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Illinois Economic and Fiscal Policy Report

The Governor's Office of Management and Budget (GOMB), pursuant to 20 ILCS 3005/7.3, annually submits an Economic and Fiscal Policy Report to the General Assembly outlining the long-term economic and fiscal policy objectives of the state, along with the economic and fiscal policy intentions for the upcoming fiscal year and for the subsequent four fiscal years. A review of the current fiscal year's enacted budget compared with the current outlook for the fiscal year is included. Also, the report includes fiscal and policy options that GOMB recommends for consideration by the General Assembly and the Governor to remedy any budgetary shortfalls in the current year or the five following fiscal years. Finally, estimates of interest payable under the Prompt Payment Act and the Insurance Code are presented.

This report provides information on national economic conditions, Illinois' economic conditions and forecast, a review of the enacted fiscal year 2019 budget and the current fiscal year outlook, a five-year budgetary forecast, and a discussion of the state's fiscal policy objectives and intentions for the five-year period starting with fiscal year 2020. An attachment, the General Funds Financial Walk Down, also provides a five-year projection of revenues, expenditures, any deficits or surpluses, and other liabilities through fiscal year 2024 as well as an agency categorization key for the expenditure categories.

ECONOMIC REVIEW

NATIONAL ECONOMIC CONDITIONS

The United States is in the 10th year of one of the longest economic expansions in American history, and real-time economic indicators point to continued near-term growth: robust consumer spending, strong employment growth and diminishing labor market slack. After growing at a rate of 2.2 percent in calendar year 2017 and the first quarter of calendar year 2018, the U.S. economy, as measured by growth in real Gross Domestic Product (GDP), grew at a rate of 4.2 percent in the second quarter of 2018. Economic growth in the second quarter-its best showing since the third quarter of 2014-was driven primarily by consumer spending and business investment. Consumer spending reached a 4 percent annual growth rate after a lackluster 0.5 percent rate in the first quarter, split nearly equally between goods and services. Business investment grew at a solid 7.3 percent annual rate, while exports surged at a 9.3 percent annual rate. Most analysts concur that GDP growth will moderate, remaining closer to 3.0 percent average over the second half of 2018.

Labor Market

At this stage in the business cycle, the labor market has maintained a balanced-growth path by steadily increasing job creation while maintaining stable levels of inflation. Total nonfarm payroll employment measured by the Bureau of Labor Statistics (BLS) Current Employment Statistics (CES) survey, rose by 2.2 million for calendar year 2017, a 1.5 percent increase from 2016.[1] The largest gains occurred in private education and health services and in professional and business services. The first three quarters of 2018 have continued a streak of consecutive months of job growth, now at 95 weeks, with the economy adding 201,000 jobs in August 2018. Some of the largest gains have been in key employment sectors: professional and business services, transportation and warehousing, manufacturing, and education and health services.[1]

The unemployment rate has continued on a downward trend that began in October 2009. According to the BLS, the unemployment rate reached 3.7 percent in September 2018, the lowest level in almost 50 years. Similarly, first time unemployment insurance claims have decreased month-over-month (seasonally adjusted) in 2018.

Coinciding with this, worker pay has begun accelerating after a rather prolonged lackluster performance: the Employment Cost Index shows private-sector hourly compensation rose at a 3.3 percent annualized rate over the first six months of 2018. Monthly data from BLS confirms this trend; total hourly compensation jumped by 0.4 percent in August, bringing total pay growth over the past 12 months to 3.0 percent. Productivity has remained level during this time period, signaling that wage growth has been due to a labor shortage.

With the U.S. labor market reaching its lowest unemployment rate in 50 years, the primary concerns are labor shortages and inflationary pressures resulting from full employment. Previously, underutilization in the labor market has averted wage push inflation but as firms seek to expand operations, the pool of skilled labor could be a limiting factor.

While rising inflationary pressures will be a growing risk, economists anticipate that the Federal Reserve will continue raising the fund's rate target at a gradual pace. At their September meeting, the Fed raised its benchmark rate by a quarter percentage point; investors expect another quarter-point increase at the Federal Reserve's final meeting of the year in December.

Federal Reserve

The Federal Reserve is tasked with fulfilling often competing dual mandates of promoting full employment and stable prices.[2] Increases in the federal funds target rate help to combat inflationary pressures but the effects are not self-contained. Tightened monetary policy with the specific intention of reducing inflationary expansions will have an effect on real interest rates and expectations for future inflation.

