It Is All About Revenue: A Common Sense Solution for Illinois’ Fiscal Solvency

September 9, 2015

1. RESOLVING ILLINOIS’ LONGSTANDING FISCAL SHORTCOMING REQUIRES BOTH REVENUE POLICY REFORM AND PENSION DEBT REAMORTIZATION: OVERSPENDING ON CURRENT SERVICES IS NOT THE PROBLEM

According to the Illinois Comptroller’s Office, Illinois has run a deficit in its General Fund every fiscal year since at least 1991, the first year for which records are available. This is a cause for concern, since $9 out of every $10 in General Fund spending on services goes to the four, core services of education, healthcare, human services, and public safety. Given the importance of those four core areas to the quality of life and economic viability of communities across the state, identifying and then resolving the actual cause of Illinois’ historic fiscal shortcomings is crucial. Based on the General Fund budget proposals introduced for Fiscal Year (FY) 2016, you would think overspending on services is a primary driver of these deficits.

That’s because both Governor Rauner and the Democrats in the General Assembly have proposed budget plans for FY2016 which cut spending on services from FY2015 levels. In nominal, non-inflation adjusted dollars, the Governor proposes cutting spending by $1.85 billion, while the budget approved by the Democrats cuts spending by $592 million. Yet, despite the significant year-to-year spending cuts on the table, both FY2016 budget proposals nonetheless increase the accumulated General Fund deficit by billions of dollars. How can that be? The data make the answer clear: spending on services is simply not the driver of Illinois’ ongoing General Fund deficits. Instead, these deficits are driven first and foremost by poor tax policy. Indeed, the state’s tax policy functions so poorly that annual revenue growth is generally insufficient to cover service cost growth from one fiscal year to the next, adjusting solely for inflation.

Rather than deal with changing tax policy to generate adequate revenue to fund core services, decision makers, for decades, have chosen instead to borrow against what was owed to the pension systems, and use this borrowed revenue to subsidize a portion of the cost of delivering current services that could not be supported by current tax revenue. This in turn led decision makers to create the second major driver of the state’s fiscal shortcoming—an unattainable, unaffordable repayment schedule for the billions of dollars in debt the state borrowed from its five pension systems.

2. ILLINOIS IS A LOW SPENDING STATE—that has been reducing spending on services over time

When compared to the rest of the nation, Illinois is low spending. Consider that Illinois has the fifth largest population and Gross Domestic Product (GDP) of any state. Despite that, Illinois ranked 28th in General Fund spending on services per capita and 36th in General Fund spending on services as a share of GDP in FY2012, the last year for which there is a national comparison. Illinois also ranks 49th out of 50 states in number of state workers per capita. No matter the metric chosen, then, Illinois is relatively low spending on current services.
As shown in Figure 1, after adjusting for inflation and population growth, General Fund appropriations for the four, core service areas of education, healthcare, social services, and public safety have declined by over 26 percent since FY2000.

**Figure 1**

Change in General Fund Appropriations from FY2000 to FY2015 (excluding Group Health)

Note: Healthcare spending was adjusted using the Midwest Medical Care CPI, all other categories of spending adjusted using the CPI or ECI. All categories of spending were adjusted for population growth. FY2015 appropriations exclude $400 million from the Fund for Advancement of Education and the Commitment to Human Services Fund.


More recently, the cuts to General Fund spending on current services have continued, even in nominal, non-inflation adjusted terms. Indeed, as shown in Figure 2, over the FY2009 through FY2015 sequence, General Fund spending on current services is down by some $2.6 billion (9.5 percent) in nominal, non-inflation adjusted dollars.

**Figure 2**

Change in Net General Fund Budgeted Appropriations for Current Services During Recovery—Post Great Recession (Nominal, non inflation-adjusted dollars)

The minor uptick in General Fund spending that occurred from FY2013 to FY2014 that is shown in Figure 2 is entirely attributable to two items. First, a number of cuts to the state’s Medicaid program previously enacted as part of the “SMART” Act were either disallowed by the federal government or overturned by state decision makers because they were not cost effective in the long term. Second, the state has never budgeted for its full Group Health liability cost (Group Health is the insurance program covering state workers), but did increase its appropriation in FY2014 to bring the budgeted amount closer to the actual liability.

Given how low Illinois ranks in General Fund spending on services nationally, and the clear trend of the state to reduce its real spending on current services over the last 15 years, it is simply not credible to argue that Illinois’ fiscal problems are driven by overspending. If anything, the evidence indicates that Illinois is in all likelihood not satisfying its demographically driven demand for core services.

### 3. FLAWED TAX POLICY IS THE PRIMARY DRIVER OF ILLINOIS’ RECURRING BUDGET CRISES

#### 3.1 Illinois’ Flawed Tax System Creates a Structural Deficit in its General Fund

As all the data show, overspending on state services is not the cause of the state’s long-term fiscal problems. Rather, the driver has been Illinois’ flawed tax code, which does not comport with the modern economy, and therefore has historically failed to generate adequate tax revenue to sustain funding on core services at the same level from year-to-year.

This ongoing mismatch between annual growth in the state’s revenue sources (which underperforms what would be generated by sound tax policy because Illinois’ tax code is not designed to match activity in the modern economy), and the cost of maintaining service levels from one fiscal year to the next (adjusting solely for increases in inflation and population) is commonly referred to as a “structural deficit.” Figure 3 below shows the structural deficit in the Illinois General Fund budget.

