

FACING FACTS 2009

AN UPDATED REPORT ON THE STATE OF ILLINOIS' FISCAL CRISIS

Civic Committee of The Commercial Club of Chicago
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The Commercial Club of Chicago



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EXECUTIVE SUMMARY

In December 2006 the Civic Committee of The Commercial Club of Chicago released its Task Force report on Illinois State Finance, entitled *Facing Facts*. In that report we showed that Illinois was heading rapidly toward financial implosion:

1. Illinois each year was spending or committing to spend billions more than it was taking in; fully funding its true costs and increasing commitments (including its commitment to K-12 education) would require about \$5.9 billion more per year in annual funding; and
2. Illinois' accumulated liabilities and unfunded commitments exceeded its assets by over \$100 billion.

We urged officials in both the Governor's office and the Illinois Legislature to recognize these financial realities and to make the tough decisions that would be necessary to bring our revenues and costs into balance;

- a) Cut costs – including the costs of the pension and retiree health care benefit programs that were responsible for a large part of the unfunded commitments. Unnecessarily expensive pension programs and health care benefits should be trimmed and brought into line with the benefit levels available in the private sector – those available to most of the State's taxpayers who pay the bills. Substantial other savings could be achieved through outsourcing, restructuring of State services, and better and tougher management.
- b) Not raise taxes – unless and until reforms were implemented in the areas of pensions, retiree health care, and education, and until the State reduced its other costs dramatically. We also opposed any increase in taxes unless the proceeds would be used to meet the State's existing commitments, rather than launching expensive new programs.

In the two years that have passed since we issued our report, two facts are striking. One is that no one in State government disagreed with our central findings or conclusions.¹ Another is that little has been done to reduce the annual operating shortfall or the growing burden of unfunded obligations. Our report was complimented – even cheered – but little if anything was done. Instead, during the intervening two years, the State's financial position has deteriorated dramatically.

Part of this deterioration occurred in the ordinary course of business, as State Executive branch and Legislative officials wrangled over budget and spending priorities. The State's operating budget for the current fiscal year (FY2009), starting July 1, 2008, was seriously out of balance, and the State's unfunded obligations had continued to grow, even before the dramatic stock market collapse and the unprecedented credit crunch in the fall of 2008. To make matters worse, in August 2008 Governor Blagojevich awarded the State's principal labor unions a 15+ percent increase in wages over the next four years, with no reforms in pensions or retiree benefits.

¹ Governor Blagojevich's office claimed that we overstated the State's retiree health care obligations, but their calculations apparently omitted many employees or retirees entitled to retiree benefits.

With the onset of the recession, the deterioration in both the State's operating budget and balance sheet has greatly accelerated:

1. Full funding of Illinois' true costs and growing commitments (not including K-12 education) would now require an increase in the annual operating budget of more than \$8 billion per year; and
2. Illinois' liabilities and unfunded commitments now total an estimated \$116 to \$132 billion.

These economic hard times would have been difficult enough for serious, responsible State executives. The chaotic and hostile relations between Governor Blagojevich and other State leaders made dealing with these problems virtually impossible. The legal and political problems swirling around the Governor, and the associated distractions, made them even more intractable. At a time urgently requiring tough-minded leadership in the Executive branch, literally no one was minding the store.

But the real problems go far deeper than Governor Blagojevich's alleged pay-to-play practices and apparent attempt to barter away a Senate seat. The reality is that politicians in both major parties, over many years, have failed to manage the State's affairs and finances consistent with the interests of the people who live and work in this State. They have ducked anything that resembled a hard choice. They have managed the State's affairs to promote their own interests and political fortunes – by providing unsustainably costly benefits to the State's employees and enriching influential contractors, by passing popular but expensive programs, and by shifting the cost burden of these programs to the future through borrowing or by simply ignoring the growing unfunded commitments.

Governor Blagojevich is now history. But his impeachment will not end corruption in Illinois, nor will it begin to solve our State's fiscal problems.

Other states are taking urgent steps to stop their own fiscal bleeding. We have done nothing here in Illinois. The new Governor and our Legislative leaders in Springfield must quickly come together to draw up the emergency measures necessary to restore some semblance of fiscal sanity in the short run, and to plan the steps for long run cost-cutting, reform and other measures that are needed to address our serious financial problems.

One of the many lessons from our country's current financial and economic crisis is that a failure to act brought unsound actions to a tipping point. When a financial tipping point is reached, it becomes impossible to contain the spread of economic damage or quickly remedy the situation. Illinois is dangerously close to a financial tipping point with unfunded debts of over \$116 billion—amounting to roughly \$10,000 per resident, if not more. Government inefficiencies and deficit budgeting will increase this by up to \$10 billion per year. Unless urgently-needed steps are taken, Illinois will soon reach a point of no return. The State will not have sufficient resources to carry out basic public functions or keep its financial obligations to retired public employees. This is a problem that will be faced by the current generation of elected officials and residents of Illinois.

The time to act is now!

INTRODUCTION

In our *Facing Facts* report issued in December 2006, we did three things: (1) reported the facts bearing on Illinois' fiscal condition – its unbalanced operating budget and the growth in its unfunded obligations; (2) described the areas of the budget responsible for the growth in these obligations (pensions, retiree health care, Medicaid, education) and proposed reforms and efficiencies that would enable the State to reduce these and other costs; and (3) analyzed revenue proposals advanced by others and opposed any tax increases without needed reforms and cuts in existing programs.²

In this fresh look at Illinois' finances we provide an updated look at the facts; and we renew our recommendations – which are now even more urgently needed in light of the greater seriousness of the State's problems and the current economic upheaval.

