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ECONOMY: Summer Slowdown Hits Employment

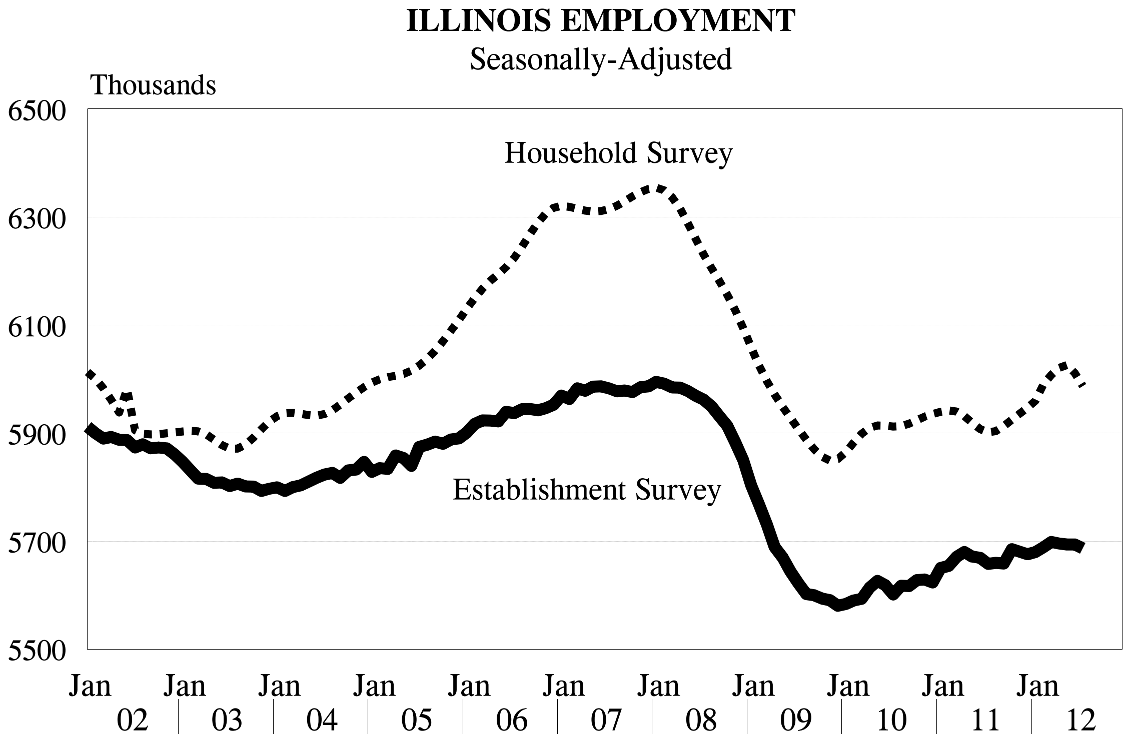
Edward H. Boss, Jr., Chief Economist

The summer slowdown in the economy was particularly evident in a weakening employment picture that was broadly felt throughout the nation. The Bureau of Labor Statistics reported that in July 44 states recorded increases in their unemployment rates with the overall national rate edging up to 8.3% from 8.2%. At the same time, the labor force participation rate fell to 63.7%, the lowest rate since April and well below the 66% average from 2002 to 2008. Without this shrinkage in the labor force, recent unemployment rates would be substantially higher.

Illinois also did not fare well. The unemployment rate in Illinois rose to 8.9% in July from 8.7% in June and was the highest rate since February. Moreover, the Household Survey from which the data are derived, show that Illinois' labor force also shrank in July. Had it been at the same level as June, the unemployment rate would have been 9% last month. While this is well below the 10.1% in July of 2011, both the high State and national rates are without precedent for the beginning of a fourth year of an economic recovery, which officially started in June 2009.

Chart 1, on the next page, shows Illinois' employment levels as measured both from the Household Survey and from the more comprehensive Establishment Survey that surveys non-farm establishments on a monthly basis. Each survey has some flaws, although the Establishment Survey generally is considered to contain "harder" data. As illustrated, both measures have risen since the lows were reached late in 2009. However, the growth has been modest and levels remain well below pre-recession levels. (*Generally, employment gains tend to lag early in an economic recovery as businesses wait until business picks up enough to hire more employees and a sustained recovery becomes evident*).

