We Are One Illinois: Summary of Findings

Pension Benefit Cut Analysis – Summary

- The first study shows how **deep** the **pension benefit cuts** would be under the "**Quinn Plan**" as represented in HB 1447.
- Workers and retirees face a **no-win, coercive choice**. Our study shows that those coerced into diminishing their cost-of-living adjustments (COLAs) would **forfeit a third of their inflation-adjusted purchasing power over the first twenty years of retirement.**
- Further, the Quinn Plan's COLA would leave retirees with **a monthly check that is 25% less than an annuity adjusted according to Social Security**'s inflation-indexed system.
- **Retired Americans are more susceptible to higher inflation** because of the services they purchase, like health care. This helps to explain why a COLA sure to lag inflation is so harmful to retirement security.
- In short, protecting against inflation matters, especially to retirees – particularly since **most Illinois public employees are ineligible for Social Security**.
- We are **still analyzing HB 6258**, but we have **completed an initial study of its effect on COLAs**. We find that **retirees in TRS or SERS would lose between 28% and 31% of their purchasing power twenty years into retirement**. This is **similar to the Quinn Plan**'s impact and a significant problem.
- Two provisions of HB 6258 are a step in the right direction. It includes a type of **pension funding guarantee** from the state, although it **needs to be toughened**. It also promises a revenue stream to help the state make future payments. But without an actuarial analysis or legal review, we **cannot ascertain** whether these provisions are **feasible or constitutional**.

Framework Recommendations – Summary

- The second study discusses our **recommendations for a responsible way forward** to address the pension debt and continue funding of vital public services, like education, health care, public safety, and infrastructure.
- **Illinois' core, chronic problem** has been its **failure to make consistent, actuarially-sound payments** into the state's pension systems.
  - That is why we propose **codifying an ironclad guarantee** to give Illinois employees a contractual right to timely and sufficient payments. **No one cares more about having solvent pensions than the workers** counting on receiving them in retirement.
  - If such an ironclad guarantee is provided, we believe employees would be prepared to pay an additional 2% of their salaries, phased in over two years. This raises **real money** for the systems – approximately $350 million annually once fully phased in. It is consistent with the principle of **shared sacrifice**.
- We also have to enable the state to **stop using its pension systems as a credit card** – that is, to **stop borrowing from its pension funds to pay for its everyday operating expenses.**
  - To this end, we propose closing approximately **$2 billion in tax loopholes** to bolster revenues.
  - Tax loopholes get a **privileged place in the tax code**. Historically, they tend to **get less scrutiny**. But they are a **type of spending** – even as other spending garners more attention in difficult fiscal times.
  - The **economic effectiveness** of some tax loopholes is **questionable**. The Illinois Department of Revenue expressed its doubts in a 2009 review. And business owners and site selectors often point to factors other than state taxes or tax incentives as reasons to locate in a state - for instance, highway accessibility and the availability of skilled labor.
- We are calling for a **pension summit in January at which our unions would be participants.** We have repeated for months that we stand ready to come to the table and negotiate a solution, and we are **renewing and reaffirming that pledge** today in a **proactive** way. We are **releasing studies today to help inform the summit**.

Analysis of Worker and Retiree Pension Benefit Cuts under the Quinn Plan and HB 6258

December 17, 2012

Executive Summary

Introduction

As is well documented, the State of Illinois suffers from substantial unfunded pension obligations that have accumulated over many years. At the close of FY 2012, actuarial unfunded liabilities for state-funded pension plans neared $95 billion.[1] It is largely undisputed that the primary cause of the unfunded liabilities is the state's failure to contribute to the funds as required – not benefit levels. In fact, the benefits for employees and retirees under Illinois' pension systems are not overly generous. On average, Illinois public employees receive a modest $32,000 benefit, and almost 80% of workers in state-funded pension systems are ineligible for Social Security, making pensions their only reliable means of retirement security. Moreover, workers faithfully contributed their fair shares to the pension systems, regardless of the state's fiscal irresponsibility. In other words, there were no "pension holidays" for employees – just the assurance that their reasonable retirement benefits, which they worked for years to earn, would be waiting for them unaltered upon retirement.

Now, some of the state's leading politicians, pundits, and business groups have advocated for the state to renege on the pension benefits owed to teachers, state employees and higher education personnel. The "Quinn plan" would cause deep harm to working and retired state employees and teachers, negatively impact the Illinois economy, and yet still not solve the state's primary pension problem – the failure to regularly fund its annual required contributions. Such a course is not only morally objectionable; it is also inconsistent with the requirements of the state's constitution, which expressly safeguards the pension benefits of public workers. Indeed, the guarantee of employee pension benefits was specifically included in the constitution in light of the state's historical nonfeasance regarding its pension obligations.

Key Findings

In the spring of 2012, the state Senate passed HB 1447 as Amended. (As of November 2012, the House has not taken up the bill.) The legislation was designed to essentially coerce state employees into accepting a significant cut in cost of living adjustments (COLA). An employee who refused to accept such a cut would lose access to retiree healthcare and, if an active employee, have his/her pensionable pay frozen at its current rate. The "We Are One Illinois" coalition has analyzed the effect of this no-win choice for workers and, using reasonable assumptions, identified the following key findings:

- Employees who suffer the reduction in COLA would forfeit a third of their inflation-adjusted purchasing power over the first twenty years of their retirement.
- Because the revised COLA lags inflation by design, income replacement rates in retirement would fall to 40% to 60% of final pay after twenty years of retirement. Experts recommend income replacement rates of 85% to maintain living standards.
- When compared with the fully inflation-indexed Social Security system, the revised COLA under HB 1447 would have left retirees with 15% less income over the last

[1] Illinois General Assembly. Commission on Government Forecasting and Accountability. "Special Pension Briefing." Springfield: November 2012. http://www.ilga.gov/commission/cgfa2006/Upload/1112specialPensionBriefing.pdf

twenty year period and a current monthly check that is 25% less than an annuity that is adjusted according to the federal Social Security formula.

The erosion of retirees' purchasing power is particularly troubling given that, compared to other age groups, older Americans more frequently purchase services, such as health care, that are susceptible to higher inflation rates. At the same time, a Teachers' Retirement System study found its retirees are highly likely to remain in Illinois, spend their pension earnings in Illinois, and thus create jobs in Illinois that contribute to the state's overall economic health. The TRS study found that the effect of $3.1 billion in retired teachers' pensions and benefits in the Illinois economy helped to support over 32,000 jobs in 2011. [2]

While the latest pension proposal – HB 6258 – contains some positive developments, it also contains significant problems. Of particular study in this analysis are COLA cuts, which are similar to the Quinn plan, and increased retirement ages. Other broad concerns about the legislation's constitutionality, feasibility, and actuarial soundness remain.

Payments to the pension fund are not only a constitutional necessity but the fulfillment of the state's ethical obligation to the people who teach our children, keep our communities safe, and provide assistance to those in need. The public workers Illinoisans rely on – teachers, caregivers, firefighters, nurses, police officers, and corrections officers, to name a few – have been promised that they will have a secure retirement in return for their service. The state must stop using its pension funds as a credit card to pay for education, public safety, health care, and other core services, and it must repay the money it has borrowed from those funds. At the same time, it is critical that Illinois has replacement revenue to fund the vitally important public services that have historically been sustained by pension borrowing.

[2] Teachers' Retirement System of Illinois, "Economic Impact Study of TRS Benefit Payments by Illinois Legislative District and County,"April 2012, http://trs.illinois.gov/subsections/general/PUB09.pdf.

Introduction

Insufficient Employer Contributions

A far reaching pension reduction proposal has been proposed by members of the General Assembly and Governor Quinn to address the funding shortfalls in state-funded pension systems. The inadequate funding of the state systems is largely due to the failure of the state to pay contributions on an actuarially appropriate basis. Indeed, the current funding plan, to achieve 90% funding over a fifty year period ending in 2045, has not led to adequate funding of the state plans. Nevertheless, employees have continued their historic pattern of making required contributions consistently. Employees have never been offered a holiday from contributions; yet, the state has never paid the "Annual Required Contribution" (ARC) as defined by the Government Accounting Standards Board (GASB), and the current plan for amortizing the unfunded liability does not meet the requirements of GASB Statement No. 25.

In an effort to address its irresponsible funding behavior, the Legislature enacted a new pension tier – Tier II – in 2010. This pension tier dramatically reduces benefits for new employees in the State Employees' Retirement System (SERS), the State Universities Retirement System (SURS) and the Teachers' Retirement System (TRS), as well as other state and local pension systems, and purports to reduce the five state systems' accrued liability by $30 billion over the next 40 years; however, the change has not been accompanied by substantially greater funding discipline on the part of the state. In fact, the state reduced its contributions to reflect the anticipated savings. This reduction was $189 million in FY 2011 for TRS. (The reduction in funding to the SERS fund was not reported in the SERS CAFR.)