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[1] Statistics, B.O. (2018, May). Employment growth moderates in 2017, continuing a lengthy expansionary period. Retrieved from Monthly Labor Review: https://www.bls.gov/opub/mlr/2018/article/employment-growth-moderates-in-2017.htm

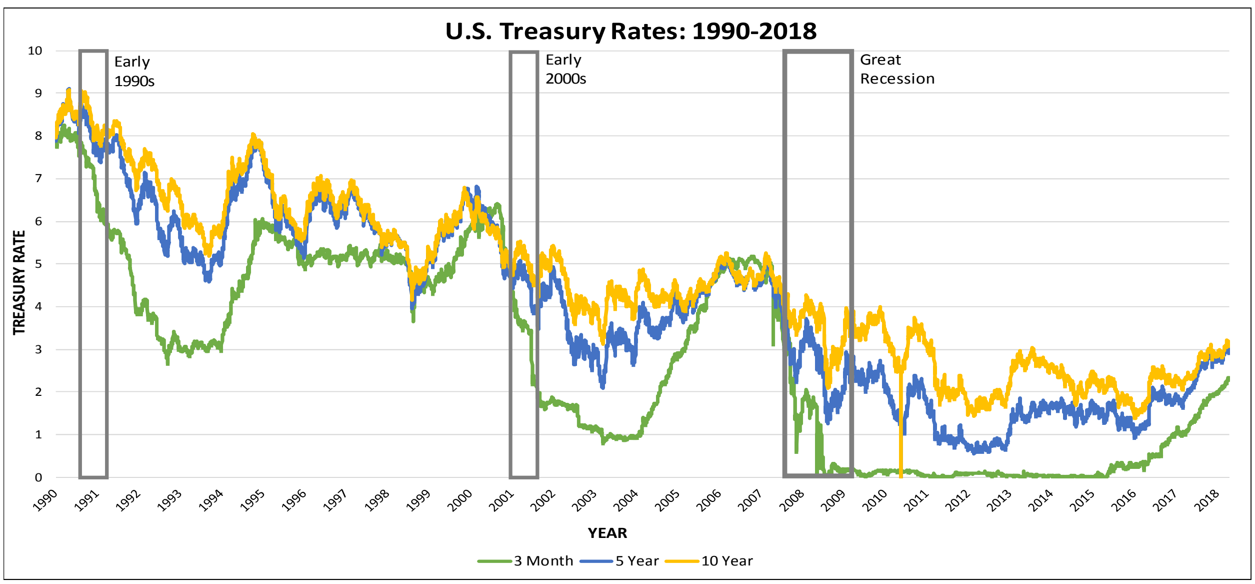
2 United States Federal Reserve. (2018). Overview of the Federal Reserve System. Retrieved from: https://www.federalreserve.gov/aboutthefed/files/pf_1.pdf

The Federal Reserve's 2.0 percent target was hit in the second quarter for the first time since 2012. Headline personal consumption expenditures (PCE), the indicator used by the Federal Reserve in determining its inflation target, rose on a year-over-year basis to 2.2 percent in August; the yearly increase in the core PCE rate that strips out food and energy was steady at 2.0 percent. Meanwhile, the consumer price index (CPI), as reported by the Bureau of Labor Statistics, rose 2.3 percent for the twelve months ending September 2018. Economists at IHS Markit (IHS) expect the core consumer inflation rate to remain at approximately 2.0 percent over the second half of 2018.

Economic expansion and job growth have translated into more tax revenue for state governments. The U.S. Census Bureau reports that total nationwide state tax revenue increased 7.8 percent to $304.8 billion in the second quarter of 2018 from $282.6 billion reported in the same quarter of 2017. Individual income tax at $118.7 billion is up 9.0 percent from $108.9 billion in the same quarter of 2017. General sales and gross receipts taxes, which accounted for $89.0 billion, increased 5.8 percent from $84.1 billion in the same quarter of 2017. At $22.0 billion, corporation net income tax collections increased 16.3 percent from the $18.9 billion collected in the same quarter of 2017.

Treasury Yields

As the Federal Reserve continues its activities, the financial market is poised for a period of uncertainty. Economists and financial analysts have begun to discuss the emergence of a flattened and possibly inverted yield curve in the bond market and the likelihood of a future period of economic downturn. Prior to each of the last six recessions, short-term rates rose above long-term rates, creating a yield curve inversion.



