

January 13, 2006

TO: CARLI Board of Directors via CARLI Finance Committee

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SUBJECT: FY 2006 Mid-Year Economic and Budget Update Report (Informational Item)

The following information has been compiled from multiple published sources and is intended to provide an update on the national and state economy through January 12, 2006, the latest available Illinois revenue forecasts and actual yields mid-year through December 2005, and the current status of the FY 2006 state budget. Reflecting the recent leadership transition in CARLI and changes in my administrative responsibilities at the University of Illinois, this will be my final monthly report to the CARLI Board and Finance Committee.

### **National Economy**

The national economy continues to show strongly positive trends, but there still remain some underlying concerns and clearly mixed signals, as illustrated by some of the most recent economic data available.

U. S. economic growth is predicted to slow further this year (from 4.1% in the previous third quarter to around 3%) as consumer spending and housing demand and values ebb. This assumes that energy prices stabilize and inflation remains contained.

Reflecting caution and value-consciousness, consumer spending increased moderately in November and December. The holiday shopping season through December reflected a moderate increase in overall retail sales, albeit showing mixed performance among the larger retailers (disappointing holiday sales results reported for Wal-Mart, Gap, Sears), with profit outlooks that may reflect the narrow margins after deep promotional/value-discounting. Retail sales from consumer use of holiday gift cards in January 2006 and shortly thereafter may improve the net sales and profit picture somewhat. Auto sales in December were higher than expected as consumers responded to discounts and incentives.

There are still some lingering concerns about the impact of higher energy prices (particularly natural gas/fuel oil used to heat homes), rising consumer credit card debt levels and recent increases in monthly credit card payment minimums, and increased interest costs on revolving credit purchases. But consumer confidence remains high. The Conference Board reported that the December 2005 Consumer Confidence Index rose to 103.6 from 98.3 in November 2005. Gains in consumer confidence generally predict and precede increases in spending. Consumer spending accounts for nearly 2/3 of the total economic activity.

Average hourly earnings paid to employees rose by 3.1% in 2005, the biggest gain recorded since 2002. While the rate of job growth slowed moderately, employers also added over 108,000 workers to their payrolls in December (compared to 305,000 added in November)—and contributed to an annual gain of more than 2 million jobs. Weekly unemployment claims continue to reflect a strong downward trend through December.

Jobless claims nationally plunged to a new 5-year low as the number of unemployment compensation claimants declined by 35,000 for the week ending December 31, 2005—this is the lowest level since September 2000, according to the U. S. Department of Labor. Overall, this is expected to drop the national seasonally-adjusted average unemployment rate to around 4.9%. Despite the impact of the hurricanes last fall, on the whole nationally job growth was solid for most of 2005, averaging just under 200,000 new jobs created each month.

The nation's service sector grew rapidly in December, continuing the 33<sup>rd</sup> straight month of expansion in this sector. Employment levels have been rising, jobless claims falling, and new orders for services have increased significantly. Concerns about higher energy costs have challenged businesses to struggle in managing or moderating pass-through of increased charges to customers for services and products.

Since the Federal Reserve is expected to raise interest rates moderately over the next two months and then hold off future increases, inflation expectations appear reasonably contained. The Fed last raised its main lending rate to 4.25% on December 13<sup>th</sup> and this was the 13<sup>th</sup> consecutive increase since June 2004, the highest level in 4 ½ years. This monetary policy is a measured and balanced approach to managing inflation while stimulating reasonable economic growth.

Inflation at the wholesale level fell in November by the largest amount in 2 ½ years, largely reflecting significant declines in gasoline prices. This pattern is not expected to continue due to likely higher global and domestic seasonal demand, the absence of stronger conservation measures, very limited domestic refining capacity, and related market factors.

Manufacturing grew at a slower pace in December. The Institute for Supply Management reported that its index value for December fell to 54.2 from the 58.1 reading in November. Any index value reading above 50 indicates an expansion in the manufacturing sector, while values below 50 indicate contraction. Only manufacturing related to booming new construction activity and new factory orders for commercial aircraft showed significant gains. Some economists are predicting a slowdown in manufacturing growth in the next few months as companies try to catch up on an order backlog caused by or in response to the Gulf Coast hurricanes.

Construction spending hit an all-time high in November as government spending to build schools, roads and sewer systems offset the slight dip in home building. Home building may have slowed due to rising mortgage interest rates. The number of new mortgage applications in late December 2005 fell to the lowest level since May 2002, providing further evidence that the housing boom has subsided and that a “soft-landing” is likely with a weaker housing market. An air of caution has entered the housing industry, and this may have a sobering impact on consumers who have used their inflated housing values to incur higher debt by tapping home equity lines of credit in order to support increased spending.

