A FISCAL ROADMAP FOR CREATING A SUSTAINABLE STATE BUDGET:
Actionable Recommendations for Governor Pat Quinn and the Illinois General Assembly

Prepared by:

The Institute for Illinois' Fiscal Sustainability
at
The Civic Federation

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EXECUTIVE SUMMARY: CIVIC FEDERATION PRINCIPLES FOR THE FY2010 BUDGET

- In FY2010, the State of Illinois cannot increase spending. It should cap or reduce spending.
- The income tax should not be raised unless an increase is reserved to make significant reductions in existing liabilities, not to fund new programs.
- Any new capital spending program must include a transparent capital improvement plan that provides an identification and evaluation of infrastructure priorities.

State Spending

The State Cannot Afford New Spending Initiatives. New program initiatives are unaffordable and imprudent during an economic downturn and will only increase the state's inability to meet its existing obligations. Raising broad-based taxes in a recession to close a budget deficit would be counterproductive and could further exacerbate the ill effects of the recession. Therefore, the state should consider freezing spending at FY2009 levels or reducing spending from previous levels.

Spending for Many Existing Programs Must be Reduced to Balance the Budget. Either a spending freeze or budget cuts will require reductions in existing programs, perhaps even deep cuts. It may well require employee layoffs and reductions in generous employee benefit packages as well as reductions in state provided grants to other governments, entities, and individuals. In our view, cutting spending and limiting future liabilities is the only fiscally responsible option that will shore up the state's precarious fiscal situation.

The State Must Prioritize Spending and Only Fully Fund Critical Programs. Only those state programs deemed absolutely necessary in FY2010 should receive full funding. Any move to cut state spending must of course consider federal mandates and the impact reductions could have on the receipt of federal matching funds. It could require the redrafting of rules and regulations in certain areas.

The Pension Systems Must be Funded According to the 1995 Reform Law. A top priority of the FY2010 budget must be full payment of the state's pension obligations under the terms of the 1995 pension funding reform law. Deviating from the path laid out by that law renders it meaningless. Eliminating or reducing the statutorily required payment will only further exacerbate the pension funds' enormous fiscal challenges.

The State Should not Borrow Funds to Pay for Operations. The Civic Federation strongly opposes any proposal to borrow funds for the FY2010 operating budget. Borrowing funds for operational expenses is a monumentally poor deal for taxpayers. It forces them to pay for costs assumed and benefits enjoyed today over a decade or more in the future. It adds hundreds of millions of dollars in interest costs that must be paid over that same time period. It pushes responsibility for today's poor fiscal planning into the future.

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A Commission on State Spending Should be Convened. The Governor should convene a Commission on State Spending. The purpose of this Commission would be to conduct a comprehensive review of state spending programs with the ultimate goal of prioritizing state programs. Those programs that are deemed to be essential to the well being of Illinoisans should be maintained or even enhanced. Those programs that are not essential may require reductions or even elimination. The framework for a review of state spending should be comprehensive and include the following considerations:

- Cost containment strategies must be considered for mandated programs;
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The State Must Develop a Performance Measurement System to Determine Priorities. Ideally, budget spending cuts in areas where they are possible should be based on a careful assessment of program and service performance rather than an across-the-board approach. Unfortunately, however, the State of Illinois does not have a fully effective performance evaluation system in place that would permit careful executive assessments. The failure to effectively measure and evaluate program performance is a serious defect in the state's management of its operations. This defect must be rectified if state programs are ever to be managed more efficiently and effectively.

The State Should Develop a Long-Term Financial Plan. The National Advisory Council on State and Local Budgeting (NACSLB) and the Government Finance Officers Association (GFOA) both recommend that all governments formally adopt a long-term financial plan as a key component of a sound budget process. Internally, the State of Illinois currently employs many of the techniques of a long-term financial planning process, including the projection of multi-year revenue trends and modeling of various revenue and expenditure options. However, the state does not develop a formal plan that is shared with and/or reviewed by key policymakers and stakeholders. The Civic Federation recommends that the state develop and implement a formal long-term financial planning process.

State of Illinois Retirement Systems

Fund State Pension Systems at Certified Contribution Amount. We urge the state to fund its pension obligations at the full amount required by the 1995 law each year. Each time the state reduces contributions to the retirement systems, it is deferring expense to future years.

Impose a Moratorium on New Pension Benefits. The state should impose a moratorium on **any** new employee benefits until the pension system has achieved a 90% funded ratio. We call on the legislature to reject, and the Governor to veto, any new pension enhancements regardless of whether they are tied to additional funding sources.

Raise the Retirement Age for New Hires. Members of the state's retirement systems are currently eligible for full retirement benefits when they reach age 60, unlike the federal Social Security system, which makes 67 the minimum age of retirement with full benefits. Therefore, the Civic Federation believes that the age at which employees become eligible for full benefits should be increased to age 67 for employees with between 8 and 30 years of service, age 65 for employees with between 30 and 35 years of service, and age 62 for employees with 35 or more years of service.

Fix Automatic Increases for New Hires at the Lesser of 2% or the Rate of Inflation. For new hires only, automatic increases should be limited to the lesser of the rate of inflation or 2% and should apply only to the first $12,000 in annual pension payments for retirees covered by Social Security and $24,000 for retirees not covered by Social Security.

Require Balance on Pension Boards between Employees, Management, and Taxpayers. Board seats should be set aside for members with professional expertise or certification in financial asset investment, and all members who do not already possess such expertise should be required to receive some relevant financial training on an annual basis.

Require a 1% Increase in Employee Contributions. The Civic Federation believes that all public employees covered by the state's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions.

Study the Costs and Benefits of Conversion to a Defined Contribution Plan. The state should undertake a study to determine both the costs and benefits of moving to a defined contribution pension plan such as is now the private sector standard.

Require Pension Benefit Reforms Before Authorizing Pension Obligation Bonds. The State of Illinois should not issue more pension obligation bonds unless it follows the precedent of the Chicago Transit Authority and negotiates reforms to employee pension benefits with unions that will curb future pension liabilities first.

<u>State of Illinois Employee and Retiree Health Insurance Plans</u>

Eliminate the Costly Indemnity Plan and place enrollees in HMO or OAP plans that cost significantly less. This measure could save the State between **$176.6** and **$253.4 million** per year (estimated savings in 2007).

Eliminate Free Health Care for Retirees for a savings of between **$20.7** and **$146.0 million per year** in premium costs (estimated savings in 2007).

Increase Employee Premium Contributions, which are lower than employee contribution levels required by other state and local governments, as well as private sector organizations. Bringing employee premium contributions in line with national averages could yield as much as **$67.3 million** in savings annually (estimated savings in 2007).

Establish an independent healthcare trust similar to the one created by the CTA to manage and provide State of Illinois retiree benefits. The trust would initially receive a one-time infusion of state funding, but subsequent funding would be from employee contributions. Once created, the trust would be solely responsible for providing retiree healthcare benefits.

State Revenues

No Increase in the State Income Tax without Significant Reforms. Raising a broad-based tax, such as the income tax, in a recession to close a budget deficit could be counterproductive and further exacerbate the ill effects of the current recession. The Civic Federation supported a reasonable 1% income tax increase to provide funds to address the State of Illinois' billions of dollars in unpaid liabilities and to provide money for education and transit in 2007. However, our support of this new revenue stream was conditioned upon such funds being coupled with structural reforms that would reduce employee benefit costs and inject more accountability into the management of school funds. The failure of our political leaders to address the enormous fiscal issues faced by the State of Illinois led us to withdraw our support for any income tax increase in 2008. Until the state can clearly demonstrate its dedication to putting its fiscal house in order, the Civic Federation and the public will not be convinced that any new tax dollars will be well spent. A new infusion of tax revenues to provide more money for new expensive programs will do nothing to reduce the enormous obligations that the State of Illinois has already incurred.

No Increase in the State Sales Tax Rate. The state sales tax is currently 6.25%. Of that amount, 5% is reserved for state purposes and 1.25% is reserved for local governments. Home rule governments may impose their own sales taxes in increments of 0.25% and other local governments have authority to impose sales taxes as well. In Chicago, the composite state and local sales tax rate is 10.25%. In suburban Cook County, the sales tax ranges from 9.00% to 10.25%, while in DuPage County the composite rate can be 7.25% to 8.25%. Because of the very high sales tax rates in Chicago, suburban Cook County, and the Collar Counties, the Civic Federation opposes any increase in the current state sales tax.

No State Gross Receipts Taxes. The Civic Federation strongly opposes any attempt to levy a gross receipts tax (GRT) on businesses. It is fundamentally a regressive, seriously flawed tax because: 1) it imposes a tax on businesses regardless of profitability or ability to pay, 2) it will increase production cost because of the pyramiding effect, 3) it is ultimately passed on to consumers, and 4) it is not transparent.

Support for User Fees and Charges. User fees and charges are voluntary payments for goods and services that benefit the individual using them. Only those individuals enjoying the use of the goods or services pay for them. This is in contrast to taxes, which are compulsory and used to pay for public goods which may or may not directly benefit the user. The Civic Federation generally supports the use of user fees and charges rather than taxes to pay for goods and services that directly benefit individuals and that can be sold in discrete units for a price.

No Securitization of Long-Term Revenues. Securitization involves packaging future cash flows into debt which is sold to investors. The state proposed in its FY2009 budget to securitize certain long-term revenues, such as tobacco settlements, to fund its one-time child and business tax credits. The Civic Federation rejects proposals that require issuing debt to pay for operating costs, particularly one-time expenses.

Support for Special Purpose Funds Sweeps. More than 600 special purpose funds have been created in Illinois to receive earmarked revenues that are only used for a designated purpose. Over time, the number of special purpose funds has increased, consuming ever larger portions of the state budget. The Civic Federation supports the concept of transferring surplus revenues from special purpose funds to General Funds with the exception of certain federal trust funds which cannot be utilized for general purposes.

Medicaid

No Changes in Eligibility Levels Should be Undertaken Without Corresponding Changes in the Budget. Expanding eligibility by simply extending payment cycles is an implicit tax on providers and discourages participation in the Medicaid program.

The First Call on Any New Money Due to Increased Match From the Federal American Recovery and Reinvestment Act (ARRA) Should be to Pay Down the Billing Backlog.

The Department of Healthcare and Family Services (HFS) and the Department of Human Services (DHS) Should Accelerate Efforts to Move Medicaid Recipients from Non-Matchable Long-Term Care Settings. Illinois spends a large amount, perhaps as much as $700 million, on long-term care services for people with mental illness that is not matched by Medicaid because it violates federal standards. Moving these clients to settings eligible for Medicaid match—and in compliance with court orders—has the potential to create savings over a relatively short period of time and the opportunity to improve the quality of life for Illinoisans receiving such services.

Develop a Coherent Strategy for the Medicaid Program as a Whole. The Governor and General Assembly should create an emergency commission to review the entire State of Illinois Medicaid program. Medicaid is 25% of the state's budget and is a very complicated program that provides primary healthcare coverage for 11% of the state's citizens. In the past six years a large number of new programs have been enacted with little financial planning or coordination. Items high on the list for consideration would include:

- Where can Illinois afford to set its basic eligibility threshold for Medicaid? The General Assembly has mandated a report on the AllKids program for 2010. This report should provide a framework for addressing how and what the state's Medicaid program will provide.
- The current reimbursement for specialist physicians and outpatient procedures is particularly inadequate. While the rate increases in primary care over the last several years were needed, without access to the next level of specialist care when required, the ability of primary care physicians to provide appropriate care is limited.
- When the AllKids program was expanded in November of 2006, the HFS created two programs—Primary Care Case Management (PCCM, also referred to as a medical home model) and a disease management program. The HFS claimed these would generate savings sufficient to fund AllKids. These programs make conceptual sense, but the HFS must provide more detailed and transparent information on how the programs are being

monitored and evaluated. Such enhanced reporting is also necessary to determine how the programs can be improved.