Source: U.S. Treasury Rate Data Retrieved from US. Department of the Treasury

As can been seen in the table above, prior to the March 2001 recession officially beginning, there was an inverted yield curve in July of 2000. The official recession forecast based on that yield curve inversion pointed at June 2001 as the most likely start for a recession. In 2006, the yield curve was inverted for 11 months and in December of 2007, the U.S. entered into a recession running from 2007 -2009.[3]

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3 Campbell, H. (2008, May 1). Yield Curve Inversion and Future Economic Growth. Retrieved from National Bureau of Economic Research: https://faculty.fuqua.duke.edu/~charvey/Term_structure/Harvey.pdf

A yield curve calculation is the interest rate used to make the present value of a bond's cash flow equal its price.[4] Due to their stability, the most common form of security used in yield curve analysis are U.S. Treasury bonds. Assumptions that factor into the use of this metric include productivity and anticipating future tax increases following periods of deficit spending. Typically, an upward sloping short-term security signals higher inflation expectations, which in turn is associated with faster economic growth expectations. When short-term interest rates are relatively high, long-term rates tend to capture longer term expectations and rise at a slower pace than short-term rates. When the slope of the short-term curve begins to flatten, this signals decreased prices and slower economic growth. The flatter the curve, the higher the risk of slowing economic growth. This is due to the expectation that long-term securities must pay out higher returns to entice investors who would otherwise take advantage of a growing economy.

2018 has seen treasury yields hit multi-year highs as prices for those securities drop in response to the Federal Reserve's tightening monetary policy. October 2018 saw the 10-year Treasury yield hit its highest point since 2011, while the two-year yield reached its highest point since 2008. As of late October 2018, the two-year Treasury note yields were 2.8 percent, versus 3.1 percent for the 10-year Treasury note.[5] During this period of 2017, the two-year treasury yield was 1.6 percent versus 2.4 percent for the 10-year Treasury note. This would signal that the yield curve is on a downward trajectory, with economic growth expected to slow in the near term.

Economic Forecasts

This report will discuss two economic forecasts provided by IHS Markit (IHS), a national economic forecasting firm. The first scenario is an optimistic forecast on the short-term future, which anticipates muted economic expansion, with real GDP slowing from 2.9 percent (annualized rate) for 2018, to 2.8 percent in 2019, and 2.1 percent by 2020. The second forecast, a more pessimistic one, includes a chance that the U.S. economy will see negative economic impacts stemming from a broad loss in confidence and a growing aversion to risk. Under this pessimistic forecast, the resulting sharp drawbacks in both consumer and business investment at the end of 2019 imply a 25 percent possibility of recession lasting three quarters beginning in the final quarter of 2019.

According to IHS, the estimated optimistic economic forecast projects that healthy consumer fundamentals - including rising incomes, lower personal tax rates, gains in employment, and rising asset values - will allow consumer spending to contribute to ongoing economic expansion. Real consumer spending is forecast to grow 3.9 percent in 2019 before softening to 3.7 percent growth in 2020. Under the pessimistic scenario real consumer spending is forecast to grow to a slightly lower 3.8 percent in 2019 before lowering to 2.5 percent growth in 2020

In the optimistic forecast, IHS economists expect the continued solid growth of employment, driven by robust, above-trend growth of U.S. output. The unemployment rate is expected to reach 3.4 percent by the second quarter of 2019, ticking upwards in 2020 to 3.5 percent and 3.7 percent in 2021. The further near-term tightening of the labor (and product) markets is anticipated to contribute to additional firming in both wage and price inflation: the increase in the employment cost index is expected to jump from 2.5

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4 Fidelity. (2018). The yield to maturity and bond equivalent yield. Retrieved from Fidelity: https://www.fidelity.com/learning-center/investment-products/fixed-income-bonds/yield-maturity-bond

5 MarketWatch https://www.marketwatch.com/investing/bond/tmubmusd02y?countrycode=bx

percent in 2017 to 3.0 percent in 2018 and reach 3.9 percent by 2021. Consumer prices will hold firm: the headline personal consumption expenditure index (which includes food and energy) is expected to average 2.2 percent over this timeframe.

The pessimistic forecast assumes economic growth grows to 3.1 percent to 2019, before contracting by 0.7 percent in 2020, with a recession from fourth quarter 2019 to second quarter 2020. The full projections going through 2024 can be seen in the table below.

