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How to Win Illinois' Battle of the Budget

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Some predictions

In January 1995, Illinois' Bureau of the Budget is expected to announce that revenues for the current fiscal year will fall approximately 3 percent short of spending, producing a "budget gap" of between $1 and $1.5 billion. Shortly after this announcement, the Chicago Public Schools will probably release a "preliminary estimate" of its own impending budget deficit and ask the state for a $300 to $500 million bail-out. Adding to the sense of urgency will be a scramble to find several hundred million dollars to fund a "truth in sentencing" policy, which has been endorsed by one leading candidate for Governor and probably will be endorsed soon by the other.

> In early 1995, common wisdom in Illinois will hold that a permanent income tax increase is necessary to close the budget gap, adequately fund schools, and make our streets safe.

The common wisdom will be that a permanent income tax increase is necessary to close the budget gap, adequately fund the schools, and make our streets safe again. The state's most powerful special interest groups — the teachers unions, public employee unions, and welfare lobby — will wage a well-financed campaign for higher taxes. The *Chicago Tribune* and *Chicago Sun-Times* will editorialize repeatedly for higher income taxes. Opinion polls will show that approximately half of Illinois voters would support higher taxes, provided the money was used to improve schools or fight crime.

How do we know these things will happen next year? One hardly needs a crystal ball to make these predictions. The same pattern has been played over and over again in recent years. Among state legislators, the looming "budget gap" and Chicago Public Schools "crisis" are common knowledge. The pro-tax-hike interest groups already have formed a coalition — called "Progress Illinois" — and have assembled a war chest for next year. Only Illinois taxpayers seem unaware of the battle about to begin.

The last time Illinois faced such a budget crisis, in 1991-1992, Governor Jim Edgar chose to cut appropriations by $273 million rather than support an income tax increase. Special interest groups were outraged and attempted to increase taxes through a constitutional amendment placed on the ballot in 1992. Voters defeated this effort.

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We believe that the average Illinois voter, if given the choice, would prefer that state spending be trimmed by a very modest 3 percent rather than see a permanent tax increase. Having studied Illinois' business climate and state budget, we are confident that state government can live within its means, without a tax hike.

This will not be easy, of course. Special interest group leaders must be reminded that they are part of the larger public, and that lobbying for their own narrow interest is really hurting the state. And elected officials must be told that they should concentrate on fulfilling old promises, rather than making new ones. The state should solve its mounting debt problem before taking on new commitments. Communicating these messages is the fundamental purpose of this report.

Organization of this report

In Part 1, we review the changes in Illinois' tax burden, economic growth, and state spending in recent years. While Governor Edgar attempted to slow the growth of spending by squeezing out waste and mismanagement, we find that his efforts were overwhelmed by growth in spending on major entitlement programs. Consequently, the first three Edgar years witnessed a pattern of spending increases more rapid than occurred during the Thompson years. This rapid increase in spending was financed from natural revenue growth and the accumulation of debt, rather than by general tax increases.

In Part 2, we project state revenues and expenditures to 1998. We ask whether natural revenue growth during the next four years will be sufficient to produce a balanced budget each year, and what assumptions or changes must be made regarding state spending to achieve that goal during these years. We conclude that natural revenue growth indeed will be sufficient to offset expected increases in state spending, but only if action is taken to control spending in at least three key areas: public aid, social services, and administrative services.

In Part 3, we examine the likely effects of tax increases on job creation, economic growth, and public education. We find strong academic agreement that high and rising taxes would mean fewer new jobs and slower rates of growth in personal income. We also evaluate the case for shifting a larger share of the state's tax burden to state income taxpayers, or creating a graduated income tax structure. We find a very weak and one-sided "equity" case for increasing reliance on income taxes or making income tax rates graduated. In fact, we find that graduated-rate income taxes are *more destructive* of jobs and economic growth than are flat-rate income taxes or other kinds of taxes.

Part 4 examines potential budget savings. We outline reform proposals that would control spending without compromising the quality of public services. While the level of spending restraint we propose will require a bold approach to curbing the state's entitlement programs, we find precedents in other states for the recommendations we make. Achieving this degree of spending restraint would enable a Governor to give back some $1.6 billion to taxpayers in 1995, and nearly $11 billion in 1998. The Governor might do this by financing a state education voucher program, reducing or rescinding the four tax hikes approved during the past three years, and/or increasing the income tax deduction for dependents.

> We find that a candidate for Governor can keep a "no tax increases" pledge for the length of the term provided he or she is willing to confront the three major spending departments.

Part 5 briefly summarizes the findings of the study. We find that a candidate for Governor can keep a "no tax increases" pledge for the length of the term provided he or she is willing to confront the three major spending departments. Since the types of policies we propose to contain spending in these areas already have been adopted in other states, the candidate need not call for "radical" or untried policy changes.

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PART 1

The Edgar Years

The State of Illinois has not seen an increase in its general sales tax, personal income tax, or corporate income tax rates since 1989, when the personal income tax rate was "temporarily" increased from 2.5 percent to 3.0 percent, and the corporate income tax rate was raised from 6.9 percent to 7.3 percent.[1] This record of relative stability in tax rates is a dramatic departure from the 1970s and 1980s, when taxes were increased at rates unprecedented in Illinois history and markedly more rapid than in other states.

Most objective observers agree that Edgar, upon taking office in 1991, inherited a bloated state bureaucracy unaccustomed to making tough decisions or reining in spending. Much to his credit, the Governor gained legislative approval for real spending cuts or freezes in most departments of state government.

Without major tax increases, Governor Jim Edgar has had to keep the rate of state spending from increasing faster than natural revenue growth. This has not been an easy task. Most objective observers agree that Edgar, upon taking office in 1991, inherited a bloated state bureaucracy unaccustomed to making tough decisions or reining in spending. Much to his credit, the Governor gained legislative approval for real spending cuts or freezes in most departments of state government. In January 1992, when budget pressures were especially severe, the Governor rejected calls for higher taxes and proposed $350 million in cuts to current-year appropriations. The Legislature approved $273 million in cuts, and the need for a general tax hike was averted.

The Governor *has* approved four tax increases during his term: HB 2758, a $1.5 billion tax on nursing home operators; SB 1378, which raised income taxes by $50 million by eliminating part of the income tax deduction for homeowners; HB 2123, which raised motor vehicle registration and title taxes by $33 million; and SB 497, which imposed a 1 percent sales tax on some downtown Chicago services to finance expansion of McCormick Place. <1> His credentials as a fiscal conservative, therefore, are hardly impeccable. Still, the absence of a *general* tax hike is a noteworthy accomplishment.

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[1] Half the increase was made permanent in 1991, and the remainder was made permanent in 1993. Corporate income in Illinois is taxed at a total rate of 7.3 percent, which includes a 2.5 percent "corporate personal property replacement tax" adopted in 1979.

While most of the state's businesses and taxpayers undoubtedly appreciate the new fiscal restraint demonstrated by their state government, this new trend is deeply disturbing to the special interest groups that benefited from the upward spiral of state spending in the 1970s and 1980s. These groups, financed primarily by organized labor and tax dollars, have pressed steadily for more spending and higher state taxes.

In 1990, many of these groups came together in the "EdEquity Coalition," which sued the Governor, State Board of Education, and State Superintendent of Schools to increase state funding of education. The suit was dismissed by the Circuit Court of Cook County. The coalition came back in 1992 with a proposed state constitutional amendment that would have forced state government to raise taxes by approximately $3 billion a year. The proposal was rejected by voters. Today, many of these same interest groups have returned, this time under the name "Progress Illinois," to propose another state constitutional amendment that would replace Illinois' flat-rate income tax with a graduated-rate ("progressive") tax.

These groups and others claim Illinois has no choice but to increase state taxes. They point to the state's delay in paying past-due bills and an underfunding of pension funds. They also focus on the state's share of education funding, which, as a percentage of total per-pupil spending, has fallen in recent years relative to local funding. Finally, as part of their most recent campaign to raise taxes, these groups now argue that a graduated-rate income tax would be more fair than the flat-rate income tax.

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How Illinois Compares

According to the advocates of higher taxes, current tax rates in Illinois are low compared to those in other states. This claim has been repeated so often in the popular press that it is now even supported by some people in the business community. <2> But an unbiased examination of the state's tax climate reveals that this perception is inaccurate.

Table 1
Illinois is an Average- to High-Tax State

	Effective Average Tax Rate (Rank)	State and Local Tax Burden (Rank)
Wisconsin	9	13
Michigan	10	12
Illinois	21	14
Indiana	39	41
Ohio	2	6
Missouri	38	37

Source: Tax Foundation, "Special Report," June 1994.

The prestigious Tax Foundation, based in Washington, DC, ranks Illinois' "effective average tax rate" in 1993 as 21st highest in the country when federal taxes are excluded. Illinois ranks 14th highest in "state and local tax burden," measured as dollars per taxpayer, excluding federal taxes. (See Table 1.) These are not the rankings of a low-tax state.

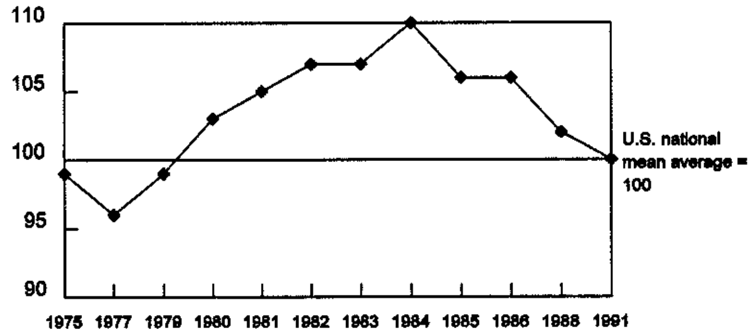
Illinois' tax burden is so poorly understood in part because Illinois relies more heavily on local property taxes than do most other states. (We'll discuss the pros and cons of this later.) Advocates of higher taxes focus only on the state's income tax rate, which is in fact lower than the national average (though per-capita income tax collections are roughly equal to the national average). Some observers also tend to exclude the 2.5 percent corporate personal property replacement tax when reporting the state's corporate income tax rate. When properly reported, Illinois' corporate income tax rate is significantly above the national average.

Plainly, focusing on state taxes alone produces an inaccurate picture of Illinois' true tax burden. When local tax collections are included, as is true of the Tax Foundation calculations, a more accurate picture of the state's relative tax burden emerges. Better still is a measurement called "tax effort," developed by the bipartisan Advisory Commission on Intergovernmental Relations (ACIR). Tax effort is the ratio of a state's actual tax revenues to its estimated capacity to raise tax revenues. Tax capacity, in turn, is calculated by determining how much revenue would be raised if the state had a statistically average tax code. The tax effort index is the difference between a state's actual per-capita tax collections and its per-capita tax capacity, expressed as a percent of the national average. A tax effort index of 107, for example, would be 7 percent greater than the national average; an index of 94 would be 6 percent less.

As Illustration No. 1 below shows, Illinois' tax effort rose from less than the national average in 1977 to as much as 10 percent above average in 1984, and then fell to a level equal to the national average by 1991 (the latest year for which figures are available. <3>) These figures suggest that Illinois was a high-tax state during the 1980s and has only recently returned to being an average-tax state.

Comparing Illinois' tax effort to the national *median* average, rather than the mean average, shows us to be solidly in the high-tax category. In 1991, only 12 states had a tax effort index higher than Illinois'.

Illustration No. 1
Illinois Tax Effort, 1975 - 1991



The Tax Foundation and ACIR data clearly demonstrate that *Illinois is not a low-tax state,* as advocates for higher taxes often claim. Illinois is either an average-tax or a high-tax state. The good news for taxpayers is that the state's relative tax burden has fallen relative to other states since the mid-1980s. Economist Robert Genetski explains, however, that Illinois' falling relative tax burden is largely the result of other states' behavior:

> The recent decline in Illinois' tax burden relative to other states seems to have little to do with Illinois controlling its budget and much to do with what other states were doing. Huge tax hikes in states such as New Jersey and Connecticut meant that the [national] average state tax burden rose substantially at the beginning of the 1990s. As a result, states that increased their taxes moderately (such as Illinois) registered a decline in their tax burdens relative to other states. <4>

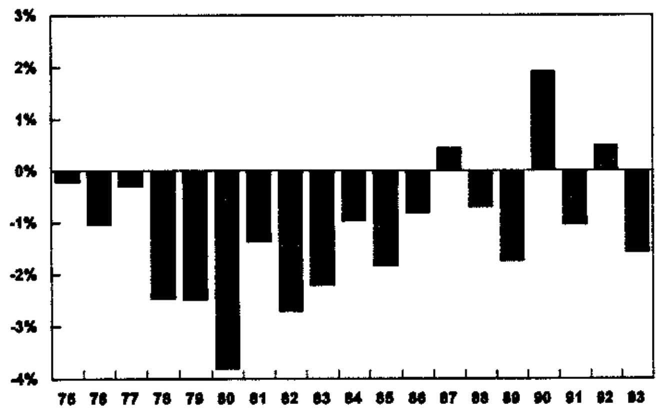
Genetski estimates that the state's All Funds budget has climbed from 10.6 percent of the state's personal income in 1984 to 13 percent in 1993, a considerable increase. <5> So quite aside from interstate comparisons showing Illinois' taxes to be high, Illinoisans can compare their tax burden today to what it was a decade ago and find ample cause for concern.

Economic Growth

Robert Genetski's analysis suggests that the rate of growth of total personal income in a state can form a benchmark against which growth in state spending can be measured. If state spending is growing faster than personal income, the state must be exacting a heavier toll on its citizens over time. While it is not intuitively obvious that state spending growth should never exceed growth in personal income, such a rule of thumb seems to have some political and popular support in Illinois.

