

Budgeting for Results Meeting

16-100 James R. Thompson Center and Room 212 Lieutenant Governor

December 21, 2011

2:00 – 4:00 PM

I. Call to Order

Chairman Kotowski called the meeting to order at 2:10 PM.

II. Approval of the November Minutes

Commissioners agreed to postpone consideration of the November minutes until the next meeting.

III. Presentation on Unfunded Liabilities

Three GOMB presentations sought to better inform the Commission on the State's accumulated liabilities and spending pressures: Background (Emily Monk), Medicaid Spending (Michael Moss), and Pension Liabilities (Hans Zigmund). Emily's presentation explained the basic situation behind the backlog of unpaid bills, while Michael and Hans' presentations discussed the two major spending pressures on the State budget (Medicaid and Pensions).

A. Background – Emily Monk, GOMB

This presentation referenced a handout titled "Payables in the Comptroller's Office from the General Revenue Fund as of 15 December 2011 are \$3.358 billion" which contains data from a recent report produced for GOMB by the Comptroller's Office. The Comptroller's Office releases a report to GOMB twice per month indicating how much the Comptroller owes for unpaid bills. It is important to note that this report does not include bills that State agencies have not yet sent to the Comptroller. The data represented on the handout only shows vouchers that have been submitted to the Comptroller, not bills that State agencies have not yet sent to the Comptroller. The "age" of these bills indicates how long they have been pending at the Comptroller. Because it can often take vendors up to two months to submit their bills to state agencies, these vouchers may be for services performed more than two months (60 days) in the past. Further, because the Comptroller can only pay bills for which there is adequate appropriation some under appropriated agencies, such as DHFS, are holding their vouchers before submitting them to the Comptroller. As a result, some bills might be at least 180 days old even if the report shows them at 60 days.

GOMB estimated that a number of vouchers being held by other agencies include: Group Health Insurance (\$1.1 billion) and Business Tax Refunds (\$500 million). Group Health Insurance has been held for 200 days for PPO (non-managed care) and 100 days for managed care. The Group Health Insurance number for FY 2011 did not include managed care, and the FY 2011 budget allocated less money for Group Health Insurance. Medicaid was not included in the bills being held by agencies in FY 2011.

Illinois has not made substantial progress in paying down bills; yet, GOMB continues to manage the fiscal crisis as best as possible. GOMB processes hardship payments when it receives calls from vendors. Additionally, the Governor has advocated debt restructuring over the past year. In preparing the FY 2013 budget, GOMB has set

money aside to pay off some of the State's backlog of old bills. However, given the size of the backlog, it will take many years to pay off the full backlog without a large influx of cash.

Discussion:

Commissioners requested that GOMB produce additional documents (see list below). Their follow-up questions related to the data they requested in these additional documents. For instance, Commissioners questioned how the number of paid and unpaid bills in December 2011 compares with the number of paid and unpaid bills in December 2010 and how many bills agencies are holding back from the Comptroller's Office due to a shortage of revenue and reduced appropriations. GOMB Staff explained that DHFS holds Group Health Insurance and medical assistance bills for 120 days, releases them to the Comptroller's Office, and then receives payment when the Comptroller has the revenue to pay providers. The Comptroller's Office experiences a delay (for minimum of 30 days) in paying the vouchers because of cash flow issues. The "Payables in the Comptroller's Office" handout only reveals processing days (not calendar days) and does not reflect the underfunding problems that cause agencies such as DHFS to hold onto bills for 120 days.

Furthermore, Commissioners wondered why agencies would delay payment to providers rather than sending all requests for payments to the Comptroller's Office. GOMB Staff explained that agencies hold vouchers because it allows them to more effectively manage their payment cycles with planned intervals of payments.

Commissioners also questioned to what extent businesses would hold bills in order to use them as forms of tax credit. GOMB Staff explained that a company can legally reduce its estimated payments and run the risk of incurring a penalty rather than essentially giving the State a loan. However, a business is not permitted to apply the amount it is owed by the State to its tax liability.

Commissioners concluded their discussion by asking GOMB to produce documents to present to the Commission in the future. These documents include: unpaid bills at the Comptroller's Office, the number of invoices that agencies are withholding from submission to the Comptroller's Office, various spending pressures influencing payment of the backlog of bills, and whether other agencies are holding vouchers before submitting them to the Comptroller.

