Commission on Government Forecasting and Accountability

MONTHLY BRIEFING FOR THE MONTH ENDED: JANUARY 2013

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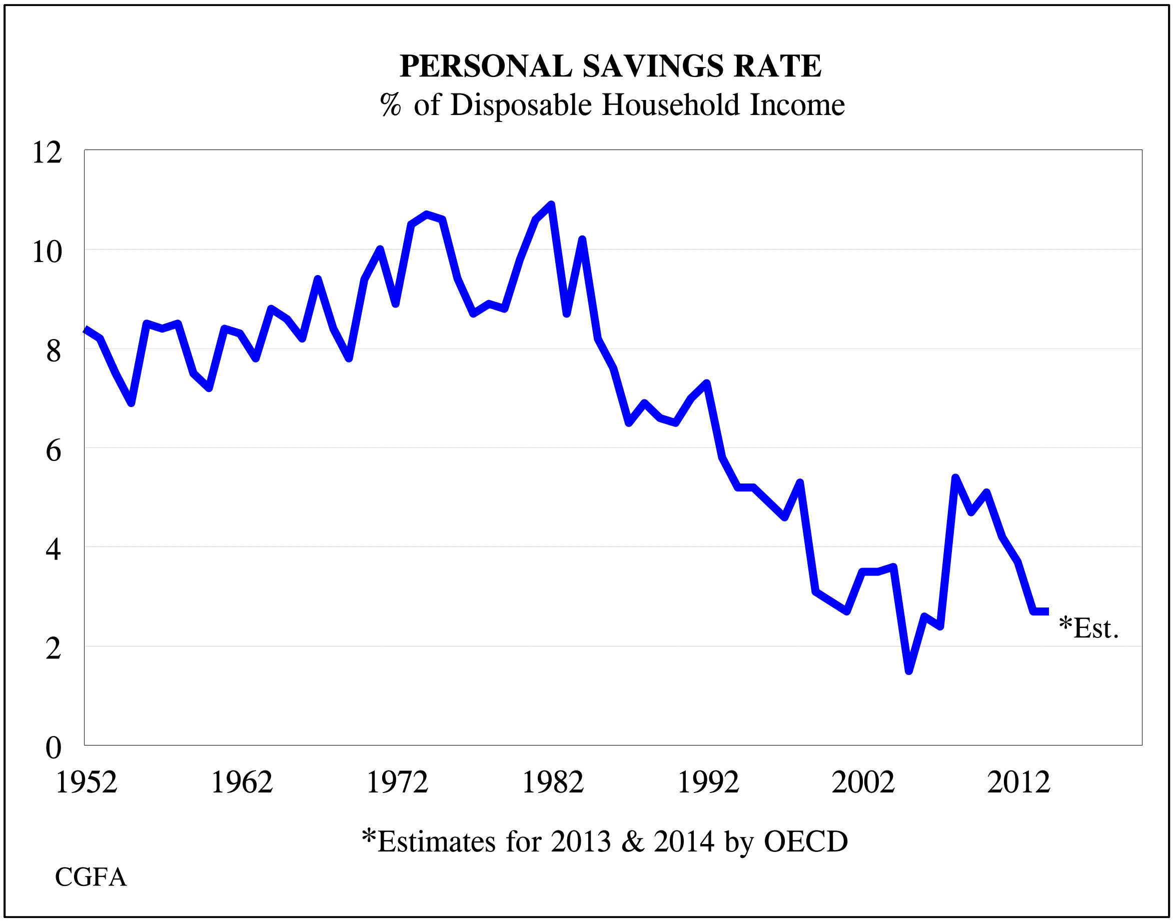
ECONOMY: Savings, Investment and Debt

Edward H. Boss, Jr., Chief Economist

The Federal Reserve's Quantitative Easing of credit, in its latest phase is purchasing $45 billion in Treasury securities and $40 billion in mortgage-backed securities each month. This has kept interest rates at extremely low levels in an attempt to stimulate the economy, particularly the housing sector. Some point to renewed increases in housing prices in recent months and continued economic growth, albeit modest, as evidence that this policy is having some success. Even so, there also are some consequences, particularly for those living on a fixed income, often the elderly.