- The current Illinois hospital reimbursement program is outdated and incoherent, particularly on the outpatient side. Revising this system will be complicated, contentious, time-consuming and, potentially, expensive. Work to reform it should begin soon.
- The state should reconsider whether the Illinois Cares Rx program is the highest priority for state dollars in light of the implementation of the Medicare pharmaceutical program.
- Illinois' approach to non-institutional long-term care, while improved in the last several years, is behind most other states. Expanded efforts in this area should be on the table, particularly those that can approach cost neutrality.
- Using the additional funds from the ARRA to reduce the state's Medicaid billing backlog would be a good first step. However, a longer term solution will require a sustained effort to reduce payment cycles to reasonable and consistent levels. Specific targets and steps to achieve and maintain it are necessary.
- Less specifically, the state should devote increased efforts to understanding the Medicaid program as an overall insurance program for supporting people's health rather than a collection of individual provider-focused programs. While there are many obstacles to such an approach—the lack of continuity in eligibility and various federal regulations foremost among them—there are potentially large payoffs, both in terms of expenditures and beneficiaries' health.

State Capital Budget and Program

The Civic Federation Supports Capital Improvements for the State of Illinois. The maintenance and construction of infrastructure is critical to the economic vitality of a region. Illinois needs investments in its infrastructure, including mass transit. However, there must be a serious evaluation of how state money will be used and prioritized before, not after, the funds are appropriated.

A Capital Improvement Plan Must be Developed to Evaluate and Prioritize Capital Projects. A serious evaluation of how capital dollars should be spent requires the development of a comprehensive five-year Capital Improvement Plan (CIP). Unfortunately, the state has not developed such a plan. Far too often capital program decisions are based on subjective standards regardless of need.

The Civic Federation believes that the citizens of Illinois and the members of the General Assembly should receive a formal CIP before being asked to approve any new revenue sources or approve any new capital projects. The public deserves, and the General Assembly should demand, as much information as possible on both the condition of existing infrastructure and the benefits of new investments so that they can make sound decisions about the efficacy of a multi-billion-dollar plan that will be paid over a number of years. Absent such a report, it is difficult for citizens and public officials to evaluate or prioritize capital improvement proposals.

A CIP has the following characteristics:

- Identifies priorities, provides a timeline for completing projects, and identifies funding sources for projects;
- Is updated annually and has formal approval by the governing body;
- Is made publicly available for review by elected officials and citizens; and

- Is published in the budget or as a separate document and made available on the government's website.

A CIP includes the following information:
- A five-year summary list of projects, expenditures per project, and funding sources per project;
- Information about the impact of capital spending on the annual operating budget for each project;
- Brief narrative descriptions of individual projects, including the purpose, need, history and current status of each project; and
- The time frame for fulfilling capital projects and priorities.

State Assets Sales or Long-Term Leases

The state proposed to lease all or a portion of the State Lottery in its FY2008 and FY2009 budgets. There may well be further discussions of the sale or long-term lease of state assets in coming months and years. The Civic Federation believes that any forthcoming proposal to transfer responsibility for a state asset to a private firm or nonprofit organization should meet the following criteria:

- There must be a marketplace of competitive, qualified vendors or service providers and strong, sustained management oversight by the government.
- The state must establish a mechanism to monitor and evaluate cost saving and efficiency benefits produced by the asset lease or sale. These efforts should include the public reporting of efficiencies and/or savings achieved.
- Asset sales or leases should only involve entities that deliver non-essential services or programs.
- When transferring responsibility for service delivery by means of a long-term lease or sale, the state must carefully consider the policy implications of matters such as limitations on competition and eminent domain. For example, the long-term leasing of a toll road should not preclude a government's ability to plan for future transportation needs in the vicinity of that toll road, including the ability to plan, acquire land, and construct new roads.
- Revenues from asset sales or leases should <u>not</u> be used for recurring expenditures.
- Revenues, asset sales or leases <u>should</u> be used to reduce existing obligations, such as long-term debt, short-term debt, or unfunded pension obligations.

STATE SPENDING

Illinois faces an enormous deficit in both the current year (FY2009) and likely in the new fiscal year that will begin July 1, 2009 (FY2010). The backlog of unpaid bills is increasing and revenues are declining from amounts collected in FY2008.

- State Comptroller Dan Hynes released a report in February estimating that the state faced a combined FY2009 and FY2010 budget deficit of $8.9 billion. The deficit is due to lower than projected revenue estimates, the backlog of unpaid Medicaid bills and required FY2010 increases for pension payments and Medicaid.[1]
- Governor Blagojevich released a statement on December 16, 2008 stating that Illinois faced a $2 billion deficit in FY2009, the current fiscal year. At that time, the state borrowed $1.4 billion in General Obligation certificates to relieve cash flow problems.[2]
- The Governor has made $1.4 billion in cuts in FY2009 spending to date.[3]
- State Comptroller Dan Hynes reported in November 2008 that the state's $4 billion backlog of unpaid bills could balloon to $5 billion by March 2009. He noted that the 12-week payment delay experienced by vendors and local governments could increase to 20 weeks by the spring.[4]
- The Commission on Governmental Forecasting Accountability reports in its December 2008 Monthly Briefing that state revenues are declining. In FY2009 as of December 2008, General Funds revenues have declined by $577 million or 3.8% from FY2008. The biggest revenue declines come in the following areas:
    - Interest earnings are down 71.8%, or $84 million;
    - Corporate Tax receipts are down 4.1%, or $32 million; and
    - Sales tax receipts have fallen by 2.2%, or $81 million.

Spending Trends

Governor Blagojevich originally proposed a total FY2009 operating budget of $49.7 billion. This was an increase of $654.6 million, or 1.3%, over the FY2008 originally proposed appropriation of $49.1 billion.

The largest fund group in the budget is the **General Funds**, which represent 58.2% of total recommended appropriations. The Governor originally proposed $28.8 billion in General Funds appropriations. These funds are used for general operations such as education, public safety, and health and human services. They are the funds over which the state has the most control and discretion. In FY2009, the Governor proposed to spend $28.9 billion in General Funds. The General Assembly ultimately approved $28.3 billion in General Funds spending.[5]

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[1] Office of the Illinois State Comptroller, "Transitional Fiscal Report/FY 2010 Budgetary Outlook," February 4, 2009.
[2] Office of the Governor, "$1.4 Billion to be Available to Pay Bills before the New Year," December 16, 2008.
[3] Christopher Wills,"Illinois Budget Questions Answered," Associated Press, December 1, 2008.
[4] Office of the Illinois Comptroller, "Hynes: State Faces Unprecedented Bill Backlog – Urges Immediate Action," November 11, 2008.
[5] Commission on Government Forecasting and Accountability. *FY2009 Budget Summary of the State of Illinois*. October 2008, p. 24

The **"Other State Funds"** are intended to receive tax revenue distributions or specific revenues such as permit and license fees which are reserved for specific projects. These funds include Highway Funds and approximately 300 funds that support diverse activities ranging from medical assistance to children's assistance to health insurance.[6] These funds represent approximately 30.0% of the total state operating budget proposal for FY2009.

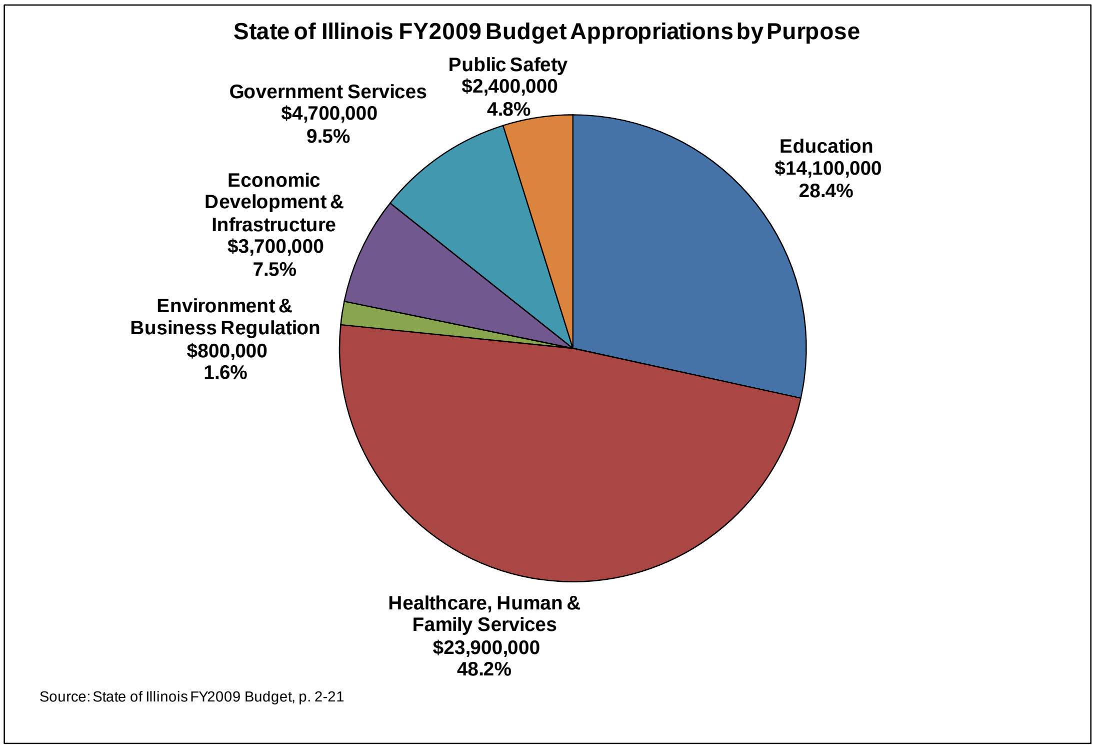
Federal funds support education, healthcare and human service, community development, transportation, and energy programs financed with federal revenues.[7] They represented nearly $5.9 billion in FY2008 and FY2009.

State of Illinois Appropriations by Fund: FY2008-FY2009 (in $ thousands)				
	FY2008 Prop.	FY2009 Prop.	$ change	% change
General Funds	$ 28,858,988	$ 28,909,285	$ 50,297	0.2%
Other Funds	$ 14,333,216	$ 14,908,166	$ 574,950	4.0%
Federal Funds	$ 5,867,905	$ 5,897,232	$ 29,327	0.5%
Total	**$ 49,060,109**	**$ 49,714,683**	**$ 654,574**	**1.3%**

Source: State of Illinois Budget FY2008, p. 2-35; State of Illinois Budget FY2009, p. 2-36

Distribution of State Funds

The largest share of the FY2009 state budget was earmarked for healthcare, human, and family service programs. They were expected to consume 48.2%, or $23.9 billion, of the entire spending plan. Spending for elementary, secondary, and higher education was the second largest category, with 28.5%, or $14.1 billion, of all appropriations. The third largest category was government services, which included those agencies involved in the administration of state government.