![Figure 3: Illinois State General Fund Structural Deficit ($ Millions)](image)

Note that the structural deficit depicted in Figure 3 assumes:

(i) a balanced FY2015 budget (in reality the General Fund ended FY2015 with an accumulated deficit of $5.9 billion);

(ii) the state maintains constant spending on services in real terms through FY2025, meaning that there are no changes in law and no programs are expanded or added;

(iii) that revenue continues to grow at historic rates.
It should also be noted that the revenue declines depicted in Figure 3 in FY2015 and FY2025 are due to the scheduled phase down of the temporary income tax rate increases previously enacted under the Taxpayer Accountability and Budget Stabilization Act (TABSA).

The first such phase down occurred on January 1, 2015, when the personal income tax rate went from five percent down to 3.75 percent, and the corporate income tax rate declined from seven percent to 5.25 percent.

Because of the structural deficit, even if the state’s current General Fund budget was balanced in FY2015, the future expansion of the Illinois economy returned to the historic rates realized before the Great Recession, and the state did not increase or expand any services it provides—the accumulation of General Fund deficits will not only persist, it will worsen. Essentially, Illinois’ current tax system is so flawed that the state lacks the fiscal capacity to maintain its current, and relative to other states, low investment levels in the four, core services of education, healthcare, human services, and public safety.

The only sustainable path to eliminating this structural deficit without imposing significant additional cuts to those four, core services involves:

(i) modernizing Illinois tax policy to generate adequate recurring, sustainable tax revenue; and

(ii) re-amortizing the debt Illinois owes to its five pension systems.

3.2 How Pension Debt Fits In

While spending on current services is not responsible for increasing the ongoing accumulated General Fund deficit in Illinois, spending on debt service is a contributing factor—in particular debt service owed to the state’s five pension systems, as shown in Figure 4.

**Figure 4**
Budgeted Appropriations for Hard Costs (FY2004-FY2016)

Note how, in Figure 4, the state’s General Fund contribution to its five pension funds increases from $1.4 billion in FY2004 to a projected $6.8 billion for FY2016. Virtually all of that $5.4 billion in growth is due to the debt service component of the pension contribution established under current law to repay the $111 billion in unfunded liability.
owed to the five state pension systems.\textsuperscript{16} To be clear, the growth in annual pension contributions revealed in Figure 4 is not due to the normal cost of funding current benefits, which has held relatively steady at $1.2$-$1.6 billion annually over the FY2004-FY2016 sequence.\textsuperscript{17}

The primary reason the state ran up so much debt to its pension systems is the structural deficit referenced above. For generations, because of its structural deficit, Illinois’ revenue growth was insufficient to maintain service levels from year-to-year. But because the politics of revenue policy are so divisive, Illinois decision makers in both parties elected to avoid modernizing the state tax code to generate adequate revenue to sustain services and eliminate the structural deficit. Instead, they chose to paper over the imbalance between revenue and service cost growth, by borrowing against what was owed to the pension systems, and using that borrowed revenue to subsidize the cost of providing current services.

This irresponsible fiscal practice became such standard operating procedure that it was codified into law as part of the “Pension Ramp” that passed in 1994.\textsuperscript{18} Under the Pension Ramp, the state—now by statute—continued the practice of borrowing against the pension systems to subsidize the cost of current services, for the first 15 years following its enactment. Then, in out-years the Pension Ramp called for an incredibly back loaded repayment schedule, which grew in unattainable, unaffordable annual increments, as shown in Figure 5.

The existing Pension Ramp creates such an unrealistic repayment schedule that it would continue to strain the state’s fiscal capacity even after modernizing Illinois tax policy. Hence, resolving Illinois’ structural deficit requires that, in addition to implementing the tax reforms identified in Section 4 of this Report, Illinois must also re-amortize the debt it owes to its pension systems, to create a realistic repayment structure. Such a re-amortization schedule is delineated in Section 5 of this Report.
4. REVENUE PROPOSAL: A RATIONAL PATHWAY TO FISCAL SOLVENCY

After the phase down in the personal and corporate income tax rates under TABSA that occurred on January 1, 2015, Illinois realized a loss of nearly $5 billion in recurring tax revenue. This revenue loss was ignored in the FY2016 budget plans proposed by both Governor Rauner and the Democrat controlled General Assembly. Ignoring that loss of revenue is why the accumulated deficit in the General Fund would grow from $5.9 billion at the end of FY2015 to over $9 billion by the end of FY2016 under either proposal—despite the material cuts to spending on current services contained in each one.

Clearly, spending cuts are not stabilizing the state’s finances. Indeed, the data indicate that the only sustainable route to eliminating the structural deficit is through a combination of generating enhanced revenue through tax policy modernization and re-amortizing the pension debt repayment schedule.

Moreover, the data indicate Illinois has the capacity as a state to raise taxes without becoming high tax. That is because Illinois has one of the lowest combined state and local tax burdens as a percentage of income of any state in the nation. That low ranking in tax burden, despite having the fifth highest population and fifth greatest economy of any state in the nation, indicate that Illinois has the capacity to increase tax revenue and still remain relatively low tax. For context, consider that a state tax increase that generates $7 billion in new, recurring annual revenue would represent a cost that is less than one percent of Illinois’ $746 billion state GDP.