While stock prices have rebounded, given the vagaries of the equity markets where many saw their 401Ks reduced to 201Ks as equity prices plunged during the prolonged recession, had shifted their savings to more secure but relatively low-yielding bonds and Treasury securities. At the same time, there were zero cost of living adjustments to Social Security payments in both 2009 and 2010. There was a 3.6% rise in 2011 and 1.7% in 2012; however, the increase could be partly or completely offset by increases in Medicare premiums.

At the same time, there is concern that these programs are unsustainable in their present forms. According to the 2012 annual reports of the Social Security and Medicare Boards of Trustees, Social Securities expenditures exceeded non-interest income in both 2010 and 2011, the first such occurrences since 1983 and estimate this will continue to exist throughout their 75-year projection period. *"Indeed, after 2020, Treasury will redeem trust fund assets in amounts that exceed interest earnings until exhaustion of trust fund reserves in 2033, three years earlier than projected last year.*



Moreover, a temporary reduction in payroll taxes reduced revenues flowing into the fund by $103 billion in 2011 and a projected $112 billion in 2012 before being reinstated this year. Even more concerning is that the Medicare Trust Fund faces depletion earlier than Social Security, with costs growing from 3.7% of GDP in 2011 to 5.7% of GDP by 2035 and projected to rise further.

It's not only the elderly, however, being affected by low rates of return on their savings. For example, growing pension fund shortfalls reflect rates of return far below those projected by actuaries just a few years earlier. Indeed, the longest recession and slowest economic recovery in the post World War II period coupled with extraordinarily high unemployment and low interest rates have cut deeply into savings. As shown in the chart, savings as a percent of disposable household income, that is money that households have available for spending and saving after income tax payments, has reached the lowest levels in the past 60 years with no improvement expected in the next few years.

Another risk of course is what will happen to the economy when interest rates rise as the Federal Reserve starts to slow their massive security purchases and begins to unwind their vast holdings. Higher interest rates would not only increase mortgage rates at a time when housing is beginning to improve but raise the cost of government borrowing, already at record levels with projected budget deficits of a trillion dollars or more as far as the eye can see. Moreover, even should the economy begin to grow at a more rapid pace, more in line with past expansions, it could spark renewed inflationary pressures. Too often in the past the Federal Reserve has overstayed a policy stance only to have to reverse it later after some damage already had begun.

In the U.S., the lack of savings or spending cuts and huge build up in public debt, now greater than the GDP, brings up comparisons with what much of Europe, particularly Southern Europe, has been facing. At the same time, the federal government has been unwilling to date to cut or reform the largest contributors to the deficit buildup. Indeed a cut in any government program seems difficult to achieve. In part this stems from the interpretation by some that savings is not equal to investment, but rather spending itself may be considered investment in the future, often for social purposes and even when funds have to be borrowed.

What are needed are long-term solutions to the lingering high unemployment situation, unsustainable government spending, and increasing debt levels. On the positive side, are encouraging data on the housing sector, improved auto sales, reduced energy imports, a rising stock market and large cash positions maintained by corporations. How monetary and fiscal policy actions handle the issues they face could well determine whether the U.S. economy assumes an improved upward growth path or follows the pattern of excessive spending, government promises made that could not be kept, and growing debt that has befallen much of Europe today.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	DEC. 2012	NOV. 2012	DEC. 2011
Unemployment Rate (Average)	8.7%	8.7%	9.7%
Annual Rate of Inflation (Chicago)	-3.1%	-4.3%	1.7%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (December)	6,643	0.1%	0.9%
Employment (thousands) (December)	6,068	0.1%	2.0%
New Car & Truck Registration (December)	41,458	2.4%	2.1%
Single Family Housing Permits (December)	540	-20.2%	16.6%
Total Exports ($ mil) (November)	5,447	-3.7%	1.4%
Chicago Purchasing Managers Index (January)	55.6	13.0%	-7.6%