The U. S. international trade deficit for November 2005 (latest data available) narrowed more than expected to \$64.2 billion, about 5.8% lower than the \$68.1 billion adjusted

gap recorded in October. Lower oil prices and increased U. S. export shipments of aircraft, cars and other capital goods accounted for the improvement. However, to put this in proper perspective, the November trade deficit was still the third highest on record. The gap for the first 11 months of 2005 totaled \$661.8 billion, exceeding the record of \$617.6 billion set in 2004.

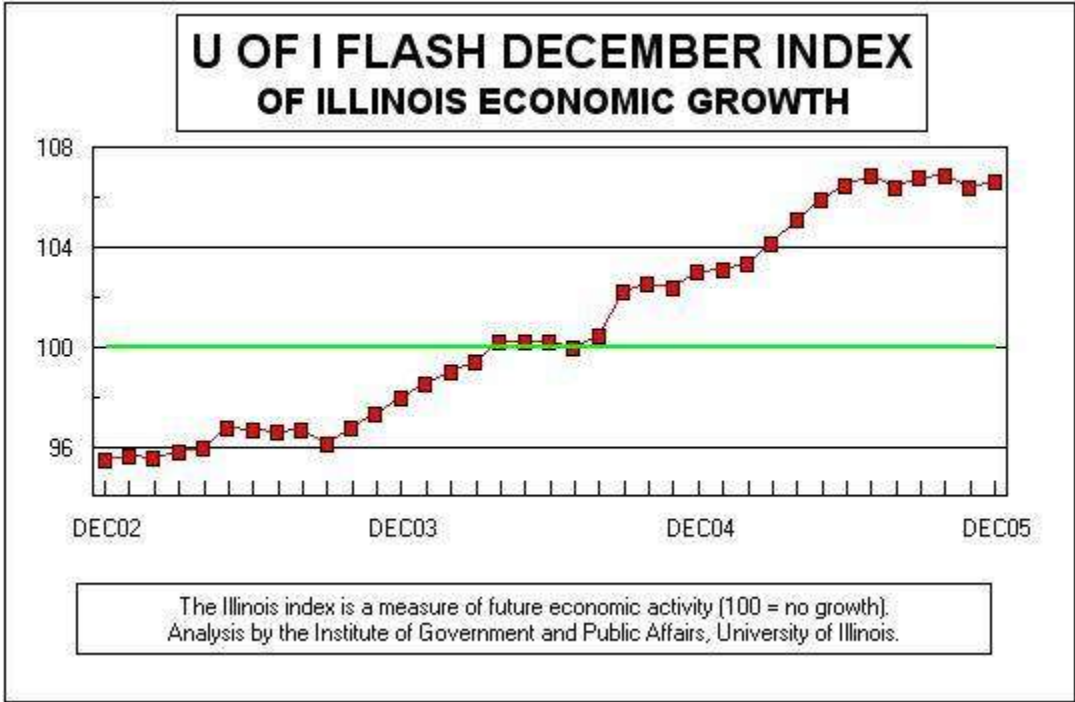
**Illinois Economy**

The University of Illinois Flash Economic Index increased slightly in December to 106.6 from its 106.4 level in November. The Index has remained in a relatively tight range with a slight upward slope (from 106.4 to 106.9) since last June. The chart trend indicates that the state economy is still growing at a moderately strong and steady rate, according to J. Fred Giertz, the University of Illinois economist who published the Flash Index chart and compiled the index data.

Despite a number of challenges in 2005, including relatively high oil prices and the continued loss of manufacturing jobs, the Illinois economy performed well, operating consistently higher than the 100 mark, the dividing line between economic growth and contraction, during the entire year.

For December 2005, corporate tax receipts were up significantly in “real” (inflation-adjusted) terms compared with December 2004. Individual income-tax receipts were virtually unchanged, while sales-tax receipts were down slightly.

The Flash Index is a weighted average of state growth rates in consumer spending, corporate earnings and personal income. Tax receipts from corporate income, retail sales and personal income are adjusted for inflation before growth rates are calculated. The growth rate for each component is then calculated for the 12-month period using data through December 31, 2005.



Illinois has generally recovered from the loss of 262,000 jobs during the economic slowdown from 2001-2004. Unemployment levels were down from a year ago in all 12 of the largest regional job markets tracked by the state. More than 5.8 million citizens in Illinois were employed in the state during 2005. Statewide unemployment of 5.3 per cent in November 2005 was the lowest since June 2001. New job creation and growth trends for the period have also been favorable, reflecting the steady turnaround in the state's economy.

