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Setting the Record Straight on Illinois' Fiscal Shortcomings:

How Governor Pritzker's Fiscal Reforms Help Address Decades of Irresponsible Practices

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Setting the Record Straight on Illinois' Fiscal Shortcomings: How Governor Pritzker's Fiscal Reforms Help Address Decades of Irresponsible Practices

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1. Introduction

In his first year in office, Governor J. B. Pritzker signed into law a General Fund budget that the General Assembly passed on a bipartisan basis—something it took his predecessor four years to accomplish. And while both the General Fund budget for fiscal year ("FY") 2020 and the Governor were new, the fiscal problems which afflict the General Fund that Governor Pritzker inherited are not. In fact, they are both longstanding and structural.

According to the Comptroller's Office, Illinois has run a deficit in its General Fund every year for the last seventeen consecutive years.[1] These ongoing deficits—which will certainly be worse over the next few years as the impact of the COVID-19 pandemic on the economy is projected to drive revenue down significantly in all 50 states[2]—are a cause for concern, since over $9 out of every $10 of General Fund spending on services goes to the four, core areas of education, healthcare, human services, and public safety.

Given how essential the core services funded by state government are to all Illinoisans, it is crucial policy makers accurately identify the true causes of these ongoing deficits, so they can devise effective solutions thereto. Unfortunately, many erroneously believe overspending on services is primarily to blame. The data, however, is completely at odds with this belief, and instead show that Illinois has cut real General Fund spending on nearly every core service since FY2000. Indeed, after adjusting for changes in inflation and population, General Fund appropriations for current services in FY2020 are scheduled to be at least 23.07 percent less than they were two decades ago in FY2000.[3]

So how is it possible that Illinois is still running such a huge General Fund deficit, given its long-term, real disinvestment in core services? Well, the data make the answer clear: Illinois' persistent General Fund deficits have two primary drivers, one revenue based, the other cost based.

First and foremost are the revenue generation problems caused by the state's tax policy shortcomings. Illinois' flawed state tax policy is simply not designed to work in the modern economy. Hence it has historically failed to generate adequate annual revenue growth to cover the cost of providing the same level of services from one fiscal year into the next.

This is known as a "**structural deficit**," and it means even when no public service programs are added or increased, the accumulated deficit grows annually. Illinois' tax policy is so poorly designed that in inflation adjusted terms, state revenue from all sources for FY2020 was projected to be roughly equivalent to what the Illinois' tax system generated two decades ago in FY2000—even before the COVID-19 pandemic hit.[4] That is eye-opening, given that the current individual income tax rate of 4.95 percent is greater than the three percent rate which pertained in 2000, and the current corporate income tax rate of seven percent is greater than the 4.8 percent rate in 2000. Yet, despite these rate increases, flaws in the design of Illinois' income tax structure have constrained revenue growth significantly. But for those aforesaid income tax rate increases, real General Fund revenue would be less today than it was in 2020 under Governor George Ryan.

Second, on the cost side of the ledger, is the irresponsibly backloaded design of the debt payment schedule created in the "Pension Ramp," which was enacted in 1995.[5] Illinois incurred this debt—which now stands at over $137 billion—because for generations elected officials in both parties approved the irresponsible practice of underfunding the actuarially required contributions owed to the state's pension systems as a way to maintain spending on services, despite the annual revenue shortfalls being caused by the structural deficit.

And rather than represent a departure from the irresponsible fiscal practices that necessitated its creation, the Pension Ramp—by design—made things worse. For starters, over the first 15 years the Pension Ramp was in place, it required payments that were so low it actually continued to increase the unfunded liability Illinois owed to its five public pension systems by tens of billions of dollars. Thereafter, the annual increases in debt service payments under the Pension Ramp grow at such unaffordable rates, that they annually exceed both inflation and what the state's flawed tax policy can accommodate.

The challenge is a structural deficit like the one in Illinois' General Fund cannot be eliminated without raising taxes. That is a challenge, because raising taxes is politically difficult at best. The good news is the current Gubernatorial Administration has publicly recognized that fundamentally flawed tax policy is one of the primary drivers of Illinois' structural deficit. In fact, Governor Pritzker has had the political will to push a tax reform package—predicated on replacing the flat rate individual income tax Illinois currently imposes with a graduated rate income tax—that would simultaneously:

- Improve the state's fiscal condition by raising approximately $3.4 billion in new, recurring revenue annually;
- Impose tax burden on taxpayers more fairly; and

- Update state tax policy to respond better to the modern economy.

The bad news is, this needed fiscal reform package, which has already passed the General Assembly, will not become effective unless this upcoming November, voters ratify the amendment to the Illinois State Constitution which makes creation of a graduated rate income tax structure in Illinois permissible. And that may be difficult to attain, given so many voters still operate under the misconception that overspending on services, rather than flawed tax policy, is responsible for driving the state's long-term, General Fund deficits, and fail to understand how that flawed tax policy is also the primary reason for the state's unfunded pension liabilities.

To counter these misconceptions, this report will: (i) address the myth of overspending; (ii) explicate how the structural deficit has been primarily caused by flawed tax policy; (iii) explain the true nature of Illinois' pension debt; and (iv) identify why steps being taken by the Pritzker Administration will help improve Illinois' fiscal condition.

2. Growth in Service Expenditures is Not Driving Illinois' Structural Deficit

To start with, Illinois is very low in spending on services when compared to the other 49 states. Despite having the sixth largest population[6] and the fifth largest Gross Domestic Product (**"GDP"**) of any state,[7] Illinois ranked 26th in General Fund spending on services per capita in 2017, the last year for which there's comprehensive data available.[8] Illinois also ranked 39th in spending as a share of GDP in the last year for which there's a national comparison.[9] Hence, no matter the metric, Illinois is relatively low spending on current services.

Moreover, aggregate General Fund spending on the four, core services of education, healthcare, social services, and public safety declined by 23.07 percent after inflation over the FY2000-FY2020 sequence, as shown in Figure 1. Higher Education has been particularly hard hit, with current funding scheduled to be almost 50 percent less in real terms than it was two decades ago.

