# The U.S., Illinois and Chicago Outlook for 2017

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#### Themes for 2017 Outlook

- Absent unforeseen changes, the Congressional Budget Office has the US economy growing at 2% for as far as the eye can see. According to this scenario, trend growth has downshifted.
- Why is faster growth hard to come by?
  - Demographics, we are getting older, prime-work age population is declining as a share of population
  - Productivity is in a rut. The last productivity spurt largely reflected the take up of IT in the economy. Incremental gains from IT have been smaller. Need a next big thing to push productivity back up?
  - Boost from higher educational attainment has peaked.
  - All of these are structural factors and can mute the impact of cyclical policies.
- Counter-vailing force--The return of fiscal policy?
- Still sluggish world economic outlook

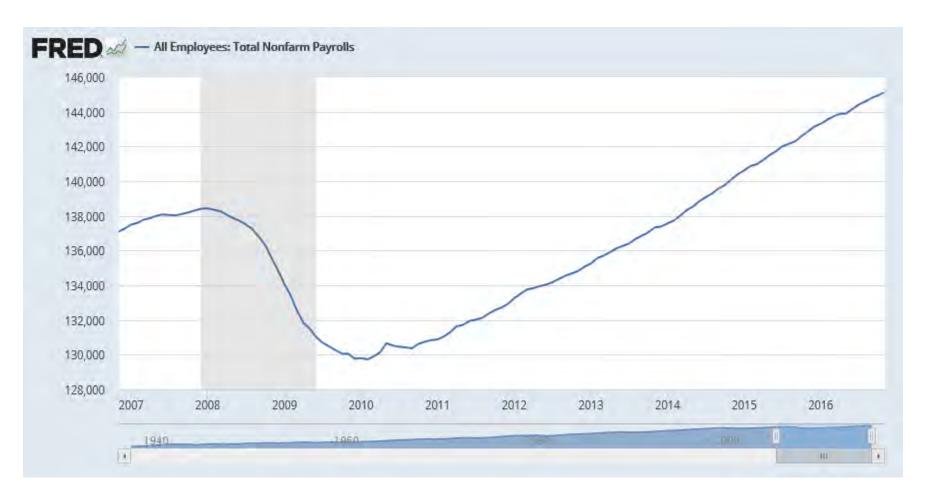
### What Won't Change From 2016

- Employment gains should hold and unemployment rate will stay low.
- Rest of the world economy won't grow particularly quickly.
- Consumer will still be the key. Right now they say they are very confident.
- U.S. Household wealth will continue to break records.
- Raising interest rates will still face some headwind from loose monetary policy in the rest of the world.

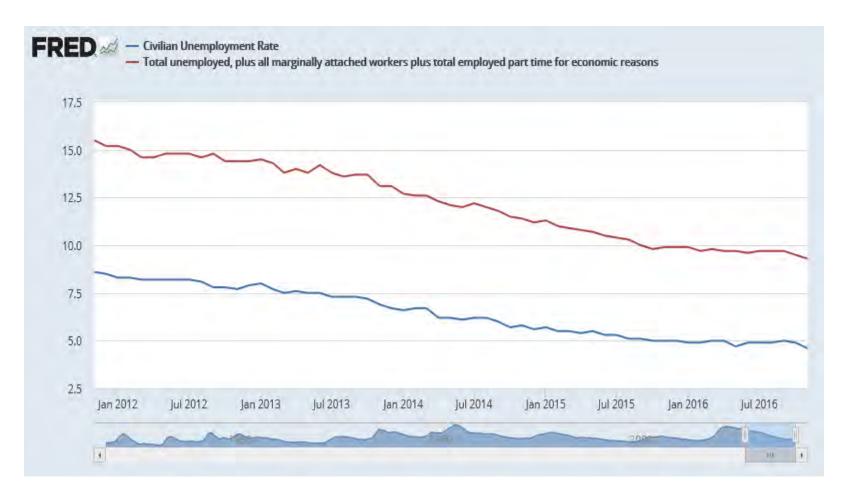
# Thinking about the impact of fiscal policy

