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EXECUTIVE OFFICE OF THE GOVERNOR
GOVERNOR'S OFFICE OF MANAGEMENT AND BUDGET
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Illinois Economic and Fiscal Policy Report

The Governor's Office of Management and Budget (GOMB) is required, pursuant to 20 ILCS 3005/7.3 et seq., to annually submit an Economic and Fiscal Policy Report to the General Assembly outlining the long-term economic and fiscal policy objectives of the state, the economic and fiscal policy intentions for the upcoming fiscal year and the subsequent two fiscal years.

This report provides fiscal year 2015 budget results, a review of the fiscal year 2016 budget, information on national economic conditions, information on Illinois' economic conditions and forecast, and policy objectives and intentions. An attachment also provides a three-year projection of revenues, expenditures, any deficits or surpluses, and other General Funds liabilities through fiscal year 2019 under current conditions and laws -- that is, these projections demonstrate the fiscal trajectory of our state absent General Assembly enactment of cost-saving structural reforms, discretionary spending reductions or new revenue.

Fiscal Year 2015 Budget Results

The fiscal year 2015 budget for Illinois took effect six months before Governor Rauner was inaugurated in January 2015. As a part of his presentation of the fiscal year 2016 budget in February 2015, GOMB estimated a $1.6 billion operational deficit for fiscal year 2015 absent further action[1].

In the spring of 2015, the Governor and the General Assembly worked together and implemented a bipartisan solution comprising several actions to address the estimated budget deficit in the General Funds budget. These budget actions were primarily included in P.A. 99-001 and P.A. 99-002 and had three main components:

- $1,284 million in reallocation of excess fund balances in other state funds to the General Funds;
- 2.25 percent reductions to many General Funds appropriation lines that yielded nearly $400 million in reduced spending authority for state agencies; and

- the Governor's issuance of Executive Order 2015-08, which authorized GOMB to direct state agencies under the Governor to establish reserves and suspend some grants to reduce spending.

Additionally, faced with the clear prospect of a fiscal year 2016 budget impasse, GOMB used expiring fiscal year 2015 statutory authority in June 2015 to interfund borrow $454 million from other state funds for the purpose of enhancing cash flow as the State entered fiscal year 2016 with no budget in place. This amount is scheduled to be repaid by the end of December 2016.

Revenues[2]: Fiscal year 2015 total General Funds revenues and transfers in (not including $454 million in revenues from interfund borrowing or $275 million in transfers from the Budget Stabilization Fund) totaled $35,888 million, an $880 million or 2.4 percent decrease from fiscal year 2014.

Effective January 1, 2015, the individual income tax rate decreased from 5.0 percent to 3.75 percent and the corporate income tax rate decreased from 7.0 percent to 5.25 percent.

Compared to February 2015 estimates, General Funds revenues exceeded forecasted revenues by $535 million after excluding the revenues from transfers of excess balances from other state funds. Individual income taxes and sales taxes exceeded the forecasts by $588 million and $80 million, respectively, while federal receipts fell below the forecast by $345 million.

Expenditures[2]: Total operating expenditures and transfers out for fiscal year 2015, from fiscal year 2015 appropriations, decreased by $1,343 million, or 3.7 percent, from fiscal year 2014 to $35,358 million.

Results[2]: As a result of the bipartisan actions in the spring of 2015, the State was able to achieve a balanced budget for fiscal year 2015. **Fiscal year 2015 actual results reflect a $1,031 million improvement in the General Funds budgetary balance (i.e., the June 30 cash balance less the General Funds obligations paid in the State's lapse period) from a deficit of $3,931 million to begin fiscal year 2015 to a deficit of $2,900 million to begin fiscal year 2016.** Excluding the $454 million in revenues from interfund borrowing, the General Fund budgetary balance improved by $577 million.

Review of Fiscal Year 2016 Budget

Fiscal Year 2016 Budget Proposal[1]: On February 18, 2015, the Governor proposed a fiscal year 2016 budget that estimated General Funds revenues would total $32 billion, based on the statutory tax rates at the time of his proposal. This was a forecasted reduction from fiscal year 2015 of $2,069 million due primarily to the full year impact of the statutory decrease of the individual and corporate state income tax rates that took effect January 1, 2015.

