Welcome

Fay Lomax Cook
Director, Institute for Policy Research
Professor of Human Development
and Social Policy
Introductions

Therese McGuire
Faculty Fellow, Institute for Policy Research
ConAgra Foods Research Professor of Strategic Management,
Kellogg School of Management
speakers

“K-12 Education and States’ Shifting Responsibilities” by Therese McGuire

“Medicaid, State Budgets, and the Challenges of Fiscal Federalism” by David Merriman

“The Impact of Pension Funding Demands on State Budgets” by J. Fred Giertz

Closing Remarks by R. Eden Martin
K-12 Education and States’ Shifting Responsibilities

*Therese McGuire*
Institute for Policy Research
Kellogg School of Management
Northwestern University

Prepared for State Budgets or Busts? The Challenges of Funding Medicaid, Pensions and K-12 Education
Institute for Policy Research, Northwestern University
June 6, 2007
The state responsibility for financing K-12 education will continue to grow and change

- Spending trends
- Demographic trends
- School finance litigation
- Implications for state budgets and education finance reform
  - Spotlight on Illinois
Questions Facing Policy Makers

**Quality: How to improve student outcomes?**

- In the last 30-40 years, a dramatic slowdown, even decline, in performance.
- U.S. school children are falling behind in international rankings.
- Extraordinarily poor performance in large inner-city schools.
- Policy response: *Increase* spending?

**Equity: How much variance to allow?**

- Reliance on local property taxes results in disparities across districts.
- Numerous state supreme court cases have declared state systems unconstitutional.
- Perhaps the most compelling argument for government involvement in the provision of education is to provide all children with an “equal opportunity” to succeed.
- Policy response: *Centralize* spending?
Spending Trends

Per Capita Expenditure and Income

From 1971 to 2003:
Per pupil spending grew 109%
Per capita income grew 92%
Sources of School Funding

Funding Sources, 1970

- Local: 53%
- State: 39%
- Federal: 8%

Funding Sources, 2003

- Local: 43%
- State: 48%
- Federal: 9%
State Budget Shares

State Expenditures by Type, 1988

State Expenditures by Type, 2005
Percent of Population in Various Age Groups
School Age Population by Race/Ethnicity

Percent of School Age Population by Race/Ethnicity

- 1980
- 2005
- 2010

Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Hispanic</th>
<th>White</th>
<th>Black</th>
<th>Asian</th>
<th>Other</th>
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<tr>
<td>1980</td>
<td>0%</td>
<td>75%</td>
<td>15%</td>
<td>10%</td>
<td>0%</td>
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<tr>
<td>2005</td>
<td>10%</td>
<td>60%</td>
<td>30%</td>
<td>5%</td>
<td>5%</td>
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<tr>
<td>2010</td>
<td>15%</td>
<td>55%</td>
<td>30%</td>
<td>10%</td>
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## School Finance Litigation

<table>
<thead>
<tr>
<th>State</th>
<th>Year</th>
<th>State</th>
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<tr>
<td>Arkansas</td>
<td>1985, 1986</td>
<td>Louisiana</td>
<td>1998</td>
</tr>
<tr>
<td>Kentucky</td>
<td>1989</td>
<td>Nebraska</td>
<td>1993</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>1993</td>
<td>North Dakota</td>
<td>1993</td>
</tr>
<tr>
<td>Ohio</td>
<td>1997</td>
<td>Plaintiffs lost, Case open</td>
<td></td>
</tr>
<tr>
<td>Vermont</td>
<td>1987</td>
<td>Florida</td>
<td>1996Filed 1999</td>
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<tr>
<td></td>
<td></td>
<td>Minnesota</td>
<td>1993 Filed 1995, 1999 Filed 1996</td>
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Key Lessons

States can’t afford to do much.
- Medicaid is squeezing state budgets and it will only do so more in the future.
- States have already taken over much of the responsibility for financing education from local governments.

States can afford to target resources to those districts most in need.
- Across the country there has been a shift in court cases from equity to adequacy.
- Foundation aid programs can be designed to target state resources to
  - Those districts that would have difficulty financing an adequate education from their own resources and
  - Those districts whose students require additional resources in the classroom.
Lessons for Illinois

What is **right** about Illinois’ system of funding schools?