When it comes to modernizing the Illinois tax code, there are a number of common sense, data-driven initiatives that get the job done—and still keep Illinois relatively low tax. The state can completely eliminate its structural deficit by making the following tax policy reforms (and re-amortizing its pension debt as detailed in Section 5):

(i) Reform state income tax policy by:
   • Increasing the personal income tax rate from 3.75 percent to 4.75 percent or 5 percent;
   • Including some retirement income in the personal income tax base;
   • Increasing the corporate income tax rate from 5.25 percent to 6 percent;
(ii) Eliminate those corporate tax expenditures which are not generating a public good;
(iii) Reform sales tax policy by expanding the base of sales tax to include most consumer services; and
(iv) Impose a tax on sugary sweetened beverages.

4.1 Income Tax Reform

4.1.1 Personal Income Tax

On January 1, 2015, the temporary increases made to Illinois’ personal and corporate income tax rates that became law under TABSA began to phase down. Consider the personal income tax rate first, which declined from five percent to 3.75 percent. While this reduction in the personal income tax rate was billed as tax relief that would put more money in the pockets of middle class and low income Illinois families, the data indicate otherwise. Indeed, when the numbers are crunched, it is clear that the tax relief from the phase down of the personal income tax rate primarily benefitted the wealthiest in the state.

Of the $3.7 billion plus in personal income tax relief under the phase down, over $2 billion (54.4 percent), went to the top 11.8 percent of income earners in the state, while the bottom 60 percent of Illinois taxpayers received just $491 million (13 percent) of the tax relief. Millionaires fared particularly well, receiving an average annual tax break of nearly $37,000, an amount that is not only 70 times greater than the tax relief realized by Illinois workers with $50,000 or less in annual taxable income, but is more than the total yearly taxable income of the bottom 60 percent of Illinois taxpayers.

Because those with higher incomes (who receive the majority of the tax relief due to the phase down) are more likely to save each additional dollar of income they receive than spend it, this tax relief cannot be expected to have a significant stimulative impact on the state’s economy. Indeed, any positive stimulative impact will likely be more than offset by cuts to public services like those contained in the budget plans proposed by the Governor and the General Assembly.
Essentially, the income tax phase down under TABSA offers little in the way of economic stimulus, at a high cost to the state (in the form of billions in foregone tax revenue). Raising the personal income tax rate would go a long way towards stabilizing the state’s finances and enabling Illinois to better invest in core public services for all residents, without imposing a significant burden on low- and middle-income earners.

The fairest, textbook way to raise additional income tax revenue would be to switch from a flat income tax rate to a graduated rate structure. Under a graduated structure, all taxpayers pay a lower tax rate on lower levels of income and a higher tax rate on higher levels of income. This allows income tax burden to track ability to pay. Furthermore, a graduated income tax can be designed to offset the regressivity of other taxes (like property and sales) imposed by state and local governments. Making the state tax burden fairer should be on the to do list of Illinois policymakers, given that Illinois, despite being low tax overall, is nonetheless one of the five most unfair (that is, regressive), taxing states in America. Hence, implementing a thoughtful, graduated income tax would both raise revenue and make Illinois’ overall tax burden fairer.

However, switching to a graduated rate structure is not as simple as having the General Assembly pass a law. That is because the Illinois Constitution prohibits lawmakers from setting marginal rates at different amounts for different levels of income, instead mandating a flat tax rate across all income brackets. Hence, to create a graduated rate structure in its personal income tax, Illinois must amend its Constitution.

So, while a graduated income tax rate structure should be pursued as a long-term goal, the state’s current revenue shortfall requires immediate legislative action. Therefore, decision makers should increase the personal income tax rate to either 4.75 percent or 5 percent, a relatively modest increase from the current level of 3.75 percent. This would generate roughly $3.3 billion or $4.2 billion, respectively, in additional net revenue, as shown in Figure 6 and Figure 7 below.

**Figure 6**

<table>
<thead>
<tr>
<th>Personal Income Tax Revenue at 4.75% Compared to 3.75% ($ Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COGFA estimate at 3.75%</strong></td>
</tr>
<tr>
<td>Personal Income Tax (gross)</td>
</tr>
<tr>
<td>Personal income tax refund amount</td>
</tr>
<tr>
<td>Fund for Advancement of Education</td>
</tr>
<tr>
<td>Commitment to Human Services Fund</td>
</tr>
<tr>
<td>Net Personal Income Tax Revenue</td>
</tr>
<tr>
<td>Source: CTBA analysis of COGFA data</td>
</tr>
</tbody>
</table>

Although it is essential that Illinois increase its current personal income tax rate to get its fiscal house in order, because that increase has to be to one, flat rate that applies to all levels of income, this reform will not enhance tax fairness. However, for low- to middle-income families the impact of any increase in the Illinois personal income tax rate can be offset through creation of new, or expansion of existing, refundable income tax credits like Earned Income Tax Credits or “EITC.” This is a very effective and targeted way to provide tax relief and create more tax fairness, despite Illinois being constitutionally required to utilize only one, flat income tax rate.

**Figure 7**

<table>
<thead>
<tr>
<th>Personal Income Tax Revenue at 5% Compared to 3.75% ($ Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COGFA estimate at 3.75%</strong></td>
</tr>
<tr>
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4.1.2 Include Some Retirement Income in the Income Tax Base

Of the 41 states with a personal income tax, Illinois is one of only three that does not tax any retirement income. This is too broad of an exclusion, given that by 2030, roughly 18 percent of the state’s population will be post retirement age. That said, as indicated previously, Illinois is one of the five most unfair taxing states in America, so care must be given that any inclusion of retirement income in the state’s income tax base does not create an additional burden for low and fixed income seniors. Given those counter-vailing factors, it is still possible for Illinois to begin including some retirement income in its income tax base, without harming low, fixed income seniors.