ILLINOIS BOND RATINGS

Lynnae Kapp, Senior Bond Analyst

The State was initially planning on selling $500 million in General Obligation Bonds, Series of February 2013, by competitive bid starting January 30th. In anticipation of the bond sale, Standard & Poor's lowered the State's rating from A down to A-, with a negative outlook. Standard & Poor's last downgraded Illinois in August 2012 down one level from A+ to A. Prior to these two downgrades, the rating agency hadn't downgraded Illinois for three and a half years. During that same time period the other rating agencies had both downgraded the State twice. Moody's, although unhappy with the lack of progress on Pension reform, reaffirmed the current rating of A2, with a negative outlook. Fitch Ratings reaffirmed Illinois' A rating but has recently put Illinois on their negative watch list. **Due to the downgrade's affect on the pricing of the bond sale, the State has postponed the bond sale until the market becomes more favorable.**

Illinois' General Obligation Ratings History

Date of	Fitch		S&P		Moody's	
Rating Action	Rating	up/down	Rating	up/down	Rating	up/down
Jan 2013			A-	↓1x		
Aug 2012			A	↓1x		
Jan 2012					A2	↓1x
Jun 2010	A	↓1x			A1	↓1x
Mar-Apr 2010	A-/A+ recal	↓1x/↑2x			Aa3 recal	↑2x
Dec 2009			A+	↓1x	A2	↓1x
Mar-Jul 2009	A	↓2x	AA-	↓1x	A1	↓1x
Dec 2008	AA-	↓1x				
May 2003	AA	↓1x			Aa3	↓1x
Jun 2000	AA+	↑1x				
Jun 1998					Aa2	↑1x
Jul 1997			AA	↑1x		
Feb 1997					Aa3	↑1x
Sep 1996	AA	initial rating				
Feb 1995					A1	↓2x
Aug 1992			AA-	↓1x	Aa	↓1x
Aug-Sep 1991			AA	↓1x	Aa1	↓2x
Mar 1983			AA+	↓2x		
Feb 1979			AAA	initial rating		
1973					AAA	initial rating

Note: "recal" means recalibration, when Fitch and Moody's revised their ratings on municipal bonds to match global/corporate ratings. These are not considered upgrades.

Agency Ratings Comparison

Fitch/S&P	Moody's
AAA+	Aaa1(Aaa)
AAA	Aaa2
AAA-	Aaa3
AA+	Aa1
AA	Aa2
AA-	Aa3
A+	A1
A	A2
A-	A3
BBB+	Baa1
BBB	Baa2
BBB-	Baa3
BB+	Ba1
BB	Ba2
BB-	Ba3
B+	B1
B	B2
B-	B3
CCC+	Caa1
CCC	Caa2
CCC-	Caa3
CC+	Ca1
CC	Ca2
CC-	Ca3
C+	C1
C	C2
C-	C3

Rating Agencies' Explanation of Recently Assigned Ratings:

FITCH	June 2010	A+	downgraded toA

"The Rating Watch Negative reflects the ongoing inability of the state to address its large and growing unfunded pension liability, most recently through the failure to pass pension reform in the 'lame duck' legislative session that ended on Jan. 8. Following several years during which the state was unwilling to take action to restructure its budget to achieve balance and increasing reliance on borrowing to close budget gaps, temporary increases in the personal and corporate income tax rates and spending limits enacted in early 2011 closed a significant portion of the structural gap in the state's budget through fiscal 2014. The enacted fiscal 2013 budget is balanced, in part through passage of Medicaid reform. Due to the temporary nature of the enacted tax increases, the state will need to find a more permanent solution to the mismatch between spending and revenues particularly as it faces steep increases in annual pension payments. The state relied on payment deferrals to manage its operating deficit through the downturn and the resulting accounts payable backlog totaled $5 billion at the end of fiscal year 2012. Although the balance is budgeted to be reduced during the current fiscal year, the state is unlikely to bring its payment obligations current in a timely manner in the absence of borrowing for this purpose. The state's debt burden is above average and has risen over the past few years with issuance for operational purposes. Further, there is a large unfunded pension liability, despite the issuance of pension obligation bonds and passage of pension reform in March 2010. Pension funding places a large and growing demand on the state's budget.

"The state benefits from a large, diverse economy centered on the Chicago metropolitan area, which is the nation's third largest and is a nationally important business and transportation center. [The] GO pledge [is] strong. There is an irrevocable and continuing appropriation for all GO debt service, and continuing authority and direction to the state treasurer and comptroller to make all necessary transfers from any and all revenues and funds of the state."

