Budget Solutions 2015:
Keeping promises to taxpayers and turning around Illinois

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Illinois Policy Institute

About the Illinois Policy Institute

The Illinois Policy Institute is fueling a movement of freedom and fairness for the people of Illinois.

By engaging citizens, lawmakers and the courts, we work to ensure all Illinoisans have:

1) An honest and transparent government

2) Educational opportunities that prepare and protect our children

3) The right to achieve and work

4) Shared accountability and consideration for everyone

5) Economic policies that create jobs and prosperity

6) Fair and limited taxation

7) Personal control over your health care

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Budget Solutions 2015:

Keeping promises to taxpayers and turning around Illinois

The 2015 fiscal year marks a long-awaited milestone for Illinoisans: taxpayers are less than one year away from tax relief. The record 2011 income tax increase is slated to partially sunset during the 2015 fiscal year.

But politicians are already crying poor as Illinois approaches the tax-hike sunset. The solutions they've offered up involve making the tax hike permanent, or worse: increasing taxes again with a progressive income tax.

The Illinois General Assembly has already had more than three full years of higher revenues from the 2011 tax hike. And by the end of fiscal year 2015, the 2011 tax hike will have raised more than $31 billion in higher taxes. Lawmakers used the new money to avoid making real reform and are now in a position that will require real spending reform and tough decisions.

General Fund revenues are expected to drop by 4.9 percent ($1.8 billion) in FY 2015 and another 9 percent ($3.1 billion) in FY 2016. That's an annualized net revenue loss of $4.9 billion during 2016, the first full fiscal year of the sunset. But revenue begins growing again by approximately 3 percent a year after the sunset, reaching nearly $35 billion in fiscal year 2019. Making up these revenue losses is more than possible – it's necessary to get Illinois' economy growing again.

Illinois' general fund is projected to bring in $34.9 billion in total revenue in fiscal year 2015. That means under no circumstances should Illinois spend more than $34.9 billion during the 2015 fiscal year.

The purpose of Budget Solutions 2015 is to offer a menu of reforms that can be used to not only allow the tax hike to sunset, but also to begin paying down Illinois' bill backlog. Tax relief is in the immediate future and Illinois needs bold leadership that will make sure it happens. Sunsetting the tax hike is more than a promise – it's the law. And it can be achieved.

Savings needed to sunset tax increase on schedule

Annualized net revenue loss of $4.9 billion

Fiscal year 2015	$1.8 billion
Fiscal year 2016	$3.1 billion

EXECUTIVE SUMMARY

Budget Solutions 2015: Menu of reform proposals

Balanced budget | Illinois hasn't had a balanced budget since 2001. Illinois needs a more stringent and enforceable balanced budget requirement that will force lawmakers to rein in spending.

Spending limit | Illinois government is spending more money than it takes in and must learn to live within its means. State spending would total $24 billion, or $10 billion less than the $34 billion in 2012 if the state would have limited spending to the rate of inflation and population growth since 1979. Illinois needs to enact a spending limit tied to the growth of population and inflation.

Spending cuts | Across-the-board spending cuts of 4.9 percent would save the state **$1.8 billion** in fiscal year 2015, and cuts of 9 percent would save the state **$3.1 billion** in fiscal year 2016.

Education | More than $870 million of Illinois' general fund for education subsidizes funding that's not based on district need. Eliminating inappropriate subsidies and returning the General State Aid to its original intent – paying school districts based on need – would save more than **$870 million**.

Medicaid | Access to high-quality care for Medicaid enrollees has collapsed, even as record amounts of taxpayer dollars are spent on this program, which covers one-fourth of the state's population. Giving patients meaningful choices improves health outcomes and increases satisfaction. In addition to reinstating a private contractor to scrub Illinois' Medicaid eligibility rolls, these reforms can save as much as **$2 billion**.

Retiree health insurance | State government retirees contribute little to nothing toward their health-insurance plans. Requiring retirees to pay at least half of their health-insurance premiums and eliminating this benefit for new workers going forward would save as much as **$800 million**.

State payroll | Illinois is broke and skyrocketing employee compensation costs are at the center of the crisis. Reducing the cost of government by reducing payroll costs 10 percent would save as much as **$300 million**.

Revenue sharing | Eliminating ineffective revenue-sharing programs between state and local governments would save up to **$1.7 billion**.

401(k)-style retirements | Defined benefit systems are inherently unpredictable and unmanageable, and are the root of Illinois' pension crisis. Ending defined benefit pension systems, protecting already-earned benefits and moving workers to 401(k)-style plans going forward is the only way to protect government workers and taxpayers. Comprehensive pension reform would save the state as much as **$2 billion**, compared with the current official pension payment.

Means-test COLAs | More than 8,000 government retirees receive cost-of-living adjustment, or COLA, benefits on top of annual pensions that exceed $100,000. Doling out COLAs to some of the state's wealthiest retirees threatens the benefits of the state workers who need them most. Pension reform must means-test the COLAs of career state workers.

Retirement age | More than 63 percent of Illinois' 200,000 government pensioners retired at or before the age of 60. Pension reform must align the retirement age with the Social Security retirement age while protecting workers currently nearing retirement.

Cost-shift | Teachers and university employees are not state employees, but the state pays the employer's share of their pensions. One unit of government hands out benefits while another pays for them, eliminating spending accountability. This practice must end.

SPECIAL REPORT

Budget Solutions 2015: Strengthen Illinois' balanced budget requirement

The problem: Despite Illinois' existing balanced budget requirement, the state hasn't had a balanced budget since 2001.[2] Illinois' inability to spend within its means has resulted in massive debt; the household share of total state debt is more than $60,000.[3]

Our solution: In addition to a spending limit, Illinois needs a more stringent and enforceable balanced budget requirement that will force lawmakers to rein in spending.

Why this works: A real balanced budget requirement lays the foundation for fiscal responsibility in Illinois and sets the stage for an economic turnaround.