This could be accomplished by phasing out the full deduction for all retirement income on a graduated basis, predicated on a taxpayer’s adjusted gross income (AGI), in a manner that ensures no low income senior is harmed. Indeed, under this approach, any taxpayer whose AGI is less than $50,000 would keep the full deduction, and pay no state income tax on his or her retirement income. Figure 8 shows how the deduction for retirement income could be phased out in a slow, graduated fashion.

Taxing retirement income in the manner delineated in Figure 8 would raise $1.05 billion in new revenue at a 4.75 percent income tax rate. If the personal income tax rate was set at 5 percent, it would raise $1.10 billion.

### Figure 8

<table>
<thead>
<tr>
<th>AGI Bracket</th>
<th>Revenue @ 4.75%</th>
<th>Revenue @ 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50,000 or LESS</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>$50,001-$75,000</td>
<td>$103,119,364</td>
<td>$108,546,699</td>
</tr>
<tr>
<td>$75,001-$100,000</td>
<td>$198,830,358</td>
<td>$209,295,113</td>
</tr>
<tr>
<td>$100,001-$150,000</td>
<td>$355,190,595</td>
<td>$373,884,837</td>
</tr>
<tr>
<td>$150,001 or MORE</td>
<td>$588,725,002</td>
<td>$619,710,529</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,245,865,319</strong></td>
<td><strong>$1,311,437,178</strong></td>
</tr>
<tr>
<td>Fund for Advancement of Education</td>
<td>$37,375,960</td>
<td>$39,343,115</td>
</tr>
<tr>
<td>Commitment to Human Services Fund</td>
<td>$37,375,960</td>
<td>$39,343,115</td>
</tr>
<tr>
<td><strong>NET REVENUE</strong></td>
<td><strong>$1,046,526,868</strong></td>
<td><strong>$1,101,607,229</strong></td>
</tr>
</tbody>
</table>


### 4.2 Corporate Income Tax Rate

The corporate income tax rate should be increased to 6 percent, a 0.75 percentage point increase from its current rate of 5.25 percent, but still less than the 7 percent that pertained in tax years 2011-2014. Increasing the corporate income tax rate to 6 percent would raise over $385.7 million in additional revenue for the state.

Note that, as shown in Figure 9, increasing the state’s corporate income tax rate to 6 percent still results in Illinois having a relatively low corporate income tax rate.

### Figure 9

<table>
<thead>
<tr>
<th>Midwest</th>
<th>Other Big States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iowa: 6% - 12% (12% at $250,000)</td>
<td>Pennsylvania: 9.99%</td>
</tr>
<tr>
<td>Indiana: 8.5%</td>
<td>New Jersey: 9%</td>
</tr>
<tr>
<td>Wisconsin: 7.9%</td>
<td>California: 8.84%</td>
</tr>
<tr>
<td>Missouri: 6.25%</td>
<td>New York: 7.1%</td>
</tr>
<tr>
<td>Kentucky: 4% - 6% (6% at $100,000)</td>
<td>Florida: 5.5%</td>
</tr>
<tr>
<td>Michigan: 4.9%</td>
<td></td>
</tr>
</tbody>
</table>
Moreover, very few businesses in Illinois will be impacted by this rate increase, virtually none of them small.33 Indeed, in the last year for which there are data, roughly 70 percent of the corporations in Illinois had zero dollars in state income tax liabilities, and 93 percent had $5,000 or less in annual Illinois state income tax liabilities.34

4.2.1 Eliminate Ineffective Tax Expenditures

Tax breaks offered to businesses are appropriately called “tax expenditures” because in effect, state government is spending public taxpayer money indirectly through the tax code either to produce a public good or service, or to avoid “tax pyramiding.” Tax pyramiding occurs when the same transaction is taxed more than once as it moves through the economy. Examples of corporate tax expenditures granted to avoid inefficient and duplicative tax pyramiding include: the sales tax expenditure granted to businesses for purchases of machinery and equipment used in manufacturing and assembling, and credits from the electricity excise tax.35

Then there are the corporate tax expenditures granted to incentivize businesses to engage in activity that provides a public good or service. There is some credible evidence that certain tax expenditures do, in certain circumstances, incentivize the desired activity—for instance, tax expenditures granted for research and development. The more problematic area involves corporate tax expenditures granted to promote job or economic growth.

Evaluating the efficacy of those corporate tax expenditures granted to stimulate job or economic growth requires determining: (i) whether such tax expenditures generally, or a given tax expenditure specifically, considering the totality of the economy and the state’s existing corporate tax policy, will be likely to produce the desired public good (job creation); and (ii) if it is likely, whether it is providing a tax expenditure (A) the most effective way to generate the desired public good of job creation and (B) the most effective utilization of public taxpayer revenue—compared to say, cancelling a given tax expenditure, collecting what would have been foregone tax revenue and spending it on the provision of direct services?

In some instances, the data clearly demonstrate that the tax expenditures in question either will not or are highly unlikely to stimulate job creation, and thus do not constitute good policy. In fact, some do not even benefit Illinois. Eliminating such ineffective corporate tax expenditures, which cost the state revenue but produce no corresponding public good, should be an essential part of comprehensive tax reform. Following is a list of corporate tax expenditures that do not generate a public good and hence should be eliminated:

- decoupling from the federal domestic activities production deduction;
- decoupling from Federal Accelerated Depreciation; and
- repealing the non-combinational rule that applies to financial organizations, insurance companies, and transportation companies.