CHART 1



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While 31 states showed some improvement in non-farm payroll employment as reported in the Establishment Survey last month, 19 showed decreases. The three largest declines were in New Jersey (-12,000), Missouri (-7, 700) and Illinois (-7,100). The largest declines in Illinois were in Government, Education and Health services, other services, and a small number in financial activities. Total non-farm payroll jobs in Illinois were 28,600 higher than a year earlier in July 2011 and higher by 106,400 since the low reached at the end of 2009. Even so, there were still more than 300,000 fewer on non-farm payrolls than at the end of 2007 when the recession began.

Like the previous two years when a summer economic soft patch occurred, most feel at least some improvement in the months ahead. This is reflected in a sharp turnaround in the Conference Board's leading economic indicators in July, improved retail sales and an increase in the Thompson Reuters/ University of Michigan Consumer Sentiment to the highest level since May and an improving housing sector. At best, however, there are enough impediments to prevent a speed up in growth, not the least of which are rising gasoline prices, troubles in the Middle East, concerns about Europe, and looming changes from the "fiscal cliff'. Indeed, a recent Congressional Budget Office (CBO) report stated that if the "fiscal cliff' is not resolved and occurs, "…the U.S. would experience a recession, with U.S. unemployment jumping to about 9% in the second half of 2013."

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	JULY 2012	JUNE 2012	JULY 2011
Unemployment Rate (Average)	8.9%	8.7%	10.1%
Annual Rate of Inflation (Chicago)	-2.8%	-0.6%	1.1%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (July)	6,574	-0.1%	0.1%
Employment (thousands) (July)	5,987	-0.3%	1.4%
New Car & Truck Registration (July)	48,213	-4.6%	13.6%
Single Family Housing Permits (July)	834	4.9%	33.2%
Total Exports ($ mil) (June)	5,892	-1.3%	6.5%
Chicago Purchasing Managers Index (August)	53.0	-1.3%	-8.8%

Bond Rating Downgrade

Lynnae Kapp, Senior Bond Analyst

Ratings:

In September 2012, the State will sell $50 million in General Obligation Bonds. Standard & Poor's lowered the State's rating to A from A+ for the first time in three and a half years, while during that same time period the other rating agencies had downgraded the State twice. Moody's, although unhappy with the lack of progress on Pension reform, reaffirmed the current rating of A2. Fitch rates Illinois an A, and has not made a new comment based on the State's September bond sale.

ILLINOIS GENERAL OBLIGATION BOND RATINGS

RATING AGENCIES	July 1997	June 1998	June 2000	May 2003	Dec 2008	Mar-July 2009	Dec 2009	Mar-Apr 2010	June 2010	January 2012	August 2012
Fitch Ratings	AA	AA	AA+	AA	AA-	A	A	A-/A+*	A	A	A
Standard & Poor's	AA	AA	AA	AA	AA	AA-	A+	A+	A+	A+	A
Moody's	Aa3	Aa2	Aa2	Aa3	Aa3	A1	A2	A2/Aa3*	A1	A2	A2

*Fitch and Moody's recalibrated their Municipal Bond ratings to be on a scale with their global ratings, thereby moving Illinois up to A+ and Aa3, respectively. These are NOT considered upgrades.

Current General Obligation Bond Rating Changes:

FITCH

December 2008	**↓ 1x**	**AA-**
July 2009	**↓ 2x**	**A**
March 2010	**↓ 1x**	**A-**
March 2010	**recalibration**	**A+**
June 2010	**↓ 1x**	**A**

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, the temporary increases in the personal and corporate income taxes that became effective Jan. 1, 2011 and enacted spending limits closed a significant portion of the structural gap in the state's budget through fiscal 2014. Due to the temporary nature of the enacted tax increases, there is still no sustainable plan to resolve the mismatch between spending and revenues. Further, despite the significant increase in tax revenues, the fiscal 2012 budget is not balanced. The state still has a significant accounts payable backlog, which totaled $5.2 billion at the end of fiscal year 2011, equal to 17% of general fund resources. Although the balance was reduced during fiscal 2011 as tax revenues increased, it is expected to increase again during the current fiscal year. 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. The state passed bipartisan comprehensive pension reform (March 2010) that will lower its future pension liability but will not have a significant near-term effect on financial operations.