The Quinn Plan

The "Quinn Plan" and Its Unconstitutionality

In 2011 and again in 2012, the Legislature and the Governor renewed efforts to address the growth in the state's unfunded actuarial accrued liability. These efforts relied, in large part, on plans to coerce employees into surrendering a part of their earned pension benefits. The state also tried to have employees waive their legally guaranteed right to earn benefits in the future at the same rate as previously provided.

The legality of these proposals is very much in doubt. The 1970 Illinois Constitution Pension Protection Clause, Article XIII, Section 5, expressly states: "Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired." Indeed, the guarantee of employee pension benefits was specifically included in the constitution in light of the state's historical nonfeasance regarding its pension obligations.

The "Quinn plan," as embodied in HB 1447 as Amended, is clearly inconsistent with the Illinois Constitution as interpreted by the state courts because the proposed legislation implements unilateral changes diminishing employee and retiree pension benefits. It stands to reason that the enactment of the measure will certainly be met with litigation. In a widely cited op-ed in the *Chicago Tribune*, former Chief Judge of U.S. Court of Appeals' D.C Circuit Abner

Mikva observed about another proposal that impaired pension benefits, the legislation would be tied up in the courts for "many years," and the state would not benefit from any immediate savings. [3]

In the end, an unconstitutional pension change would be nullified by the court, and the legislature would have, once again, merely kicked the can down the road. Alluding to such an outcome, Judge Mikva noted that passage of a "show" pension bill of "dubious" constitutionality may actually have the effect of signaling to the bond market that Illinois is not serious about addressing pension funding issues. This is the exact opposite result to what policymakers are hoping to signal with pension legislation.

The Quinn Plan: A Harmful False Choice

The Quinn plan presents employees and retirees with two no-win options, both of which would reduce an employee's pension benefit. Under HB 1447 as Amended, state employees eligible for Tier I benefits (i.e., hired prior to January 1, 2011) could "choose" to opt into a reduced post-retirement cost of living adjustment (COLA) formula of the lesser of 3 percent or one-half of the Consumer Price Index (i.e., the actuarial equivalent of a 1.5 percent adjustment), annually, non-compounded (i.e., the COLA is calculated only on the initial pension benefit amount) in exchange for the right to participate in an unspecified retiree health care benefit. Furthermore, employees who opt into to the lower COLA would be ineligible for the COLA until the earlier of January following the attainment of age 67 or January 1 following the fifth anniversary of the retired employee's annuity starting date.

Employees who do not "choose" the lower COLA formula would continue to receive a full COLA of 3% annually, compounded (i.e., each annual adjustment is based on the previous year's pension benefit amount), but would have his/her final average compensation (FAC) for pension purposes frozen at its current rate of pay and would also be ineligible for retiree health care. The chart below summarizes the proposed changes:

Table 1: Employee "Choices" Under the Quinn Plan (HB 1447 as Amended)

	Opt-in to lower COLA	Maintain COLA
COLA Rate	Lesser of 3% or one-half of CPI annually, non-compounded	No change: 3% annually, compounded
COLA Implementation	Delayed five years, or to age 67, whichever comes first	No change
Final Average Compensation	Increases in future based on pay increases	Frozen at 2013 level
Retiree Health Care	Eligible, benefit unspecified	Ineligible

The effects of these options on employees are substantial and vary, depending on the particular situation of the employee. The apparent goal of the of the legislation is to reduce the accrued liability in the pension funds by forcing employees to choose from among two options

[3] "Deserving of high praise for pension reform effort." Hon. Abner Mikva, *Chicago Tribune*, April 9, 2010. http://articles.chicagotribune.com/2010-04-09/news/ct-oped-0409-pension-20100409_1_pension-reform-pension-laws-third-rail

that reduce an employee's earned benefit. Accordingly, to the extent employees opt into the lower COLA formula, the goal of the legislation is achieved. A reliable estimate of the impact of the proposal on the funded status of the pension funds and the state's annual pension payments has not been made available to the public.

The Quinn Plan: Key Findings

Loss of Purchasing Power in Retirement under the Quinn Plan

Our analysis of the proposal indicates that it would be less economically injurious for the vast majority of employees to opt into the lower pension COLA formula because the freeze in pensionable compensation will impose a far greater financial penalty on employees. Employees intending to retire at age 60 with 30 years of service must be within four years of their intended retirement date for it be in their economic interests to not surrender their current COLA. In essence, the proposal coerces active employees into a forfeiting a benefit that they have both earned by service and purchased with their own contributions.

Our analysis of the proposed impact on a newly retired employee opting into the lower COLA shows the hardship such an employee would face. The COLA reduction leads to significant erosion in the purchasing power of the pension because the COLA under the Quinn Plan is inadequate *by design* to keep pace with assumed rates of inflation. In other words, because the COLA is reduced, the retiree will face a greater deterioration in his/her standards of living each year. The following chart depicts the loss of real income within an example retiree's monthly pension check. In the first five years, at age 65, the retired state employee's real purchasing power is cut by 13.7 percent. The loss of income worsens each year so that, by age 75, the retiree's pension is worth 26.2 percent less than when he/she retired in real terms. By age 90, it is a staggering 43.4 percent less.

Table 2: SERS COLA Reduction for State Employee Retiring at Age 60 under Quinn Plan

Age	Loss of Real Income (percent)
65	13.7%
70	20.0%
75	26.2%
80	32.2%
85	37.9%
90	43.4%

The proposed pension change is even more egregious on teachers participating in TRS, assuming this policy is extended to them. The loss of purchasing power suffered by TRS participants, depicted in the chart below, is particularly troublesome because Illinois' teachers are excluded from the federal Social Security system. The chart shows that after five years of retirement, at age 65, the purchasing power of the teacher's pension is 13.7 percent less. The loss of value escalates more rapidly than the retired state employee's pension so that, by age 75, the retired teacher has lost 29.3 percent of the value in his/her pension, and by age 90, 48.4 percent.

Table 3: TRS COLA Reduction for Teacher Retiring at Age 60 under Quinn Plan

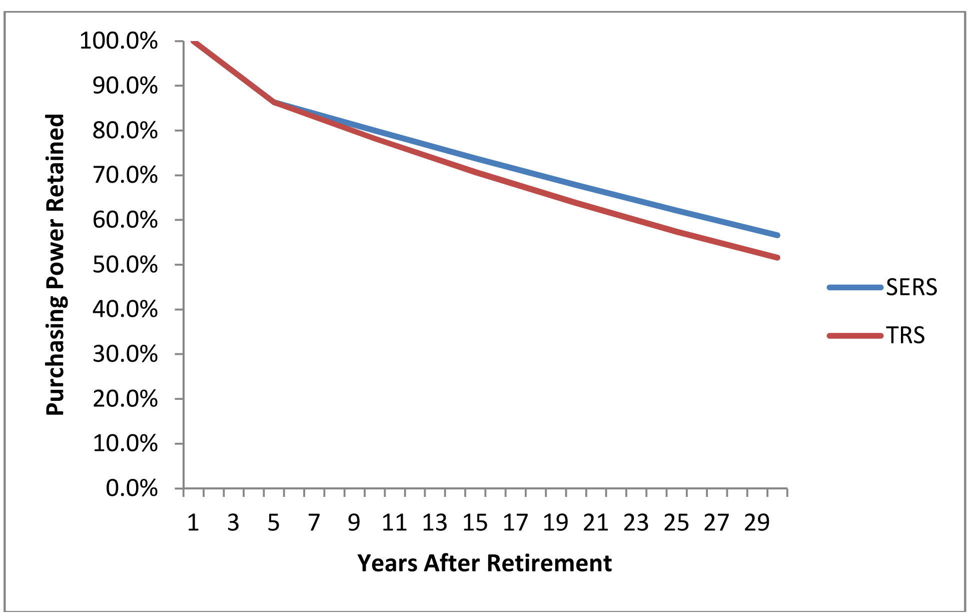
Age	Loss of Real Income (percent)
65	13.7%
70	21.8%
75	29.3%
80	36.2%
85	42.6%
90	48.4%

As demonstrated by the above tables, employees affected by these changes would see a substantial reduction in retirement security. A state employee living to the age of 80, which is close to the approximate average life expectancy in the US, would see a loss of 32.2% in purchasing power in his/her pension check. In other words, by age 80, a retired employee would have a third less pension income on which to live.

The impact of the proposed changes on teachers is even more devastating. A typical teacher would suffer a loss of over a third (36.2%) in terms of purchasing power by age 80. Retirees living to longer ages would suffer even deeper reductions.