Eliminating these tax expenditures would generate approximately $426 million in new revenue in FY2016, at the 6 percent rate.36

4.3 Sales Tax Expansion

Currently, Illinois is one of 45 states that impose a general sales tax.37 A sales tax is usually assessed at a specified percentage (e.g., 5 percent) of the final purchase price of a retail good or service. Sales taxes are typically charged on the final retail sales transaction involving the end-user and generally do not cover many business-to-business transactions nor professional services.38 If the sale of a product or service is subject to the applicable sales tax, then that product or service is in the “base” of said sales tax.

While it is commonly referred to as a singular tax, the Illinois sales tax is actually created under several different sections of the state tax code.39 The sales tax rate for most goods at the state level in Illinois is 5 percent. However, Illinois’ state sales tax rate is usually identified as 6.25 percent. This is because since 1990, the state rate of 5 percent was combined with a local sales tax rate of 1.25 percent.40 Hence, the 6.25 percent sales tax rate is actually made up of a 5 percent state sales tax rate and 1.25 percent standard local government sales tax rate.41 Illinois’ state sales tax rate of 5 percent is below the national average of 5.5 percent.42
Sales taxes can be designed to be significantly less volatile than personal and corporate income taxes, a well-designed sales tax should lower the overall volatility of state revenues, thus providing a more stable revenue source than the income tax. A stable revenue source, like the sales tax, maintains adequate base revenue generation even during poor economic cycles. Stability is also helpful to taxpayers as it provides a level of predictability regarding what they will owe in taxes.

For a sales tax to play its role of generating stable revenue for a fiscal system, it needs to apply broadly to most transactions that occur in the consumer economy. The reasons for this are easy to understand. First, consumer spending is the largest segment of both the nation’s and Illinois’ respective economies, accounting for nearly 70 percent of all economic activity. Second, consumer spending usually does not decline substantially—even during major economic downturns. For instance, during the Great Recession, consumer spending remained relatively constant, with real personal consumption expenditures declining by less than one percent from 2007 through 2010. Hence, if a sales tax base broadly applies to most transactions in the consumer economy, that sales tax will have the capacity to provide some stability to a state’s fiscal system, even when other more volatile/responsive revenues are declining rapidly. In addition, a broadly applicable sales tax is efficient—it does not distort consumer decision-making by exempting, and thereby favoring, one business sector over another.

The “base” of a sales tax is simply the basket of items and services that the tax applies to when sold. In general, Illinois’ sales tax applies to goods (like clothing and furniture) and not services (like pet grooming, health clubs, lawn care, and haircuts).

Indeed, Illinois’ general sales tax only applies to five of the 168 service industry categories identified by the Federation of Tax Administrators in its survey of service taxation. This makes Illinois an outlier among the 45 states that levy a sales tax on services (among these states, the average number of service industries taxed is 51). In fact, Illinois ranks dead last among the 45 states in the number of service industries subject to its general sales tax. By excluding most services from the sales tax base, Illinois has created a fiscal mismatch between the actual state economy and the portion of the economy taxed to fund public services.

The data make it clear that Illinois’ exclusion of most consumer services from its sales tax base diminishes the ability of the Illinois sales tax to generate adequate revenue. Consider, for instance, that in 1965, the sale of services accounted for 51 percent of all economic activity in Illinois, while the sale of goods accounted for 41 percent. Over the next half century, the Illinois economy greatly changed. As shown in Figure 10, by 2012, the sale of services increased to represent 72 percent of the state’s economy, while the sale of goods declined significantly, accounting for just 17 percent of the Illinois economy. Put another way, the base of Illinois’ sales tax lost more than half of its value, measured as a share of Illinois’ economy, over the last four decades.

![Figure 10](image-url)  
**Figure 10**  

Source: Bureau of Economic Analysis
Just as Illinois’ overall economy has changed dramatically, national household consumption patterns have also shifted over time. Services now take up a greater share of household consumption than goods. While Illinois’ economic base and household consumption have shifted dramatically over the last three decades from goods to services, there has been no corresponding change in Illinois’ tax structure. Simply put, the Illinois sales tax base has not been adjusted to reflect either changing consumption or economic patterns.

Therefore, to modernize its sales tax and generate revenue in a stable fashion that comports to modern consumption and economic patterns, decision makers should expand the base of the Illinois sales tax to include consumer services. Expanding the sales tax base to include consumer services—while continuing to exclude professional and business-to-business services (for a detailed description of why those services should be excluded, please see the report “Expanding the Base of Illinois’ Sales Tax to Consumer Services Will Both Modernize State Tax Policy and Help Stabilize Revenue” which CTBA coauthored with the Taxpayers’ Federation of Illinois)—would generate nearly $2.1 billion more in sales tax revenue than is generated with the current base, as show in Figure 11. Moreover, local units of government would receive an additional $529 million more in sales tax revenue than the $2.0 billion that is generated with the current base.

### Figure 11
Expanding the Sales Tax Base to Include Consumer Services (\$ Billions)

<table>
<thead>
<tr>
<th>Consumer Services Excluding Business to Business and Professional Services</th>
<th>COGFA FY2011 Estimates</th>
<th>FY2016 Estimate, General Fund Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$1,949.9</td>
<td>$2,099.4</td>
</tr>
</tbody>
</table>

Source: CTBA analysis of COGFA data

#### 4.4 Tax Sugar-Sweetened Beverages

A potential new source of tax revenue for the state to consider which would, like the expansion of the sales tax base referenced above, recognize modern consumption trends, involves levying a tax on sugar-sweetened beverages (i.e. soda pop, sports drinks, energy drinks). Such a tax would help offset various public costs associated with obesity, while promoting a healthier lifestyle.