The selection of the optimistic revenue projections for fiscal year 2019 and for the pessimistic forecast for 2020 forward is informed by the economic review above. Fiscal year 2019 has seen above average actuals in key revenue sources but increased risk of an economic tightening in the out years tempers those expectations. In fiscal year 2019, the optimistic forecast is selected due to economic trends during fiscal year 2018 and the first quarter of fiscal year 2019. In fiscal year 2020 and beyond, the pessimistic scenario is selected due to the inflationary pressure and yield curve concerns lain out in the economic conditions section of this report.

Variables	2019 (p)	2019 (o)	2020 (p)	2020 (o)	2021 (p)	2021 (o)	2022 (p)	2022 (o)	2023 (p)	2023 (o)	2024 (p)	2024 (o)
U.S. Real Gross Domestic Product	3.1%	2.8%	(0.7%)	2.1%	1.6%	1.7%	1.9%	1.8%	1.4%	1.6%	1.5%	1.7%
Illinois Real Gross Domestic Product	2.4%	2.3%	0.3%	1.6%	(0.4%)	1.0%	1.5%	1.1%	0.7%	0.8%	0.5%	0.8%
Illinois Non-Farm Employment	1.1%	1.2%	0.0%	1.0%	(0.7%)	0.3%	0.4%	0.1%	0.5%	0.1%	0.2%	0.0%
Illinois Wage Disbursements	3.7%	4.0%	2.9%	4.4%	2.9%	4.2%	4.6%	4.1%	4.6%	4.2%	4.0%	4.0%
Domestic U.S. Corporate Profits	10.0%	8.8%	(1.0%)	3.2%	0.6%	0.0%	8.8%	2.0%	(0.3%)	2.0%	(0.5%)	2.3%
Illinois Retail Sales	3.8%	3.9%	2.5%	3.7%	3.0%	3.5%	3.9%	3.2%	3.4%	3.1%	2.9%	2.9%

Data provided by IHS Marketplace

ILLINOIS' ECONOMIC CONDITIONS AND FORECAST

The Illinois economy and job market has been expanding at a slow stable pace, a condition that is expected to continue throughout the five-year forecast horizon absent reforms. U.S. real GDP grew 2.2 percent in 2017 while Illinois' real GDP grew just 1.2 percent. The recovery of employment in Illinois since the recession has also lagged behind the nation. The U.S. experienced a 1.7 percent growth in total nonfarm employment from September 2017 to September 2018 while Illinois' total nonfarm employment grew by 0.83 percent. During the same period, the state did see significant gains in the following sectors: 14,600 jobs in manufacturing, 7,800 jobs in financial activities, 6,500 jobs in construction, and 1,900 jobs in professional and business services.

Barring the passage of meaningful economic and political structural changes, Illinois' anemic employment and economic growth is expected to continue to underperform the nation over the next five years. Slower job growth in Illinois will mean slower growth in wages and slower consumption growth. This translates to slower growth in the long run for both income and sales tax revenues collected by the state.

A REVIEW OF THE FISCAL YEAR 2019 BUDGET

On June 4, 2018, Governor Rauner signed P.A. 100-586, authorizing an agreed-upon fiscal year 2019 budget. P.A. 100-586 was a result of bipartisan negotiations that included an agreed upon revenue estimate. The fiscal year 2019 general funds budget agreement estimated general funds operating revenues and transfers in from other state funds to be $38.5 billion, including a projected $800 million from interfund borrowing. Total fiscal year 2019 expenditures were estimated at $38.5 billion, resulting in a modest $14 million surplus. Revisions in this report to fiscal year 2019 projected revenues and expenditures changes the fiscal year end result to a deficit of $546 million (See chart below).

Changes to FY 2019 Projections
($ in Millions)

Revenues		Expenditures	
Income Taxes	$ 380	SURS	$ 70
Removal of JRTC Sale	(300)	Pension Buyout Bond Debt Service	33
Transfers In*	118	Capital Bond Debt Service	(118)
Federal Sources	(285)	All Other Changes	41
Interfund Borrowing	(400)	**Total Changes**	**$ 26**
All Other Changes	(48)		
Total Changes	**$ (535)**		

Revision to Forecast

Initial Surplus/(Deficit)	$ 14
Decrease to Revenue Forecast	535
Increase in Projected Expenditures	26
Revised Surplus/(Deficit)	$ (546)

*Includes revision to the total Income Tax Refund Fund transfer.