The Governor's budget proposal estimated that under a maintenance "auto-pilot" General Funds fiscal year 2016 budget (i.e., no changes to state statutes or other spending controls), spending would total $38,210 million, or over $6 billion more than the baseline revenue forecast. The Governor instead recommended fiscal year 2016 General Funds spending totaling $31,495 million, a decrease of approximately $4 billion from fiscal year 2015 spending and a decrease of over $6 billion from the "auto-pilot" projection.

In May 2015, the General Assembly took action on several appropriation bills, acknowledging publicly that their spending plan was dramatically out of balance, and forwarded them to the Governor for his consideration. In June 2015, the Governor signed parts of the budget into law, including funding for elementary and secondary education, and capital appropriations for the Illinois Department of Transportation. However, during the summer the Governor vetoed the vast majority of appropriation bills, including bills funding the majority of the State's General Funds budget, noting that projected spending in the legislature's budget plan exceeded forecasts of available revenue by well over $4 billion. Therefore, the unbalanced budget passed by the legislature was unconstitutional. The Governor called upon the General Assembly to send him a balanced budget. To date, no balanced budget has been sent to the Governor's desk. Other appropriations have been enacted since then, including spending of certain federal revenues and appropriations primarily from funds outside the General Funds, most of which would have little to no effect on the budget deficit.

Fiscal Year 2016 Spending in Absence of a Budget: The State began fiscal year 2016 on July 1, 2015 without a fully enacted budget in place. Certain General Funds spending has continued to occur in the absence of a budget.

- *Appropriations signed into law*: Some General Funds appropriations were enacted into law for a few state agencies. The Governor signed P.A. 99-005, which authorizes $6.5 billion in spending for elementary and secondary education grants and $3.7 billion for the state's annual contribution to the Teachers' Retirement System. P.A. 99-491 authorizes $28 million in General Funds appropriations for domestic violence shelters and spending by the Secretary of State.
- *Continuing appropriations authorized by statute*: Certain state spending obligations are covered by statutory continuing appropriations, i.e., in situations where annual line-item appropriations are not enacted, an appropriation is established equal to the amount required to be spent by statute in lieu of an annual appropriation. Approximately $3 billion in General Funds appropriations have been established for payments to the other four state's retirement systems in addition to the amount appropriated for the Teachers' Retirement System. Additionally, certain spending related to some retiree health care, operations of the legislative and judicial branches, and debt service payments have continued pursuant to continuing appropriations.
- *Statutory transfers to other state funds*: Certain transfers must be made from the General Funds into other funds in the State Treasury based on existing statutes.
- *Court Orders/Consent Decrees*: Certain spending from the General Funds can occur without passage of a budget if the State is ordered to make such payments by court order or consent decree. Various court actions since July 2015 and prior consent decrees have directed the State to continue to make payments in the absence of appropriations for items such as state employee salaries, payments to Medicaid providers, the operations of the Department of Children and Family Services and the Department of Juvenile Justice, and certain human services programs.

Current Fiscal Year 2016 Estimated Revenues: Under current statutes, total General Funds revenues and transfers in for fiscal year 2016 are projected to be $31,927 million, a reduction of $3,961 million or 11% from fiscal year 2015 actual revenues and transfers in of $35,888 million. Federal sources are projected to increase to $4,408 million in fiscal year 2016 from $3,331 million in fiscal year 2015, but this increase will depend on the ability of the State to make certain levels of payments to Medicaid service providers to qualify for the federal reimbursement.

Current Fiscal Year 2016 Estimated Expenditures. Total General Funds expenditures for fiscal year 2016 are estimated at $36,553 million, an increase of $1,195 million or 3.4% from fiscal year 2015. Significant increases are estimated for payments for Medicaid and the state's contribution to the retirement systems, both of which are mandated by the legislature through law.