S&P

March 2009	**↓ 1x**	**AA-**
December 2009	**↓ 1x**	**A+**
August 2012	**↓ 1x**	**A**

The downgrade reflects the state's weak pension funding levels and lack of action on reform measures intended to improve funding levels and diminish cost pressures associated with annual contributions. The downgrade also reflects continued financial weakness despite significant measures in the past two years to improve structural budget performance. The negative outlook reflects the potential for further erosion of the state's pension funds during the two-year outlook horizon and the uncertainty and risk to future budget performance due to the expiration of personal and corporate income tax rate increases on Jan. 1, 2015, which we believe could weaken financial operating results.

MOODY'S	**April 2009**	**↓ 1x**	**A1**
	December 2009	**↓ 1x**	**A2**
	April 2010	**recalibration**	**Aa3**
	June 2010	**↓ 1x**	**A1**
	January 2012	**↓ 1x**	**A2**

Illinois' general obligation bond rating was lowered to A2 from A1 on January 6 because of the state's failure last year to implement solutions to its largest credit challenges: severe pension under-funding and chronic bill-payment delays. It remains to be seen whether the state has the political will to impose new pension reforms and other measures that restore fiscal strength in the near term. The stable outlook acknowledges an ability to reach consensus on difficult decisions, such as temporary tax increases enacted early in 2011 that allowed Illinois to end reliance on deficit bonds to finance annual pension contributions. Sovereign revenue and spending powers, as well as state legal provisions giving payment of G.O. debt service priority over other expenditures, also help support Illinois' stable outlook.

WHAT COULD MAKE THE RATING GO UP:

- *Implementation of a credible, comprehensive long-term pension funding plan*
- *Substantial progress in reducing payment backlog, with adoption of a legal framework or plan to prevent renewed buildup of bills*

WHAT COULD MAKE THE RATING GO DOWN

- *Early phase-out of 2011 tax increases without offsetting binding expenditure actions, increasing the structural gap*
- *Further deterioration in pension funded status or failure to make legally required pension contributions in full*

Current Build Illinois Bond Rating Changes

FITCH	**April 2010**	**↑ 1x**	**AA+**
MOODY'S	**October 2009**	**↓ 1x**	**A1**
	December 2009	**↓ 1x**	**A2**
	April 2010	**recalibration**	**Aa3**
	June 2010	**↓ 1x**	**A1**
	January 2012	**↓ 1x**	**A2**

BUILD ILLINOIS BOND RATINGS						
Rating Agencies	Apr/July 2009	Oct 2009	Dec 2009	Mar-Apr 2010*	June 2010	January 2012
Fitch Ratings	AA	AA	AA	AA+	AA+	AA+
Standard & Poor's	AAA	AAA	AAA	AAA	AAA	AAA
Moody's	Aa3	A1	A2	Aa3	A1	A2
*Fitch and Moody's Recalibration.						

As of March 2010, S&P gives the State's sales-tax backed Build Illinois bonds an AAA rating with a stable outlook which "reflects both the state's extremely strong legal protections against dilution of coverage by additional debt and strong sales tax revenue growth." Fitch gives Build Illinois bonds an AA+ rating while Moody's A2 is based on "the breadth and long-term growth of the state economy and sales tax base, very high debt service coverage provided by the pledged revenue stream, and the fact that sales-tax revenue in excess of the amount necessary to pay debt service comprises a large and essential component of state general fund revenues."

History:

On May 13, 2003, Moody's lowered the State of Illinois' general obligation rating from Aa2 to Aa3, after the sale of $1.5 billion in G.O. Certificates, the short-term borrowing plan to pay off overdue bills. On May 23, 2003, Fitch lowered Illinois' rating from AA+ to AA. Both agencies explained that in addition to the short-term borrowing plan, a combination of factors led to this change in status, including the increase by $10 billion of principal outstanding for the state's unfunded pension liability. Other factors involved were the second annual decline in State tax collections, an increase in the GAAP deficit recorded in the General Fund, budget uncertainty, and the increase of the State's debt ratios due to the issuance of the Pension Obligation Bonds. [Downgrades affect what is called State tax-supported debt. This includes General Obligation, Build Illinois, Civic Center, and McCormick Place Expansion Project bonds.]

In August of 2005, Standard & Poor's removed Illinois from their negative watch list and affirmed their AA rating as stable. In April 2006, Fitch reaffirmed its AA rating, but put the State on their negative watch list due to concerns over Illinois' unfunded pension liability.