Annual personal income growth (the change in the incomes reported by Illinoisans) and rate of employment growth (the change in the number of jobs in the state) offer two good measures of economic well-being in Illinois.

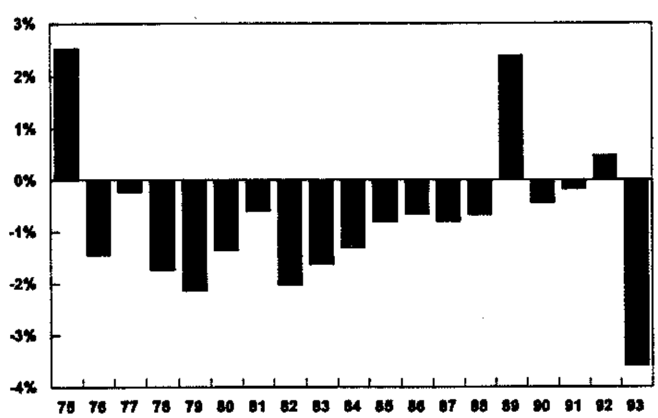
Illustration No. 2
Growth of Personal Income, Illinois and U.S.
1975 - 1993



According to the Department of Commerce and Community Affairs, total personal income in Illinois rose from $78.4 billion in 1975 to $264.2 billion in 1993 (the last year for which data are available). Past changes in personal income appear to be trendless, probably because national trends tend to overwhelm local factors.

One way to obtain a clearer picture is to view the difference between Illinois' growth and national annual growth. Illustration No. 2 shows the average annual rate of change in Illinois personal income minus the average annual rate of change in U.S. personal income from 1975 to 1993.

Illustration No. 3
Growth of Employment, Illinois and U.S.
1975 - 1993



The rate of employment growth in the state can be similarly analyzed. According to figures supplied by the Illinois Department of Employment Security, employment in Illinois grew from 4,418,900 in 1975 to 5,538,000 in 1993. Illustration No. 3 shows the average annual rate of change in Illinois employment minus the average annual rate of change in U.S. employment from 1975 to 1993.

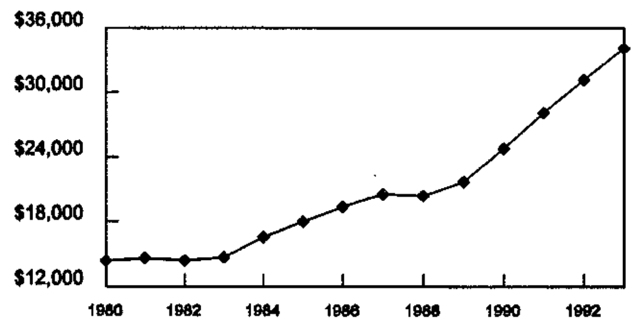
Personal income growth in Illinois lagged behind the national growth rate in all but two of the fourteen years of the administration of Governor James Thompson;

employment growth in Illinois lagged behind the national growth rate in all but one year. During the first three years of the Edgar Administration, little improvement in Illinois' economy is evident. This concerns us greatly, as it offers additional evidence that even the relatively minor tax hikes approved by Governor Edgar (and, as we shall see later, the state's increasing reliance on debt to address budget problems) are slowing the economy's recovery from the high tax burdens of the 1980s.

State Spending

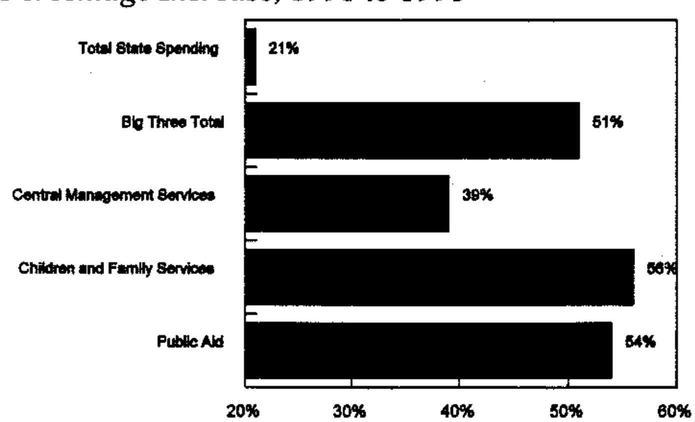
State spending in Illinois has increased 137 percent since 1980, averaging 7 percent per year. Since 1990, state spending has increased at the rate of almost 12 percent per year. Illustration No. 4 shows this growth, as reported by the Illinois Economic and Fiscal Commission in November 1993.

Illustration No. 4
Total State Expenditures
1980 - 1993, in millions



This record seems surprising at first, since the first three years of the Edgar Administration were characterized by talk of "spending cuts" and "belt-tightening," and indeed the Edgar budgets are filled with real cuts in scores of departmental and executive budgets. This stands in striking contrast to the Thompson era, characterized by major new spending initiatives, ambitious public investment programs, and very rarely reductions in more than a handful of department budgets. Why then did state spending tend to increase at a slower pace during Thompson's term than it has under Jim Edgar?

Illustration No. 5
Sources of Growth in State Spending
Percentage Increase, 1991 to 1993



The answer is found in the budgets of three departments of Illinois government: the Department of Public Aid (DPA), the Department of Children and Family Services

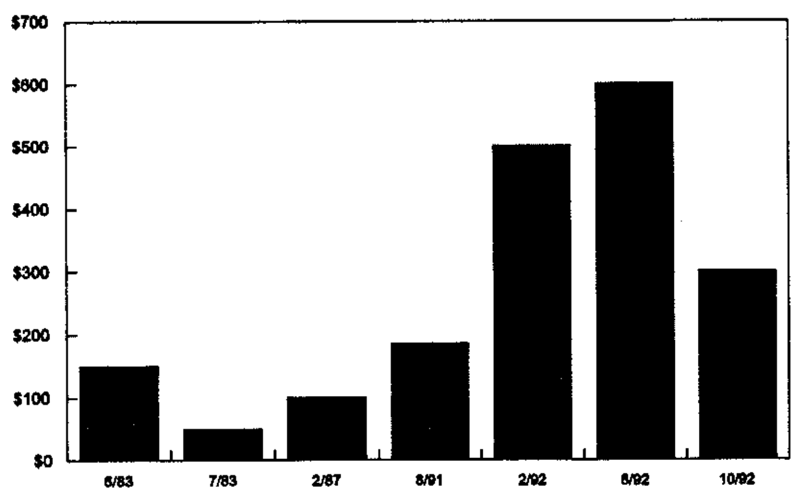
(DCFS), and Central Management Services (CMS). As Illustration No. 5 indicates, spending by "The Big Three" departments increased between 1991 and 1993 by 51 percent — from $5.7 billion in 1991 to $8.6 billion in 1993. Total state spending, by contrast, increased just 21 percent over the three-year period.

In Part 4 we will examine the factors behind the rapid growth of spending in these departments and propose ways to bring spending under control.

State Debt

One way state government has been able to increase spending at a record pace without increasing general tax rates is by increasing its use of debt instruments. The Illinois Constitution and the Casual Deficit Act authorize the state to borrow up to 15 percent of appropriations in a fiscal year for cash flow purposes, but such debt must be repaid within one year of its issuance. As Illustration No. 6 demonstrates, the state has relied on short-term debt much more in recent years than it has in the past.

Illustration No. 6
Short-Term Debt
(in millions of dollars by date issued)



Source: Illinois State Budget Fiscal Year 1994, page Ch. 8-10.

A second way debt has been used to bridge the cost of higher spending has been through the Build Illinois program, a 12-year, $2.36 billion bonding program established by Governor James Thompson in 1985. As of the end of 1993, the state had issued $1.4 billion in Build Illinois bonds, accounting for most of the increase in state debt since 1984. (See Illustration No. 7 below.) General obligation debt increased from $4.01 billion in FY 1989 to $4.44 in FY 1994 (projected), an increase of 10.7 percent. <6>

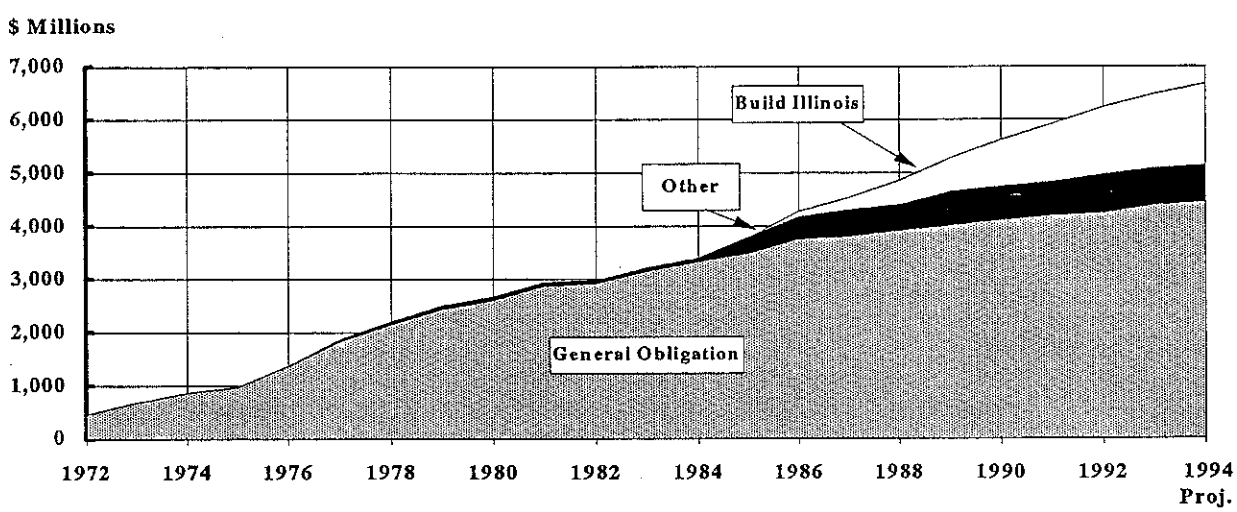
A third and final way debt has been increased to accommodate higher spending is by a steady short-changing of the state's employee pension funds. At the end of 1992, the state's pension fund assets totaled $17 billion, while actuarial liabilities stood at $30 billion, for an unfunded liability of $13 billion. <7> By the end of 1993, this had risen to an estimated $14 billion. While the biggest cause of the short-fall is a deliberate and long-standing policy of diverting funds from pensions to general operating budgets, other practices also have contributed to the problem:

- Many government employees are transferred to higher-paying positions for their final year of employment before retirement. Since the size of a pension is determined by the salary paid in the last year of employment, this practice can inflate an employee's pension benefits by thousands of dollars a year.

- Similarly, public school teachers frequently receive 20 percent salary increases in each of the last two years of employment specifically to boost their pension benefits. The teachers contract for Carol Stream, for example, *requires* that such raises be given.

There is a limit to how much further the state can increase its debt and underfund its pension funds to offset rising spending. In 1992, Standard & Poor's lowered its rating on Illinois' general obligation debt from AA to AA-, and Moody's lowered its rating from Aa1 to Aa. <8> These moves represented a warning to the state's elected officials that the rapid expansion of debt would bring with it an even higher cost of borrowing money. The expense of repaying short-term debt and making service payments on long-term debt already consume a growing share of the state's natural revenue growth each year.

Illustration No. 7
State of Illinois Outstanding Indebtedness



Clearly, the state's increasing debt has marred the record of the Edgar Administration. Opposition to tax increases is no more than empty rhetoric if spending is not also kept in check. Debt at the state level is little better than debt at the federal level: Both represent the unjust transfer of a financial burden to the next generation; allow political representatives to avoid accountability to taxpayers for spending public funds wisely; and require that a growing portion of total spending be devoted to interest payments, rather than new and promising programs. Illinois should do what it can now to avoid this fate.

Conclusions

We can reach several conclusions regarding the Edgar years in Illinois:

1. The Edgar years are best characterized as a period of stabilizing tax burdens but continued slow economic growth in Illinois. The decade that preceded the Edgar Administration was defined by high and rising taxes and very slow economic growth.

2. Despite many real cuts in the budgets of specific departments, the Edgar Administration has presided over a period of spending increases that have been more rapid than the spending increases that took place during the Thompson era. These spending increases, unlike those during the Thompson years, have been paid for by natural revenue growth, debt, and revenue enhancements short of general tax increases.

3. Illinois' falling tax burden relative to other states since 1984 helped to make possible somewhat improved economic growth , though personal income and employment growth have still lagged behind national averages.

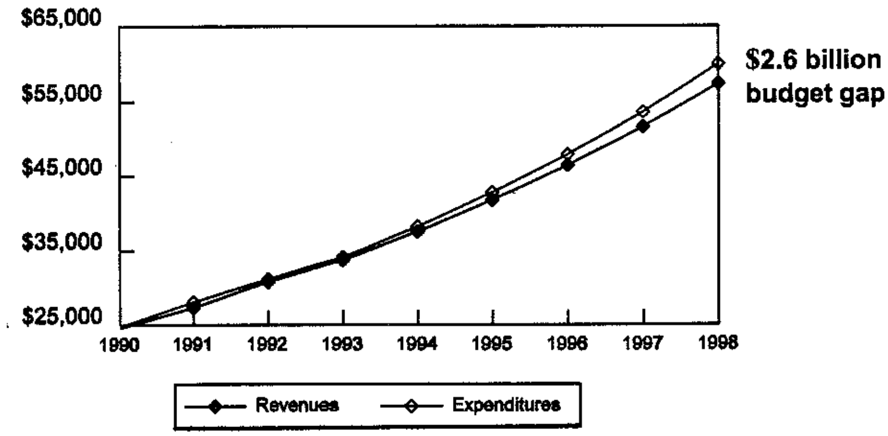
4. Most of the increase in state spending has been the result of dramatic spending increases in three departments: Public Aid, Children and Family Services, and Central Management Services.

