

CHAPTER 2



CHAPTER 2



Dye

Merriman

Hudspeth

Crosby

And Miles to Go Before It's Balanced: Illinois Still Faces Tough Budget Choices

By Richard F. Dye, David F. Merriman, Nancy Hudspeth and Andrew Crosby

This chapter discusses decisions that must be made now to set the state budget on a path toward balance. The authors observe that although progress has been made toward sustainability through policies implementing cost reductions (especially in health care) and increased revenue (through income and cigarette taxes), the state will need to focus on a longer-term strategy going forward.

NEED TO KNOW

- Progress was made on several fronts in 2012, but unpaid bills (the state has about \$5 billion in unpaid obligations from prior years), Medicaid expenditures, and pensions will continue to be issues for the state moving forward.
- The *Fiscal Futures Model* demonstrates that the combination of increased income tax, large cuts in spending, and the effect of a gradually improving economy will decrease the deficit to an estimated \$4.9 billion in FY2013 and a projected \$1.6 billion in 2014.
- The *Fiscal Futures Model* also illustrates several important outcomes for different policy options, such as:
 - Holding Medicaid expenditures to the rate of inflation would decrease spending by \$3 billion by 2020.
 - Avoiding getting farther behind on pension liabilities would cost an extra \$1 billion to \$2 billion for each of the next 10 years.
- Although Illinois has taken important steps to deal with its fiscal challenges, more action will be needed in the coming years. The authors present several policy options for consideration.

Editor's Note: *The Fiscal Futures Project at the Institute of Government and Public Affairs is dedicated to informing the public and policymakers about state budget transparency and long-term budget concerns. Each year since 2009, the Fiscal Futures Project team has presented its assessment of Illinois government's financial condition as part of The Illinois Report. This chapter represents that assessment for 2012-13.*

I. Careening Toward a Date with Fiscal Reality

The Illinois budget has been unbalanced and unsustainable for many years. Recently, national attention was focused on the state's fiscal problems by the State Budget Crisis Task Force, which concluded:

"[W]ithout any sort of long-term financial plan to restore balance, and without reserves ... Illinois has been doing backflips on a high wire, without a net."¹

A harsh statement, but a reasonable characterization of the risky behavior involved. As a result of these "fiscal backflips" —paying for expanded programs with borrowing, pension holidays, delayed payments to creditors, fund-balance transfers and

¹ State Budget Crisis Task Force. *Report of the State Budget Crisis Task Force: Illinois Report*, October 2012 (p. 7). <http://www.statebudgetcrisis.org/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf> (Archived by Web Cite® at <http://www.webcitation.org/6CS0WV10v>)

other gimmicks—Illinois was effectively insolvent going into the Great Recession. In late 2010, the future appeared so bleak that we characterized Illinois' fiscal condition as "Titanic and Sinking."²

Two years later we see signs of progress. Illinois certainly has a long way to go to achieve fiscal balance, but problems are being recognized and state leaders have taken several positive steps during the past year. One of the biggest strides occurred in June 2012 with a \$2.7 billion plan to "save" Medicaid that consisted of cost reductions, significant new revenue, and other changes. In addition, Illinois' implementation of *Budgeting for Results* has broadened the state's budget focus and key budgeting players are now considering a longer-term picture in budgeting.

However, recent developments have, at best, temporarily fixed a number of looming problems. Medicaid expenditures are expected to continue to rise, placing additional budget pressures on Illinois. The state faces an estimated \$100 billion in unfunded pension obligations with no clear solution. Finally, in what has become a tradition in Illinois budgeting, the state will use approximately \$5 billion in fiscal year 2013 revenues to pay fiscal 2012 bills, and has no agreed upon plan to address the backlog.³

Section II of this chapter reviews the budgetary events of the past year. In Section III, we present our long-term projections of the state's structural deficit from the *Fiscal Futures Model*. In Sections IV and V, we analyze and present projections regarding Medicaid and pensions, respectively. Section VI reviews recent state efforts to adopt improved financial practices, such as *Budgeting for Results* and the addition of multiyear projections. Finally, we offer concluding remarks and policy options.

\$5
BILLION

The estimated amount of current revenue that will be used to pay last year's bills.

II. 2012 – Year in Review

Over the past year, the *Fiscal Futures Project* team collaborated with the State Budget Crisis Task Force, a national working group headed by former Federal Reserve Chairman Paul Volcker and former New York Lieutenant Governor Richard Ravitch. The Task Force studied the fiscal conditions in six states and identified six major threats to states' fiscal stability. It concluded that all six apply to Illinois. These include critical problems of unfunded pension liabilities, debt service, and Medicaid costs, which are growing faster than the state's revenue sources. Illinois' lack of transparency and the use of borrowing and budget maneuvers—such as putting off bills until next year—contributed to the lack of recognition of the state's desperate fiscal condition.

Going forward, "Illinois faces serious threats from future federal budget cuts and diminishing economic growth. Its revenues were stagnant for a decade before the onset of the Great Recession and have eroded over time. It is likely that state revenues will not be able to offset predicted cuts in federal funds," according to the task force.⁴ As the federal government works to reduce its own deficits and expands spending on health care under the Patient Protection and Affordable Care Act (PPACA, also known as simply ACA or "Obamacare"), other areas of discretionary spending—such as grants to state and local governments—will probably be cut. In Illinois, this means that there probably will be reductions in federal monies for education, transportation, human services, and natural resources.

² Richard Dye, Nancy Hudspeth, and David Merriman, "Titanic and Sinking: The Illinois Budget Disaster." *The Illinois Report 2011*, Institute of Government and Public Affairs at the University of Illinois (Board of Trustees of the University of Illinois, 2011) 27-38. <http://igpa.uillinois.edu/node/1282> (Archived by WebCite® at <http://www.webcitation.org/6AepU2dOD>).

³ Judy Baar Topinka, Comptroller of Illinois, "Backlog Grows – Fiscal Outlook Cloudy," *The Illinois State Comptroller's Quarterly*, 7, November 2012.

⁴ *Ibid.*

In November, Democrats won a supermajority in both houses of the Illinois General Assembly, potentially breaking a political stalemate.⁵ This could reduce political obstacles to progress on Illinois' most pressing issues.

Medicaid. In summer 2012, Illinois enacted cuts and efficiencies in the Medicaid program expected to save \$1.6 billion in fiscal year (FY) 2013.⁶ With President Obama's re-election removing much of the uncertainty about the phase-in of the ACA, Illinois is moving to expand its Medicaid program. The state is opting into the ACA early in Cook County to collect federal monies to pay health care costs of an estimated 115,000

"Illinois' lack of transparency and the use of borrowing and budget maneuvers—such as putting off bills until next year—contributed to the lack of recognition of the state's desperate fiscal condition."

previously uninsured patients.⁷ Illinois is also reportedly making progress on establishing a state health insurance exchange.⁸ We look at the impact of the recent cuts, ACA expansion and other ideas for Illinois' Medicaid program later in this chapter.