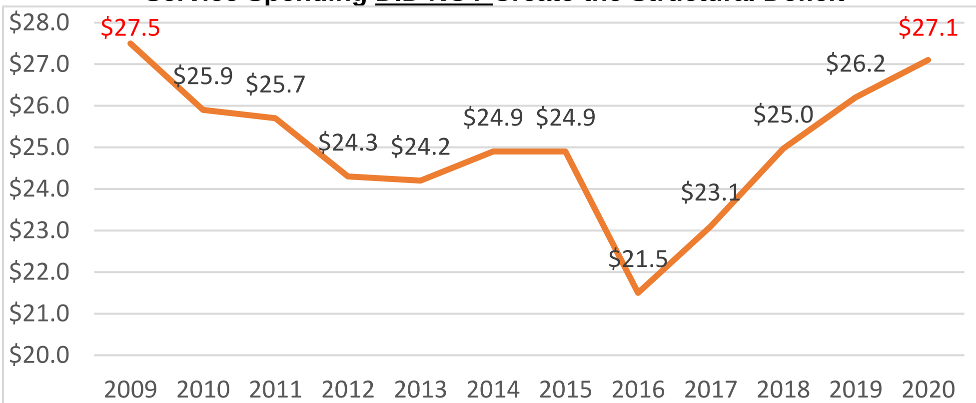
Figure 1
General Fund Spending on Current Services, FY2000 Compared to FY2020 ($ Millions)

Category	FY2000 Enacted General Fund Budget (Nominal)	FY2000 Enacted General Fund Budget (Adj for Inflation & Population)	FY2020 Enacted General Fund Budget	$ Difference (ECI and Pop Growth Adjusted)	% Change
K-12 Education	$4,674	$8,234	$8,339	$102	1.27%
Early Childhood Education	$170	$299	$545	$245	81.89%
Higher Education	$2,152	$3,791	$1,943	($1,848)	-48.75%
Healthcare	$5,022	$10,301	$7,619	($2,682)	-26.04%
Human Services	$4,599	$8,102	$6,298	($1,804)	-22.27%
Public Safety	$1,350	$2,378	$1,979	($399)	-16.78%
Gross General Fund Service Appropriations	$20,064	$35,347	$27,192	($8,155)	-23.07%

Source: CTBA Analysis of FY2000 & FY2020 enacted budget

Indeed, General Fund spending on current services for FY2020 is projected to be $400 million less in nominal, non-inflation adjusted terms than it was in FY2009, at the end of the Great Recession, as shown in Figure 2.[10]

Figure 2
Service Spending DID NOT Create the Structural Deficit



Source: CTBA analysis of P.A. 100-0586 and COGFA data.

Bottom line: the evidence compellingly demonstrates that spending on services is not a cause of the structural deficit in Illinois' General Fund.

3. Flawed Tax Policy Drives the Structural Deficit

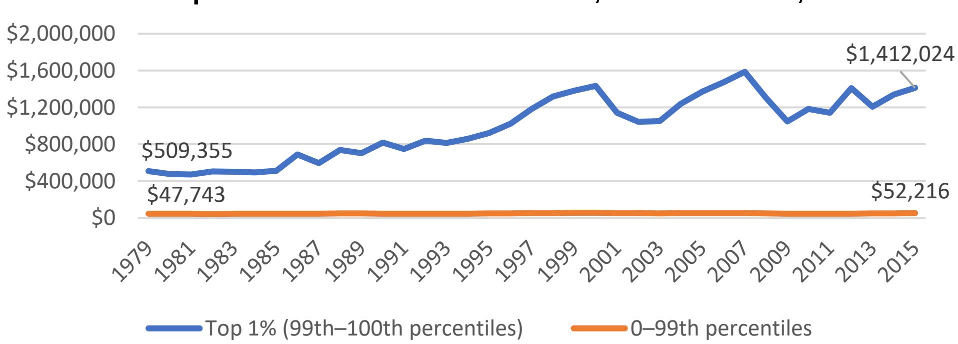
On the other hand, all the data show that flawed tax policy very much drives the state's structural deficit. Here's why: to fund services sustainably over time in a modern economy, tax policy must satisfy three economic principles.[11] It must be:

- **FAIR** to taxpayers;
- **RESPONSIVE** to growth in the modern economy; and
- **STABLE** during poor economic cycles.

"**Fairness**" is determined by how tax burden is shared by various taxpayers, and is measured in two ways: "horizontally", that is comparing the tax burden of different taxpayers with similar income levels, and "vertically", that is comparing the tax burden of taxpayers across different income levels.[12] Tax policy achieves horizontal fairness if taxpayers with similar incomes have similar tax burdens.[13] Generally, a tax system will attain horizontal fairness if it does not contain numerous tax breaks which favor one taxpayer over another similarly situated taxpayer.

Tax policy achieves vertical fairness if the tax burden imposed across different income levels comports with ability to pay, taking into account how income growth is distributed over time in the modern economy. As shown In Figure 3, given the substantial growth in income inequality that has occurred in Illinois since 1980, the only way a tax system can distribute burden fairly among taxpayers with different incomes in our state is to impose tax burden in a "progressive" manner.

Figure 3
Incomes of Top 1% and Bottom 99% in Illinois, in 2015 Dollars, 1979-2015

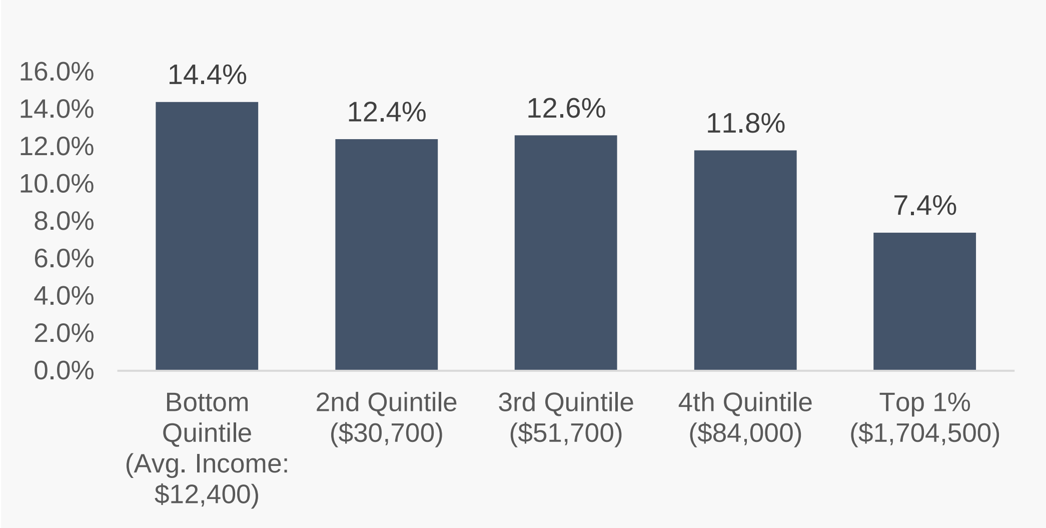


Source: CTBA Analysis of Economic Policy Institute "Unequal States of America" 2018.