Earlier this year, the Healthy Eating Active Living (HEAL) Act was introduced into the Illinois House of Representatives and Senate by state Representative Robyn Gabel (D-Evanston) and state Senator Mattie Hunter (D-Chicago) respectively. The bill, which would place a one cent tax on each ounce of sugar contained in food and drink sold in Illinois, would raise $600 million in annual revenue for the General Fund.

#### 4.5 Total New Revenue from Proposals in this Study

If Illinois were to increase income taxes to 4.75 percent, tax some retirement income, expand the sales tax base to include most consumer services, eliminate the tax expenditures noted above, and impose a new tax on sugary beverages, the state would raise over $7.9 billion in new revenue in FY2016, as illustrated in Figure 12.

### Figure 12
Proposal for Additional Revenue; Personal Income Tax Rate at 4.75% (\$ Millions)

<table>
<thead>
<tr>
<th>CTBA Proposal</th>
<th>Additional Revenue (FY2016)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase the Personal Income Tax to 4.75%</td>
<td>$3,339.6</td>
</tr>
<tr>
<td>Tax Some Retirement Income at 4.75%</td>
<td>$1,046.5</td>
</tr>
<tr>
<td>Increase the Corporate Income Tax to 6%</td>
<td>$385.7</td>
</tr>
<tr>
<td>Expand the Sales Tax Base</td>
<td>$2,099.4</td>
</tr>
<tr>
<td>Tax Sugar-Sweetened Beverages</td>
<td>$607.3</td>
</tr>
<tr>
<td>Eliminate Tax Expenditures</td>
<td>$426.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$7,904.5</strong></td>
</tr>
</tbody>
</table>
If the state were to increase income taxes to 5 percent, tax some retirement income, expand the sales tax base to include most consumer services, eliminate the tax expenditures, and impose a tax on sugary beverages as noted above, the state would raise nearly $8.8 billion in new revenue in FY2016, as illustrated in Figure 13.

While the amount of new annual revenue that would be generated under the proposals identified in this study is significant, in the context of the Illinois economy it is a relatively small tax increase. In 2014, Illinois’ state-level GDP was $746 billion. This means the larger of the tax increase suggested above would amount to just over one percent of the state’s economy.

### 5. PENSION RE-AMORTIZATION

If the state were to reform its tax policy as suggested previously in this Report, but failed to address the current repayment schedule for its pension debt, Illinois would continue to experience fiscal problems. While modernizing Illinois’ flawed tax system represents the first and most crucial step needed to resolve the state’s fiscal issues, to eliminate the entire structural deficit, one more reform is needed: re-amortizing the debt owed to the state’s five pension systems.

The current legislation covering repayment of the unfunded pension liability is the Pension Ramp, which was codified in Public Act 88-593 in 1994. As referenced previously (and illustrated in Figure 5), by design the Pension Ramp significantly back-loaded the cost of repaying the pension debt. While this approach alleviated the structural deficit for the first 15 years after enactment, by permitting elected officials to continue the irresponsible practice of underfunding the pensions during that time period, it simultaneously exacerbated the structural deficit over the long term by requiring payments in future years to escalate annually in unaffordable increments.

To date, most of the attempts to resolve the unfunded liability in the state’s five pension systems have focused on cutting retirement benefits for public sector workers, rather than re-amortizing the pension debt. This focus, however, is doomed to fail for two fundamental reasons. First, under the plain language of the Illinois Constitution, retirement benefits for public workers cannot be “diminished or impaired.” Illinois Supreme Court decisions—including one issued earlier this year—have consistently ruled that the constitutional prohibition on “diminishing or impairing” retirement benefits means precisely what it says. Hence, attempts to cut benefits are unconstitutional.

Second, benefits offered under the state retirement systems are neither the cause of the unfunded liability to begin with, nor what is creating the significant pressure on the state’s fiscal system. All the data compellingly demonstrate that the largest cause of the unfunded liability is the significant borrowing against the pension contributions that occurred over at least the last 25 years—while the cause of the pressure on the state fiscal system is the back loaded repayment schedule for that debt enacted under the Pension Ramp. Given that benefits cannot be cut constitutionally, the only viable option for resolving the significant unfunded liability owed to the state’s pension systems is to re-amortize the repayment schedule created under the Pension Ramp in a manner that:

<table>
<thead>
<tr>
<th>CTBA Proposal</th>
<th>Additional Revenue (FY2016)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase the Personal Income Tax to 5%</td>
<td>$4,166.5</td>
</tr>
<tr>
<td>Tax Some Retirement Income at 5%</td>
<td>$1,101.6</td>
</tr>
<tr>
<td>Increase the Corporate Income Tax to 6%</td>
<td>$385.7</td>
</tr>
<tr>
<td>Expand the Sales Tax Base</td>
<td>$2,099.4</td>
</tr>
<tr>
<td>Tax Sugar-Sweetened Beverages</td>
<td>$607.3</td>
</tr>
<tr>
<td>Eliminate Tax Expenditures</td>
<td>$426.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,786.5</strong></td>
</tr>
</tbody>
</table>
(i) increases the funded ratios of the five systems annually to the point that they become healthy; 
(ii) accomplishes that growth in funded ratio even after accounting for all cash flow obligations of the systems to pay benefits to current and future retirees; and 
(iii) is affordable, given the other demands on current tax revenue to fund core services.