- Many forms—tax cuts, infrastructure, defense spending
- Issues to consider
  - Deficit impact
  - Who benefits? Marginal propensity to consume
  - Impact on monetary policy—do interest rates rise? Impact on interest rate sensitive purchases like homes and cars
  - Timing? Actions require legislative action, also timing relative to the condition of the economy (tight employment/rising interest rates?)
  - Unintended consequences—example state and muni-debt,
    - Lower marginal tax rates will lower the incentive for high income earners to buy muni-debt
    - Caps or outright elimination of tax-free state and local debt issuance could raise state and local borrowing costs

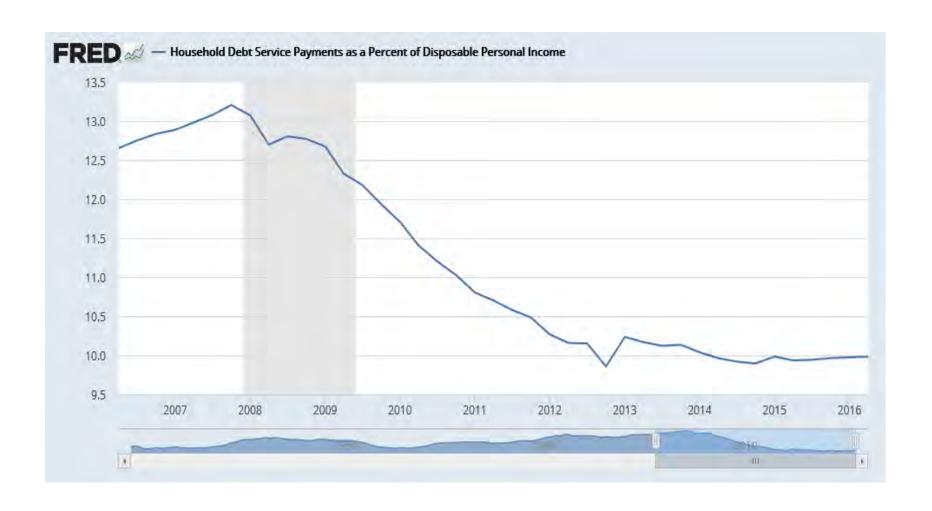
# Employment Continues to Improve While Unemployment falls to 4.7%



# Still, the U-6, While Improving is Higher Than We Would Like, (9.6)



### Households have deleveraged



## Key to Consumer Spending--Atlanta Fed Wage Tracker Shows Wage Gains of 3.9%



#### The Current Forecast

- Last FOMC (December, 2016) central tendency projection for GDP growth in 2016 is 1.8 to 1.9%. Long-run 1.8% to 2.0%. Faster growth in 2017 at 1.9 to 2.3%
- inflation is running well below target. CPI and core have seen either declines or minimal growth. FOMC forecast has PCE at 1.5% in 2016. Long-run estimate is at 2%, with 2017 projected at 1.7% to 2.0%.
- FOMC forecast has unemployment 4.7% to 4.8% (2016), 4.5 to 4.6 % (2017). Long-run—4.7% to 5.0%
- Fed policy. December, 2016 was the second quarter point increase since 2008. Big issue will be the pace of potential future increases to get to "normalization" (now 2.9%). Latest meeting suggests possibility of 3 hikes in 2017.

#### Illinois outlook

- State has both underperformed US and region during the last recession and during the recovery.
- Unemployment rate has been higher than US and growth slower.
- Big question is the impact of poor fiscal conditions on future growth
- Employment recovery (or lack of) tells the story....

#### Illinois Job Recovery vs the US

(November 2016)

Illinois U.S.