A "**progressive**" tax imposes a greater tax burden on high income taxpayers than low- and moderate-income taxpayers, when tax burden is measured as a percentage of income. Progressive income tax rates are the favored method of creating vertical fairness in a tax system.[14] In fact, the income tax is literally the only tax that can be designed to impose tax burden in a progressive manner. Every other tax—like for instance a sales or excise tax—is regressive in nature. A **regressive tax** results in low- and middle-income earners paying a larger share of their income in taxes than higher-income earners.

Illinois has a flat, rather than progressive income tax structure. Because of that, the state's income tax cannot offset the regressive nature of all other taxes that are imposed to fund services. The has led to Illinois having one of the most regressive state and local tax systems in America, as shown in Figure 4.

Figure 4
Total Average State and Local Tax Rate Paid in Illinois by Income



Source: ITEP, "Who Pays?", 2018.

"**Responsive**" tax policy focuses revenue generation where growth is actually being realized in the economy. That means taxes should be imposed where economic activity is significant and where it is increasing over time.[15] A responsive tax system generates the fiscal capacity for revenue to keep pace with the inflationary cost of providing services overtime, since it responds to growing economic activity. Having a progressive income tax rate structure is the only way to ensure income tax revenue growth will respond to the economy, given the worsening of income inequality that has been a consistent feature of the modern economy since 1980.[16]

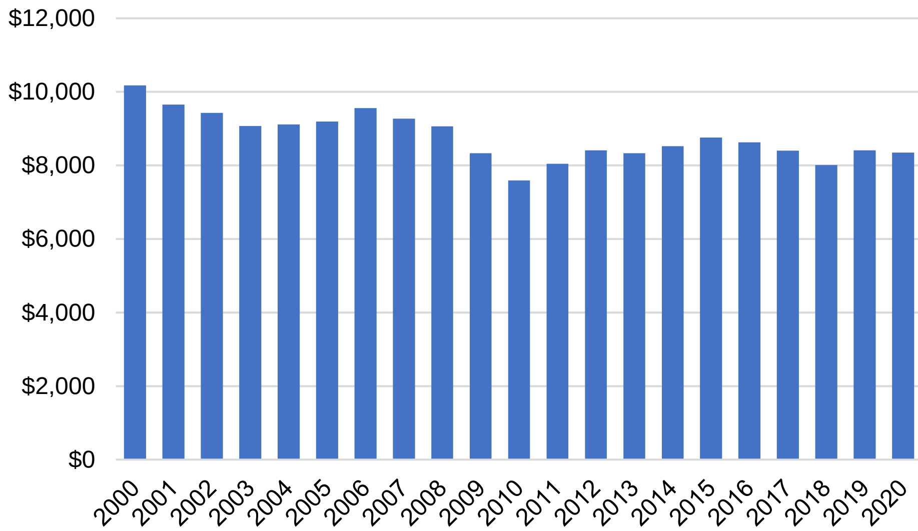
Figure 5
Real Change in Average Illinois Income Over Time

Income Group	1979 – 2015
Top 10%	**108%**
Bottom 90%	**-8%**

Source: CTBA Analysis of data from Estelle Sommeiller and Mark Price. "The New Gilded Age." Economic Policy Institute, July 19, 2018

A "**Stable**" tax maintains some decent base revenue generation during poor economic cycles.[17] Generally, having a sales tax that is imposed on a broad range of the transactions actually occurring in the consumer economy is the best way to bring some stability to a state-level tax system. The reason for this is two-fold. First, consumer spending constitutes most of the private sector economy, consistently accounting for around 67 percent of GDP.[18] Second, consumer spending typically does not decline substantially, even during recessions.[19] Of course, the recent recession being caused by the COVID-19 pandemic is somewhat unique, and consumer spending will decline far more significantly than it usually does. That said, broadly taxing what consumers are actually purchasing usually stabilizes revenue generation even during poor economic cycles. Unfortunately, Illinois taxes less economic activity than any of the 45 states with a general sales tax,[20] thereby failing to satisfy the stability principle. That in turn has led to the decline in real General Fund revenue from the state's sales tax over the last 20 years as shown in Figure 6.

Figure 6
Net Sales Tax Revenues, FY2000 – FY2020
(Millions of Dollars), Inflation-Adjusted Using 2019 Dollars



Source: COGFA Historical Revenue Tables

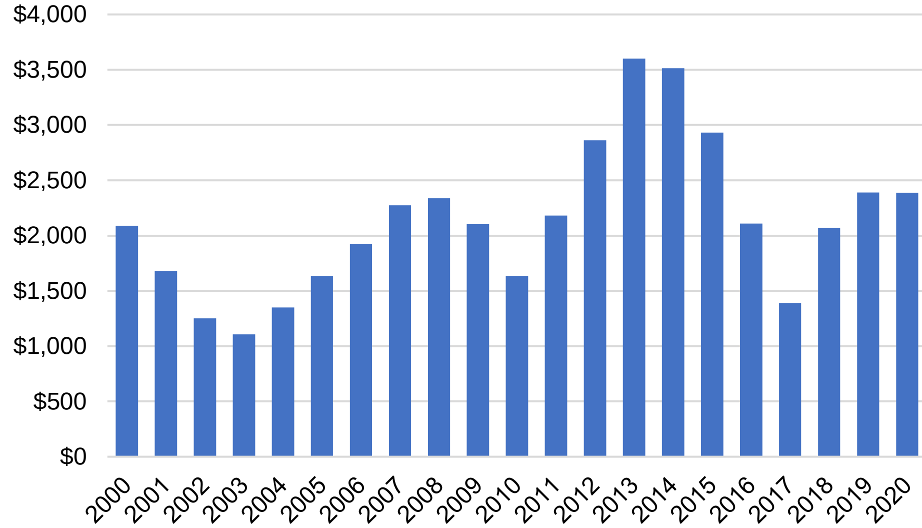
This decline has been significant. Consider that net sales tax revenues in FY2019 were $8.41 billion, or roughly 21 percent of all General Fund revenue. In inflation-adjusted dollars, that means sales tax revenue comprised $1.77 billion or five percent less of total General Fund revenue in FY2019 than the 26 percent sales tax revenue accounted for in FY2000.