For the G.O. bond sales in June of 2006, Moody's reaffirmed its Aa3 rating and stable outlook "based on broad governmental powers to raise revenues and lower spending, as well as a diversified economy returning to growth in line with national trends…Balanced against these strengths are credit challenges such as narrow reserve and liquidity levels, the use of non-recurring measures to address structural budget gaps, a sizeable accumulated pension fund deficit, and a growing debt burden".

In April 2008, Standard & Poor's reaffirmed its stable outlook on the AA rated bonds adding strengths of-- ongoing budgetary adjustments, increased combined funds and budget stabilization fund cash reserves, reductions in accounts payable including lapse period spending, approved pension reform, and the ability through legislative action to access substantial amounts of cash for operations that are on deposit in other funds. S&P sees the challenges to the State as being the high GAAP general funds deficit, the large unfunded actuarial accrued liability for its five pensions, and a fairly high debt burden.

In an April 2008 review of Illinois G.O. debt for the State's April $125 million issuance, Fitch reaffirmed its AA rating with a continued negative outlook. "The Negative Rating Outlook reflects continued financial challenges, including a current year revenue shortfall and balancing an upcoming budget pressured by the weakened national economic environment and continued significant growth in funding requirements to address the pension systems' large unfunded liabilities…Fitch will revisit the outlook and rating following decisions made in the 2009 budget and will assess the extent to which solutions address fiscal balance.

The State sold $1.4 billion in General Obligation Certificates in December 2008. Fitch Ratings downgraded Illinois' G.O. bonds from an AA to an AA- with a stable outlook, stating that "the rating downgrade reflects deterioration of the state's fiscal position and a continuing inability to achieve solutions…given the controversy and uncertainty surrounding the Governor's [Blagojevich] situation, as well as the inability last fiscal year, and so far this year, to achieve a consensus on corrective measures, it is unclear at this time how budgetary solutions will move forward and be implemented". [www.fitchratings.com, "Fitch Downgrades Illinois' GO Bonds to 'AA-'; Outlook Stable", December 15, 2008]

In December 2008, Standard and Poor's put Illinois' G.O. bonds on its credit ratings watch list for a possible negative downgrade stating, "The CreditWatch placement reflects our opinion of the state's growing budgetary shortfall, now projected at $2.0 billion for the current fiscal year, and our concern that the legal charges now facing the governor and his chief of staff may challenge the state to respond to this fiscal situation on a timely basis." [www.ratingsdirect.com, S&PCORRECTED: "Illinois' GO Rating Placed On CreditWatch Negative", December 11, 2008].

Moody's gave the State's December 2008 G.O. Certificates a MIG 2 rating, lower than the MIG 1 ratings given to the G.O. Certificates of April 2008 and September 2007. The lower rating was given due to the State's stressed liquidity, increases in accounts payable, and the State's current fiscal year deficit. Moody's downgraded the State from Aa3 to A1 in April 2009, citing the state's plan to use deficit borrowing across fiscal years, which they say is a clear indication of fiscal stress, along with other strains on the state's finances.

As of April 2009, Fitch gave Illinois a negative outlook stating that although the "state's political situation has improved…its financial situation has continued to deteriorate as economically sensitive revenues – particularly income and sales taxes –

have dramatically declined and a two year budget deficit of $11.6 billion is now projected…The negative watch will be resolved following the sale of the GO notes, the enactment of the budget, and an assessment of the extent to which the final budget addresses the funding imbalances."

In March 2009, S&P did lower the State's rating to AA-, due to the "State's limited action to date to address what we view as a sizable budget gap for fiscal 2009", which has "weakened liquidity and contributed to substantial payment delays…[T]he State has historically maintained minimal financial reserves that we believe limit flexibility; it also has very high unfunded pension liabilities that will likely create added budget pressure in the next several years". At this time, S&P also put the December 2008 G.O. Certificates, which have an SP-1+ rating, on negative watch due to concerns over the State's liquidity. The April 2010 G.O. short-term borrowing received a lower SP-1 rating due to worries over the State's cash flow.[www.ratingsdirect.com].