- Illinois’ state aid program reduces disparities in spending across districts, and it does so by bringing the bottom up.
- Illinois school districts have access to the local property tax if they want to increase spending.
- Illinois’ state aid program recognizes that school districts with higher concentrations of poor students need more resources per pupil.

What is **wrong** about Illinois’ system of funding schools?

- The local property tax has been so constrained and restricted by the state that it no longer functions properly.
- The foundation level is not fully funded.
Medicaid, State Budgets, and the Challenges of Fiscal Federalism

David Merriman
School of Business Administration
Loyola University Chicago

Prepared for State Budgets or Busts? The Challenges of Funding Medicaid, Pensions and K-12 Education
Institute for Policy Research, Northwestern University
June 6, 2007
Main points

- Spending on health, in general, and Medicaid, in particular, is a large and growing government obligation.
- Despite the “new federalism” the federal government’s share of spending for social welfare in general and Medicaid, in particular, has risen.
- The share of Illinois’ spending devoted to Medicaid is below the national average and has not increased substantially in recent years.
- Formidable budgetary challenges loom because of the large and growing pressure from the federal gov’t to reduce Medicaid cost-shifting.
Government Spending on Health and Medicaid
Total Federal, and State and Local government spending on health as a share of GDP

Source: National Health Accounts
Federal and State and Local spending on Medicaid as a share of GDP

Source: National Health Accounts
Federal and state spending for social welfare and Medicaid
Total Federal, State, and Local Spending by Social Welfare Program

### Millions of Nominal Dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Medicaid</th>
<th>AFDC/TANF</th>
<th>Food Stamps</th>
<th>SSI</th>
<th>EITC</th>
<th>GA</th>
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</thead>
<tbody>
<tr>
<td>1980</td>
<td>25,781</td>
<td>13,019</td>
<td>9,576</td>
<td>8,435</td>
<td>2,033</td>
<td>1,386</td>
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<tr>
<td>1990</td>
<td>72,492</td>
<td>21,200</td>
<td>17,686</td>
<td>17,233</td>
<td>5,303</td>
<td>2,924</td>
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<tr>
<td>2000</td>
<td>207,195</td>
<td>14,490</td>
<td>20,341</td>
<td>35,066</td>
<td>25,800</td>
<td>2,649</td>
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<tr>
<td>2002</td>
<td>258,216</td>
<td>13,035</td>
<td>24,054</td>
<td>38,522</td>
<td>27,830</td>
<td>3,251</td>
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### Real 1983 Dollars Per Capita

<table>
<thead>
<tr>
<th>Year</th>
<th>Medicaid</th>
<th>AFDC/TANF</th>
<th>Food Stamps</th>
<th>SSI</th>
<th>EITC</th>
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<tr>
<td>1980</td>
<td>1374</td>
<td>694</td>
<td>510</td>
<td>450</td>
<td>108</td>
<td>74</td>
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<tr>
<td>1990</td>
<td>2217</td>
<td>648</td>
<td>541</td>
<td>527</td>
<td>162</td>
<td>89</td>
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<tr>
<td>2000</td>
<td>4276</td>
<td>299</td>
<td>420</td>
<td>724</td>
<td>532</td>
<td>55</td>
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<tr>
<td>2002</td>
<td>4973</td>
<td>251</td>
<td>463</td>
<td>742</td>
<td>536</td>
<td>63</td>
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Sources: Various issues of the Statistical Abstract of the United States, U.S. Department of Commerce, Bureau of the Census
### Allocation of State Spending Across Categories  
(Percent of Total)