|                                | Losses<br>during<br>recession<br>(in 000s) | Performance during the recovery (in 000s) | Recovery<br>rate | Losses<br>during<br>recession<br>(in 000s) | Performance during the recovery (in 000s) | Recovery<br>rate |
|--------------------------------|--|---|------------------|--|---|------------------|
| All industries                 | -344.0                                     | 401.9                                     | 116.8%           | -7,393                                     | 14,437                                    | 195.3%           |
| Construction                   | -52.4                                      | -2.9                                      | -5.5             | -1,534                                     | 776                                       | 50.6             |
| Education, Health              | 27.8                                       | 99.4                                      | n/a              | 689  | 3,267                                     | n/a              |
| FIRE                           | -25.5                                      | -3.2                                      | -12.5            | -461                                       | 528                                       | 114.5            |
| Government                     | 7.7  | -22.2                                     | n/a              | 200  | -276                                      | n/a              |
| Information                    | -9.9                                       | -9.3                                      | -93.9            | -228                                       | -12                                       | -5.3             |
| Leisure                        | -17.5                                      | 86.1                                      | 492.0            | -474                                       | 2,522                                     | 532.1            |
| Manufacturing                  | -100.1                                     | 4.2                                       | 4.2              | -2,020                                     | 592                                       | 29.3             |
| Other services                 | -2.7                                       | -1.2                                      | -44.4            | -144                                       | 354                                       | 245.8            |
| Prof. and Business<br>Svs.     | -91.7                                      | 183.0                                     | 199.6            | -1,615                                     | 4,079                                     | 252.6            |
| Trade, Transport and Utilities | -79.7                                      | 68.0                                      | 85.3             | -1,806                                     | 2,607                                     | 144.4            |
|                                |  |   |                  |  |   |                  |

#### Dimensions of the Fiscal Problem

- State has not had a full year budget for 2 years
- Credit rating is worst in the nation leading to higher borrowing costs (160+ bp above triple A)
- Debt is more than just underfunded pensions. It also is a structural budget deficit (since 2001) where expenditures are exceeding revenues
- IGPA Fiscal Futures Project shows the complexity of the solutions

### How does Illinois stack up?

#### State Government Tax Revenue (2015)

|           | Amount Per<br>Capita | Per Capita<br>Rank | Amount as a % of Personal Income | Personal<br>Income Rank |
|-----------|----------------------|--------------------|----------------------------------|-------------------------|
| Wisconsin | \$2,949              | 18                 | 6.5%                             | 19                      |
| Illinois  | \$3,055              | 15                 | 6.2%                             | 24                      |
| Indiana   | \$2,628              | 28                 | 6.4%                             | 20                      |
| Iowa      | \$2,942              | 19                 | 6.5%                             | 17                      |
| Michigan  | \$2,717              | 24                 | 6.4%                             | 22                      |
| U.S.      | \$2,851              |                    | 6.0%                             |                         |

Source: U.S. Census Bureau, 2015 Annual Survey of State Government Tax Collections

# Total State and Local Government (2013)

|           | Per Capita<br>Local Revenue | Per Capita<br>Rank | Total State/Local Expenditures | State/Local<br>Expenditures<br>Rank |
|-----------|-----------------------------|--------------------|--------------------------------|-------------------------------------|
| Wisconsin | \$4,833                     | 20                 | \$9,703                        | 25                                  |
| Illinois  | \$5,666                     | 7                  | \$10,408                       | 15                                  |
| Indiana   | \$4,266                     | 35                 | \$8,088                        | 45                                  |
| lowa      | \$5,106                     | 13                 | \$10,260                       | 19                                  |
| Michigan  | \$4,741                     | 24                 | \$9,020                        | 30                                  |
| U.S.      | \$1,709                     |                    | \$10,137                       |                                     |

Source: U.S. Census Bureau, 2013 Annual Survey of State and Local Government Finances

## Illinois Spending Patterns, State and Local, 2013

|           | K-12 Spending per capita/ (rank) | Higher Education Spending per capita/ (rank) | Police Spending per capita/ (rank) | Highways Spending per capita/ (rank) | Debt<br>Outstanding |
|-----------|----------------------------------|--|------------------------------------|--------------------------------------|---------------------|
| Illinois  | \$1,942 (15)                     | \$718 (38)                                   | \$390 (7)                          | \$569 (20)                           | \$11,542 (6)        |
| Indiana   | \$1,462 (42)                     | \$896 (22)                                   | \$181 (49)                         | \$388 (45)                           | \$7,520 (30)        |
| Iowa      | \$1,929 (16)                     | \$1,150 (7)                                  | \$222 (43)                         | \$704 (8)                            | \$5,985 (40)        |
| Michigan  | \$1,665 (29)                     | \$1,059 (10)                                 | \$259 (31)                         | \$339 (48)                           | \$7,712 (28)        |
| Wisconsin | \$1,783 (20)                     | \$1,017 (14)                                 | \$323 (16)                         | \$667 (13)                           | \$7,738 (27)        |
| U.S.      | \$1,802                          | \$826  | \$321                              | \$502                                | \$9,347             |