Unpaid bills. Although the state's ability to carry Medicaid and employee health bills over to the next fiscal year is being phased out,⁹ Illinois' perennial problem with late payments

to vendors and service providers continues. According to the Illinois comptroller, "Illinois is again on track to use approximately \$5 billion in current revenue to pay prior year liabilities."¹⁰ In November

⁵ Reuters. "Illinois faces own fiscal cliff after big Democratic election win." November 10, 2012, <http://www.reuters.com/article/2012/11/10/usa-campaign-illinois-idUSL1E8M8AC820121110> (Archived by WebCite® at <http://www.webcitation.org/6CxP1ee4a>)

⁶ Cuts – see Dave McKinney, "Gov. Quinn signs Medicaid cuts, cigarette tax into law." *Naperville Sun*, June 14, 2012. <http://naperville.sun.suntimes.com/business/13180145-420/gov-quinn-signs-medicaid-cuts-cigarette-tax-into-law.html> (Archived by WebCite® at <http://www.webcitation.org/6CxZxuFcZ>). Also see Dave McKinney, "Illinois House passes bill to cut \$1.6 billion from Medicaid." *The Southtown Star*, May 24, 2012. <http://southtownstar.suntimes.com/news/12753459-418/illinois-house-passes-bill-to-cut-16-billion-from-medicaid.html> (Archived by WebCite® at <http://www.webcitation.org/6CxZWVLPt>) and Ray Long, "Illinois legislature passes deep health care cuts." *Chicago Tribune*, May 25, 2012. http://articles.chicagotribune.com/2012-05-25/news/chi-health-care-cuts-gain-team-in-illinois-house-20120524_1_discount-drug-coverage-people-from-medicaid-coverage-payment-rates (Archived by WebCite® at <http://www.webcitation.org/6CxZbkvvG>) Cigarette taxes - see Rick Pearson and Ray Long, "Lawmakers OK \$1-a-pack cigarette tax hike." *Chicago Tribune*, May 30, 2012. http://articles.chicagotribune.com/2012-05-30/news/ct-met-illinois-legislature-0530-2012-0530_1_cigarette-tax-tobacco-tax-measure-tax-hike (Archived by WebCite® at <http://www.webcitation.org/6CxTdLpfp>) and Doug Finke, "Quinn wants Medicaid cuts, \$1 cigarette tax hike." *The State Journal-Register*, April 20, 2012. <http://www.sj-r.com/top-stories/x787558596/Quinn-wants-Medicaid-cuts-1-cigarette-tax-hike>. (Archived by WebCite® at <http://www.webcitation.org/6CxTZ99UY>).

⁷ Lewis Wallace, "Cook County begins enrolling 250,000 new Medicaid recipients." *WBEZ 91.5*, November 19, 2012. <http://www.wbez.org/news/cook-county-begins-enrolling-250000-new-medicaid-recipients-103902> (Archived by WebCite® at <http://www.webcitation.org/6Cxb2Eu2h>) and The Associated Press, "Cook County gets go-ahead to expand Medicaid coverage early, bringing in more federal dollars." *Chicago Tribune*, October 31, 2012. <http://www.chicagotribune.com/news/local/sns-ap-il-cook-county-medicaid-expansion-20121031,0,482870.story>. (Archived by WebCite® at <http://www.webcitation.org/6CxatFptF>).

⁸ The Associated Press. "Illinois keeps pace on Obama's health law." *Crain's Chicago Business*, November 16, 2012. <http://www.chicagobusiness.com/article/20121116/NEWS03/121119806/illinois-keeps-pace-on-obamas-health-law> (Archived by WebCite® at <http://www.webcitation.org/6CxbQk1Gv>) and Dave McKinney, "Legislative battle looms over Illinois health insurance exchange." *Chicago Sun-Times*, November 11, 2012. <http://www.suntimes.com/news/16282096-418/illinois-pursues-health-exchange-but-faces-fight-over-control.html> (Archived by WebCite® at <http://www.webcitation.org/6CxaiZ7J3>) and Peter Frost, "Illinois to submit health exchange blueprint Friday." *Chicago Tribune*, November 15, 2012. http://articles.chicagotribune.com/2012-11-15/business/chi-illinois-to-submit-health-exchange-blueprint-friday-20121115_1_health-insurance-plans-health-care-illinois-plans (Archived by WebCite® at <http://www.webcitation.org/6CxaatBT>).

⁹ Under Section 25 of the Illinois State Finance Code, liabilities for Medicaid, state employees' and retirees' health insurance (and some liabilities in the Department of Public Health) that were incurred in Year 1 could be carried forward and paid with Year 2 revenue. Medicaid reform legislation enacted in January 2011 requires that this practice be phased out over a ten-year period and eliminated in FY 2021.

¹⁰ Judy Baar Topinka, Comptroller of Illinois, "Backlog Grows – Fiscal Outlook Cloudy," *The Illinois State Comptroller's Quarterly*, 7, November 2012.

2012, Gov. Pat Quinn proposed issuing bonds to pay the backlog.¹¹

Pensions. With the worst unfunded public pension liability of any state, the biggest issue facing Illinois continues to be pension reform. However, progress has been made in increasing awareness of the severity of the problem. For the first time in two years, Illinois did not issue bonds to cover its mandatory contributions to the state pension systems in FY 2012, but that meant cuts in other areas. In August 2012, before a special legislative session to deal with pension reform, Governor Quinn's office issued analyses arguing that increased pension costs are putting pressure on education spending and without reform the situation will grow worse. The governor's office launched a new media campaign that said that Illinois has been underfunding its pension systems since their inception in the 1940s.¹²

State retiree health insurance. A new law enacted in June 2012 changed the formula that determined retiree health insurance premiums. Potentially, this will require annuitants to pay part of their health

"Moody's downgraded Illinois General Obligation Bonds to A2 in January 2012, making Illinois its lowest-rated state and giving Illinois the lowest rating it has had in at least a dozen years."

care premiums, based on ability to pay. The new law states that the Department of Central Management Services (CMS) will determine the state's contribution to the program, as well as retiree premiums. CMS had not yet finalized a new premium reimbursement formula by the end of 2012.¹³

Bond ratings downgrade. Illinois' bond rating was downgraded twice in 2012, largely due to the unpaid bill backlog and failure to reform state pensions.¹⁴ Moody's downgraded Illinois

General Obligation Bonds to A2 in January 2012, making Illinois its lowest-rated state and giving Illinois the lowest rating it has had in at least a dozen years. On December 13, 2012, Moody's lowered Illinois' credit outlook to "negative" from stable, noting that "fiscal 2014 marks the last year before Illinois' 2011 income tax increases are partly unwound, putting the state on track to deal with simultaneous growth in pension funding needs and loss of revenue."¹⁵ Standard & Poor's downgraded Illinois in August 2012, after a special legislative session to reform pensions was unproductive, making Illinois its second-lowest rated state, ahead of only California.

¹¹ Reuters. "Illinois governor eyes bonds to pay off growing bill pile." November 15, 2012. <http://www.reuters.com/article/2012/11/15/illinois-bills-idUSL1E8MFIZ620121115> (Archived by WebCite® at <http://www.webcitation.org/6Cxa4eJw5>).

¹² Monique Garcia and Rick Pearson, "Quinn's pension marketing push is derided as 'juvenile.'" *Chicago Tribune*, November 18, 2012. <http://www.chicagotribune.com/news/local/ct-met-governor-quinn-pension-reform-20121119,0,3422889.story>. (Archived by WebCite® at <http://www.webcitation.org/6Cxv7ESYN>).

