above do not take into account homestead exemptions which would reduce the average effective tax rate in Cook County by 15% for 2003 and by greater amounts (estimated at 19% and 23% ) for 2004 and 2005

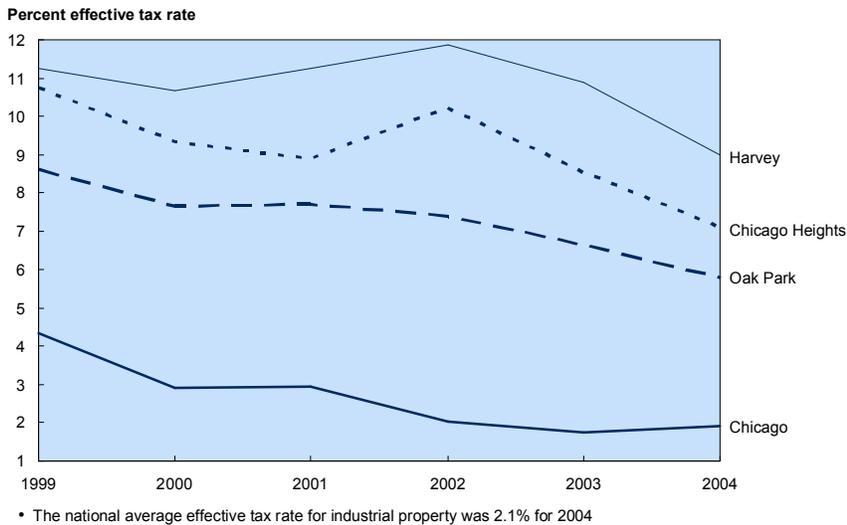
Source: Civic Federation; Taxpayers' Federation of Illinois

**COOK COUNTY EFFECTIVE TAX RATES FROM CIVIC FEDERATION STUDY COMMERCIAL – SELECTED CITIES**



Source: Civic Federation; Taxpayers' Federation of Illinois

**COOK COUNTY EFFECTIVE TAX RATES FROM CIVIC FEDERATION STUDY INDUSTRIAL – SELECTED CITIES**



Source: Civic Federation; Taxpayers' Federation of Illinois

As the charts above demonstrate, the effective tax rates for residential, commercial and industrial properties within Cook County vary significantly. The effective tax rates for the City of Chicago have declined over the last few years to a level close to the national average. However, the property-poor communities of Harvey and Chicago Heights levy substantially higher rates; these higher rates are necessary to raise needed revenue from a relatively low base (as measured by the equalized assessed

valuation of property in the community). Relatively high property tax rates discourage private and commercial property owners from locating in these communities, driving property values even lower, which further necessitates relatively high tax rates, and so on.

This cycle of low property values, high tax rates and disincentives to prospective property owners may be a reasonable basis for a policy that breaks the cycle and is targeted to the affected communities. However, it does not support an across-the-board “tax swap” such as that envisioned in the tax reform proposals described here.

Another related argument is that, as noted before, the structure of property taxes in Cook County is imprudent or unfair because commercial owners pay higher taxes in relation to property values than homeowners. Such an argument points in the direction of eliminating the disparity rather than reducing all property taxes and raising others – such as income or sales taxes. In any event, a recent analysis performed by the Civic Federation suggests that the alleged past disparity between commercial and non-commercial property tax levies in Cook County has been reduced.

Proponents also support a “tax swap” as a way to address perceived political realities, rather than policy goals. For example, some local officials may derive political advantage from supporting reductions in property taxes, or they may believe that property tax relief must be part of any overall package of revenue reform in order to enhance its chance of passage. But even if such political assessments were correct, one may question whether it is wise to support a large statewide tax increase to fund such a “tax swap.” There are at least three reasons for concern.

First, property taxes are a more stable, less fluctuating, source of funds than statewide income or sales taxes, which tend to vary with the level of economic activity in the state at the time. Down-turns in the business cycle, for example, tend to have a more direct impact on statewide revenues than local property taxes. Retaining the property tax as a principal support for K-12 education funding tends to protect schools from such fluctuations.

