UPDATE ON ILLINOIS’ ECONOMIC AND FISCAL CHALLENGES AND RESPONSES

PRESENTATION TO THE BOARD OF TRUSTEES OF THE UNIVERSITY OF ILLINOIS
JANUARY 24, 2013

DAVID MERRIMAN, PROFESSOR AND ASSOCIATE DIRECTOR INSTITUTE OF GOVERNMENT AND PUBLIC AFFAIRS

ECONOMIC AND FISCAL UPDATE
OVERVIEW

• Recent IGPA activities

• Brief Economic Overview
  – The U of I Flash Index
  – Illinois Unemployment; Employment Growth Comparison
  – Projections for 2013

• Fiscal Overview: Highlights of Fiscal Futures’ Illinois Report 2013 chapter

• Summary
RECENT IGPA ACTIVITIES

• *The Illinois Report 2013*
  – IGPA’s signature publication, in its 7th edition for 2013
  – Examination of the state of Illinois' performance on several critical issues
  – Fiscal Futures chapter: *And Miles to Go Before It’s Balanced: Illinois Still Faces Tough Budget Choices*
  • Highlighted in coming slides
The State Economy as a Whole — November 2012 IGPA Flash Index

- Up from 102.9 at the previous board meeting and 91.0 in November 2009; down slightly from 104.0 in October 2012. An index over 100 indicates the economy is expanding.
- IGPA Director Giertz notes, “Unlike most previous recessions, productivity continued to increase during and after the recent recession. Because of increased productivity, firms have been able to increase output without hiring many additional workers.”
ECONOMIC OVERVIEW – ILLINOIS UNEMPLOYMENT

January 2010
IL Rate: 11.4%

Sep-Nov 2006:
IL Rate: 4.4%

Nov. 2012
IL Rate: 8.7%

Nov. 2012
US Rate: 7.7%

Shaded areas indicate US recessions.
2013 research.stlouisfed.org

ILUR
UNRATE
ECONOMIC OVERVIEW – UNEMPLOYMENT

<table>
<thead>
<tr>
<th>State</th>
<th>August 2012</th>
<th>November 2012</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>9.1%</td>
<td>8.7%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Michigan</td>
<td>9.4%</td>
<td>8.9%</td>
<td>-0.5%</td>
</tr>
<tr>
<td>Indiana</td>
<td>8.3%</td>
<td>8.0%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>7.5%</td>
<td>6.7%</td>
<td>-0.8%</td>
</tr>
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</table>
ARE THERE STILL RISKS FROM THE FISCAL CLIFF?

• Increased taxes and other provisions in the fiscal cliff deal will still create some drag on the economy (initial estimates range from 0.4 to 0.6 percent of GDP), although less than initial “cliff” projections

• “The main risk at this point is that Congress fails to effectively tackle the spending side of the equation in the next two months. Under this scenario, the budget sequester would kick in, possibly some retroactive consequences.”
  – Another “cliff” is possible March 1

• A possible showdown over the debt limit could cause additional fiscal changes

### What about the Fiscal Cliff?

**Potential Impacts on Federal Revenues**

**Selected Indicators of States’ Potential Vulnerabilities to Spending Cuts in the Fiscal Cliff**

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<tr>
<td><strong>National Average</strong></td>
<td>6.6%</td>
<td>5.3%</td>
<td>3.5%</td>
<td>1.8%</td>
<td>1.0%</td>
</tr>
<tr>
<td><strong>Illinois</strong></td>
<td>8.5%</td>
<td>2.5%</td>
<td>1.5%</td>
<td>1.0%</td>
<td>0.6%</td>
</tr>
</tbody>
</table>

What about the Fiscal Cliff?
Potential Impacts on Tax Revenues

<table>
<thead>
<tr>
<th>Tax Categories:</th>
<th>Personal Income Tax</th>
<th>Corporate Income Tax</th>
<th>Estate Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal changes under the fiscal cliff:</td>
<td>Increase total federal tax liability</td>
<td>Reduce certain federal personal deductions</td>
<td>Reduce certain federal credits</td>
</tr>
<tr>
<td>State linkage to federal policy:</td>
<td>State allows deduction for federal income taxes</td>
<td>State linked to those deductions</td>
<td>State linked to the Earned Income Tax Credit</td>
</tr>
</tbody>
</table>

Illinois

△ indicates an expected increase in state revenue
▼ indicates an expected decrease in state revenue
N/A indicates the state is not linked to the federal provision or does not levy this tax
UNKNOWN indicates any potential impact could not be identified at the time of writing

FISCAL OVERVIEW
ILLINOIS FINANCES OVER TIME

Consolidated Expenditures vs. Receipts (w/o Borrowing),
FY 1997-2013 (real)
AND MILES TO GO BEFORE IT’S BALANCED: ILLINOIS STILL FACES TOUGH BUDGET CHOICES

2013 ILLINOIS REPORT
CAREENING TOWARD A DATE WITH FISCAL REALITY

• Late 2010: Fiscal Futures calls Illinois’ fiscal condition “Titanic...and Sinking”
• Two years later, we see signs of progress, but we have a long way to go.
If higher tax rates expire in 2014, the State will face a deficit of **$4 billion in 2015** and nearly **$7 billion by 2019**

Even if tax rates kept up, Illinois will have a deficit of **approximately $2 billion**
PENSIONS: A LOOMING CRISIS

• The State continues to get into a deeper pension hole by not paying normal cost plus interest
• Existing schedule shows pension payments would increase from $5.9 billion in FY 2013, to $9.2 billion in FY 2023, to $11.5 billion in 2030, and to $17.6 billion in 2045
Moody’s issued a negative outlook for Illinois’ bonds on December 13, 2012 warning “fiscal 2014 marks the last year before Illinois’ 2011 income tax increases are partly unwound, putting the state on track to deal with simultaneous growth in pension funding needs and loss of revenue.”