PART 2

Income and Spending Projections

In this section we address two questions: Will natural revenue growth in Illinois be sufficient to balance the state budget during the next four years? What assumptions or changes must be made regarding state spending to achieve this goal?

Illustration No. 8
Revenue and Expenditure Trends
1990 - 1998 (projected, in millions)



While state spending has grown since 1990 at an annual rate of 11.95 percent, state revenues have increased at an annual rate of 11.2 percent. If these trends continue, by 1998 Illinois can expect expenditures to outpace revenues by $2.6 billion. (See Illustration No. 8.)

Fortunately, Illinois can gain control of its budget by focusing on just three departments: Public Aid, Children and Family Services, and Central Management Services. Table 2 below shows how The Big Three have been largely responsible for the growth of state spending in Illinois. Exclusive of The Big Three departments, state spending grew at an average annual rate of 6.7 percent during the Edgar years. By contrast, spending in The Big Three increased at an average annual rate of 23 percent.

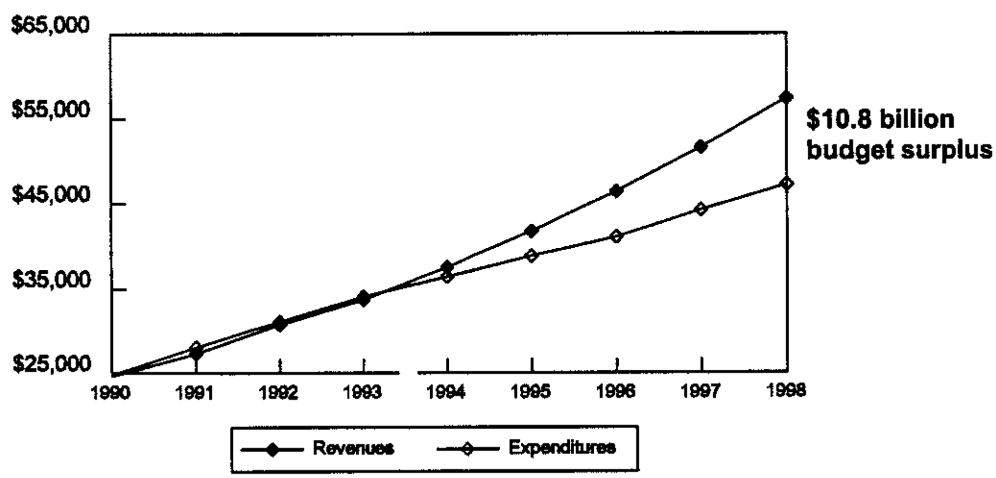
If spending in these three departments were held to the projected rate of growth in personal income (5.2 percent[2]), while the remainder of the state budget continued to grow at an annual rate of 6.7 percent, overall state spending still would increase at a healthy pace of

[2]Since 1990, personal income in Illinois has grown at the rate of 6.0 percent annually. DCCA forecasts personal income growth rates of 4.2 percent in 1993, 5.5 percent in 1994, and 6.0 percent in 1995. Although these forecasts obviously are affected by national economic trends as well as changes in national and state public policies, we have used a simple average of DCCA's three-year forecast (5.2 percent per year).

Table 2 Sources of Growth in State Spending 1991 - 1993, in millions				
	1991	1992	1993	Percent Increase
Public Aid	$4,174	$5,966	$6,427	54%
Children and Family Services	$500	$648	$781	56%
Central Management Services	$1,046	$1,167	$1,449	39%
Big Three Total	$5,720	$7,781	$8,657	51%
Total State Spending	$28,093	$31,156	$34,108	21%
Total State Spending Exclusive of Big Three	$22,373	$23,375	$25,451	14%
Big Three as a Percent of Total State Spending	20.4%	25.0%	25.4%	

6.4 percent annually — but this rate of spending could be absorbed easily by natural revenue growth. Illustration No. 9 below shows spending and revenue projections following such growth. By 1998, revenues would outpace expenses by $10.8 billion.

Illustration No. 9
Revenue and Expenditure Trends
1990 - 1998 (projected, in millions)



We conclude that natural revenue growth will be sufficient to offset expected increases in state spending, but only if action is taken to control spending in at least the Departments of Public Aid, Children and Family Services, and Central Management Services. Opportunities for substantial reform of these departments are discussed in Part 4. But first, we examine the consequences of the alternative course: raising taxes.

PART 3

Consequences of Tax Increases

If state government spending continues to grow at the rates that prevailed in 1991-1993, natural revenue growth alone will be insufficient to produce a balanced budget in Illinois. The alternative to controlling spending is to increase taxes.

The case for higher state taxes does not rest solely on the state's approaching budget crisis. Various interest groups are pressing for higher taxes for other reasons, including property tax relief, boosting spending on education, and greater "tax equity." In this section we examine the likely consequences of a state tax increase, as well as the validity of these other arguments for higher taxes.

Effect on Job Creation and Economic Growth

Increasing state and local taxes will affect the state's rate of income growth and job creation. This effect has been studied by a score of independent scholars and researchers:

- Carl E. Ferguson, Jr. found in 1985 that employment and real per-capita personal income were negatively related to increases in state and local taxes. <9>

- In 1985, Jay L. Helms found that states with relatively high state and local taxes experienced slower overall economic growth. <10>

- Also in 1985, Michael Wasylenko and Therese McGuire found that state tax rates as a percent of personal income were negatively related to overall employment growth. <11>

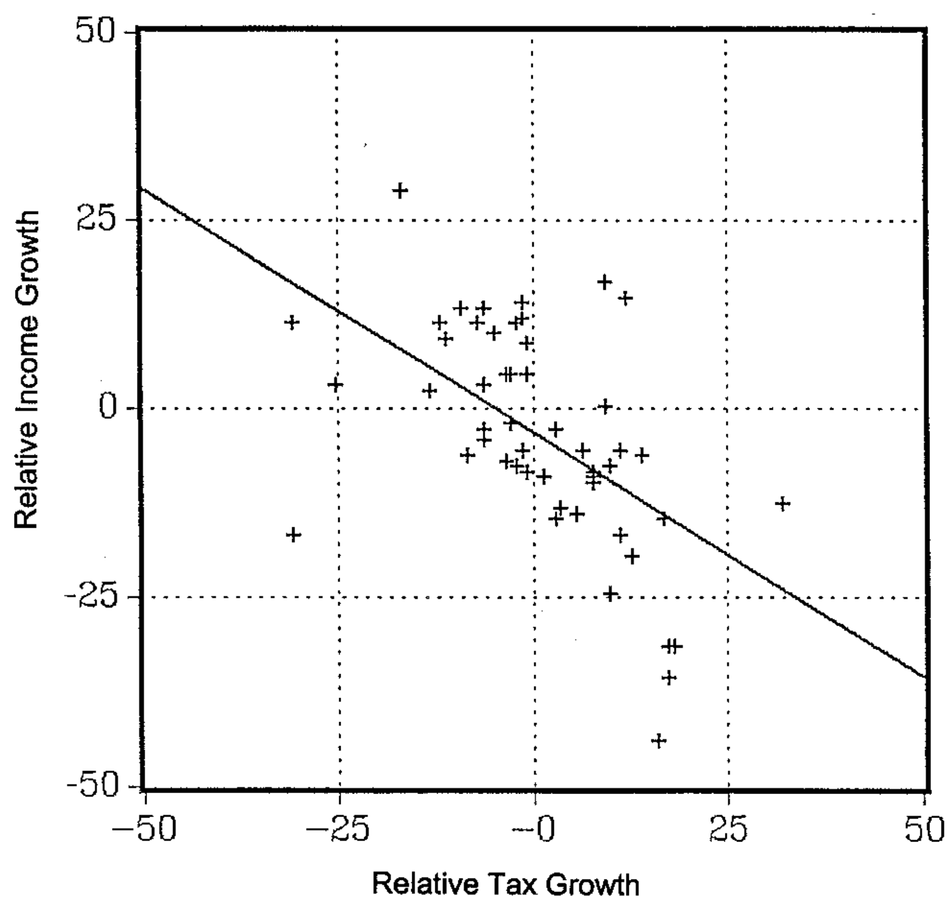
- Walter S. Misiolek and Carl E. Ferguson, Jr. found in 1988 that change in total state-only tax burden was negatively related to a state's overall economic growth, and also negatively related to income and employment growth in each of nine subsectors of the states' economies. <12>

- In 1991, Gerald W. Scully found that "an increase in a state's own tax rate relative to the rates in all others slows the rate of economic growth in 45 of 49 states." <13>

- In February 1994, *Business Week* reported its findings that "job growth in low-tax states over the last eight years has been a stunning 65% higher than in high-tax states. . . . And there's a growing consensus among economists that state and local taxes have a significant effect on almost every other aspect of economic activity — business location decisions, startups, and income growth." <14>

In 1990, Dr. Robert Genetski (Robert Genetski & Associates, Inc.) and John Skorburg (Chicagoland Chamber of Commerce) tested the relationship between taxes and economic growth. Using tax effort indices and personal income data for all fifty states and the District of Columbia, they found that nearly every state that raised its taxes relative to the national average experienced slower-than-average growth, while nearly every state that lowered its relative tax burden experienced above-average economic growth. <15> Illustration No. 10 shows these findings.

Illustration No.10
Taxes and Economic Growth



Using standard regression analysis, Genetski and Skorburg estimated that for every one percentage point rise in tax effort relative to the rest of the nation, a state can expect its annual rate of growth in per-capita income to drop .6 percentage points below the national average rate.

In October 1992, Genetski and Joseph L. Bast applied the Genetski/Skorburg analysis to a proposed state constitutional amendment that would have increased taxes by an estimated $3 billion to finance public education in Illinois. Genetski and Bast concluded that

> Passage of the education amendment would cost Illinoisans nearly $12 billion a year in lost income. This amount is approximately equal to the entire increase in state personal income projected to occur in 1992. Passage of the amendment could mean the difference between economic recovery and zero-growth. . . .
>
> [Moreover], passage of the education spending amendment could reduce the number of Illinois jobs that would have been created or retained each year by 250,483 — over a quarter million lost jobs each year. <16>

Clearly, there is a trade-off between higher taxes, job creation, and personal income. Tax increases are *not* an "easy way out" for hard-pressed legislators seeking a balanced budget. Increasing taxes one year means slower economic growth and perhaps lower-than-expected revenues the following year. Slow economic growth can mean mounting public aid bills and unemployment insurance claims, fueling higher state spending.

Tax increases are *not* an "easy way out" for hard-pressed legislators seeking a balanced budget. Increasing taxes one year means slower economic growth and perhaps lower-than-expected revenues the following year.

Economic development in Illinois will be hurt a second way if state tax increases further split taxing and spending authorities. When reliance on property taxes is minimized, communities lose an incentive to welcome industry and business. A busy shopping mall, noisy factory, or visually discomforting landfill may be tolerated in many communities largely because they generate taxes needed to support local schools.

Will communities that now host these businesses zone them out of existence when they no longer need their property tax dollars? What incentives do communities have to become hosts of new factories, power plants, and waste disposal sites when the state's tax system redistributes the tax benefits of tolerating such facilities to communities not bearing the costs?

> Increasing reliance on state income taxes rewards communities that refuse to accept the risks and inconveniences that come with economic development and growth.

By limiting the benefits of hosting business and industry, raising state taxes rewards communities that refuse to accept the risks and inconveniences that come with economic development and growth. Thus, in the long run, this new incentive structure will slow economic growth and job creation in the state. The growth of critical industries, such as electric power generation and waste disposal, will be increasingly crippled by a "not in my back yard" (NIMBY) mentality that is now minimized because communities reap tax benefits when they tolerate such investments.

A state easily can become trapped in a dangerous spiral of rising taxes, declining economic growth, and increasing demands for public services — a trap that Illinois seemed perilously close to falling into by the end of the Thompson era. Before taking such a risky step, policy makers should be sure all other options have been explored.

Effect on Education

Would higher taxes benefit Illinois' public schools? Although often advocated by teacher unions and school board members, higher state taxes earmarked for public schools would be more likely to harm than improve the quality of public education in Illinois.

An increase in state income taxes for education would centralize funding responsibility at the state level, far removed from parents, educators, and children. Such a loss of local control has been directly linked to poorer quality public schools in a number of studies. <17> Dr. Herbert J. Walberg, research professor of education at the University of Illinois at Chicago, concludes in a 1993 report that states whose education funding is concentrated at the state level experience poorer student achievement levels, after controlling for such differences as per-pupil expenditure and student socioeconomic status. <18> He writes:

> Efforts to further shift the burden of education funding from local sources to state sources should be looked upon with great skepticism. The increasing bureaucracy and declining local accountability that accompany "remote" spending on education have a demonstrably negative effect on student achievement. It is especially important to note that *who funds* education — state or local sources — is a much more significant determinant of student achievement than *how much* is spent (which is actually unrelated to achievement.) <19>

Research conducted in Illinois by DePaul University economist Dr. William Sander and nationally by Dr. Eric A. Hanushek and others has found no relationship between student achievement and per-student spending[3], a finding that suggests that higher spending will not improve student achievement. <20> According to Sander,

> The most important finding of this study is that the wealth, parental college education, and ethnic composition of a community were the key determinants of student achievement in Illinois for the 1988-1989 school year. One of these socioeconomic variables — per-capita income — had an influence on ACT scores that was substantially greater than per-pupil spending. Spending had a weak positive effect on student achievement, but only when higher spending was used to pay higher teacher salaries, and even then only when higher salaries were used to attract teachers with advanced degrees and more teaching experience. Higher per-pupil spending, even when used to employ better teachers, had no effect at all on student achievement in the Chicago Public Schools. <21>

Research by Dr. Herbert Walberg and William Fowler on the relationship between spending and student achievement in New Jersey public schools found ". . . if anything, higher expenditures are associated with lower achievement once [socioeconomic status and district size] are taken into account." <22>

Research conducted in Illinois and nationally has found no relationship between student achievement and per-student spending.