#### Major Categories

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Welfare</th>
<th>Health &amp; Hospitals</th>
<th>Higher Education</th>
<th>Elementary and Secondary Education</th>
<th>Other</th>
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<tr>
<td>1980</td>
<td>19.4</td>
<td>7.8</td>
<td>12.3</td>
<td>21.8</td>
<td>38.7</td>
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<tr>
<td>1985</td>
<td>19.5</td>
<td>8.0</td>
<td>13.9</td>
<td>21.0</td>
<td>37.7</td>
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<tr>
<td>1990</td>
<td>20.7</td>
<td>8.4</td>
<td>13.2</td>
<td>20.7</td>
<td>37.1</td>
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<tr>
<td>1995</td>
<td>26.6</td>
<td>8.2</td>
<td>12.2</td>
<td>19.4</td>
<td>33.6</td>
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<tr>
<td>2000</td>
<td>24.8</td>
<td>7.8</td>
<td>12.5</td>
<td>21.0</td>
<td>34.0</td>
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<tr>
<td>2003</td>
<td>26.9</td>
<td>7.6</td>
<td>12.5</td>
<td>20.3</td>
<td>32.7</td>
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</table>

Note: The other category includes spending on highways, police protection, corrections, natural resources, parks and recreation, and government administration.
### Allocation of state spending (continued)

<table>
<thead>
<tr>
<th>Year</th>
<th>Medical Vendor Payments</th>
<th>Cash Assistance</th>
<th>Other Public Welfare</th>
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<tr>
<td>1980</td>
<td>8.3</td>
<td>3.3</td>
<td>7.8</td>
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<td>1985</td>
<td>9.3</td>
<td>2.8</td>
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<tr>
<td>1995</td>
<td>16.4</td>
<td>2.1</td>
<td>8.1</td>
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<tr>
<td>2000</td>
<td>15.9</td>
<td>1.2</td>
<td>7.7</td>
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<tr>
<td>2003</td>
<td>18.1</td>
<td>1.0</td>
<td>7.8</td>
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Source: U.S. Census of Governments
The share of Illinois spending devoted to Medicaid is below the national average and has not changed much in recent years.
Shares of Medical Vendor Payments and Public Welfare in Illinois’ General Expenditures

Source: U.S. Census of Governments
Large and growing pressure by the federal government to reduce Medicaid cost-shifting presents a fiscal challenge.
Momentum for devolution

• Perceived success of the 1996 welfare reforms

• Perceived cost-shifting abuses
1996 welfare reform debate was a fierce battle in a very long war over the role of the federal government in social assistance policy.

Welfare reform changed cash assistance system from a federal matching grant (like Medicaid) to a block grant. Making Medicaid a block grant also was widely discussed but was narrowly avoided.

Opponents of welfare reform predicted a “race to the bottom” and disaster, but this did not happen.
Perceived cost-shifting abuses

- **History**
  - Early and mid-1990s Medicaid expansions and cost shifting

- **Current mechanisms for cost shifting**
  - Contingency-fee consultants
  - Intergovernmental Transfers (IGT) and Upper Payment Limits (UPL)
  - Provider assessments
Illustration of IGT and UPL

In FY2004, Cook County transferred $827 million in health care participation fees to the state's County Provider Trust Fund.

Because the UPL allows Illinois to reimburse Cook County for Medicaid services at the higher rates Medicare would have paid, Illinois reported Medicaid expenditures of approximately $1.872 billion to the federal government.

This generated a 50 percent federal match of $936 million.

The federal match of $936 million was added to the $827 million Cook County already transferred to the state; the total deposit in the County Provider Trust Fund grew to $1.763 billion, which was paid to Cook County providers.

The county then transferred just over $400 million to the state, which was credited to the GRF.

Source: Heather O'Donnell and Ralph Martire (9/06) Center for Tax and Budget Accountability.
FOR IMMEDIATE RELEASE
November 21, 2006

Gov. Blagojevich’s $1.8 billion plan to help Illinois hospitals wins federal approval
Illinois Department of Healthcare and Family Services wins federal approval for Hospital Assessment Plan

CHICAGO - Gov. Rod Blagojevich today learned that the Federal Centers for Medicare and Medicaid Services (CMS) has approved his plan for securing $1.8 billion in new federal funding to strengthen Illinois’ health care system over three years. The state’s Hospital Assessment plan will help Illinois hospitals continue to recruit and retain doctors, provide advanced medical care, and serve Illinois’ most vulnerable patients.