B. Medicaid Spending – Michael Moss, GOMB

This presentation provided a historical overview of federal assistance provided to the State Medicaid Program. In the last few years, Illinois received assistance under the federal stimulus act. Illinois' Medicaid bills were traditionally matched by the federal government at 50%, but under the American Reinvestment and Redistribution Act (ARRA), Illinois only had to pay approximately 40%, and the federal government covered the other 60% of costs. The enhanced match under ARRA saved Illinois a substantial amount of money. Illinois agencies (DHFS, DHS, and Aging) took advantage of the enhanced Medicaid match before it expired on July 1, 2011 by processing their vouchers as soon as possible. As a result, Illinois ended FY 2012 with a minimal number of unprocessed Medicaid vouchers.

Due to the expiration of the federal stimulus act, the State Medicaid system had to confront severe underfunding in FY 2012. The amount of underfunding totaled nearly \$2 billion. As a result, Illinois has \$2 billion less in resources to operate a \$10 billion Medicaid Program that continues to grow each year. During Veto Session (October and November 2011), the General Assembly provided some assistance to the Medicaid Program through a reallocation package (SB 2412 and SB 1311) that transferred \$300 million from GRF to produce a 50% Medicaid match from the Hospital Provider Relief Fund, and thus, to pay down the State's Medicaid bills by \$600 million. Currently, Illinois has approximately \$1.7 billion in unpaid Medicaid bills. Experts anticipate

that the relief provided under the reallocation package will reduce those unpaid bills down to \$1.1 billion by the end of FY 2012. The reallocation package transferred existing money from other programs into Medicaid.

Even with help from the reallocation package, Illinois faces a massive lack of funding for its Medicaid Program. A large pressure in the FY 2013 budget consists of the need to pay for the underfunding of Medicaid. As a result, the State will need to increase funding to support the Program, reduce the costs of the Program, or adopt a combination of the two options. If Medicaid (hypothetically) experiences no growth, then the State would need to appropriate an additional \$2 billion more than the current appropriation due to this year's funding shortfall. Since the Medicaid Program continues to grow, Illinois would need to add an additional \$2 billion in appropriations to the existing cost of the Program (\$10 billion), plus medical inflation and growth. The \$2 billion is a gross number, including a federal match (\$1 billion) on state funds (\$1 billion). The \$1 billion federal match goes into GRF. Experts believe that Medicaid will grow less fast than previous years (which experienced between 6.5% and 7% growth), or below 6% of growth this year. This 6% of growth on a \$10 billion Program will result in \$600 million in new costs for Medicaid.

If the State Medicaid Program costs \$10 billion but was funded at \$8 billion in FY 2012 due to the lack of an enhanced match from ARRA (and assuming the Program's costs remain the same in FY 2013), then the State will need to add \$2 billion to the Medicaid appropriation. Hence, at a minimum (without the 6% increase), next year's Medicaid costs will include the \$1.1 billion in unpaid bills plus the \$2 billion deficit and the \$10 billion cost of operating the Program, or a combined total of \$13 billion.

Discussion:

Commissioners requested documents from GOMB related to the \$2 billion (state and federal matches) in Medicaid funding and a breakdown of bills owed to providers (see below). GOMB explained that the unpaid Medicaid bills owed to providers now will be held by DHFS for less than 120 days because of the reallocation package (which injected \$600 million into the Program). Commissioners also questioned the typical length of time for the State to pay its Medicaid bills. The Medicaid payment cycle varied considerably over the years. When Governor Edgar took office, the cycle was approximately 120 days, and when Governor Edgar left, the cycle was around 15 days. When Governor Ryan took office, the payment cycle ranged from 5 to 60 days, and when Governor Ryan left office, the cycle rested at about 80 days. A 30-day Medicaid payment cycle remains an ideal goal, but it rarely has been achieved.

Commissioners further discussed how Illinois could reach a 30-day payment cycle for Medicaid. Illinois could appropriate additional money (\$4 billion) to the Medicaid Program in order to reach a 30-day payment cycle, or it could make the Medicaid Program less costly to operate. If Illinois cut the Program, the payment cycle would be smaller and the Program costs would decrease. If Illinois appropriated an additional \$3.7 billion to Medicaid (on top of the Program costs of \$10 billion), then all of the outstanding bills would be paid and \$13.7 billion would fund Medicaid with growth included. The \$13.7 billion comes from the \$2 billion in underfunding, \$1.1 billion in unpaid bills, 60% of program growth (\$600 million), and \$10 billion annual operating cost.

C. Pension Liabilities – Hans Zigmund, GOMB

This presentation sought to accomplish two goals: (1) to explain the change in the current year contribution; and (2) to dispel myths about why Illinois faces a pension crisis. The projected increase in next year's pension payment increased because SURS and SERS reduced their expected rates of return (ROR) on their pension assets. The RORs are probably still too high for SURS (6.1%) and SERS (6.45%) given historical rates of return, but it is a move in the right direction. The pension funds could lower their RORs by using the risk

adjustment ROR through a treasury bond. However, there is no consensus on what a ROR for a pension fund should be, and the systems should remain sensitive about how further reducing the ROR would negatively affect the State budget. Figuring out how to properly lower the RORs will take time.