As a result, the State has a current projected operating deficit in the General Funds for fiscal year 2016 of approximately $4.6 billion. GOMB directed many state agencies, in areas under the Administration's control, to implement budget management steps to reduce spending by more than $700 million. Without these cost saving measures, the projected deficit would have been much higher.

National Economic Conditions

The United States economy, measured as real Gross Domestic Product (GDP), grew at a rate of 2.0 percent in the third quarter of 2015 after expanding at a 3.9 percent rate in the second quarter.[3] Personal consumption expenditures (PCE), nonresidential fixed investment and residential investment are the primary drivers of economic growth.[3] On December 16, 2015 the Federal Open Markets Committee (FOMC) decided to raise the target federal funds rate for the first time since setting the target rate near zero seven years ago. The FOMC increased the target federal funds range by 25 basis points from a range of zero to ¼ percent to ¼ to ½ percent.[4] In the committee's judgment, "considerable improvement in labor market conditions this year" has given the committee confidence that "inflation will rise over the medium term."[4] According to FOMC economic projections, the unemployment rate will range between 4.6 and 5.0 percent from 2016 through 2018.[5] PCE inflation is expected to rise from 0.4 percent in 2015 to 2.0 percent in 2018.[5] The FOMC long run PCE inflation forecast is 2.0 percent. PCE inflation less food and energy, so called "core inflation," is estimated to finish 2015 at 1.4 percent, increasing to 1.7 percent in 2016 and plateau at 2.0 percent in 2018.[5]

The FOMC assessment of "appropriate" monetary policy is a gradual increase in the federal funds rate over the next three years to control inflation and maintain full employment.[6] The majority of FOMC members expect the federal funds rate to rise from the current target range to around 1.375 percent in 2016 and a range of near 3 percent to 4 percent in the next three years.[6]

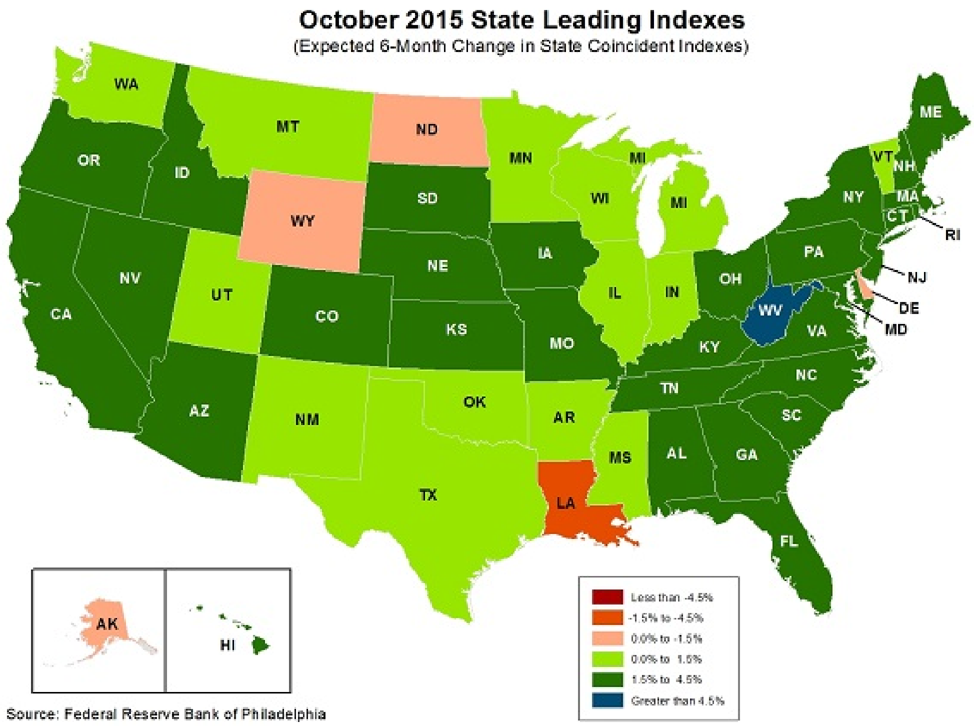
The FOMC has embarked on what has historically been a nearly impossible task -- increasing interest rates just enough to comply with its dual mandate of price and employment stability without causing a recession. The FOMC remains confident it can gradually increase its target interest rate without damaging the economy. To this point the FOMC press release stated "the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data."[4] Prior FOMCs have shared the confidence of the current committee in their ability to curb inflation and engineer a soft economic landing without inducing recession; however, it is a challenging task.