The primary reason sales tax revenues have declined in real terms over time is that Illinois has one of the narrowest sales tax bases of the 45 states that impose a general sales tax.[21] The "base" of a tax is simply what the tax is assessed against. In the case of the sales tax, the "base" is comprised of the type of sales transactions the tax covers. Illinois has one of the narrowest sales tax bases of any state because Illinois' sales tax applies mainly to the sale of goods rather than services.

That's problematic because the economy has transitioned from being primarily products-based to being primarily service-based. Illinois' sales tax has failed to respond to this fundamental transformation. Consider that, between 1990 and 2016, the sale of goods went from accounting for 25.4 percent of Illinois' GDP to just 17.4 percent, while the sale of services increased from 64.7 to 73 percent of state GDP. Leaving the largest and fastest growing segment of the economy out of the state's sales tax base obviously restricts revenue from growing with the economy over time, and thereby impedes Illinois' ability to generate adequate revenue to fund core services from year-to-year.[22]

Revenue from several other state tax sources that feed the General Fund have experienced real declines over the FY2000 – FY2019 sequence, including: corporate income taxes; public utility taxes; cigarette taxes; and vehicle use taxes. Federal contributions to the state General Fund have also decreased during this period.[23]

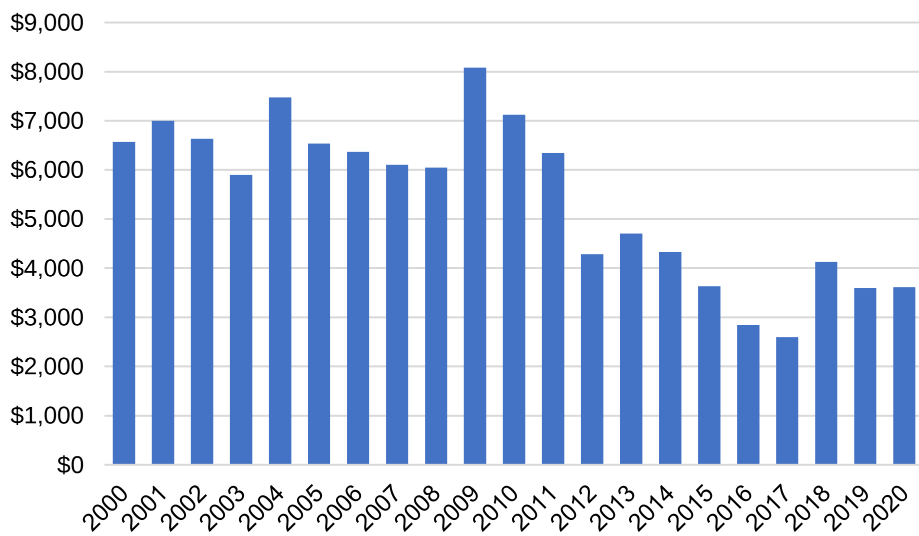
Figure 7
Net Corporate Income Tax Revenues, FY2000 – FY2020
(Millions of Dollars), Inflation-Adjusted Using 2019 Dollars



Source: COGFA Historical Revenue Tables

Of these declining revenue sources, corporate income tax revenues have experienced one of the most precipitous real declines from its peak. Even before the COVID-19 pandemic hit, Corporate income tax revenues were projected to decline by some 33.4 percent from their peak of $3.59 billion in FY2013, to $2.39 billion in FY2020, as shown in Figure 7.

Figure 8
General Funds Federal Source Revenues, FY2000 – FY2020
(Millions of Dollars), Inflation-Adjusted Using 2019 Dollars

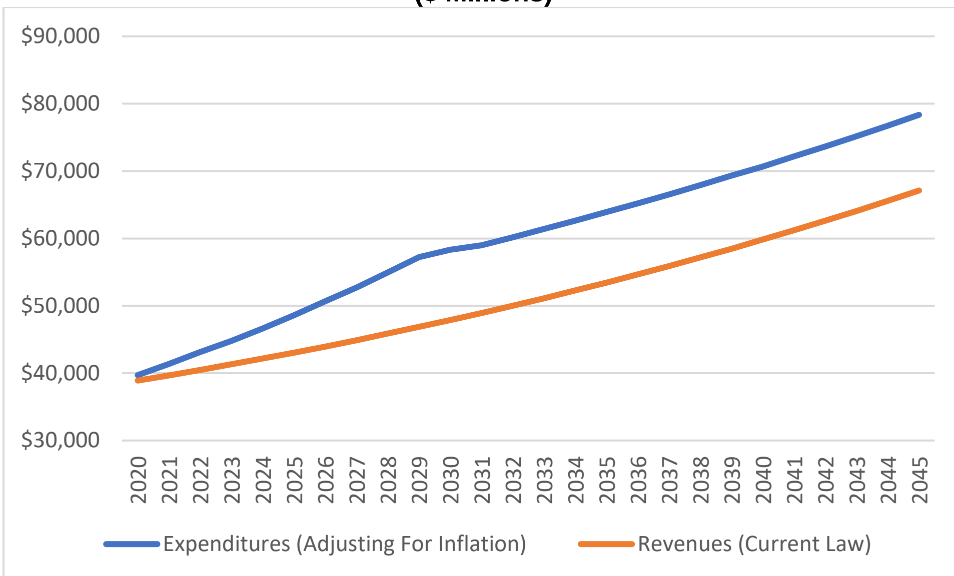


Source: COGFA Historical Revenue Tables

Meanwhile, although federal transfers to Illinois have seen some variation over the past 20 years, since FY2009 the clear trend has been a notable decline. Indeed, federal transfers to the Illinois General Fund have dropped from a peak of $8.07 billion in FY2009, to a projected $3.61 billion in FY2020 (again, this projection was pre-COVID-19), as shown in Figure 8.[24] The significant year-to-year increase in federal transfers Illinois realized over the FY2017–FY2018 sequence was primarily due to enhanced federal matching dollars received following the state's utilization of $6 billion in general obligation bond proceeds to pay past due Medicaid bills in FY2018.[25]

The bottom line: Illinois' tax policy does not satisfy any of the three principles of sound tax policy. That of course doesn't work–and causes the ongoing mismatch between revenue growth and service cost growth from one fiscal year to the next, which is depicted in Figure 9.