Pension payments are statutorily mandated. In 1996, the General Assembly passed a law designed to gradually increase the State's contributions to a 90% funding target by 2045. Actuaries calculate normal cost and projected earnings and liabilities in order to find the amount of funding required to hit their funding targets. Although Illinois has paid normal cost for the last two years and has passed prospective pension reform, the State faces massive issues in making its pension payments because its pension contributions, as well as debt service on its pension bonds, will increase every year and the State will experience difficulty in absorbing them. In FY 2010, the systems recorded a combined total of \$57.3 billion of unfunded pension liability.

The "urban myth" about pension reform consists of the belief that the General Assembly shirked its responsibility by underfunding pensions for the past few decades. However, \$11.9 billion of the \$52.7 billion of unfunded liability results from asset returns below the expected RORs.

Discussion:

The discussion began with Commissioners inquiring how much of the unfunded pension liability belongs to each of the 5 pension systems (SERS, SURS, TRS, Judges, and General Assembly funds). TRS carries the largest chunk of unfunded liability with \$14.4 billion in unpaid normal costs. However, all funds did not have a lower actuarial assumption until recently. TRS was 8.5%, SURS and SERS were 8.75% until 2010, and Judges and the GA systems went from 8% to 7%. The debt service on the pension obligation bond increases every year. By 2032, the bond will double from its 2010 amount to reach a total of \$1.159 billion. The debt service on the bond was calculated so that remaining payment plus the bond was the same number as the debt without the pension obligation bond.

Commissioners then asked why the goal for funding the systems was set at 90% in the 1996 law. The funding rate was set at 90% because if it was set under 90%, then the rating agencies would take issue with the State. Currently, SERS is only 35% funded, TRS 46% funded, and SURS 44% funded. If Illinois were to reduce the funding goal from 90% to 80%, then the State would leave more money at the actuarially assumed ROR, which would produce a higher number than what the State owes. As a result, reducing the funding goal from 90% to a lesser percentage does not make sense. A Commissioner asked if retirees are being paid today. Yes, even if Illinois paid nothing into the pension funds, the systems' assets would allow Illinois to make payments to beneficiaries through 2018. This year's pension payments consisted of \$5.5 billion in State contributions and \$8 billion in payouts to beneficiaries.

Two other questions arose about the employee costs of participating in a pension plan and the RORs on pension investments. Commissioners first inquired about the total normal costs for pensions, especially what the employee contributes and what percentage of the annual growing cost is paid by employees. Actuaries use a pension obligation approach to determine normal cost. Normal cost can differ, depending on what approach the system uses to calculate it. Employees are paying into SERS at lower costs than they were paying 20 years ago. The portion of the total annual increase in total cost has changed in the past 20 years, and the employee share has remained virtually stagnant. However, the total cost has grown substantially over the past 20 years.

Secondly, Commissioners questioned whether a 6% ROR compares favorably to other states or whether Illinois cannot properly manage its investments. GOMB explained that the asset performance of TRS has outperformed expectations over the last 30 years. TRS' most recent asset return was 23.4%. However, the problem was that

in the past, the rate did not perform consistently (for instance, 22% one year, 12% another year, and -22% another year). TRS only makes money by taking risks with its investments; as a result, risks translate into inconsistent returns on investment.

The State's overly optimistic anticipated returns on investment are not uncommon; however, the State uncommonly underfunded its pension systems for several years. Illinois has put less money into its pensions systems than it needed to put into its pensions systems. Even with the 1996 roadmap to 90% funding, the funding ratio proves detrimental because the unfunded liability is massive. If Illinois made its full contribution in FY 2013, it would need \$9 billion (not including the debt service on POBs). Contrarily, if Illinois paid what actuaries have determined that it needs to pay, then Illinois would pay \$9 billion plus the cost of POBs. Illinois paid \$4 billion plus POBs in FY 2012. The GRF cost of pensions is \$4.2 billion, and the total cost of pensions is \$4.8 or \$4.9 billion. Employer contributions total \$4.5 billion. Despite these costs, the pension fund ran a surplus in FY 2012.

Commissioners concluded their discussion by inquiring about the real number of beneficiaries in the pension systems. GOMB and the Governor's Office confirmed that the number of beneficiaries seems to grow. The source of actual loss has changed because retirees are living longer and more individuals are reaching retirement age. Commissioners followed with a question about the pension payments made by retirees.