I. The Gap between Illinois' Annual Costs and Own-Source Revenues Has Grown Dramatically Since Our Report Two Years Ago.

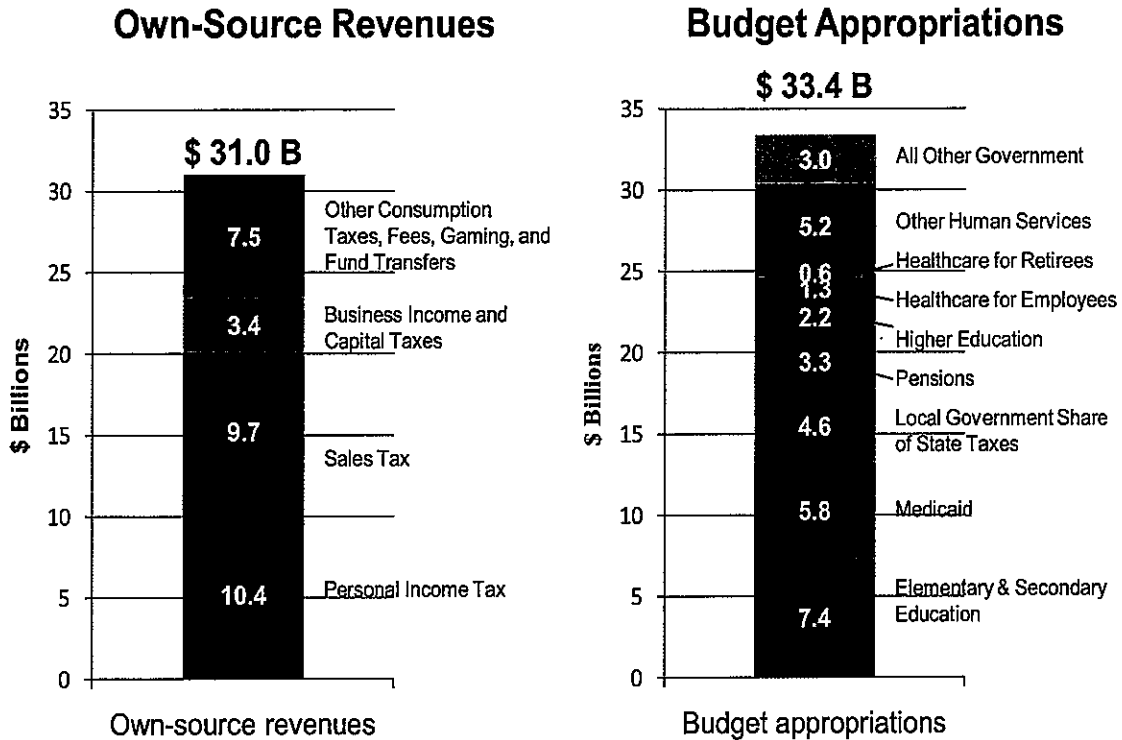
Two years ago (FY2007) Illinois' own-source revenues and expenses – the portion of the overall budget over which the State has discretion and autonomy – amounted to approximately \$28.8 billion. On a “cash basis” the State's budget looked “balanced.” There was approximately as much money coming in as going out.

The problem was that some of the revenues were borrowed, and some of the costs being incurred (including commitments being made) were being ignored. When one took into account the State's true costs during FY2007 – including the amounts by which the State's pension, retiree health care and Medicaid commitments were increasing – the gap between revenues and costs was approximately \$4.3 billion. If one added the unkept “commitment” (by statute) to fund K-12 education at a minimum “foundation” level, the gap between revenues and costs enlarged to approximately \$5.9 billion per year – about 20% of the State's annual revenues.

Today (FY2009) there is not even a pretense that the State's budget is “balanced.” Even on a “cash basis,” at the beginning of the fiscal year (July 1, 2008) there was a projected budget deficit of approximately \$2.4 billion. Despite the State Constitutional requirement for a balanced budget, this unbalanced budget was passed by the General Assembly and signed into law by the Governor.

² The Commercial Club of Chicago is a group of approximately 325 business and civic leaders in the greater Chicago area. The Civic Committee of the Club includes approximately 90 CEOs of Chicago-area companies, professional firms and not-for-profit entities. Through projects and reports such as the historic Burnham Plan for Chicago in 1909, the Club and its Civic Committee have historically sought to help make Chicago and Northern Illinois a better place to live and conduct business.

Illinois Own-Source Revenues and Spending 2009 Budget



Source: Taxpayers' Federation of Illinois.

Moreover, this “cash-basis” gap of \$2.4 billion does not take into account two things: (1) the budget was based on revenue projections that were unrealistic when made (in mid-2008) – and have now become even more dramatically overstated in the wake of the credit crunch that has gripped the State since the fall of 2008; and (2) the expenses reflected in the budget – like the version in FY2007 two years ago – do not include a full measure of the State’s increasing commitments in the form of pension costs, retiree health care costs, and unpaid Medicaid bills.

When these two factors are taken into account – the revenue shortfall and the unfunded pension and retiree health care commitments and unpaid Medicaid bills – the real *annual* budget gap is increased from \$2.4 billion to over *\$8 billion*. If one adds the failed commitment to fund K-12 education at the recommended “foundation” level, the gap grows to *\$9.6 billion*.

A. Revenue Growth Assumptions

The Governor's office and Legislature assumed that revenues would grow by \$500 million in FY2009 compared to the prior fiscal year. That assumption was optimistic even when the new fiscal year began – July 1, 2008. In light of the unprecedented credit crunch that struck the entire country last fall, it is clear now that tax revenues (income tax and sales tax) will be sharply reduced – perhaps in the range of \$1 billion, if not more – below original projections. Gaming revenues will also be down. (Estimate from Comptroller Hynes' "Transitional Fiscal Report/FY 2010 Budgetary Outlook," February 2009.)

Thus, just on a cash basis, it is likely that the State's budget gap this fiscal year may be in the range of \$3.4 billion – and that is before taking into account the growth in unfunded commitments and unpaid bills.

Such a decline in Illinois revenue collections would be consistent with the experience of the past few months and in previous recessions. Tax collections for FY2009 are already well below original projections. Reduced sales taxes, personal income taxes and corporate taxes were all experienced in Illinois during our last recession – from 2001 to 2002. Unemployment levels in Illinois are already over 7% – above those reached during the last recession. Real disposable personal income among Illinois citizens has fallen in three out of the past six quarters; and this decline will surely continue in the quarters to come. And sales tax revenues are declining, as reflected in the decline in retail sales.

B. Pension Costs

Our report two years ago explained that Illinois has systematically underfunded its pensions for years. The pension payment schedule adopted by the State in 1995 was not based on an actuarial estimate or determination of how much the State should contribute each year to cover its pension costs. Instead, it was based on what the State decided it could comfortably afford to contribute. So the funding schedule back-end loaded its pension costs. In effect it pushed off costs being incurred today (in the form of commitments) to future generations of taxpayers.

This back-end loading is reflected in the unfunded liability for pensions that is projected to grow for at least 20 years – even if the State were to adhere to the 1995 payment schedule.