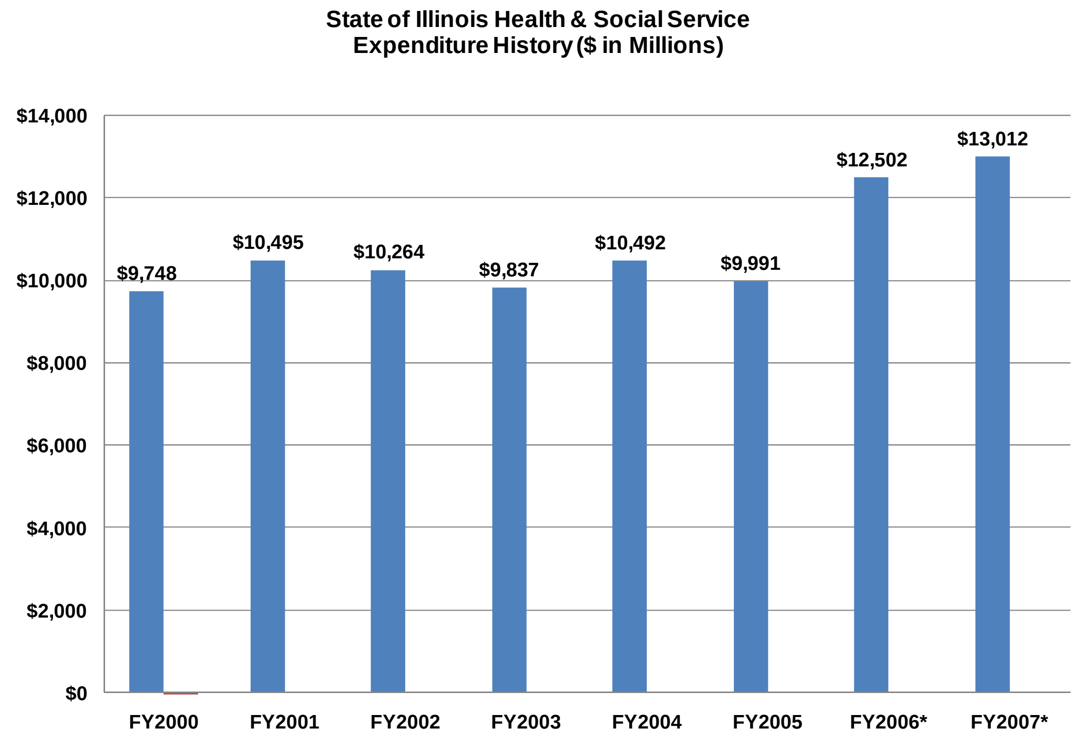


[6] *State of Illinois FY2009 Budget*, p. 2-11.
[7] *State of Illinois FY2009 Budget*, p. 2-12.

Spending for Social Services and Education

The Governor of Illinois generally proposes an operating budget in February. However, the General Assembly later approves a final budget in appropriation bills. The monies that are actually spent each year represent a different final number. The next three exhibits present historical trend information regarding actual spending for two significant elements of the state budget: health and social services and elementary and secondary education. The third exhibit shows the history of general state aid educational foundation levels, the amount that the state mandates as the minimum per pupil level of funding statewide.

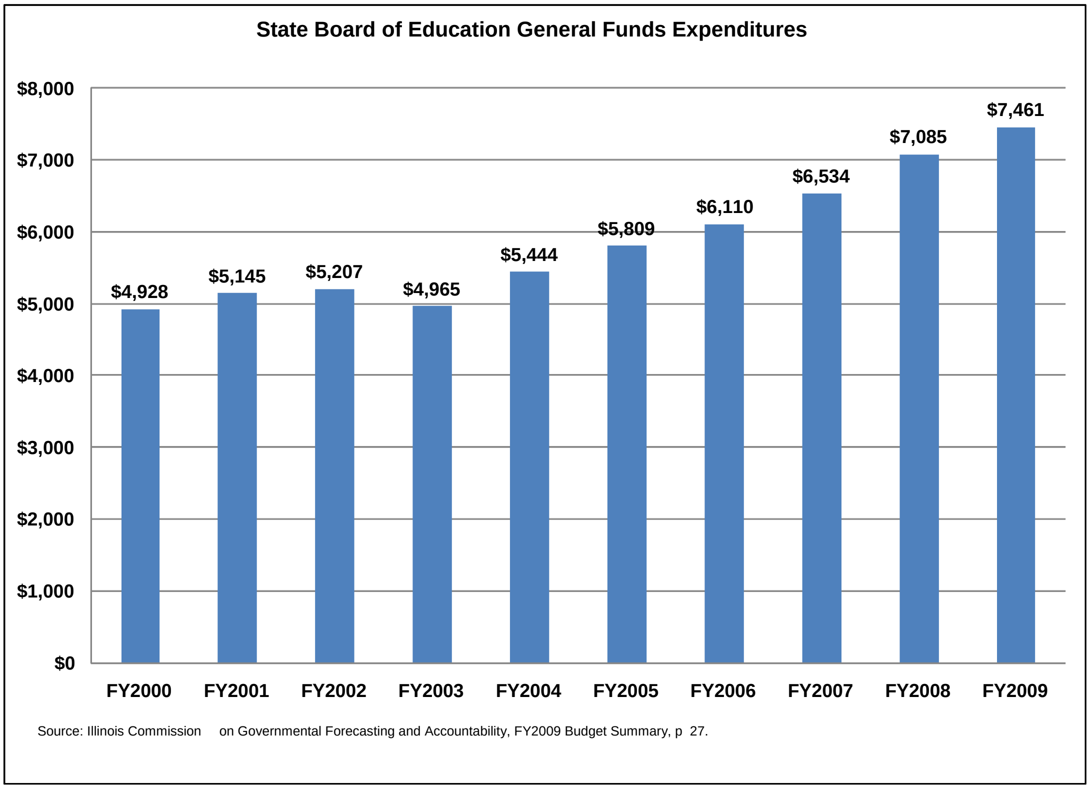
Health and social service spending has risen by 33.5% between FY2000 and FY2007, from $9.7 billion to $13.0 billion. However, much of the sharp increase in FY2007 was due to a category reclassification as spending for state employee health insurance was transferred from the general government to this category.[8]



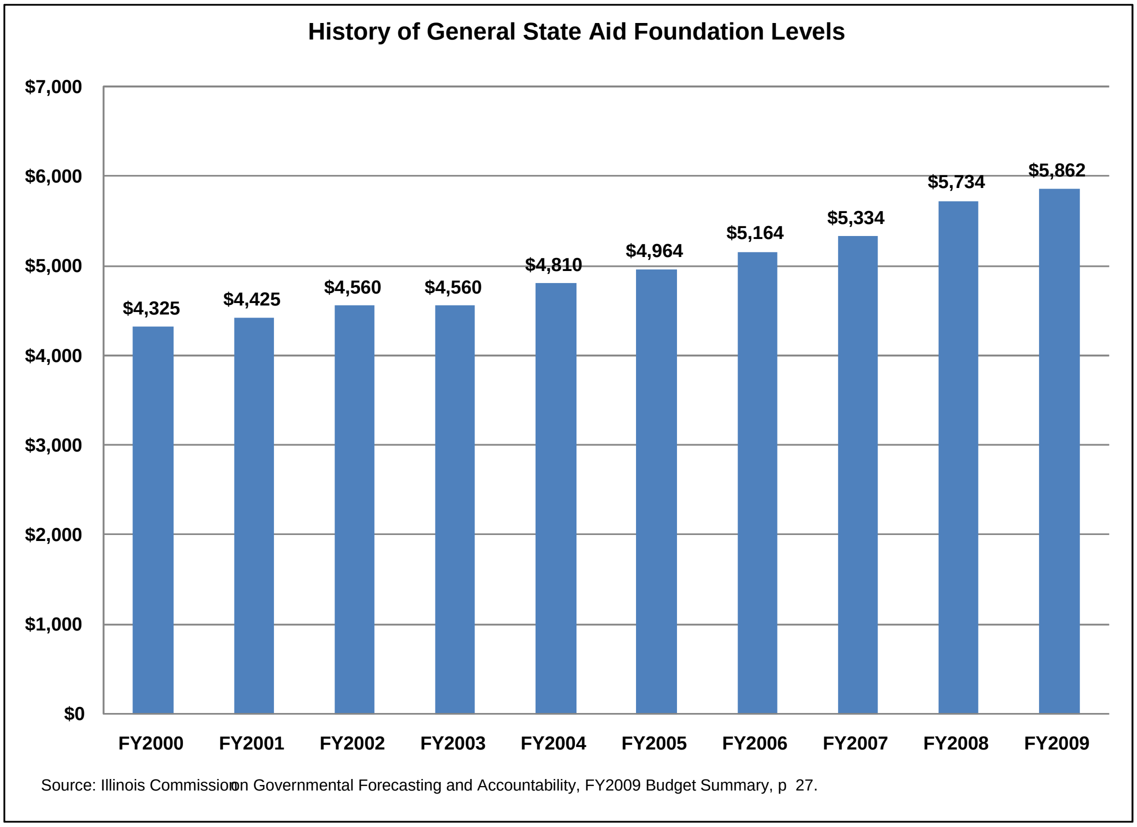
Source: Illinois Commission on Governmental Forecasting and Accountability, FY2009 Budget Summary, p. 31
*FY2006 & FY2007 expenditures reflect the shifting of employee health insurance from General Govermnent to Health & Social Services.

Expenditures for the State Board of Education for the funding of elementary and secondary education increased by 51.4% between FY2000 and FY2007, rising from $4.9 billion to $7.5 billion.

[8] Commission on Governmental Forecasting and Accountability, *FY2009 Budget Summary of the State of Illinois*, October 2008, pp. 31 and 32.



The final exhibit shows the foundation level for elementary and secondary education from FY2000 and FY2009. During that period, the foundation level increased from $4,325 per pupil to $5,862. This is a 35.5% increase.



Civic Federation Recommendations on State Spending

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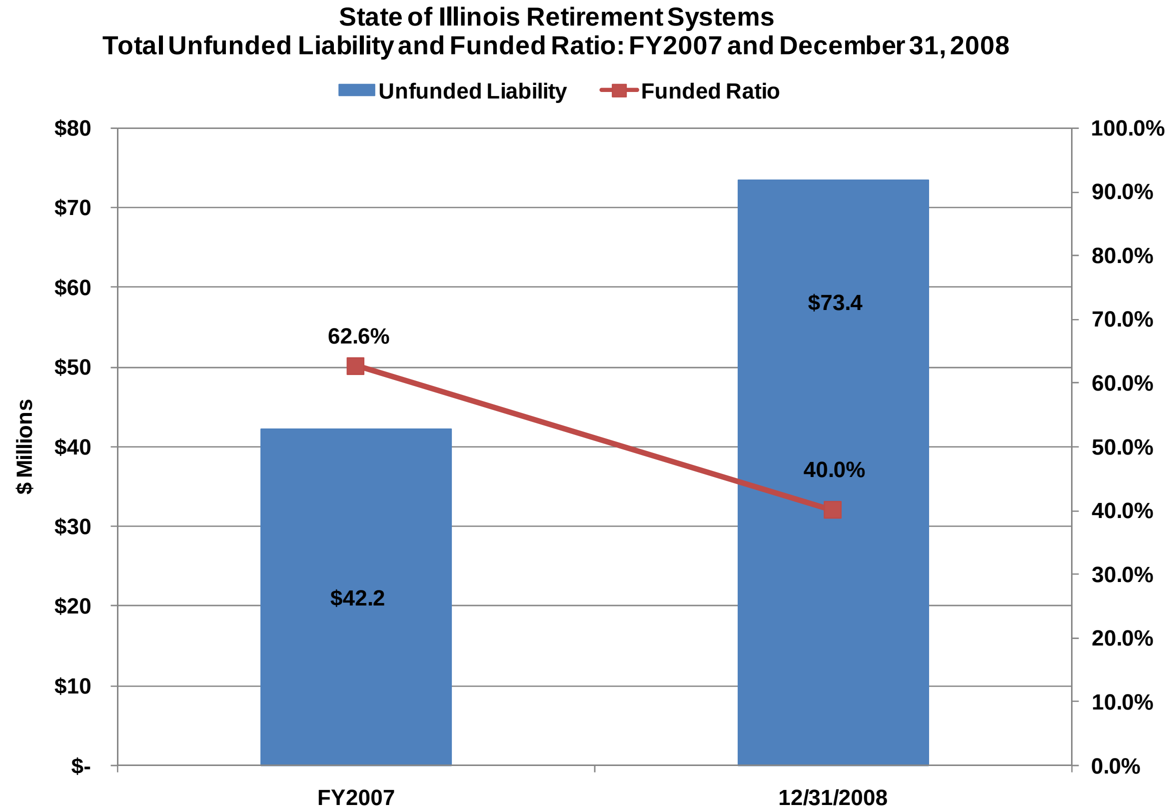
STATE OF ILLINOIS RETIREMENT SYSTEMS

The total unfunded liability for the State of Illinois' five state-funded pension funds surpassed **$54 billion** at the close of the fiscal year on June 30, 2008 and has further increased as of December 31, 2008 to more than **$73 billion** due to months of massive market losses. The unfunded liability jumped by over **$31 billion** between June 30, 2007 and December 31, 2008, while the funded ratio dropped from 62.6% to 40.0%.