Finally, an analysis of the impact of the COLA reduction on current retirees reveals that the impact is similarly substantial. After ten years, by the time the retirees in these examples are approximately 80 years old, he/she would also be suffering an ongoing loss of 15% of pension earnings with such reductions escalating each year. At age 85, the monthly pension check is reduced by 23%.

Graph 1: Annual Benefit Loss in Real Income/Purchasing Power under Quinn Plan



As explained and illustrated above, the impact on individual retirees of the reduction in COLA is dramatic. Most retirees would see a reduction in the income necessary to support their living standards by 30% to 40% over the course of their retirement. The consensus opinion among financial planners and retirement security analysts is that pension and retirement benefits must be fully indexed for inflation in order to achieve their express purpose of maintaining living standards in retirement. After all, retirees have extremely limited capacity to find alternatives to compensate for the loss of the pension income.

A member of TRS retiring with 30 years of service would receive a pension benefit that replaces approximately 60% of his/her final rate of pay under the pension formula, far below the 78% to 85% range recommended by expert analysts. Under the current COLA formula, this level of replacement is maintained over time. However, as noted above, the revised, lower COLA formula would effectively reduce this replacement rate each year in retirement so that by the time the teacher has been retired for 20 years, the replacement rate is less than 40% of final pay. The result is that a retired teacher would earn about half of the recommended level of income replacement necessary to maintain living standards at the age of 80.

State employees are covered by Social Security, so the impact of the reduced COLA formula is significant, but not as severe as the effect on teachers. Under the lower basic pension formula offered to state employees, the pension replaces about half of the retiree's pay at retirement. Assuming final pay was $50,000, the employee would begin to collect about $12,000 in annual Social Security benefits, bringing the initial replacement to a barely acceptable 74%. However, the replacement rate would suffer over time. Although the Social Security benefit is fully indexed for inflation, the state pension benefit would lose substantial ground to inflation, as noted above. By the time the state employee has been retired for 20 years and is approximately 80 years old, the replacement rate is just 57% of the income necessary to maintain living standards.

As demonstrated by this analysis, the proposal to coerce teachers and state employees into the lower the COLA formula will not only result in the unfair seizure of an earned benefit to which the employees have substantially and directly contributed, but also will lead to the impoverishment of many of these retired public service workers.

The federal Social Security program is fully indexed for inflation, as measured by the CPI for Urban Wage Earners and Clerical Workers (CPI-W). That index provides inflation protection that is more beneficial for retirees than the Illinois SERS, SURS, and TRS COLAs, which are 3% each year regardless of the rate of inflation. Since 1975, the CPI-W has grown by an average of 4.2% annually, [4] with average annual Social Security COLA growth essentially tracking this figure over this timeframe.[5]

The following chart illustrates the significant erosion of the value of the proposed reduced COLA formula when compared with a fully inflation indexed COLA as provided in the Social Security system. In this illustration, an initial $700 monthly Social Security benefit subject to the actual annual COLA benefits provided under the Social Security system is compared with an initial $700 pension annuity provided under the proposed new COLA formula

[4] United States. Social Security Admin. Office of the Chief Actuary. "Average CPI by Quarter and Year." http://www.ssa.gov/oact/STATS/avgcpi.html
[5] Ibid. "Social Security Cost-of-Living Adjustments." http://www.ssa.gov/oact/COLA/colaseries.html

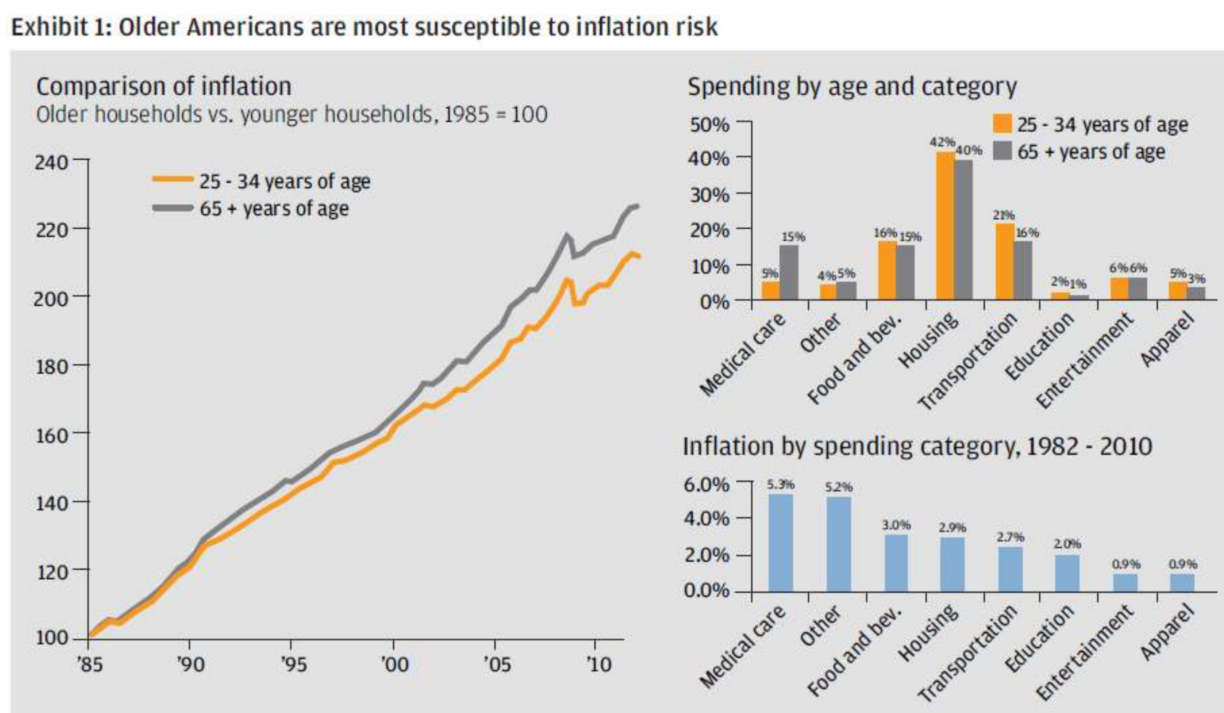
under SERS and TRS. The illustrations are for an employee who both achieves age 65 and retires on December 16, 1992, and provides an analysis of how the COLA adjustments would affect retirement income.

Table 4: Social Security vs. Quinn Plan's COLA

	Social Security	**Quinn Plan's COLA**
Initial Annuity – 1993	$700/month; $8,400/year	$700/month; $8,400/year
Annuity in 2012	$1,146/month; $13,752/year	$855/month; $10,260/year
% reduction in 2012		-25%
% reduction 20 year total		-15%

Full inflation indexation is also important because retirees purchase goods and services that have historically suffered price inflation to the greatest extent. For example, older Americans purchase more health care, which has a higher inflation rate, and less apparel, which has the lowest inflation rate, than other Americans. The chart on the following page, reproduced from the "Retirement Inflation Threat" publication produced by JPMorgan Asset Management, demonstrates the greater effect of inflation on the elderly and near elderly population.[6]

Graph 2: The "Retirement Inflation Threat"



Source (Left chart): Estimates based on Consumer Price Index and Expenditure Surveys, BLS, December 2011, J.P. Morgan Asset Management. Source (Top right chart): BLS, Consumer Expenditure Survey. Data as of December 2011. Source (Bottom right chart): BLS, Consumer Price Index, J.P. Morgan Asset Management. Data represents annual percentage increase from December 1981 through December 2011 with the exception of recreation and education and communication, which were first published in 1998.

---

[6] See JPMorgan Asset Management's "Retirement Inflation Threat," available at: http://www.jpmorganinstitutional.com/cm/BlobServer/The_Retirement_Inflation_Threat.pdf?blobkey=id&blobwhere=1321476229876&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs&isAMIA=yes

In consideration of the higher cost of living, and inflation rates, faced by seniors, Senator Tom Harkin (D-IA) has recently proposed use of a new Consumer Price Index (CPI-E), to reflect the differing market basket of goods and services purchased by seniors.[7] Unfortunately, some Illinois policymakers are intent on moving in the opposite direction.

Economic Harm under the Quinn Plan

Of course, the economic harm of the Quinn plan does not remain just with the retirees, but instead extends out into the entire Illinois economy. Tens of thousands of retired state employees and teachers live in Illinois, reaching every county in the state, and they spend their retirement benefits on goods and services primarily in their local communities. Reducing their incomes will have a deeply harmful ripple effect throughout Illinois' economy. TRS reported this year that 80 percent of TRS benefit recipients live in Illinois. Pension benefit disbursements generated secondary economic impacts equal to 44 percent of the original benefit payments and were responsible for the creation of more than 32,000 jobs in the state.[8]

Finally, for all the harm that these benefit reductions would do to retired state employees and teachers and to Illinois' economy, the Quinn plan and similar proposals still would do nothing to address the widely-acknowledged cause of the state's pension funding issues: the failure on the part of the state to make regular, adequate, actuarially-sound payments to fund the plans. As previously explained, the state in 2010 sharply reduced retirement benefits for newly hired employees, but rather than using the savings to improve its funding position, state officials instead reduced contributions.