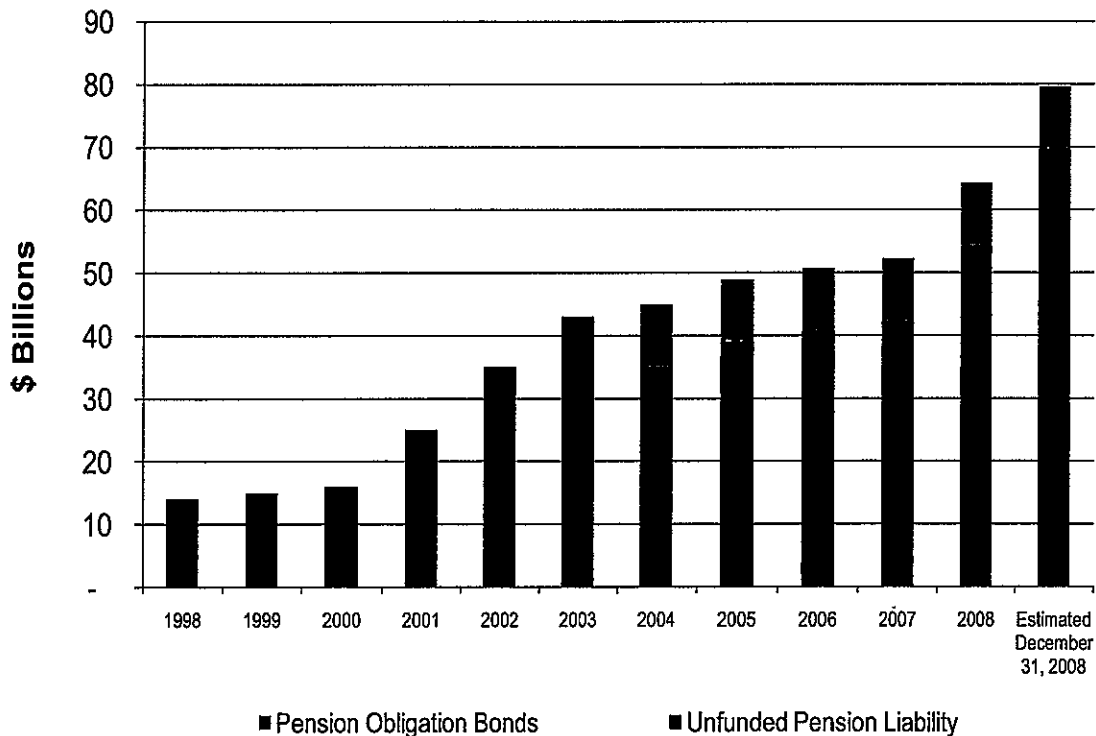
In fact, the State has not adhered to that schedule, but has instead in recent years re-jiggered the schedule and reduced annual pension contributions – moving even further away from an actuarially-sound funding plan.³

The net result of the State's historical underfunding, as well as recent negative asset returns, has been an explosion in the State's unfunded pension obligations – from around

³ In FY2003 the State borrowed \$10 billion in pension obligation bonds and put only \$7.3 billion of the proceeds directly toward the unfunded liability. After using \$500 million in bond proceeds to pay transaction fees and first-year interest on the bonds, the State then used the remaining \$2.2 billion to pay part of its pension contribution in FY2003 and the entire FY2004 pension contribution – thus using debt to pay current costs. In FY2005 the pension contribution was underfunded by \$300 million. In FY2006 the General Assembly passed some benefit reductions and then underfunded the pension contribution by \$1.2 billion. In FY2007 the pension contribution was underfunded by \$1.1 billion.

\$15 billion in the late 1990's to an estimated \$70 billion, along with an *additional \$9.9 billion* in outstanding pension bonds, as of December 31, 2008 – bringing the total to \$80 billion. The State uses an 8.5% discount rate to bring the entire stream of future pension payments back to a “present value.” Use of a lower and arguably more economically-appropriate discount rate would dramatically increase the estimated “present value” of the unfunded obligation. Much of this recent increased underfunding is, of course, due to the collapse of the stock market in the fall of 2008 and the impact on asset values in the pension funds.

State Unfunded Pension Liability and Pension Obligation Bonds



Source: “2007 Bonded Indebtedness Report of the State of Illinois,” January 2008, Commission on Government Forecasting and Accountability; “Report on the Financial Condition of the State Retirement Systems,” February 2008, Commission on Government Forecasting and Accountability; “Report on the Financial Condition of the State Retirement Systems,” July 2007, Commission on Government Forecasting and Accountability; 2008 unfunded liability from November 2008 Monthly COGFA Briefing; December 31, 2008 unfunded liability is based on estimated State pension fund asset values as of December 31, 2008 and a recent COGFA estimate of the total pension liability at the end of FY 2008; Historical unfunded liability data from Senate GOP staff.

How much of a shortfall is there between (1) the amount the actuaries say the State should be contributing to the pension funds each year, and (2) the amount it is *scheduled* to contribute in the current fiscal year – FY2009?

The actuaries say that in order to keep the unfunded pension liability from growing, the funding should cover “Normal Cost plus Interest.” That is, the actuarially-determined amount to cover the growth in liability during this year, plus interest on the unfunded balance. That amount in FY2009 is approximately \$5.9 billion.⁴ However, in FY2009 the State is scheduled to contribute only \$2.8 billion⁵ to the pension funds (other local employers will contribute an additional \$.1 billion) – leaving a funding gap of about \$3 billion.

Taking this shortfall into account would bring the budget gap estimated above to a total of about \$6.4 billion. But this total does not include the growth in retiree health care costs.

C. Retiree Health Care

In FY2009 the State will pay about \$1.3 billion in cash for health care for employees and about \$.6 billion for retirees. These payments are made as the bills come in from medical providers, on a “pay-as-you-go” basis. Unlike pensions, the State has not set up a trust fund to pay for retiree health care in future years, even though these benefits are earned in much the same way as pension benefits, during the course of the employee’s career with the State.

In its FY2008 financial statements, the State is now required to report the liability associated with retiree health care benefits that have already been earned, in much the same way as it reports its pension liability. It is also required to report the extent to which the liability is covered by assets, and the remaining unfunded liability. The total unfunded retiree health care liability has been estimated by the State to be \$24 billion.

