

Budget & Innovation

Aspiration: providing Illinois residents with a more stable and prosperous future

The state of Illinois and its residents deserve a stronger fiscal situation and stable future. Years of a lack of strategic direction and failed leadership have put Illinois in a situation where a quick fix is not possible. However, this administration should take the opportunity to adopt a balanced approach, leaving behind the partisan battles of the past four years, and focusing on discipline and pragmatism to help build fiscal stability in the short-term and put the state on the path to a better financial future.

To begin, this administration should strive to balance the budget while accounting for and providing all necessary services to the residents of Illinois. In the short term, state leaders should return to working together across the political spectrum and passing balanced budgets that both invest adequately in current services, and reduce the state's long term accumulated deficit. At the same time, the state needs to think long-term about addressing the growing pension and debt challenges. While any one solution won't fix all of Illinois' fiscal challenges overnight, this administration can start laying the foundation by taking critical steps that will put Illinois on the path toward long-term fiscal stability. This administration will need to be innovative and not shy away from difficult decisions. Effective strategies that are new and innovative as well as tried and true will be needed to solve Illinois' structural fiscal problems.

Illinois Today: Significant fiscal challenges

The state of Illinois faces significant long- and short-term financial challenges that will take years to put behind us. In the short-term, the state must address its significant balance of unpaid bills caused in part by the previous administration's unprecedented 736-day budget impasse. Illinois' failure to pass a budget for fiscal years 2016 and 2017 led the state's backlog of unpaid bills to reach historic heights – exceeding \$16.6 billion in November 2017¹ and with staggering amounts remaining. The Illinois Office of the Comptroller estimated that 7.9 billion in unpaid bills remain.² The state also has an additional \$5.5 billion in backlog borrowing, \$650 million in interfund borrowing and \$500 million in estimated backpay for state workers.

Years of underfunding the state's long-term liabilities has led to severely underfunded pension plans, which in turn has negatively impacted the state's bond ratings. With a collective funded ratio of approximately 39.8 percent, Illinois' five pension funds are in a critical state and are among the most poorly funded pension funds in the nation.³ In addition, unfunded liabilities continue to grow due to recent actuarial adjustments, change in forecasted investment returns, and insufficient state contributions. Already, the state's creditworthiness has been affected (downgraded to Baa3 in mid-2017 as a direct result of the budget impasse and growing pension

¹ Illinois Comptroller's Office, Backlog Voucher Report (<https://illinoiscomptroller.gov/financial-data/backlog-voucher-report-bvr/>)

² <https://illinoiscomptroller.gov/comptroller/assets/file/DTA/current/DTARreport.pdf>

³ <https://www.usnews.com/news/best-states/rankings/fiscal-stability/long-term>

debt, but holding steady in 2018),⁴ making it more expensive to borrow money to both pay down the pension debt and make other critical investments.

An examination of state revenue sources and spending highlights a range of opportunities⁵:

- For FY19, the state projects \$38.0 billion in general fund revenues. Individual income taxes account for \$18.1 billion, or 47 percent of general fund revenues. Sales tax contributes \$8.2 billion, and the remaining revenues come from sources including corporate taxes, federal funds, fees, and gaming revenues. Over the next five years, revenues are expected to grow 1.8 percent per year.
- Total general fund expenditures are projected to be \$38.5 billion. The largest projected expenditures for FY19 are education (\$10.1 billion) and health care & human services (\$13.8 billion), which together are estimated to account for 62 percent of spending for FY19. Over the next five years, expenses are expected to grow 2.9 percent per year.

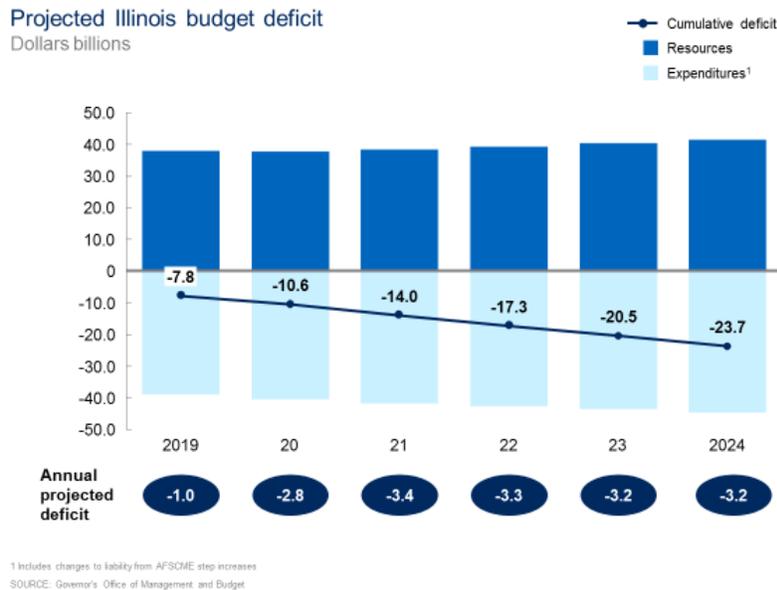
The November Governor's Office of Management and Budget review of the enacted budget for FY19 projected a deficit of approximately \$1 billion (approximately 50 percent from the budget shortfall and 50 percent from projected payments to certain members of expired collective bargaining agreements). That report showed that without intervention, this shortfall could grow in coming years to a total cumulative deficit of more than \$20 billion by 2023⁶ (see Exhibit 1). In order to provide the services that the state's residents expect and deserve, it is necessary that structural reforms are put in place to balance the budget while achieving both short- and long-term goals.