Finally, it is important to note that education spending in Illinois is already at the national average. According to the National Center for Education Statistics, Illinois will spend an estimated $5,299 per student in 1993-94; the national average is just $15 more. This fact is rarely mentioned by advocates of higher spending, who focus on *state-only* spending rather than combined state and local spending. Spending increases during the 1980s routinely outpaced inflation and the cost of living. In 1992-93, average teacher pay in Illinois ranked 10th in the nation at $38,576 a year. <23>

These figures almost certainly understate by a sizeable margin the true level of spending on public schools in Illinois. Dr. Myron Lieberman, a distinguised education writer and consultant, has identified 25 cost factors that are not included in conventional estimates of per-pupil spending. <24> Capital outlays and interest on school debt, for example, are excluded from these estimates, even though nationwide they amounted to over $26 billion in 1991-1992. Lieberman estimates that $2 billion in spending by the U.S. Department of

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[3]More information on the relationship between spending and student achievement is available in "Education: Spending and Student Achievement," document #2176001 available from the ***PolicyFax*** information service. For information about how to use ***PolicyFax***, see the back page of this *Policy Study*.

Education is not counted in estimates of per-pupil costs, nor are unfunded pension liabilities or donations from foundations (the MacArthur Foundation's *$40 million grant* to the Chicago Public Schools in 1990 is not counted) and corporations. In other words, Illinois' public schools are spending considerably more than the $5,300 they report.

Even disaparities in spending across school districts in Illinois are not as dramatic as advocates of higher taxes claim. Genetski and Bast reported in their analysis of the proposed 1992 Education Amendment,

> Despite frequent references to school districts spending $12,000 per student or more, in 1989 just eight school districts of the 972 in the state spent more than $8,000 per student. The statewide average in 1989 was $4,217. Chicago spends just 6 percent less per pupil than Barrington, the state's third highest spending district. Chicago ranks sixth highest of all 35 unit districts in the Chicago metropolitan area. <25>

> In 1989, just eight school districts of the 972 in Illinois spent more than $8,000 per student. The statewide average in 1989 was $4,217. Chicago spent just 6 percent less per pupil than Barrington, the state's third highest spending district.

Clearly, the claim that state taxes must be increased to better fund the state's public schools is weak. Centralizing funding at the state level is known to *hurt*, not improve, student achievement. Higher spending has not been shown to result in better schools, and current spending levels seem generous by national standards as well as by common-sense judgment. If there is a reason for increasing state taxes, it must lay elsewhere.

The Income Tax vs. Other Taxes

Fairness Issues

It is an article of faith among many advocates of higher taxes that an income tax is somehow more "fair" than other taxes. Because an income tax (even a flat-rate income tax) collects more money from a taxpayer as the taxpayer's income rises, it is considered "progressive." Taxes that collect from low-income people the same amount or more than is collected from higher-income people are often referred to as "regressive."

In fact, however, the relative "fairness" of income taxes vis-a-vis other taxes is greatly exaggerated. All forms of taxation have advantages and disadvantages and affect different populations in different ways. While the income tax conforms to some of our attitudes about justice and fairness, it is quite at odds with other ideals and objectives. This unfairness is demonstrated in several ways.

First, an income tax weighs disproportionately on persons whose wealth consists almost entirely of earned salary or wages — often younger people who have acquired few assets. Individuals who, due to past earnings or inheritance, derive considerable comfort from tax-sheltered investments or assets such as a home, automobile, and appliances, get a "free ride" from the income tax. Those who are still trying to work their way up the economic ladder will find their climb made more difficult by income taxes. As economists Walter Blum and Harry Kalven write,

> The income tax can do nothing to mitigate existing inequalities in wealth, and, moreover, it retards the accumulation of new fortunes. The progressive income tax alone, no matter how steep the progression, tends to preserve and magnify the advantages of inherited wealth. <26>

Is an older couple who owns a large and expensive home, vacation property out of state, and several automobiles, but reports little earned income, "poorer" than a young couple living with borrowed furniture in a small apartment, struggling to get by on two or three minimum-wage jobs? Surely not. But an income tax may consider the young couple to be the wealthier of the two. It hinders the young couple's efforts to acquire the assets of the other, obviously wealthier, couple. Is this fair or just? Most people wouldn't think so.

The tendency of income taxes to weigh most lightly on those who already have acquired the assets of a comfortable lifestyle may explain why some wealthy people (and/or their spouses) advocate higher income taxes. It is not a difficult position to endorse *once you've already got yours.*

Second, relying on a state income tax also means that the amount one pays has little or no connection to the cost of the public services one uses.[4] For example, if a community makes a large investment in a park, swimming pool, or local school, shouldn't the residents who benefit from the facilities

> A state income tax pretends that every taxpayer benefits equally from public services, or that such services are costlessly produced.

[4]This concern may not apply to a local income tax whose proceeds are distributed locally.

be asked to pay for it? And conversely, shouldn't those who do not benefit from such investments be exempted from having to pay for them? A state income tax ignores this aspect of tax fairness: It pretends that every taxpayer benefits equally from public services, or that such services are costlessly produced. Obviously, neither assumption is true.

Finally, when proponents of income taxation assume that "ability to pay" is the most important attribute of a "good" tax, they typically overlook the flip-side of this cliché: Those with the greatest ability to pay are also society's most productive members. By relying on income taxes, we tax the most those who are doing the most good. Since we invariably get less of what we tax and more of what we subsidize, it follows that a tax on society's most productive members means we will produce fewer productive members, and more members who will live at the expense of others. Is this "fair"?

Efficiency of Collection

> The cost of collecting the income tax is an astonishing 65 cents for every dollar collected. In 1993, tax law compliance cost American business $123.4 billion, and individuals $60 billion.

Beyond the fairness issue, proponents of income tax increases sometimes point out that income taxes are more efficiently collected than other kinds of taxes. This is a popular myth that, upon closer examination, is demonstrably false. The myth remains only because much of the expense of collecting income taxes is borne by the taxpayer rather than the state.

According to Dr. James L. Payne, the real cost of collecting the income tax is an astonishing 65 cents for every dollar collected. Payne explains,

> [T]he collecting of taxes imposes a huge burden on Americans and the American economy. These costs include the cost of funding the IRS and other government agencies involved in administering the tax system, compliance costs (recordkeeping, learning about the tax code, preparing forms), enforcement costs (responding to IRS computer accusations, audits, penalties, collection actions, and participating in tax litigation), evasion and avoidance costs, and disincentive costs. Finally, there are many emotional and moral costs, ranging from the anxiety the tax system creates to the inculcation of dishonest habits. A comprehensive estimate of the monetary costs alone puts these at 65 cents for each tax dollar collected. <27>

In support of his estimate, Payne cites a 1988 survey conducted by Arthur D. Little for the Internal Revenue Service. <28> The survey, which calculated the federal tax compliance burden for businesses and individuals, concluded that in 1985 it took more than five billion hours to comply with federal tax laws. The value of the labor was 24 percent of tax revenues collected. Another study, published in *The American Economic Review* in March 1985, calculated the disincentive ("deadweight") cost of the tax system at roughly 33 cents per tax dollar collected. <29> These two studies indicate that the compliance and disincentive effects of income taxes cost 57 cents per dollar of taxes collected. The many other expenses identified by Payne can be easily expected to bring the total to Payne's 65-cent estimate.

The Tax Foundation estimates that in 1993 tax law compliance cost American business \$123.4 billion, and individuals \$60 billion. According to senior economist Arthur P. Hall, businesses with assets of less than \$1 million spent \$390 on compliance for every \$100 they paid in taxes. In 1990, these businesses spent \$15.9 billion to complete the basic corporate tax forms — and sent just \$4.1 billion in taxes to the federal government. <30>

Related to the issue of collection costs is the fact that income taxes require the violation of privacy rights to a much greater extent than is true of property, sales, and excise taxes. Enforcement of income taxes requires governments to have access to the most intimate details of business and household budgets. Civil libertarians ought to be greatly alarmed by the opportunities for the abuse of state power created by income taxes.

Property Tax Relief

Another reason often advanced for higher income taxes is that an increase may provide relief from a more universally hated tax, the property tax. Illinois does indeed rely more heavily on property taxes than most other states. Property taxes are paid directly out of a taxpayer's checkbook in one or two often painfully large lump sums a year. Income taxes, on the other hand, are usually deducted in smaller amounts from the salaries and wages of most taxpayers — who rarely suffer the psychological pain of having to write a check to the Illinois Department of Revenue.

Far from being a reason to prefer the income tax, this lower visibility is a *disadvantage* of the income tax. Taxing bodies are able to "get away with" setting an income tax at levels higher than taxpayers would tolerate if the burden were more visible. While appeals of property tax assessments are common, no similar mechanism is regularly at work to keep income tax collectors accountable to taxpayers. Does anyone sincerely believe that income tax rates would be as high as they are now if taxpayers had to make lump-sum payments on April 15th each year?

> The record of *any* state tax increases producing promised property tax relief has been dismally poor in Illinois and in other states.

Moreover, the promise of property tax reduction in exchange for income tax increases is unlikely to be kept. The record of *any* state tax increases, income or otherwise, producing promised property tax relief has been dismally poor in Illinois and in other states. The Illinois sales tax was passed amid promises that it would allow property tax relief, but none followed. When the "temporary" 1989 income tax increase was made permanent in two steps, the increases were supported by some "taxpayer watchdogs" in the expectation of property tax relief. However, few Illinois taxpayers saw such a reduction; at best, a few experienced a reduction in the *rate of increase* of their local property tax.

Illinois' neighbor to the north, Wisconsin, returns a higher percentage of state tax dollars to local governments for "property tax relief" than does any other state. Yet Wisconsin's local property taxes still rank *sixth-highest* in the nation. Even more disturbing, Wisconsin's *overall* tax burden is also sixth-highest in the nation — suggesting that this tax shifting has resulted in an overall *increase* in the tax burden. <31>

As they are currently administered in Illinois, property taxes are neither fair nor efficient sources of government revenue. But they do have two virtues: First, they reflect, at least in rough terms, the cost of public services delivered to the taxpayer. Second, local taxing authorities are more easily held accountable than state and federal income-taxing authorities. Choosing among fundamentally unfair taxes can hardly be easy, but the choice should not be based on misleading information or unchallenged claims of moral superiority.

Graduated vs. Flat-Rate Income Taxes

Illinois' flat-rate income tax is admired by finance professors and economists around the country. Indeed, tax reforms at the national level for the last decade (except the Clinton Administration tax increase passed last year) have attempted to move away from a highly graduated ("progressive") income tax and toward a flat-rate income tax. This movement is fueled by several observations on which there is general consensus:

- A graduated-rate income tax is much more damaging to economic growth and job creation than a flat-rate income tax. According to economists Jude Wanniski and David Goldman, the world's fastest-growing economy, Hong Kong, also has the "flattest" tax rate schedule in the world. <32> Graduated tax rates discourage work and often lead to wealth-destroying efforts to shelter income. Economist George Gilder writes in *Wealth and Poverty:*

> Steeply progressive rates may have an idealistic ring, but their effect is to reduce incentives for economic success, work, and risk, and to favor the search for unproductive sinecures that make small encroachments on leisure time or household comforts. If the economy cannot offer large rewards to enterprise, the ambitious man will seek the advantages of insurance and security, political power and bureaucratic pelf. In short, high marginal rates continuously undermine the very diligence and determination that are necessary to accomplish any useful work in the world. They diminish the motive to move up and promote the impulse to pull out and return to the household economy. <33>

Even Swedish economist Gunnar Myrdal, a lifelong socialist, has denounced the highly progressive income tax of his homeland, writing:

> Of all the deficiencies in our tax system, for me the most serious is that the laws directly invite us to commit tax evasion and tax cheating. The honesty of Swedes has been a source of pride to me and my generation. Now I have a feeling that we are becoming a nation of hustlers because of bad laws. <34>

- Progressive income taxes invariably lead to political pressure for loopholes and exemptions, making tax laws increasingly complex and less fair. Nobel laureate economist Milton Friedman, long a proponent of flat-rate income taxes, writes:

> [High and highly graduated income taxes] have stimulated both legislative and other provisions to evade the tax — so-called "loopholes" in the law such as percentage depletion, exemption of interest on state and municipal bonds, specially favorable treatment of capital gains, expense accounts, other indirect ways of payment, conversion of ordinary income to capital gains, and so on in bewildering number and kind. The effect has been to make the actual rates imposed far lower than the nominal rates and, perhaps more important, to make the incidence of the taxes capricious and unequal. <35>

Ironically, the advocates of graduated tax rates are often also the loudest voices raised against loopholes and tax shelters. Friedman's analysis suggests that they cannot have it both ways.

- Graduated tax rates do not raise more money than flat tax rates, because of offsetting changes in the conduct of taxpayers and greater collection expenses. Gilder reports, for example, that annual receipts from the capital gains tax in the U.S. *fell* after the rates were raised in 1973.

Advocates of higher taxes in Illinois appear to be unaware of, or have chosen to ignore, the extensive scholarship favoring flat-rate income taxes. Indeed, they are now campaigning for a constitutional amendment to replace the state's flat-rate income tax with a graduated-rate income tax. We already have rebutted arguments based on fairness or efficiency and shown how making the income tax more "progressive" would destroy jobs, increase tax complexity and compliance costs, and probably not raise significantly more revenues for the state. Why then does "Progress Illinois" advocate a graduated-rate income tax for the state? We can see only two reasons:

- Progress Illinois wants higher government spending. It knows that the large majority of taxpayers do not support higher taxes. It believes, however, that it can deceive the public into supporting higher taxes by appealing to people's sense of envy — offering them "something for nothing" in the form of more public services paid for by a tax on "rich people."