This estimate covers only the liability associated with the State Employees Group Insurance Program (for State employees including State university employees). However, the State also helps fund and administer two additional health insurance plans – the Teachers’ Retirement Insurance Program (for “downstate” teachers) and the Community College Insurance Program (for community college employees). The unfunded liability for the TRIP program is about \$14 billion and for the CIP Program about \$2 billion.⁶ Whether Illinois must report these as liabilities of the *State* is perhaps less important than the fact that the State has historically helped fund them and continues to do so. We have seen no evidence that the State intends to stop funding TRIP and CIP. If all three plans are taken into account, the State’s retiree health care unfunded liability would rise to about \$40 billion.

As in the case of pensions, the State’s actuaries calculate the “Annual Required Contribution” that should be made to cover the growth in these unfunded liabilities each year. In FY2008 the amount of *underfunding* associated with the State Employees Group Insurance Program was about \$1.1 billion; if TRIP and CIP were included, the unfunded amount rises to approximately \$2 billion.

⁴ The “Normal Cost Plus Interest” amount is determined by adding the estimated FY2009 Normal Cost (\$1.4 billion) to the “Interest” on the Unfunded Liability at the end of FY2008 (.085 X \$54 billion).

⁵ The pension contribution required under the State’s payment *schedule* for the next fiscal year (FY2010) is expected to increase to \$4.0 billion as a result of declines in pension fund asset values.

⁶ Source: Financial Audits of the Teacher Health Insurance Security Fund and the Community College Health Insurance Security Fund for the year ending June 30, 2007.

If only the State Employees Group Insurance annual shortfall of \$1.1 billion is added to the shortfall estimated above, the total gap for this fiscal year comes to \$7.5 billion.

D. Medicaid

The State is generally required to pay for liabilities incurred within a given year out of that year's budget. However, there are exceptions – called “Section 25 liabilities” – which allow certain spending (such as Medicaid, State employee and retiree health care and some spending from the Departments of Human Services and Public Health) to be paid out of the next year's budget. Medicaid liabilities make up the majority of these “Section 25 liabilities.”

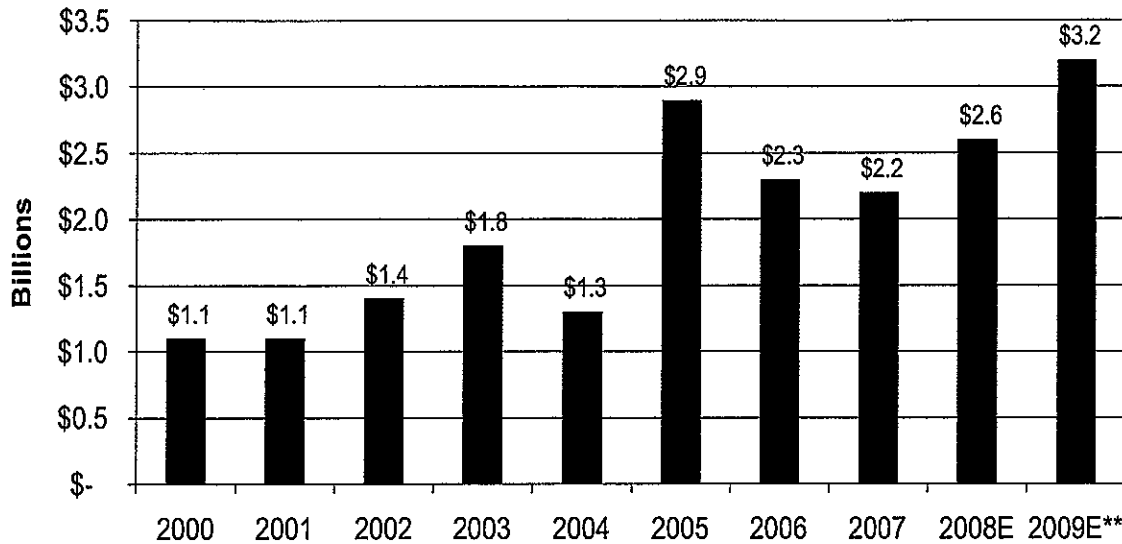
This exception has evolved into a budgeting tool – one which permits borrowing from one fiscal year to the next. It permits a budget to appear “balanced” on a cash basis. An insufficient amount can be appropriated for Medicaid in the current year knowing that any unpaid bills can be paid out of next year's appropriations. It is the State's version of kiting checks⁷.

The result of this device has been the accumulation of billions of dollars in unpaid Medicaid bills at the end of each fiscal year. These unpaid bills are expected to total more than \$3 billion by the end of FY2009 (June 2009).

However, the State will only have to cover about half of these liabilities from its own source funds; the rest will be covered by federal matching funds. The annual underfunding of Medicaid bills in FY2009 will be equal to (1) the State's portion of the additional liabilities incurred in FY2009, plus (2) amortization of the liabilities that were outstanding at the end of FY2008. The total of these is estimated to be about \$600 million.

⁷ Because 50% of Medicaid payments are covered by Federal matching funds, Illinois bears only half the total cost. Illinois covers at least some of its half by borrowing – often from the Medicaid providers themselves. So – much of what we actually pay is borrowed or covered by Federal matching. What we cannot pay, we put off to a future year.

Section 25 Medicaid and Health Care Liabilities*



*Section 25 liabilities include Medicaid and other health care payables accrued as of June 30th. In 2007, State health insurance liabilities were \$93 million of the total.

**Section 25 Medicaid liabilities are expected to grow by \$600 million during FY2009 because the 2009 State budget was “balanced” by reducing Medicaid appropriations without changing benefit levels or eligibility requirements. In addition, it is estimated that approximately \$400 million of the State’s FY2008 budget deficit was covered by increasing Section 25 liabilities.

Note: In FY2003 and 2004, the State utilized short-term borrowing to reduce outstanding Medicaid bills at year-end. According to the Governor’s office, without such borrowing (and the Federal match on those dollars), Section 25 liabilities would have been \$3.9 billion in 2003 and \$3.0 billion in 2004.