[9] The FY2009 Illinois State Budget included five years of performance metrics for each agency. However, most of these metrics were workload measures, which are counts of the number or percentage of activities undertaken or services delivered. While these are important statistics, they do not provide information about the goals for the statistics that are being measured. This system makes it impossible to determine if agencies are meeting, exceeding, or falling short of program and policy goals. In addition, there are no efficiency, effectiveness or service quality measures that would permit a focused evaluation of how well agencies and programs are meeting stated goals.

[10] National Advisory Council on State and Local Budgeting, "Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting," Government Finance Officers Association, p. 43, http://www.gfoa.org/services/dfl/budget/RecommendedBudgetPractices.pdf (accessed February 27, 2009).



Sources: Commission on Government Forecasting and Accounability, Monthly Briefing February 2009, p. 8, http://www.ilga.gov/commission/cgfa2006/Upload/1108revenue.pdf (accessed March 5, 2009); Commission on Government Forecasting and Accountability, Monthly Briefing November 2007, p. 9, http://www.ilga.gov/commission/cgfa2006/Upload/1107revenue.pdf (accessed February 27, 2009).

The worsening of the retirement systems' fiscal condition in 2008 means that the state will have to contribute more money to the systems in FY2010 in order to fulfill the statutory requirement that the systems attain a 90% funded ratio by June 30, 2045. The required contribution for FY2010 is now over **$4.0 billion** or roughly 8% of the state's current operating budget.

State of Illinois Retirement Systems
Projected State Contribution Requirements as of June 30, 2008
($ millions)

Pension Fund	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Teachers (TRS)	$ 1,449.9	**$ 2,087.7**	$ 2,189.6	$ 2,267.1	$ 2,380.4	$ 2,494.3
University (SURS)	$ 450.2	**$ 702.5**	$ 733.5	$ 760.4	$ 788.7	$ 818.8
State Employees (SERS)	$ 863.0	**$ 1,167.3**	$ 1,217.5	$ 1,265.3	$ 1,316.2	$ 1,362.7
Judges (JRS)	$ 60.0	**$ 78.8**	$ 82.2	$ 85.5	$ 88.7	$ 91.7
General Assembly (GRS)	$ 8.8	**$ 10.5**	$ 10.9	$ 11.3	$ 11.7	$ 12.2
TOTAL	**$ 2,831.9**	**$ 4,046.8**	**$ 4,233.7**	**$ 4,389.6**	**$ 4,585.7**	**$ 4,779.7**

Note: Projections for the five state-funded retirement systems are based on the laws in effect on June 30, 2008
Source: Commission on Government Forecasting and Accountability, Monthly Briefing November 2008, p. 13, http://www.ilga.gov/commission/cgfa2006/Upload/1108revenue.pdf (accessed February 27, 2009).

Civic Federation Recommendations for State Pension Reform

Fund State Pension Systems at Certified Contribution Amount. We urge the state to fund its pension obligations at the full amount required by the 1995 law each year. Each time the state reduces contributions to the retirement systems, it is deferring expense to future years.

Impose a Moratorium on New Pension Benefits. The state should impose a moratorium on **any** new employee benefits until the pension system has achieved a 90% funded ratio. We call on the legislature to reject, and the Governor to veto, any new pension enhancements regardless of whether they are tied to additional funding sources.

Raise the Retirement Age for New Hires. Members of the state's retirement systems are currently eligible for full retirement benefits when they reach age 60, unlike the federal Social Security system, which makes 67 the minimum age of retirement with full benefits. Therefore, the Civic Federation believes that the age at which employees become eligible for full benefits should be increased to age 67 for employees with between 8 and 30 years of service, age 65 for employees with between 30 and 35 years of service, and age 62 for employees with 35 or more years of service.

Fix Automatic Increases for New Hires at the Lesser of 2% or the Rate of Inflation. For new hires only, automatic increases should be limited to the lesser of the rate of inflation or 2% and should apply only to the first $12,000 in annual pension payments for retirees covered by Social Security and $24,000 for retirees not covered by Social Security.

Require Balance on Pension Boards between Employees, Management, and Taxpayers. Board seats should be set aside for members with professional expertise or certification in financial asset investment, and all members who do not already possess such expertise should be required to receive some relevant financial training on an annual basis.

Require a 1% Increase in Employee Contributions. The Civic Federation believes that all public employees covered by the state's five retirement systems should contribute an additional 1% of their salaries to the cost of their pensions.

Study the Costs and Benefits of Conversion to a Defined Contribution Plan. The state should undertake a study to determine both the costs and benefits of moving to a defined contribution pension plan such as is now the private sector standard.

Require Pension Benefit Reforms Before Authorizing Pension Obligation Bonds. The State of Illinois should not issue more pension obligation bonds unless it follows the precedent of the Chicago Transit Authority and negotiates reforms to employee pension benefits with unions that will curb future pension liabilities first.

STATE OF ILLINOIS EMPLOYEE AND RETIREE HEALTH INSURANCE PLANS

The Civic Federation conducted a review of the State of Illinois' employee health insurance program in 2007. The research was published in a separate report, "State of Illinois Employee Health Insurance Plans: Analysis and Recommendations for Cost Containment," which can be accessed at http://www.civicfed.org/articles/civicfed_245.pdf.

The State of Illinois Group Insurance Program offers three different health insurance plan types to employees, retirees, and dependents of the state government, state universities, the General Assembly, and judges. The plan types are:

- A self insured indemnity plan, commonly called a fee-for-service or traditional plan (the Quality Care Health Plan);

- A modified preferred provider plan (the Open Access Plan or OAP); and
- Various health maintenance organizations (HMOs).

Between FY1998 and FY2009, Illinois State health insurance liabilities are expected to rise from $802.8 million to $1.99 billion, a nearly $1.2 billion or 148.1% increase. These liabilities have risen at a much faster rate than the State of Illinois total budgetary appropriations. The average rate of increase for budget appropriations between FY1998 and FY2009 will be approximately 5.5%, while the average rate of increase for health insurance liabilities was 8.5%.[11]

In FY2009 State employee health insurance liabilities represented approximately 4% of the proposed State operating budget of $49.7 billion. This is an increase from 3.4% of the operating budget in FY2007. The State's employee healthcare costs of $1.99 billion exceeded the entire FY2009 proposed operating budget of $1.3 billion for the Illinois Department of Children and Family Services, the $1.4 billion budget of the Department of Corrections, and the $1.8 billion budget of the State Treasurer.[12]

The Civic Federation's report found that three features of the State of Illinois Group Health Insurance Plan drive larger State health insurance costs: an expensive indemnity plan, the provision of free health insurance to many retired employees, and employee contributions to premiums that are lower than national private sector averages. The Federation recommended that the State move to implement three key fiscal reforms to address these issues:

- Eliminate the Costly Indemnity Plan and place enrollees in HMO or OAP plans that cost significantly less.
- Eliminate Free Health Care for Retirees.
- Increase Employee Premium Contributions to be in line with national averages.

By implementing all of the Federation's recommendations, in 2007 the State could have reduced its total annual spending on employee and retiree healthcare by between **$264.6** and **$466.0 million**. The savings are likely to be even greater today.

The approval of employee benefit reforms by the Chicago Transit Authority (CTA) demonstrates that it is politically possible to reach a consensus among employees and governments in order to achieve reforms that protect employee health benefits, adequately fund healthcare obligations, and contain governments' costs. The reforms negotiated between the CTA and its labor unions were included in omnibus mass transit funding and structural reform legislation approved in 2007 by the General Assembly.[13] We believe that this legislation provides a realistic model for the State of Illinois and other governments. The CTA's healthcare cost containment reforms included:

- Establishing an independent healthcare trust to manage and provide CTA retiree benefits. After January 1, 2009, the trust will be solely responsible for providing retiree healthcare benefits;

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[11] Commission on Governmental Forecasting and Accountability. *Fiscal Year 2009 Liabilities of the State Employees' Group Insurance Program*, March 2008, p. 8.
[12] FY2009 Illinois State Budget, pp. 2-27 to 2-36.
[13] See Illinois P.A. 95-708.

- Requiring active employees to contribute at least 3% of compensation for retiree healthcare on a pre-tax basis (previously they contributed nothing);
- Requiring retirees and dependents to contribute up to 45.0% of coverage (previously retirees paid nothing and dependents paid 20.0% of the cost of coverage);
- Healthcare is available to retirees at age 55 and after 10 years of service (previously 3 years of service);
- Retiree healthcare benefits are no more than 90.0% in network, 70.0% out of network (previously benefits included 100% indemnity coverage); and
- Funding shortfalls will be financed with increased employee contributions or reductions in benefits.

Civic Federation Recommendations for Employee and Retiree Health Insurance Plans

Eliminate the Costly Indemnity Plan and place enrollees in HMO or OAP plans that cost significantly less. This measure could save the State between **$176.6** and **$253.4 million** per year (estimated savings in 2007).

Eliminate Free Health Care for Retirees for a savings of between **$20.7** and **$146.0 million per year** in premium costs (estimated savings in 2007).

Increase Employee Premium Contributions, which are lower than employee contribution levels required by other state and local governments, as well as private sector organizations. Bringing employee premium contributions in line with national averages could yield as much as **$67.3 million** in savings annually (estimated savings in 2007).

Establish an independent healthcare trust similar to the one created by the CTA to manage and provide State of Illinois retiree benefits. The trust would initially receive a one-time infusion of state funding, but subsequent funding would be from employee contributions. Once created, the trust would be solely responsible for providing retiree healthcare benefits.