¹³ Jeff Houch, "Legislative Update," *The SURS Advocate*, November 2012, p. 3 <http://www.surs.org/pdfs/advocate/November12.pdf>. (Archived by WebCite® at <http://www.webcitation.org/6Cyxjb6Aw>).

¹⁴ Moody's January – see Jamey Dunn, "Moody's downgrades Illinois' credit rating." *The Illinois Issues Blog*, January 6, 2012. <http://illinoisissuesblog.blogspot.com/2012/01/illinois-credit-rating-downgraded.html> (Archived by WebCite® at <http://www.webcitation.org/6CxTxF2d3>). Also see, The Associated Press, "Moody's lowers Illinois credit rating, again." *Lake County News-Sun*, January 6, 2012, <http://newssun.suntimes.com/news/9859142-418/moodys-lowers-illinois-credit-rating-again.html> (Archived by WebCite® at <http://www.webcitation.org/6CxULTUOk>) and Brian Chappatta, "Illinois Becomes Moody's Lowest-Rated U.S. State With Debt Downgrade to A2." *Bloomberg*, January 6, 2012. <http://www.bloomberg.com/news/2012-01-06/illinois-rating-lowered-to-a2-by-moody-s-with-32-billion-of-debt-affected.html> (Archived by WebCite® at <http://www.webcitation.org/6CxUWkEOV>) S&P August – see Reuters, "UPDATE 2 - S&P cuts Illinois rating to A, outlook still negative." August 29, 2012. <http://www.reuters.com/article/2012/08/29/illinois-rating-sp-idUSL2E8JT9FD20120829> (Archived by WebCite® at <http://www.webcitation.org/6CxUh2W6P>). Also see Monique Garcia, "Illinois' credit rating downgraded after pension reform failure." *Chicago Tribune*, August 30, 2012, http://articles.chicagotribune.com/2012-08-30/news/ct-met-quinn-credit-rating-20120830_1_pension-reform-pat-quinn-credit-woes (Archived by WebCite® at <http://www.webcitation.org/6CxUqlwg1>) and Mark Peters and Kelly Nolan, "Illinois Suffers Credit Downgrade." *The Wall Street Journal*, August 29, 2012.

¹⁵ *Chicago Sun-Times*, "Moody's lowers Illinois' credit outlook." December 14, 2012. <http://www.suntimes.com/business/17001449-420/moodys-lowers-illinois-credit-outlook.html> (Archived by WebCite® at <http://www.webcitation.org/6CzXqk1s1>).

New revenue. Although new revenue sources for Illinois are an important step toward fiscal stability, those that have been recently created will generate modest additional revenue and are insufficient to solve Illinois' long-term fiscal issues. In June 2012, the cigarette tax was increased from \$0.98 per pack to \$1.98. The legislation also expanded the definition of a "cigarette" and raised taxes on other tobacco products. This increase is estimated to raise \$675 million that will be used for Medicaid.¹⁶

In September 2011, a private company began managing the Illinois State Lottery with the intent to increase earnings by \$4.8 billion over the next five years, or nearly \$1 billion per year.¹⁷ Although lottery receipts reported by the Illinois Comptroller's Office did increase—from about \$1.09 billion in FY 2011 to \$1.27 billion in FY 2012—they fell short of the target.¹⁸

After several years of regulatory delays, video gambling machines began operating in about 65 locations in October 2012.¹⁹ Due to the controversial nature of gambling, several municipalities, including the City of Chicago, opted not to legalize video gambling. Similarly, proposals to increase the number of casinos—including a land-based casino in Chicago—were not enacted.

**\$675
MILLION**

Amount of money estimated to be raised for Medicaid from the cigarette tax.

III. Fiscal Futures Model Projections

As in previous editions of *The Illinois Report*, we present the projected gap in Illinois' consolidated budget from the *Fiscal Futures Model*, which:

- Consolidates the General Funds and more than 600 other state funds, meaning:
 - Year-to-year accounting reassignment of budget items between funds will not be confused with a change in the state's fiscal condition
 - Within-year transfers between funds will not be confused with a change in the state's fiscal condition;
- Divides the budget into a number of categories of spending and receipts that are consistently defined over time;
- Estimates the statistical relationship between budget categories and selected economic or demographic "driver" variables from historical data;
- Uses the current year's consolidated funds budget as a starting point;

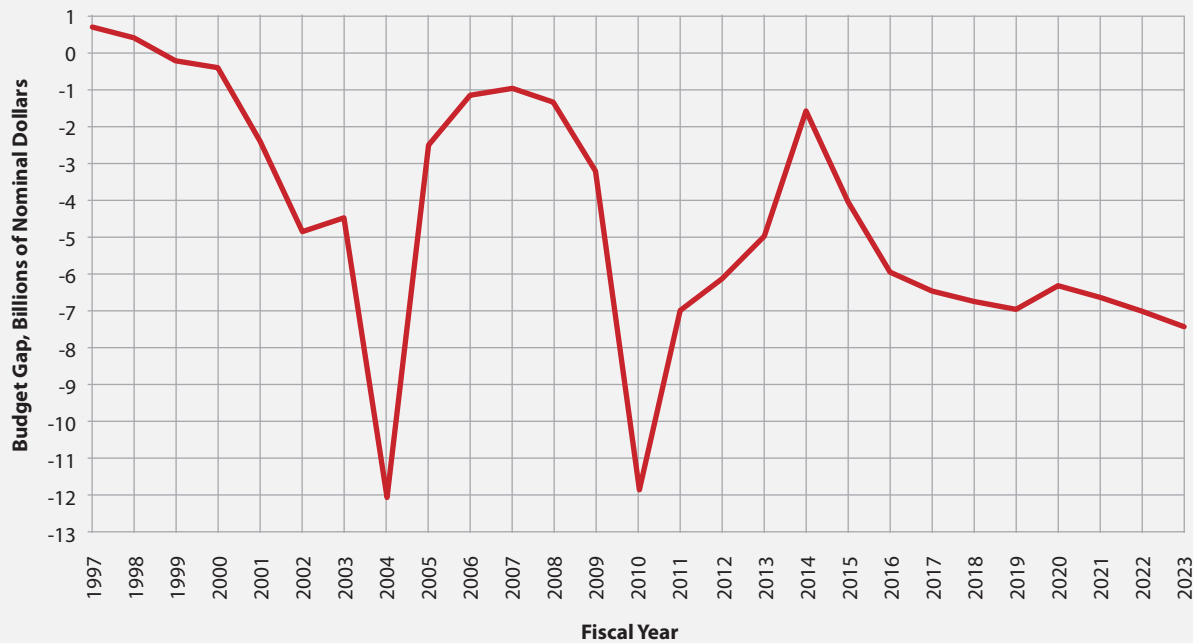
¹⁶ Rick Pearson and Ray Long, "Lawmakers OK \$1-a-pack cigarette tax hike." *Chicago Tribune*, May 30, 2012. http://articles.chicagotribune.com/2012-05-30/news/ct-met-illinois-legislature-0530-20120530_1-cigarette-tax-tobacco-tax-measure-tax-hike (Archived by WebCite® at <http://www.webcitation.org/6CxTdLpfp>) and Doug Finke, "Quinn wants Medicaid cuts, \$1 cigarette tax hike." *The State Journal-Register*, April 20, 2012. <http://www.sj-r.com/top-stories/x787558596/Quinn-wants-Medicaid-cuts-1-cigarette-tax-hike>. (Archived by WebCite® at <http://www.webcitation.org/6CxTZ99UY>).