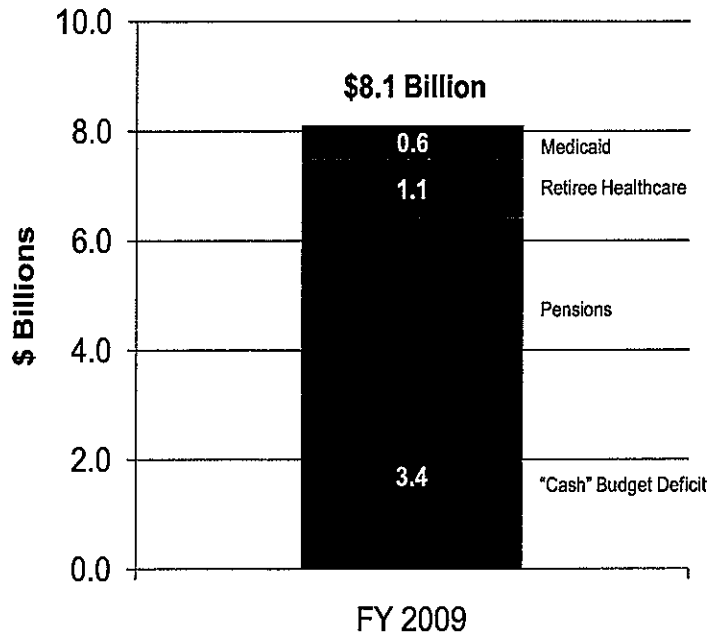
Source: Illinois Comptroller’s Office website “Section 25 data” (2001-2007 liabilities); Fiscal Year ‘09 Budget Presentation made to the Taxpayers’ Federation of Illinois by John Filan on May 5, 2008; Taxpayers’ Federation of Illinois analysis.

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The total annual budget gap – including the annual growth in commitments – is thus in the range of \$8.1 billion, if not more.

If we funded K-12 education at the recommended “foundation” level (adjusting for recent inflation), that would add an additional \$1.5 billion to the total expenditures. The total annual gap – if we include the gap in K-12 education funding (at the “foundation” level) – would thus be in the range of \$9.6 billion.

Total Annual Budget Gap



Note: Pension gap is equal to Normal Cost Plus Interest payment in FY2009 of \$5.9 billion minus Total Employer Contribution of \$2.9 billion. Retiree healthcare gap is equal to FY2008 ARC of \$1.7 billion minus FY2008 State healthcare payments for retirees of \$0.6 billion. Medicaid gap is equal to forecasted increase in State share of unpaid Medicaid bills from FY2008 to FY2009 (\$0.3 billion) plus amortization of State's share of FY2008 Section 25 liabilities (assuming \$1.3 billion in State Section 25 liabilities are amortized over 4 years).

Source: Various reports of the Commission on Government Forecasting and Accountability; Governor's office estimates; Taxpayers' Federation of Illinois analysis.

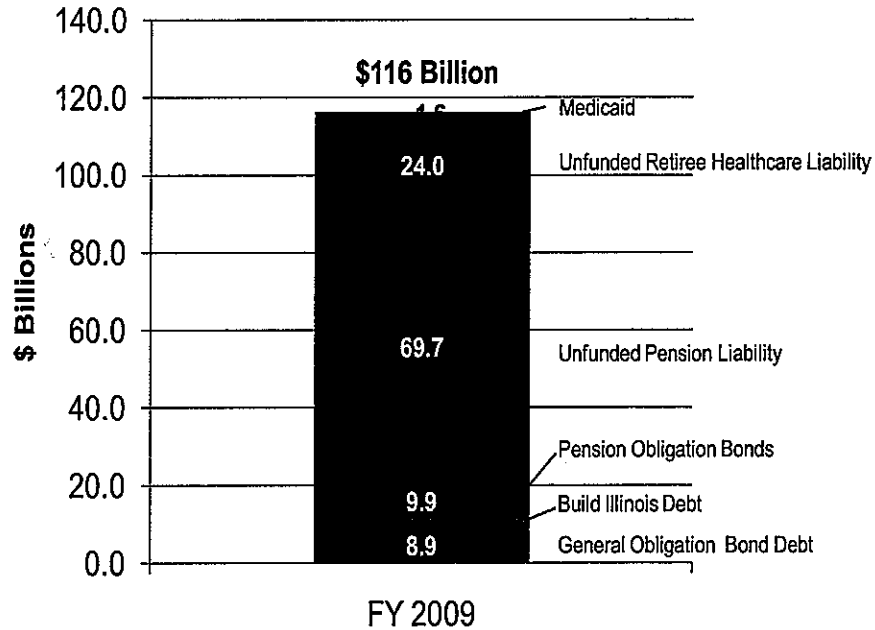
II. The Total Amount of Illinois' Debt and Unfunded Obligations Has Skyrocketed.

We now move away from the annual gap in the State's operating budget and look at that part of the State's balance sheet showing total obligations: general obligation debt (including pension bonds), Build Illinois debt, unfunded pension and retiree health care obligations, and the State's portion of unpaid Medicaid bills.

The total of these Illinois obligations is now in the range of \$116 billion. If we include the retiree health care liability associated with the TRIP and CIP programs, the total would rise to about \$132 billion.

At the \$116 billion level, this represents roughly \$10,000 per person for the State's 12 million residents.

Total State Debt and Unfunded Obligations



Note: GO bond debt and Build Illinois debt are COGFA forecasts of June 30, 2009 amounts outstanding. Pension Obligation Bond debt is forecast of June 30, 2009 debt based on POB principal repayment schedule from COGFA. Unfunded pension liability estimate is based on estimated State pension fund asset values as of December 31, 2008 and a recent COGFA estimate of the total pension liability at the end of FY2008. Unfunded retiree healthcare liability estimate is the point estimate from the Governor's office of the 2008 unfunded retiree health care liability. Medicaid debt assumes that half of projected unpaid Medicaid bills at the end of FY2009 are the responsibility of the State (based on 50% federal match).

Source: Various reports of the Commission on Government Forecasting and Accountability; Pension fund estimates; Governor's office estimates; Taxpayers' Federation of Illinois analysis.

To put these unfunded obligations in perspective, according to the Pew Center on the States, Illinois' unfunded pension liability in 2006 (the most recent year reported by Pew) was one of the highest in the country, second only to California. Illinois' total debt per capita (including unfunded liabilities) was the ninth largest in the country, higher than comparable

numbers in New York and California.⁸ Illinois' debt was also one of the largest in the country in relation to its tax base.⁹

Illinois general obligation and revenue bond debt outstanding increased from less than \$8 billion in 2000 to around \$23 billion in 2006 (this growth was largely due to the State's issuance of \$10 billion in pension obligation bonds in 2003).