- Progress Illinois sincerely believes in the discredited socialist doctrine "from each according to his ability, and to each according to his needs." It sees punitive taxes and the destruction of jobs as a necessary and acceptable cost for imposing this ideology on the residents of Illinois.

Advocates of higher taxes in Illinois appear to be unaware of, or have chosen to ignore, the extensive scholarship favoring flat-rate income taxes.

Though these assessments may seem harsh, we have little doubt that they help explain Progress Illinois' motivations and goals. Progress Illinois' membership list is dominated by groups with a direct financial interest in greater public spending: the American Federation of State, County, and Municipal Employees (AFSCME), Chicago Teachers Union, Illinois Library Association, Illinois Retired Teachers Association, and Public Welfare Coalition, to name only a few of the most obvious ones. The League of Women Voters, which staffs the coalition, is well-known for its advocacy of left-leaning causes in Illinois and across the country. This combination of self-interest and ideology is strikingly apparent in Progress Illinois' literature.

Progress Illinois' strategy of misleading the public about the true costs of its proposals is a replay of tactics its members used to promote the "education amendment" defeated by voters in 1992. <36> During that campaign, the EdEquity Coalition specifically kept the words "tax increase" out of the proposed constitutional amendment's language, even though (by the Coalition's own admission) passage of the amendment would have required an estimated $3 billion tax increase. The Coalition's promotion of the amendment was filled with misinformation, including claims that spending on education in Illinois lags behind such spending in other states (it is, in fact, at the national average) and that the state's income tax is among the lowest in the nation.

Conclusion

Illinois has a state and local tax burden that is equal to or higher than the national average. Illinois relies more heavily on local property taxes than do other states, but this may be an *advantage* rather than a disadvantage. We find no compelling "equity" case for increasing state income taxes or making the rate structure more graduated. In fact, we find substantial support for the opposite proposition: that graduated-rate income taxes are less fair and more destructive of jobs and economic growth than are flat-rate income taxes or other kinds of taxes.

An objective analysis of Illinois' tax climate concludes that the state's income taxes, along with property taxes, sales taxes, and other tax revenue sources, should be kept as low as possible in order to avoid adverse effects on economic growth and job creation. Excessive reliance on any one tax is not good public policy; instead, a balanced revenue plan avoids unfairly burdening or benefiting any one class of taxpayer.

Given the disadvantages that would accompany a decision to raise state taxes, it is imperative that we examine every possible alternative to higher taxes.

Given the disadvantages that would accompany a decision to raise state taxes, it is imperative that we examine every possible alternative to higher taxes. Is it possible for the state to meet its obligations without resorting to a tax hike? We address this question in the following section.

PART 4

Opportunities for Reform and Budget Savings

Governor Edgar slowed the growth of spending in many departments of state government by reducing waste and mismanagement, and for that he is to be commended. However, as was established in Part 1, whoever is elected governor in 1994 must do more: Specifically, he or she must gain fiscal control over the Departments of Public Aid (DPA), Children and Family Services (DCFS), and Central Management Services (CMS). The 1993 budget for these three departments totaled over $8.6 billion dollars. Spending on The Big Three rose 51 percent between 1991 and 1993, a rate of growth that is plainly unsustainable.

> The ultimate goal of public aid must be to help the poor become independent of government.

Clearly, the state's public welfare programs are in most need of reform. With 1993 spending of $7.2 billion, DPA and DCFS are the two programs that drive the state budget. Whoever is elected governor in 1994 has the opportunity to present bold new initiatives in this area — initiatives that will make a real difference to taxpayers and, as we will show, to public aid recipients.

Four basic understandings must guide these reforms.

- *Public aid should be viewed as temporary assistance.* Some public aid spending is intended to help citizens who are in permanent need of assistance, such as the aged, blind, and disabled. But most is designed to assist those who are temporarily impoverished.

  Recent proposals for welfare reform in states across the country operate from the premise that citizens are not entitled to permanent financial support from the government. The ultimate goal of government agencies that provide public aid must be to help the poor become independent of government assistance, rather than fall victim to an incentive structure that encourages dependency and discourages work.

- *Economic growth benefits everyone.* A healthy and growing economy creates jobs, increases incomes, and makes more money available for charity and tax collection. As a result, the number of people in need of public assistance will fall.

- *Private and voluntary organizations must play a key role.* In Illinois there are thousands of private charities, nonprofit service organizations, and commercial job training and placement programs that do excellent work serving the needy. These community-based organizations have shown themselves to be cost-effective and accountable.

- *Government agencies must be held accountable to the taxpayers who finance them.* Government bureaucracies too often fail to operate efficiently or effectively, the result of perverse incentive structures, lack of information, and political interference. New ways must be found to "reinvent" government welfare programs.

While it is not the intention of this paper to provide a detailed proposal for the overhaul of The Big Three, we sketch below some basic reform plans that would control spending without compromising — and indeed improving — the quality of the services provided by these departments.

Department of Public Aid (DPA)

The Illinois Department of Public Aid is the largest department of Illinois state government. Its 1993 budget accounted for nearly 19 percent of total state spending; in just three years (from 1991 to 1993), the department's budget increased 54 percent (from nearly $4.2 billion to over $6.4 billion). DPA is responsible for such expensive and high-profile programs as the Medical Assistance Program (Medicaid) and Aid to Families with Dependent Children (AFDC).

Medicaid

In 1991, Illinois spent $2.5 billion — 60 percent of DPA's budget — on Medicaid. By 1993, the state spent $4.8 billion — 75 percent of DPA's budget — on Medicaid. In just three years, the state's Medicaid budget nearly doubled. By contrast, the non-Medicaid portion of DPA's budget actually fell by 2 percent during this period. Clearly, any real reform in DPA must begin with Medicaid.

Despite the immense financial resources entrusted to the state's Medicaid program, it is by almost any standard in a state of chaos and disarray; riddled with fraud, corruption, mismanagement, and waste; and providing second-rate care for recipients. <37> State Comptroller Dawn Clark Netsch regularly reports that Illinois is behind in its reimbursements to providers; in April 1994, for example, Netsch reported:

Stop gap measures, such as extending the payment cycle and postponing payments for one fiscal year to the next, have been used in the past to alleviate budget pressures. For example, the payment cycle has varied from an average of 28 days at the end of fiscal 1989 to 87 days at the end of fiscal 1993, while postponing payments has more than doubled from $586 million in fiscal 1991 to almost $1.2 billion in fiscal 1993. Both of these measures are expected to increase in fiscal 1994. However, these measures do not reduce liabilities or costs, but merely delay payments. <38>

In January 1994, Governor Edgar announced an 18-month postponement of planned increases in the state's Medicaid reimbursement rates, a move made necessary because the state underestimated its 1993 Medicaid costs. <39>

Analysis

Medicaid is a joint state-federal program. Eligibility is extended to aged, blind, and disabled individuals whose incomes are below the poverty level, as well as to individuals who cannot afford to pay their medical bills but whose income exceeds poverty standards for other forms of cash assistance. Applicants for government cash assistance (such as AFDC) are automatically enrolled in the Medicaid program. The federal government requires states to provide recipients with a minimum package of medical services; states may provide additional benefits.

Table 3
Selected Federal Medicaid Mandates

Omnibus Reconciliation Act of 1980	Anti-Drug Abuse Act of 1986
Omnibus Budget Reconciliation Act of 1981	Omnibus Budget Reconciliation Act of 1987
Deficit Reduction Act of 1984	Family Support Act of 1988
Consolidated Omnibus Budget Reconciliation Act of 1986	Omnibus Budget Reconciliation Act of 1989
Omnibus Budget Reconciliation Act of 1986	Omnibus Budget Reconciliation Act of 1990
Immigration Reform and Control Act of 1986	

Source: Mackinac Center for Public Policy, May 1993.

A major reason for rising Medicaid costs in Illinois is the enactment by the federal government of a long list of unfunded Medicaid mandates. (See Table 3.) These laws require Illinois to broaden eligibility, prolong coverage, submit additional documentation to federal authorities, and expand the range of services that must be offered to Medicaid recipients. A study of Medicaid mandates in Michigan indicates that they added $40 million to that state's Medicaid bill in 1990, and the figure is expected to reach $137 million by 1995. <40> The impact of Medicaid mandates on Illinois is likely to be similar.

But the federal government is not entirely to blame for Medicaid spending increases. Illinois is among the 16 states offering the most generous Medicaid benefits, as is shown in Table 4. Illinois covers 26 optional services, including podiatry, optometry, and chiropractic services; dentures; eyeglasses; and transportation. <41>

When a Medicaid recipient visits a health care provider, he or she presents a Medicaid card; the provider, after rendering services, completes a Medicaid billing form that is sent to Springfield. There, the bill is entered into a computer, checked for basic information, and either rejected or approved for payment. When approved, payment vouchers are sent to the State Comptroller's office, which processes the vouchers for payment to the provider.

Although the system seems rather simple, it has left itself open for the crisis it now experiences. A bloated state bureaucracy; coverage of expensive optional benefits; extensive opportunities for fraud by patients, providers, and insurers; and no accountability have resulted in rapidly escalating Medicaid costs in Illinois. Worse, the human costs far exceed the financial.

Table 4
Optional Services in State Medicaid Programs
25 Most Generous States
Health Care Financing Administration
October 1, 1993

Wisconsin	31
Indiana	30
Arizona	29
New Jersey	29
Montana	29
Vermont	29
California	28
Washington	27
Massachusetts	27
Maine	27
Utah	26
New York	26
Oregon	26
Illinois	**26**
North Dakota	26
Michigan	26
Kansas	25
Nevada	25
Nebraska	25
New Hampshire	25
District of Columbia	25
Maryland	24
Iowa	24
Hawaii	24
West Virginia	24

The services that Medicaid provides are often poor. Honest, needy patients can wait for hours in cramped storefront offices to see a doctor who may not be board certified. These problems are not limited to the Chicago area: In the 26-county area that comprises southern Illinois, the nearest Medicaid doctors may practice fifty or one hundred miles away from recipients in need of care. A five-county area in this part of the state has nearly 7,000 people on Medicaid, yet only three Medicaid doctors.

Millions of Illinoisans are in a public aid system that promises adequate health care, yet does not deliver.

Millions of Illinoisans are in a public aid system that promises adequate health care, yet does not deliver. There can be no doubt that a majority of Medicaid recipients would leave the system if they could afford to, but they are given no alternative.

Medicaid is largely immune to the basic forces that work in the private sector to ensure delivery of a sound product at a decent price. Medicaid patients have no incentive to shop around for the least expensive qualified provider: Medicaid picks up the entire bill, no matter how expensive or inexpensive it is. For the same reason, Medicaid patients are free to over-use medical services, seeking appointments and prescriptions even if there is no real medical need.

Medicaid providers face similarly perverse incentives. The state reimburses doctors at only a fraction of the amount paid by private insurers. Consequently, many good doctors avoid the system, while some of those who choose to participate use billing procedures and medical practices that are ethically and legally suspect. Medicaid operates like any other wage and price control scheme: It forces customers to queue, and it encourages producers to "play the system" to produce the maximum income while delivering the lowest quality service that can get by the rare government inspector.

Finally, government agents assigned to make the Medicaid system work better face an impossible task. No amount of coaching or training will make Medicaid patients more price-conscious consumers of a product that is, for them, free. And adequately policing the activities of doctors around the state would require a staff of thousands of highly trained monitors, impossible to finance even under wildly optimistic budget forecasts, and of dubious merit in the long run. Compounding the government's problem is its lack of good information regarding the quality of providers or the genuine medical needs of its patients; a bureaucratic environment that discourages innovation and rewards growth in staffing levels and budgets; and constant political interference by elected and appointed officials who, for reasons good and bad, try to influence the day-to-day operations of the multi-billion dollar agency.

Tinkering around the edges of the system will not bring the Medicaid crisis under control. Deeper, more structural reforms are needed.

The Edgar Reform Plan

In his 1994 budget message, Governor Edgar called for enrolling one million Medicaid recipients in a "managed care" program by mid-1995 — in effect creating a $5 billion Health Maintenance Organization (HMO). Health care providers would be paid a flat fee for each patient they agreed to treat, and either a government employee or a private insurance company contracting with the state would monitor each patient's use of health care services. The General Assembly approved the Edgar plan during its 1994 session.

> The Edgar Medicaid reform plan does not go far enough to ensure that the principles of competition and efficiency are applied.

In theory, HMOs contain costs because doctors are paid a salary or annual per-patient fee, and because patients' access to doctors and specialists is restricted. HMOs depend heavily on primary care physicians: They are the salaried professionals who staff HMOs, acting as "gatekeepers" to direct their patients' use of all health care services. Unfortunately, Illinois currently suffers from a severe shortage of primary care physicians. Of the 29,074 practicing non-federal physicians in Illinois, just 3,121 — 10.7 percent — are family or general practice physicians. <42> To put Illinois' 1.4 million Medicaid recipients into a system of HMOs thus will require many more primary care physicians than are now in the system.

At least in part because of the shortage of primary care physicians to staff them, HMOs nationwide often fail to achieve their cost-saving potential. Half of the employers responding to a 1991 survey by A. Foster Higgins, an employee benefits consulting firm, said their HMO rates were as high or higher than their non-managed care plans. <43> A Congressional Budget Office survey of research found that enrolling Medicare patients in HMOs "had little or no effect on hospital use and costs"; the study concluded that "During the past decade, managed care appears to have had little effect on total health care spending in the nation." <44>

Governor Edgar's HMO plan suffers from a more fundamental weakness: The patients who use the system still won't pay for their care. The utilization monitors employed by the state or private insurance company will face an impossible job, "second guessing" patients who say they need to see a doctor. The state will still receive, process, and pay bills under the Edgar plan; the state will still centrally manage the system.