IHS Economics' December macroeconomic forecast includes a scenario assigning a 20 percent probability of a two quarter recession starting in middle of the calendar year 2016. While it is impossible to know whether or not there will be a recession at any point within the three year forecast horizon, it is the opinion of the Illinois Department of Revenue's economists that a 20 percent probability is a reasonable risk assessment for planning revenue and expenditures.

Illinois' Economic Conditions and Forecast

Total non-farm employment grew at an average annual rate of 62,500 jobs since employment began recovering in August 2010 through May of 2015.[7] Employment growth has slowed since May falling to an average annual increase of just 40,050 jobs.[7] Illinois gained just 35,700 net new non-farm jobs for the year when comparing November 2015 to November 2014.[7] The job growth deceleration is not evenly distributed across all sectors.[7] Some sectors, such as Business and Professional Services and the Education and Health sectors registered strong job gains adding 15,700 and 12,500 employees respectively.[7] Employment in other sectors declined including Information (-800), Financial Activities (-200), Mining (-1,100) and Manufacturing (-12,800).[7] The deceleration in employment growth is a reason for pessimism about near term economic growth.

All indicators point toward tepid growth for Illinois over the forecast horizon. The IHS Economics forecast of 1.0-1.5 percent real GDP growth in fiscal year 2016 is both reasonable and consistent with other forward looking indicators. The Philadelphia Federal Reserve Bank Index of Leading Economic Indicators forecasts six month growth in the index of coincident economic indicators for each state. The index of coincident economic indicators is a near real time proxy for economic growth in the state. The Index of Leading Economic Indicators is predicting 1.12 percent growth in the index of coincident indicators over the six months period beginning in November.[8] This is a decline of 0.37 percent from the prior measurement in September and 0.4 percent below the national average. The following map illustrates the relative six-month growth rates in the coincident index across states.



National economic conditions are the most influential factor in state economic outcomes. Predicting the precise end of the current national recovery is difficult but there are indications it is time to start considering the probability of an end to the current expansion. Tighter FOMC monetary policy will dampen economic growth. Depressed energy commodity prices are already negatively affecting some state economies, such as North Dakota and Wyoming.

Table 1 summarizes the medium term forecast for several key state economic variables based on IHS Economics twenty percent recession risk and baseline scenarios. Causal factors of recession risk in the recession risk scenario include: a continued slump in commodity prices and the past growth in manufacturing construction depresses more rapidly and severely than the baseline scenario predicts. The recession risk scenario also anticipates more rapid inflation beginning in the second half of calendar year 2017 and a federal funds rate increase to 4.5 percent rather than the 3.25 percent in the baseline.

Table 1 Revenue Forecasting Economic Variables

	Fiscal Year Growth Rate							
Variables	**2016 (p)**	**2016 (b)**	**2017 (p)**	**2017 (b)**	**2018 (p)**	**2018 (b)**	**2019 (p)**	**2019 (b)**
Illinois Real Gross Domestic Product	1.00%	1.50%	-0.20%	2.50%	1.80%	2.40%	1.90%	2.30%
Illinois Non-Farm Employment	0.40%	0.50%	-0.40%	1.00%	0.30%	1.00%	0.80%	1.00%
Illinois Wages and Salaries	2.70%	3.10%	2.10%	4.50%	3.60%	4.90%	4.60%	4.70%
Domestic U.S. Corporate Profits	-2.20%	1.30%	-3.20%	7.70%	3.90%	-0.40%	2.70%	0.10%
Illinois Retail Sales	1.70%	2.20%	3.00%	5.60%	4.60%	5.00%	3.90%	4.20%

Source: IHS Economics, (p) = 20 Percent Probability of Recession (b) = Baseline, December 2015

The revenue projections attached to this report use a blended approach of the recession risk and baseline scenarios.