HB 6258

Just before this report's release, HB 6258 was introduced. It has five principal components affecting Tier 1 employees in SERS, TRS, SURS, and GARS:

1. Reduces cost-of-living-adjustments (COLA) by capping the annual 3 percent COLA at $600 per year for employees covered by Social Security and $750 for employees not covered by Social Security;
2. Delays the COLA until the earlier of age 67 or five years after retirement;
3. Increases employee contributions by 1 percent of pay in fiscal year 2014 (effective July 1, 2013) and by an additional 1 percent of in fiscal year 2015 (July 1, 2014);
4. Increases the retirement age by one year for employees who are at least 40 but not yet 45; by three years for employees who are 35 but not yet 40; and by five years for employees younger than 35; and
5. Caps pensionable salary at the greater of the Social Security taxable wage base ($113,700 effective January 1, 2013) or the employee's current rate of pay as established in a collective bargaining agreement at the time the law is adopted.

---

[7] See Sen. Tom Harkin's website: http://www.harkin.senate.gov/documents/pdf/5011b69191eb4.pdf

[8] Teachers' Retirement System of Illinois, "Economic Impact Study of TRS Benefit Payments by Illinois Legislative District and County,"April 2012, http://trs.illinois.gov/subsections/general/PUB09.pdf.

HB 6258: Key Initial Findings

COLA Reductions

We have modeled the impact of the reduction in COLA benefits on typical system members. For purposes of this illustration, we assume that the employee retires on December 31 at the age of 60. A SERS member is assumed to have final average compensation of $60,000 after 30 years of service, and a TRS member is assumed to have final average compensation of $75,000 after 27 years of service. (In the case of TRS, the age, service, and salary figures are averages for newly retired members according to the TRS 2011 CAFR). Based on these assumptions, we find that both SERS and TRS members would suffer dramatic losses in real income as their pension payments fail to keep pace with assumed long term annual inflation rates of 3 percent. The loss of purchasing power suffered by TRS participants, depicted in the chart below, is particularly troublesome because Illinois teachers are excluded from the federal Social Security system. The real income reduction is shown in the following charts:

Table 5: SERS COLA Reduction for State Employee Retiring at Age 60 under HB 6258

Age	Loss of Real Income (percent)
65	13.7%
70	18.2%
75	23.0%
80	28.1%
85	33.2%
90	38.2%

Table 6: TRS COLA Reduction for Teacher Retiring at Age 60 under HB 6258

Age	Loss of Real Income (percent)
65	13.7%
70	19.3%
75	25.0%
80	30.7%
85	36.2%
90	41.5%

Just as significantly, the amount of pension collected over the members' first twenty years in retirement, by age 80, would be 20 percent less for a TRS member and 18 percent less for a member of SERS.

Contribution Increases

Payroll information contained in the Financial Reports of the state retirement systems (SERS, SURS, TRS, GARS) indicates that an additional 1 percent of payroll contribution would provide the systems, on aggregate, with $175 million in revenue each year. When the 2 percent of pay contribution increase is fully phased in, the systems will gain an additional $350 million each year from active employees.

Increase in Normal retirement Age

The increase in the normal retirement ages for relatively younger active employees effectively reduces the value of those employees' accrued retirement benefits. The SERS and TRS reduce a member's annuity at retirement by 6 percent for each year the member's age is below the normal retirement age. Using this rate, the chart below shows the loss in value stemming from the higher retirement ages proposed in HB 6258:

Table 7: Retirement Age Increase and Annuity Reduction/Value Lost

Age	Years Added to Retirement Age	Value Lost by Member
40 but less than 45	1	6%
35 but less than 40	3	18%
Less than 35	5	30%

Cumulative Value of Loss for Employees under Age 45

As the chart immediately above shows, employees affected by increased retirement ages will suffer a loss in the value of their pension of up to 30% immediately upon retirement. When combined with the loss suffered due to the delayed and reduced COLA benefit, the economic reduction in the value of their retirement benefit is severe. In the case of an employee under the age of 35, the combination of the higher retirement age and COLA restrictions reduce the value of his/her pension benefit by approximately 40% by age 80. For an employee between the ages of 35 and 40 the loss of value because of the increase in the normal retirement age when combined with the COLA restriction yields a 24% loss of benefit by age 80. For an employee between the ages of 40 and 45, the reduction is 24% by age 80.

Conclusion

For the reasons outlined in this report, proposals similar to the Quinn Plan, as embodied in HB 1447 as Amended, are ineffective solutions to the funding challenges facing Illinois' state funded pension systems. Because the Illinois Constitution expressly protects employees' pension benefits, efforts to simply "cancel" accruals will inevitably be overruled by the courts. It is also quite likely that the courts would not allow such proposals to be implemented at all, as Judge Mikva indicated. In effect, the Quinn Plan is a political ploy, not a meaningful resolution of the funding challenges faced by the state's pension systems.

In sum, payments to the pension fund are not only a constitutional necessity but the fulfillment of the state's ethical obligation to the people who teach our children, keep our communities safe, and provide assistance to those in need. The public workers Illinoisans rely on – teachers, caregivers, firefighters, nurses, police officers, and corrections officers, to name a few – have been promised that they will have a secure retirement in return for their service. The state must stop using its pension funds as a credit card to pay for education, public safety, health care, and other core services, and it must repay the money it has borrowed from those funds. At the same time, it is critical that Illinois has replacement revenue to fund the vitally important public services that have historically been sustained by pension borrowing.

This paper compares expected retirement outcomes for three sample careers in the Illinois State University Retirement System (SURS). Table 1 compares each of the existing Tiers' provisions with those of HB6258.

Table 1: SURS Evolution - Comparing Terms

	Tier 1 (for employees hired before 1/1/2011)	Tier 2 per 2010 legislation (new hires as of 1/1/11)[1]	HB6258
Retirement Age	-Age 62 with at least 5 years of service. -Age 60 with at least 8 years of service. -Any age with 30 years of service.	-Age 67 with 10 or more years of service. -Early at age 62 with 10+ yrs. (6% reduction per year under age 67)	-Age 59.5
Retirement Formula	2.2% of FAS for each year of service.	Not changed	-an employer pay credit of 6.2% and an employee contribution of 8.0%, -an interest credit of at least 4.0% & at most 10%, and -an annuitization rate of at least 4% & at most 8%.
Max. annuity	80% of FAS.	FAS may not exceed $106,800, (adjusts with inflation)	No maximum.
Final Average Salary	Average annual earnings during the 4 consecutive academic years of service which his or her earnings were the highest.	Average of the 8 highest consecutive years within the final 10 years.	All pay
Annual COLA	3% compounded.	Lesser of 3% or one-half of the annual increase in the CPI-U during the preceding 12-month calendar year; not compounded i.e., after 10 years, benefit will increase by about 20%	3% not compounded i.e., after 10 years, benefit will increase by about 40%
Employee contributions	8.0% of salary	Not changed	Not changed

[1] Does not include state policemen, firefighters, and correctional officers.

Tables 2 and 3 show 20, 30 and 40 year employee expected replacement ratios for Tier 2 and HB 6258, respectively. The average, new entrant active member is a 27 year old according to the 2011 SURS Actuarial Valuation Report. No scenario reflects a Social Security benefit because these workers do not participate in that program. Lastly, this analysis does not consider obstacles that may be encountered due to the legality or taxability of the changes. All scenarios assume the average member retires at 67 and ends with 105k in annual pay projected at 3.75%. This increment is the wage inflation rate from the aforementioned report. Table 2 represents Tier 2's provisions as defined by Public Act 96-0889 and displays these expected replacement ratios:

Table 2: Tier 2 Benefit Adequacy at Age 67

Interest Credit	N/A		
Future Years of Service	20	30	40
Expected Replacement Ratio	***36%***	***53%***	***71%***

Under Tier 2; the short, medium and long service workers' replacement ratios would be 36%, 53%, and 71%; respectively.

