**STATE OF ILLINOIS**
**EXECUTIVE OFFICE OF THE GOVERNOR**

# GOVERNOR'S OFFICE OF MANAGEMENT AND BUDGET

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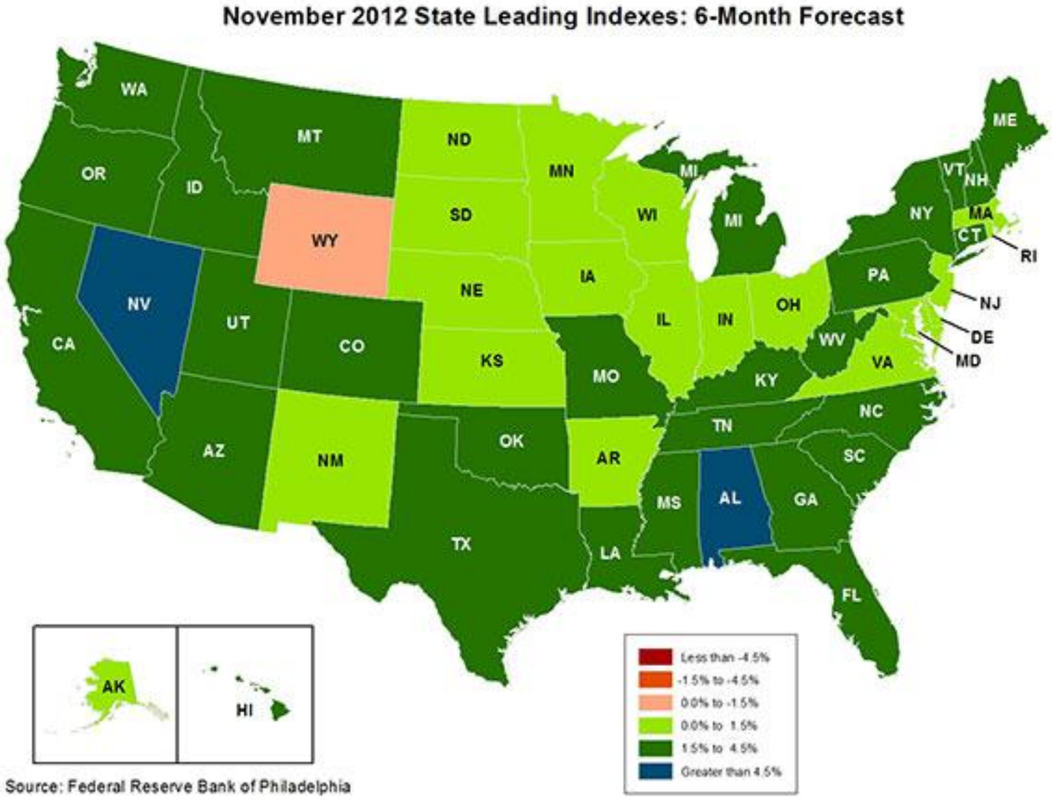
***Illinois' Economic and Fiscal Policy Report (Public Act 96-1354)*** requires the Governor's Office of Management and Budget to annually submit an economic and fiscal policy report to the General Assembly outlining the long-term economic and fiscal policy objectives of the state, the economic and fiscal policy intentions for the upcoming fiscal year and the subsequent two fiscal years.

The Three-Year Projection *(attached)* highlights revenues, expenditures, any deficit or surplus, and other General Revenue Fund liabilities through Fiscal Year 2016.

## Illinois Economic Conditions and Forecast

Illinois real gross domestic product is expected to grow at a rate of 1.2 percent for the remainder of fiscal year 2013. Both the Philadelphia Federal Reserve Bank Index of Leading Economic Indicators for Illinois[1] and the IHS Global Insight economic model predict growth rates within 0.1 percent of each other.The map below illustrates how Illinois growth compares with the rest of the nation. The table below summarizes the key economic variables driving the tax forecasting models.

[1] 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. Federal Reserve Bank of Philadelphia, "State Leading Indexes", Retrieved 1/10/2013 from http://www.philadelphiafed.org/research-and-data/regional-economy/indexes/leading/




### Key Revenue Forecasting Economic Variables

| Variables | Fiscal Year | | | |
|---|---|---|---|---|
| | FY13 | FY14 | FY15 | FY16 |
| Illinois Real Gross Domestic Product | 1.2% | 2.0% | 2.9% | 2.8% |
| Illinois Employment | 0.9% | 1.0% | 1.2% | 1.2% |
| Illinois Wages and Salaries[2] | 2.4% | 3.1% | 3.6% | 3.9% |
| Domestic Corporate Profits | 6.9% | -4.1% | -1.2% | 2.1% |
| Illinois Retail Sales | 2.3% | 1.8% | 2.6% | 2.9% |

State source revenue from taxes will increase $847 million in fiscal year 2014. This assumes the individual income tax refund fund diversion rate is lowered from 9.75 percent to 9 percent and the corporate income tax diversion rate is lowered from 14 percent to 12 percent. Diversion rates are lower because the Department of Revenue has cleared out the backlog of unpaid income tax refunds.