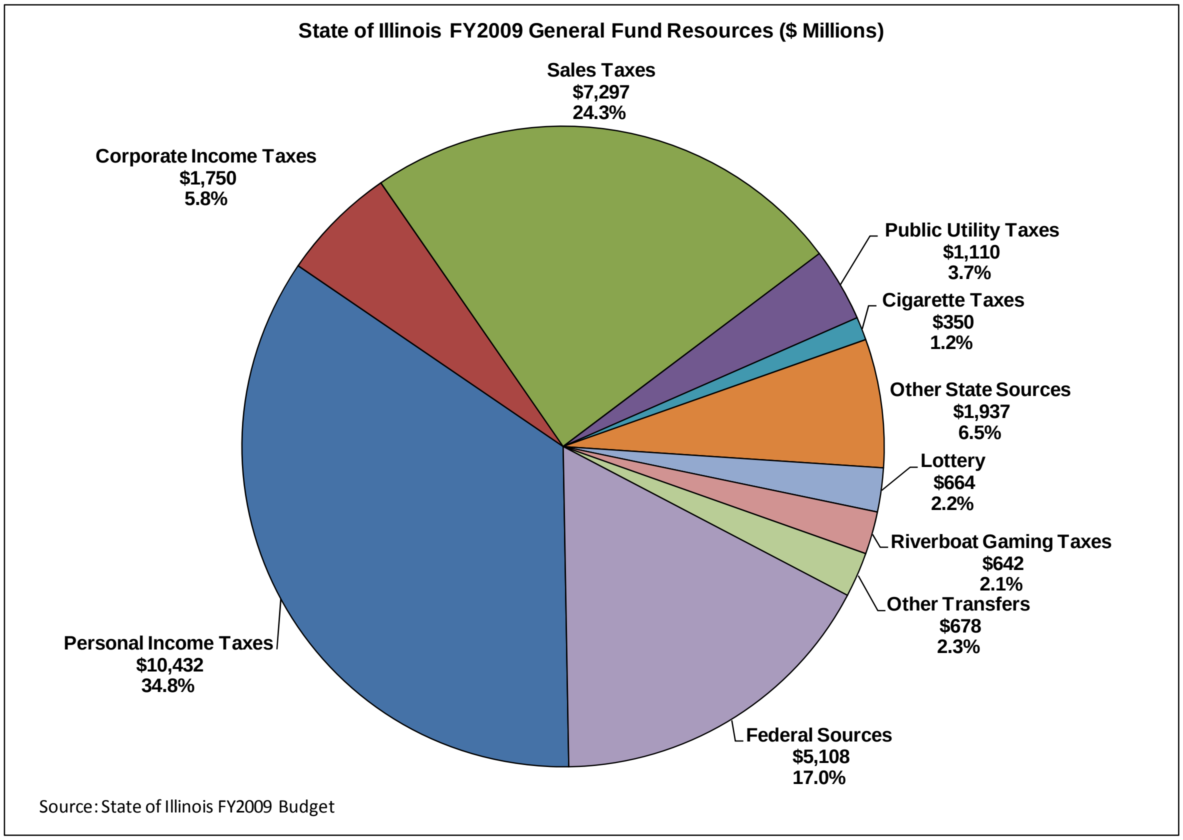
ILLINOIS STATE REVENUES

State Revenue Trends

- The Commission on Governmental Forecasting and Accountability reported in its December 2008 Monthly Briefing that state revenues are declining. As of December 2008, General Funds revenues have declined by $577 million or 3.8% from December FY2007. The biggest revenue declines come in the following areas:
    - Interest earnings are down 71.8% or $84 million;
    - Corporate tax receipts are down 4.1% or $32 million; and
    - Sales tax receipts have fallen by 2.2% or $81 million.

FY2009 General Fund Receipts

General Funds receipts are those resources that the state most directly controls and uses for general operations. In the FY2009 budget, personal and corporate income taxes accounted for 40.6% of all revenues, sales taxes for 24.3% of revenues, and federal receipts or 17.0%.



The exhibit below compares revenue amounts budgeted for FY2009 versus revenues actually received in FY2008. Overall, General Funds were expected to decline by 6.4% between FY2008 and FY2009, falling from $33.8 billion to $31.7 billion, a drop of $2.2 billion. The declines reflect the economic downturn. The major economically sensitive revenues were flat or declining. Personal income tax receipts grew by just 1.1% while corporate income taxes fell by 5.9%. Sales taxes rose by 1.1%, increasing by just $82 million. The FY2009 budget proposal included $575 million in revenues from the sale of the state's tenth riverboat license.[14] However, no funds will actually be received until FY2010, when the state will receive $125 million and the succeeding 30 years when Illinois will receive $10 million per year.

[14] State of Illinois FY2009 Budget, p. 5-17.

Illinois State Revenues for General Funds: FY2008-FY2009 (in $ millions)				
	Actual FY2008	Budget FY2009	$ Change FY08-FY09	% Change FY08-FY09
Base Revenues				
State Sources				
Income Taxes (Net)	$ 12,180	$ 12,182	$ 2	0.0%
Personal	$ 10,320	$ 10,432	$ 112	1.1%
Corporate	$ 1,860	$ 1,750	$ (110)	-5.9%
Sales Taxes	$ 7,215	$ 7,297	$ 82	1.1%
Public Utility Taxes	$ 1,157	$ 1,110	$ (47)	-4.1%
Cigarette Taxes	$ 350	$ 350	$ -	0.0%
Liquor Taxes	$ 158	$ 161	$ 3	1.9%
Inheritance Taxes	$ 373	$ 275	$ (98)	-26.3%
Insurance Taxes & Fees	$ 298	$ 325	$ 27	9.1%
Corporate Franchise Fees & Taxes	$ 225	$ 205	$ (20)	-8.9%
Interest on State Funds & Investments	$ 212	$ 180	$ (32)	-15.1%
Cook County Intergov. Transfer	$ 302	$ 256	$ (46)	-15.2%
Other State Sources	$ 474	$ 535	$ 61	12.9%
Transfers-In				
Lottery	$ 657	$ 664	$ 7	1.1%
Riverboat Gaming Taxes	$ 564	$ 642	$ 78	13.8%
Other Transfers	$ 679	$ 678	$ (1)	-0.1%
Subtotal State Sources	**$ 24,844**	**$ 24,860**	**$ 16**	**0.1%**
Federal Sources	$ 4,815	$ 5,108	$ 293	6.1%
Total Base Revenues	**$ 29,659**	**$ 29,968**	**$ 309**	**1.0%**
Increases to Base Revenues				
Short Term Borrowing	$ 2,400	$ -		
Budget Stabilization Fund Tranfer	$ 276	$ -		
HPF & HHSMTF Transfers	$ 1,503	$ -		
One-Time Revenues	$ -	$ 665	$ 665	
Recurring Revenues	$ -	$ 1,036	$ 1,036	-
Total Adjusting Sources	**$ 4,179**	**$ 1,701**	**$ (2,478)**	**-59.3%**
Total General Fund Revenues	**$ 33,838**	**$ 31,669**	**$ (2,169)**	**-6.4%**

Sources: State of Illinois FY2009 Budget, Table II-B General Funds Revenues by Source, p. 2-38.
State of Ilinois FY2008 Budget; Commission on Governmental Forecasting and Accountability, FY2009 Budget Summary of the State of Illinois, October 2008, p. 29.

Civic Federation Recommendations on State Revenue Issues

The Civic Federation offers a number of recommendations on both general state tax policy and specific tax proposals.

General Tax Policy

User Fees and Charges. User fees and charges are voluntary payments for goods and services that benefit the individual using them, and only those individuals enjoying the use of the goods or services pay for them. This is in contrast to taxes, which are compulsory and used to pay for public goods which may or may not directly benefit the user. The State of Illinois currently collects over 1,500 different fees. Examples of user fees include park and recreation fees, professional license fees, hazardous waste disposal fees, and bank fees. The Civic Federation generally supports the use of user fees and charges rather than taxes to pay for goods and services that directly benefit individuals and that can be sold in discrete units for a price.

Securitization of Long-Term Revenues. Securitization involves packaging future cash flows into debt which is sold to investors. The state proposed in its FY2009 budget to securitize certain long-term revenues, such as tobacco settlements, to fund its one-time child and business tax credits. The Civic Federation rejects proposals that require issuing debt to pay for operating costs, particularly one-time expenses.

Eliminating Favorable Tax Treatment for Out of State Businesses, Transactions, or Individuals. No public policy purpose is served by providing out of state companies, transactions, or individuals lesser tax liabilities than in-state companies or individuals. In fact, such treatment unfairly penalizes Illinois companies and residents, putting companies at a competitive disadvantage. In light of this position, the Civic Federation has supported past state efforts to:

- *Tax Industrial Insurance Purchased by Large Companies from Unlicensed International Insurance Companies.* This proposal would bring Illinois tax law into conformity with 27 other states. It is reasonable that the tax code treat all insurance companies doing business in the State of Illinois the same way.
- *Eliminate the Tax Exemption for fuel from in-state refineries that is exported out of state.* Fuel from Illinois' refineries and pipelines that is used in-state is currently subject to a 1.1 cent per gallon storage tank fee.
- *Enforce Withholding on Non-Resident Gaming Winnings Over $1,000.* There is no good public policy reason why out-of-state residents should be able to take their gaming winnings without paying Illinois income taxes.

The Civic Federation would likely support such tax treatment changes again if they are proposed.

Special Purpose Funds Sweeps. More than 600 special purpose funds have been created in Illinois to receive earmarked revenues that are only used for a designated purpose. The General Funds, in contrast, are used for any purpose that the state deems fit. Over time, the number of special purpose funds has increased, consuming ever larger portions of the state budget. These funds had aggregate balances of approximately $3.0 billion at the end of FY2007.[15] The special purpose funds will constitute 30.0% of the entire state operating budget, or $14.9 billion in FY2009.

The Civic Federation supports the concept of transferring surplus revenues from special purpose funds to General Funds. It is a common budgetary practice to "sweep" funds and transfer surpluses in segregated funds to help close budget gaps. Exceptions of course must be made for certain federal trust funds which cannot be utilized for general purposes. We do caution that the state has a responsibility to evaluate and review such transfers. A needs assessment should be conducted for special purpose funds supported by targeted user fees and the results of that evaluation should be disclosed in order to be certain that programs have sufficient resources to perform their statutorily required duties and functions. The General Assembly has a corresponding responsibility to review such assessments and determine if proposed appropriations are appropriate for such programs.

[15] *Illinois State Budget FY2009*, p. 2-4.

The Civic Federation also supports efforts to consolidate special purpose funds into the General Fund when appropriate. Such a move would simplify cash management, expedite bill paying, and simplify the state audit process.

Broad Based Taxes

State Income Tax Increase. The Civic Federation supported a reasonable 1% income tax increase to provide funds to address the State of Illinois' billions of dollars in unpaid liabilities and to provide money for education and transit in 2007. We supported the creation of this new revenue stream if, and only if, such funds were coupled with structural reforms that would reduce employee benefit costs and inject more accountability into the management of school funds. However, the failure of our political leaders to address the enormous fiscal issues faced by the State of Illinois led us to withdraw our support for any income tax increase in 2008. Until the state can clearly demonstrate its dedication to putting its fiscal house in order, the Civic Federation and the public will not be convinced that any new tax dollars will be well spent. A new infusion of tax revenues to provide more money for new expensive programs will do nothing to reduce the enormous obligations that the State of Illinois has already incurred.

State Sales Tax Rate. The state sales tax is currently 6.25%. Of that amount, 5% is reserved for state purposes and 1.25% is reserved for local governments. Home rule governments may impose their own sales taxes in increments of 0.25% and other local governments have authority to impose sales taxes as well. In Chicago, the composite state and local sales tax rate is 10.25%. In suburban Cook County, the sales tax ranges from 9.00% to 10.25% while in DuPage County the sales can be 7.25% to 8.25%. Because of the very high sales tax rates in Chicago, suburban Cook County, and the Collar Counties, the Civic Federation opposes any increase in the current state sales tax.

Food and Drug Exemption for State Sales Taxes. The current sales tax exemption for food and drugs is far too broad, benefiting many more than the lower income households it was intended to benefit. Removing food and drugs from the sales tax base has also forced rates on general merchandise to levels that now rank among the highest in the nation. It would be a far better fiscal policy to target relief for food and drug purchases to those who need it through refunds or credits than to provide the benefit to everyone. This might make possible a reduction of the sales tax rate as the base is increased.

Counties and municipalities in Illinois currently receive the proceeds of a 1% sales tax on food, prescription drugs, and medical appliances. In Cook County, the Regional Transit Authority (RTA) levies an additional 1.25% sales tax and in the Collar Counties the RTA levies a 0.75% tax. These taxes are collected by the State of Illinois and distributed to the various counties and municipalities; the state does not keep any of this revenue.

The exemption of food and drugs is intended to provide relief to lower income people by limiting sales taxes on purchases of essential items. However, this relief is not targeted. All citizens, rich or poor, benefit from the exemption. In addition, the exemption significantly narrows the base available for taxing sales by limiting it to general merchandise. The result is a very high sales tax rate on non-food items, which paradoxically has a disproportionate impact on lower income individuals.

The Civic Federation believes there are better ways to target relief to the poor than by exempting food and drugs from sales taxes. Federal law already exempts food purchased with food stamps from sales taxes, which covers a significant portion of the typical lower income household's grocery bills. Additional targeted relief can be offered by making lower income taxpayers eligible for refunds of sales tax payments and/or by authorizing state income tax credits for food purchases. Structuring targeted relief helps those who need assistance the most, rather than providing everyone with a broad benefit.