Based on year-to-date revenue collections and the economic indicators discussed in the Economic Review, fiscal year 2019 estimated revenues are now projected to total $38.0 billion, including a downward revision of interfund borrowing estimates to $400 million. The state's three largest revenue sources, individual income tax, corporate income tax and sales tax, are estimated to total $28.7 billion, a net increase of approximately $1.2 billion or 4.3 percent when compared to fiscal year 2018. Sales tax revenues reflect an approximate $372 million increase compared to fiscal year 2018 due to expanded legal authority to require out-of-state online retailers to collect sales tax on sales to Illinois customers as a result of the recent decision by the United States Supreme Court in *South Dakota v. Wayfair* and on newly-enacted state legislation in P.A. 100-587. The general funds estimate excludes approximately $1.8 billion from income and sales tax receipts deposited directly into the Local Government Distributive Fund, Public Transportation Fund and Downstate Public Transportation Funds. Fiscal year 2019 projected revenues no longer assume the receipt of $300 million of non-recurring revenues from the anticipated divestiture of the James R. Thompson Center.

The fiscal year 2019 general funds budget projects that federal revenues will total $3.5 billion, a decrease of $532 million, or 13.2 percent from fiscal year 2018 federal revenues net of the additional $1.2 billion in revenues from the payment of prior year Medicaid liabilities. Budgeted transfers in for fiscal year 2019 are projected to be $2.0 billion, an increase of $92 million, or 4.8 percent above fiscal year 2018. Also included in fiscal year 2019 revenues is $400 million in interfund borrowing.

The fiscal year 2019 general funds enacted budget includes projected expenditures and transfers from the general funds of $38.5 billion. The fiscal year 2019 general funds budget projects transfers out to other state funds, including debt service, to total $3.1 billion, a decrease of $267 million from fiscal year 2018. The State estimates that debt service for GO Bonds, which includes pension, capital, pension buyout and Section 7.6 Bonds, will total $2.7 billion from the general funds. Monthly transfers from the general funds with respect to such debt service will average approximately $225 million per month. General fund revenues from state sources available to make debt service payments in fiscal year 2019 are projected to average approximately $2.7 billion per month, providing 11.9 times debt service coverage.

The fiscal year 2019 general funds enacted budget relies in part on reducing the state's contribution to certain of the state's retirement systems by instituting accelerated pension benefit payment programs and by shifting a portion of pension contributions related to late-career raises from the state to the Teachers' Retirement System (TRS) and the State Universities Retirement System (SURS) employers. P.A. 100-587 establishes two accelerated pension benefit payment programs pursuant to which eligible members of the retirement systems may forgo certain benefits to which they are entitled under the Illinois Pension Code in exchange for a payment from the state. In addition, P.A. 100-587 lowers the threshold from 6 percent to 3 percent on the annual salary increase for active TRS and SURS members above which the employing entity, rather than the state, is responsible for paying the present value of additional retirement benefits. This provision shifts TRS and SURS retirement contributions to non-state entities but does not reduce future liabilities. These programs are projected to result in General Fund savings for the state of approximately $400 million, but the state can provide no assurance as to the amount of savings actually realized from the implementation of such programs. The current five year projection only projects savings from the current valuations in fiscal year 2019 for TRS and State Employees Retirement System (SERS) and in fiscal year 2020 for SURS.

The fiscal year 2019 general funds budget is projected to result in a budgetary deficit of $546 million. The State and the American Federation of State, County and Municipal Employees, Council 31 (AFSCME) currently have a case before the Illinois Labor Relations Board to determine if the parties had reached impasse in their negotiations for a 2015-2019 collective bargaining agreement and if so, when impasse occurred. The state estimates a potential liability range of $170 million to $500 million. The highest estimate of liability has been included for this report. Should the Illinois Labor Relations board determine that impasse had occurred, the liability will be adjusted downward. Any required payment of these additional costs would further exacerbate the fiscal year 2019 general funds budget deficit.

Five Year Budgetary Forecast

Pursuant to 20 ILCS 3005/7.3, attached to this report is a financial walk down of the budgetary outlook for fiscal year 2019 through fiscal year 2024.

The projections used for fiscal year 2019 assume optimistic growth in revenues under existing law and the five subsequent fiscal years are driven by the pessimistic economic forecast scenario, increases in pension payments, projected debt service amounts, and moderate increases in other spending. All projections assume no significant reforms or spending controls aside from what is in current statute.