¹⁷ Matthew Walberg, "Lottery management firm could owe state millions." *Chicago Tribune*, November 9, 2012. http://articles.chicagotribune.com/2012-11-09/news/ct-met-lottery-arbitrator-20121109_1_northstar-lottery-group-illinois-lottery-revenue-targets (Archived by WebCite® at <http://www.webcitation.org/6CyxxMiV>). Also see *Chicago Sun-Times*, "Northstar begins Illinois Lottery management, (No Date). <http://www.suntimes.com/news/metro/3378774-418/story.html>. (Archived by WebCite® at <http://www.webcitation.org/6CxPdSoml>).

¹⁸ Paul Merrion, "Big penalty scratched for Illinois Lottery's private manager." *Crain's Chicago Business*, November 9, 2012. <http://www.chicagobusiness.com/article/20121109/NEWS02/121109730/big-penalty-scratched-for-illinois-lotterys-private-manager> (Archived by WebCite® at <http://www.webcitation.org/6CxTSU4oF>) and Matthew Walberg, "Lottery Manager Misses Revenue Goal by about \$100M." *Chicago Tribune*, July 31, 2012. http://articles.chicagotribune.com/2012-07-31/news/ct-met-lottery-appeal-20120731_1_northstar-lottery-group-illinois-lottery-private-manager (Archived by WebCite® at <http://www.webcitation.org/6AgfCRdoQ>).

¹⁹ Erin Meyer, "It's official: Video gambling now legal in Illinois." *Chicago Tribune*, October 9, 2012. http://articles.chicagotribune.com/2012-10-09/news/chi-video-gaming-legal-in-illinois-beginning-today-20121009_1_video-poker-machines-businesses-or-clubs-central-computer-system (Archived by WebCite® at <http://www.webcitation.org/6CxT0Ngkp>) and Tammy Webber, "Video Poker Arrives in Illinois." *NBC Chicago*, October 9, 2012. <http://www.nbcchicago.com/news/business/illinois-video-poker-173402711.html> (Archived by WebCite® at <http://www.webcitation.org/6CxTFbFX4>).

Figure 1
Illinois Consolidated Funds Expenditures Minus Receipts FY 1997-2023



Source: IGPA Fiscal Futures Model, November 2012.
 Notes: Borrowing and fund balance transfers not counted as receipts. FY 1997 to 2011 are based on historical data; FY 2012 data is preliminary; FY 2013 is estimated based on appropriations and other information; FY 2014 to 2023 are projected by the Fiscal Futures Model.

- Uses forecasts of the driver variables and the estimated relationships to project each spending and receipt category into future budget years;
- Assumes no borrowing—or reductions in pre-existing fund balances—as receipts.

In Figure 1, we revise our earlier projections with updated numbers for the FY 2012 and 2013 budgets and more recent forecasts of the economic and demographic variables that drive the projections of future budget years. The figure presents the budget gap, which equals expenditures minus receipts and serves as a single measure of the state’s fiscal condition.

For reference, Figure 1 includes the consolidated budget gap for completed fiscal years 1997 to 2012. The budget was roughly balanced from FY 1997 to 2001, but moved to a roughly \$5 billion deficit in FY 2002 and 2003. Since the budget gap measure presented here does not count borrowing as a receipt, there was a huge increase in the deficit associated with spending the proceeds of pension obligation bonds in 2004. FY 2006-2008 was a period of peak economic activity and revenue collections, but still

had a roughly \$1 billion deficit on a consolidated funds basis without considering borrowing as a source of revenue.

Figure 1 shows the precipitous decline in Illinois’ fiscal condition between FY 2008 and FY 2010 associated with the Great Recession. In *The Illinois Report 2012*, we described the tax increases of 2011 and the other policy changes made in response to the state’s fiscal crisis.²⁰ The combination of increased income taxes, large cuts in many areas of spending, and the effect of a gradually improving economy will decrease the deficit to an estimated \$4.9 billion in FY 2013 and to a projected \$1.6 billion in FY 2014.

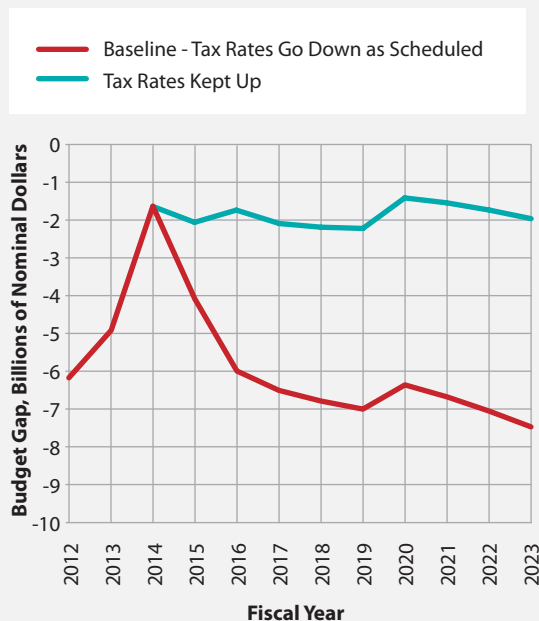
²⁰ Richard Dye, Nancy Hudspeth, and David Merriman, “Through a Dark Glass: Illinois’ Budget Picture is Dire and Distorted.” *The Illinois Report 2012*, Institute of Government and Public Affairs at the University of Illinois (Board of Trustees of the University of Illinois, 2012) 41-56. <http://igpa.uillinois.edu/IR12/pdfs/ILReport2012web.pdf> (Archived by WebCite® at <http://www.webcitation.org/6A jnahvnQ>).

After 2014, the temporary tax increases of 2011 start to be phased out and by FY 2016 the projected deficit increases to \$6 billion. Figure 2 projects the fiscal condition of the state if personal and corporate income tax rates do not fall as scheduled in calendar year 2015. The red line in the diagram is the baseline budget projection from currently scheduled tax rates (identical to Figure 1 except beginning in FY 2012). The blue line in Figure 2 projects a budget deficit on the order of \$2 billion per year for the 2015 to 2023 period even if the tax rates stayed at the current 5 percent for individuals and 7 percent for corporations.²¹

IV. Medicaid: A Temporary Fix; Long-Term Concerns

This section is divided into two parts. First, we analyze the impact of the June 2012 Medicaid reform legislation. Second, we look at the expansion of Illinois' Medicaid program under the ACA.

Figure 2
Illinois Consolidated Funds Budget Gap Projections to FY 2023 with and without Phase-Out of Higher Income Tax Rates After 2014



Source: IGPA Fiscal Futures Model, November 2012.
See notes to Figure 1.

A. June 2012 Medicaid Reform Legislation

In our chapter in *The Illinois Report 2012*, we estimated that the budget could balance in 2019 if the higher (2011) income tax rates do not expire in 2015 and all programs except pensions and debt service were held to grow only at the rate of inflation. In recent years, Illinois' Medicaid expenditures have been increasing about 2 percent per year above inflation. What would it look like if growth of Illinois Medicaid expenditures were held to inflation?