The problem

- Illinois has failed to balance its budget since 2001, despite a constitutional requirement to do so. Politicians consistently find loopholes that make the requirement ineffective. The result is a culture of deficit spending and a backlog of $7 billion in unpaid bills.[4]

Illinois: No balanced budget since 2001

Fiscal year	Fulfills constitutional requirement?	Balanced?
2000	Yes	Yes
2001	Yes	Yes
2002	Yes	No
2003	Yes	No
2004	Yes	No
2005	Yes	No
2006	Yes	No
2007	Yes	No
2008	Yes	No
2009	Yes	No
2010	Yes	No
2011	Yes	No
2012	Yes	No
2013	Yes	No

Source: State of Illinois Comptroller, "Defining a Balanced Budget"

- Illinois politicians have used borrowing and budgeting gimmicks, rather than real spending reforms, to present the false appearance of balanced budgets. For example:
  - » In May 2011, less than six months after the General Assembly enacted a 67 percent state income tax increase, lawmakers passed what they called a balanced budget. In reality, this budget used an accounting gimmick to push more than $1 billion in unpaid bills to the next fiscal year.[5]
  - » In fiscal year 2010, Gov. Pat Quinn borrowed $3.5 billion to finance the state's pension systems. In fiscal year 2011, Quinn borrowed another $3.7 billion for the same reason.[6]
  - » Illinois' unwillingness to balance its budget has resulted in long payment delays to government vendors. Many institutions have been forced to reduce or cut services after waiting months to be paid.
- Illinois' fake balanced budget requirement allows lawmakers to spend beyond the state's means, ignore unpaid bills, incur deficits and put taxpayers on the line for more debt.

Our solution

- Any spending incurred during a fiscal year must be paid for with revenue from the same fiscal year.
- Borrowing or dipping into other state funds and refinancing debt cannot be counted as revenues.
- A system of checks and balances should require the comptroller to verify revenue estimates and spending proposals from the Governor's Office of Management and Budget.
- Appropriations for a fiscal year should not exceed the average annual revenue collected for the three previous years, adjusted for inflation and population.
- The governor must submit to the General Assembly a balanced budget, and the lawmakers must pass a balanced budget. The Illinois comptroller shall certify that the budget signed into law is balanced.

Why this works

- The most basic tenet of good public policy and fiscal management is not to spend more money than is available.
- Strengthening the balanced budget requirement would hold politicians accountable for their spending decisions.
- A balanced budget would restore the confidence of investors, businesses and entrepreneurs to invest in Illinois.
- A balanced budget would end the cycle of credit downgrades and set the foundation for a positive outlook.

SPECIAL REPORT

Budget Solutions 2015: Enact a responsible spending limit

The problem: Illinois government is spending more money than it takes in and must learn to live within its means. State spending would total $24 billion, or $10 billion less than the $34 billion in 2012, if the state would have limited spending to the rate of inflation and population growth since 1979.

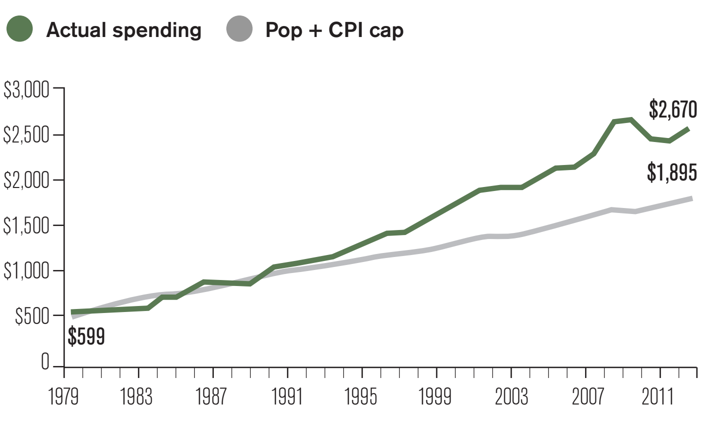
Our solution: Enact a spending limit tied to the growth of population and inflation.

Why this works: More resources in the market economy allow entrepreneurs and small businesses to thrive.

The problem

- Politicians and others have attributed Illinois' fiscal problems to not having enough revenue and the effects of the national recession. This is not the root of Illinois' problems. At the core of the state's fiscal woes is decades of overspending and overtaxing.
- Illinois' General Revenue Fund spending totaled $6.8 billion in 1979. By 2012, that number had increased more than 400 percent, to $34.4 billion. Even after adjusting for inflation, that's a 60 percent increase in state spending.
- If Illinois had limited its per capita spending growth since 1979 to the rate of inflation, per capita spending would be $1,895. That means Illinois would be spending nearly $800 less per person today. Said differently, if Illinois would have implemented a strict spending limit in 1979, state spending would total $24 billion, or $10 billion less than the $34 billion Illinois spent in 2012. This type of responsible spending limit could have helped prevent the state's many crises.[8]

Spending (per capita)



Source: U.S. Bureau of Economic Analysis, the U.S. Bureau of Labor Statistics and the State of Illinois Comptroller

Our solution

- Illinois needs a real and effective spending limit. Legislators passed a fake limit in 2011 that set the ceiling far too high. The limit is arbitrary and far greater than available resources.

The spending limit in place now is akin to somebody earning a salary of $35,000 annually, and pledging to only spend $39,000 on annual expenses. The 2015 limit, for example, is more than $4 billion higher than Illinois' expected revenue.[9]

Illinois' spending limit should be:

- Tied to the sum of the growth in the state's inflation and population.
- Codified in the state's constitution.
- Based on spending, not revenues.
- Designed to require a supermajoirty from the General Assembly and a public vote for an override.
- Designed with triggers to automatically save or refund surpluses in excess of the limit.

Illinois' fake spending limit exceeds available revenue by more than $4 billion in 2015

Numbers in millions

Fiscal year	Spending limit	Revenue forecast	Difference
2013	$37,554	$36,362	$1,192
2014	$38,305	$36,725	$1,580
2015*	$39,072	$34,934	$4,138

Source: Public Act 096-1496, GOMB 5-year budget projection

*Note: *indicates revenue forecast*

Why this works

- A responsible spending limit forces government to spend within its means and limits politicians' ability to make promises they can't keep.
- Codifying a spending limit in the Constitution makes it binding.
- Reducing government spending lessens the tax burden on individuals and businesses, encouraging economic growth.

SPECIAL REPORT

Budget Solutions 2015: Improve formula for education spending

The problem: Illinois public schools are funded through a web of confusing and complicated formulas. The formulas governing Illinois' single-largest education expenditure – General State Aid, or GSA – direct more than $750 million in subsidies to districts primarily located in Cook County and its collar counties. This is unfair to downstate taxpayers.

Our solution: Eliminate subsidies and return the GSA to its original intent: paying school districts based on need.