S&P	August 2012	A+	downgraded toA
	January 2013	A	downgraded toA-

"The downgrade reflects what we view as the state's weakened pension funded ratios and lack of action on reform measures intended to improve funding levels and diminish cost pressures associated with annual contributions…Although Illinois has experienced economic and revenue recovery and several revenue enhancements and overall spending restraint have improved structural budget performance in our view, revenues and expenditures have not been fully aligned and payables outstanding continue to be significant….

"The negative outlook reflects what we view as the range of challenges Illinois faces that will require legislative consensus and action. We believe the outcome of deliberations relating to pension reform and the expiration of current personal and corporate income tax rate increases on Jan. 1, 2015, along with other normal budget pressures, could have a profound effect on the state's budgetary performance and liquidity over the two-year outlook horizon. While it is unusual for a state rating to fall into the 'BBB' category, lack of action on pension reform and upcoming budget challenges could result in further credit deterioration, particularly if it translates into weaker liquidity. We could revise the outlook to stable if Illinois achieves pension reform that lowers liabilities and associated costs to the state and takes credible actions to achieve structural budget balance over the two-year outlook horizon. We believe there is limited upside potential for the rating in the next two years given the size of the accumulated deficit and the liability challenges Illinois faces but will evaluate the state's progress in addressing key budget and pension challenges."

MOODY'S	**June 2010**	**Aa3**	**downgraded to**	**A1**
	January 2012	A1	downgraded toA2	

"Illinois' A2 general obligation rating and negative outlook are consistent with our view that the state's pension funding pressures are likely to persist and perhaps worsen in the near term. Lawmakers' repeated inability to reach consensus on retiree benefit measures last year underscored the task's extreme difficulty. Any meaningful pension reforms enacted in coming months are likely to be challenged in court, given the state constitution's pension protection clause. This litigation threat and accompanying political pressures may once again deter action altogether or lead to reforms with little effect. Despite a diverse economy and above-average wealth, Illinois has a tax structure that cannot provide enough revenue to maintain public services at current levels while meeting rising employee benefit costs. The state's payment backlog already is sizable. Because fiscal 2014 marks the last year before recent income tax increases are mostly phased out, Illinois is heading towards an unsustainable combination of higher pension contribution needs and reduced tax revenues."

REVENUE
Revenues Up to Begin 2013

Jim Muschinske, Revenue Manager

Overall base revenues grew $480 million in January. The growth was in large part due to a surge in reimbursable spending which translated into higher federal source receipts. Gross personal income taxes also performed well, while sales tax performance lagged. One additional receipting day likely contributed somewhat to the monthly advance.

Gross personal income taxes grew $262 million, or $218 million net of refunds. Gross corporate income tax revenues rose $24 million, or $23 million net of refunds. Other sources gained $15 million, corporate franchise $8 million, insurance taxes $3 million, interest earnings $2 million, and the cigarette tax $1 million.

Sales tax receipts suffered a drop of $14 million in January. A few other revenue sources experienced monthly drops as inheritance tax declined $7 million, public utility taxes $1 million, and liquor taxes $1 million.

Overall transfers grew $9 million for the month. Other transfers increased $14 million, while lottery transfers managed a $1 million advance. Those gains were partially offset by a drop of $6 million from Riverboat transfers. Federal sources surged $224 million in January, the result of a concerted effort to pay down the backlog of Medicaid bills.

Year to Date

Through January, overall base revenues have grown $1.272 billion. Gross personal income taxes were up $690 million, or $533 million net of refunds. Gross corporate income taxes increased $300 million [$300 million net of refunds as well]. Due to the lagged timing of receipts related to a prior tax change, inheritance tax was up $69 million. All other tax sources totaled a net gain of $42 million.

The performance of both personal and corporate income taxes has been quite good. However, expectations should be tempered by certain timing issues that have yet to be realized as well as numerous legislative changes that may interrupt historic receipt patterns. Some examples include: implementation timing of rate increase that resulted in a positive FY'12 impact of an estimated $500 million during last spring—that will not recur in FY'13. Also, changes related to federal expensing, net operating loss, and other tax changes all add uncertainty and may impact receipts over the remaining months.