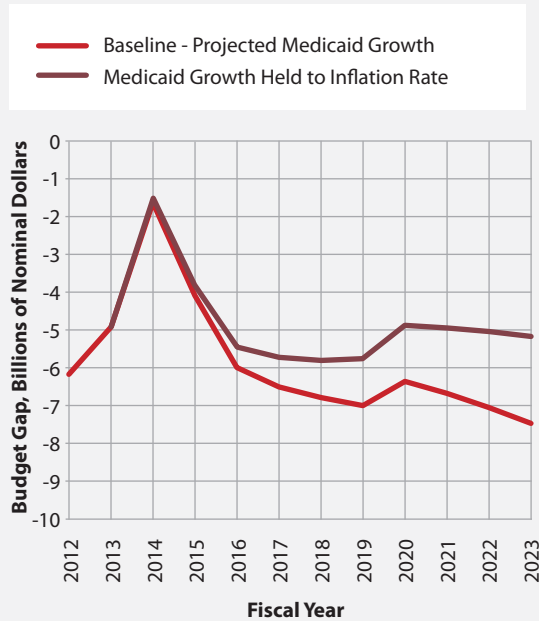
"The combination of increased income taxes, large cuts in many areas of spending, and the effect of a gradually improving economy will decrease the deficit to an estimated \$4.9 billion in FY 2013 and to a projected \$1.6 billion in FY 2014."

Figure 3 (page 20) illustrates the budget gap with two alternatives going forward from 2013: (1) the baseline projection of the model based on historical growth in Medicaid expenditures higher than the rate of price inflation (red line); or (2) holding Medicaid expenditures to the rate of inflation (purple line). If Medicaid expenditures were held to the rate of inflation, expenditures would be about \$3 billion less for FY 2020. The cuts needed to keep Medicaid at zero growth in real dollars would be significant but even this, by itself, would be nowhere near enough to balance the budget.

The American Recovery and Reinvestment Act (ARRA) provided Illinois with additional federal funds for Medicaid through an increase in the reimbursement rate from 50 percent to 61.88 percent for

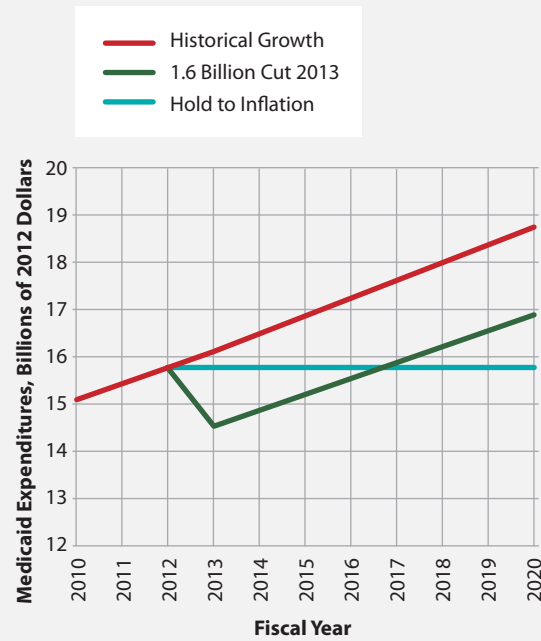
²¹ Note that by choosing to report projections of the model only 10 years into the future, the projections stop in FY 2023 and do not show the baseline impact of scheduled cuts in the personal income tax rate to 3.25 percent and the corporate income tax rate to 4.8 percent in calendar year 2025.

Figure 3
Illinois Consolidated Funds Budget Gap Projections to FY 2023 with Medicaid Growth as Projected or Held to Consumer Price Index Inflation Rate



Source: IGPA Fiscal Futures Model, November 2012. See notes to Figure 1.

Figure 4
Illinois Medicaid Expenditures Projections to FY 2020: Historical Growth, Held to Consumer Price Index Inflation Rate, \$1.6 Billion Cut and Historical Growth



Source: IGPA Fiscal Futures Model, November 2012.

FYs 2009-2011.²² In FY 2012, as the federal stimulus ended, Illinois received \$2.7 billion less in federal monies than it had received in FY 2011. To offset this reduction, Illinois leaders enacted a plan of cost savings and cuts expected to save \$1.6 billion in FY 2013. If Medicaid growth continues at historical rates, the one-time cuts of \$1.6 billion made in 2013 will hold spending below its inflation-adjusted 2012 level for about five years (Figure 4).

B. Medicaid Expansion under ACA

The Affordable Care Act (ACA) will expand Medicaid to provide health coverage for those with incomes at 138 percent of the federal poverty level (FPL) and below.²³ Because the Illinois Medicaid program has historically provided broader coverage than many other states, analysts anticipate that the ACA will have less impact upon Illinois. For example, Illinois already covers patients up to 133 percent of the FPL. However, Illinois relies on federal funds

²² For Q1 and Q2 of Federal Fiscal Year (FFY) 2009 the match rate was increased to 60.48 percent; then increased to 61.88 percent Q3 FFY 2009 thru Q1 FFY 2011; then dropped to 59.05 percent for Q2 FFY 2011, 57.16 percent for Q3 FFY 2011, 50.20 percent for Q4 FFY 2011 and back to 50.0 percent in Q1 FFY 2012. The federal fiscal year begins October 1; the state fiscal year begins July 1. Q1 federal FY = Q2 state FY. See The Council of State Governments, "States Face Medicaid Match Loss After Recovery Act Expires." March 2011, http://knowledgecenter.csg.org/drupal/system/files/States_Face_Medicaid_Match_Loss_After_Recovery_Act_Expires_0.pdf (Archived by WebCite® at <http://www.webcitation.org/6CdtSjxW9>).

²³ The ACA will expand Medicaid to cover individuals in households with incomes below 133 percent of the FPL. However, 5 percent of income will be disregarded, which effectively raises the limit to 138 percent of the federal poverty level. See Kaiser Family Foundation, "Determining Income for Adults Applying for Medicaid and Exchange Coverage Subsidies: How Income Measured With a Prior Tax Return Compares to Current Income at Enrollment." March 2011, <http://www.kff.org/healthreform/upload/8168.pdf>. (Archived by WebCite® at <http://www.webcitation.org/6CxSUoHoM>).

for many other budgetary priorities. It is likely that increases in federal spending on health care will require discretionary spending to be cut, which could affect Illinois' budget for education, human services, transportation, and natural resources.

Somewhere between 600,000 and 970,000 new patients are likely to enroll under the ACA.²⁴ In 2011, our colleagues Robert Kaestner and Nicole Kazez estimated that the ACA would increase Medicaid enrollment between 640,000 and 962,500.²⁵ Similarly, a 2010 study by the Kaiser Family Foundation estimated between 631,000 and 911,000 new Medicaid enrollees. Of these, about 70 percent would be those who were previously ineligible for Medicaid.²⁶ Approximately 200,000 people ("current eligibles") would qualify for Medicaid under current laws.

Much of the debate about the cost of the ACA to states is focused on the number of people who are currently eligible for Medicaid and are not enrolled

"It is likely that increases in federal spending on health care will require discretionary spending to be cut, which could affect Illinois' budget for education, human services, transportation, and natural resources."

in the program, but will enroll during the ACA expansion. These enrollees will be covered by a 50 percent federal match, not the 90-100 percent that covers the newly-eligible.²⁷ For this reason, providing health care for additional current eligibles is the main cause of increased expenses for states under the ACA. However, other costs are possible. If increased federal spending on health care leads to reductions in federal funds for education, transportation and human services, Illinois may increase its spending in these areas.