As the State's debt has increased, so has the percentage of General Fund revenues required to *service* this debt – leaving less revenue for other State programs. Illinois' general obligation and revenue bond debt service in 2000 was less than four percent of the State's general revenue funds; by 2006 it had risen to over seven percent. If actuarially-required contributions for pensions and retiree health care¹⁰ were added to general obligation and revenue bond debt, the State's total debt service in 2006 would have amounted to around thirty percent of the State's general revenue funds.¹¹

The State's fiscal problems have affected its credit ratings and its cost of borrowing. Fitch assigned Illinois a "negative outlook" as of November 2008 and S&P put Illinois on "credit watch" as of December 2008.

It is sometimes said that a state cannot go bankrupt. Unless things change quickly in Illinois, we may be about to test that proposition.

III. The State Must Improve the Quality and Transparency of its Financial and Operational Reporting.

Before we discuss the painful steps that Illinois must take to avert the financial crisis, we address an issue that has compounded the difficulty of dealing with the State's financial mess – the lack of transparency in our State's fiscal affairs.

Illinois has a State constitutional "balanced budget" requirement; but we do not have a balanced budget in any meaningful sense. In fact, we have two budgets – the General Funds budget, and the larger "All Appropriated Funds" budget. The General Funds budget focuses primarily on government operations and grants; the Appropriated Funds budget includes significant additional operational spending as well as funds for transportation and local governments, and much of the State's capital spending. The Appropriated Funds budget also includes – but does not cancel out – inter-governmental transfers. Capital items are appropriated and included in the budget in the hope that they will be funded – but with no firm intent on the

⁸ Debt includes GOB, revenue, term, serial, pollution, special assessment bonds and certificates of participation. Unfunded liabilities include Pension and OPEB liabilities. Illinois OPEB liability is estimated at \$24B which only includes state employees. Source: Census, Pew Center.

⁹ Debt includes GOB, revenue, term, serial, pollution, special assessment bonds and certificates of participation. Unfunded liabilities include Pension and OPEB liabilities. Illinois OPEB liability is estimated at \$24B which only includes state employees. Source: Census, Pew Center.

¹⁰ 2006 Pension Normal Cost Plus Interest payment of \$4.5B and 2008 OPEB Actuarially Required Contribution of \$1.7B. Source: Commission on Government Forecasting and Accountability; Governor's Office.

¹¹ The Task Force is indebted to McKinsey & Company for their assistance in developing data putting Illinois' situation in national perspective.

part of the legislature to do so in a given year. Unspent dollars are often left to accumulate in special-purpose funds, and can only be “swept” out and used for other purposes with legislative approval.

Once the Governor introduces his proposed budget in February, there is no comparable report of the budget that is finally enacted by the State legislature and passed into law. As a result, except for periodic revenue or spending briefings by the Commission on Government Forecasting and Accountability (COGFA) and the Comptroller’s office, the only comprehensive public record of actual State revenues and spending is the Consolidated Annual Financial Report (CAFR), which is published long after the fiscal year ends, making the CAFR more of a historical record.

There is no State agency that provides regular, timely and comprehensive reviews and analysis of State fiscal issues. COGFA provides information relevant to the Illinois economy and the State’s revenues, and it is a respected and reliable source; but COGFA has a limited mandate.

Illinois needs what many other states have created: a strong, professionally-staffed State-level equivalent of the federal Congressional Budget Office, which would produce easily understood financial statements for the entire budget in a timely manner.

IV. Illinois Must Reform the Pension and Retiree Benefit Programs that Have So Largely Contributed to This Financial Mess, and Make Massive Cuts in its Other Costs of Operations.

In our report two years ago we showed that in the private sector, employee pensions and retiree health benefits have become less generous and less costly as a result of competitive pressures on employers. Many companies have shifted away from defined benefit plans, and others have retained those plans but trimmed benefits. Still others have adopted two-tier plans – one for existing employees whose rights have vested, and new ones for new employees. Our 2006 report discussed similar reforms and adjustments that could be made by the State and estimated the savings to the State that might result. We will not repeat that discussion here.

During the intervening two years, Illinois has not adopted any of the reforms or benefit adjustments that we suggested. State benefit plans remain more generous than those available to most taxpayers. State health care costs continue to rise.

A. Costs Must Be Cut.

In our *Facing Facts* report, we stated our conviction that the State must significantly reduce its operating costs. Now, in light of what has happened to the economy and to the State’s revenue collections, greater cost reductions than those envisioned in *Facing Facts* will need to be made. These may have to include budget items that have traditionally been a high priority for Illinois legislators.

The costs of Illinois State government – like those of Cook County and the City of Chicago – appear to be bloated by benefit levels, pensions and retiree health care benefits, and outsourced contracts and supply arrangements that are excessive by private market standards. These higher costs are due, in tangled ways that are hard to see or prove, to the monopoly nature of many State services and to the political and sometimes corrupt nature of State government.

The difficulty of making cuts is compounded by the fact that wage levels – which are set by multi-year contracts and which were recently increased for State unionized workers by Governor Blagojevich – cannot be reduced except through contract renegotiation. In addition, a provision in the State Constitution arguably precludes reductions in the benefits provided by the State's pension plans.

One of the first tasks of Governor Quinn and his colleagues must be to go through all the State's operations and grants – program by program – and discontinue or trim those where such cuts do not directly affect the public safety or welfare. Other states, such as Ohio and Missouri, are taking such painful steps. Illinois must follow suit.¹²

We should start with the bloated programs that helped create this mess:

1. Pension Reforms

State retirees currently receive more generous benefits than Illinois taxpayers. We recommend the following revisions to bring the State's pension benefits into line with those of most of the taxpayers who pay the State's bills.

- Create a 2nd tier of pension benefits for *new employees only*. That 2nd tier could be a defined contribution plan or a hybrid defined contribution/defined benefit plan, or a defined benefit plan with less-generous benefit levels (i.e., requiring a higher age at which retirees can access full benefit levels) than the current plan. Any defined benefit plan offered to new employees should be aligned with private sector standards. For example, it should:
 - Raise the retirement age to 67 (same as Social Security), but allow for early retirement at 62 (same as Social Security).
 - Limit automatic cost-of-living increases to the lesser of CPI or 2%.
- Increase the required percentage of compensation that *all* employees must contribute to fund their own pensions by at least 1 percentage point.