In March 2010, Fitch downgraded the State from A to A- due to "the magnitude and persistent nature of the state's fiscal problems and the likelihood that the budget to be enacted for fiscal year (FY) 2011 will not sufficiently address either the annual operating deficit or accumulated liabilities. Accounts payable are expected to remain high throughout the next fiscal year and the state expects to use additional deficit borrowing to close its projected budget gap. The Rating Watch Negative will be resolved after an assessment of the extent to which the state addresses its funding imbalances in the context of the current legislative session and the further development of a budget for FY 2011."

The State's rating was recalibrated upward to A+ at the end of March 2010 as part of Fitch's nationwide public finance ratings recalibration, but was downgraded in June 2010 to A. "The rating downgrade reflects the magnitude and persistent nature of the state's fiscal problems and passage of a budget for fiscal (FY) 2011 that does not address either the annual operating deficit or accumulated liabilities…The state has not demonstrated the political willingness to take action during the fiscal crisis to restructure its budget to achieve balance and has relied almost exclusively on borrowing to close its sizeable budget gaps. The state's accounts payable backlog is projected to increase by more than $2 billion to $6.4 billion by the end of FY 2010, equal to 23% of general fund resources. The state continues to manage its budgetary deficit by deferring payments to vendors and others. The state's debt burden is rising and additional borrowing is expected under the $31 billion capital plan and with significant borrowing expected to close the projected FY 2011 budget gap. There is a large unfunded pension liability, despite the issuance of pension obligation bonds. The state passed bipartisan comprehensive pension reform (March 2010), which should lower its future pension liability but is not likely to have a significant near-term effect on financial operations."

Moody's Investors Service lowered the State of Illinois' general obligation (G.O.) bond rating to A1 from Aa3 in June 2010, “following the state's failure to enact significant recurring measures to address its structural budget imbalance for the fiscal year starting next month. This failure underscores a chronic lack of political will that indicates further erosion of an already weak financial position. In connection with the downgrade, ratings linked to Illinois' G.O. debt also have been lowered by one notch. These rating actions apply to Metropolitan Pier and Exposition Authority debt, which was downgraded to A2 from A1, and to Build Illinois sales-tax revenue bonds, which were downgraded to A1 from Aa3. Illinois' outlook, previously negative, has been revised to stable, because of the state's strong powers to control revenues and expenditures. Significant risks to the rating remain, however, given the state's likely reliance on inter-year cash-flow debt, delays of payments other than debt service, and various non-recurring resources, some of which are uncertain. The legislature's failure to enact substantial recurring budget-balancing measures is consistent with recent years, when infighting between the executive and legislative branches caused budget delays and allowed both the erosion of the state's finances and the widening of severe pension funding gaps. The longer the solutions to the state's challenges are deferred, the more difficult they will become to implement. We view the failure to enact significant new recurring fiscal measures as a troublesome indicator with respect to Illinois' governance and management profile.”

Moody’s downgraded the State again in January 2012 to A2. “The downgrade of the state's long-term debt follows a legislative session in which the state took no steps to implement lasting solutions to its severe pension under-funding or to its chronic bill payment delays. Failure to address these challenges undermines near- to intermediate-term prospects for fiscal recovery. It remains to be seen whether the state has the political willingness to impose durable policies leading to fiscal strength, though in the recent past it has reached consensus on difficult decisions, such as temporary income tax increases enacted last year that stabilized state finances and reduced the state's need for non-recurring budgetary measures. Illinois retains the sovereign revenue and spending powers common to all U.S. state governments. These powers, along with Illinois' legal provisions giving G.O. debt service priority over other state spending, support the move to a stable outlook. We have also downgraded to A2 from A1 the rated portion of the state's $2.47 billion of outstanding Build Illinois sales tax revenue bonds, and to A3 from A2 $2.48 billion of Metropolitan Pier and Exposition Authority and $73 million of Civic Center Program bonds.”

REVENUE
August Posts Modest Gains
Jim Muschinske, Revenue Manager

Overall base revenues grew $47 million in August as mixed results resulted in little net change. While income taxes again posted decent gains, sales tax receipts fell for the month. August transfers were down for the month, but that falloff was essentially offset by growth in federal sources. August had the same number of receipting days as last year.

Gross personal income tax revenues rose $33 million, or $18 million net of refunds. Gross corporate income tax performed well—up $14 million [also $14 million net of refunds]. Inheritance tax receipts jumped $23 million as a consequence of tax changes that went into effect January 2011 [and which were accompanied with an approximate ten month timing delay]. Corporate franchise taxes increased $6 million, insurance taxes rose $5 million, and other sources gained $5 million.