“This is a great day for health care in Illinois. We’ve been on a mission to make sure that everyone in Illinois can get the health care they need, and nearly $2 billion in new federal funds for hospitals will help us get there,” said Gov. Blagojevich. “I want to thank HHS Secretary Michael Leavitt, House Speaker Dennis Hastert, Senator Jeff Schoenberg, Rep. Barbara Flynn Currie, and all the members of the coalition that fought for this assessment, including the Illinois legislature, the Department of Healthcare and Family Services and the Illinois Hospitals Association.”
Conclusion

- Spending on health care will inevitably involve public policy and public budgets.
- Recent trend has been for the federal gov’t to shoulder an increasing share of the social welfare burden.
- Illinois’ Medicaid obligations are large but they are not unusual nor are they growing faster than the national average.
- Fiscal challenges lay ahead as the political landscape changes.
These successful Medicaid financing programs may be vulnerable to federal budget cost cutting pressures. The Medicare, Medicaid, and SCHIP Benefits Improvement and Protection Act of 2000 attempted to tighten limits on these payments.

Federal rules were promulgated to reduce the upper payment limit (UPL) applicable to non-state owned hospitals. Fortunately, a special provision protected Cook County’s longstanding IGT arrangement with the state.

Pressure to reduce Medicaid reimbursements to the states is likely to be revisited during the current year. The president’s fiscal year 2006 budget proposals include significant federal savings from new limits on Medicaid reimbursements both for IGTs and for provider taxes and assessments.

Fiscal Focus, May 2005
4 Percent of Medicaid Population Accounted for 48% of Expenditures in 2001

Enrollees
Total = 46.9 million

Expenditures
Total = $180.0 billion

> $25,000 in Costs
- Children (.2%)
- Adults (.1%)
- Disabled (1.6%)
- Elderly (1.8%)

<$25,000 in Costs
- Children 3%
- Adults 1%
- Disabled 25%
- Elderly 20%

SOURCE: Urban Institute estimates based on MSIS 2001 data.

Source: Robin Rudowitz, Kaiser Commission on Medicaid and the Uninsured
Figure 2

Medicaid Enrollees and Expenditures by Enrollment Group, 2003

Elderly 11%  
Disabled 14%  
Adults 26%  
Children 49%  

Elderly 28%  
Disabled 42%  
Adults 12%  
Children 18%  

Enrollees  
Total = 55 million

Expenditures on benefits  
Total = $234 billion


Source: Robin Rudowitz, Kaiser Commission on Medicaid and the Uninsured
Deferred Medicaid Liabilities Under Section 25

Not all Medicaid claims are paid for in the fiscal year in which they are incurred. Section 25 of the State Finance Act provides that expenditures for liabilities incurred within a given fiscal year be paid from that same year’s appropriation, but exceptions are made for liabilities such as Medicaid, state employee and retiree health insurance and certain spending from the Department of Public Health.

Payments made under these exceptions to Section 25 are similar to normal lapse period spending (the sixty days following the end of the state’s fiscal year) in that both types of payments are for liabilities incurred before the end of the fiscal year, but paid after June 30th. However, on a cash basis, normal lapse period spending is charged to an appropriation from the fiscal year in which the liability arose, but payments made for items covered by the exceptions to Section 25 are made from a subsequent year’s appropriation (and, therefore, are not included in lapse period spending).

For the past several years, significant amounts of Medicaid liabilities have been carried over into the next fiscal year. Deferred Medicaid liabilities more than tripled growing from $560 million in fiscal year 1997 to just over $1.7 billion in fiscal year 2003. In fiscal year 2004 Medicaid deferred liabilities decreased to $1.2 billion, but that followed short-term borrowing of $850 million in June 2004 to pay Medicaid bills that otherwise would have carried over into fiscal year 2005.