Overall transfers were down $256 million. The falloff was due in part to the one-time $73 million sale of the 10th license last year, as well as timing related to last year's settlement of protested liquor taxes. Federal sources have managed to post a $584 million gain through January due to higher general funds spending on Medicaid bills. It is anticipated that Medicaid spending will begin to slow, as well as, shift to non-GRF funding sources. As a result, current rates of growth of federal sources are expected to reverse course over the next five months.

GENERAL FUNDS RECEIPTS: JANUARY
FY 2013 vs. FY 2012
($ million)

Revenue Sources	Jan. FY 2013	Jan. FY 2012	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$2,126	$1,864	$262	14.1%
Corporate Income Tax (regular)	112	88	$24	27.3%
Sales Taxes	643	657	($14)	-2.1%
Public Utility Taxes (regular)	96	97	($1)	-1.0%
Cigarette Tax	30	29	$1	3.4%
Liquor Gallonage Taxes	18	19	($1)	-5.3%
Vehicle Use Tax	2	2	$0	0.0%
Inheritance Tax (Gross)	22	29	($7)	-24.1%
Insurance Taxes and Fees	7	4	$3	75.0%
Corporate Franchise Tax & Fees	22	14	$8	57.1%
Interest on State Funds & Investments	4	2	$2	100.0%
Cook County IGT	0	0	$0	N/A
Other Sources	65	50	$15	30.0%
Subtotal	$3,147	$2,855	$292	10.2%
Transfers				
Lottery	48	47	$1	2.1%
Riverboat transfers & receipts	21	27	($6)	-22.2%
Proceeds from Sale of 10th license	0	0	$0	N/A
Other	49	35	$14	40.0%
Total State Sources	$3,265	$2,964	$301	10.2%
Federal Sources	$542	$318	$224	70.4%
Total Federal & State Sources	$3,807	$3,282	$525	16.0%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($207)	($163)	($44)	27.0%
Corporate Income Tax	($16)	(15)	($1)	6.7%
Subtotal General Funds	$3,584	$3,104	$480	15.5%
Short-Term Borrowing	$0	$0	$0	N/A
FY'13 Backlog Payment Fund	$0	$0	$0	N/A
Tobacco Liquidation Proceeds	$0	$0	$0	N/A
Pension Contribution Fund Transfer	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$3,584	$3,104	$480	15.5%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 1-Feb-13

GENERAL FUNDS RECEIPTS: YEAR TO DATE ***FY 2013 vs. FY 2012*** ***($ million)***				
Revenue Sources	**FY 2013**	**FY 2012**	**CHANGE FROM FY 2012**	**% CHANGE**
State Taxes				
Personal Income Tax	$9,704	$9,014	$690	7.7%
Corporate Income Tax (regular)	1,513	1,213	$300	24.7%
Sales Taxes	4,337	4,312	$25	0.6%
Public Utility Taxes (regular)	579	601	($22)	-3.7%
Cigarette Tax	206	206	$0	0.0%
Liquor Gallonage Taxes	104	103	$1	1.0%
Vehicle Use Tax	16	16	$0	0.0%
Inheritance Tax (Gross)	180	111	$69	62.2%
Insurance Taxes and Fees	165	152	$13	8.6%
Corporate Franchise Tax & Fees	129	114	$15	13.2%
Interest on State Funds & Investments	12	11	$1	9.1%
Cook County IGT	56	56	$0	0.0%
Other Sources	248	239	$9	3.8%
Subtotal	$17,249	$16,148	$1,101	6.8%
Transfers				
Lottery	356	347	$9	2.6%
Riverboat transfers & receipts	242	234	$8	3.4%
Proceeds from Sale of 10th license	0	73	($73)	N/A
Other	306	506	($200)	-39.5%
Total State Sources	$18,153	$17,308	$845	4.9%
Federal Sources	$2,231	$1,647	$584	35.5%
Total Federal & State Sources	$20,384	$18,955	$1,429	7.5%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($946)	($789)	($157)	19.9%
Corporate Income Tax	($212)	($212)	$0	0.0%
Subtotal General Funds	$19,226	$17,954	$1,272	7.1%
Short-Term Borrowing	$0	$0	$0	N/A
FY'13 Backlog Payment Fund Transfer	$264	$0	$264	N/A
Tobacco Liquidation Proceeds	$0	$0	$0	N/A
Pension Contribution Fund Transfer	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$275	$275	$0	0.0%
Total General Funds	$19,765	$18,229	$1,536	8.4%

SOURCE: Office of the Comptroller, State of Illinois: Some totals may not equal, due to rounding.