Table 3 represents HB6258's cash balance plan's provisions, which SURS has summarized.[2] To project cash balances, the model reflects three different interest crediting scenarios varying with plan rates of return (ROR). The first is 4.0%, the plan minimum. Each of the next two interest credit scenarios applies HB6258's formula for when plan returns exceed certain minimum thresholds. This threshold is twofold: the ROR for the preceding year and the average ROR for the preceding 5-year period must both exceed 4%. Because SURS' 5-year period returns would have credited only 4% in two of the last three fiscal years, this 4.0% scenario is the most likely outcome, and represents the guaranteed benefit for employees covered by the cash balance plan. The "5.5%" interest credit sums an assumed treasury rate of 4.0% with 2/3 * (6.25% - 4.0%) where 6.25% is the sample ROR. The last scenario credits 6.5% in the instance that plan assets return 7.75%, which is what SURS expects. In each case, the assumed annuitization rate sums the same assumed treasury rate of 4.0% and 200 basis points.

Table 3: HB 6258 Benefit Adequacy at Age 67

Interest Credit	**4.0%**			**5.5%**			**6.5%**		
Future Years of Service	20	30	40	20	30	40	20	30	40
Expected Replacement Ratio	***21%***	***31%***	***42%***	***25%***	***40%***	***59%***	***28%***	***48%***	***74%***

[2] http://surs.org/shepherd.surs?flk=Bills&shp=62

Table 3 illustrates the risk an employee assumes and how much benefit adequacy depends on length of service and rates of return.

Another result of the HB 6258 cash balance proposal would be that this public plan may no longer suffice as a Social Security alternative. Internal Revenue Service Publication 963[3] elaborates:

> A defined benefit retirement system that qualifies as an alternative to social security provides for a retirement benefit to the employee that is comparable to the benefit provided by the social security part of FICA. Generally, a plan meets the requirement if the benefit under the system is at least 1.5 percent of average compensation during an employee's last three years of employment, multiplied by the employee's number of years of service.

In SURS, 3-year final average salary (FAS) is about 96% of the final salary, given the 3.75% average wage inflation assumption. Therefore, a benefit that provides at least a 1.5% of final 3-year FAS would compare to the projected minimum benefits of this plan as follows in Table 4.

Table 4: SURS Tier 2 and HB 6258 Replacement Ratios vs. Social Security Minimums

Years of Service	20 years	30 years	40 years
Tier 2 Replacement Ratio	36%	53%	71%
Minimum Social Security alternative Replacement Ratio	29%	43%	58%
HB 6258 Minimum Replacement Ratio	21%	31%	42%

In conclusion, Tier 2 provides replacement ratios that exceed the Social Security minimum requirement, while HB 6258's proposed cash balance plan would likely mean that SURS no longer qualifies as an alternative to Social Security.

[3] http://www.irs.gov/pub/irs-tege/p963_1111.pdf

A Way Forward: Framework Recommendations to Address Illinois' Fiscal Dilemma

December 17, 2012

Executive Summary

In the "Analysis on Worker and Retiree Benefit Cuts in the Quinn Plan and HB 6258," the We Are One Illinois coalition showed that cutting pension benefits imposes serious and inequitable harm to Illinois' retired public employees. Taking away retirees' cost-of-living adjustments, as put forward in the "Quinn plan" (embodied in HB 1447 as Amended), equates to a cut in benefits of between 25 and 30 percent after 15 years. Similar COLA cuts would occur under HB 6258. This violates the Illinois Constitution's clear language that prohibits employee benefit reductions as well as the case law supporting it. Moreover, any proposals similar to the Quinn plan would harm not only the retired public employees themselves, but the entire Illinois economy, as the loss of benefit payments would ripple through every county in the state, magnifying the negative economic impact. But the worst part of the Quinn plan is that, for all the harm it would impose, it still would do nothing to address the fundamental cause of Illinois' pension liability, which is the state's historical unwillingness to make annual, actuarially-sound contributions to the systems.

The way forward that we present here recognizes those realities. Instead of unlawful, harmful and ineffective cuts, our proposal is built on the principle of shared sacrifice by all groups with a stake in protecting Illinois' public services. Public employees have said time and again that we are willing to do our part to aid in the stabilization of pension funding. We will only do so, however, if there is an ironclad guarantee that the state will fulfill its funding responsibilities. Moreover, our coalition will join with other concerned parties to ensure that sufficient revenues can be found to fund vital services that have in the past relied on using the pension systems as a credit card to receive funding. To those ends, the We Are One Illinois coalition proposes the following:

1. The state should adopt statutory language establishing for employees an unimpairable and enforceable contractual right to timely and sufficient employer pension contributions.
2. With that ironclad guarantee, employees could be asked to pay an additional contribution of 2% of their pensionable salary.
3. In order to sustain education, health care and other vital public services, all concerned parties should work together to close tax loopholes that benefit special interests and raise needed revenue, from among the $2 billion in revenue options outlined in this report.

The We Are One Illinois coalition remains open to other ideas and proposals that truly solve our pension funding issues and that are consistent with the principle of shared sacrifice.

1. Statutory Funding Guarantee

The State of Illinois must ensure that pension contributions from the employer are made on an actuarially sound basis. In this regard, we note that although the Illinois Constitution guarantees employee pension benefits, there is no guarantee that the employer will properly fund such benefits. New York State, for example, guarantees both benefits *and* actuarially sound funding. Accordingly, New York State's pension fund is virtually fully funded while Illinois' pension funding approach has never been actuarially sound.

In 2011 New Jersey adopted legislation addressing its inadequate pension funding. Unlike Illinois, New Jersey had a history of responsibly funding its pensions until the late 1990s. Unfortunately, over the last 13 years, the state has not been a responsible steward of its pension fund. To address its own behavior, the 2011 legislation provided employees with both a contractual right to their pension benefit as well as to proper funding.

The specific statutory language in the New Jersey legislation is as follows:

> *Each member of the Teachers' Pension and Annuity Fund, the Judicial Retirement System, the Prison Officers' Pension Fund, the Public Employees' Retirement System, the Consolidated Police and Firemen's Pension Fund, the Police and Firemen's Retirement System, and the State Police Retirement System shall have a contractual right to the annual required contribution amount being made by the member's employer or by any other public entity. The contractual right to the annual required contribution means that the employer or other public entity shall make the annual required contribution on a timely basis to help ensure that the retirement system is securely funded and that the retirement benefits to which the members are entitled by statute and in consideration for their public service and in compensation for their work will be paid upon retirement. The failure of the State or any other public employer to make the annually required contribution shall be deemed to be an impairment of the contractual right of each employee. The Superior Court, Law Division shall have jurisdiction over any action brought by a member of any system or fund or any board of trustees to enforce the contractual right set forth in this subsection. The State and other public employers shall submit to the jurisdiction of the Superior Court, Law Division and shall not assert sovereign immunity in such an action. If a member or board prevails in litigation to enforce the contractual right set forth in this subsection, the court may award that party their reasonable attorney's fees.*

In closing, consider the Prairie State's own Illinois Municipal Retirement Fund (IMRF), a state managed plan for participating municipal governments. Unlike the state-funded pension systems, the IMRF enjoys acceptable levels of funding (83% ratio of assets to liabilities). The reason for the distinction is clear: the IMRF has required participating governments to fund the plan based on generally accepted accounting and actuarial principles. The difference is not due to benefits; the IMRF offers more generous benefits than State Employees Retirement System (SERS). As the recently released report of the State Budget Crisis Task Force put it, "The primary cause of the state pension systems' underfunding is that the state does not impose the same obligation on itself that it imposes on local governments, and for decades its employer contributions have been below annually required amounts."[1]

2. Employee Contributions

[1] Report of the State Budget Crisis Task Force. Illinois Report. Richard Ravitch & Paul Volcker Co-Chairmen. October 2012. http://www.statebudgetcrisis.org/wpcms/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf p. 19

If sacrifice is truly shared and appropriate safeguards are established regarding employer contributions, employees eligible for Tier I benefits in the five affected systems – SERS, SURS, TRS, JRS, and GARS – could also be asked to contribute another 2% of pensionable pay over and above current contribution rates, phased in over two fiscal years. We estimate that such contribution increases will yield over **$350 million** annually by the end of the phase in.

Public employees have said time and again that we are willing to do our part to aid in the stabilization of pension funding. We will do so if there is an ironclad guarantee that the state will fulfill its funding responsibilities. Moreover, we will join with all other concerned parties to ensure that sufficient revenues can be raised to fund all of the vital services that have in the past relied for their funding in part from pension borrowing.

3. Close Special Tax Breaks to Fund Vital Services

If Illinois is to stop relying on its pension systems as a credit card to pay for education, health care and other vital public services, all concerned parties must work together to close wasteful special tax breaks to raise needed revenue. The We Are One Illinois coalition strongly recommends that we look first at special tax breaks that benefit those who have gained the most from the Illinois economy and are in the best financial position to support public services. This section contains about **$2 billion in revenue options**. We also remain open to other ideas and proposals for revenue.