The Edgar plan does not go far enough to ensure that the principles of competition and efficiency are applied. Nor does it ensure that Medicaid recipients receive the same quality care as other citizens. While recognizing that the private sector is better equipped than the state to provide health care, the Edgar plan does little to change the incentives that have caused bureaucracy and waste to run rampant in the system. Indeed, the Edgar plan may well increase government's presence in this arena by requiring a huge bureaucracy to create and operate a state-run HMO.

A Better Reform Plan

There is a better way. The Heartland Institute — and dozens of think tanks across the country — urge the privatization of Medicaid. Our proposal is based on a plan set forth by the Alabama Family Alliance in its publication, *Getting Off the Critical List.* <45>

Individuals eligible for Medicaid would be provided vouchers with which they could purchase private health insurance. The value of the voucher would be equal to the current average Medicaid expenditure for a family of the same size as the recipient's family — in Illinois, approximately $4,000 for a family of four.

Four thousand dollars buys high-quality insurance coverage in the private sector. A family of four living in the south suburbs today pays a monthly premium of roughly $339 ($4,068 a year) for private health insurance; a family of four in Chicago pays about 18 percent more ($4,800 a year). <46>

Insurers wishing to accept Medicaid vouchers would be required to make available policies that cover all federally mandated Medicaid services, but *not* the many optional services added by the state. Insurers also would be required to accept the voucher as full payment for the policy premiums, although they would be permitted to charge reasonable copayments and deductibles for some services. An insurer might, for example, develop a policy with zero copayments for the federally mandated benefits, but 20 percent copayments on optional benefits such as prescription drugs or eyeglasses.

Medicaid voucher recipients would be allowed to pool their vouchers in order to purchase group health insurance policies. For example, residents of a public housing project or members of a church might choose to pool their vouchers and negotiate with insurers for the best group policy.

When the value of the Medicaid voucher exceeds the price of the private insurance policy chosen by the voucher recipient, the excess could be saved by the recipient in a Medical Savings Account (MSA) — much like an IRA, only restricted for medical expenditures. The Medicaid voucher recipient could use these funds (essentially a reward for cost-conscious shopping) to pay copayments and deductibles. Over time, the balances in these MSAs would grow, making it prudent to purchase less expensive insurance coverage with higher deductibles or copayments.

A voucher system would bring Illinois' Medicaid crisis under control. Recognizing the potential of this reform, lawmakers in several states are now considering Medicaid voucher proposals. To assist state lawmakers, the American Legislative Exchange Council (ALEC) has developed a prototype bill. <47> Among the many benefits we could expect to see from a Medicaid voucher program are the following:

- Health care providers no longer would be shortchanged for treating Medicaid patients, so fewer physicians would refuse to treat them. Access to care — particularly in areas of the state where there are few Medicaid physicians — would improve dramatically.

- Medicaid recipients no longer would be treated differently than the privately insured, because *they would be privately insured.* The quality of care they receive would improve.

- Like the privately insured, Medicaid voucher recipients would have an opportunity to purchase insurance policies closely tailored to their personal needs. Relatively expensive policies would offer coverage for optional benefits, while less expensive policies would not. Medicaid patients themselves would choose the level of coverage that suits them best.

- Fraud and abuse in the Medicaid system would fall as new incentives (such accumulating money in Medical Savings Accounts) would encourage voucher recipients to limit their health care spending. Insurers providing voucher-eligible policies would monitor providers, just as they do now for the privately insured market. Many Medicaid beneficiaries would enroll in existing managed care programs, where systems are already in place to monitor use of services. The imposition by insurers of reasonable deductibles and copayments will encourage Medicaid patients to utilize health care services more wisely. Finally, Medicaid vouchers would be made non-transferrable and would purchase *only* medical services.

- The bureaucracy and inefficiency that pervade the state's Medicaid system would be greatly decreased. Government employees no longer would process claims or monitor utilization. The Department of Public Aid's responsibilities for Medicaid would largely be limited to determining eligibility and ensuring that vouchers are issued to eligible recipients. The cost to implement and operate a voucher system would be a fraction of the cost of operating the present Medicaid system.

The Medicaid spiral must end if Illinois is to keep DPA's budget within the 5.2 percent annual growth rate we have set as our goal. No other reform offers as much likelihood of success in meeting this goal as does a voucher system. Whoever is elected Governor in November 1994 should immediately take steps to implement this Medicaid privatization.

Aid to Families With Dependent Children (AFDC)

While not as expensive as Medicaid, AFDC in Illinois is still a costly, self-defeating, inefficient program. Administered by DPA, AFDC is a cash assistance program that aids poor families with one or more dependent children. Most families on AFDC are eligible for Medicaid and Food Stamps as well. AFDC payments are determined by the number of household members and the area of the state in which the family lives. Benefits increase with the number of children; an AFDC mother in Illinois receives $47 to $99 more per month with each birth. <48> More than 237,000 families receive AFDC payments each month; all told, 700,000 Illinois citizens — two-thirds of them children — are on AFDC.

Analysis

There are few incentives built into the AFDC program to encourage recipients to find ways off welfare — and many incentives for them to remain on. The average AFDC family in Illinois receives monthly tax-free benefits that are significantly greater than it would receive if someone in the family worked at a minimum-wage job. And most people on AFDC won't qualify for much more than minimum-wage positions, as they lack the job skills and education necessary for substantial employment.

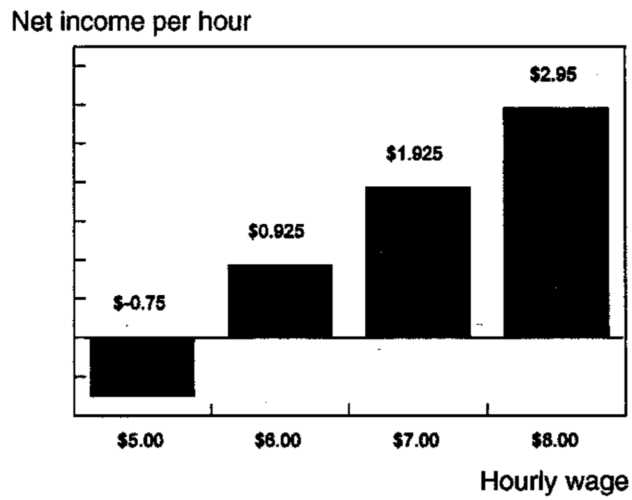
There are few incentives built into the AFDC program to encourage recipients to find ways off welfare — and many incentives for them to remain on.

Consider, for example, the average AFDC family of three. It receives $662.00 per month from AFDC and Food Stamps, plus Medicaid benefits. Assume that a family member is offered a job that pays $5.00 an hour after taxes. After allowing $50.00 a month for transportation to and from work, and $100.00 a month for health insurance, the family is left with $650.00 a month — $12.00 less than it would have if no one in the family was employed.

AFDC benefits give recipients little incentive to work at even higher-paying jobs. If someone in the AFDC family of three accepts a job paying $8.00 an hour after taxes, he or she earns (after transportation and health insurance) $1,130 per month — $468.00 more a month than the person would receive on welfare. The loss of AFDC benefits means the worker gains less than $2.95 an hour by working a full-time job.

Illustration No. 11 demonstrates this point. Along the bottom axis is take-home pay after taxes and after a $150 monthly allowance for health insurance and transportation. A family of three in Illinois, receiving AFDC and Food Stamps plus Medicaid, actually loses 75 cents an hour if a family member takes a job that offers take-home pay of $5.00 an hour. Even the unusually skilled welfare recipient who is able to find a position that pays $8.00 an hour after taxes, health insurance, and transportation will clear just $2.95 an hour more by working than if he or she were to remain on welfare.

Illustration No. 11
Per-Hour Gain or Loss for Employment by Welfare Recipients



AFDC distorts other incentives, too. While it may seem reasonable to increase benefits when an AFDC mother has more children, doing so encourages poor parents to have larger families, thus increasing the number of children born into poverty. AFDC benefits may also explain the extraordinarily high rate of illegitimacy among the poor. The Ways and Means Committee of the U.S. House of Representatives reported in 1992 that 54 percent of the children in AFDC families were born out of wedlock. <49>

Clearly, positive incentives to leave AFDC are missing — and the program lacks negative incentives as well. In Illinois, AFDC recipients may remain on welfare indefinitely. Eligibility is recertified only once every six months. By contrast (for example), unemployment insurance recipients in Illinois are required to apply every two weeks, and benefits expire after six months. AFDC recipients get monthly checks indefinitely, and they are not required to do much in return. In his 1994 state budget message, Governor Edgar took a small step in the needed direction by proposing a requirement that mothers under the age of 18 earn a high school diploma (or its equivalent) or lose their welfare benefits. <50>

A Reform Plan

AFDC should be ended. Current political sentiment favors such a move. Even President Clinton campaigned in 1992 on a promise "to end welfare as we know it." More importantly, welfare reform is well underway in several states, giving Illinois working examples to which it can turn. Neighboring Wisconsin, in particular, has begun to radically reform its welfare program, with the ultimate goal of ending AFDC by 1996. This innovative plan, promoted by Governor Tommy Thompson, should be the starting point for reform in Illinois.

> After two years on AFDC in Wisconsin, adults can no longer receive cash benefits, although Food Stamps and Medicaid coverage continue.

Two Years and Out. The centerpiece of the Wisconsin reform plan is Thompson's "Work, Not Welfare" program. <51> This plan was recently put into place on a trial basis in several Wisconsin counties. Under Work, Not Welfare, able-bodied welfare recipients are required to find full-time work or enter a job training program within 30 days of applying for assistance. If a recipient finds employment, money earned on the job is then deducted from his or her government check — but the welfare check is not eliminated entirely if a person is employed. If a recipient is unable to find work and does not enter a job training or education program, the state assigns the person a job in the community. After two years on AFDC, adults can no longer receive cash benefits, although Food Stamps (a federal program) and Medicaid coverage continue.

Several analysts in Wisconsin have outlined job training and employment possibilities for AFDC recipients in the program. In *Reforming Welfare In Wisconsin*, Dr. Daniel J. Alesch offers several examples. <52> A young divorced mother with basic work skills and a school-age child, for example, might receive a technical school education or specialized training. Someone with no employment skills might enter a development program, where she would learn basic skills in home or money management as well as fundamental work skills.

Alesch encourages the development of public-private partnerships to increase job opportunities for program participants. He also proposes a 1990s' version of the 1930s' Civilian Conservation Corps (CCC), which taught young people work, living, and vocational skills while providing them with a modest income. This new version could include jobs such as child care, food services, cleaning, and care for the elderly.

Thompson also has ordered that a permanent substitute, either Work, Not Welfare or something else, be developed to replace AFDC. A team of national welfare reform experts will be assembled to devise such an alternative. Thompson has stressed that any new program must emphasize work, parental accountability, and fairness to taxpayers. <53>

To be sure, Wisconsin's plan has weaknesses. Jobs may not be available in a community. The state assumes responsibility for job training and placement for hundreds of thousands of people, even though a great deal of academic study has questioned the value of such government-run programs. <54> Nevertheless, the Wisconsin plan moves in the right direction — away from the permanent dependence that is created by AFDC systems such as Illinois'.

Illinois should use the Wisconsin plan as a starting point for ending AFDC. Work, Not Welfare has the major components for success. The program is intended to return welfare to its proper role as temporary aid for the needy. The program mandates that recipients leave the welfare rolls after two years; it requires people to become gainfully employed; and it finds a job for recipients unable or unwilling to do so themselves. By requiring work or training, the program promotes self-sufficiency and helps people obtain the skills necessary for becoming active in the workforce.

If Illinois' new governor does not follow Wisconsin's lead, Illinois is at risk of becoming a *welfare magnet* for people who are ineligible for welfare benefits in other states. Illinois' budget problems will only *worsen* if it does not adopt real welfare reform.

Other Reforms

In addition to the specific Medicaid and AFDC reforms proposed here, we recommend the establishment in Illinois of a Grace Commission-type panel to examine the Department of Public Aid with an eye toward increasing efficiency and cutting costs. The Grace Commission was a task force of two hundred business leaders, headed by industrialist Peter J. Grace, established by President Ronald Reagan early in his tenure. Its final report made 2,478 recommendations and ultimately saved the federal government more than $250 billion by the end of FY 1992. <55>

We have no doubt that the tremendous increase in DPA's budget over the past several years brought with it a substantial amount of waste, mismanagement, and inefficiency. Surely the largest department of state government merits a more detailed analysis than we are able to provide here.

Department of Children and Family Services (DCFS)

The Illinois Department of Children and Family Services, which had a 1993 budget of $781 million, has grown at a rate even faster than DPA, increasing expenditures 56 percent between 1991 and 1993. The DCFS workforce grew 15 percent during this period. By June 1994, DCFS had a record 40,000 children in its custody. <56>

DCFS was created in 1964 following the recommendation of a special state task force; child welfare had been, for much of the twentieth century, the responsibility of charitable or religious organizations. Government involvement primarily concerned inspection and licensing of private facilities. As Illinois passed stricter child abuse and neglect laws, the responsibilities placed on DCFS increased. <57>

Although DCFS has several functions, its primary responsibility is protecting children by removing them, temporarily or permanently, from unsafe homes. DCFS caseworkers are assigned to investigate cases of reported abuse or neglect, and children found in danger are taken into protective custody and sent to emergency centers where their cases are processed.

> Despite its promises and a substantial increase in funding, DCFS' record on reform has been spotty at best.

Like DPA, DCFS has been plagued with failure and has come under tremendous public scrutiny and criticism for mismanagement. This, in turn, has caused many demands for reform — and in some instances, demands for a complete overhaul of the department. These demands came to a head in 1988 when the Illinois American Civil Liberties Union (ACLU) sued DCFS, charging that the department was in such disarray that it inflicted additional harm on many of the children it was designed to protect. In 1991, DCFS settled the suit in a consent decree by promising to improve services and hire more workers; specifically, 93 reform promises were made and were to be implemented under U.S. District Court supervision. Much of the increase in DCFS' budget is a consequence of the department's attempted compliance with these promises.