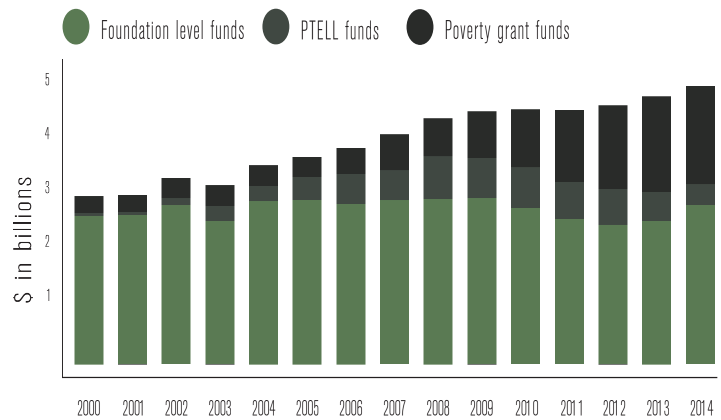
Why this works: Doing this ensures that education money is distributed equitably and based on need.

The problem

- General State Aid, or GSA, funds were meant to ensure that needy school districts have a base level of funding per student, known as the Foundation Level. But today, only 50 percent of GSA funds are distributed to property-poor districts to help them reach that base level of funding, down from 90 percent in 2000.
- The remaining 40 percent of funding goes to two items that undermine the state's goal of using GSA money to help fund districts based on need:

1. **Property Tax Extension Limitation Law, or PTELL, adjustment.** To protect taxpayers from skyrocketing property tax increases, state law allows communities to cap property tax revenue growth. These caps were meant to keep local government spending at responsible levels. The problem is that school districts in these tax-capped areas refused to rein in spending. Instead, they requested relief from state lawmakers, who adjusted the GSA formula to help these districts make up for their excessive spending. The end result is that state law forces taxpayers across Illinois to subsidize districts with property tax caps.
2. **Tax Increment Financing, or TIF, districts.** TIFs are special tax zones established by cities in an effort to spur economic development. In many towns across Illinois, local governments choose to give tax breaks to private developers that invest in these special tax zones. These tax breaks reduce the amount of tax revenues communities have available for education. Facing shortfalls in education funding, these school districts were granted relief by state lawmakers, who adjusted the GSA formula. However, by providing this relief, education funding indirectly subsidizes private developers located in special tax zones.
3. **Poverty grants.** The state provides all districts with additional funding based on the concentration of low-income students it has in its district. The higher the concentration, the more funding per low-income student a district receives, from a low of $355 to a high of $2,994. When the state distributes this money it does not take into account a district's property wealth. This means some property-wealthy districts receive additional state funding even though they have enough local property tax revenue to pay for their low-income students' education expenses.

Funding for property-poor districts continues to get squeezed



Source: Illinois State Board of Education

- The failures of the GSA formula push the state further away from the important concept of allowing money to follow the child.

The solution

- End GSA subsidies that enable school districts to bypass local spending limits. Savings estimate: $500 million.
- End GSA subsidies that, in effect, fund real-estate development projects. Savings estimate: $400 million.
- By implementing both of these reforms at the same time, the state would realize an overlap in savings totaling $750 million.
- End GSA subsidies that provide property-wealthy districts with funding to pay for the education of their low-income students even though they can fund it themselves. Savings estimate: $124 million.

Why it works

- Ending inappropriate GSA subsidies increases spending accountability and transparency, and ensures that the GSA funds what it is meant to: school districts most in need.

SPECIAL REPORT

Budget Solutions 2015: Improve health care for Medicaid patients

The problem: The Illinois Medicaid program is failing the state's most vulnerable populations and is fiscally unsustainable.

Our solution: Illinois' fee-for-services Medicaid program should be transformed into a sliding scale premium assistance program, paired with savings accounts for nonelderly and nondisabled patients.

Why this works: By transforming Medicaid to a sliding scale premium assistance program, the state can improve outcomes for Medicaid patients while spending less taxpayer money, giving Medicaid patients more control over meeting their own health-care needs and preferences.

The problem

- **Low reimbursement rates and payment delays.** The Medicaid program in Illinois operates on a fee-for-service basis, reimbursing doctors and hospitals for services they provide at a specified rate. Illinois' reimbursement rates are substantially below the national average – only six states have lower fees than Illinois. These fees generally do not even cover the actual cost of providing services. These payment problems make it difficult for doctors to take on new or additional Medicaid patients.
- **Limited access and worse outcomes.** These factors have created an environment in which Medicaid enrollees theoretically have medical coverage, but limited access to care. Children on Medicaid, for example, are six times more likely than privately insured patients to be denied an appointment to see a specialist. If and when Medicaid patients receive care, they frequently suffer worse outcomes than both privately insured and uninsured patients.
- **ObamaCare will further strain the system.** The problems Illinois' Medicaid program faces today are alarming, but ObamaCare is expected to drive even more people to this failing system.

Our solution

- **Premium assistance.** Premium assistance models – through which Medicaid recipients pay a share of the plan premium and contribute to their health savings account – provide recipients with a defined contribution toward the purchase of private health insurance. Using the funds in this personal medical savings account, individuals can select the insurance that best fits their needs and preferences. If Medicaid patients paid a share of health insurance costs and co-pays, based on income, this approach – which would curb over-utilization and give patients some "skin in the game" – has the potential to save more than $1.7 billion per year. The state's total annual liability for the program is about $10 billion.
- **Workers gain more control over their own health care.** After paying for the insurance premium, Medicaid patients could use remaining funds in the account for health-care expenses such as doctor visit co-pays, prescription drugs and hospital stays.The poorest enrollees would receive full subsidies based on the average insurance premium and deductible cost by age in Illinois, but the subsidies would gradually phase out for those who can afford to pay a portion of their health-care cost.
- **Eligibility verification.** In addition, the state should reinstate a private vendor to verify Medicaid eligibility. The state of Illinois had been using a private contractor to scrub its Medicaid eligibility rolls and found that 40 percent of the Medicaid enrollees were ineligible for the program. Based on an analysis by the Illinois Department of Healthcare and Family Services, this approach can save about $350 million per year.[10]

Why this works

These solutions would:

- Improve outcomes for Medicaid patients while spending less taxpayer money.
- Give the most vulnerable residents the freedom to choose health plans that meet their needs, based on price, range of options and quality.
- Doctors will no longer need to limit the number of Medicaid patients they see due to low and late reimbursements from the state.
- Medicaid can be a program that offers actual access to health care, not just meaningless coverage.
- By improving eligibility verification, the state will also ensure that precious resources are not misdirected. Every dollar in waste, fraud and abuse are funds that are not being spent on patient care.

SPECIAL REPORT

Budget Solutions 2015: Reform state retiree health insurance

The problem: State government retirees contribute little to nothing to their health insurance plans. The state has a $50 billion unfunded retiree health insurance liability, and no money to pay it down.