In addition to the above economic variables, income tax refund fund diversion rates impact the revenue estimates for net income taxes. A percentage of gross income taxes must be deposited into the Income Tax Refund Fund to allow the Illinois Department of Revenue to issue refunds due to taxpayers who have paid more than their income tax liability. The individual income tax and corporate income tax refund fund diversion rates are calculated by statutory formula in the absence of a budget. The current diversion rates are insufficient to pay the estimated refunds during fiscal year 2016. The forecast assumes the refund fund diversion rate for individual income tax is increased from 9.75 percent to 10.2 percent for the remainder of fiscal year 2016. A 10 percent diversion rate is assumed in each subsequent fiscal year. The current corporate income tax diversion rate is 15.2 percent. This rate must be increased to 17.3 percent for the remainder of fiscal year 2016 to pay all expected business refunds. A refund fund diversion rate of 15.5 percent is necessary in fiscal year 2017 and 14 percent in the following years. Higher diversion rates will be needed if changes to the existing statutory formula are enacted later than early January 2016.

Policy Objectives and Intentions

These three-year budget forecasts assume moderate natural growth in revenues under existing law, the increases in pension payments as projected by the pension systems under existing law, and moderate increases in other spending, assuming no significant reforms or spending controls.

Under these forecast assumptions -- that is, assuming the General Assembly does not enact cost-saving structural reforms, discretionary spending reductions or new revenue -- the State's bill backlog would far exceed the historic high next year and mushroom to nearly three-fourths of the forecasted annual revenue by fiscal year 2019. This explosion in our past-due bills would put an unfair and suffocating burden on the State's providers, vendors and local governments, while the state's late-payment interest and borrowing costs would multiply. The State must move off this trajectory if we want to nurture our economy and avoid passing on our debts to the next generation.

The failure to enact a complete and balanced fiscal year 2016 budget six months into the year makes it significantly more difficult to balance revenues and spending this year or reduce the bill backlog. Working with the General Assembly, the Governor is committed to enacting balanced budgets for fiscal years 2017, 2018 and 2019 and reducing the bill backlog.

The State's payments for pensions, employee health insurance and Medicaid have increased in recent years far beyond the growth in inflation and the total budget, leading to cuts in some State services and insufficient funding for education and other priorities. Benefit reforms that would reduce our budget-busting payments for pensions, employee health insurance and Medicaid would help put the State on a responsible and sustainable fiscal path, far different than the future that Illinoisans will face if there are no reforms.

Make Illinois More Competitive for Jobs & Balance the Budget: Illinois regularly finds itself in the position of having a higher than average unemployment rate compared to the national average. Table 2 illustrates how unemployment rates have impacted the six-county Chicago Metro region and the Balance of State (i.e. 96-county balance of Illinois) unevenly since January 2000. The unemployment rate for the Balance of State was higher in November 2015 than the Illinois average and the six-county Chicago Metro region. In January 2000, the Balance of State unemployment rate was lower than the Illinois average and the six-county Chicago Metro region.

Table 2 Unemployment Rates

Date	Nation	Illinois	Six County Chicago Metro	Balance Of State
January 2000	4.0%	4.2%	4.4%	4.0%
November 2015	5.0%	5.7%	5.4%	6.2%

Source: U.S. Bureau of Labor Statistics, Local Area Unemployment Statistics provided by Illinois Department of Employment Security
Six County Chicago Metro includes Cook, DuPage, Grundy, Kendall, McHenry and Will counties. The Balance of State includes the remaining 96 counties.