State Gross Receipts Taxes. The FY2008 state budget proposed a gross receipts tax on all receipts at two rates: 0.85% for the agriculture, mining, manufacturing, construction, wholesale, and retail industries and 1.95% for service related industries and activities. The proposal included a number of exemptions, including one for businesses with annual receipts under $2 million. The Civic Federation strongly opposes any attempt to levy a gross receipts tax (GRT) on businesses. It is fundamentally a regressive, seriously flawed tax because: 1) it imposes a tax on businesses regardless of profitability or ability to pay, 2) it will increase production cost because of the pyramiding effect, 3) it is ultimately passed on to consumers, and 4) it is not transparent.

Tax Expenditures

Sunsetting of State Tax Incentives and Exemptions. The Civic Federation endorses state efforts to end outdated and economically inefficient corporate tax deductions or credits, often characterized as "loopholes." We believe as a matter of principle that tax exemptions and benefits should be sunsetted and their renewals debated and discussed, not continued indefinitely.

Evaluation and Reporting of the Economic Benefits of State Tax Incentives, Credits, and Exemptions. Tax incentives, credits, and exemptions are usually authorized on the basis of producing jobs or economic development. However, little effort is made to consistently quantify and report the actual benefits produced. The Civic Federation believes that the state should provide evidence that tax credits or reductions granted actually produce the benefits promised through ongoing evaluation processes and that the results of such evaluations be made public. If no evidence can be produced of the beneficial impact of a tax incentive, the General Assembly should seriously consider repeal of that incentive, credit, or exemption. The lack of objective beneficial evidence led the Civic Federation to support repeal of the following two credits in its FY2009 budget analysis:

- The Research and Development Credit because there was little objective evidence that the credit has actually increased research and development activities; and
- The Manufacturer's Purchase Credit because we had not seen any evidence of the effectiveness of this credit.

Specific Business Tax Treatments

Proposals to Decouple State Business Income Tax Treatments from Federal Requirements. The FY2009 state budget includes proposals to decouple Illinois' treatment of certain corporate income tax regulations from the federal tax code. These specific proposals include:

- Using straight line instead of accelerated depreciation;

- Repealing the deduction for foreign and domestic dividends received by corporations; and
- Decoupling from the Federal Qualified Production Activities Income Deduction.

The Civic Federation believes on principle that Illinois' definition of income for taxation purposes should conform to the federal tax code. Differing federal and state tax treatments violate the core tax principle of simplicity and impose additional economic costs on both businesses and individuals.

Repealing the Single Sales Factor. It is critically important that state tax policy be consistent over time so that businesses can make rational economic decisions. Therefore, the Civic Federation opposes the state's proposed shift from the single sales factor back to a three factor income tax apportionment in its FY2009 budget. Many other states are adopting the single sales factor; repeal of the provision will make Illinois businesses less competitive. Further, we believe that the single sales factor is an important incentive for businesses that export most of their production out-of-state to expand facilities and increase jobs, as well as for attracting businesses that are focused on export-oriented activities.

Collecting Sales Taxes on Prewritten Licensed Software. The Civic Federation recognizes that some prewritten licensed software used by businesses is similar to software purchased by individuals off the shelf and therefore should be taxed in the same manner. However, we have concerns about how a sales tax on prewritten licensed software would be implemented. Our support for such a tax would be contingent on the Illinois Department of Revenue basing the tax on point of delivery, a method consistent with the sourcing rules of the Streamlined Sales Tax Project. This is the method used in other states that tax software. Methods proposed to date by the State of Illinois fail to meet this requirement. Any taxation of prewritten licensed software used by businesses that is not similar to off-the-shelf software purchased by individuals should be considered in the larger context of the taxation of business services.

Restricting the Cost of Collection Discounts. The Civic Federation supports efforts to reduce cost of tax collection discounts offered to vendors. It is reasonable to limit discounts for larger vendors in particular as the automation of records has dramatically reduced the administrative costs associated with collection of various taxes. The discount amounts to a windfall for larger businesses and many other states limit it.

Regarding sales taxes, retailers currently are allowed to take a discount of 1.75% of the tax receipts collected if they file returns and pay sales taxes owed on time. The discount is intended to be an incentive for prompt payment of the tax and to compensate businesses for administrative costs.[16] However, automation of records has dramatically reduced the administrative costs associated with collection. As a result, 24 states offer no discount. Nine states cap the discount at amounts ranging from \$600 to \$39,600 per year, and one state caps the amount at \$30 per report.[17]

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[16] Illinois Department of Revenue. *Publication 133: Retailer's Overview of Sales and Use Tax*, April 2005, p. 8.
[17] Federation of Tax Administrators, "State Sales Tax Rates and Vendor Discounts." January 1, 2007. www.taxadmin.org/fta/rate/sale_vdr.html.

MEDICAID

Illinois Medicaid Issues

- Illinois historically has experienced difficulties in meeting its Medicaid obligations to providers in a timely fashion due to serious cash flow issues.
- The size of the backlog in bills owed to hospitals and pharmacies for Medicaid-related expenses was approximately $2.8 billion of the $4.5 billion in unpaid bills the state owed for FY2009.[18]
- State Comptroller Dan Hynes released a report in February noting that the Medicaid payment cycle increased sharply in FY2009 and that circumstances were likely to grow worse as the recession deepens and state revenues fall.[19]
- The Associated Press reports that the official wait for payment from state Medicaid to healthcare providers is currently up to 62 days.[20]
- In addition to billions of dollars monies owed for services already rendered, appropriations in FY2010 may have to grow by $1.95 billion to keep up with increases in the Medicaid population and to reduce the payment cycle to a reasonable level that assures the reliability of service provision.[21]
- Some financial assistance is forthcoming to Illinois from the recently approved federal stimulus package. Approximately $15 billion will available in first payments to the states for Medicaid assistance. Of that amount, Illinois' estimated proportion will be $471 million.[22]

Facts about the Illinois Medicaid Program

Medicaid, Title 19 of the Social Security Act, is a joint federal-state program to support healthcare services for specified populations under rules promulgated by the federal government. These populations include children and adults living in poverty and the disabled. Medicaid was created in 1965, along with Medicare, and is a major feature of every state's budget, as well as the federal budget. Medicaid is a state-administered program with federal financial participation. The federal government offers a financing match (ranging from 50% to 70%, depending on a state's wealth) to state expenditures for healthcare to eligible recipients.

Medicaid has often been thought of as a program to support healthcare for mothers and children on welfare. However, an equally accurate characterization of the program would be as a supplement to the Medicare program. As the exhibit below shows, while more than 60% of Illinois recipients are mothers or children, more than 60% of the expenditures are on behalf of people who are or eligible for Medicare or to bridge eligibility to Medicare. Illinois is completely typical among the states in this regard.

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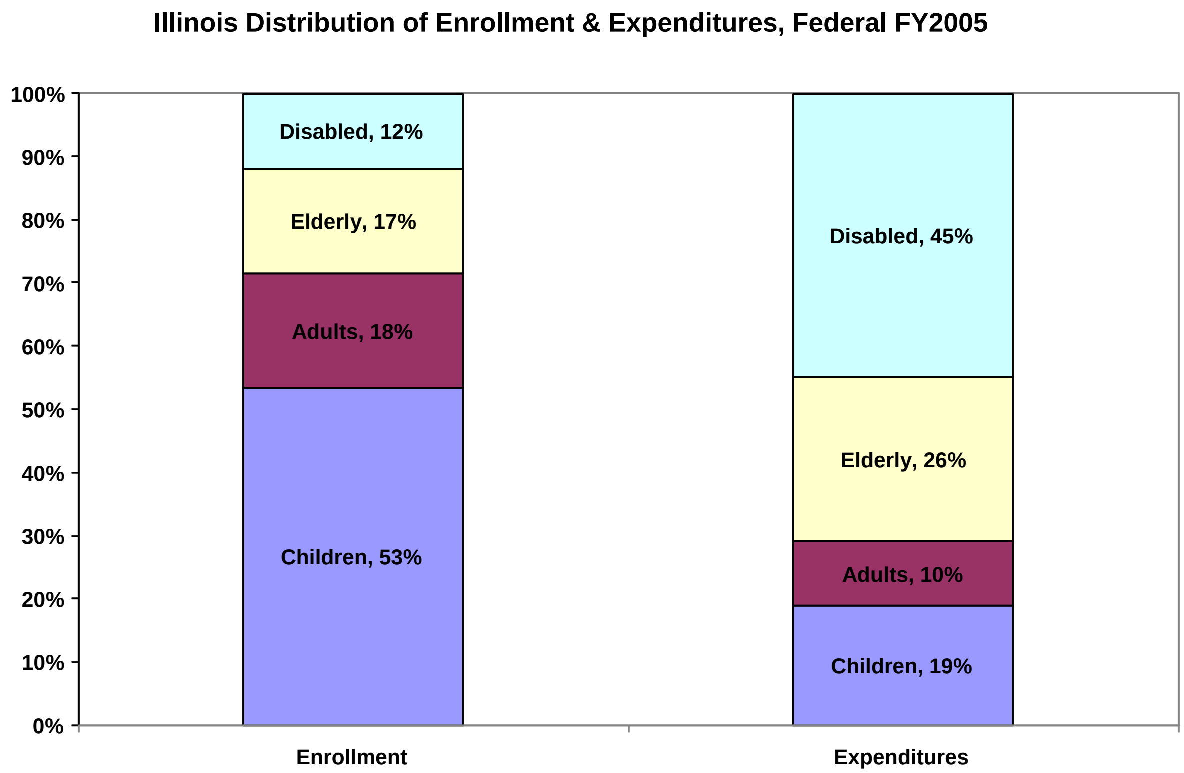
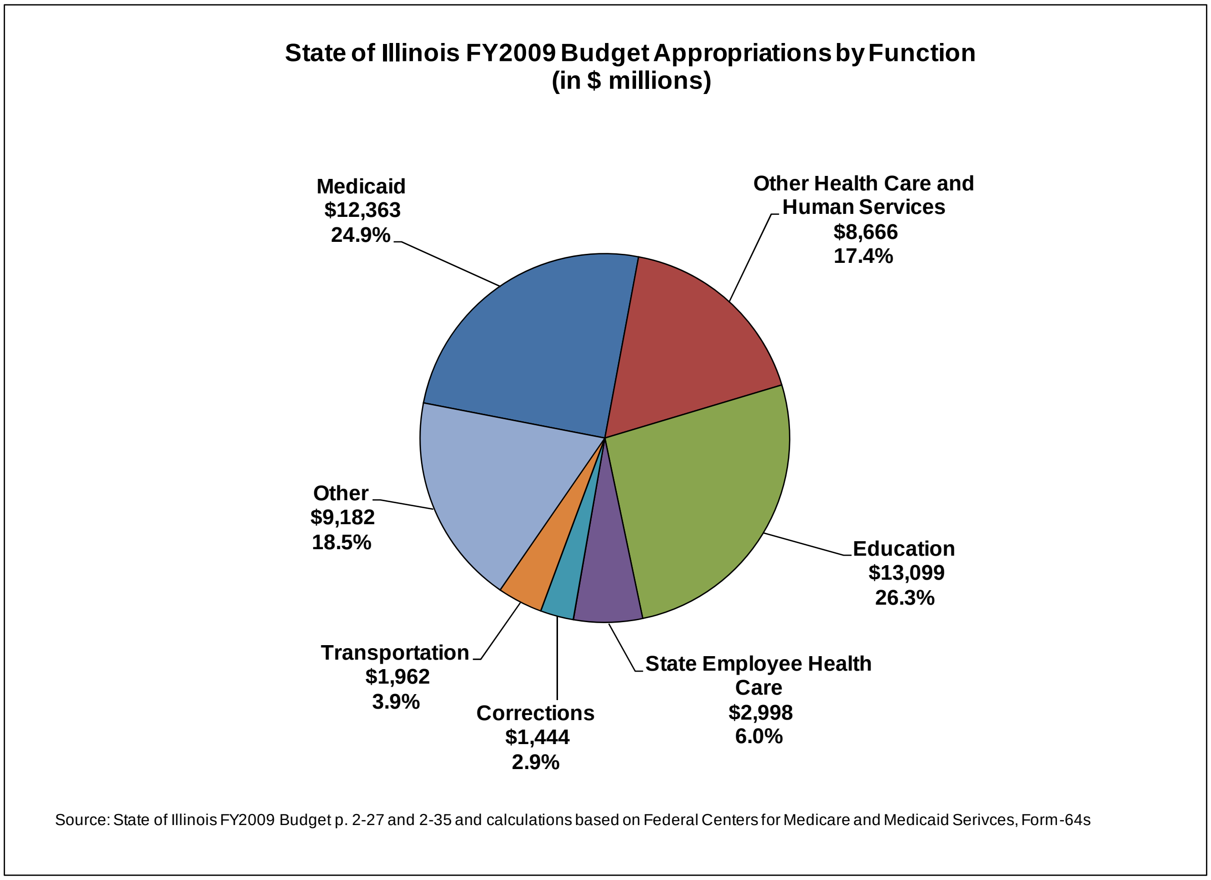
[18] Associated Press, "Obama's Medicaid Money Release Could Mean $471 Million For Illinois," February 23, 2009.
[19] Office of the Illinois State Comptroller. *Transitional Fiscal Report/FY 2010 Budgetary Outlook*, February 4, 2009.
[20] Associated Press, "Obama's Medicaid Money Release Could Mean $471 Million For Illinois," February 23, 2009.
[21] Office of the Illinois State Comptroller. *Transitional Fiscal Report/FY 2010 Budgetary Outlook*, February 4, 2009.
[22] Associated Press, "Obama's Medicaid Money Release Could Mean $471 Million For Illinois," February 23, 2009.