Analysis

Despite its promises and a substantial increase in funding, DCFS' record on reform has been spotty at best. As part of the agreement ending the ACLU lawsuit, the District Court appointed retired Cook County judge Joseph Schneider to periodically evaluate the progress of DCFS reform. On February 1, 1994, Schneider issued a 168-page report assessing the department's compliance with the Consent Decree between January 1 and December 31 1993. Schneider concluded that the department largely failed to live up to reform promises (fulfilling only 51 of 93 made) or provide better care for children in its custody. <58>

Other investigations have been highly critical of DCFS. On May 20, 1993, the Illinois Auditor General issued a two-volume Financial and Compliance Audit of the department for the two years ended June 30, 1992. The Audit "noted 26 findings that individually and cumulatively demonstrate a failure by the Department to properly establish and maintain administrative internal controls. . .; [and] 10 findings indicating a failure by the Department to take steps necessary to ensure that children are adequately protected . . ." And Schneider, in a June 27, 1994 response to DCFS' fiscal year 1995 annual plan, noted:

> The Department has been reluctant to engage in discussion of the areas of noncompliance detailed in the February 1, 1994 Report of the Monitor. DCFS has also wished to defer and postpone the filing of these objections. The reform initiative is at a critical juncture and it is not acceptable to let it drift. In the February 1st Report, I noted that if the increasing caseloads continued unchecked "it will have serious implications for meeting the requirements of the entire system." Since that time, the increases have continued unabated and the Department has achieved an all time high caseload of over 40,000 children in care. The reforms have yet to take hold in a manner that affects these dynamics. <59>

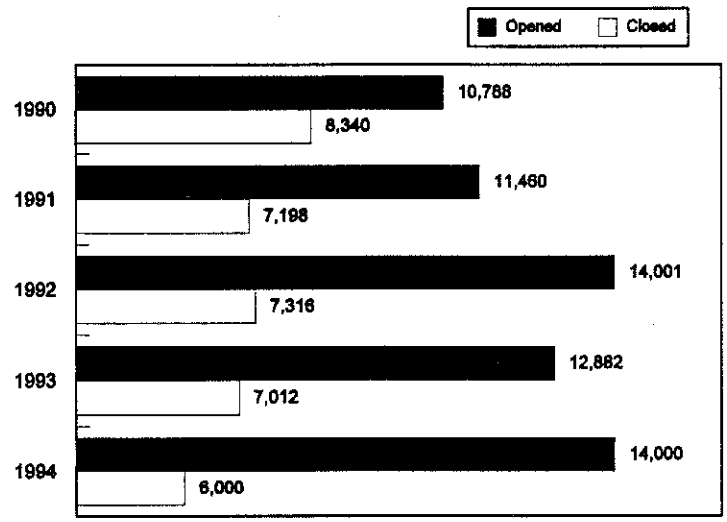
Attorneys Benjamin S. Wolf and Michael L. Brody, of the law firm Schiff Hardin & Waite, also filed a response to the Department's fiscal year 1995 plan. They wrote:

> It is our view that the Department is massively out of compliance with both the letter and the spirit of the B.H. Consent Decree. There is no hope that full compliance will be achieved by the July 1, 1994 date set forth in the Decree. Moreover, the problem is not simply one of missed deadlines; the problem is that the Department has in many fundamental respects failed to make substantive progress towards compliance with the Decree, and has even, in some cases, moved backwards in terms of compliance. <60>

Investigative reports by several news organizations in the state also have been highly critical of the department. Stories abound of neglected and abused children apparently under DCFS care, misplaced files, files filled with inaccurate information, poorly trained workers, and misguided foster placements. It is apparent that, despite the tremendous increase in resources made available to DCFS during the Edgar years, the department's problems are worse than ever.

A key problem for DCFS has been the great increase in the number of children in its care. According to Schneider's February report, the number of children for whom DCFS has taken responsibility increased by 38 percent in the past three years. While it is likely that there has been some increase in the number of children abused or neglected, and probably an increase in the number of cases reported during this period, neither factor can account for the increase in the DCFS caseload. Where does the explanation lay?

Illustration No. 12
DCFS Case Openings and Closings
1990 - 1994 (projected)



According to the Schneider report, "[t]he caseload increase is due primarily to children staying longer in the system. Even though intake has remained steady or decreased, case closings have slowed even more." <61> Between 1991 and 1993, while DCFS' budget was increasing by 56 percent and its staffing by 15 percent, the department was able to close only 63 cases for every 100 it opened. In 1990, nearly 1.3 cases were opened for every 1 case closed; in 1994, the ratio will be an estimated 2.3 to 1. (See Illustration No. 12.) <62>

According to a March 1994 *Chicago Tribune* report, fewer than 23 percent of the children in DCFS custody were either adopted or moved back to their families last year. Children in DCFS care are transferred to new locations an average of five times during their first year in custody. Children are becoming trapped in the system; there may be literally thousands of children "adrift" in DCFS. <63> Clearly, such a record of failure cannot be sustained; any real reform at DCFS must focus on effectively moving cases through the system and closing them more quickly.

A Reform Plan

Transfer caseload to the private sector. As we have noted, DCFS originally played a regulatory role in child welfare: It set guidelines for determining abuse and neglect, regulated foster homes and orphanages, and assumed guardianship of children only as a last resort. Most children classified as welfare cases were placed into the care of private groups, such as Catholic Charities. Today, just 62 percent of the DCFS foster care cases are handled by private groups, <64> although private agencies have expressed their willingness to accept more. Don Kent, executive director of Catholic Charities of Chicago, has stated that his organization alone could handle several hundred additional cases immediately; in the next several years, he noted, private groups throughout the state could take over the entire DCFS caseload. More importantly, Kent suggested that private groups could expand their roles in such areas as follow-up investigations and home visits, currently low priorities for DCFS.

DCFS must take advantage of the expertise and willingness of private groups for an expanded role in foster care and other DCFS responsibilities. While DCFS remains legally responsible for children in its custody, the transfer of cases to the private sector could provide more quickly stabilized home environments for the state's least fortunate children and great savings to the taxpayers of Illinois.

Improve caseworker training and support at DCFS. To the extent that DCFS maintains a caseworker role in child welfare cases, the agency apparently needs a complete overhaul in the way it trains new employees and manages their integration into the department. According to the February Schneider report, when 500 new caseworkers were hired in May 1993, they were subject to training sessions that were disorganized, too theoretical, and of little practical value. Moreover, the transfer of 25,000 cases to newly hired caseworkers in September 1993 was characterized by Schneider as "a disaster." He wrote:

> From all reports of field workers and supervisors, the transfer was a disaster. Workers had one or two days to prepare entire caseloads for transfer. Records were not put in proper order. Critical information, such as court dates, was missing. No master files were prepared, and case records were piled in conference rooms waiting to be packed and shipped. Records freqently went astray, and workers reported frustration in serving "phantom" cases for which there was no record. Many had to recreate these records from scratch. . . . One new supervisor said she came into her office one day to find 500 cases in boxes. It took her a week to go through them to get them assigned, check court dates, etc. <65>

As a result, DCFS workers failed to appear at more than 500 dispositional hearings in Cook County Juvenile Court during the months of October and November 1993. <66> Clearly, much of the funds used to hire these new workers was wasted. Transfering cases to private charities would dramatically reduce the pressure on DCFS staff, giving it the opportunity to get organized and better trained. New hires should stop immediately, and over time the size of DCFS staff should be allowed to fall to the levels that prevailed before it assumed its present caseworker role.

Other DCFS reforms. Beyond better ways of hiring, training, and integrating new workers, DCFS is in need of further reform. The Schneider report found that the department has failed to maintain complete case files documenting the needs of and services provided to children placed in its custody. Caseworkers have been very slow to complete assessments of children's health, education level, and family histories. Simple recordkeeping in the department is in poor shape; the Illinois Auditor General's task force reported that almost 40 percent of documents required to be in DCFS case files were missing, as were over 20 percent of follow-up caseworkers' files. A key document — that which explains the care required for a child — was missing from 26 percent of the files in Downstate Illinois and from 38 percent in Cook County. In fact, DCFS computers are largely unable to determine exactly where a foster child is being housed at any given time. Not surprisingly, foster parents were found to have received inadequate information about children who come into their homes; as a result, placements are often poor and must be redone, sometimes two or three times.

The Schneider report paid special attention to the "revolving door" atmosphere of foster care in Cook County. DCFS has largely failed in training foster parents. A recent DCFS survey found that 53 percent of foster parents had completed no training. <67> Before foster parents can accept children, they must be licensed by the state. Yet the *Chicago Tribune* reports that DCFS has failed to license 24 percent of foster homes that take in children related to them. This failure costs Illinois taxpayers $8.6 million a year, because the federal government will not reimburse the state for care in unlicensed homes.

DCFS must maintain better and more complete files on the children in its custody. We recommend a complete overhaul of the department's file development and maintenance.

Schneider's report suggests that disrupted foster home placements are all too common, the result of poor assessment of children's needs, inappropriate placement, and lack of crisis intervention. More thorough and accurate assessments would lead to improved case planning and more effective services overall in the department — efficiencies that would ultimately control costs.

DCFS must maintain better and more complete files on the children in its custody. We recommend a complete overhaul of the department's file development and maintenance procedures. Fundamentally, this is a matter of better information processing. The department should turn to experts in the private sector who can help find the best possible way to implement this reform.

Finally, we also recommend a Grace Commission-type panel to study DCFS and suggest further reforms to ensure efficiency, particularly emphasizing middle- and upper-level management practices. In their response to the DCFS fiscal year 1995 plan, attorneys Wolf and Brody noted that:

[M]anagement must create a cultural transformation of the Department so that it will simply become unthinkable for DCFS personnel to fail to protect and care for the children in their custody. In order to get workers to assure safety and permanence for every child in their care, DCFS management itself must also undergo a "sea change." Management at every level must see the servicing of front-line workers, and their delivery of services to children and families, as the end to which the entire Department labors. <68>

A recent *Chicago Sun-Times* editorial agreed:

The process [of reform] has revealed DCFS as a highly centralized bureaucracy far removed from the real business of serving and saving the state's neediest children. . . . Caseworkers who complete paperwork but do nothing of real substance are rarely disciplined. The state money keeps flowing. . . . In short, DCFS cannot serve the abused and neglected children in its care because it serves only itself — with forms and procedures and policies that are layers removed from the streets and the squalor and the children themselves. <69>

Department of Central Management Services (CMS)

The budget of the state's Department of Central Management Services increased 39 percent between 1991 and 1993, from $1.05 billion to nearly $1.44 billion. (See Table 5 below.) According to the CMS state budget appropriation document, the department

provides a broad range of centralized services to other state agencies in order to maximize efficiency, eliminate duplication, and benefit from economies of scale. The department procures goods and services for state agencies, operates the state's garages, provides maintenance and security at a number of state office buildings, provides electronic data processing, statistical services and support, manages the state's telecommunications network, administers the personnel system, and manages the State Employees' Group Insurance and Deferred Compensation programs. <70>

Analysis

The goal of increased efficiency in government is laudable. <71> But escalating expenditures in the Department of Central Management Services suggest that the department is not meeting the goal, and thus is due for a careful review of its role in state government. The experiences of states and cities across the country show that many of the responsibilities given over to CMS can be provided more efficiently and at a higher quality by firms in the private sector. For many of these responsibilities, the market for private-sector providers is highly competitive — an ideal environment for a form of privatization known as "competitive contracting."

Table 5 Department of Central Management Services Programs and Expenditures, 1991-1993 *(in thousands)*			
	1991	1992	1993
Administrative Operations	4,009.7	5,907.6	7,248.8
Benefits	814,994.0	869,486.0	1,190,055.8
Communication and Computer Services	152,004.1	142,169.6	151,837.3
Information Services	5,757.3	5,241.8	6,136.8
Minority and Female Business Enterprise	349.2	560.8	588.0
Personnel	12,304.6	9,742.8	17,989.2
Property Management	22,147.8	20,283.4	24,488.0
Support Services	32,685.3	30,898.6	32,648.0
Internal Security and Investigations	1,948.1	1,712.9	2,930.2
Total	**$1,046,200.1**	**$1,086,003.5**	**$1,433,922.1**

> The experiences of states and cities across the country show that many of the responsibilities given over to CMS can be provided more efficiently and at a higher quality by firms in the private sector.

Competitive contracting has been used for decades by private businesses and government agencies to ensure that goods and services of a defined quantity and quality are produced for the lowest possible cost. When applied to government services, competitive contracting involves a synthesis of public and private roles. The public sector decides what services should be produced and what specifications should apply to the service. The competitive market responds to the invitation and determines how best to produce the service at the lowest possible cost.