Figure 9
Illinois State General Fund Structural Deficit
($ Millions)



Source: CTBA analysis of Illinois General Fund budgets, COGFA pension reports

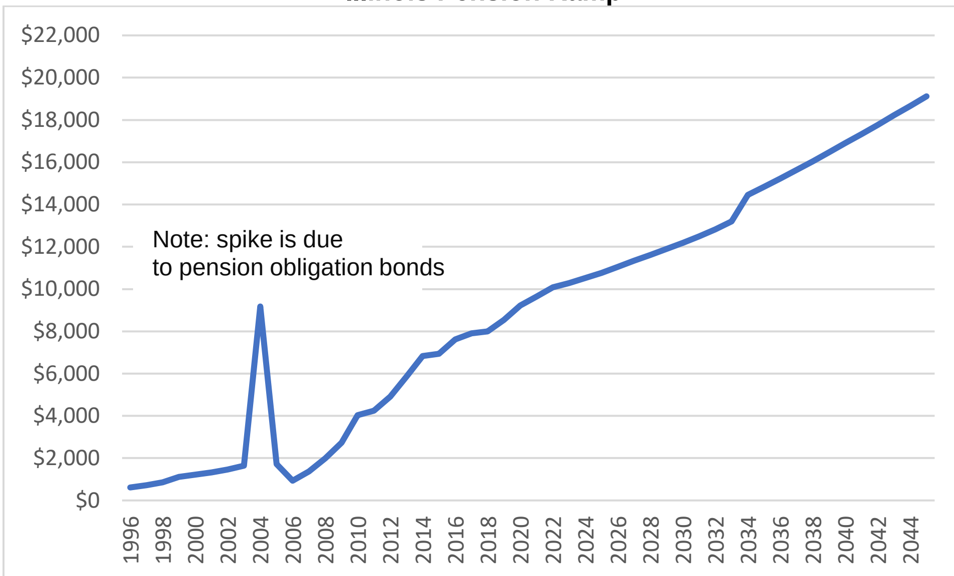
Illinois' tax policy is so flawed, the state lacks the fiscal capacity to maintain its current—and relative to other states, low—investment levels in the four, core services over time.

4. The Current Pension Debt Repayment Schedule Passed in 1995 was Irresponsible, and Exacerbates the Structural Deficit

For generations, Illinois' structural deficit meant revenue growth was insufficient to maintain service levels from year-to-year. But honestly fixing that problem would have required elected officials to raise taxes. And that is so divisive politicians in both parties wanted to avoid it. So, they did. Rather than raise taxes, 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 revenue that should have funded pensions, to instead subsidize the cost of providing current services. Sure, this irresponsible practice helped politicians in both parties by temporarily hiding the structural deficit from taxpayers, but over time, it became the primary reason the state developed such a significant—as in $137 billion—unfunded liability that exists today.[26]

Unfortunately, the irresponsible practice of borrowing against the pensions became such standard operating procedure that it was codified into law as part of the "Pension Ramp" that passed under Republican Governor Jim Edgar in 1995.[27] Under the Pension Ramp, the state—now by statute—continued the practice of borrowing against the contributions owed to pension systems to subsidize the cost of delivering current services, for the first 15 years following its enactment. Then in out-years, the Pension Ramp created an incredibly back-loaded repayment schedule, which grows in unattainable, unaffordable annual increments, as shown in Figure 10.

Figure 10
Growth in Annual Payments Under the Illinois Pension Ramp



Source: COGFA, *Illinois State Retirement Systems: Financial Condition as of June 30, 2018* (Springfield, IL: April 2019). Note: contributions for 1996-2019 are actual appropriations and 2020-2045 are projections.

The Pension Ramp creates such an unrealistic repayment schedule that it would continue to strain Illinois' fiscal capacity even after modernizing tax policy. Given that the Pension Ramp is the poster child of irresponsible fiscal practices, a comprehensive approach to addressing Illinois' fiscal shortcomings should replace this irresponsible ramp with a more rational approach to handling the state's pension debt. This will be especially important after the impact of the downturn in the economy caused by the COVID-19 pandemic on the asset base of the state's five pension systems is determined. Already, the Teachers' Retirement System—which also happens to be the largest state pension system—is projecting a $4 billion asset loss due to the pandemic.

To be both sustainable and responsible, any re-amortization of the state's pension debt should:

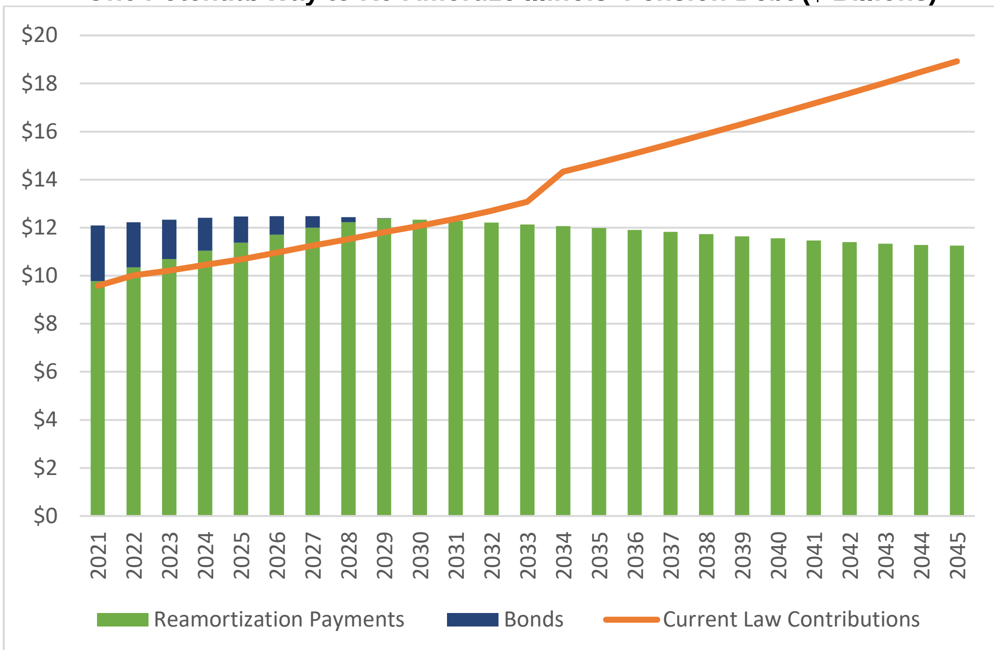
- increase the funded ratios of the five systems annually, until they become healthy;
- accomplish that growth in funded ratio after accounting for all cash flow obligations to pay benefits to current and future retirees; and
- be affordable, given the other demands on current tax revenue to fund core services.