Kaestner and Kazez estimated that Illinois' Medicaid expenditures would increase by 5 to 9 percent by 2020, suggesting that Illinois' share of total Medicaid spending would increase from about \$5.5 billion in FY 2011 to close to \$6 billion in FY 2020, due to the ACA.²⁸ A 2010 study by the Kaiser Commission on Medicaid and the Uninsured found that Illinois state spending would increase \$1.2 billion to \$2.4 billion over the five-year period 2014-2019.²⁹

²⁴ Media reports indicate 500,000 new enrollees but there is no source cited for this estimate. Dean Olsen, "Illinois likely to expand Medicaid under federal insurance law." *The State Journal-Register*, July 22, 2012. http://www.sj-r.com/top-stories/x691231625/Illinois-likely-to-expand-Medicaid-under-federal-insurance-law?zc_p=1. (Archived by WebCite® at <http://www.webcitation.org/6CxS5KOor>). Also see Dean Olsen, "Illinois eyes expansion of Medicaid rolls under federal health care law." *The State Journal-Register*, September 25, 2012, <http://www.sj-r.com/top-stories/x1784770704/Illinois-eyes-expansion-of-Medicaid-rolls-under-federal-health-care-law>. (Archived by WebCite® at <http://www.webcitation.org/6CxSP1FJz>).

²⁵ Robert Kaestner and Nicole Kazez, "Health Reform and Medicaid: Covering the Uninsured." *The Illinois Report 2011*, Institute of Government and Public Affairs at the University of Illinois (Board of Trustees of the University of Illinois, 2011) 61-67. <http://igpa.uillinois.edu/node/1282> (Archived by WebCite® at <http://www.webcitation.org/64ZKV8DjP>).

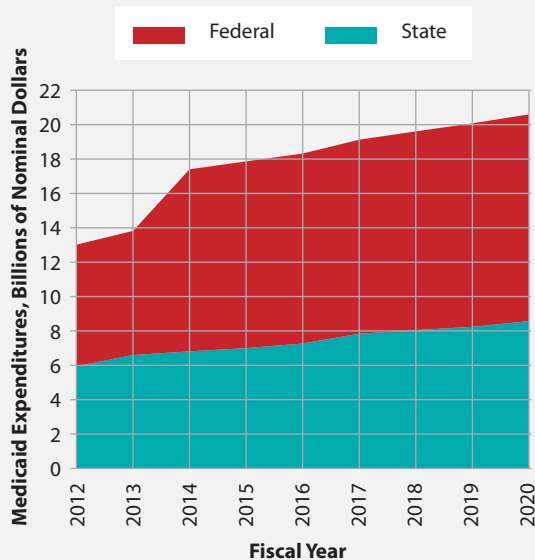
²⁶ John Holahan and Irene Headen, "Medicaid Coverage and Spending in Health Reform: National and State-by-State Results for Adults at or Below 133% FPL." Kaiser Commission on Medicaid and the Uninsured, Kaiser Family Foundation, May 2010. <http://www.kff.org/healthreform/upload/Medicaid-Coverage-and-Spending-in-Health-Reform-National-and-State-By-State-Results-for-Adults-at-or-Below-133-FPL.pdf> (Archived by WebCite® at <http://www.webcitation.org/64jCCYcqe>).

²⁷ From FY 2014 thru 2016, the federal government will pay 100 percent of the Medicaid expenses for those who are newly-eligible under the ACA. Beginning in FY 2017, the federal share will drop gradually to 90 percent in FY 2020 and beyond.

²⁸ Robert Kaestner and Nicole Kazez, "Health Reform and Medicaid: Covering the Uninsured." *The Illinois Report 2011*, Institute of Government and Public Affairs at the University of Illinois (Board of Trustees of the University of Illinois, 2011) 61-67. <http://igpa.uillinois.edu/node/1282> (Archived by WebCite® at <http://www.webcitation.org/64ZKV8DjP>).

²⁹ John Holahan and Irene Headen, "Medicaid Coverage and Spending in Health Reform: National and State-by-State Results for Adults at or Below 133% FPL." Kaiser Commission on Medicaid and the Uninsured, Kaiser Family Foundation, May 2010. <http://www.kff.org/healthreform/upload/Medicaid-Coverage-and-Spending-in-Health-Reform-National-and-State-By-State-Results-for-Adults-at-or-Below-133-FPL.pdf> (Archived by WebCite® at <http://www.webcitation.org/64jCCYcqe>).

Figure 5
**Illinois Medicaid plus ACA Expenditures
 with State and Federal Shares, FY 2012-2020**



Sources: Fiscal Futures Project, Kaiser Foundation.
 Note: 2012 numbers are preliminary.

Governor Quinn has said that Kaiser’s estimate of \$2.4 billion in additional state spending is too high, but at the time of this writing the state had not yet released its own estimates.³⁰

Our projection of future Medicaid spending under ACA (using data from the Kaiser Foundation) is shown in Figure 5. Note that FY 2012 numbers are preliminary because final data were not available, but estimates show total Medicaid spending rising above \$20 billion by 2020. However, the federal share will be much larger than in the past, due to the higher match rate for some expenditures under ACA.

\$96.8
BILLION Total unfunded liabilities of the five state-funded pension systems (combined) as of 2012.

V. Pensions

A. State of the Current Systems

As shown in Table 1, Illinois’ five state-funded systems combined had a total of \$96.8 billion in unfunded liabilities as of 2012. Illinois has the biggest unfunded pension liability of any state, with some of the lowest funded ratios in the nation.³¹ The overall funded ratio for the state systems is 39 percent, with the State Universities Retirement System (SURS), General Assembly Retirement System (GARS), and the Judicial Retirement System (JRS) far below the combined ratio.

Underfunding of state pensions dates back decades. In 1994, the Illinois General Assembly acknowledged the problem and established a plan—known as the “pension ramp”—to achieve a 90 percent funded ratio for its systems by 2045. However, the payment schedule has ramped up so slowly that in 2013, 18 years into the plan, the state is still not making large enough payments to keep the unfunded liability from growing.

Even though payments are not yet sufficient to reduce the unfunded liability, Illinois is having serious trouble meeting its scheduled obligations. In several past years, Illinois has taken “pension holidays” and skipped or only partially made payments. In FY 2010 and 2011, the state had to borrow to make its payments. In each of the three years from FY 2011 to 2014, the state’s scheduled contribution increased another \$1 billion per year. If debt service on the

³⁰ Dean Olsen, “Illinois likely to expand Medicaid under federal insurance law.” *The State Journal-Register*, July 21, 2012. http://www.sj-r.com/top-stories/x691231625/Illinois-likely-to-expand-Medicaid-under-federal-insurance-law?zc_p=1. (Archived by WebCite® at <http://www.webcitation.org/6CxS5KOor>).

³¹ Illinois Department of Healthcare and Family Services. “Institutional Provider Rate Reductions Effective July 1, 2012.” June 30, 2012. <http://www.hfs.illinois.gov/html/063012n9.html>. (Archived by WebCite® at <http://www.webcitation.org/6CxQzeGHa>).