⁴ <https://www.chicagobusiness.com/article/20170601/BLOGS02/170609991/s-p-moody-s-lower-illinois-bond-rating-to-one-level-above-junk; Moody's, July 2018> (https://www.moody.com/research/Moodys-revises-Illinois-outlook-to-stable-affirms-Baa3-GO-rating--PR_904656669)

⁵ <https://www2.illinois.gov/sites/budget/Documents/Economic%20and%20Fiscal%20Policy%20Reports/FY%202018/General-Funds-Financial-Walk-FY19.pdf>

⁶ https://www2.illinois.gov/sites/budget/Documents/Economic%20and%20Reports/FY%202017/Economic_and_Fiscal_Policy_Report_Five-Year_Projection_10.12.17.pdf

Exhibit 1



Path forward: A holistic approach to short- and long-term budget management

We believe Illinois must pursue initiatives from three categories to address these structural budget issues and put the state on a fiscally sustainable path.

- **Increase revenue generation** including strengthening tax collection and compliance, increasing revenues from existing sources, and identifying new sources of revenue.
- **Improve expense management and efficiency** by spending state funds more strategically, decreasing the cost of procured services, enhancing the efficiency of state agencies, and increasing coordination between state and local governments.
- **Address the pension and debt challenge** by increasing the inflow of funds to the system, reshaping the pension payment curve, and improving the performance of the investment engine.

1) Expense management and efficiencies

As Illinois explores a range of options to achieve and maintain a balanced budget, state spending—both in how to be more strategic in spending state dollars as well as qualifying for federal matching funds—offers several levers. While capturing more revenues is an important step in closing the state's budget gap, it should be matched with improved management of state spending. Given the scale of state expenditures, significant savings can be achieved by changing how state government operates—with an emphasis on greater transparency, coordination, and operational efficiency.

Manage spending in key categories

Procured goods and services represents a key area for improvement, and the state could implement best practices to drive down costs. Currently, mandated policies have made the procurement process inefficient. The new administration should evaluate the existing procurement process to understand its flaws in detail and implement steps for improvement. In addition, there are specific procured goods and services that could benefit from a closer analysis of spending. Overall, any changes to procurement processes should strike the right balance between ethics, efficiency, value, needs of Illinois residents, and the interests of small and minority-owned businesses to ensure inclusiveness.

Concentrating efforts on high-cost users of the health care system could offer a significant opportunity for savings. The state also has an ability to improve health care outcomes by focusing spending on preventative care and innovative delivery of service and improved care coordination. Illinois should move to empower local governments to adopt better community-based care programs that will help decrease hospitalization of people for health services. For the residents with the highest need for public health care services, the new administration should proactively educate and provide access to preventative care to reduce costs. The City of Rockford offers a compelling case study: it has identified the most frequent users of 911 EMS services and proactively provided them with support services such as scheduled preventive care appointments.

Improve operational efficiency of state and local agencies

Private-sector organizations use management approaches, technology, and data to enable departments to work together more productively, and Illinois should seek to follow suit. Digital tools should be deployed to simplify and digitize government services and administrative processes such as time and expense reporting and payroll. Mirroring the approaches on tax compliance, Illinois could leverage advanced analytics tools internally to improve cost management and identify redundant spending. Digital tools can be used to improve Illinois residents' experience with government services by both streamlining the processes and re-designing the steps with a resident-centric perspective.

In addition to digital tools to drive efficiency, better collaboration between governmental units and agencies at the state and local levels could eliminate duplicative spending and ensure that programs are achieving the best outcomes.

2) Increase revenue generation

Illinois has a real opportunity to approach revenue generation in a manner which maintains Illinois' competitiveness while distributing the burden fairly among Illinois residents and businesses and positioning the state to get its fair share of funding from the federal government.

Explore new sources of revenue

Illinois should take measures to broaden their tax base by exploring new sources of revenue. This committee believes several areas could be particularly productive. The state could levy a sales or excise tax on products and services that have traditionally been exempted in Illinois but not exempt from taxation in neighboring states. These categories include new products (e.g., e-

cigarettes, cannabis), products that carry a cost to society (e.g., plastic bags), and various services that have been traditionally exempt.

The legalization of untaxed industries — including sports betting, internet gaming, and cannabis usage — would generate additional annual revenues. New sources of revenue should be considered through both a fiscal and a fairness lens, and the state should prioritize progressive taxes that help the middle class and those striving to get there.