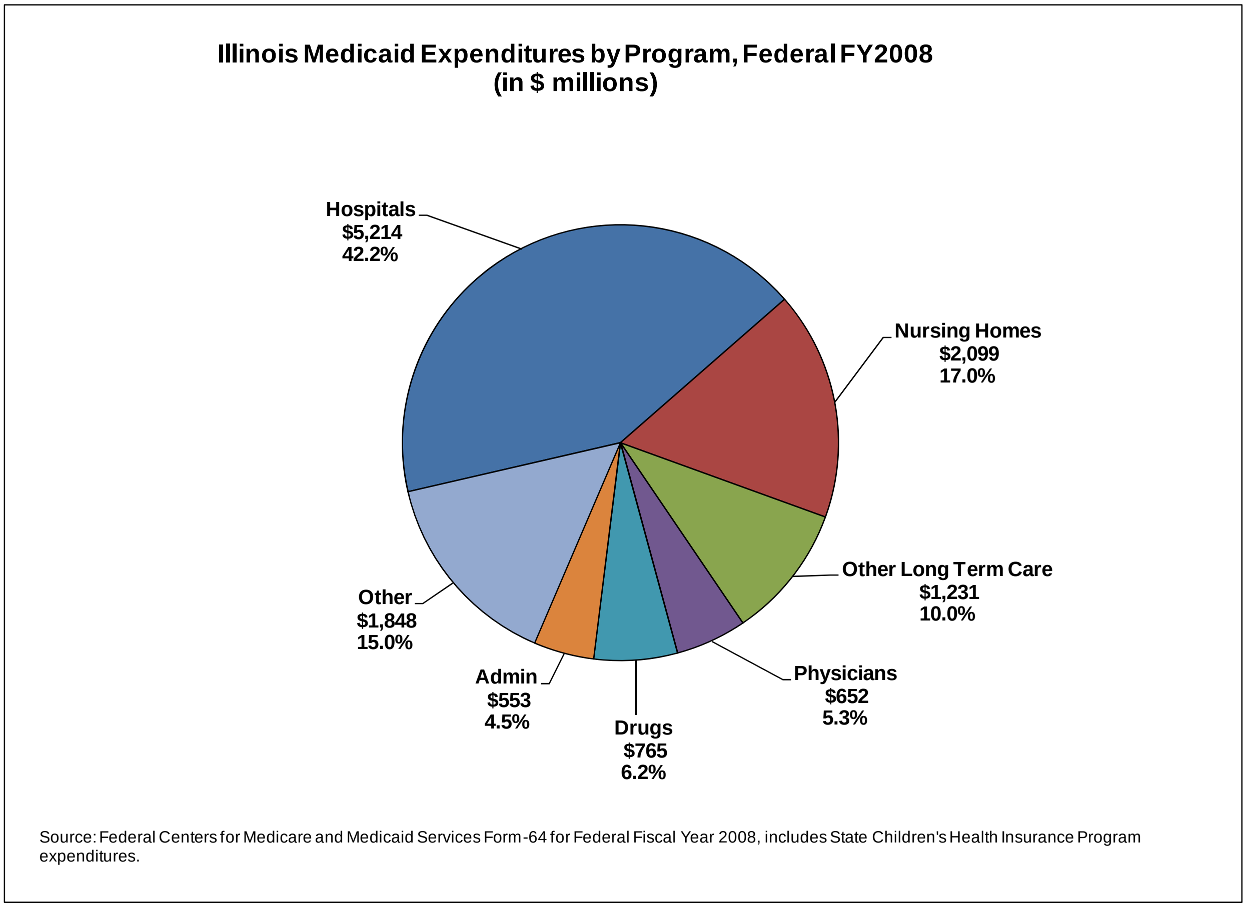
Source: Kaiser Family Foundation Website, "Illinois Distribution of Medicaid Enrollees by Enrollment Group, FY2005," Kaiser Family Foundation http://www.statehealthfacts.org/ (accessed Feburary 27, 2009).
Note: Includes State Children's Health Insurance Program expenditures. Data were adjusted to exclude uncategorized expenditures.

The Illinois Medicaid program is administered primarily by the Department of Healthcare and Family Services (HFS)[23] and "Medicaid" is often treated as synonymous with the HFS Medical Assistance program. However, while there is significant overlap, 1 out of 6 Medicaid dollars is expended by some other Illinois agency—mostly the Department of Human Services (DHS)—and only 4 out of 5 dollars in the HFS program budget are funded by Medicaid. In addition, all expenditures include expenditures from the State Children's Health Insurance Program (SCHIP). Overall, Medicaid expenditures constitute approximately one-quarter of the state's operating budget.

[23] The HFS was previously known as the Illinois Department of Public Aid and many people still refer to it as "IDPA" rather than HFS.



More than 40% of total expenditures within the Medicaid program are made in hospitals. Nursing homes account for another 17.0% of all Medicaid expenditures, while other long-term care (LTC) accounts for another 10.0%. Other LTC includes Medicaid-eligible expenses for mental health facilities. No other program accounts for more than 10% of total expenditures.



Civic Federation Recommendations on Medicaid

No Changes in Eligibility Levels Should be Undertaken Without Corresponding Changes in the Budget. This is such a fundamental idea that it should not be necessary to articulate, but it is. Legal and political issues aside, expanding eligibility by simply extending payment cycles is an implicit tax on providers and discourages participation in the Medicaid program.

The First Call on Any New Money Due to Increased Match from the Federal American Recovery and Reinvestment Act (ARRA) Should be to Pay Down the Billing Backlog.

The Department of Healthcare and Family Services (HFS) and the Department of Human Services (DHS) Should Accelerate Efforts to Move Medicaid Recipients from Non-Matchable Long-Term Care Settings. Illinois spends a large amount, perhaps as much as $700 million, on long-term care services for people with mental illness that is not matched by Medicaid because it violates federal standards. Moving these clients to settings eligible for Medicaid match—and in compliance with court orders such as the Olmstead decree[24]—has the potential to create savings over a relatively short period of time and the opportunity to improve the quality of life for Illinoisans receiving such services.

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[24] This 1999 U.S. Supreme Court decision upheld the integration mandate of the Americans with Disabilities Act that requires public agencies to provide services “in the most integrated setting appropriate to the needs of qualified individuals with disabilities.” *Olmstead v. L. C.* (98-536) 527 U.S. 581 (1999) 138 F.3d 893, affirmed in part, vacated in part, and remanded.

Develop a Coherent Strategy for the Medicaid Program as a Whole. Attacking this issue must be the first order of business for this administration. A reasonable step would be for the Governor and General Assembly would be to create an emergency Commission to review the entire State of Illinois Medicaid program. Medicaid is 25% of the state's budget and is a very complicated program that provides primary healthcare coverage for 11% of the state's citizens. In the past six years a large number of new programs have been enacted with little financial planning or coordination. Comprehensive review of the Medicaid program is needed since so many of the state's individual programs impact on one another. Items high on the list for consideration would include:

- Where can Illinois afford to set its basic eligibility threshold for Medicaid? The General Assembly has mandated a report on the AllKids program for 2010. This report should provide a framework for addressing how and what the state's Medicaid program will provide.
- The current reimbursement for specialist physicians and outpatient procedures is particularly inadequate. While the rate increases in primary care over the last several years were needed, without access to the next level of care when required, the ability of primary care physicians to provide appropriate care is limited.
- When the AllKids program was expanded in November of 2006, the HFS created two programs—Primary Care Case Management (PCCM, also referred to as a medical home model) and a disease management program. The HFS claimed these would generate savings sufficient to fund AllKids. These programs make conceptual sense, but the HFS must provide more detailed and transparent information on how the programs are being monitored and evaluated. Such improved reporting is also necessary to determine how the programs can be improved.
- The current Illinois hospital reimbursement program is outdated and incoherent, particularly on the outpatient side. Revising this system will be complicated, contentious, time-consuming and, potentially, expensive. Work should begin soon.
- The state should reconsider whether the Illinois Cares Rx program is the highest priority for state dollars in light of the implementation of the Medicare pharmaceutical program.
- Illinois' approach to non-institutional long-term care, while improved in the last several years, is behind most other states. Expanded efforts in this area should be on the table, particularly those that can approach cost neutrality.
- Using the additional funds from the ARRA to reduce the billing backlog would be a good first step. However, a longer term solution will require a sustained effort to reduce payment cycles to reasonable and consistent levels. Specific targets and steps to achieve and maintain it are necessary.
- Less specifically, the state should devote increased efforts to understanding the Medicaid program as an overall insurance program for supporting people's health rather than a collection of individual provider-focused programs. While there are many obstacles to such an approach—the lack of continuity in eligibility and various federal regulations foremost among them—there are potentially large payoffs, both in terms of expenditures and beneficiaries' health.

ASSET SALES AND LONG-TERM LEASES

Governments in the United States increasingly are considering transferring the ownership or management of assets such as toll roads or parking facilities to the private sector. In recent years, the City of Chicago has successfully concluded long-term asset leases of the Chicago Skyway, municipal parking garages, and Midway Airport with private operators.

Asset sales or long-term leases are forms of "alternative service delivery" or ASD. ASD is any process that shifts some or all of the functions or responsibilities of delivering a service from the public sector to the private sector. It is commonly referred to as privatization. In regard to transferring control of public assets, ASD can take two forms:

- **Asset Sale or Transfer,** whereby a government divests itself **completely** of an asset, turning over ownership to a private firm, a nonprofit organization or another government.
- **Contracting out Management** of an asset, service, or function to a private or nonprofit entity. In this case, the government retains ownership of any asset involved. However, the managing entity assumes responsibility for personnel. If a government transfers responsibility for management of service provision or a function to a **private** entity, it is referred to as **commercialization**. An example of a commercialization effort is long-term lease arrangement that the City of Chicago has negotiated with the Cintra-Macquarie Consortium for operation of the Skyway. An example of a nonprofit entity managing an asset is the Lincoln Park Zoological Society operating the Lincoln Park Zoo in Chicago.[25]

The Civic Federation supports alternative service delivery efforts that contain certain safeguards. If properly implemented and monitored, these efforts can be effective means of reducing costs and/or improving efficiency. In our view, competition from private, nonprofit, and even other public entities helps reduce the cost and operational inefficiencies inherent in a system of monopoly service provision by a single government.