The Impact of Pension Funding Demands on State Budgets

J. Fred Giertz
Institute of Government and Public Affairs
University of Illinois at Urbana-Champaign

Prepared for State Budgets or Busts? The Challenges of Funding Medicaid, Pensions and K-12 Education
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Basic Points

- Underfunding of state pensions is widespread
  - Illinois is notable in this regard
  - History of underfunding
- Underfunding is the result of cyclical factors, but more often the lack of state effort
- Defined benefit and defined contribution issues
  - Moral hazard and underfunding
    - Illinois example
  - Risk transfer between employer and employee
Funding Levels—National

Funding Levels

<table>
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<tbody>
<tr>
<td>Level</td>
<td>80%</td>
<td>90%</td>
<td>90%</td>
<td>110%</td>
<td>100%</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
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</table>

Funding Levels (%)
National Underfunding Levels

Underfunding

Billions

Underfunding

National Underfunding Levels
## Comparative Magnitude of Underfunding Problems

<table>
<thead>
<tr>
<th></th>
<th>Unfunded Liability (billions)</th>
<th>Percentage of GDP</th>
<th>Percentage of Tax Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private</td>
<td>141</td>
<td>1.1%</td>
<td></td>
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<tr>
<td>State</td>
<td>284</td>
<td>2.1%</td>
<td>43.8%</td>
</tr>
<tr>
<td>Federal</td>
<td>65,900</td>
<td>497.6%</td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td>40.7</td>
<td>7.3%</td>
<td>154.2%</td>
</tr>
</tbody>
</table>
Additional Points

- Investment returns on pension assets constitute a large and often overlooked portion of state “revenues”
- These returns are volatile and are correlated with changes in tax revenues
- This short term volatility does not appear to create major problems over the long run—at least in the last 15 years
Investment Returns and Pension Funding

Sources of Funds for State Pension Systems

- Employee
- Employer
- Investment

3.3 times employer
5.8 time employee
Investment Returns and State Taxes

Change in Pension Assets
Compared to State Tax Revenues

- 23% of total
- 69% of income taxes

Billions

(100)


Change in Assets
Total Taxes
Income Taxes
Investment Returns and State Taxes (percentage terms)
Returns over Time

Public Pension Systems Returns

-10%  -5%   0%   5%   10%   15%   20%

-10% -9% -8% -7% -6% -5% -4% -3% -2% -1%  0%  1%  2%  3%  4%  5%  6%  7%  8%  9%  10%
Meeting Expectations

Actual vs. Assumed Returns
100 in 1989

Actual
8 Percent
8.5 Percent

Actual vs. Assumed Returns
100 in 1989
Illinois Pension Issues

“To alcohol: the cause of, and solution to, all of life’s problems.”
--Homer Simpson

- Pensions have come to be seen as both the cause of and solution to the state’s fiscal problems
- Pensions have been used as a means for the state to avoid hard choices:
  - Implicit borrowing without the usual constraints
  - Expanded benefits have been used in lieu of regular pay increases
  - Pension underfunding has allowed the state to spend more on other programs
- If the state had made reasonable contributions in the past, there would be no problem today
- General state budget problem, not just a “pension problem”
Brief Review of Pension Funding in Illinois

- Pre-1995—Chronic, planned underfunding of pensions
- 1995-2003—Plan to address underfunding over a period of 50 years—Pain back-loaded
- 2003-2005—Pension borrowing within the framework of 1995 plan
- 2005-2007—Pension “reform” and restructuring of payment schedule—Pain again back-loaded
- Future—Large scheduled contribution increases
- Reporting of post retirement health care obligations
New and Old Illinois Pension Funding Requirements

Fiscal Year

Billions

Old-1995  New--2003 & 2005

New and Old Illinois Pension Funding Requirements
Scheduled State Increases in Pension Contributions

![Bar chart showing yearly and cumulative increases in pension contributions from FY2007 to FY2011.]

- **Fiscal Year**
  - 07
  - 08
  - 09
  - 10
  - 11

- **Millions**
  - 0
  - 500
  - 1,000
  - 1,500
  - 2,000
  - 2,500
  - 3,000

- **Yearly Increase**
- **Cumulative increase from FY2007**

Legend:
- Red: Yearly Increase
- Green: Cumulative increase from FY2007
Conclusion

- Pension funding remains a problem, but a manageable one (even in Illinois)
- The problem is a matter of will not capacity
- Tendency to systematic underfunding endemic to defined benefit plans
- Defined contribution plans solve some problems, but at a cost
For more information, please visit our Web site:

http://www.northwestern.edu/ipr