While the state's macroeconomic performance is expected to improve markedly in fiscal years 2015 and 2016, income tax revenues decline because of the statutory reductions in the individual income tax rate from 5 percent to 3.75 percent and the corporate income tax rate from

[2] Based on a comparison of previous forecast to actual wage levels, Illinois Department of Revenue and Illinois Department of Employment Security economists believe IHS Global Insight is overestimating wages and salaries growth in Professional and Business Services and Information employment sectors. Wage and salary forecasts were correspondingly revised downward.

7 percent to 5.25 percent for tax year 2015. In fiscal year 2016 receipts from individual and corporate income taxes are forecast to be $4.69 billion less than fiscal year 2014 levels. Even after accounting for growth in sale taxes and other sources, total available resources are forecast to be $3.76 billion lower in fiscal year 2016 than 2014.

## Risks to Forecast

1. Federal Fiscal Policy: Tax revenues are sensitive to changes in economic conditions. Contractionary policies by the federal government may adversely impact state tax receipts. Reductions in federal funding of programs may also adversely effect the state's ability to deliver services.

2. The Impact of Capping/Suspending Net Operating Losses (NOLs): This estimate was developed based on an average of 10 years of Net Operating Losses used by firms and adjusted for the increased tax rate. The Department of Revenue will be able to gauge the accuracy of this estimate when they receive 2011 tax returns. Return data will inform the Department as to the net losses incurred by firms and the amount of their Illinois income. The Department is especially concerned about the estimate of the impact the NOL cap/suspension may have between fiscal year 2015 and 2017, when firms can use NOLs they earned during 2011 – 2014 but may not have been able to use.

3. Impact of Federal 100 Percent Expensing: Illinois' estimate starts with the Joint Commission on Taxation's national estimate and then brings the number down to the state level. This estimate was checked for reasonability against an Illinois estimate developed by the Center on Budget and Policy Priorities and Department of Revenue estimates from data on our prior decoupling from federal 30% and 50% bonus depreciation. The estimates were comparable in magnitude. There is no way to determine the actual value of this policy because Illinois is coupled with the federal government and did not break this item out on the tax return.

4. Timing of Taxpayer Response: The forecast for fiscal year 2015 – 2016 assumes that taxpayers will respond to the lower tax rate and the availability of Illinois NOLs to apply to their tax bills by reducing their payments during subsequent accounting periods. Taxpayers may anticipate the reduction or may delay responding, affecting the accuracy of our estimates for NOLs and gross corporate income tax receipts.

# POLICY AND BUDGET IMPLICATIONS

For decades the presentation of the Illinois State budget has been limited to a display of annual revenues and expenditures without full disclosure of liabilities carried from prior fiscal years. This Three Year Budget Projection discloses the full amount of these liabilities including "Section 25" liabilities for all years displayed. The state additionally has obligations accumulated over prior fiscal years in respect of the unfunded liabilities of the state pension funds and other post-retirement benefits, which are disclosed in the state's Official Statements for its bond offerings and its Comprehensive Annual Financial Reports.

Illinois faces tremendous fiscal challenges in the coming three years. At the end of fiscal year 2012, Illinois had accumulated nearly $9.4 billion in back bills. The state will cut substantially into this backlog during fiscal year 2013, paying $1.3 billion of Medicaid and other bills. Unfortunately, under- appropriations of at least $1 billion in the state's group health insurance program and several other programs have limited the ability of the state to make progress in reducing liabilities under Section 25 of the State Finance Act.

In fiscal year 2014, state tax revenues are estimated to increase by approximately $600 million. That revenue growth will be offset by increased pension obligations of $945 million. Spending reductions and program efficiencies will enable the state to continue to reduce the backlog of past due bills while continuing to provide basic support for its statutory obligations for education, public safety, healthcare, human services and other government-mandated programs.

The challenge in the years ahead is management of the state’s accumulated bills in the face of continuously increasing pension contributions and the statutory reductions in the individual income tax rate from 5 percent to 3.75 percent and the corporate income tax rate from 7 percent to 5.25 percent for tax year 2015 and subsequent years. The following section illustrates the spending reductions necessary to meet this challenge.

Although the total expenditure line increases by $1 billion from fiscal year 2013 to 2014, most of that total is the statutorily required payment to the pension systems, to which both the statutory ramp in the 1995 pension reform law and the lowered expected rate of return on the investments of the Teacher’s Retirement System (TRS), adopted as a result of the quadrennial ”experience study”, contributed. Other increases are appropriations commensurate with the actual liabilities.

Fiscal year 2015 and 2016  will require much larger reductions in spending, requiring extensive program re-design to meet the projected budget targets. The budget will be balanced with across-the-board spending reductions of 5.7 percent and 13.6 percent in fiscal years 2015 and 2016, respectively. Statutory pension contributions will be made in each year.