Our solution: Require current retirees to pay at least half of their health insurance premiums, mirroring what other states require government workers to pay on average. Going forward, the state should eliminate this benefit for new employees.

Why this works: These reforms dramatically reduce the unfunded liability, yet protect current retirees through a need- and merit-based formula.

The problem

- There is no shortage of headlines highlighting the fact that the state's five pension funds are short by about $100 billion. But there is another looming problem. Illinois has promised state retirees $100 billion in health benefits over the next 30 years, and has also failed to fund those benefits.[11]
- Referred to as "other postemployment benefits," which include retiree health care and life insurance, these benefits are the equivalent of more than $12,000 for every working-age adult in the state.[12] That is in addition to other state- and municipal-level unfunded liabilities and tax obligations.
- Continuing to push off reform to future generations may be a politically safe approach for lawmakers who do not wish to make tough financial decisions. But that approach is unfair to the taxpayers who are footing the bill for lavish benefits that most do not receive themselves.
- According to a 2010 survey of health benefits, states pay, on average, about 46 percent of retiree health premiums for their Medicare-eligible and nonMedicare-eligible retirees.[13] Illinois taxpayers' contributions to state workers' retiree health premiums are out of line with other states and with the vast majority of employers.
- To reduce the programs' unfunded liabilities, lawmakers should bring the state's benefits in line with other state governments and the private sector. Doing so will ensure the long-term stability of these benefits, while addressing a looming and unsustainable budget crisis.

Our solution

- **Increase retiree contributions toward premiums.** By increasing the average retiree contribution to 54 percent of the total cost, the state could save about $800 million in fiscal year 2015.
- **Cap retiree subsidies.** Capping retiree subsidies at $4,000 per enrollee, for example, could achieve similar savings. Lawmakers could establish a lower cap for dependents, retirees younger than 65, and retirees earning six-figure pensions.
- **Means-test retiree subsidies.** State lawmakers should consider further increasing retiree contributions or ending taxpayer-funded subsidies for retirees earning six-figure pensions.
- **End retiree subsidies.** State lawmakers should consider ending dependent subsidies for early retirees and those retirees earning six-figure pensions.

Why this works

The central criticism of the proposed reforms is that it increases the financial burden of state workers and retirees. There are legitimate questions as to how much state employees and retirees should be required to pay. However, these objections must be examined in light of whether the state will be able to make good on these future payments, and whether it is reasonable to expect taxpayers to foot the bill for benefits that far exceed what most private sector workers receive. Illinois' government employee benefits are far and above what its own taxpayers receive, as well as most states across the country. The bottom line is that it is time to face fiscal reality.

- Retiree health insurance is virtually unheard of in the private sector. Fewer than 15 percent of private citizens receive such a benefit. Asking taxpayers to subsidize almost the entire cost of retiree health care for government workers – a perk private citizens can't enjoy themselves – is wrong.
- The state is funding state retiree health premium benefits from general revenues. There is no retiree piggy bank from which to pay for these benefits. There are no quick fixes to solve this looming crisis.
- The time has come for Illinois lawmakers and citizens to hold an honest and open discussion about the state's fiscal future, including the best ways to meet the state's fiscal obligations and deliver health benefits to government workers when they retire. While it may not be politically popular, securing a sustainable financial future for the state's public employees and taxpayers should be lawmakers' top priority.

SPECIAL REPORT

Budget Solutions 2015: Rightsize state payroll costs

The problem: Illinois is broke and skyrocketing employee compensation costs are at the center of the crisis.

Our solution: Reduce payroll costs.

Why this works: Limiting the cost of government is an important step to stabilizing Illinois' fiscal position.

The problem

- Total government employee costs consumed approximately one-third of the state's general funds budget in 2013. That figure includes salaries, wages and fringe benefits for current workers, and pension benefits and health insurance costs for retired workers.[14]
- Quickly growing compensation costs are crowding out funding for core services such as education, public safety and health care for the poor and disadvantaged.
- Payroll for state workers totals about $3 billion. Illinois cannot continue increasing its payroll costs, which is one of the biggest drivers of the state's deficit woes. Even after imposing a record income tax increase in 2011, the state is nearing insolvency.
- Individuals working for state government in Illinois often make more than the statewide average salary for doing the same job. Consider the following annual-salary comparisons[15]:
  - » **Janitor**
    - Illinois average for state workers = $48,282
    - Illinois statewide average = $26,290
  - » **Barber**
    - Illinois average for state workers = $70,800
    - Illinois statewide average = $35,340
  - » **Administrative assistant**
    - Illinois average for state workers = $61,496
    - Illinois statewide average = $35,250
  - » **Plumber or steamfitter**
    - Illinois average for state workers = $85,866
    - Illinois statewide average = $67,470
- According to contracts, American Federation of State, County and Municipal Employees workers have received 24 types of pay increases since January 2005: 15 general wage increases and nine annual step increases.
- Gov. Pat Quinn signed a contract in 2010 that included five pay raises to government workers during the course of just 13 months.[16] Due to budget constraints, not all state employees were given all five pay raises; but it's contracts such as these that continue to drive up salaries for state workers.
- Employee salaries determine the size of future pensions and other fringe benefits. Because salaries are the driver for total government-employee costs, reforms to bring down ballooning compensation costs must begin with payroll reductions.

Our solution

- Reduce the cost of government by reducing payroll costs 10 percent. Savings: as much as $300 million.
- End automatic pay increases for state employees and make merit pay increases contingent on economic or fiscal factors.

Why this works

- A reduction in the size of employee-payroll costs will slow the dramatic growth in other benefits, making the security of future employee benefits more likely.
- Reducing the cost of government is a necessary step to improving Illinois' finances.
- These reforms help salvage Illinois' fiscal situation, thus enhancing the job security of current state employees.

SPECIAL REPORT

Budget Solutions 2015: Eliminate ineffective revenue sharing programs

The problem: The Local Government Distributive Fund, or LGDF, one of Illinois' largest revenue-sharing programs, exemplifies the shell game of government spending in Illinois; one unit of government raises money and another spends it. This arrangement fosters waste and abuse.

Our solution: Eliminate ineffective revenue-sharing programs and return $1.7 billion to taxpayers in the form of lower state income taxes.

Why this works: This solution ensures that services provided by local government reflect the willingness of residents to pay for those services through local taxes.