Second, though reductions in local property taxes would make suburbanites feel good when they receive their next property tax bill, this sensation of pleasure would wear off when they realize that their income taxes or sales taxes have increased. Moreover, such reductions would make it possible for local taxing authorities over time to raise the property taxes back up to (if not above) the current levels. In other words, it might be hard to make the “tax swap” “stick.”

Third, and more fundamentally, shifting from local taxes to statewide taxes to support K-12 education increases the likelihood that governance of K-12 education will gradually shift away from local districts and local people in the direction of statewide control. The tendency in government is for those who have authority over money to set conditions on its use. A related tendency is to use such authority for political purposes rather than those related to sound public policy. Those who believe that education

decisions should be made locally may find such a centralizing shift toward state control of education dangerous.

#### **D. Three Recent Tax Increase Proposals**

Three plans for tax increases have been put forward in recent years – but of course there is an infinite variety of possibilities. The three that have been put forward are:

-- **2003 Plan** – proposed by the Cook County Assessor.

-- **House Bill 750** – advocated by the Center for Tax and Budget Accountability (CTBA).

-- **A new “gross receipts” tax** – proposed recently by the Cook County Assessor.

These proposals -- and their revenue generating effects -- may be summarized as follows.

1. **2003 Plan** – increased income taxes and sales taxes – for (a) “tax swap” and (b) additional money for K-12 education:

The 2003 Plan proposed by the Cook County Assessor would have provided \$4.5 billion in property tax relief, replaced that lost revenue with new state money for K-12 education, and also provided an additional \$1.5 billion of funds for K-12 education. The Plan proposed to:

-- Increase the personal income tax rate from 3% to 4% and apply the tax to retirement income over \$100,000, but also increase the personal exemption to \$6,000. The reason for this exemption is that the Illinois Constitution mandates a flat – i.e. not “progressive” – income tax rate. Some people believe that this “flat” tax restriction is misguided. Increasing the personal exemption to \$6,000 would benefit low-income families, thus having the effect of making the personal income tax more “progressive” in substance, if not in form. The net revenue effect of this increase in the income tax rate from 3% to 4% would be about **\$1.9 billion**.

-- Increase the corporate income tax rate from 4.8% to 6.4% -- thereby raising **\$450 million**.

-- Expand the sales tax base to include food, non-prescription medicine and medical supplies, as well as most services. The revenue effect would be about **\$4.6 billion**.

-- As an “offset” to broadening the sales tax base, reduce the state sales tax rate from 5% to 4% -- having a **negative revenue effect of \$1.3 billion**.

-- Other changes would yield \$400 million.

The revenues thus raised would be approximately **\$6 billion**. These revenues would be used, according to the proponents, to:

a. Provide property tax relief -- \$4.5 billion; and

b. Replace the lost property tax funds to support K-12 education, and provide additional revenues for K-12 education of \$1.5 billion.

No funds would be available for other purposes – e.g. pensions, employee/retiree health care.

2. **House Bill 750** – increase income tax, broaden sales tax – for (a) “tax swap” (b) additional money for K-12 education and (c) “structural deficit.”

HB750 was last introduced in the General Assembly in February 2005. It is supported by Senators Meeks and del Valle, as well as the CTBA, headed by Ralph Martire. In its current incarnation, HB750 would:

-- Increase the personal income tax rate from 3% to 5%, but also create a new family tax credit for low and moderate income workers. The net revenue effect would be about **\$5 billion**.

-- Increase the corporate income tax rate from 4.8% to 8% -- generating about **\$1 billion**.

-- Expand the sales tax base to include all personal services, entertainment and other consumer services – generating about **\$2.2 billion**.

The total revenue thus created would be about **\$8.1 billion**.

The supporters of HB750 would use this money to:

a. Provide property tax relief of \$2.7 billion -- only about half the amount proposed by the Assessor;

b. Provide funds for K-12 education of \$2.7 billion (replacing the lost property taxes) plus an additional \$2.2 billion for K-12; and

c. Provide an additional \$2.5 billion to eliminate the state’s “structural budget deficit” and additional funds of \$700 million to local governments.

