UPDATE ON ILLINOIS’ ECONOMIC AND FISCAL CHALLENGES

PRESENTATION TO THE BOARD OF TRUSTEES
OF THE UNIVERSITY OF ILLINOIS
NOVEMBER 13, 2014

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INSTITUTE OF GOVERNMENT AND PUBLIC AFFAIRS
OUTLINE

• IGPA activities on fiscal topics
• Economic Overview
  – Illinois Unemployment
  – Labor Force
• Fiscal Overview
  – January 1, 2015 income tax rate reduction
  – Large and growing structural deficit
  – Illinois’ Bond Rating
• Summary
IGPA ACTIVITIES ON FISCAL TOPICS

• Recent
  – Fiscal Futures Model projections of Dec. 2013 pension law
  – Study: Effect of 2011 IL tax increase on economic indicators
  – Study: Borrowing cost penalty of IL’s poor fiscal reputation

• Upcoming
  – Annual update of data and model
  – Analysis of state’s capacity to issue debt
  – Budget transparency initiative
ECONOMIC OVERVIEW
Figure 1: Illinois v. US Unemployment

Shaded areas indicate US recessions - 2014 research.stlouisfed.org
**Figure 2: Midwestern State Unemployment**

<table>
<thead>
<tr>
<th>State</th>
<th>Sept. 2013</th>
<th>Sept. 2014</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>9.1%</td>
<td>6.6%</td>
<td>-2.5%</td>
</tr>
<tr>
<td>Michigan</td>
<td>8.8%</td>
<td>7.2%</td>
<td>-1.6%</td>
</tr>
<tr>
<td>Indiana</td>
<td>7.3%</td>
<td>5.7%</td>
<td>-1.6%</td>
</tr>
<tr>
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Shaded areas indicate US recessions - 2014 research.stlouisfed.org
**Unemployment Rate is an Imperfect Measure of Economic Conditions**

\[
\text{Unemployment rate} = \frac{\#\text{Unemployed}}{\#\text{Employed} + \#\text{Unemployed}}
\]

- Working-age population is divided into:
  - Not in Labor Force
  - Unemployed
  - Employed

- Flows in and out of labor force complicate interpretation
Figure 3: Labor Force in IL, US, IN, MI & WI (As percent of December 2007 levels)

- Civilian Labor Force in Illinois, 2007-12=100
- Civilian Labor Force in Michigan, 2007-12=100
- Civilian Labor Force in Indiana, 2007-12=100
- Civilian Labor Force in Wisconsin, 2007-12=100
- Civilian Labor Force, 2007-12=100

Shaded areas indicate US recessions - 2014 research.stlouisfed.org
### Relative Change in Number Employed & Unemployed from Sept. 2013 to Sept. 2014

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<tr>
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ECONOMIC/FISCAL UPDATE

9 | SLIDE
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<td>Michigan</td>
<td>-10</td>
<td>+14</td>
<td>+4</td>
</tr>
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<td>Wisconsin</td>
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FISCAL OVERVIEW
FY 2015 BUDGET

- Temporary income tax increase to phase out:
  - Gov. Quinn proposed permanent extension for FY 2015
    - Would raise about $2 billion in FY2015 & $4 billion in FY2016
  - General Assembly did not pass income tax extension in FY 2015 budget, rather
    - Borrow from future years with “fund sweeps”
    - “Borrow” by allowing unpaid bills to increase
    - Allocate “surplus” from FY2014

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Pre-2011</th>
<th>2011-14</th>
<th>2015-24</th>
<th>Post-2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Rate</td>
<td>3.0%</td>
<td>5.0%</td>
<td>3.75%</td>
<td>3.25%</td>
</tr>
<tr>
<td>Corporate Rate</td>
<td>4.8%</td>
<td>7.0%</td>
<td>5.25%</td>
<td>4.8%</td>
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IGPA’s Fiscal Futures Model

• **Forward-Looking**: projects out 10+ years
• **Broad-based**: “All Funds” budget measure eliminates distortions from fund shifting
• **Focus on** *Structural Budget Gap*

\[
\text{Total Revenue} - \text{Total Spending}
\]

  - Want *sustainable* Total Revenue so do not count new borrowing or other one-time sources

• Our most recent projections:
**Figure 4: Illinois All-Funds Revenue, Spending, and Budget GAP (= Revenue – Spending) Projections**

Source: IGPA Fiscal Futures Model, May 2014.

Note: Revenue excludes new borrowing.
Figure 5: Illinois All-Funds Budget Gap Projections With & Without Phase-Out of Higher Tax Rates after 2014 & 2024

Source: IGPA Fiscal Futures Model, May 2014

Note: Revenue excludes new borrowing
**Figure 6: Illinois All-Funds Budget Gap Projections With & Without December 2013 Pension Law Changes**

- **Taxes drop; old pensions**
- **Taxes drop; pensions cut**

Source: IGPA Fiscal Futures Model, May 2014

Note: Revenue excludes new borrowing
MORE DIMENSIONS TO ILLINOIS’ BUDGET CRISIS THAN LARGE AND GROWING DEFICITS

• Decreases in fund balances & other state assets

• Large liabilities for
  – Unfunded pension obligations ($100 billion)
  – Unfunded retiree healthcare obligations ($34 billion)
  – Unpaid bills ($4.9 billion as of end of September)

• Illinois Supreme Court ruling in July
  – Voids 2012 law shifting retiree health costs
  – Poses threat to Dec. 2013 pension reduction law
ILLINOIS BOND RATINGS

• Illinois has worst ratings of 50 states
  – S&P A- with negative outlook
  – Moody’s A3 with negative outlook
  – Fitch A- with negative outlook

• Lower ratings mean higher borrowing costs

• Recent IGPA study: IL borrowing costs higher than low ratings justify, a “penalty for IL’s poor fiscal reputation”

• S&P July 2014: “could lead to downgrade” if
  – pension reform is found invalid or delayed
  – lack of action on structural budget gap and payables
ILLINOIS BOND RATINGS WARNING FROM S&P

• July 23, 2014: Standard & Poor’s dropped Illinois’ credit outlook to “negative.” Saying:

• “If the pension reform is declared unconstitutional or invalid, or implementation is delayed and there is a continued lack of consensus and action among policymakers on the structural budget gaps and payables outstanding, we believe there could be a profound and negative effect on Illinois' budgetary performance and liquidity over the next two years and that this could lead to a downgrade”

SUMMARY

• Illinois is still lagging significantly behind the Midwest in economic conditions
  – despite the recent “improvement” in Unemployment rate

• Illinois has a large and growing structural deficit
  – larger than proposed higher tax rates and legislated lower pension costs together would eliminate

• Illinois has huge liabilities from past deficits
  – payoff of liabilities will crowd-out future spending

• Illinois’ bond ratings threatened by fiscal inaction
  – increased borrowing costs will affect state, related entities (e.g., universities), and local governments
FOR MORE INFORMATION:

IGPA.UILLINOIS.EDU