These reforms would save significant sums in the future, but would do little to reduce costs immediately – i.e., in the current fiscal year (FY 2009) or the next few years.

¹² The difficulty in Illinois will be greater than in many neighboring states because of our failure in the past to provide cash reserves or budget contingencies. Our FY2009 budget *deficit* (on a cash basis alone) is in the range of 6-10% – far greater, for example, than that of Ohio or Missouri. Ohio already reduced spending by about 10% over the past two years; and Missouri has proposed comprehensive spending cuts to plug its projected gap. Indiana and Texas are expected to experience surpluses in FY2009. Indiana has balanced its budget and produced a surplus every year since FY2005. The Task Force is grateful to McKinsey & Company for developing historical and comparative data relating to Illinois' economy.

2. Retiree Health Care Reforms

Health care benefits currently offered to State retirees are also substantially more generous than those of ordinary taxpayers. For example, state retirees pay nothing toward their own health insurance premiums if they have 20 years of service or more. Most retired *taxpayers* must pay their own insurance premiums until they reach 65 and are eligible for Medicare. (Even after they qualify for Medicare, private sector retirees have their Medicare premiums deducted from their Social Security distribution, and many buy Medicare supplemental insurance policies as well.)

Retiree health care benefits are not guaranteed under the State's Constitution. We recommend that the State follow the example set by the Chicago Transit Authority (and approved by its unions), and end its role as guarantor of retiree health care benefits in the future. Rather than guaranteeing a certain level of retiree health care *benefits*, the State should make a fixed *contribution* toward the retiree health care plan each year.

- Create a Retiree Health Care Trust Fund to develop and fund a reasonable health care program for the State's retirees.
- Contribute a fixed amount annually to the Trust Fund.
- Require retirees to contribute significantly toward the cost of their own health insurance premiums.
- Offer a reasonable health care plan to retirees given the total contributions available to fund the plan (including the State's annual contribution).

These measures could save the State \$1.1 billion in additional required contributions toward the unfunded retiree health care liability.

3. Medicaid Reforms

At present, the State is dealing with its rising Medicaid costs by paying its bills more slowly, in effect borrowing from its service providers. The State should commit to paying its Medicaid service providers on a timely basis, while aggressively taking advantage of opportunities to reduce its Medicaid costs.

- Seek a Federal waiver to structure a more cost-effective Medicaid program that incentivizes the most efficient delivery of health care.
- Shift all children and non-disabled, non-elderly adults into risk-based managed care programs.
- Pay Medicaid providers within 60 days.

The opportunities for Illinois to reduce its Medicaid costs are enormous – such as using outpatient rather than inpatient services, requiring “gatekeeper” referrals to specialists, switching

from institutional to “community-based” care where possible, reducing utilization of emergency departments, and other efficiency and quality measures.

We believe annual savings in the range of \$1.5 billion might be achieved in this area – of which Illinois would benefit to the extent of \$750 million in savings (due to the current 50/50 Federal match).

4. Improvements to Processes and Controls in State Purchasing and Contracting

- Enhance and improve reliance on information technology.
- Improve vendor and contract management.
- Accelerate consolidation of various Human Resource departments.
- Improve processing and monitoring of benefits eligibility.

These measures might save Illinois in the range of \$400 million per year, once fully implemented.

5. Reductions/Caps in Revenue Sharing and Grants to Local Governments

If revenue sharing and grants to local governments were capped going forward, this could save in the range of \$200-300 million per year.

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Illinois no longer has a choice. It *must* reform its pension and retiree health care systems. It is unsustainable to maintain and pay for benefits to State employees that are more generous and more costly than those available to most Illinois taxpayers. The other major categories of costs and disbursements embodied in Illinois’ operating budget must also be analyzed in detail – and slashed.

Without the benefit of access to the State’s detailed records – but with the advice of knowledgeable experts familiar with what other states have achieved – we think the following *annual* cost savings should be achievable, though some would take more time to implement than others. This list is only illustrative – there are likely other areas in which savings can and should be achieved.

1. *Pensions*

Zero

(The State Constitution arguably precludes benefit cuts in pensions for current employees. Significant savings could be achieved in future years as “new” employees replace “old” ones.)

2. *Retiree Health Care* *\$1.1 billion*

(The State Constitution does not preclude changes in health care programs. Shifting to a Retiree Trust Fund would eliminate the growing liability – each year – to pay those costs in the future.)

3. *Medicaid* *\$750 million*

4. *Purchasing and Contracting* *\$400 million*

5. *Reducing/Capping Revenue Sharing and Grants to Local Governments* *\$200-300 million*

\$2.5+ billion

B. Unless and Until Benefit Programs Are Reformed and Costs Are Cut, Illinois Should Not Raise Taxes.

Unfortunately, when faced with budget imbalances, State and local government officials too often ignore the need to cut costs and jump immediately to a revenue solution. Or they “solve” the problem by borrowing or by ignoring the build-up of obligations not reflected in current cash outlays. Those growing obligations are then left to some future generation of officials – and taxpayers.

The reasons for allowing such build-ups are not that complicated. It is hard to cut costs. Program cuts hurt the beneficiaries. They complain, and interest groups representing them put pressure on elected officials. A large part of government expenditures is for employee costs – wages and benefits. If these are cut or held down, the employees and their unions put pressure on officials. Employee unions are among the most active and powerful interest groups in Illinois and Chicago. The political pressure they inflict on elected officials or candidates is enormous. As a result, State employee costs – wages and benefits – have not reflected competitive pressures to the same extent as in the private sector.

It is time to change the way elected officials in Illinois think about our State’s budget. We are in a fiscal crisis. This is not rhetoric; it is fact. Because the market does not provide the direct pressures on State officials to hold down costs the way it does on the private sector, citizens and civic groups must provide that pressure. We need to say – loudly and clearly – you cannot simply *tax* your way out of this budget deficit. A tax-only solution – adding \$8 billion or more to the State’s current annual operating budget – would take Illinois from the middle to very near the top of the list of states, ranked in terms of their tax burden per citizen, which would severely impact the investment and job creation environment of the State. Pension reforms should be the first step, not the last. Retiree health care reforms should also be at the top of the list. So should Medicaid, and other large cost categories.