The problem

- Each year, Illinois state government collects billions in income tax revenues. As part of a revenue-sharing agreement, the state is required to send more than $1 billion back to local governments through the Local Government Distributive Fund, or LGDF.[17]
- These shared revenues are placed by the state in the LGDF, which distributes the money to local governments based on each locality's share of the state population. These shared revenues allow localities to spend money on local programs without having to directly raise those taxes from their taxpayers.
- This arrangement allows local governments to avoid spending accountability.
- There is no real justification for state government to play the middleman between taxpayers and local governments. The LGDF simply perpetuates the spending shell game for which Illinois is well known.
- In addition to the more than $1 billion in state income taxes redistributed to local governments, the state also spends almost $700 million of general-fund money on special funds dedicated to projects such as agriculture promotion, downstate public transportation and tourism promotion.[18]

Our solution

- **End LGDF revenue sharing.** This eliminates the transfer of more than $1 billion in state tax revenues to local governments.
- **Reduce the state income tax.** By ending LGDF revenue sharing, the state will have $1 billion in excess tax revenues. That amount should be returned to taxpayers in the form of lower state income taxes.
- **Require local spending accountability.** By eliminating LGDF funds from the state, statewide taxpayers won't be forced to subsidize local projects they will never utilize. And accountability is increased because local government officials must use money from their own community to pay for programs and services. If the money does not exist in the budget, they'll have to ask taxpayers to pay higher local taxes if they really want them.
- **End other tax revenue redistribution programs.** The same logic and steps apply to $700 million in other general-fund transfers.

Why this works

- Eliminating the LGDF and other nontransparent funds:
  - Allows for the return of billions of taxpayer dollars to Illinoisans in the form of lower tax rates.
  - Holds local government agencies accountable for their spending because these agencies can't ask the state to pay for programs that only people in a specific locale can enjoy.

Budget Solutions 2015: Modernize Illinois' government retirement system

The problem: For decades, Illinois has struggled with billions of dollars in government pension debt. Pension systems as generous as Illinois' largely have been abandoned in the private sector because defined benefit systems are inherently unpredictable, unmanageable and unaffordable.

Our solution: Illinois must modernize its pension system to protect the retirement security of workers and reduce government retirement costs paid for by taxpayers. Illinois should freeze the pension systems and benefits earned to date, and going forward provide benefits to government workers using 401(k)-style plans.

Why this works: The 401(k)-style system is the most popular retirement vehicle in the U.S. It puts workers in control of their retirement, while offering an affordable solution to taxpayers.

The problem

- Illinois state government has promised pensions to government workers, but does not have enough money to pay for them. Even after the December 2013 pension law was signed, Illinois still has a similar amount of pension debt as it did in 2011. Without a complete overhaul of the government retirement system, the retirements of government workers are in jeopardy. Critics can look to other cities for evidence: Workers in Central Falls, R.I., and Pritchard, Ala., saw their retirement funds cut as part of bankruptcy proceedings, some by as much as 55 percent. Detroit pensions are on the chopping block now, and retired city workers will be receiving much less than what was promised to them.
- Bankrupt pensions are the unintended consequence of state and local governments not allowing workers to manage their own retirement savings. Instead, these workers are forced to participate in pension systems run by politicians and government bureaucrats. The supposed beneficiaries have no control, no voice and no exit.
- One of the most common narratives regarding the pension crisis in Illinois is that the state's five pension systems are underfunded because politicians "skipped" pension payments. But much of the growth in the unfunded liability has been due to the inherent flaws in the defined benefit model. Fifty-eight percent of the growth in unfunded state pension liabilities from 1996 to 2012 were due to flaws in the defined benefit pension plan[19]:
  - » Poor investment returns: $17.2 billion
  - » Benefit increases: $5.8 billion
  - » Changes in actuarial assumptions: $8.8 billion
  - » Other factors: $12.9 billion

The solution

- The only way to end Illinois' pension crisis once and for all is to move benefits for all future work to a defined contribution system used by the private sector. The solution:
  1. Protects already-earned benefits for all workers by freezing the defined benefit plan at current levels. Government workers will still receive already-earned pension benefits, but future benefits will accrue in 401(k)-style plans.
  2. Empowers workers with defined contribution plans for all future work. Going forward, employees will contribute 8 percent of their salary toward retirement savings, while the employer matches 7 percent of salary.
  3. Means-tests cost-of-living adjustments by protecting these benefits for career employees who dedicated 25-30 years to public service and have limited annual pensions.
  4. Aligns the retirement age with the Social Security retirement age and protects workers nearing retirement under current law.
  5. Requires school districts and state universities to pay the employer share of their employees' retirement savings plans.
  6. To pay off the existing pension debt, the state should make level payments to fully fund the pension system by 2045.

Why it works

- Moving to a 401(k)-style system is the only way to solve the pension crisis. A plan developed by the Illinois Policy Institute in 2013 would immediately cut the state's pension debt in half and ultimately eliminate the unfunded liability. It also would reduce the state's annual pension contribution by approximately $2 billion, compared with the current official pension payment.
- A portion of the Institute's plan was scored by the Commission on Government Forecasting and Accountability, and found to save more money than any other plan proposed in 2013 or to date.
- Moving to a 401(k)-style system modernizes the state's retirement system by eliminating political control and giving government workers the secure retirement they deserve.
- Protecting already-earned benefits and offering state workers choice and mobility through 401(k)-style retirement plans also creates greater budget certainty for the state moving forward, ending the pension repayment ramp and replacing it with level annual payments.

SPECIAL REPORT

Budget Solutions 2015: Means-test cost-of-living adjustments

The problem: Supersized cost-of-living adjustments, or COLAs, are threatening the retirements of all state workers and are responsible for nearly one-third of Illinois' unfunded pension liability.[20]

Our solution: Means-test COLAs by protecting these benefits for career employees who dedicated 25-30 years to public service and have limited annual pensions.

Why this works: Means-testing COLAs can significantly reduce the state's unfunded pension liability while preserving the benefit increases for the state retirees who need them the most.

The problem

- One of the biggest forces behind Illinois' quickly growing pension debt is the cost-of-living-adjustments, or COLAs, which retirees of the five state-run retirement systems receive annually.[21] The pension reform included in Senate Bill 1 started to address COLAs, but only tackled a portion of the problem.