The most effective way to re-amortize the pension debt would be to ditch the politically devised and irresponsible backloading of the repayment, and instead smooth the obligation out into annual payments that are level, akin to a traditional, fixed rate mortgage.

This level dollar approach to paying off unfunded liabilities is fiscally responsible because the state's repayment obligation stays the same from year-to-year in nominal dollars. Hence in real, inflation adjusted terms, the annual contribution actually becomes a declining financial obligation over time. For instance, prior to accounting for whatever asset losses and related impacts to the state's pension systems that are being caused by the economic downturn associated with the COVID-19 pandemic, Illinois could have resolved its unfunded liability, grown its funded ratio, and met all system cash flow obligations to pay retirement benefits, by covering the annual normal cost of benefits being earned each year, plus utilizing a level dollar annual repayment of its pension debt set at approximately $9.6 billion. This hypothetical re-amortization structure is shown in Figure 11.

Note that, for each of the first nine years following the implementation of this plan, it is contemplated that Illinois would issue relatively small pension obligation bonds, to cover the difference between the pension contribution called for under current law and the contribution called for under the re-amortization. Repayment of those pension obligation bonds—calculated at a 6.55 percent interest rate over 25 years—is included in Figure 11.

Figure 11
Pension Fund Contributions under Current Law, Compared to One Potential Way to Re-Amortize Illinois' Pension Debt ($ Billions)



Source: CTBA analysis using Illinois state pension fund actuarial valuations.

Under this approach to re-amortization of the pension debt that existed pre-COVID-19, Illinois' five pension systems would have been approximately 72 percent funded by FY2045, thus creating a sustainable path to full funding, given they were only 39 percent funded before the pandemic hit. Implementing such a re-amortization would not only get the pension systems on a sustainable path to solvency but should also significantly benefit taxpayers. For instance, the hypothetical shown in Figure 11 would have saved taxpayers $45 billion in debt service payments over the Pension Ramp.

Previously, some politicians resisted any suggestion that the state re-amortize its pension debt, out of concern doing so could be perceived as rewarding Illinois for the past, irresponsible behavior of intentionally underfunding the pensions to begin with. Which is all well and good, except that those expressing such concerns never managed to put a workable alternative for dealing with the problem on the table. Of course, even to the extent there was any legitimacy to holding such concerns previously, the COVID-19 pandemic has rendered them moot.

After all, the repayment schedule set forth in the Pension Ramp was so backloaded that Illinois' fiscal system could not possibly accommodate it even before COVID-19. With the state's five public employee pension systems facing material asset losses and diminished investment returns from the impact of the pandemic on the economy, the annual debt payments required under the Pension Ramp will jump significantly from what is established under existing law. This in turn means finding a responsible approach to flattening the arc of future debt payments under the Pension Ramp is no longer optional, nor can be considered as rewarding past bad behavior, but rather constitutes a rational and necessary component of a comprehensive approach to resolving Illinois' fiscal shortcomings in a sustainable fashion.

5. The Pritzker Administration has Demonstrated the Political will to Address Illinois' Long-Standing Fiscal Shortcomings on a Bipartisan Basis

5.1 Creating the Realistic Expectation Illinois will Responsibly Address Fiscal Policy

Governor Pritzker's approach to fiscal policy during his first year in office has created the reasonable hope that Illinois will finally start addressing its long-term fiscal shortcomings in a meaningful way. This stands in stark contrast to his immediate predecessor Bruce Rauner. The Rauner Administration struggled to find common ground with the General Assembly on most issues generally—and on fiscal policy issues specifically.

For instance, it wasn't until Rauner's last year in office that he was able to negotiate a General Fund budget with the General Assembly that he felt comfortable signing into law. Governor Pritzker, on the other hand, accomplished that feat in his first attempt—with bipartisan support.[28]

In addition, Governor Pritzker was able to work both sides of the aisle to gain bipartisan support for numerous pieces of significant, and in some cases groundbreaking legislation, particularly when it comes to fiscal policy. This legislation included everything from legalizing—and taxing—the recreational use of cannabis, to establishing a record-breaking $45 billion capital program, passing pro-business tax initiatives championed by Republican House Minority Leader Jim Durkin, and getting a super-majority of the General Assembly to approve a constitutional amendment that would permit creating a graduated rate income tax structure, that will come to voters for ratification in the upcoming general election in November 2020.

Following is a brief summary of fiscal policy actions taken during Pritzker's first year in office which demonstrate that Illinois is beginning to address its fiscal shortcomings in a responsible fashion.

5.2 Short-Term Budget Stability

As will be outlined in Section 5.3 of this report, a resolution to authorize amending the Illinois Constitution to permit a graduated rate income tax passed the General Assembly and has been signed by Governor Pritzker.[29] However, said amendment won't become law unless it is ratified by voters this November—which is at least five months into FY2021. Realizing that would be well after introduction of his first budget proposal in FY2020, and that the state's structural deficit meant there wouldn't be adequate new revenue in FY2020 to maintain core services at FY2019 levels, Governor Pritzker took the fiscally responsible step of designing his FY2020 budget proposal as a "bridge budget," building into it limited, new revenue sources to cover anticipated growth in spending. These new revenue proposals are identified in Figure 12.

Figure 12
New General Fund Revenue Sources for FY2020, Proposed and Enacted

Revenue Source	Proposed	Enacted	FY2020 Projected Additional Revenue (in millions)
Recreational Cannabis	Yes	Yes	$57[30]
Managed Care Organization Assessment*	Yes	Yes	$390
Delinquent Tax Payment Incentive Program	Yes	Yes	$175
Decoupling from Federal Repatriation	Yes	Yes	$94
Sports Wagering	Yes	Capital	$200
Online Sales Tax Collection	No	Yes	$80
Capping Private School Scholarship Credit	Yes	No	$6
Bag Tax	Yes	No	$19-$23
Progressivity in Video Gaming	Yes	No	$89
Cap Retailer's Discount	Yes	No	$75

Hence, in contrast to many of his predecessors in office, Governor Pritzker demonstrated the political will to raise current revenue to support current expenditures, rather than borrowing to spend.