Table 1
Summary Statistics for Illinois State Retirement Systems

FY 2011	Teachers	State Universities	State Employees	General Assembly	Judicial	TOTAL
Active Members (# persons)*	133,920	71,888	66,363	180	968	273,319
Current Annuitants (# persons)*	90,967	42,682	47,002	291	720	181,662
FY 2012						
Actuarial Accrued Liability (\$ billion)**	90.0	33.1	33.2	2.0	0.3	158.6
Assets (current market value, \$ billion)**	36.5	11.0	13.7	0.6	0.1	61.8
Unfunded Liability (\$ billion)**	53.5	22.1	19.5	1.4	0.3	96.8
Funded Ratio (Assets pct. of Liability)**	40.6%	33.1%	41.3%	28.6%	17.4%	39.0%
State Contribution (\$ billion)*	2.4	1.0	1.4	0.01	0.1	4.9

* Commission on Government Forecasting and Accountability. A Report on the Financial Condition of the Illinois State Retirement Systems as of June 30, 2011. (March 2012). <http://www.ilga.gov/commission/cgfa2006/Upload/FinCondILStateRetirementSysMarch2011.pdf>.

** Commission on Government Forecasting and Accountability. Special Pension Briefing (November 2012). <http://www.ilga.gov/commission/cgfa2006/Upload/1112specialPensionBriefing.pdf>.

pension obligation bonds issued in 2003, 2010 and 2011 is added to the scheduled payments to the pension funds, pension costs are projected to take one-quarter of state tax revenue by 2015.

B. Scheduled Payments vs. "Required" Contributions

Because defined benefit pensions are calculated from employees' years of service and salary, the state incurs future pension obligations for its workforce each year. If the state does not put aside current resources to match those future obligations, unfunded liabilities will grow. This has been the historical pattern in Illinois. Some important terminology for this discussion:

- **Normal cost** is the present value of future pension obligations incurred in the current year;
- **Unfunded liability** is the difference between the present value of all future pension liabilities minus the value of assets held by the pension fund;
- **Normal cost plus interest** on pre-existing unfunded liability is how much the state would have to pay in the current year to keep unfunded liability from growing;
- **Annual required contribution (ARC)**, a concept defined by the Government Accounting Standards

"If debt service on the pension obligation bonds issued in 2003, 2010 and 2011 is added to the scheduled payments to the pension funds, pension costs are projected to take one-quarter of state tax revenue by 2015."

Board (GASB), is normal cost plus a 30-year amortization of pre-existing unfunded liability (or normal cost, plus interest, plus a payoff of principal);

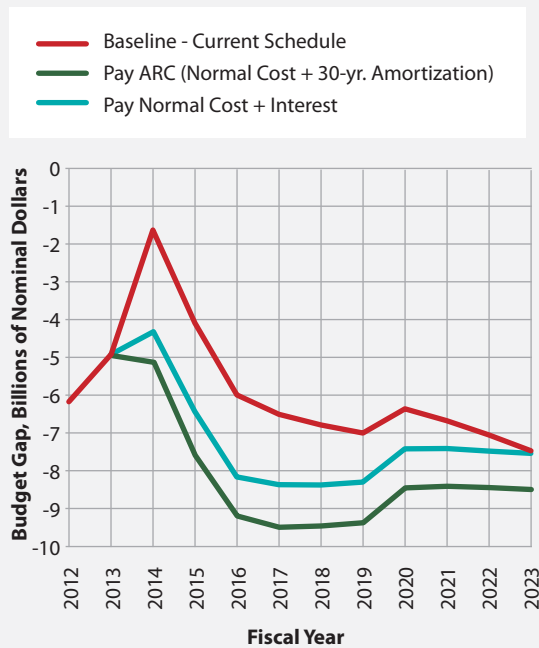
- **Employer's annual required contribution** is ARC net of investment income and employee contributions.

It is noteworthy that the state of Illinois, which manages but does not fund the Illinois Municipal Retirement Fund (IMRF), requires that participating local governments pay the ARC each year, and as a result IMRF has a modest unfunded liability. The state has not imposed the same requirement on itself.

Figure 6 (page 24) presents the state's projected budget gap for the next 10 years under three alternative scenarios: the baseline gap with payments as currently scheduled; the larger gap if the state paid normal cost plus interest to keep unfunded liabilities from growing; the even larger gap if the state paid the ARC to gradually pay down the unfunded liability.

The red baseline budget gap projection is the same as earlier figures and includes the pension payment schedule required under current law. It is not

Figure 6
**Illinois Consolidated Funds Budget Gap
 Projections to FY 2023 with Three Alternative
 Pension Funding Scenarios**



Source: IGPA Fiscal Futures Model, November 2012.
 See notes to Figure 1.

shown in the figure, but the existing schedule shows pension payments would increase from \$5.9 billion in FY 2013, to \$9.2 billion in FY 2023, to \$11.5 billion in 2030, and to \$17.6 billion in 2045. It is not until after 2030 that estimated unfunded liabilities start to decline and not until 2045 that a 90 percent funded ratio is achieved under this scenario.

The blue line in Figure 6 represents how much more funding would be required to keep the amount of unfunded liability from growing. This simulation assumes that the new funding target is part of the FY 2014 to 2023 budgets. The extra amount required would be \$2.6 billion in 2014, declining to almost zero in 2030. After 2030, the existing funding schedule—which has put off all the big payments into later years—would have larger contributions.

The green line in Figure 6 simulates how much larger the budget gap would be if the state were to pay ARC or normal cost plus amortization of unfunded liabilities at a rate that would achieve 100 percent funding in 2045 (just over 30 years). Compared to the baseline case, this would require an

extra \$3.5 billion in 2014, declining to an extra \$1 billion in 2023. State payments would stay in the \$8 billion to \$10 billion range instead of rising to \$17.6 billion in 2045 under the existing ramp law.

One of the problems that helped to create the current fiscal mess is that Illinois uses cash accounting and does not show unfunded liabilities or the annual accrual of additional liabilities in the form of normal cost plus interest. Real costs have been hidden from view and consequently it has been easier to avoid paying them in a timely fashion. Another way of viewing the alternative scenarios in Figure 6 is that they represent the full cost—cash plus accruals—of pension promises: what it would take to not get in a deeper hole (the blue line) or what it would take to eventually cover past underpayments and fill in the hole (the green line).

C. Pension Reform

Figure 6 illustrates the magnitude of the problem facing pension reformers. The current unfunded liability is close to \$100 billion. Just avoiding getting farther behind would cost an extra \$1 billion to \$2 billion for each of the next 10 years, and eliminating the unfunded liability would cost an extra \$1 billion per year on top of that.

Some of the major pension reform options have involved increasing employee contribution rates, delaying the normal retirement age, reducing how much benefits are increased in post-retirement years, and shifting the burden of paying normal costs to school districts and universities. The information given with these plans is hard to translate into annual savings for the *Fiscal Futures Model*. However, the simulations of Figure 6 have shown how large the shift in lower benefits would have to be, and how high employee and employer contributions would have to go to manage Illinois' unfunded pension liabilities.