- The pension systems will collapse if COLAs are not reformed. Consider the following examples that have driven Illinois pension systems near insolvency:

  - There are more than 8,000 government retirees who receive more than $100,000 in annual pension benefits and the COLAs that go with them.[22]

  - For example, annuitant Dr. Leslie Heffez of the State Universities Retirement System, or SURS, received a $500,000 pension in 2013. But on top of that, Dr. Heffez received more than $15,000 in an annual COLA. A COLA of this magnitude would boost Dr. Heffez's pension benefits by nearly $6 million over the course of his retirement, assuming he reaches his life expectancy of age 80.[23]

  - Nearly 45 percent of Teachers' Retirement System, or TRS, members with 30 years of experience retire before age 60.[24] The typical 30-year TRS worker retiring in 2013 had a starting pension of $71,000, and is on average age 59. COLA benefits significantly boost these pension benefits during retirement.

- Government COLA benefits are out of sync with the private sector. With a maximum annual Social Security benefit of $30,396, private sector workers who retire at the full retirement age of 66 will receive a COLA of just $456 for 2014.[25] In contrast, the average state-level retiree with a 30-year career has a pension of $63,527 and received an average COLA of $1,906. That's nine times higher than the COLA for an average Social Security beneficiary.

Our solution

- The pension law passed in December 2013 limits the salary base on which workers earn a COLA to $1,000 per year of service. But this tinkering with the COLA formula continues to pay COLAs to high five- and six-figure pensioners – failing to address a fundamental problem with COLAs in Illinois.

- A complete suspension of COLAs until Illinois' pension systems return to full health could reduce the state's unfunded liability by nearly one-third.[26]

- If COLAs must remain part of the pension system in some form, they should be means-tested. That means protecting COLAs for career employees who dedicated 25-30 years to public service and have limited annual pensions.

- COLA benefits should be protected for those earning annual pensions of less than the maximum annual Social Security payment for a private sector worker who's reached the full retirement age.

Why it works

- COLAs are meant to help pensioners with low annual retirement benefits weather changes in the economy or cost of living, not turn six-figure pensioners into millionaires. Supersized COLAs are threatening the retirements of all state workers. Means-testing COLAs can significantly reduce the state's unfunded pension liability while preserving the benefit increases for the state retirees who need them the most.

- Means-testing COLAs will save taxpayers from having to bail out Illinois' failed pension system. It will also save the state from being forced to increase funding for pensions at the expense of essential services upon which the poor and disadvantaged depend.

- Finally, means-testing COLAs will mean that public workers can feel more secure about the health of their retirements.

SPECIAL REPORT

Budget Solutions 2015: Align government retirement age with private sector

The problem: Early retirements combined with large final salaries are bankrupting Illinois' pension systems.

Our solution: Align the retirement age with the Social Security retirement age and protect workers nearing retirement under current law.

Why this works: Aligning the retirement age with Social Security ensures that older workers near retirement will be affected less, but that the retirement age is equitably increased to protect Illinois' pension systems from insolvency.

The problem

- Unlike their private sector counterparts, Illinois government workers are able to retire in their 50s while collecting most of their final average salary. Some spend more years collecting a pension than they did on the job. This puts a tremendous strain on taxpayers and the pension systems themselves.
- The pension reform included in the December 2013 pension law attempted to address the retirement age problem in Illinois, but didn't go far enough. Specifically, the pension law increased the retirement age on a sliding scale for those younger than 46. But the pension law still allows many state workers to retire before age 60 with full benefits. Taxpayers will still be paying for the pensions of state workers who will retire a full decade before they will.

63 percent of state workers retired before age 60

Age at retirement	Total number of retirees	Cumulative % of total
40-44	7	0.0%
45-49	3,924	2.0%
50-54	41,048	22.5%
55-59	81,311	63.1%
60-64	54,553	90.3%
65-69	15,213	97.9%
70-74	3,068	99.5%
75-79	819	99.9%
80-84	181	100.0%
85-89	37	100.0%
90+	3	100.0%
Total	**200,164**	

Source: Freedom of Information Act data from all five state retirement systems

- There are more than 200,000 retirees across Illinois' five state retirement systems. More than 60 percent of Illinois government pensioners retired before the age of 60.[27] The average pension for workers who retired before the age of 60 with at least 30 years of service credit is $63,424.
- The government workers who retired early did nothing wrong. They made an economic decision that is lucrative and fair game under current law. But the state no longer can afford to offer these benefits.
- According to a recent poll, 82 percent of working Americans age 50 or older say it is at least somewhat likely they will work for pay in retirement.[28] The survey also found that 47 percent of working survey respondents now expect to retire later than they previously thought and, on average, plan to call it quits at about age 66.
- It's unfair to force taxpayers to work into their late 60s to pay for government workers retiring in their early 50s. It's also not fair that young government workers are trapped in a pension system that may collapse before they reach retirement age.

The solution

- The reforms in the December 2013 pension law need to be taken further. Illinois should follow the lead of Rhode Island's 2011 pension reform and align the retirement age with the Social Security retirement age while still protecting workers who are nearing retirement under current law.[29]
- Protect workers currently nearing retirement by discounting the new retirement age proportionally based on how close workers are to retirement. The closer employees are to the current legal retirement age, the fewer additional years should be added to that retirement age, provided the new age should be no lower than 59.
- Government workers should be free to retire when they wish, but should not begin collecting a pension until they have reached the Social Security retirement age.

Why it works

- If Illinois lawmakers are serious about pension reform, they will align the government worker retirement age with those in the private sector.
- Following Rhode Island's pension reform by aligning the retirement age with Social Security ensures that older workers near retirement will be affected less, but that the retirement age is equitably increased to protect Illinois' pension system from insolvency.

SPECIAL REPORT

Budget Solutions 2015: Free state from paying local pension costs

The problem: A significant driver of Illinois' pension crisis is that the state makes the "employer" share of pension contributions on behalf of school districts and universities for their workers, even though these individuals aren't employees of the state.

Our solution: Shift to a 401(k)–style retirement plan going forward and require school districts and state universities to pay the employer share of their employees' retirement savings plans.

Why this works: This reform increases accountability and prevents the current pension system from crowding out state dollars meant for the classroom.

The problem

- Local school districts set salaries for teachers. These salaries determine a teacher's eventual pension benefit. To fund these pensions, the employee (the teacher) and the employer (the school district) contribute specific amounts to the teacher retirement funds each year. But the school district – the employer of these teachers – does not pay the full employer contribution to TRS. Instead, the state pays the employer share on behalf of these districts.[30]

- By paying the employer contribution of teachers' pensions on behalf of school districts, the state is essentially paying for spending decisions over which it has little control. One unit of government hands out benefits while another pays for them, leading to abuse and the destruction of spending accountability.

- This arrangement provides an incentive for school districts to continually increase teacher benefits. As more school districts balloon benefit packages to attract talent, other districts compete by doing the same, which ultimately perpetuates the cycle of unaffordable and unsustainable retirement benefits.