State officials in Illinois are not anxious to raise taxes because they fear the political repercussions. They remember Governor Ogilvie, whose re-election campaign in 1972 failed because he had instituted the State’s income tax. We need to magnify that fear. We need to say:

Unless you take a hatchet to the State's budget, and unless you make major reforms in the State's pension and benefit programs, and its Medicaid systems, and other areas of the budget, we will oppose tax increases; and we will hold you responsible.

But there is a hard truth here too, and we should face it. We cannot simply *cost-cut* our way out of this budget deficit. As we pointed out in our *Facing Facts* report, Illinois has dug a fiscal hole so huge that it will not be practically possible to dig out of it by relying *solely* on budget reforms and expense reductions. (*Facing Facts*, p. 31.) Most of the revenues collected by the State are not spent at the State level, but instead "flow through" to others (see *supra* "Budget Appropriations," p. 5). Even if we could somehow eliminate *all* salaries and benefits for all 57,000 or so State employees, we would not eliminate the State's budget deficit.

The reforms and cuts described above will generate a positive impact on the budget over time. In the long run, we think billions can be saved annually. It would take enormous effort and political will, but we believe annual savings in the range of \$3 billion or more could be achieved over time. But savings in such magnitudes cannot be implemented in time to be fully effective in the current fiscal year, or FY2010 or even FY2011.

The reforms and cost cuts can, however, be *put in place*—and now. In order to keep the pressure for budget accountability at full throttle, we would oppose any tax increase until that happens. But once they are in place, we will have to face tax increases.¹³

The question is not whether. It is *when*. Shall we start to bear that pain now, or shall we continue – as we have over the past decade – to keep putting it off to the future, knowing it will just get bigger and harder to bear? The matter of timing is complicated by two factors. First, the Federal Government is proceeding with an enormous economic stimulus package, which will reportedly include money over a three-year period for state and local governments. (Based on preliminary estimates, it appears that Illinois can expect to receive: (a) increased funding for education, (b) approximately \$2.9 billion in Medicaid funding – some of which may cover rising numbers of Medicaid recipients and the rest of which may be used for budget relief, and (c) funding for other programs such as Community Services Block Grants and jobs programs. We are awaiting greater detail on the extent and timing of these Federal monies.) Second, a major recession is the worst possible time to have a tax increase. Instead of stimulating the economy, a greater tax burden will have a depressing effect.

However, even if it was entirely free of programmatic restrictions, the Federal aid package will not even come close to closing Illinois' budget deficit, which now exceeds \$8 billion annually. As to the recession point, there will never be an easy time to start taking our fiscal medicine. No one knows when this recession may end. Each year of putting off the problem will add billions more to the budget hole and will make the service cuts and tax increases *even larger* in future years.

Moreover, we are nearing a "tipping-point" time when businesses and investors, and citizens in general, may start to steer clear of Illinois—or even to leave it—in order to avoid

¹³ We described the tax alternatives in *Facing Facts*. Using 2006 data, increasing the personal income tax rate by one percentage point (with a corollary increase in the corporate income tax) was expected to yield about \$3 billion. A broadening of the State sales tax to include personal, entertainment and consumer services was estimated to yield about \$2 billion.

having to bear the compounded burden of both (a) the deferred costs of the past, and (b) the “normal” operating costs of future years.

We say: Better to start now. Reform pensions and health care and Medicaid now. Make the cuts now, even though they will hurt. If we do not start now, it will hurt more people a lot more later. Only then consider the tax increase.

Furthermore—and this point must be emphasized—the proceeds of any such tax increase *must* be used to cover the already piled-up debts and unfunded obligations, rather than undertaking new ones.

The risk is that our new leaders in Springfield will continue to try to muddle through *without* making the hard choices. That would mean continued underfunding of pensions and retiree health care, and more borrowing – in other words, more burden-shifting to the future. This cannot go on forever, either economically or legally. Under our State Constitution, we are supposed to have a balanced budget (Article VIII, Section 2). The Governor, with legislative approval, can borrow in “emergencies,” but the debt would have to be repaid within one year (Section 9 (d)):

State debt may be incurred by law in an amount not exceeding 15% of the State’s appropriations for that fiscal year to meet deficits caused by emergencies or failures of revenue. Such law shall provide that the debt be *repaid* within one year of the date it is incurred.

The current economic recession and budget crisis should qualify as such an “emergency or failure of revenue.” But any borrowing pursuant to this section would have to be repaid within one year. The framers of our constitution did not want our officials engaging in longer-term borrowing to meet operating deficits. They expected any such deficits to be eliminated by cutting, or tax increases – but not borrowing.¹⁴

¹⁴ Another provision of the State Constitution, Section 9(b) permits borrowing with a 3/5th approval of each house “for specific purposes.” Borrowing under this section is not subject to the one-year pay-back requirement. Such “specific purposes” might include a capital construction program. It would be a stretch to contend that general budget relief would be such a “specific purpose” – particularly if the cause of borrowing in reality is the “emergency” and “failure of revenue” covered in Section 9(d).

CONCLUSION

Illinois has been heading toward financial implosion for years. Since our *Facing Facts* report two years ago, little has been done to deal with either side of the budget gap – the costs or the revenues. Pension and retiree health care benefit levels have been left in place, and new wage commitments have been made. Employees and retirees of State and local government entities can no longer be confident that the money they have counted on for their retirements will be there when they need it.

As the State has moved through political chaos over the past two years, the difficulties of dealing with these serious problems have become greater; and the recession starting in the fall of 2008 has made them literally herculean.

Let us hope that the new Governor will have the resolve and talent to do what must be done, and that the new Governor will have the support of leaders in the Illinois Legislature, as well as the cooperation and support of heads and members of departments and agencies of Illinois State government. If the new Governor and his colleagues in the Legislature take these hard steps, it will not make them popular. But they will be doing their job. And citizens who care about the long-term fiscal health of the State will be grateful.

We stand ready to help. Our organization and other business and civic organizations have at our disposal talented financial and budget experts. We'll call on them for help if Governor Quinn or our legislative leaders want it. In addition, there are many national experts in state budgets and operations—professionals who have worked with leaders in other states to achieve significant savings and efficiencies in government operations. We should draw on their expertise and experience.

The citizens of Illinois must understand that service and funding cutbacks have now become unavoidable. Local governments may receive less money from the State than they have in the past. So they may have to tighten their belts as well. We must support responsible State and local leaders who undertake this necessary but highly-unpopular work.

Finally, let us remember, as we think about which candidates to support in future political campaigns, that none of this was necessary.