Illinois' Revenue Challenges

Illinois is a low-tax state. Total state taxes amounted to just 5.5 percent of total in-state personal income in 2011, falling well behind the 6.2 percent fifty-state median and placing Illinois 37th in a ranking of state tax burden. This remains the case even after the income tax increase that took effect in 2011. (The most recent figures for combined state and local revenue date to 2010, before the January 2011 income tax increase. That data also shows a very low comparative tax burden, with Illinois ranking 42nd among the states in the share of personal income levied in all state and local revenues.)[2]

Such low taxes have proven inadequate to the state's needs. Illinois has a longstanding history of structural budget deficits and underinvestment in core public services. Despite its higher-than-average per-capita income, Illinois spends at below-average per-capita levels on education, human services, Medicaid, and public safety. The state also has carried out a deliberate, long-term policy of underfunding its public employee pensions. This has allowed the unfunded pension liability to grow despite the state's low state employee headcount per capita (49th in the nation), low ranking among the states in education funding, and relatively modest pension

[2] Federation of Tax Administrators, "2011 State Tax Revenue," http://www.taxadmin.org/fta/rate/11taxbur.html and "2010 State & Local Revenue as a Percentage of Personal Income," http://www.taxadmin.org/fta/rate/10stl_pi.html.

benefits.[3] The state's neglect of its public commitments in all of these areas stems from an unwillingness to raise adequate revenues.

Illinois has the potential to meet its revenue challenge by adopting reforms that will modernize the tax system, eliminate special tax breaks for corporations and the wealthy, and protect the state from the negative impacts of federal tax changes. Each of these proposals are described in detail in this section and highlighted in Table 1, below.

Table 1. Illinois Revenue Options

($ Millions)	Potential Revenue
Reform Tax Expenditures (See Table 2)	$1,001
Tax Foreign Dividends	386
Repeal the Single Sales Factor	146
Decouple from the Federal Domestic Production Deduction	146
Repeal the CME-CBOE Special Tax Break	85
Tax Offshore Oil Drilling	75
Equalize Satellite and Cable TV Taxes	75
Repeal the Estate Tax Exemption Increase	64
End the For-Profit Hospital Tax Break	10
Tax Digital Goods	10
Total New Revenue Options	$1,998

Reform Corporate Tax Expenditures

Illinois' tax system is less productive than it could be given its statutory tax rates, because its "Swiss-cheese" structure allows numerous loopholes, credits, and exemptions. These tax expenditures constitute state spending just as much as budget appropriations, but they are carried out through the tax code. And, unlike budget appropriations, these tax breaks traditionally carry on from year to year with little evaluation as to their effectiveness – and without undergoing any competition for scarce resources that typifies the annual budgeting process. Tax expenditures get their funding first, before public safety, human services, education, or any other public priority. Although the General Assembly has begun to pay more attention to tax expenditures in recent sessions, it is unclear if this tradition will take hold absent a formal, systematic review process.

As a result, tax expenditures continue to grow even as services provided by the state continue to be cut. In fiscal year (FY) 2011, the total cost of tax expenditures rose $430 million, or 6.8 percent, from 2010. The value of reported tax expenditures has increased by 119 percent since 1993 – from $3.1 billion in that year to $6.8 billion in 2011.[4] That averages out to 6.6 percent

[3] Center for Tax and Budget Accountability, "Funding Our Future: Reforming Illinois Tax Policy," October 29, 2010, http://www.ctbaonline.org/New_Folder/Budget,%20Tax%20and%20Revenue/FINAL%20Funding%20Our%20Future-CTBA%20Report%2010.29.2010.pdf.

[4] "Illinois Tax Expenditure Report for Fiscal Year 2011," Office of the Comptroller, August, 2012, http://www.ioc.state.il.us/?LinkServID=B0F39EC1-1CC1-DE6E-2F48E706F850E182&showmeta=0, p. 5.

growth each and every year, even through two deep recessions and state fiscal downturns. Tax expenditures are expected to continue growing, in part because their value has risen with the increase in state tax rates. Several tax expenditures should be repealed or amended to bring their costs more in line with reasonably expected benefits. In the cases of expensive, poorly-targeted tax breaks, reform can save taxpayers money while improving the benefit for Illinoisans with the greatest need. **We estimate that reform of corporate tax expenditures could save $1 billion**. Table 2, below, outlines these questionable tax expenditures.

Table 2. Reform Corporate Tax Expenditures

($ Millions)	**Cost FY 2010**	**Cost FY 2011**	**Potential Savings**
Traded-In Property Sales Tax Exemption	$109	$309	$309
Biofuels Subsidies	186	234	234
Economic Development Tax Incentives (see Table 3)	356	374	187
Sales Tax Retailers' Discount	109	116	116
Farm Chemical Exemption	191	241	50
Non-Sales Tax Collection Discounts	45	47	47
Newsprint and Ink Exemptions	39	33	33
Rolling Stock Exemption	33	58	25
Total Tax Expenditures	**1,068**	**1,412**	**1,001**
Source: Illinois Tax Expenditure Report for FY 2011.			

Traded-In Value Sales Tax Exemption

Illinois exempts the sales price of a vehicle, watercraft or other tangible property when the buyer trades in a used item of the same type in partial payment. This exemption cost the state **$309 million** in FY 2011, an astounding $200 million increase from 2010. It is debatable whether consumers receive any benefit from this exemption, which nevertheless serves to treat purchasers without trade-ins inequitably. California, the District of Columbia, Hawaii, Maryland and Michigan do not offer this exclusion. Illinois should eliminate the exclusion.

Biofuels Subsidies

Illinois spent **$234 million** in tax subsidies on gasohol, biofuels, and ethanol tax preferences in FY 2011, an increase of $48 million from 2010. Taxpayer subsidies for these fuels, derived primarily from corn, soybeans and other agricultural products, are fiscally and environmentally wasteful, fail to promote sustainable energy production, and even drive up prices for food, and should be eliminated.

Economic Development Tax Incentives

The economic development tax incentives for businesses below cost $374 million in FY 2011, an increase of $18 million or 5 percent from FY 2010. Table 3, below, lists various incentives and their cost over the past two years.

Table 3. Economic Development Tax Incentives

($ Millions)	Cost FY 2010	Cost FY 2011
Manufacturing and Assembling Machinery and Equipment Exemption	$174	$184
Enterprise, Foreign Trade, River Edge and Other Special Zone Incentives	94	91
Manufacturer's Purchase Credit	33	38
Individual Income Tax Credits and Subtractions	7	21
Research and Development Credit	19	13
Film Production Services Credit	11	12
Graphic Arts Machinery and Equipment Exemption	8.6	8.3
High Economic Impact Business Investment Credit and Dividend Subtraction	4.9	4.3
Purchase of Electricity Generated by Solid Waste Energy Facility Credit	3.2	2.2
Job Training Contribution Subtraction	1.1	0.5
Total	**356**	**374**
Source: Illinois Tax Expenditure Report for FY 2011.		

A 2009 Illinois Department of Revenue review of the state's business incentives concluded, "there is scant evidence that economic development programs and incentives have significant impact on economic growth."[5] This conclusion is echoed by the state legislature's Commission on Government Forecasting and Accountability, which said a literature review found "state and local tax cuts and incentives are not effective for stimulating economic activity or creating jobs in a cost-efficient manner." Business owners and site selection decision makers have consistently said factors other than state taxes or tax incentives, especially highway accessibility, labor costs, and the availability of skilled labor, play a larger role in investment and location decisions.[6] This is consistent with the overwhelming body of research on business tax incentives, which shows that such incentives are ineffective at raising the level of a state's economic development.[7]

Corporate tax subsidies also invite other problems, including inequities between industries and even between competitors within an industry, particularly favoring the largest, most profitable corporations. The Illinois Department of Revenue review found that the bulk of the subsidies benefited just a handful of companies.[8] Tax incentives also tend to persist even after their stated purpose has been cast into doubt. For example, the solid waste energy facility credit discussed

[5] Illinois Department of Revenue, "Analysis of Selected Illinois Business Tax Incentives," Revised May 13, 2009, http://www.revenue.state.il.us/AboutIdor/TaxResearch/ILBusinessTaxIncentivesBook.pdf.
[6] Illinois Commission on Government Forecasting and Accountability, "Illinois Tax Incentives," July 2009, http://www.ilga.gov/commission/cgfa2006/Upload/2009JULYILLINOISTAXINCENTIVES.pdf.
[7] One comprehensive review of studies found that incentives do not typically raise total employment or affect business location decisions. Robert G. Lynch, *Do State and Local Tax Incentives Work?*, (Washington, D.C.: Economic Policy Institute, 1996).
[8] Illinois Department of Revenue, "Analysis of Selected Illinois Business Tax Incentives," Revised May 13, 2009, http://www.revenue.state.il.us/AboutIdor/TaxResearch/ILBusinessTaxIncentivesBook.pdf.

below provides a subsidy to trash-burning power plants, even though such operations have been shown not to provide environmental or renewable-energy benefits.[9]

Too often, states agree to weaken their revenue systems based on vague corporate claims of "job-killing taxes" or a state's lack of "business-friendliness" without any evidence of the actual tax burdens of companies. This overemphasis on lowering taxes ignores the relatively small role impact taxes have on states' economic development climates and neglects the very important role those taxes play in funding the services and infrastructure that actually do attract investment and jobs. Once written into law, these tax breaks are rarely if ever reviewed to see if they fulfilled their intentions.