The solution

- Rather than the state making contributions to the Teachers' Retirement System, the state should require school districts to pay the employer share of their employees' retirement savings plans.

- Under the defined contribution plan, a teacher pays 8 percent of his or her salary into his or her 401(k)-style plan, and the school district contributes 7 percent of that teacher's salary to his or her retirement plan. The cost to school districts is a simple calculation – 7 percent of the district's TRS payroll.

- The cost shift gives school districts predictability in budgeting teacher retirement costs. The 7 percent employer contribution will cost school districts, on average, an amount equal to 2.9 percent of their total education expenditures.[31]

- Give school districts the ability to manage the increased costs by renegotiating the prevailing wage requirement, project labor agreements and other unfunded mandates. School districts should manage costs by opening up teacher contracts, negotiating benefits and ending the practice of picking up the pension contributions for their employees.

Why it works

- Requiring school districts to pay the employer share of their employees' 401(k)-style retirement savings plans creates an incentive to be more prudent with the compensation packages they award, thereby increasing the overall security of the retirement system. This plan also enhances spending accountability, because costs are paid where they are incurred.

- Requiring school districts to be directly accountable for their employees reduces the state's fiscal year 2015 cost by more than $750 million. The state could also save more than $400 million by implementing similar reforms for public universities.[32] Combined, these reforms would ultimately reduce the overall cost of state government by more than $1.1 billion.

Budget Solutions 2015: By the numbers

General Fund revenues are expected to drop by 4.9 percent ($1.8 billion) in FY 2015 and another 9 percent ($3.1 billion) in FY 2016. That's an annualized net revenue loss of $4.9 billion during 2016, the first full fiscal year of the sunset. But revenue begins growing again by approximately 3 percent a year after the sunset, reaching nearly $35 billion in fiscal year 2019. Making up these revenue losses is more than possible with the menu of reforms offered here.

State of Illinois five-year revenue projection *(in millions)*

	Actual 2013	Raised Revenue 2014	Forecast 2015	Forecast 2016	Forecast 2017	Forecast 2018	Forecast 2019
Resources							
Individual income tax	$16,538	$16,301	$14,844	$11, 884	$12,330	$12,929	$13,509
Corporate income tax	$3,177	$3,317	$3,071	$2,640	$2,809	$2,954	$3,096
Sales tax	$7,355	$7,610	$7,810	$8,020	$8,265	$8,430	$8,599
All other state sources	$3,151	$3,106	$3,020	$2,941	$2,924	$2,924	$2,924
State sources	$30,221	$30,344	$28,745	$25,485	$26,328	$27,237	$28,128
Federal sources	$4,154	$4,113	$4,294	$4,455	$4,613	$4,778	$4,948
Transfers in	$1,987	$2,278	$1,895	$1,854	$1,875	$1,896	$1,918
Total resources	**$36,362**	**$36,725**	**$34,934**	**$31,794**	**$32,816**	**$33,911**	**$34,994**
Change in income tax revenue		-$97	-$1,703	-$3,391	$615	$744	$722
Change in other sources		$460	- $88	$251	$407	$351	$361
Net revenue change		**$363**	**-$1,791**	**-$3,140**	**$1,022**	**$1,095**	**$1,083**

Source: *Five year budget projection General Funds FY15-FY19, Governor's Office of Management and Budget (2014)*

Scenario 1: full menu of reforms *(in billions)*

Comprehensive pension reform	$2.00
Education	$0.87
Retiree health insurance	$0.80
Revenue sharing	$1.70
State payroll	$0.30
Medicaid	$2.00
Spending cuts	$1.80
Total reform savings	**$9.47**
Achieves sunset	**Yes**
Revenue surplus for unpaid bills	**$7.67**

Scenario 2: pensions and education *(in billions)*

Comprehensive pension reform	$2.00
Education	$0.87
Total reform savings	**$2.87**
Achieves sunset	**Yes**
Revenue surplus for unpaid bills	**$1.07**

Scenario 3: Medicaid and insurance *(in billions)*

Retiree health insurance	$0.80
Medicaid	$2.00
Total reform savings	**$2.80**
Achieves sunset	**Yes**
Revenue surplus for unpaid bills	**$1.00**

The five scenarios presented here provide a variety of options to sunset the tax hike and begin paying down Illinois' backlog of unpaid bills. The full scenario includes every reform option offered in Budget Solutions 2015. This option not only sunsets the tax hike but leaves enough to pay the state's entire $7 billion backlog of unpaid bills.

The other potential scenarios provide reform options that allow the state to more than make up for the revenue loss in both FY15 and FY16 from the sunset. For example, implementing scenario 2 in FY15 and something similar to scenario 3 in FY16 would completely accommodate for the annualized sunset in the state budget.

The bottom line is this: there is absolutely no excuse for lawmakers to not allow the tax hike to sunset.

Scenario 4: revenue sharing and payroll *(in billions)*

Revenue sharing	$1.70
State payroll	$0.30
Total reform savings	**$2.00**
Achieves sunset	**Yes**
Revenue surplus for unpaid bills	**$0.20**

Scenario 5: spending cuts *(in billions)*

Spending cuts	$1.80
Total reform savings	**$1.80**
Achieves sunset	**Yes**
Revenue surplus for unpaid bills	**$0.00**

ENDNOTES

[1] "Three year budget projection General Funds FY15-FY17," Governor's Office of Management and Budget (2013) - http://www2.illinois.gov/gov/budget/Documents/Economic%20and%20Fiscal%20Policy%20Reports/FY2014/FY15%203%20year%20projection.pdf

[2] "Defining a balanced budget," State of Illinois Comptroller (2013), http://www.ioc.state.il.us/index.cfm/fiscal-condition/defining-a-balanced-budget/. Note: The Illinois comptroller uses three methods of calculating a balanced budget. The analysis here is based on the second method because the comptroller notes: "The second measure, called the budgetary balance, is the most comprehensive because it views a budget as balanced in any given year when the available resources meet or exceed the uses of those resources."