Re-amortization is simply changing the annual repayment schedule for the pension debt Illinois owes. The most effective approach to re-amortizing the state’s pension debt is to ditch the politically devised, backloading of the repayment, and instead smooth the obligation out into annual payments that are level, akin to a traditional, fixed rate mortgage.

A level dollar approach to paying off unfunded liabilities is advantageous because the state’s repayment obligation stays the same from year-to-year in nominal dollars. This means that in real, inflation adjusted dollars, the annual contribution actually becomes a declining financial obligation over time. CTBA has run the numbers, and Illinois can resolve its unfunded liability, grow its funded ratio, meet all system cash flow obligations to pay retirement benefits, and free up substantial current revenue to fund current services by utilizing a level dollar annual repayment of its pension debt of approximately $7.014 billion.

In addition to making that aforesaid amount of level dollar debt service, the state would have to make its annual employer normal cost contribution in full, which is an additional $1.97 billion in FY2016 and is projected to decrease over time. In addition, General Fund revenue that is currently spent on the debt service from the 2010 and 2011 pension obligation bonds will become additional contributions to the pension systems once those bonds are retired—$364 million in FY2019, and $1 billion each year after until the systems are each 100 percent funded.

Figure 14 compares the proposed pension re-amortization scenario delineated in this report to the state’s required contributions under current law. The pension re-amortization scenario in Figure 14 includes the contributions from retired pension obligation bonds (POB).

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![Figure 14](image-url)

**Figure 14**
Pension Fund Contributions under Current Law, Compared to CTBA’s Pension Re-Amortization Proposal ($ Millions)

The required contributions (including the POB amounts) under the re-amortization plan identified in this report would be higher than current law until FY2027, after which point they would be less than required under the Pension Ramp. The contributions under the re-amortized level dollar schedule (shown in purple) are projected to
decline over time because of the reduced benefits under the state’s “Tier-II” retirement system that are applicable to anyone hired on or after January 1, 2011.

Under CTBA’s pension proposal, the state's five pension systems would be approximately 72 percent funded by FY2045, putting them on a sustainable path to full funding. In total, contributions over the FY2016-FY2045 sequence would total $280.4 billion (including the POB amounts). This represents a savings of $65.6 billion above what the state’s contributions would be during that time under the current Pension Ramp law, which stands at an estimated $346.1 billion.

6. STRUCTURAL DEFICIT ELIMINATION

If Illinois lawmakers were to make these revenue changes and enact the pension re-amortization plan outlined in this Report, the structural deficit in the state’s General Fund would be eliminated, as shown in Figure 15. In Figure 15, the red line represents the projection for state revenue under current law—which includes the phase down of the income tax rates under TABSA. Meanwhile, the green line is the revised revenue projection for Illinois that would pertain if the proposals outlined in this Report are enacted.

With the structural deficit eliminated and the additional revenue from the changes to state tax policy recommended in this Report, Illinois will have the fiscal capacity to continue to balance its budget into the foreseeable future, make all its re-amortized pension payments, and even invest more in current services, which, by the end of FY2015, have been cut by over 26 percent in real, inflation adjusted dollars since FY2000. For instance, Illinois could significantly enhance its investment in K-12 Education—which is something all the data on school funding indicate is needed to gain both equity and adequacy in education statewide. The brown line in Figure 15 shows that, even after making all its re-amortized pension payments and investing $5.7 billion more annually in K-12 education by FY2019 than it did in FY2015, Illinois would have the capacity to restore cuts previously made to human services and still operate under a balanced budget.
7. CONCLUSION

Despite being one of the wealthiest, most populous states in the nation, Illinois continually struggles to fund the core services of education, healthcare, human services, and public safety. This severely impacts the most vulnerable populations in the state, such as individuals suffering from mental illness, those with disabilities, the elderly, and all students in the state’s public, K-12 Education system.

The root cause of all these problems is the state’s poorly designed and antiquated tax policy, which is so flawed it has generated structural deficits in the General Fund that have persisted for over 25 years. The reforms outlined in this paper effectively eliminate the state’s structural deficit, and generate the fiscal capacity Illinois needs to satisfy the state’s demographically-driven demand for core services.

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ENDNOTES


4 For more information on adjustments made to state spending data, see CTBA, Issue Brief: How Does Illinois Spending on Public Services Compare to Other States? January 2014, http://www.ctbaonline.org/reports/issue-brief-how-does-illinois-spending-public-services-compare-other-states, Note 6, Fig. 5 and 7.


6 This source was used because, in prior years, GOMB lumped pension contributions in with current year spending.

7 Numbers used from this source are from the January 2011 Revised Budget.

8 Public Act 97-689.


10 COGFA, FY2016 Liability of the State Employees’ Group Health Insurance Program (March 2015), 2.

11 CTBA, It Is All About the Revenue, Fig. 2.

12 Sources for inflation and population for spending on current year services: inflation used is the Congressional Budget Office’s projection for Nominal Wage Growth for Workers Covered by Social Security (Percent) from its 2015 Long-Term Budget Outlook (http://www.cbo.gov/publication/50250) and population is from the Illinois Department of Public Health’s Annual Survey of Public Employment & Payroll.