CGFA 1-Feb-13

PENSIONS
New Police and Fire Report
Matt Dragoo, Pension Analyst

On January 25th, the Commission released the *Report on the Financial Condition of the Downstate Police and Fire Pension Funds in Illinois.* The report examines the financial status of the 642 Police and Firefighter pension funds outside of Chicago, commonly referred to as the Downstate Police and Fire Funds. This report comes about as a result of the enactment of P.A. 96-1495 (SB 3538), which became effective on January 1, 2011 and contained a number of reforms to police and fire pension funds in Illinois. Most notably, the Act provided for the addition of a second tier of benefits for newly hired police and fire personnel after January 1, 2011 and a change in the funding methodology for municipalities.

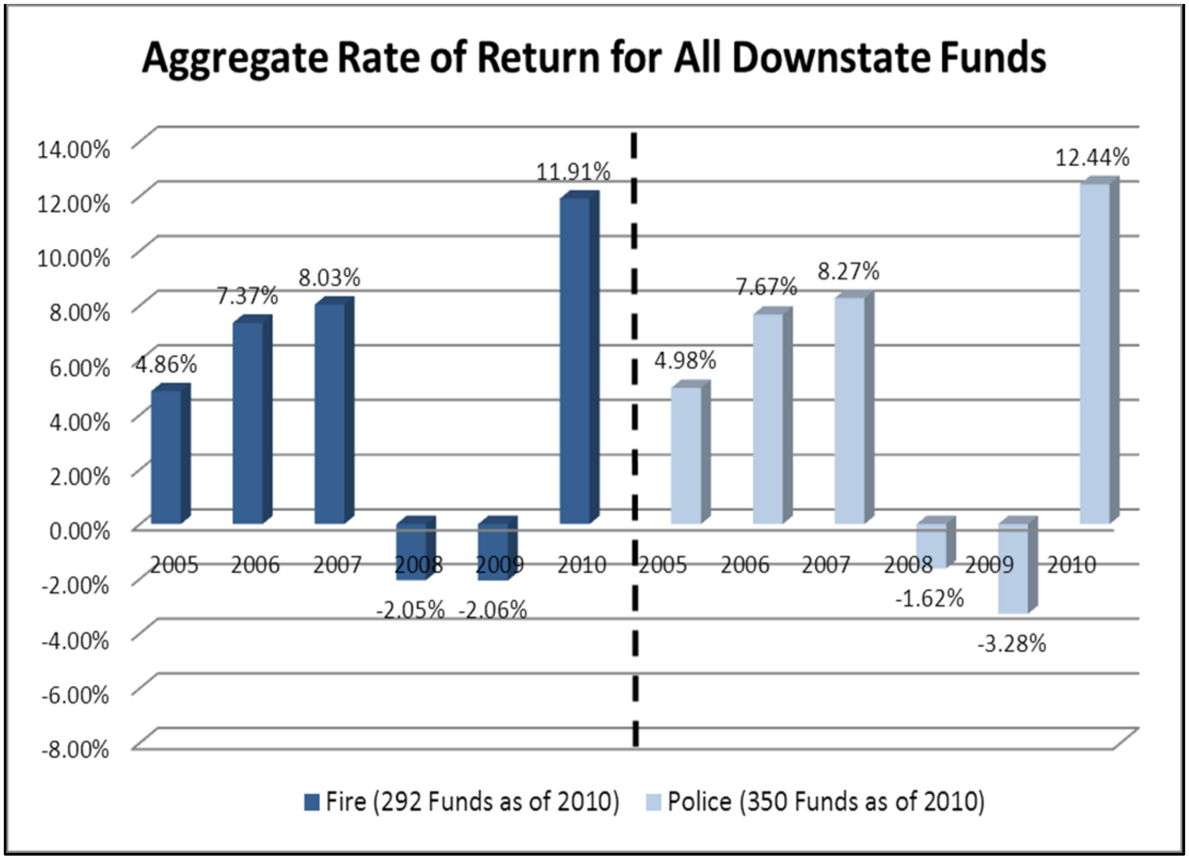
For the period of time covered in the report, FY 2004 – FY 2010, municipal contributions to police and fire pension funds were governed under the pre-P.A. 96-1495 statutory provisions. These provisions required the amortization of all unfunded liabilities by 2033 for Fire funds, and the latter of 2033 or 40 years after the date of establishment of the pension fund for Police funds. All of the data contained in the report was gathered from the annual pension reports that individual police and fire pension funds file annually with the Public Pension Division of the Illinois Department of Insurance. *CGFA did not independently verify the accuracy of the data obtained from DOI.*