In another nod to sound fiscal policy, when Governor Pritzker made his General Fund budget proposal for FY2021, he emphasized the importance of building a real "rainy day" fund in Illinois. This makes sense, given that Illinois was recently cited as one of seven states that had inadequate policies governing the use of rainy day funds.[31] According to Crain's Chicago Business, many states used the time since the last economic downturn (the longest U.S. economic recovery on record) to boost "Rainy Day" funds, as all the while Illinois failed to contributed to enhance its Rainy Day fund for more than a decade.[32]

Governor Pritzker's proposal was to contribute $50 million of the then anticipated FY2020 surplus to the Budget Stabilization Fund (which is what Illinois has instead of a true "Rainy Day" fund), with an additional $50 million targeted to that Fund in FY2021, if the new graduated rate tax structure under P.A. 101-0008 goes into effect on January 1, 2021.[33] In subsequent years, payments into the Stabilization Fund would be automatically added to build up the balance and thereby help improve Illinois' credit rating. Of course, the timing and amount of this new investment will be changed by the impact of the COVID-19 pandemic.

That said, Pritzker's focus on building a true rainy-day fund is clearly sound and needed fiscal policy. After all, on average, the typical state could operate for a median of 27.9 days with the $74.9 billion in rainy-day funds they had established in the aggregate as of the end of fiscal 2019. FY2019 was also the ninth-straight year of rainy-day fund increases made by states nationally.[34]

Contrast that to Illinois' current Stabilization Fund which contains only about $60,000–or not even enough to cover 30 seconds worth of operating expenses for the state.[35] Creating a real, adequately funded Rainy Day fund for Illinois as Pritzker has said he would like to do, would help with the long-term, fiscal outlook for Illinois, as ratings agencies view the health of Rainy Day funds as an indicator of a state's credit value, so building them up results in a better credit rating that in turn will mean taxpayers pay less when the state borrows.[36]

5.3 Addressing Long-Term Revenue Shortcomings with a Graduated Rate Income Tax

On June 5, 2019, Governor Pritzker signed Public Act 101-0008 (P.A. 101-0008), the "Illinois Income Tax Act", into law, which, if it becomes effective, would replace Illinois' current flat rate income tax with a graduated rate tax structure.[37] Referred to as the "**Fair Tax**" by proponents because it ties tax burden to ability to pay, it will only go into effect if voters ratify the ballot initiative based on Senate Joint Resolution Constitutional Amendment No. 1, during the November 2020 General Election.[38] This Senate Joint Resolution removes the current requirement set forth in Article IX, Section 3 of the Illinois Constitution that requires income taxes be assessed using only one flat rate.

The graduated rate income tax structure under P.A. 101-0008 would raise significant new revenue for the state, while shifting tax burden as a percentage of income from lower- and middle-income earners to very wealthy earners. Figure 13 shows the income tax structure that would pertain under P.A. 101-0008. Note that, if taxable income is over $750,000 for single filers or $1 million for joint filers, then all of any such taxpayer's taxable income will be taxed at a flat 7.99 percent, rather than the marginal rates applicable to other taxpayers.

Figure 13
Fair Tax Graduate Rate Income Tax Structure

Income Bracket (Single)	Income Bracket (Joint)	Marginal Rate	Percent of Taxpayers
$0-$10,000	$0-$10,000	4.75%	27.2%
$10,001 - $100,000	$10,001-$100,000	4.90%	58.9%
$100,001 - $250,000	$100,001-$250,000	4.95%	11.1%
$250,001 - $350,000	$250,001-$500,000	7.75%	1.9%
$350,000- $750,000	$500,001-$1,000,000	7.85%	0.6%
$750,001+	$1,000,001+	7.99%	0.3%

Source: CTBA analysis of P.A. 101-0008 and IDOR Individual Income Tax return data

For all those with annual taxable incomes less than either $750,000 (if filing single) or $1 million (if filing jointly), the final income tax paid in a year will be that amount which is equal to the marginal rate applicable to each bracket of taxable income for such taxpayer, multiplied by the amount of his, her, or their taxable income in each such bracket.

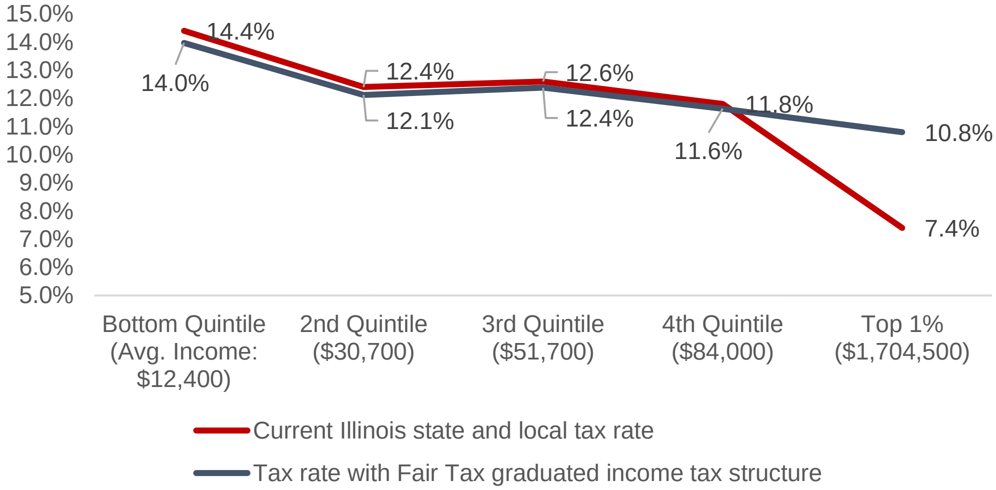
The graduated rate structure created under the Fair Tax Legislation would accomplish the following outcomes:

- It will raise an estimated $3.4 billion in new, recurring annual tax revenue (although given the impact of the COVID-19 pandemic, that level of revenue generation is not likely to materialize for a couple of fiscal years) to help address the state's structure deficit;
- All new revenue it generates will be paid by only those taxpayers with taxable incomes that place them among the wealthiest three percent (3%) of taxpayers in Illinois;
- Fully 97 percent of all taxpayers would pay less in Illinois state income taxes under the Fair Tax Legislation than they do under Illinois' current flat-rate income tax of 4.95 percent – hence the Fair Tax Legislation will reduce the regressivity of Illinois' overall tax system, making it fairer for taxpayers; and
- It accomplishes these outcomes through implementation of an income tax rate structure that is well within national norms.

Because income taxes are just one part of Illinois' state and local tax system—alongside sales taxes, property taxes, excise taxes and fees— and because Illinois' General Fund is subject to a multi-billion dollar structural deficit, the Fair Tax

Legislation cannot, on its own, completely eliminate the regressive nature of Illinois' tax system. That said, however, it is an essential, sound and needed step toward fiscal stability—and as shown in Figure 14 would in fact make the tax burden in Illinois less regressive and hence fairer to taxpayers.