Estimated Resources

As noted earlier, GOMB estimates that under current statutes, general funds revenues for fiscal year 2019 will total $37,985 million. The general funds revenue projection includes one-time revenues from authorized interfund borrowing.

Revenue estimates going forward are based on projections provided by the Illinois Department of Revenue (IDOR) economists using the IHS's pessimistic forecast. While it is impossible to predict definitively a recession at any point in the five-year forecast horizon, the IDOR economists incorporated IHS' potential risk for a recession into the revenue forecast. The possibility of a recession translates into a forecast in which individual income tax gross receipts grow approximately 2 percent in fiscal years 2020 and 2021 and then grow at closer to 7 percent after that. Corporate income tax receipts are expected to grow approximately 3 percent in fiscal year 2020, stagnate in fiscal years 2021 and 2022, and grow at approximately 5 percent after that.

The diversion rate of 9.7 percent of total individual income tax revenues in fiscal year 2019 to the Income Tax Refund Fund is assumed to increase to 9.75 percent in fiscal year 2020 and the remainder of the forecast. The corporate income tax forecast assumes a refund fund diversion rate of 15.5 percent in fiscal year 2019 that will fall to 14.75 percent in fiscal year 2020, before declining to 14 percent for the remainder of the forecast.

Fiscal year 2019 estimated base general funds receipts for federal sources total $3.5 billion based on appropriations that are expected to generate federal match if payments are released timely. Federal reimbursements for Medicaid spending are returned to the same fund that was used for the original expenditure. It is assumed that the Department of Healthcare and Family Services will continue to maximize the use of non-general funds for Medicaid spending, which will reduce federal receipts into the general funds. Growth in federal revenues is projected to show only moderate growth over the forecast horizon.

Estimated Expenditures

Fiscal year 2019 estimated general funds spending in the financial walk down totals $38.5 billion. Future-year spending estimates are based on moderate growth rates in the various categories of state spending from fiscal year 2019 appropriations, without significant changes to programs.

GOMB estimates fiscal year 2019 spending will exceed current resource projections by $546 million. This reflects the structural deficit of the general funds budget, excluding any potential impact from the AFSCME case. Projected maximum impact from the AFSCME case further reduces the fiscal year 2019 deficit to $1.046 billion

Fiscal Year Results

The projected fiscal year 2019 deficit would cause the state’s outstanding accounts payable to increase from approximately $6.8 billion at the end of fiscal year 2018 to an estimated $7.8 billion at the end of fiscal year 2019.

Without changes to the current trajectory of the state’s finances, year-end accounts payable will continue to grow year by year throughout the reporting period. Options must be considered for implementing structural reforms, imposing spending reductions and enhancing revenues to balance the state’s budget and resolve the budget shortfalls projected in this report.

Estimated Interest Expenses

The State Prompt Payment Act (30 ILCS 540/3-2) establishes a specified time-frame in which bills for goods and services shall be paid. In the event that the bills are not paid within the specified time frame, an interest penalty is applied for each month, or portion thereof, until final payment is made. Similarly, the Illinois Insurance Code (215 ILCS 5/368a and 5/370a) establishes timely pay for health care services under the State Employees Group Health Insurance Program. In the event that health care services bills are not paid within the specified time frame, the health care service provider is entitled to interest for each month, or portion thereof, until final payment is made.

In order to calculate the interest due an eligible vendor or provider, an agency must know two critical dates: the date the proper bill or invoice was received by the agency and the date the payment to the eligible vendor or provider was issued by the Illinois Office of the Comptroller. With that information, agencies can then calculate the amount of days that passed beyond the established payment time-frames and the appropriate interest due the vendor or provider. Until such time as a bill is paid, the agencies are not able to calculate interest. The Comptroller’s office determines which bills get paid and when, making it difficult for the agencies to calculate an interest amount.

With respect to the State Employees Group Health Insurance Program, the Department of Central Management Services (CMS) has been able to estimate that the program will incur approximately $419 million in interest expense in fiscal year 2019 from fiscal year 2018 and prior years. In this instance, CMS is able to project its fiscal year 2019 interest costs due to known fiscal year 2018 interest carry-over. Future interest expense estimates cannot be made due to fluctuations in when invoices are received and the payment timing decisions made by the Comptroller.

Policy Objectives and Intentions

Fiscal year 2019 policy is embodied in the enacted budget. Fiscal policy for fiscal year 2020 and beyond will be directed by Governor-elect Pritzker.