[3] An Illinoisan's share of the total debt burden includes the following:

- $209 billion in pension debt http://illinoispolicy.org/moodys-illinois-2011-unfunded-liability-jumps-by-65-percent/
- $54 billion in unfunded retiree health insurance liabilities: http://illinoispolicy.org/simplereport/another-54-billion-in-addition-to-pensions-the-state-owes-billions-more-in-retiree-health-benefits/
- $30 billion in direct bonded debt: http://www.ioc.state.il.us/index.cfm/resources/reports/bonded-indebtedness/
- $7 billion in unpaid bills: http://www.illinoiscomptroller.com/index.cfm/resources/topinka-unveils-money-matters/

[4] Monthly money matters March 2014," Illinois State Comptroller (2014), http://www.illinoiscomptroller.com/index.cfm/resources/topinka-unveils-money-matters/

[5] "Budget FAIL: Plan Awaiting Gov. Quinn's signature grows spending, debt," Illinois Policy Institute (2011), http://illinoispolicy.org/news/article.asp?ArticleSource=4219

[6] Ben VanMetre, "Two year anniversary of 2011 tax hike nothing to celebrate," Illinois Policy Institute (2013), http://illinoispolicy.org/two-year-anniversary-of-2011-tax-hike-nothing-to-celebrate/

[7] "Traditional budgetary financial report," State of Illinois Comptroller (2013), http://www.ioc.state.il.us/index.cfm/resources/reports/traditional-budgetary-financial/fy-2013/ "SA1-3 personal income summary," U.S. Bureau of Economic Analysis (2013) http://www.bea.gov/iTable/iTable.cfm?reqid=70&step=1&isuri=1&acrdn=4#reqid=70&step=1&isuri=1 "Gross domestic product by state millions of current dollars ," U.S. Bureau of Economic Analysis (2013), http://www.bea.gov/regional/index.htm "Consumer price index all urban consumers," U.S. Bureau of Labor Statistics (2013), http://www.bls.gov/cpi/#data

[8] In previous editions of Budget Solutions we have used Census spending data. When using those data, per capita spending outpaced inflation by 3 to 1. In the current edition we use spending data from the Illinois Comptroller.

[9] "P.A. 096-1496 The Taxpayer Accountability and Budget Stabilization Act," http://www.ilga.gov/legislation/publicacts/96/pdf/096-1496.pdf "Three year budget projection General Funds FY15-FY17," Governor's Office of Management and Budget (2013) - http://www2.illinois.gov/gov/budget/Documents/Economic%20and%20Fiscal%20Policy%20Reports/FY2014/FY15%203%20year%20projection.pdf

[10] http://www.dailyjournal.net/view/story/1b22b662f55b46b2a031d11f88411e52/IL--Medicaid-Eligibility/#.UrGa99JDs98, http://www2.illinois.gov/hfs/SiteCollectionDocuments/SB%202840%20MedicaidSpendingReductionsrev.pdf

[11] Ted Dabrowski, Amanda Griffin-Johnson and Jonathan Ingram, "Budget Solutions 2013," Illinois Policy Institute (2012), http://illinoispolicy.org/wp-content/files_mf/138489602084422843BudgetSolutions2013InnovationforIllinois.pdf#.

[12] Author's calculations based on U.S. Census population estimates at http://quickfacts.census.gov/qfd/states/17000.html.

[13] Mercer, "Retiree Health Contributions," Commission on Government Forecasting and Accountability, May 17, 2011, p. 2 at http://cgfa.ilga.gov/Upload/2011-MAY-17MercerRetireeHealthcareContributions.pdf.

[14] Ted Dabrowski, Ben VanMetre and Jonathan Ingram, "Budget Solutions 2014," Illinois Policy Institute (2013), http://illinoispolicy.org/policy_posts/budget-solutions-2014-pension-reform /

[15] Freedom of Information Act request from the Illinois Comptroller and data from the U.S. Bureau of Economic Analysis (2013)

[16] Kristina Rasmussen, "Billions in the Hole? Time for Pay Raises!" Illinois Policy Institute (2012), http://illinoispolicy.org/billions-in-the-hole-time-for-pay-raises/

[17] "Table I-D – General Funds Transfers Out," Governor's Office of Management and Budget (2014), http://www2.illinois.gov/gov/budget/Pages/BudgetBooks.aspx

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[19] Ted Dabrowski, "Lessons from the Edgar plan: why defined benefits can't work," Illinois Policy Institute (2013), http://illinoispolicy.org/

simplereport/lessons-from-the-edgar-plan-why-defined-benefits-cant-work/

[20] Ted Dabrowski and John Klingner, "Pension solutions: Cost-of-living adjustments are super sizing state pensions," Illinois Policy Institute (2013), http://illinoispolicy.org/wp-content/files_mf/1389312113COLA.pdf#

[21] State retirees are those enrolled in the Teachers' Retirement System, State Universities Retirement System, State Employees' Retirement System, Judges' Retirement System and General Assembly Retirement System.

[22] Ted Dabrowski, "Time to means-test COLAs," Illinois Policy Institute (2013), http://illinoispolicy.org/pension-reform-time-to-means-test-colas/

[23] Freedom of Information Act data from Illinois' five state-run retirement systems. For ease of comparison, Dr. Heffez's first pension amount is annualized.

[24] Freedom of Information Act data from Illinois' five state-run retirement systems.

[25] U.S. Social Security Administration, http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/59

[26] Ted Dabrowski, Ben VanMetre and Jonathan Ingram, "Budget Solutions 2014," Illinois Policy Institute (2013), http://illinoispolicy.org/policy_posts/budget-solutions-2014-pension-reform/

[27] Ben VanMetre, Ted Dabrowski and John Klinger, "Pension solutions: reforming retirement age," Illinois Policy Institute (2014), http://illinoispolicy.org/simplereport/pension-solutions-reforming-retirement-age/

[28] Jill Schlesinger, "Retirement now requires those living longer to work longer," Chicago Tribune, (2013), http://www.chicagotribune.com/business/sns-201310161730--tms--retiresmctnrs-a20131016-20131016,0,7752242.story

[29] For more details on the Rhode Island plan, see Employees' Retirement System, "An employee's guide to understanding the Rhode Island Retirement Security Act," Employees' Retirement System (2012), http://www.treasury.ri.gov/documents/SPRI/FINAL_RIRSAGuide_January2012.pdf

[30] The school district's portion of the normal cost is 0.58 percent of payroll. The state currently pays the remainder of the employer share.

[31] Ben VanMetre, "The cost shift: Why school districts would benefit from a 401(k)-style retirement plan," Illinois Policy Institute (2013), http://illinoispolicy.org/simplereport/pension-cost-shift-why-school-districts-would-benefit-from-a-401k-style-retirement-plan/

[32] "State Universities Retirement System of Illinois Actuarial Valuation Report as of June 20, 2013," Gabriel Roeder Smith & Company Consultants & Actuaries (2013), http://www.surs.com/pdfs/invinfo/avr13.pdf

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