Illinois' reputation as a state that is bad for business and fiscal instability have hurt Illinois' competitiveness. Illinois has trailed most of the nation in job creation over the last two decades. Since the year 2000, the nation has added nearly 12 million new jobs. Other states have added millions of net new jobs over the last fifteen years while Illinois has added none. **In fact, Illinois has 84,300 fewer jobs today than it did 15 years ago.**

Table 3 Current Employment Statistics (Seasonally Adjusted Employment)

Date	Nation	Illinois
January 2000	131,009,000	6,011,500
November 2015	142,900,000	5,927,200
Difference Jan-00 to Nov-15	11,891,000	(84,300)

Sources: Nation – USDOL - Bureau of Labor Statistics – November 2015 is preliminary
Illinois[7] – Illinois Department of Employment Security
Payroll job estimates of non-farm industries

Without the ability to grow our economy and create more jobs and opportunities for Illinois' workers, the State will not be able to adequately address its perpetually lingering fiscal problems. Structural budget deficits, high unfunded pension liabilities and bill backlogs have caused Illinois to receive several credit rating downgrades, dropping us to the lowest-rated state in the nation. Actions are needed to fix our structural deficit and to set us on a sustainable and stable path before we can expect to improve our credit ratings.

Governor Rauner has proposed a series of reforms in the political and economic realm that are designed to restore trust in government and put Illinois in a better position to compete with other states for jobs. The package of proposals is referred to as the Turnaround Agenda and includes transformative proposals such as workers compensation reform, tort reform, property tax relief, collective bargaining reforms, redistricting reform and term limits.

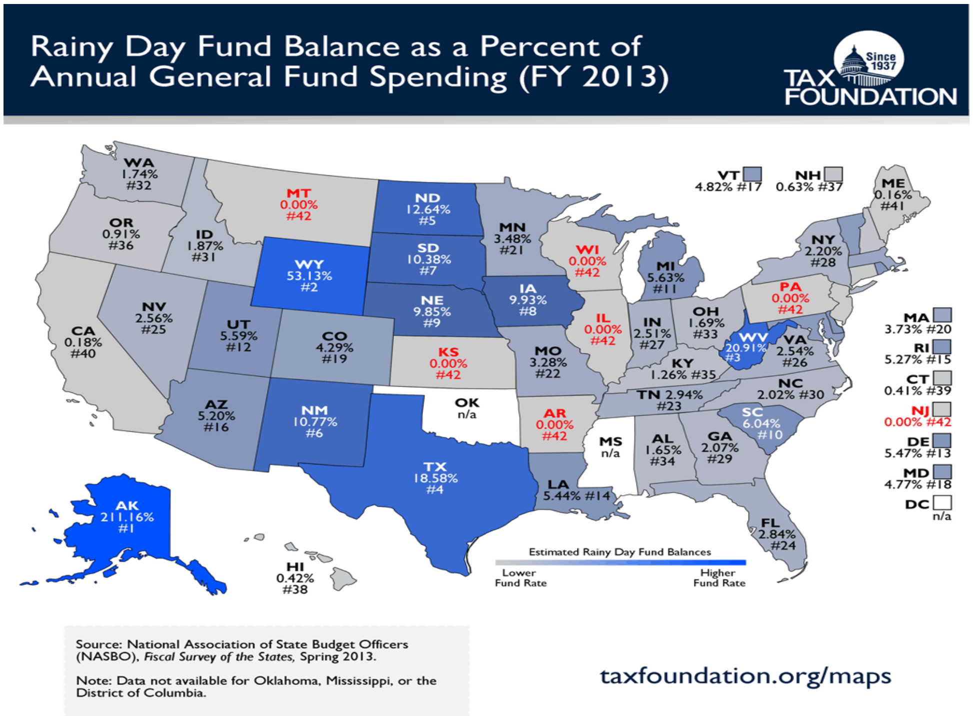
By restoring our citizens' faith in Illinois government and making ourselves more economically competitive with other states, Illinois will be able to recruit and retain more employers, leading to more quality jobs for the people of Illinois. More people working in the private sector will lead to increased economic activity as those people spend those dollars in the Illinois economy. This will have the dual positive effect of leading to increased state revenues and a reduced reliance on state government services.