In a sense, even the daunting calculations underlying Figure 6 are overly optimistic because they rely on current estimates of Illinois' unfunded pension liabilities. Currently, Illinois discounts its future liabilities using an assumed rate of return of about 8

percent. New Government Accounting Standards Board (GASB) rules announced in June 2012 will require Illinois and other states with unfunded liabilities to calculate the present value of future pension obligations with lower discount rates. The lower discount rate will increase unfunded pension liabilities and decrease the funded ratio significantly.³² Compliance with these new GASB rules will require even larger fiscal adjustments than shown in our projections.

VI. Reviewing Budgetary Reform Efforts

In 2010 and 2011, Illinois enacted *Budgeting for Results* (BFR), a reform that will “institute a results-based budgeting practice that will end the practice of funding programs based on prior budgets” and instead will shift funding to a performance-based system.³³ In November 2012, the BFR Commission released its second annual report as required by law. The report included 18 new recommendations for 2012, which include:³⁴

- More public hearings and greater efforts to engage stakeholders in BFR;
- Infrastructure improvements to support program evaluation;
- Legislative changes to the appropriations and budget approval process to ensure BFR is fully realized;
- Projection of revenue, expenditures, and liabilities for three years in the Governor’s Office of Management and Budget’s annual economic

“A number of these recommendations, particularly the requirement for long-term projections and the consideration of spending commitments outside the appropriation process, have the potential to improve fiscal decision making.”

and fiscal policy report;

- Changing the state budget process to address liabilities that incur outside of the appropriation process (for example, Medicaid).

A number of these recommendations, particularly the requirement for long-term projections and the consideration of spending commitments outside the appropriation process, have the potential to improve fiscal decision making.

Despite a promising mission, Illinois will not be in a position to achieve its stated goal of ending incremental budgeting in the immediate term. Only in FY 2014 will baseline data be collected for state agencies, and only in FY 2015 will the state be in a position for “greater agency coordination, eliminating program redundancies, sharing best practices and encouraging innovation.”³⁵ In addition, as noted in the recommendations highlighted above, legislative approval is required to change the appropriations and budget approval process, so even in FY 2015 an end to incremental budgeting is far from assured.

Only in FY 2014 will baseline data be collected for state agencies, and only in FY 2015 will the state be in a position for “greater agency coordination, eliminating program redundancies, sharing best practices and encouraging innovation.”³⁵ In addition, as noted in the recommendations highlighted above, legislative approval is required to change the appropriations and budget approval process, so even in FY 2015 an end to incremental budgeting is far from assured.

VII. Conclusion and Policy Options

As a result of a combination of past shortsighted decisions, difficult current economic conditions, long-term trends in health care costs, and the aging population, Illinois will face extraordinarily tough fiscal choices for the foreseeable future. Current spending levels cannot be sustained with currently

³² Lisa Lambert and Nanette Byrnes. “New rules may make public pensions appear weaker.” Reuters, June 25, 2012, <http://www.reuters.com/article/2012/06/25/us-usa-pensions-standards-idUSBRE85001Z20120625> (Archived by WebCite® at <http://www.webcitation.org/6CxR9CNBO>). Also see *Chicago Tribune*, “Demanding truth in numbers: Finally, more honest measures of an Illinois (and Chicago) debacle. July 2, 2012, http://articles.chicagotribune.com/2012-07-02/news/ct-edit-pension-20120702_1_pension-funds-pension-systems-major-pension-plans (Archived by WebCite® at <http://www.webcitation.org/6CxROETu6>).

³³ State of Illinois Budgeting for Results Commission. *Budgeting for Results Commission: 2nd Annual Report*, November 1, 2012 (p. 6). <http://www2.illinois.gov/gov/budget/Documents/Budgeting%20for%20Results/Related%20Documents/Budgeting%20for%20Results%20Commission%20Report%20Nov%202012.pdf> (Archived by WebCite® at <http://www.webcitation.org/6CS1Fp8Nz>).

³⁴ Illinois BFR report, pp. 15-16.

³⁵ *Ibid*, p. 31.

available revenue. Compounding Illinois' problems are the scheduled phase-out of the 2011 income tax rate increase, new GASB rules requiring accounting adjustments to the pension systems' unfunded liabilities, federally required expansion of the Medicaid population due to health care reform, and the potential decline in federal support for non-health-care spending.

"Illinois will face extraordinarily tough fiscal choices for the foreseeable future."

Illinois has begun to take important steps to deal with its fiscal challenges. There have been significant actions to increase revenue (increases in income and cigarette taxes) and to trim spending (important cuts in Medicaid), and general spending restraint. Perhaps even more importantly, there have been major changes in the legislative processes—*Budgeting for Results* and the requirement that the governor present three-year projections of revenue and spending—and serious discussions about resolving the problem of unfunded pension liabilities.

More action will be needed in the coming years. The Task Force on the State Budget Crisis has made a series of specific recommendations with respect to tax reform, pensions, Medicaid, infrastructure, and Illinois' "fiscal toolkit"—i.e. the way Illinois calculates and reports its revenue, expenses and liabilities. All of these recommendations deserve serious consideration. In a sense, the fiscal toolkit recommendations—technical changes such as timely reporting, multi-year forecasting, consolidated budget reporting, and apolitical revenue estimates—are both the easiest and the hardest to accomplish. They are easiest because they can be done at little or no cost and therefore need not compete with other spending priorities. They are hardest because they have the greatest potential to alter the information used in fiscal decision making on an ongoing basis, and thus the greatest potential to fundamentally change budgeting. One option would be to use the *Budgeting for Results* apparatus that is now in place to study and develop a complete and coherent response to the fiscal toolkit recommendations of the Task Force on the State Budget Crisis. Such an action might show Illinois'

understanding of fundamental problems in its fiscal apparatus and could demonstrate to citizens, creditors and the rest of the nation its good-faith efforts to improve. This could even please credit-rating agencies enough to lower Illinois' borrowing costs.

Of course, Illinois will also need to deal with the specific elements of its current fiscal imbalance. Although Illinois made important adjustments to its Medicaid program in 2012, our analysis shows that without fundamental changes to the current program design, costs are still likely to rise faster than available revenue. Illinois faces three fundamental (but not mutually exclusive) options: (1) make permanent adjustments in the benefits offered to Medicaid recipients to slow the growth in program costs; (2) identify efficiencies perhaps by using the *Budgeting for Results* apparatus; and (3) adopt policies to increase revenue that are timed to Illinois' expected increase in Medicaid costs from natural growth of the program and from the phase-in of the ACA.

Another area of potential spending growth is Illinois' underfunded public pensions. This is almost certain to get prominent discussion in the 2013 legislative session. Our analysis shows that the magnitude of the underfunding challenge depends in part on how it is conceptualized. We show that even making the currently annual scheduled pension payments—which allow unfunded pension liabilities to grow in the short-term—will present Illinois with enormous fiscal challenges. If Illinois is to reduce or eliminate the underfunding of its public pension system it will require additional resources. We have not explored the fiscal implications of the various pension reform plans, but some would shift the burden from the state to the local level. If pension costs are to be shifted between levels of government it is important to understand the long-term fiscal pressures that each is likely to face.

Illinois faces enormous fiscal challenges, but clear thinking and transparent explanations of the costs and consequences of alternative decisions can help make the transition to budgetary balance and sustainability in the fairest and most efficient way. ■