### **State Revenues and Expenditures**

According to the Illinois Commission on Government Forecasting and Accountability (See December 2005 Monthly briefing report: [http://www.igla.gov/commission/cgfa/cgfa\\_home.html](http://www.igla.gov/commission/cgfa/cgfa_home.html)), total receipts from all sources for December fell by \$49 million, primarily due to a decline in federal sources and a slowdown in a variety of transfers to the state's general funds. While overall receipts were down, several revenue sources posted significant gains during the month of December compared to the same time last year:

- Gross corporate income taxes up \$57 million
- Gross personal income tax increased \$28 million
- Sales taxes were up by \$5 million
- Liquor taxes rose \$4 million
- Inheritance taxes were up by \$2 million
- All other sources were up by \$19 million

These monthly revenue gains were offset to a greater extent by lower transfers from the Lottery and Riverboat Casino gaming taxes, and federal sources (-\$57 million).

According to the State Comptroller ( Quarterly Report, Edition 18, January 2006, please see: <http://www.ioc.state.il.us/ioc-pdf/COJan2006.pdf>), for the six month period through December 2005, total state base revenues including transfers into the general funds increased by \$528 million (from \$12.391 billion to \$12.919 billion), or nearly 4.3% over the same period a year ago. In particular, corporate income tax receipts have increased significantly by over 32.5% or nearly \$326 million from a year ago at the same time. Sales tax receipts for the first 6 months are also up by \$154 million or more than 6% from a year ago. The state issued \$1 billion in short-term borrowing certificates for deposit in the general funds in November. As a result, total revenues were up by \$1.528 billion. This short-term borrowing, used to address the backlog of Medicaid payments due to providers, must be repaid by the end of the state's current fiscal year. Federal sources increased \$723 million or 34.3%, primarily due to the growth in Medicaid spending that was supported by the short-term borrowing.

Through December 2005, base expenditures in the state's general funds increased \$1.608 billion or 12.8%, again largely driven by Medicaid spending over the first half of FY 2006. General fund appropriations are up \$571 million or 2.4% over last year and spending in the first half of FY 2006 is running ahead of the same period previously (52.3% of appropriations spent in FY 2006 vs. 46.7% spent during the same period last year).

### **State Budget Outlook**

Based on these trends, it is appropriate to ask: what lies ahead? According to State Comptroller Hynes, it is likely that the backlog of Medicaid payments will begin to build and the state will have to resort to another round of short-term borrowing in FY 2007, and cash flow difficulties are likely to persist through the remainder of FY 2006, especially as the state reserves sufficient resources to repay the current short-term debt. The current shortened legislative cycle during an election year, and previous agreement on reducing state pension system payments takes some of the pressure off the state budget, but provides

only a temporary opportunity to defer consideration of more serious measures needed to address the state's fiscal problems, which present longer-term challenges and very difficult choices ahead.

While the national and state economies continue to expand at fairly robust rates, and revenues from traditional state tax sources are reasonably strong, the revenue growth still appears insufficient to meet core state expenditure requirements, especially considering significant pension obligations and general obligation bond debt service—and driven by increases in Medicaid and related health care costs.

This situation has been acknowledged by many economists as a structural problem requiring control on both the revenue and expenditure sides of the state budget. The revenue problems are compounded by non-progressive, flat rate tax structures, narrowed tax bases and exemptions (e.g. no sales taxes on services), tax base erosion (e.g., Internet mail order and e-commerce shopping), and inelasticity of tax yields in response to changing economic conditions.

Illinois, like many other states, has had to weather a significant downturn in the economy between 2001-2004, but no fundamental changes to the state's overall tax structure during this period were enacted. On managing the revenue side of the state budget during this period, the State has had to resort to increasing fees, conducting fund sweeps and transfers, implementing a temporary tax amnesty program, maximizing claims for federal reimbursement funding, issuing pension bonds and incurring short-term debt to pay a backlog of Medicaid bills, and making other changes to other non-income and sales tax sources.

On the expenditure side, state government has gone through significant downsizing and deep cuts in state agency spending along with reductions in public higher education spending. Control of Medicaid and health-related costs, pension and insurance/benefit costs will present a significant challenge to the state in addition to managing the increased debt service and pension under-funding problems. There will be significant and growing required state contributions to each of the state pension systems between 2007-2045, according to the Illinois Commission on Governmental Accountability and Forecasting (December 2005 Monthly Briefing, Table 1: State Funded Retirement Systems-Projected Contributions, Dan Hankewicz-Pension Analyst, p. 10). Between FY 2006 and 2045, total projected contributions to all state retirement systems will increase from \$935.6 million to over \$3.6 billion in FY 2010, and increase further to over \$8.0 billion in FY 2030, and finally reach a peak of over \$15.6 billion to attain the 90% statutory target funding ratio by FY 2045.

### **Conclusion and Recommendations**

Based on these state budget considerations and likely future constraints, it would seem prudent for CARLI to continue the program of preparing and monitoring closely a five year rolling budget plan, carefully controlling expenditures, maintaining adequate funding reserves to meet state budget contingencies, evaluating the feasibility of imposing additional fees for membership and service or cost recovery charges based on optional participation in specific programs and services, and pursuing other external grants, gifts and foundation funding opportunities to diversify the organizational funding base.