In evaluating alternative service delivery proposals advanced by state or local governments, the Civic Federation uses the following criteria.

General Guidelines for Alternative Service Delivery Efforts

- Alternative service delivery or privatization is not a panacea for a government's financial problems.
- Transferring responsibility for service delivery to a private firm or nonprofit organization can be beneficial only if there is a marketplace of competitive, qualified vendors or service providers and strong, sustained management oversight by the government.
- Governments must establish a mechanism to monitor and evaluate cost saving and efficiency benefits produced by any alternative service or privatization efforts. These efforts should include the public reporting of efficiencies and/or savings achieved.
- Privatization efforts, i.e., the transfer of service delivery responsibilities to the private sector, should be focused on non-essential services or programs.
- When transferring responsibility for service delivery by means of a long-term lease or sale, governments must carefully consider the policy implications of matters such as

[25] Civic Federation, "Alternative Service Delivery: A Civic Federation Issue Brief," December 1, 2006, p. 3.

limitations on competition and eminent domain. For example, the long-term leasing of a toll road should not preclude a government's ability to plan for future transportation needs in the vicinity of that toll road, including the ability to plan, acquire land, and construct new roads.

Appropriate Disposition of the Revenues from Asset Sales or Leases

- Revenues from commercialization efforts such as asset sales or leases should <u>not</u> be used for recurring expenditures.
- These revenues should be used to reduce existing obligations, such as long-term debt, short-term debt, or unfunded pension obligations.

<u>State of Illinois Long-Term Asset Lease Proposals</u>

Governor Blagojevich made two proposals to enact a long-term lease of the State Lottery.

Lottery Lease in the FY2008 State Budget

As part of the FY2008 budget, the Governor proposed a long-term lease of the Illinois State Lottery. This transaction was projected to generate at least $10 billion. All proceeds of the lottery lease transaction would be paid into the state retirement systems. The Governor proposed replacing the $650 million in annual general fund lottery revenues that funded education with revenues generated by the gross receipts tax.

The Civic Federation supported the Governor's proposal provided that the adoption of this proposal was linked to the implementation of significant pension benefits reforms. Such reforms would include a moratorium on new pension benefit enhancements, a higher retirement age for new hires, and the limitation of automatic increases to the lesser of 2% or CPI for new hires. Revenues lost as a result of the lottery lease would be supplemented by funds from an increase in the state income tax, not from the gross receipts tax proposed by the Governor. The Civic Federation's support for the Governor's proposal was also contingent upon all proceeds from the transaction being used to reduce past unfunded liabilities rather than to avoid paying the pension fund's current annual operating costs. We believe that the pension fund's normal costs must be paid for out of current revenues.

The General Assembly did not enact the Governor's proposal.

Lottery Lease in the FY2009 State Budget

In the FY2009 budget, Governor Blagojevich again proposed a long-term lease of the Illinois State Lottery. This time the proceeds were to be used to partially fund a $25.0 billion capital program entitled *Illinois Works*.

The second proposal differed from the first in that the state offered only a partial concession of the Illinois State Lottery system. A partial concession meant that the state would retain a 20.0% ownership stake in the Lottery as well as the ability to regulate the operations of the entire entity. The partial concession would likely last for a 30-year term and was expected to generate between $10-12 billion, $7.0 billion of which would be directly used to fund *Illinois Works*. Approximately $3.5 billion in proceeds from the long-term lease, plus revenues from the 20.0%

share retained by the state, would be placed in a trust fund to guarantee a continued funding stream for education. These proceeds were expected to generate General Fund revenues of $657.0 million in FY2008 and $664.0 million in FY2009. It was expected that the proceeds would also generate all fund revenues of $986.0 million in FY2008 and $976.0 million in FY2009.[26] The long-term Lottery lease would be the first effort of its kind in the United States.

The Civic Federation opposed the long-term partial concession of the Illinois State Lottery in the FY2009 budget year because the proceeds were to be used to support a multi-year $25.0 billion capital program that failed to provide the public with sufficiently detailed information about how the funds would be spent and did not include either a needs assessment or information regarding prioritization criteria.

The General Assembly did not enact the Governor's proposal.

Civic Federation Recommendations on Asset Sales and Long-Term Leases

Any forthcoming proposal to transfer responsibility for a state asset to a private firm or nonprofit organization must meet the following criteria to gain Civic Federation support:

- There must be a marketplace of competitive, qualified vendors or service providers and strong, sustained management oversight by the government.
- The state must establish a mechanism to monitor and evaluate cost saving and efficiency benefits produced by the asset lease or sale. These efforts should include the public reporting of efficiencies and/or savings achieved.
- Asset sales or leases should only involve entities that deliver non-essential services or programs.
- When transferring responsibility for service delivery by means of a long-term lease or sale, the state must carefully consider the policy implications of matters such as limitations on competition and eminent domain. For example, the long-term leasing of a toll road should not preclude a government's ability to plan for future transportation needs in the vicinity of that toll road, including the ability to plan, acquire land, and construct new roads.
- Revenues from asset sales or leases should <u>not</u> be used for recurring expenditures.
- Revenues from asset sales or leases <u>should</u> be used to reduce existing obligations, such as long-term debt, short-term debt, or unfunded pension obligations.

ILLINOIS CAPITAL BUDGET

Capital Budget Challenges

Much of Illinois' infrastructure is in dire need of repair or replacement. In 2007 the Illinois Department of Transportation requested nearly an additional $10.9 billion investment over the next five years to keep roads and bridges in the state system from falling in to further disrepair.[27] The Regional Transit Authority claims it needs another $7.3 billion to maintain the current

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[26] *State of Illinois Budget FY2009*, pp. 2-37 and 2-38. These are estimated figures.

[27] Illinois Department of Transportation, *Special Report: System Preservation and Maintenance*, amended December 2007. http://www.illinoistransportationplan.org/info_center/presentations.html (accessed February 27, 2009).

services over the same timeframe and a total of $10 billion to enhance mass transit in order to keep up with demand.[28] These needs are well beyond the capacity of the state's current pay-as-you-go funding sources and do not include other critical capital investments for public schools, hospitals, and other government resources.

Although Illinois can expect some immediate funding from federal stimulus package aimed at infrastructure investment, such funding will pale in comparison to the state's current needs. It is also unclear how long the state will have to wait for its next annual allotment of federal transportation dollars. The current six-year national highway transportation bill expires on September 30, 2009 and needs reauthorization by Congress before states will receive further annual formula-based dollars, which provide essential pay-as you-go funding for road, bridge, and other mass transit projects. [29]

Capital Budget Trends

The Illinois Capital Budget Act requires the Governor's office to present an annually updated five-year capital plan coordinated with all state agencies requesting capital appropriations as part of the annual state budget process.[30] However, the FY2009 Capital Plan proposed by the governor did not include a five-year plan but was tied to the $25 billion Illinois Works Capital Program. The Illinois Works legislation, which was not approved by the legislature, was presented as an appropriations bill lacking any significant capital planning documentation. To finance the program the bill proposed:

- Several new funding sources but a no five year spending plan for the FY2009 Capital Budget;
- The majority of the funds were to come from an 80% lease of the state lottery along with some smaller bond issuances. This program would have included $13.5 billion in new capital appropriation for FY2009; and
- The Illinois Works Program was primarily a pay-as-you-go plan and without the new funding sources, only $2.1 billion of reappropriated bond funds from previous years were available for new funding in the 2009 Illinois Capital Budget.

The possibility of securitization of state revenue, long-term leases of assets, new bond issuances, and other new revenue sources will likely be reconsidered as part of the FY2010 capital budget process.

[28] Regional Transportation Authority, *Mass Transit Capital Funding: The need to maintain enhance and expand*, http://www.rtachicago.com/CMS400Min/uploadedFiles/Bklt-Web.pdf (accessed February 27, 2009).
[29] The current federal highway and transit bill, the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU), was signed into law August 10, 2005. It guaranteed funding for highways, highway safety, and public transportation totaling to $244.1 billion. SAFETEA-LU builds off two transportation bills: the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) and the Transportation Equity Act for the 21st Century (TEA-21).
[30] 20 ILCS 3010

Lack of Capital Improvement Plan (CIP)

The state legislature has not approved a statewide CIP since the Illinois FIRST legislation was passed nearly a decade ago.[31] It is unclear without an updated planning document what areas of infrastructure are now in the most critical need for investment and what the state's spending priorities should in the FY2010 capital budgeting process. A proper CIP provides objective standards to determine which projects deserve continued funding from scarce pay-as-you-go resources in the upcoming state budget or whether new revenue from securitization of revenue, long-term leases, capital bonds for financing, or other new revenue sources are justifiable.

Goals and guidelines in a comprehensive CIP document help manage spending effectively to meet legislative goals, which should include maintaining current assets while improving those assets through upgrades and improvements while monitoring any increases in operational cost that often accompany new capital projects.

The Capital Development Board (CDB) along with Central Management Services (CMS) and Governor's Office of Management and Budget (GOMB), have yet to complete the process of identifying and prioritizing the system-wide capital and repair projects with state owned facilities which was underway during last year capital budget process.[32] It is essential for the results of this process to be made public in order to properly prepare a multi-year CIP.

Civic Federation Recommendations on Capital Budgeting

The Civic Federation **opposed** Illinois Works for lack of a comprehensive CIP prior to the introduction of a capital budget. The Civic Federation **agrees** with the National Advisory Council on State and Local Budgeting that all governments should develop a five-year capital improvement plan (CIP) that identifies priorities, provides a timeline for completing projects, and identifies funding sources for projects. The CIP should be updated annually and have formal approval by the governing body. A formal capital improvement plan includes the following information:

- A five-year summary list of projects, expenditures per project, and funding sources per project;
- Information about the impact of capital spending on the annual operating budget for each project;
- Brief narrative descriptions of individual projects, including the purpose, need, history, and current status of each project; and
- The time frame for fulfilling capital projects and priorities.

In addition, the CIP should be made publicly available for review by elected officials and citizens. It should be published in the budget or as a separate document and made available on the government's website.

[31] Illinois Fund for Infrastructure, Roads, Schools, and Transit (FIRST) was passed in 1999 (IL SB 1018, 1028, 1066, 1203). It was the last statewide capital funding bill approved by the legislature. Illinois FIRST appropriated $6.3 billion for school and transportation projects and through matching funds matching funds provided $2.2 billion for schools, $4.1 billion for public transportation, another $4.1 billion for roads, and $1.6 billion for other projects. Illinois FIRST funding expired in 2004.

[32] *State of Illinois FY2009 Capital Budget*, p. 3.

The citizens of Illinois and the members of the General Assembly should receive a formal CIP before being asked to approve any new revenue sources or approve any new projects. The public deserves, and the General Assembly should demand, as much information as possible on both the condition of existing infrastructure and the benefits of new investments so that they can make sound decisions about the efficacy of a multi-billion dollar plan that will be paid over a number of years. Absent such a report, it is difficult for citizens and public officials to evaluate or prioritize such capital improvement proposals.

The Civic Federation supports capital improvements for the State of Illinois. The maintenance and construction of infrastructure is critical to the economic vitality of a region. Illinois needs investments in its infrastructure. However, we believe that there must be a serious evaluation of how state money will be used and prioritized before, not after, the funds are appropriated.