Increase existing sources of revenue

Illinois is one of just eight states with a flat income tax⁷. Adopting a fair tax structure, where there is a variable rate structure tied to minimum income levels and increasing the tax rate for larger wage earners would increase revenue for the state and reduce the tax burden for the vast majority of Illinoisans. It would also result in a more equitable tax structure in the state and reduce some of the regressive unfairness in the tax code while keeping Illinois' tax rates competitive.

Currently, corporate income taxes contribute \$2 billion to the state each year. While many Illinois businesses pay their fair share, some companies have used profit shifting and equipment depreciation to significantly reduce their tax burden. Corporations also unfairly benefit from questionable tax rules that the state has automatically incorporated into its own tax code without any vote by the General Assembly. The state should consider new ways to improve the overall business climate in Illinois while at the same time closing unjustified tax loopholes that corporations use to minimize their tax burden.

Also, the new administration should explore ways to maximize revenue from federal match programs that exist for Housing and Urban Development, Medicaid, and Behavioral Health.

Strengthen tax collection and compliance

Strengthening tax compliance processes could ensure that the state collects a higher percentage of funds owed by individuals and corporations. To support this priority, the state should adopt advanced analytics tools for tax administration and enforcement to better identify entities that are committing tax fraud or illegally evade their tax obligations. In the private sector, such tools have helped financial institutions to increase fraud detection significantly while enabling existing staff to cover more ground.

Further, Illinois must find ways to increase tax compliance on e-commerce companies selling to Illinois residents. In 2018, the Supreme Court ruled in *South Dakota vs Wayfair* that states may charge tax on purchases made from out-of-state sellers. It is important to realize this revenue source as the current FY19 budget has already provisioned an inflow of \$372M⁸ from this tax.

3) Pensions and debt management

Illinois must take significant steps to make substantial progress in confronting its unfunded pension liabilities. Concentrating on one area will not be sufficient. Instead, a portfolio of initiatives across different levers will likely be required.

⁷ <http://www.nprillinois.org/post/illinois-issues-why-does-state-have-flat-income-tax#stream/0>

⁸ Governor's Office of Management and Budget FY2019. <https://www2.illinois.gov/sites/budget/Documents/Economic%20and%20Fiscal%20Policy%20Reports/FY%202018/Economic-and-Fiscal-Policy-Report-FY19.pdf>

Increase funding to the pension system

Opportunities exist to find unique and new ways to increase funding. The state could apply a direct revenue stream to help pay down the pension debt. These revenue streams could have provisions to ensure they are only used for payment of pension debt and benefits. Asset transfers could also be used as a means to add value to pension systems. For example, if the state were to move an asset to a pension fund, it could be used to reduce the unfunded liabilities for the pension system and increase the funding ratio, leading to potentially reduced interest costs on pension debt.

Improve the investment engine

The returns that Illinois currently achieves on its pension funds could also be increased by improving the investment engine. To generate higher returns and with the added benefit of enhanced efficiency, Illinois could work with local constituencies to consolidate pension funds for similar systems within verticals (e.g., fire, public safety). This move would help smaller funds not only achieve higher returns but also reduce the cost of fund administration and give managers greater visibility into investment decisions and trade-offs.

While consolidation could take time, there are shorter term opportunities. For one, the state could negotiate a standard “one-price” investment management fee for all Illinois pension funds to eliminate the variance in fund management costs. In addition, the state could revisit pension investment management; asset allocations could be reassessed to ensure that investments are providing the highest possible risk-adjusted returns.

Re-shape the pension payment curve

To put the pension funds on a more sustainable path, the committee discussed whether the state could consider re-shaping the pension payment curve. For instance, the state could create a sustainable amortization schedule combined with other changes to improve the system which could meet short term budget needs while improving the funded ratio in the long term. The goal here is to find a rational payment plan that increases the funded ratio each year while still meeting the cost of paying benefits to current and future retirees. Such action would need to be taken in conjunction with changes that increase funding, improve investments, and/or increase stability such that debt markets see that Illinois is serious about comprehensively solving the pension funding deficiency.

Modernize Bonded Debt Provisions

Illinois should also explore ways to improve its existing bonded indebtedness provisions to provide government officials with more flexibility in managing debt. The state should consider changes including but not limited to: maturity limitations, current statutory refunding and/or restructuring requirements within constitutional limitations, and available security. This could help the state create innovative financial vehicles to manage all of its debt including the pension debt while also strengthening Illinois’ creditworthiness.

Moving into a more stable financial future

Illinois’ growth prospects and its reputation have been affected by the past four decades of unstable fiscal policies. Fortunately, we still have a wide array of actions that could put our fiscal house in order.

Each new administration brings with it a fresh perspective and momentum to change course. By pursuing a robust portfolio of initiatives, Illinois can propel itself towards fiscal stability. It will realistically take many years to address the accumulated deficit, but it is essential that the state immediately identify the path to fiscal stability so that the state can meet strategic priorities and bring Illinois back to the forefront.