13 Growth rate for state revenue sources is approximately 2.8 percent. For the revenue growth rate for federal revenue CTBA used the Congressional Budget Office’s Nominal Wage Growth for Workers Covered by Social Security (Percent) from its 2015 Long-Term Budget, which are the same projections used for spending on current year services.

14 Public Act 096-1496.

15 Public Act 096-1496.

16 For information on how the debt service component of the pension contribution is calculated, see CTBA, Analysis of the FY2014 Illinois General Fund Budget, October 2013, http://ctbaonline.org/reports/analysis-fy2014-general-fund-budget, Fig. 1.

17 For more information, see CTBA, Analysis of the FY2014 Illinois General Fund Budget, Fig. 1.


CTBA, It Is All About the Revenue, Fig. 15 and Fig. 16.


For more information on how such tax relief fails to meaningfully stimulate the economy, see CTBA, Issue Brief: Tax Relief from the Phase-down of the Personal Income Tax Disproportionately Goes to Illinois' Wealthiest, 3-5.

For more information on the impact of the income tax rates under TABSA, see CTBA’s Issue Brief Tax Relief from the Phase-down of the Personal Income Tax Disproportionately Goes to Illinois’ Wealthiest, February 2015.


Mississippi and Pennsylvania exempt all retirement income. Illinois exempts all retirement income, except if the income is from private sector employment that is not from a qualified employee benefit plan or a self-employed retirement plan. Wisconsin Legislative Fiscal Bureau, Individual Income Tax Provisions in the States – Informational Paper 4, January 2015, https://docs.legis.wisconsin.gov/misc/lfb/informational_papers/january_2015/0004_individual_income_tax_provisions_in_the_states_informational_paper_4.pdf


In general, businesses structure themselves into one of five different legal forms: S-Corporation (“S-Corp”), C-Corporation (“C-Corp”), partnership, sole proprietorship, and limited liability company (LLC). Most small businesses are structured as an S-Corp, partnership, sole proprietorship or LLC. A key distinction between those classifications is that at the federal level, C-Corps pay the corporate income tax, while S-Corps, partnerships, and sole proprietorships pay the individual income tax. Depending how an LLC is structured it pays either the personal or corporate income tax.

CTBA analysis of data provided by the Illinois Department of Revenue (May 2013).

Enterprise zones are specific job depressed areas.

37 “State Sales Taxes—Food and Drug Exemptions (January 1, 2014),” Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/vendors.pdf. The states that do not impose a sales tax are: Alaska, Delaware, Montana, New Hampshire, and Oregon. In Alaska and Montana, however, local governments are allowed to impose their own sales taxes.

38 Some business-to-business transactions are taxed, although from a policy perspective they should all be exempt. It can be difficult differentiating whether certain purchases of products or services are typically made in a business-to-business environment, or are more of a consumer-type interaction.

39 (i) “Retailers’ Occupation Tax” is assessed on the gross receipts retailers collect from selling tangible property in Illinois and is what most people think of as the sales tax in Illinois; (ii) the “Use Tax,” which is assessed on consumers who make out of state purchases and use that property in Illinois; (iii) “Service Occupation Tax” and (iv) the “Service Use Tax,” (the “SOT” and “SUT”) which interestingly are not imposed on services, making the titles of the acts quite a misnomer. Instead, the SOT and SUT impose tax on tangible property that is sold or acquired incident to purchasing a service.

40 IDOR, Annual Report of Collections and Distributions: Fiscal Years 2011 and 2012 (Springfield, IL), 22.

41 Local units of government in Illinois may impose additional levies, increasing the total sales tax rate that is assessed in their respective jurisdictions. The ultimate sales tax rate customers pay in any given community in Illinois, then, is the combination of the state and all applicable local tax rates. For example, on top of the 5 percent state rate and the 1.25 percent standard local government rate, the City of Chicago imposes an additional 1.25 percent sales tax, Cook County imposes an additional 0.75 percent sales tax, and the Regional Transportation Authority imposes an additional 1 percent sales tax. Thus, in 2015, the total sales tax rate for most purchases made in Chicago is 9.25 percent.


51 Estimate calculated using the UConn Rudd Center for Food Policy & Obesity, “Revenue Calculator for Sugar-Sweetened Beverage Taxes” http://www.uconnruddcenter.org/revenue-calculator-for-sugar-sweetened-beverage-taxes? In CTBA’s structural deficit model, revenue from the tax decreases over time due to people drinking fewer sugary drinks and fees associated with selling of the drinks.

In their National Report Card, the Education Law Center gave Illinois a failing grade (F) in K-12 funding equity each year from 2007 to 2012 [Education Law Center, *Is School Funding Fair? A National Report Card*, Spring 2015, http://www.schoolfundingfairness.org/National_Report_Card_2015.pdf, 25, 38-39]. Additionally, Illinois fails to meet its own standard for public education funding. Every year the nonpartisan Education Funding Advisory Board (EFAB) is required by law to recommend a “Foundation Level” of per pupil spending that is sufficient to cover the cost of an adequate K–12 education. For FY16, the state’s actual Foundation Level is an estimated $3,000 less per child than the EFAB recommended Foundation Level [CTBA analysis of January 2013 EFAB data. Education Funding Advisory Board, *Illinois Education Funding Recommendations*, (Springfield, IL: January, 2013), p. 9. Appropriations adjusted using ECI and Midwest Medical Care CPI (for Healthcare) from the BLS as of January 2013, and population growth from the Census Bureau as of January 2013].