Further details on each of these tax incentives follow:

- The Manufacturing and Assembling Machinery and Equipment Exemption allows sales of machinery and equipment to be used in manufacturing to be tax-free. Most states exempt such purchases in order to provide an incentive for businesses to purchase equipment. The Illinois Department of Revenue has recommended keeping the exemption on interstate tax-comparability grounds. (The department nevertheless cautioned that a proposed expansion of the exemption was ill-advised.)[10]

- The Enterprise, Foreign Trade, River Edge and Other Special Zone Incentives are a collection of tax incentives for business investment and hiring in certain locations. Enterprise zones were introduced to the United States in the 1980s and have since multiplied by the hundreds across the country, promising to entice businesses to create jobs in disadvantaged communities. Since then, many analyses of Enterprise Zone effectiveness have been conducted, most of which show a failure to generate economic development cost-effectively.[11] Illinois' Enterprise Zone programs are often combined with the EDGE and High Economic Impact credits into a package incentive award to businesses.[12]

- The Manufacturer's Purchase Credit is a sales tax credit given to manufacturers based on the value of or machinery and equipment purchases they make. The Department of Revenue criticized the program as duplicative because it grants a credit on purchases that are already exempt from the sales tax through the Manufacturing and Assembling Machinery and Equipment Exemption.[13] Similarly, California allowed its Manufacturers

[9] Sierra Club, "Don't Burn or Bury Garbage; Garbage is Not Renewable Energy," http://www.sierraclub.org/committees/zerowaste/garbage/.
[10] Illinois Department of Revenue, "Analysis of Selected Illinois Business Tax Incentives," Revised May 13, 2009, http://www.revenue.state.il.us/AboutIdor/TaxResearch/ILBusinessTaxIncentivesBook.pdf.
[11] See, for example, Alan Peters and Peter Fisher, *The Effectiveness of State Enterprise Zones* (Kalamazoo, Mich.: W.E. Upjohn Institute for Employment Research, 2002); and Jed Kolko and David Neumark, "Do California's Enterprise Zones Create Jobs?" Public Policy Institute of California, June 2009, http://www.ppic.org/content/pubs/report/R_609JKR.pdf.
[12] Good Jobs First, "AccountableUSA – Illinois," http://www.goodjobsfirst.org/states/illinois.
[13] Illinois Department of Revenue, "Analysis of Selected Illinois Business Tax Incentives," Revised May 13, 2009, http://www.revenue.state.il.us/AboutIdor/TaxResearch/ILBusinessTaxIncentivesBook.pdf.

Investment Credit to expire a decade ago, after studies found the costly program had failed to produce the job growth promised.[14]

- Individual income tax credits and subtractions are various business incentives that are applied to individual income taxes rather than corporate income taxes. The cost of these credits and subtractions rose sharply, from $7 million in fiscal year 2010 to $21 million in 2011.

- The Research and Development Credit provides businesses a tax credit based on a percentage of new R&D spending. The Illinois Department of Revenue found that the credit was "not very effective in stimulating additional research and development in Illinois." This conclusion is consistent with analyses of other states' R&D credit programs.[15] The credit, implemented in 1990, has been repealed and reinstated once before and has been proposed for elimination in the past.[16]

- The Film Production Services Credit is Illinois' entry into the multistate subsidy competition for media and entertainment productions. These incentives have been found to cost more than the benefits they generate, sometimes much more. Film incentives are also increasingly ineffective, since more than 40 states began offering incentives. Iowa suspended its film credit program in 2010 after widespread abuses by film companies and officials of the state film office were exposed, leading to criminal convictions of seven individuals.[17]

- The Graphic Arts Machinery and Equipment Exemption provides an exemption similar to the Manufacturing and Assembling Machinery and Equipment Exemption, specifically for graphic arts production equipment. The Illinois Department of Revenue found that the program exempts a much broader range of equipment purchasers than the legislation's original intent, thereby nearly doubling the exemption's annual cost.[18]

- The High Economic Impact Business Investment Credit and Dividend Subtraction programs provide firms with tax credits for certain investments in federally designated foreign trade zones. The programs are often combined with Enterprise Zone, EDGE, and other programs in an incentive package.

---

[14] California Budget Project, "Unkept Promises: California's Manufacturers' Investment Tax Credit," *Budget Brief*, April 2003, http://www.cbp.org/pdfs/2003/bb030404mic.pdf.

[15] See, for example, California Legislative Analyst's Office, "An Overview of California's Research and Development Tax Credit," November 2003, http://www.lao.ca.gov/2003/randd_credit/113003_research_development.html.

[16] Illinois Department of Revenue, "Analysis of Selected Illinois Business Tax Incentives," Revised May 13, 2009, http://www.revenue.state.il.us/AboutIdor/TaxResearch/ILBusinessTaxIncentivesBook.pdf.

[17] Kay Bell, "Film tax incentives sometimes lead to extra state costs for criminal prosecution," Don't Mess With Taxes (blog), June 6, 2012, http://dontmesswithtaxes.typepad.com/dont_mess_with_taxes/2012/06/sometimes-film-tax-incentives-include-the-costs-of-criminal-prosecution.html.

[18] Illinois Department of Revenue, "Analysis of Selected Illinois Business Tax Incentives," Revised May 13, 2009, http://www.revenue.state.il.us/AboutIdor/TaxResearch/ILBusinessTaxIncentivesBook.pdf.

- The Solid Waste Energy Facility Credit provides an electricity excise tax credit for power purchases from facilities that convert solid waste to energy. Only seven other states qualify municipal solid waste for tax credits.[19] Environmental advocates criticize these subsidies, citing waste-to-energy plants' inefficiency and their substantial pollution and greenhouse gas emissions.[20]

- The Job Training Contribution Subtraction provides a 100 percent deduction for contributions to qualified job training programs.

The economic development tax expenditures discussed above will cost an estimated $374 million absent any other change in the claiming of credits or exemptions and before accounting for the impact of higher corporate income tax rates. It would be a reasonable goal to reduce economic development tax expenditures by half from that level, saving **$187 million** per year and offering the opportunity to reform the state's economic development incentive efforts to focus on programs that best achieve the state's highest priorities. In particular, since Illinois has multiple tax credit programs (such as the Enterprise Zone and High Impact Business programs) that are frequently bundled into a single incentive offer, it would be particularly beneficial for state policymakers to look comprehensively at these programs and redesign them to lower taxpayer costs while maximizing economic development benefits.

Sales Tax Vendor Discounts

Illinois rebates a portion of sales taxes that retail vendors collect, as compensation for the time and cost involved in collecting and remitting the tax. Illinois' vendor discount program is the most generous in the nation, giving back 40 percent more than the next-largest state (Texas) as of 2008. Illinois' program is generous to retailers for two reasons: first, the 1.75 percent discount rate is relatively high; second, and more importantly, the compensation is not capped. Sales tax vendor compensation is not universal among the states. For example, Iowa and Minnesota do not provide any vendor compensation for sales tax collection. Illinois is among just 26 states that provide it, and it is one of only 13 with no cap on the amount any individual store or chain can receive. This policy can be lucrative for large retailers. In 2008, a report by the taxpayer subsidy watchdog group Good Jobs First calculated that Wal-Mart alone received more than $8.3 million per year in vendor compensation.[21] Illinois could generate **$116 million** in additional revenue by scrapping its sales tax vendor discounts. Alternatively, capping the discount to the first $1 million in sales would save approximately $100 million per year.[22]

---

[19] U.S. Environmental Protection Agency, "Renewable Energy Production Incentives," http://www.epa.gov/osw/hazard/wastemin/minimize/energyrec/rpsinc.htm.

[20] U.S. PIRG, "More than half of the state Renewable Electricity Standards exclude municipal waste combustion as a renewable source of energy," available at http://www.sierraclub.org/committees/zerowaste/downloads/msw-statestandards.pdf.

[21] Philip Mattera with Leigh McIlvaine, "Skimming the Sales Tax: How Wal-Mart and Other Big Retailers (Legally) Keep a Cut of the Taxes We Pay on Everyday Purchases," Good Jobs First, November, 2008, http://www.goodjobsfirst.org/sites/default/files/docs/pdf/skimming.pdf.