The full report is available online at the CGFA homepage: http://www.ilga.gov/commission/cgfa2006/home.aspx. The report can be accessed by clicking on "Latest Publications."

What follows is a brief abstract of the report:

Financial History: In FY 1999, the aggregate funding ratio for police and fire pension funds reached peaks of 76.37% and 78.57%, respectively, but then a year-over-year downward trend began. Police and fire pension funds bottomed out in the low 50's in the wake of the stock market downturn, with a slight recovery in FY 2010.

Rate of Return: Police and Fire pension funds were certainly not immune to the market downturn during FY 2008-2009, as is evident by the negative investment returns in nearly every instance except for the smallest funds. Even taking into consideration the effects of the FY 2008-2009 downturn, the investment returns of both police and firefighters modestly increased, on average, with respect to the size of the fund. This improvement can be attributed to the larger funds' freedom to invest in equities, which typically carry a higher risk/reward component than the fixed income investments that are prevalent in smaller funds.



The above chart illustrates the rate of investment return for the various pension funds as an aggregate whole, but the full report segregates funds with respect to asset class to show a clearer picture of investment returns for smaller and medium-sized police and fire pension funds. Additionally, the report provides comprehensive financial data for all 642 Downstate Police and Fire Funds individually.

History of Accrued Liabilities for Police Funds Aggregate

FY	Total Liabilities	Net Assets	Unfunded Liabilities	Funded Ratio
1999	$4,247,846,406	$3,244,205,234	$1,022,268,917	76.37%
2000	$4,677,884,400	$3,465,654,699	$1,230,663,775	74.09%
2001	$5,172,463,383	$3,553,848,981	$1,618,614,402	68.71%
2002	$5,511,543,068	$3,483,510,140	$2,028,032,928	63.20%
2003	$6,070,739,449	$3,703,714,557	$2,367,024,892	61.01%
2004	$6,528,244,107	$4,041,785,697	$2,486,458,410	61.91%
2005	$7,008,875,255	$4,264,855,261	$2,744,019,994	60.85%
2006	$7,535,450,868	$4,636,640,484	$2,898,810,384	61.53%
2007	$8,052,610,022	$5,005,666,995	$3,046,943,027	62.16%
2008	$8,624,428,235	$4,851,201,322	$3,773,226,913	56.25%
2009	$9,194,323,785	$4,694,478,158	$4,499,845,627	51.06%
2010	$9,723,248,357	$5,279,164,952	$4,444,083,405	54.29%

History of Accrued Liabilities for Fire Funds Aggregate

FY	Total Liabilities	Net Assets	Unfunded Liabilities	Percent Funded
1999	$3,159,512,638	$2,482,357,842	$720,778,358	78.57%
2000	$3,395,154,498	$2,600,116,111	$819,459,944	76.58%
2001	$3,669,673,784	$2,600,044,108	$1,069,683,676	70.85%
2002	$3,943,449,031	$2,595,476,011	$1,347,973,019	65.82%
2003	$4,253,267,707	$2,730,779,514	$1,522,488,193	64.20%
2004	$4,565,283,258	$2,957,625,791	$1,607,657,467	64.79%
2005	$4,897,042,244	$3,117,782,713	$1,779,259,531	63.67%
2006	$5,269,519,348	$3,377,315,833	$1,892,203,515	64.09%
2007	$5,759,980,557	$3,633,741,877	$2,126,238,680	63.09%
2008	$6,310,641,604	$3,482,932,952	$2,827,708,652	55.19%
2009	$6,653,138,230	$3,408,606,874	$3,244,531,355	51.23%
2010	$6,938,692,039	$3,803,024,202	$3,135,667,837	54.81%