3. **“Gross Receipts” tax** – increase personal income tax rate, eliminate corporate income tax and some other business taxes, reduce sales tax, impose new tax on “gross receipts” – for (a) “tax swap” and (b) additional K-12 education.

A proposal recently advanced by the Cook County Assessor as a way to pay for a “tax swap” is to create a new tax on business “gross receipts.”

-- This proposal would increase the personal income tax rate from 3% to 4.5% and would apply the tax to retirement income over \$100,000, but would increase the personal exemption to \$6,000 (to make the effect more progressive). The net revenue effect would be **\$2.4 billion**.

-- The Assessor would also levy a tax on “gross receipts” of business of 1%. This does not appear to be an “income” tax because the tax would be on “receipts” – with no reduction or deduction for expenses. It would apply to “gross receipts” of *all* business, including suppliers and wholesalers (unlike the European VAT). This would generate **\$9.5 billion**. Business might or might not, depending on competitive circumstances, be able to “pass through” some of this tax in their pricing to customers.

-- To make the “gross receipts” tax more palatable, the proposers would repeal the corporate income tax rate as well as some other business taxes – **reducing revenues by \$1.6 billion**.

-- In addition, the proposers would reduce state sales tax rate from 5% to 3% and reduce excise taxes by half -- **reducing revenues by \$3.6 billion**.

-- Other changes would reduce revenues by \$200 million.

The net effect of these pluses and minuses would be additional total revenues of approximately **\$6.5 billion**. These revenues would be used to:

- a. Provide property tax relief of \$4.9 billion – the “tax swap;” and
- b. Replace the lost property tax funds to support K-12 education, and also add an additional \$1.6 billion of K-12 education funding.

No funds would be available for other purposes – e.g. pensions, employee/retiree health care.

## Comparison of Reform Proposals

Tax Change	Current	2003 Plan	HB750	Gross Receipts Plan
Personal income tax	3.0%	4.0% (Includes retirement income; increases exemption) <b>\$1.9 billion</b>	5.0% (Creates new family tax credit) <b>\$5.0 billion</b>	4.5% (Includes retirement income; increases exemption) <b>\$2.4 billion</b>
Corporate income tax	4.8%	6.4% <b>\$450 million</b>	8.0% <b>\$980 million</b>	Repeal <b>(\$840 million)</b>
Gross receipts tax				1.0% <b>\$9.5 billion</b>
Sales tax	5.0% <b>General Merchandise</b>	4.0% Add food, most services* <b>\$3.3 billion</b>	5.0% Add personal and consumer services <b>\$2.2 billion</b>	3.0% No change in base Reduce excise taxes by half <b>(\$3.6 billion)</b>
Other		Net <b>\$413 million</b>		Net <b>(\$1.0 billion)</b>
<b>Total revenue generated</b>		<b>\$6.0 billion</b>	<b>\$8.1 billion</b>	<b>\$6.5 billion</b>
<b>Property tax relief</b>		<b>(\$4.5 billion)</b>	<b>(\$2.7 billion)</b>	<b>(\$4.9 billion)</b>
<b>Additional school funding</b>		<b>(\$1.5 billion)</b>	<b>(\$2.2 billion)</b>	<b>(\$1.6 billion)</b>
<b>Structural deficit funding</b>			<b>(\$2.5 billion)</b>	
<b>Funds to local government</b>			<b>(\$.7 billion)</b>	

\*Includes personal services, repair services, recreation, professional and technical services  
Source: Cook County Assessor's Office; Center for Tax and Budget Accountability

All three tax reform proposals incorporate a significant amount of property tax relief as well as additional school funding (largely to fund the EFAB foundation level). But, as shown in the previous discussion of "tax swaps," property tax relief appears warranted only in those communities where low property values force the levying of very high tax rates in order to raise sufficient funds to support public programs (largely the support of local schools).