[22] Center for Tax and Budget Accountability, "Revenue Options for Illinois," 2007, http://www.ctbaonline.org/All%20Links%20to%20Research%20Areas%20and%20Reports/Budget,%20Tax%20and%20Revenue/Revenue%20Options%20for%20Illinois2.pdf.

Farm Chemical Exemption

The cost of this tax exemption was $241 million in FY 2011, an increase of 26 percent over the previous year. Rapidly growing tax breaks should be scrutinized to determine if they are being exploited to inappropriately lower tax liabilities and whether they continue to serve a worthwhile purpose cost effectively. Illinois should take steps to roll back the cost of this tax exemption at least to 2010 levels, which would save **$50 million**.

Non-Sales Tax Cost-of-Collection Compensation

In addition to the sales tax vendor discount (discussed above), Illinois also compensates the businesses that collect taxes other than the sales tax. In FY 2011, the state spent **$47 million** on cost-of-collection compensation and prompt payment discounts for motor fuel, telecommunications, cigarettes, hotel, liquor, underground storage tank, gas use and auto rental taxes.[23]

Newsprint and Ink Exemption

The state's newspaper and magazine industry has enjoyed a special, industry-specific sales tax exemption on the newsprint (paper) and ink they purchase. This tax break cost Illinois **$33 million** in FY 2011.

Rolling Stock Exemption

The sales and vehicle use tax includes an exemption for business purchases of rolling stock (including motor vehicles, aircraft, watercraft or railroad vehicles) used in interstate commerce. The cost of this exemption grew by **$25 million** in FY 2011, a 77 percent increase from 2010. As with other rapidly-growing tax expenditures, this raises a question of whether tax provisions are being used to inappropriately lower tax liabilities and whether the exemption continues to serve a worthwhile purpose cost effectively.

Tax Foreign Dividends

Illinois exempts the dividend income of foreign affiliates from companies' in-state income, even though such income is taxable at the federal level. Taxing foreign dividend income in Illinois would raise **$386 million** per year.

Repeal the Single Sales Factor

The Single Sales Factor determines a multistate corporation's in-state income based only on in-state sales rather than the traditional combination of sales, employees and property in the state. Since it was enacted in 1998, Single Sales Factor has benefited a handful of large multistate and multinational corporations, but has done nothing to benefit Illinois small businesses, and has failed spectacularly in boosting manufacturing employment as its promoters promised.[24] The tax

[23] "Illinois Tax Expenditure Report for Fiscal Year 2011."

[24] Greg LeRoy, The Great American Jobs Scam (San Francisco: Berrett-Koehler Publishers, 2005), pp. 101-103.

break was estimated to cost the state close to $100 million per year at the previous corporate income tax rate,[25] equivalent to **$146 million** today.

Decouple from Federal Domestic Production Deduction

Section 199 of the federal Internal Revenue Code allows companies to claim a tax deduction based on profits from "qualified production activities," a sweeping category that goes well beyond manufacturing to include such diverse activities as food production, mining, filmmaking, and utilities. The deduction is unlikely to protect or create jobs within the state, because multi-state corporations can claim the deduction for out-of-state "production activity" just as they can for in-state activity. Twenty-two states, including Indiana, Wisconsin and Minnesota, have decoupled from this federal deduction in order to preserve state revenue. Illinois could recoup more than **$146 million** (based on the new corporate tax rate) by decoupling from this provision.[26]

Repeal the CME-CBOE Special Tax Break

After threatening to leave the state, the Chicago Mercantile Exchange and the Chicago Board Options Exchange won an expensive new tax break last year that lowers the share of electronic trading income apportioned to the state from 100 percent in 2011 to 27.54 percent by 2013. This tax giveaway for just two financial institutions will cost the state **$85 million** per year by FY 2014.[27] Special tax breaks for well-connected corporations are not a solid foundation for economic equity and prosperity and should be repealed.

Tax Offshore Oil Drilling

A loophole in Illinois' tax code allows profits from oil production activities in the outer continental shelf to go untaxed. Other states, including Iowa, do consider profits from such activities in their calculations of tax liabilities for in-state companies. The state Senate in May passed a measure (House Bill 5342) to close this loophole, which would prevent the loss of **$75 million** per year.[28]

Equalize Satellite and Cable TV Taxes

Satellite TV companies currently are exempt from the 5 percent franchise tax that cable TV companies pay to municipalities. The state Senate in May passed a bill (House Bill 5440) to levy a 5 percent tax on satellite companies, raising **$75 million** per year.[29]

---

[25] Institute on Taxation and Economic Policy, "Illinois Must Ignore CME's Tax Tantrum: Statement from Institute on Taxation and Economic Policy," press release, June 16, 2011, http://www.itep.org/pdf/ILstatementfinal.pdf.

[26] Illinois' revenue loss from the federal Section 199 Domestic Production Deduction was $103 million in 2011. Nicholas Johnson and Ashali Singham, "States Can Opt Out of the Costly and Ineffective 'Domestic Production Deduction' Corporate Tax Break," January 14, 2010, http://www.cbpp.org/files/7-29-08sfp.pdf.

[27] "Illinois Tax Expenditure Report for FY 2011."

[28] Ameet Sachdev and Alejandra Cancino, "Quinn Again Targets Oil Companies' Loophole," *Chicago Tribune*, February 23, 2012.

[29] Eric Timmons, "Satellite TV companies say Illinois tax plan would raise customers' bills," November 14, 2012, *Moline Dispatch / Rock Island Argus*, http://qconline.com/archives/qco/print_display.php?id=616202.

Repeal the Estate Tax Exemption Increase

Illinois increased its estate tax exemption from $2 million in 2011 to $3.5 million in 2012 and $4 million thereafter. Expanding a tax benefit to such a small portion of the very wealthiest residents will cost $41 million in FY 2013 and **$64 million** in FY 2014[30] – lost revenue that cannot be justified on economic development or equity grounds. The state should repeal this expanded exemption and restore the $2 million exemption.

End the For-Profit Hospital Tax Break

Illinois for-profit hospitals won a big tax break in a little-noticed provision of the Medicaid bill last spring. This law gives for-profit hospitals a tax credit for the lesser of their charity care, or their property tax bill. So it does nothing to incentivize charity care spending beyond the cost of their property taxes. Worse, unlike residential property tax credits, the hospitals can sell their unused credits or carry them forward for up to five years.[31] The savings would be **$10 million to $15 million** per year, with $5.5 million of that going to one company, Vanguard Health Systems of Nashville, Tennessee.

Tax Digital Goods

Illinois could gain an estimated **$10 million** per year by extending the sales tax to digital goods like books, magazines, music, movies and games that are delivered electronically to consumers. The state already taxes such purchases when they are delivered in tangible form. At least 23 states already tax such goods delivered electronically, including nearby states Indiana, Kentucky and Wisconsin, as well as many states with "low-tax" reputations including Alabama, Arizona, Idaho, Mississippi, Nebraska, South Dakota, Tennessee, and Utah.[32]

Conclusion

Payments to the pension funds are not only a constitutional necessity but the fulfillment of the state's ethical obligation to the people who teach our children, keep our communities safe, and provide assistance to those in need. The public workers Illinoisans rely on – teachers, caregivers, firefighters, nurses, police officers, and corrections officers, to name a few – have been promised that they will have a secure retirement in return for their service. The state must stop using its pension funds as a credit card to pay for education, public safety, health care, and other core services, and it must repay the money it has borrowed from those funds. At the same time, it is

---

[30] "Illinois Tax Expenditure Report for FY 2011."

[31] Carla K. Johnson, "Ill. hospital tax break costs $10M," *Pantagraph*, November 8, 2012, http://hosted.ap.org/dynamic/stories/U/US_HOSPITALS_TAX_BREAK_ILLINOIS_ILOL-?SITE=ILBLO&SECTION=HOME&TEMPLATE=DEFAULT.

[32] John C. Healy and Michael S. Schadewald, *2012 Multistate Corporate Tax Guide* (Chicago: CCH, 2012), vol. II; Mike Riopell, "Should Illinois Tax iTunes Downloads?" *Pantagraph*, April 21, 2010, http://www.pantagraph.com/news/state-and-regional/illinois/article_8b5cc214-4ccd-11df-80a9-1cc4c03286.html.

critical that Illinois has replacement revenue to fund the vitally important public services that have historically been sustained by pension borrowing.

The We Are One Illinois coalition has put forward a proposal that achieves that goal, and that recognizes that benefit cuts are neither legally permissible, equitable, nor economically sound. Instead, we present a plan based on the principle of shared sacrifice that requires the state to fund its retirement systems, asks more from employees, and protects funding for vital public services by raising needed revenue.