For the next BFR Commission meeting, Commissioners requested that COGFA give a presentation explaining the impact of the pension obligation bonds and why the State decided to take on \$13 million in debt in FY 2003. Additionally, Commissioners requested a presentation by someone from a pension fund (such as TRS) to talk about their fund's historic performance. Governor's Staff will collect feedback from the Commission in order to prepare the next presentation on pensions. Commissioners indicated that they want the presentation to address: unfunded liabilities (and the impact of borrowing and pension holidays on those unfunded liabilities), assets that are not performing, and the impact of COLAs on unfunded liabilities.

IV. Closing

Commissioners decided to hold a few meetings in January in order to make progress on BFR before Spring Session starts in February. The BFR Commission recommended that the State develop a plan to fund Medicaid in its November 2011 report (Recommendation 7), and the Commission can work on that plan if it chooses. Additionally, the Commission can develop a plan to tackle the State's unfunded liabilities. Three basic approaches exist to deal with the State's unfunded liabilities: (1) debt restructuring; (2) paying off liabilities over time; and (3) living with the backlog of unpaid bills. The Commission can always recommend that the third option, living with the backlog of unpaid bills, cannot be acceptable. The two January meetings will focus on spending pressures and anticipated revenues, respectively. Some Commissioners would like the BFR Commission to focus on government transparency and consistency in processing unpaid bills.

BFR meetings will occur on the third Fridays of every month (except for May) from 1-3 PM in Room 16-145 of the James R. Thompson Center and Room 205 of the State Capitol. Two of the Commission's recommendations have been implemented in the FY 2013 budget process: (1) examining/reviewing statutory transfers; and (2) developing a separate outcome for health care. The Governor's Office is working with GOMB to make sure that everyone explains BFR in a consistent manner and will have a Communications Plan available at the next BFR meeting.

V. Adjournment

The meeting ended at 4:05 PM.

VI. Documents that Commissioners would like a few weeks before the next BFR Commission meeting (January 27th):

- An “apples to apples” comparison of the amount of bills unpaid at this time last year (December 2010): GOMB explained that the report containing the data identified in the “Payables in the Comptroller’s Office” handout was not produced by the Comptroller’s Office last year. As a result, it would be difficult for GOMB to produce an “apples to apples” comparison because they do not have the same categories of data as the Comptroller’s Office for 2010. Commissioners believe that an “apples to apples” comparison would prove beneficial because it would allow them to better advocate for a policy solution to solve the problem of unfunded liabilities. GOMB agreed to produce a general document comparing the amount of bills unpaid at this time last year with the amount of unpaid bills during December 2011.
- Amounts of bills held at agencies in FY 2011 and FY 2012: GOMB already possesses a document with this information for FY 2012. However, some differences exist between this year and FY 2011. For instance, the Department on Aging sent bills to the Comptroller and ran out of its appropriation in FY 2011. This example demonstrates why agencies (such as DHFS) hold their bills for a period of time before sending them to the Comptroller’s Office. If an agency submits more bills than it has an appropriation to pay for during the Fiscal Year, then it costs the State more money to pay for those bills over a longer period of time. Agencies can only send bills to the Comptroller for amounts up to their appropriated amounts in the annual budget; otherwise, agencies will run out of their appropriations.
- Breakdown of the \$2 billion state and federal matches in Medicaid: Commissioners requested this document from GOMB. GOMB agreed to produce a document breaking down the \$1 billion federal Medicaid match, as Commissioners would like to know whether the match benefits the State. GOMB reminded Commissioners that due to the nature of matching, when revenues increase or decrease, then the match increases or decreases accordingly.
- Breakdown of bills owed to providers: Commissioners would like a document detailing bills owed to vendors
- Breakdown of the \$33.2 billion budget from a revenue standpoint: Commissioners also requested a breakdown of the \$33.2 billion in the Senate Joint Resolution for the budget. For instance, 14.8% of that budget consists of federal receipts for Medicaid. The Commission would like to learn how those receipts breakdown from a revenue standpoint.
- Breakdown of unfunded liability by all pension funds: Commissioners asked GOMB for a document breaking down all unfunded liability by pension funds.
- COLA affects on the cost of unfunded liability for pension funds: Commissioners requested an analysis of the cost of the State’s unfunded pension liability due to guaranteed COLAs. It was determined that GOMB cannot calculate the affects of COLAs on unfunded liability for TRS because schools have different rates.

- Employee contributions on pension plans: Commissioners would like to have a document displaying employee contributions in pension plans so that they can determine the employee's cost of participating in a pension program. A noted exception to this comparison is SURS, which has an optional defined contribution plan.