However, *most* of the billions of dollars proposed for property tax relief in these proposals would *not* go to property-poor communities. Assuming a 25% dollar-for-dollar reduction in property taxes, those districts spending far *above* the state average in per pupil spending would receive *much more* property tax relief than those districts spending at or below the state average.

Even in property-poor communities, property tax relief may not be justified. That is because the other use of funds envisioned by the tax reform proposals – additional school funding – should remove the need for levying such high tax rates in the first place.

By definition, the “foundation level” is supposed to provide sufficient funds per pupil to allow an efficient school district to offer an adequate education to its students. The amount of money each school district receives under the general state aid formula is based on a “reasonable” tax rate set by the state (rather than the actual property tax rate levied by the district) and the actual value of property in the district. The State then makes up the difference between what the district could collect in revenues using this reasonable tax rate and what the “foundation level” provides. Using this formula, any district that is willing to spend exactly the “foundation level” on each student should be able to set this reasonable tax rate and then let the State make up the difference in funding.

The foundation aid formula thus effectively removes the pressure to levy relatively high tax rates in property-poor school districts. The state formula does not prevent districts from levying higher tax rates if they choose – that choice is still a local one – but under the formula, property-poor school districts are no longer compelled to increase tax rates simply to provide an adequate level of per pupil funding.

Therefore, a weakness shared by all three proposals is their incorporation of substantial property tax relief. Since this relief is unnecessary, even for property-poor school districts, any new tax revenues should be redirected to fund other state financial commitments.

Additionally, each reform proposal has particular benefits and risks based on its specific sources and uses of funds.

**Tax Reform Proposals**  
**Benefits and Risks**

<i>Proposal</i>	<i>Benefits</i>	<i>Risks</i>
<b>2003 Plan</b>	<ul style="list-style-type: none"> <li>-Policy of moving to median tax rates in the nation is easy to understand</li> <li>-Does not require major overhaul of current tax system</li> <li>-Inclusion of food in sales tax base will make sales tax more stable source of revenue</li> <li>-Inclusion of most services will tie proposal closely to state economic activity</li> <li>-Expanded sales tax base benefits local government and transit agencies</li> </ul>	<ul style="list-style-type: none"> <li>-Issues with moving from local to state control of school funding (pension lessons)</li> <li>-Policy of moving to median tax rates in the nation is not based on good tax policy, just “what everyone else is doing”</li> <li>-Greatest extension of sales tax base of all three reform proposals – potential resistance to expansion, especially issues of “fairness” surrounding sales tax on food</li> <li>-Inclusion of professional services in sales tax base will lead to pyramiding of tax burden; also difficult to identify where professional services are consumed</li> <li>-Does not address structural deficit</li> </ul>
<b>HB 750</b>	<ul style="list-style-type: none"> <li>-Generates greatest revenue of all three reform proposals</li> <li>-Does not require major overhaul of current tax system</li> <li>-Creation of new refundable tax credit is more useful to low and moderate income families than increasing personal exemption</li> <li>-Addresses structural deficit as well as increased school funding</li> <li>-Expanded sales tax base benefits local government and transit agencies</li> </ul>	<ul style="list-style-type: none"> <li>-Issues with moving from local to state control of school funding (pension lessons)</li> <li>-Proposes highest rates of all three reform proposals for personal income, corporate income and sales taxes</li> <li>-Provides unnecessary increased funding for local governments – monies would be better spent fulfilling state financial obligations</li> </ul>
<b>Gross Receipts Plan</b>	<ul style="list-style-type: none"> <li>-Creates very broad, very low tax that automatically adjusts to changes in economy</li> <li>-Reduces sales tax burden</li> </ul>	<ul style="list-style-type: none"> <li>-Issues with moving from local to state control of school funding (pension lessons)</li> <li>-Pyramiding of tax through distribution chain (no input credit)</li> <li>-Increases price of exports: tax on exports, none on imports</li> <li>-Impact on high volume, low margin businesses</li> <li>-Lack of transparency (hidden tax)</li> <li>-Does not address structural deficit</li> </ul>

#### IV. An Alternative Approach to State Finance

If a statewide tax increase is inevitable, an alternative approach would be to take elements from the proposals described above, and use the funds generated to fund the state obligations detailed earlier in this report. Such a tax proposal might consist of the following elements:

1. Increase the personal income tax rate from 3% to 4% (rather than the 5% proposed by the CTBA), apply the tax to retirement income over \$75,000 and create a new family tax credit for low and moderate income workers. The net revenue effect would be about **\$2.5 billion** (assuming no sharing of the increase with local governments; current local share is 10%).