Enacting all or a significant part of the Governor's Turnaround Agenda, improving the economy and balancing the budget for the long term is the Rauner Administration's top fiscal and policy objective. With progress in the Turnaround Agenda that would ensure our State's future, the Governor is willing to partner with legislators to increase revenues and responsibly limit spending.

Pay Down Backlog of Bills and Prevent Future Backlogs: The Governor has a long term goal of paying down the backlog of bills to a normal level, where all vendors are getting paid in 30 days or less. Once Illinois' backlog of bills can be paid down to reasonable levels, GOMB would seek the elimination of the loopholes in state law that have allowed the State to create backlogs of bills. This is a form of borrowing from the State's vendors that has allowed the State to avoid making tough decisions to balance the budget. This mechanism should be eliminated so that future backlogs of bills cannot be created.

Enhance the Budget Stabilization Fund: Illinois has $275 million in its Budget Stabilization Fund (i.e. "rainy day" fund). This is one of the lowest rainy day fund balances as a percentage of general fund spending of any state in the nation. Governor Rauner would like to see Illinois get into a position, when the backlog of bills are paid, where additional dollars could be allocated to the Budget Stabilization Fund.

A higher balance in the Budget Stabilization Fund would help alleviate the type of crisis governing that has plagued Illinois in the past. With a healthy balance in the Budget Stabilization Fund, the State would be in a much better position to weather the inevitable economic downturns without resorting to tax increases or sudden emergency budget cuts which hurts the most vulnerable at a time they need help the most. It would help provide a softer landing during downturns and would provide the government the flexibility to more effectively manage through tough times.



In summary, taxpayers' hard-earned dollars are our top priority. It is our objective to use these dollars to fund core priorities to:

- invest in our future workforce via pre-K-12 education;
- protect our children;
- serve those most in need;
- provide compassionate care through community-based services;
- reform our criminal justice system; and
- focus on programs that serve the entire state.

Illinois' can no longer afford to continue with the status quo regarding economic and fiscal policies. The State's fiscal trajectory is unsustainable and the General Assembly and the Governor must take deliberative actions to improve the State's economic conditions in order for the State to:

- resolve its structural budget imbalance;
- eliminate the payment backlog;
- improve long-term liability funding ratios; and
- ensure adequate funding for the core priorities mentioned above.

Footnotes and References:

[1] Governor's Fiscal Year 2016 Budget Book, February 18, 2015
http://www.illinois.gov/gov/budget/Documents/Budget%20Book/Budget%20Book%20FY16/FY2016IllinoisOperatingBudgetBook.pdf

[2] Comptroller's Fiscal Year 2015 Traditional Budgetary Financial Report, December 30, 2015
http://ledger.illinoiscomptroller.com/ledger/assets/File/TradBudgetaryFY2015-FINAL.pdf

[3] National Income and Product Accounts Gross Domestic Product: Third Quarter 2015 (Third Estimate) Corporate Profits: Third Quarter 2015 (Revised Estimate) http://www.bea.gov/newsreleases/national/gdp/2015/gdp3q15_3rd.htm

[4] Federal Open Markets Committee Press Release, December 16, 2015.
http://www.federalreserve.gov/newsevents/press/monetary/20151216a.htm

[5] Table 1 Economic projections of Federal Reserve Board members and the Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy, December 2015,
http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20151216.pdf

[6] Figure 2 FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate. http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20151216.pdf

[7] Illinois Department of Employment Security, Current Employment Statistics Program, Seasonally Adjusted Employment, Monthly Statewide Data, Year 2000 – Current. http://www.ides.illinois.gov/LMI/Pages/CES.aspx

[8] The leading index for each state predicts the six-month growth rate of the state's coincident index. In addition to the coincident index, the models include other variables that lead the economy: state-level housing permits (1 to 4 units), state initial unemployment insurance claims, delivery times from the Institute for Supply Management (ISM) manufacturing survey, and the interest rate spread between the 10-year Treasury bond and the 3-month Treasury bill. A time-series model (vector autoregression) is used to construct the leading index. Current and prior values of the forecast variables are used to determine the future values of the index.