Competitive contracting makes an important distinction between two sides of the public service delivery coin: *production* and *provision*. Dr. E.S. Savas, chairman of the Department of Management at Baruch College (City University of New York) and widely credited as a founder of the modern competitive contracting movement, writes:

> One must distinguish between government *production* and government *provision* of a service. [Peter] Drucker referred to the former as "doing" and the latter as "governing." The former utilizes government employees to perform the work. The latter involves a government decision to pay for a service but to have a private firm supply it, perhaps by hiring a contractor to repair streets or collect refuse, or by issuing food stamps that poor people can spend in a private supermarket. <72>

This simple, common-sense distinction has made possible tremendous improvements in the delivery of public services at the local, state, and national government levels. Competitive contracting is one key mechanism for applying this distinction to the real world of public service delivery. <73>

Cost savings potential

Competitive contracting reduces the cost of public services in three ways. First, **competitive contracting results in lower costs for the service contracted**. Cost savings of 15 to 30 percent are common, with occasional savings of 50 percent or more. Touche Ross reported cost savings in 98 percent of the competitively contracted services it studied, with savings of more than 40 percent in some cases. <74> The Mercer Group, in a 1990 update of a survey originally conducted in 1988, reported that "fully 100 percent of respondents claim to have achieved financial savings through contracting out. . . " <75> In *Privatization: The Key to Better Government*, E.S. Savas reviewed nearly a dozen studies of competitive contracting, all of which find significant savings. <76>

Second, **competitive contracting results in lower costs for other government services**. Competitive contracting induces improved efficiency for services retained by the government agency but subject to competitive contracting. For example, when a transit agency contracts for 20 percent of route service, there is a decline in costs even in the remaining 80 percent of route service produced by the agency. <77> This "ripple effect" has been identified in various government services, including solid waste collection, public transit, and fire protection. Public employee unions have negotiated competitive wage and benefit packages in response to competitive contracting. As a City of Phoenix public administrator put it:

> Our people are in a competitive mode. We have cut our costs way back because we have learned from the experience of private contractors. We have the unions convinced about the need to improve productivity. <78>

Finally, **competitive contracting results in lower net costs** as a result of taxes paid by private contractors on supplies they purchase, assets they own, or profits they earn. Government agencies are exempt from these taxes, which in the private sector may exceed 10 percent of gross revenues. The private bus industry, for example, paid average taxes of 9 percent on gross revenues from 1971 to 1982, with the highest year at 13 percent. <79>

Table 6
Estimated Range of Cost Savings
Selected CMS Services

Administrative Operations	18 to 30 percent
Information and Communication Services	8 to 24 percent
Personnel	15 to 25 percent
Property Management	18 to 30 percent
Support Services	18 to 30 percent
Internal Security and Investigations	34 to 59 percent

The Reason Foundation has examined over 75 services commonly provided by state or local governments, estimating the range of cost savings that could be achieved through the privatization of each. <80> In Table 6 we apply Reason Foundation savings estimates to some of the services currently provided in Illinois by CMS.

Extent of Privatization

In one of the most comprehensive surveys of state privatization efforts, 54 percent of responding state agency officials reported an increase in their use of privatization in the area of administrative and general government services. <81> Nearly 92 percent of respondents who used privatization for these services utilized the technique of competitive contracting. Several states have employed competitive contracting for services that, in Illinois, are currently performed by government employees in the Department of Central Management Services. For example,

- In **Massachusetts**, privatization of management for the state's transportation building has saved the state nearly $1.2 million. <82>

- In **Texas**, reports the Reason Foundation, the permanently established Council on Competitive Government "is expected to save the state about $11 million in 1994 by consolidating state printing shops and then putting printing out to bid. The Department of Information Service's Data Center will also be opened up to competition." <83>

- A 1991 report by Republicans in the **Pennsylvania** House of Representatives estimated the state could save $2 million by abolishing the State Capitol Police and instead providing for private policing of State buildings and facilities. <84>

- **Colorado, Maine, North Dakota, West Virginia,** and **Wisconsin** all contract with private-sector firms for the design, installation, and maintenance of their telecommunications systems. **Colorado** and **Wisconsin** also contract out their employee benefits programs and for their mailroom services. <85>

Clearly, Illinois' new governor need not "reinvent the wheel" as he or she considers privatization opportunities in the Department of Central Management Services. Not only have the governors of the above-mentioned states laid privatization groundwork for Illinois, but so too have the mayors of some of the country's largest cities. For example, <86>

- **Indianapolis.** Since taking office in 1992, Mayor Stephen Goldsmith has moved 50 services into the competitive marketplace, saving the city $28 million a year. A private firm does the city's microfilm work for 61 percent less; printing costs are 47 percent lower than they were before privatization.

- **Philadelphia.** Under Democratic Mayor Edward Rendell, thirteen services have been privatized since October 1992, for a projected five-year savings of $18 million. Another 30 candidates for competition have been identified.

- **Chicago.** Since taking office in the spring of 1989, Mayor Richard M. Daley has privatized about 25 services, ranging from water customer billing to drug and alcohol treatment programs. "When government tries to be everything to everybody, it becomes nothing to anybody," says the mayor, who has turned over many ancillary services, such as job training and gang intervention, to community groups.

- **Los Angeles.** During the 1993 mayoral campaign, Richard Riordan proposed privatizing a host of city services, including trash collection and the Los Angeles International airport. Since taking office as mayor, Riordan has announced pilot projects to privatize six services in 1994, including workers compensation claims processing.

- **New York.** Newly elected mayor Rudolf Giuliani also has pledged to improve the efficiency of city services through privatization and plans to reduce the municipal workforce by over 15,000 by June 1995. The Mayor's first budget was released in February 1994, and it calls for opening up numerous services to private sector competition. The proposal also calls for numerous asset sales, including 85 of the city's 500 gas stations, WNYC (the city-owned radio and television stations), city-owned land, and parking garages. The privatization proposals, if implemented, could save the city $78 million.

- **Cleveland.** Elected to a second term as mayor in 1993, Michael R. White created a Council on Competitiveness in early 1994 to explore ways to open up city hall to competition from private firms. Promising that he will not back down from plans to privatize services no matter how strong the opposition is from the unions, White says someone needs to stand up for the taxpayers. "While we have 8,000 employees, there are 500,000 Clevelanders, and they pay for this," said the mayor. "I think that somebody, somewhere ought to stand up for them, since they're paying the tab."

The new Illinois governor could do far worse than to ask for privatization assistance from these mayors, and also from Illinois' own "unsung privatization hero": Mayor Chester Stranczek of Crestwood, a small suburb south of Chicago. The Heartland Institute reported on Stranczek's efforts in early 1994:

> In the 24 years since [Stranczek was first elected in 1969], he has contracted out virtually everything, from bookkeeping to street maintenance to water and sewer repair. . . . Crestwood contracts with a part-time accountant to handle the bookkeeping, at a cost of $7,000 a year. The village pays an outside contractor $600 a month to handle water billing. Most towns have two or three full-time employees to handle water bills. <87>

Finally, whoever takes the reins as governor in 1995 can turn to the privatization analysis conducted by Governor Edgar's Private Enterprise Review and Advisory Board. Created by an Executive Order issued by Governor Edgar in October 1991, <88> the Board was directed to, among other things, "study activities performed by the state to determine if it would be in the state's interest to have these activities performed by the private sector." In its March 1993 report, the Board identified 44 state government activities that it recommended be studied for privatization, including 34 programs and services for which competitive contracting was recommended. <89>

Recommendations

Illinois' new governor should work with the General Assembly to make privatization and competitive contracting an integral part of the state's budget and service provision process. Three reforms, each adopted already elsewhere in the U.S., stand out as offering tremendous potential:

- Adopt "Internal Markets" legislation that would allow departments of state government to purchase support services from private firms. Reports the Reason Foundation:

Internal support services that serve other government units, such as computer repair and copying, can also be exposed to market forces. Called "internal markets" in the private sector, this management technique requires every business unit within a corporation to operate as an independent firm, deciding whether to purchase input supplies from other departments of the corporation or from outside suppliers.

. . . [T]he city of Milwaukee has introduced internal markets into some city services to push support service units to lower costs and become more competitive. The city's Internal Service Improvement Project (ISIP) allows city departments to purchase six different internal services from private firms, instead of city departments, if they can obtain a lower price and/or better quality. . . .

The program, launched in 1992, has already produced results. Some departments are cutting costs and obtaining better quality services by contracting with outside vendors. This has spurred the internal units to make dramatic changes and operate efficiently. The building maintenance division, for instance, is doing customer surveys and beginning to come in with lower bids than private firms. <90>

Milwaukee's program was developed by staff in the city's Department of Administration, Division of Budget and Management, which in early 1991 interviewed city department representatives and asked them to assess internal services. The "customers" expressed overall low satisfaction with internal services, citing lack of responsiveness, lack of timeliness, poor quality, high cost, and their own lack of control over results. According to the project team's report,

Many [interviewees] said they could perform services themselves or that private firms could provide a service at equal or better price and quality compared to internal service providers. When we asked interviewees whether they would have time to procure services or provide the service themselves without adding staff, a common reply was that it would not take any more time than it takes now to get needed services from internal providers, and at least the time would be spent productively. <91>

- Adopt "Petition of Interest" legislation, which requires that an agency of state government competitively bid a service or conduct a "make or buy" analysis whenever the agency receives a bona fide expression of interest by a private sector firm capable of producing the service. Texas passed such legislation in 1993, with the support of both the State Comptroller and the State Auditor. Said State Comptroller John Sharp, "the Council on Competitive Government is an invitation to Texans all over the state: If you think your company can do a better job of landscaping the Capitol grounds, or even running the massive computer system in my agency, start preparing your bid." <92> The Arizona legislature passed such a bill in 1990, but it was vetoed by the governor. <93>

The "petition of interest" approach is uniquely valuable because it focuses competitive contracting efforts on public services for which the private sector demonstrates both sufficient capability and an interest in providing the service.

- Consider the creation of a permanent Council on Competitive Government, as has Texas, charged with examining state government activities and determining whether the private sector can perform them more efficiently. <94>The Council could be an outgrowth of Governor Edgar's Private Enterprise Review and Advisory Board — whose March 1993 report appears to have been largely ignored by state government officials.

PART 5

Summary and Conclusions

Illinois must make a choice in 1995: Either to control spending by state government, or to raise taxes. The Edgar Administration has been able to resist calls for higher taxes for three years by cutting spending in some areas of government, increasing debt, and relying on natural revenue growth, but the limits of these approaches have been reached.

Increasing state taxes could have serious negative consequences for Illinois residents. We have documented the loss of jobs and income that would result from a state income tax hike, and we have rebutted claims that higher state income taxes would be fairer, more efficient, or create better schools. Illinois' tax burden, as we have shown, is already either equal to or above the national average.

If increasing taxes is not an attractive alternative, then controlling spending is the only option. Our analysis concludes that spending in the Department of Public Aid (DPA), Department of Children and Family Services (DCFS), and Department of Central Management Services (CMS) can be brought under control in the next four years if:

1. Medicaid is privatized through a voucher system.

2. Aid to Families with Dependent Children (AFDC) is phased out and replaced with a "Work, Not Welfare" reform plan similar to the one adopted in Wisconsin.

3. The Department of Children and Family Services (DCFS) is returned to its original, regulatory purpose, while private agencies take principal responsibility for the state's child welfare caseload.

4. Complete reform of DCFS operating procedures occurs.

5. A Grace Commission-type outside panel examines in careful detail both DPA and DCFS, with the goal of identifying and implementing efficiency-enhancing and waste-reducing reforms.

6. Competitive contracting is aggressively employed in the Department of Central Management Services.

In addition to these Department-specific reforms, we recommend consideration of broader measures to constrain state spending — thus allowing Illinois to maintain a balanced budget without statewide tax increases. Among the measures we recommend:

- Adoption of a constitutional limit on taxes and expenditures, such as has been adopted in Missouri (the Hancock Amendment), Michigan (the Headlee Amendment), and 20 other states. The Cato Institute recently reported that, properly designed, tax and expenditure limitations (TELs) can and do limit the growth of state taxes and spending. Policy analyst Dean Stansel wrote:

  > The five-year growth rate of per-capita state spending in TEL states fell from 0.8 percentage points above the U.S. average before TEL enactment to 2.9 percentage points below the U.S. average after TEL enactment. . . . The five-year real growth rate of per-capita state spending in TEL states fell from 7.1 percent before TEL enactment to 1.8 percent after TEL enactment. <95>

  In an analysis for Jack Roeser, a candidate in the 1994 Republican gubernatorial primary, economists Robert Genetski and Joe Lichtenberger outlined a proposal that would limit state spending growth to match the growth in population and inflation. <96> This proposal merits further study.

- Adoption of a super-majority requirement that would prohibit tax increases (or the creation of new taxes) without the approval of more than a simple majority of legislators. The Illinois Tax Accountability Amendment, first proposed in 1990, would require two weeks of public debate and approval by two-thirds of the legislature for tax increases to pass. It, too, deserves consideration.

- Adoption of stronger statewide property tax limitation — such as the Tax Freedom Act, which would roll back and freeze property taxes and local taxes to their 1990 levels and would require 60 percent voter approval for any increases in property taxes or other local revenues.

- Adoption of more accurate and accountable budget reporting and procedures. Genetski and Lichtenberger note:

  > Illinois' financial system does not include a coordinated fiscal code; it is instead a collection of laws scattered throughout the statute books. This leads to the use of a wide variety of budgets and accounting systems in an attempt to depict the state's financial condition. . . .
  >
  > The state's budgets are unintelligible to most people. Those individuals most familiar with the intricacies of the various state budgets maintain that this is the way career politicians prefer to operate. If the budgets are largely unintelligible, it becomes extremely difficult to judge performance. <97>

Whoever is elected governor in November 1994 has an unprecedented opportunity to limit state taxes and continue the economic recovery witnessed during the Edgar years. Moreover, he or she will be in a position to initiate bold new reforms to set the state on track for balanced budgets and reformed social programs. The experience of other states shows that the relentless upward spiral of state spending can be halted. At the same time, Illinois can become a national leader in efforts to better serve the needs of its citizens. It's time for new ideas; Illinois deserves a governor with the courage and conviction to act on them.

# # #

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> Government has become such a big part of our lives that just making it better [ie, more efficient and more effective] may not be enough. . . . America is based on the concepts of individual liberty and self-sufficiency. We never envisioned government *doing things for us* as much as we saw government protecting our rights so we would be free to *do things for ourselves*. . . . I'm still glad that many government officials are taking the time to read *Reinventing Government*. I just wish they would spend as much time discussing the proper role of government in a free society.

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