2. Increase the corporate income tax rate from 4.8% to 6.4% -- generating about **\$500 million** -- and producing a total corporate tax rate of 8.9%. The ratio of a 6.4% corporate income tax rate and a 4% personal income tax rate is aligned with the State constitution's cap on the corporate-to-personal income tax rate at an 8-to-5 ratio (Illinois State Constitution, Article IX, Section 3). Additionally, an increase in the corporate income tax would guarantee that business "shares the burden" of the tax increases necessary to cover the State's deficit.

3. Expand the state sales tax *base* to include personal, entertainment and other consumer services. The revenue effect would be about **\$2 billion**.

The revenues thus raised would be approximately **\$5 billion**. These revenues could be used to fund the gap between current state revenues and total state expenses, including financial obligations to fund pensions, employee/retiree health care, Medicaid costs and the foundation level of school funding.

The rationale behind such a tax reform proposal would be to raise additional revenue to cover the current funding gap, connect the State's tax base more closely to underlying economic activity, and to "cushion" low income workers from tax increases.

The increase in the personal income tax rate from 3% to 4% would be offset for low and moderate income workers by the creation of a new family tax credit. Expanding the State sales tax base to include consumer services would tie it more closely to the growing services sector.

The revenue generated from tax changes under this proposal would not be "spent" on unnecessary property tax relief. Instead, the additional monies would go to fund the State's pension funds, employee/retiree health care and Medicaid obligations, and to increase school funding to the EFAB-recommended foundation level.

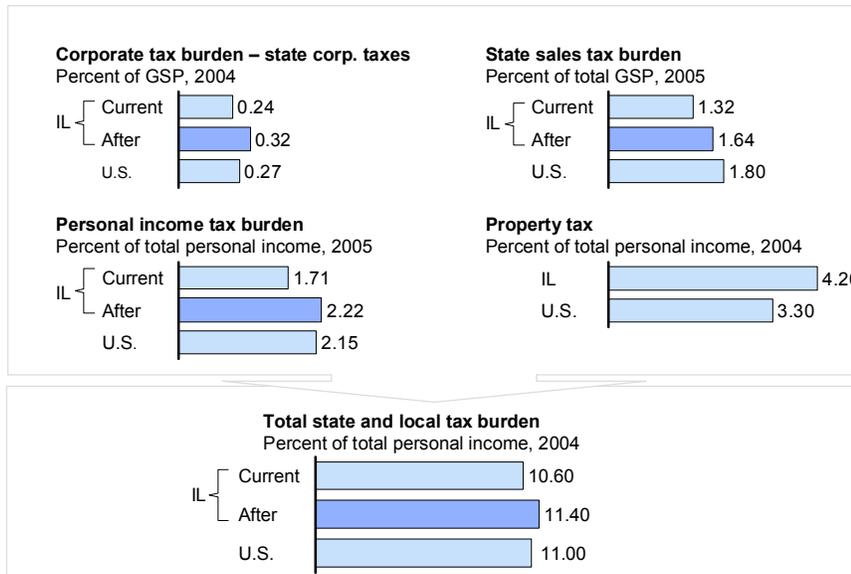
Additionally, local governments and transit agencies would benefit from the expansion of the sales tax base envisioned under this proposal. The average total sales tax in Illinois is 7.55%. Of this total, 5.0% goes to the State and 2.55% goes to local

government and transit agencies. Local government and transit agencies would benefit from the application of this 2.55% rate to the expanded sales tax base, which would generate about \$1 billion in additional revenue. This additional revenue should be used to cover the same kind of pension gaps at the local level that have been described for the state.