Figure 14
Total effective state and local tax rate by income category: Current law v. proposed Fair Tax graduated income tax structure



Source: ITEP, "Who *Pays?" 2018 and* CTBA analysis

5.4 Gaining Bipartisan Support for Capital Programs and Pro-Business Fiscal Policies

On June 28, 2019, Governor Pritzker signed the largest and most comprehensive capital plan ever passed in Illinois.[39] The historic $45 billion investment designates money for fixing Illinois' crumbling roads and bridges and making comprehensive improvements in education facilities, the state crime lab, state parks and historic sites, clean water infrastructure, and conservation of natural resources, all while creating jobs.[40] Indeed, the $33.2 billion investment into Illinois' aging transportation system alone will support an estimated 540,000 jobs throughout the state.[41] Passed on a bipartisan basis, Rebuild Illinois targets capital investments statewide, and is the first major capital program in Illinois since the "Illinois Jobs Now!" program in 2010.

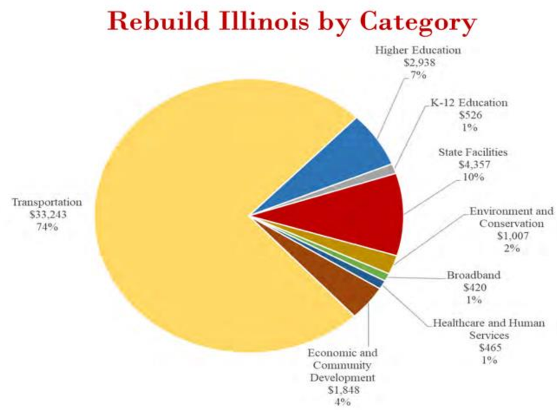
Key components of the plan include[42]:

- $33.2 billion to upgrade the state's aging transportation system, supporting an estimated 540,000 jobs;
- $420 million for statewide broadband development and expansion;
- $3.4 billion to enhance Illinois' quality and competitiveness in education;
- $4.3 billion to upgrade existing and create new and better state facilities;
- More than $1 billion to expand and strengthen environmental programs;
- $465 million for improving and expanding facilities for healthcare and human services; and
- More than $1.8 billion for enhanced economic and community development.

On top of that, local governments will receive $4 billion in transportation funds to meet their specific needs–their first increase in 20 years.[43]

Figure 15 displays a breakdown of Rebuild Illinois funding by category, as presented by the State of Illinois.

Figure 15
Building Illinois by Funding Category



Source: Illinois Department of Commerce and Economic Development, Rebuild Illinois, J.B. Pritzker. Springfield, Illinois, 2020. https://www2.illinois.gov/IISNews/20266-Rebuild_Illinois_Capital_Plan.pdf, (June 28, 2019).

The Rebuild Illinois program is supported by a number of earmarked revenues.[44]

For years, Republican Minority Leader Jim Durkin had pushed passage of numerous, pro-business tax breaks, unsuccessfully. However, during Pritzker's first year in office, the Governor worked successfully with Durkin to gain passage of the following pro-business tax breaks:

(i) SB 689, the "Blue Collar Jobs Act," which creates or expands a series of tax credits—including the High Impact Business Construction Jobs Credit, Enterprise Zone Construction Jobs Credit, Economic Development for a Growing Economy ("EDGE") credit, and the River Edge Redevelopment Zone credit—designed to incentivize construction throughout the state, while being capped in cost at $20 million per fiscal year.[45] SB 689 also instituted a phasing out of the Illinois Franchise Tax, by amending various sections of the Business Corporation Act ("BCA"). Under this change, the Franchise Tax paid by businesses will be completely phased out by 2024.[46]

(ii) SB 1591, which creates two new business tax credits, the Data Center Investment Tax Credit and the Apprenticeship Tax Credit.[47] The Data Center Investment Tax Credit provides qualifying Illinois data centers with exemptions from state and local taxes while also providing a 20% tax credit towards wages paid for development and construction in underserved areas.[48] The apprenticeship tax credit provides an income tax credit towards education expenses for apprentices up to $3,500.[49]

5.5 Meaningful Local Pension Reform

On December 18, 2019, Governor Pritzker signed SB 1300 into law, consolidating 649 local pension plans for police officers and firefighters serving municipalities across Illinois.[50] And while a small minority of these plans were very well funded individually, when considered together, they had an aggregate "funded ratio" of only 55 percent, meaning they had just over half of the financial assets they needed to cover the benefits they're obligated to pay.[51] SB 1300 focused on generating viable, long-term funding enhancements, that can reasonably be projected to flow from consolidating the investment assets of the 649 local police and fire pension funds that exist today, into one large statewide fund for police, and another for fire.

Based on anticipated reductions in administrative, asset manager, and investment charges, and access to a greater variety of investment vehicles, the Illinois Department of Insurance projected the consolidation would generate anywhere from $820 million to $2.5 billion more in asset growth over the next five years than if these funds remained segregated in 649 smaller, local plans as they are now.[52] Obviously, those projections will not likely materialize, given the impact of the COVID-19 pandemic on the economy. However, in time the economy will recover, and the anticipated asset growth should materialize.

6. Conclusion

Given the decades of evidence, there's no question that the root cause of Illinois' fiscal struggles is poorly designed tax policy. For generations, politicians in both parties lacked the political will to implement the policy reforms needed to modernize the state's tax system and generate adequate, recurring revenue. Instead, they chose the irresponsible path—again on a bipartisan basis—of covering up a portion of the revenue shortfall generated by poor tax policy, by intentionally underfunding the state's pension systems, and using the revenue that should have covered pensions to instead pay for current services. This practice was tantamount to borrowing against pensions to fund services. Decisionmakers then compounded that mistake by creating an unaffordable, back-loaded pension debt service repayment plan. Taken together, the state's flawed tax policy and irresponsible handling of it pension debt has generated structural deficits in the Illinois General Fund for decades.

This has had consequences, not the least of which is, despite being one of the wealthiest states in America, Illinois has struggled to fund core services like education and the social safety net for years. This negatively impacts vulnerable people, such as individuals suffering from mental health concerns and those with disabilities, while denying most children the educational opportunity they need to build a successful future.

Governor Pritzker inherited the state's long-term fiscal problems when he took office in January of 2019. Since that time, his administration has proposed some of the structural reforms needed to address the state's fiscal shortcomings in a sustainable way, and has consistently demonstrated the political will to tackle the State of Illinois' thorny fiscal problems once and for all.

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