Sales tax continues to soften, falling $18 million in August. Despite the recent increase in the tax rate, cigarette taxes fell by $8 million. The falloff was likely due to the stockpiling effect. Public utility taxes dropped $1 million for the month.

Overall transfers fell $46 million in August, due to last year's $73 million receipt from the sale of the 10th riverboat license. Riverboat transfers rose $15 million, other transfers were up $10 million, and lottery transfers rose $2 million. After experiencing a very poor month last fiscal year, this August saw Federal sources managing a gain of $48 million.

Year to Date

Through the first two months of FY 2013, overall base revenues have grown $231 million. Gross personal income taxes are up $112 million, or $79 million net of refunds. Gross corporate income taxes have increased $39 million, or $37 million net of refunds. All other tax sources totaled a net increase of $44 million.

Overall transfers are down $231 million. The falloff is due 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, after experiencing a very weak beginning to last fiscal year, managed to post a $302 million gain over the first two months.

GENERAL FUNDS RECEIPTS: AUGUST

FY 2013 vs. FY 2012

($ million)

Revenue Sources	August FY 2013	August FY 2012	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$1,177	$1,144	$33	2.9%
Corporate Income Tax (regular)	68	54	$14	25.9%
Sales Taxes	583	601	($18)	-3.0%
Public Utility Taxes (regular)	96	97	($1)	-1.0%
Cigarette Tax	21	29	($8)	-27.6%
Liquor Gallonage Taxes	12	12	$0	0.0%
Vehicle Use Tax	3	3	$0	0.0%
Inheritance Tax (Gross)	24	1	$23	N/A
Insurance Taxes and Fees	19	14	$5	35.7%
Corporate Franchise Tax & Fees	19	13	$6	46.2%
Interest on State Funds & Investments	1	0	$1	N/A
Cook County IGT	0	0	$0	N/A
Other Sources	37	32	$5	15.6%
Subtotal	$2,060	$2,000	$60	3.0%
Transfers				
Lottery	37	35	$2	5.7%
Riverboat transfers & receipts	33	18	$15	83.3%
Proceeds from Sale of 10th license	0	73	($73)	N/A
Other	57	47	$10	21.3%
Total State Sources	$2,187	$2,173	$14	0.6%
Federal Sources	$183	$135	$48	35.6%
Total Federal & State Sources	$2,370	$2,308	$62	2.7%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($115)	($100)	($15)	15.0%
Corporate Income Tax	($9)	(9)	$0	0.0%
Subtotal General Funds	$2,246	$2,199	$47	2.1%
Short-Term Borrowing	$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	$2,246	$2,199	$47	2.1%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 5-Sep-12

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	$2,344	$2,232	$112	5.0%
Corporate Income Tax (regular)	155	116	$39	33.6%
Sales Taxes	1,198	1,207	($9)	-0.7%
Public Utility Taxes (regular)	166	178	($12)	-6.7%
Cigarette Tax	34	59	($25)	-42.4%
Liquor Gallonage Taxes	29	29	$0	0.0%
Vehicle Use Tax	5	6	($1)	-16.7%
Inheritance Tax (Gross)	75	1	$74	N/A
Insurance Taxes and Fees	22	18	$4	22.2%
Corporate Franchise Tax & Fees	32	26	$6	23.1%
Interest on State Funds & Investments	2	1	$1	100.0%
Cook County IGT	0	0	$0	N/A
Other Sources	74	68	$6	8.8%
Subtotal	$4,136	$3,941	$195	4.9%
Transfers				
Lottery	85	76	$9	11.8%
Riverboat transfers & receipts	62	53	$9	17.0%
Proceeds from Sale of 10th license	0	73	($73)	N/A
Other	104	280	($176)	-62.9%
Total State Sources	$4,387	$4,423	($36)	-0.8%
Federal Sources	$586	$284	$302	106.3%
Total Federal & State Sources	$4,973	$4,707	$266	5.7%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($228)	($195)	($33)	16.9%
Corporate Income Tax	($22)	($20)	($2)	10.0%
Subtotal General Funds	$4,723	$4,492	$231	5.1%
Short-Term Borrowing	$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	$275	$275	$0	0.0%
Total General Funds	$4,998	$4,767	$231	4.8%

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

CGFA 5-Sep-12