Since about half of this additional sales tax revenue (\$.5 billion) would be collected by the State (the 1.25% “local” component of the state and local sales tax rate of 6.25%), the State should set parameters for the use of these additional revenues. For example, creating a mechanism for *guaranteeing* that at least \$.5 billion of the additional local government and transit agency revenue went to funding local pensions and other obligations, rather than new programs, would be an important component of this tax reform proposal.

Any tax increase will hurt the State’s competitive position; and the impact of this alternative approach cannot be estimated with precision. However, it appears that the increased sales tax burden on individuals and corporations in Illinois under such a tax proposal would remain below the national average, while the corporate and personal income tax burden would move from somewhat below average to somewhat above average. Overall, the total state and local tax burden would move to slightly above the national average tax burden.

**TAX BURDEN COMPARISON:  
CURRENT VS. AFTER HYPOTHETICAL TAX INCREASE\***



\* Tax burden after hypothetical tax increase is calculated by estimated tax levied in 2007 assuming GSP/total personal income grow at 4.1% annually plus tax revenue increase after reform, then divided by estimated 2007 GSP/total personal income

Source: US Census; Bureau of Economic Analysis; Tax Foundation; McKinsey analysis

## **V. Recommendations of the Task Force on State Finance of the Civic Committee of The Commercial Club of Chicago**

The debate over state finance should not be postponed any longer. We expect that public debate will grow as the State Legislature, during the spring of 2007, addresses the next State budget, for FY 2008. The Task Force on State Finance of the Civic Committee makes the following findings and recommendations:

1. Illinois should not – and cannot – continue to incur annual costs, including increased obligations, that vastly exceed its own-source annual revenues. Shifting costs to future generations of taxpayers by borrowing or by ignoring the costs of government today is fundamentally irresponsible. These practices inherently lead to waste and inefficiency. They should stop.

2. Good government in a democracy involves making hard choices. The citizens who live in Illinois and pay taxes here, and the businesses located here, all must make such choices. Their government should do no less. Avoiding such choices undercuts democracy.

3. Illinois should keep its obligations and commitments to those who have worked for it and who will work for it in the future. Failure to fund adequately to cover such obligations is unfair to employees whose rights have vested.

4. The private sector is forced by competitive realities to trim or hold down costs in the areas of retirement benefits and employee and retiree health care costs. The public sector should not continue to maintain pension and health care programs for state employees that are more generous than private-sector employees. The programs that have led to the current State fiscal crisis should be trimmed, and costs should be reduced. Some examples of ways to cut costs are set forth in this report. Cutting costs of state government and state programs should be the first resort – not the last resort.

5. More money should not be injected into the operation of school districts such as Chicago without fundamental reforms to improve accountability and transparency, and to create more competition and choices within the districts. In Chicago, the cap on charter schools should be eliminated. It would be little short of tragic if the opportunity to achieve fundamental reforms in K-12 education – at the same time taxes were increased – were somehow lost.

6. Reforms and efficiencies in state programs will probably not be adequate to enable Illinois to keep the commitments it has already made – to its employees, retirees, and school families. In the context of the State's current precarious financial condition, and the projected trends in both revenues and expenses, a significant tax increase appears inevitable if the State is to maintain access to public debt markets, and to avoid a massive cut in State services and outlays, and possibly even bankruptcy. As pointed out earlier, however, any tax increase should only be considered as part of a program to achieve

fundamental reform in all aspects of the operation of State government, and particularly with respect to schools.

7. The proceeds of any statewide tax increases should not be used to pay for a property “tax swap,” but to cover the costs of the commitments the State has already made, including the commitment to maintain local spending among poorer school districts at a minimum “foundation level.” Reducing local property taxes and paying for the lost revenue through statewide taxes would tend to centralize control over local education at the state level. This would be a bad result.

8. The proceeds of any increased taxes should be first committed to satisfying and funding the State’s growing obligations which have necessitated the increases. Such increased monies should not be spent for new programs, however popular, if the effect is to increase further the State’s already-existing unfunded obligations.

Respectfully submitted,

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