If Moody’s were to downgrade Illinois to A3, it would be not only the lowest rating in the nation, but two steps below the next lowest state, California (rated A1).

Sources:
- 2012 Data: http://www.ioc.state.il.us/index.cfm/fiscal-condition/bond-ratings/
- 2011 Data: Standard and Poor’s Brief History of US State Credit Ratings, July 2011; Moody’s Investors Service; Fitch Ratings; http://www.ioc.state.il.us/index.cfm/fiscal-condition/bond-ratings/
- 2009 and Earlier Data: http://www.census.gov/compendia/statab/past_years.html

SUMMARY

• State economic conditions continue to improve slowly
• A phase-out of tax increases after 2014 would create a large deficit, and even keeping the rates higher will not solve Illinois’ budget woes
• Pensions are a looming problem that continues to grow as the state pays less than normal cost plus interest
• Illinois’ bond rating continues to be threatened by fiscal inaction.
FOR MORE INFORMATION:

IGPA.UILLINOIS.EDU
GOMB PROJECTIONS: 2014-2016 REVENUE

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<tr>
<td><strong>Base Resources</strong></td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Individual Income Tax</td>
<td>15,512</td>
<td>15,273</td>
<td>15,717</td>
<td>14,255</td>
<td>12,188</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>2,461</td>
<td>2,513</td>
<td>2,871</td>
<td>2,116</td>
<td>1,708</td>
</tr>
<tr>
<td>Sales Tax</td>
<td>7,226</td>
<td>7,335</td>
<td>7,385</td>
<td>7,570</td>
<td>7,765</td>
</tr>
<tr>
<td>All Other State Sources</td>
<td>3,051</td>
<td>3,047</td>
<td>3,043</td>
<td>3,073</td>
<td>3,106</td>
</tr>
<tr>
<td><strong>State Sources</strong></td>
<td>28,250</td>
<td>28,168</td>
<td>29,015</td>
<td>27,014</td>
<td>24,767</td>
</tr>
<tr>
<td>Federal Sources</td>
<td>3,682</td>
<td>4,231</td>
<td>4,222</td>
<td>4,441</td>
<td>3,981</td>
</tr>
<tr>
<td>Transfers In</td>
<td>1,763</td>
<td>1,962</td>
<td>1,723</td>
<td>1,749</td>
<td>1,775</td>
</tr>
<tr>
<td><strong>TOTAL RESOURCES</strong></td>
<td><strong>33,695</strong></td>
<td><strong>34,360</strong></td>
<td><strong>34,960</strong></td>
<td><strong>33,203</strong></td>
<td><strong>30,523</strong></td>
</tr>
</tbody>
</table>

- New GOMB forecast assumes phase-out of January 2011 tax increases, and an income tax revenue decline of more than $4 billion from 2012 amounts by 2016 ($17.97 billion vs. $13.89 billion)

Source: Governor’s Office of Management and Budget: http://www.state.il.us/budget/Financial%20Reports/3%20Year%202013%20FINAL.pdf (Archived by WebCite® at http://www.webcitation.org/6Dj56uT1H)
### GOMB Projections: 2014-2016 Expenditures

- Education (before pensions) would face cuts of more than $2.1 billion from 2012 levels by 2016.
- More than $7.4 billion in unpaid bills would remain with no plan to address them.

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<tbody>
<tr>
<td>Education (including pensions)</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Education (before pensions)</td>
<td>12,073</td>
<td>12,551</td>
<td>12,999</td>
<td>12,755</td>
<td>11,835</td>
</tr>
<tr>
<td>K-12 Education Pensions</td>
<td>8,843</td>
<td>8,521</td>
<td>8,127</td>
<td>7,735</td>
<td>6,690</td>
</tr>
<tr>
<td>State Universities' Pensions</td>
<td>2,480</td>
<td>2,777</td>
<td>3,513</td>
<td>3,621</td>
<td>3,753</td>
</tr>
<tr>
<td></td>
<td>750</td>
<td>1,253</td>
<td>1,360</td>
<td>1,399</td>
<td>1,392</td>
</tr>
<tr>
<td><strong>TOTAL EXPENDITURES</strong></td>
<td>33,801</td>
<td>33,986</td>
<td>34,860</td>
<td>33,203</td>
<td>30,523</td>
</tr>
<tr>
<td>Repay Interfund Borrowing &amp; Budget Stabilization Fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General Funds Surplus/Deficit</td>
<td>(738)</td>
<td>242</td>
<td>100</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>General Fund Balance (Accounts Payable less cash)</td>
<td>(5,361)</td>
<td>(5,119)</td>
<td>(5,019)</td>
<td>(5,019)</td>
<td>(5,018)</td>
</tr>
<tr>
<td>Section 25 Bills</td>
<td>(3,966)</td>
<td>(3,169)</td>
<td>(2,405)</td>
<td>(2,405)</td>
<td>(2,405)</td>
</tr>
<tr>
<td><strong>GROSS BILL BACKLOG AT END OF FISCAL YEAR</strong></td>
<td>(9,327)</td>
<td>(8,288)</td>
<td>(7,424)</td>
<td>(7,424)</td>
<td>(7,423)</td>
</tr>
</tbody>
</table>

*Fiscal year 2014 growth makes up for previous underappropriation.*

Source: GOMB, 2013 (please see previous slide for URL)
MEDICAID: PROMISING, BUT SHORT TERM

If growth continues at historical rates, 2012 cuts will hold spending below its inflation-adjusted 2012 level for only about 5 years.

Cuts needed to keep Medicaid at zero growth in real dollars would be significant and still would not balance budget.