Source: U.S. Census Bureau, 2013 Annual Surveys of State and Local Government Finances

### Thoughts on Illinois ranking

 Good news—Illinois is generally middle of the pack on most of these ranking (particularly as a share of personal income). Biggest distortion is actually at the local tax level do to high reliance on property tax, and relatively low state contribution for K-12 education.

| Overall rank | Corporate<br>Tax | Individual<br>Income | Sales | UI Tax | Property |
|--------------|------------------|----------------------|-------|--------|----------|
| 23           | 26               | 10                   | 35    | 38     | 46       |

- Bad news—the revenue raised through this tax structure doesn't pay the bills.
  - Tax Foundation, State Business Tax Climate Index, FY2017 gave Illinois an overall rank of 23, however when the temporary personal and income tax rate hikes were in effect in FY13-15, Illinois ranked 30 to 31
- The longer-term problem—solving the pension problem....

## How do Midwest states stack up? (actuarial reported, 2014)

|           | Pension debt (S&L combined, thousands) | Funded ratio | Debt/households |
|-----------|--|--------------|-----------------|
| Illinois  | \$140,261,234                          | 44.5%        | \$29,390        |
| Indiana   | \$13,589,278                           | 72.1%        | \$5,430         |
| Iowa      | \$4,124,909                            | 87.4%        | \$3,323         |
| Michigan  | \$36,342,281                           | 66.8%        | \$9,478         |
| Wisconsin | \$795,885                              | 99.2%        | \$345           |

### Pensions are the most visible problem, but even this may be understated...actuarial reported versus market

| Illinois 2014   | All State and Local Systems | All State Systems | Local Systems |
|---|-----------------------------|-------------------|---------------|
| Pension debt (thousands)                              | \$140,261,234               | \$99,978,217      | \$40,283,017  |
| Funded ratio  | 44.5%                       | 44.5%             | 44.5%         |
| Assumed rate of return                                | 7.89%                       | 7.89%             | 7.89%         |
| Debt per<br>household                                 | \$29,390                    | \$20,949          | \$8,441       |
| Debt as a share of total (S +L) general fund revenues | 3.81%                       | 2.72%             | 1.10%         |
|   |                             |                   |               |
|   |                             |                   |               |

## But if you change a few assumptions, things look much worse

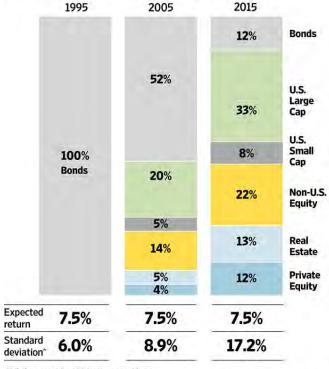
| Illinois 2014<br>Market                               | All State and Local Systems | All State Systems | Local Systems |
|---|-----------------------------|-------------------|---------------|
| Pension debt<br>market<br>(thousands)                 | \$371,398,779               | \$264,733,075     | \$106,665,704 |
| Funded ratio  | 23.3%                       | 23.3%             | 23.3%         |
| Assumed rate of return                                | 3.0%                        | 3.0%              | 3.0%          |
| Debt per<br>household                                 | \$77,822                    | \$55,471          | \$22,350      |
| Debt as a share of total (S +L) general fund revenues | 10.10%                      | 9.33%             | 3.76%         |

## Changing risk profile to get a 7.5% return

#### **Rolling the Dice**

Investors grappling with lower interest rates have to take bigger risks if they want to equal returns of two decades ago.

#### Estimates of what investors needed to earn 7.5%



<sup>\*</sup>Likely amount by which returns could vary Source: Callan Associates

## University of Illinois Fiscal Futures Project Analysis

- "If you find yourself in a hole, stop digging" (Will Rogers)
- All funds budget
- Structural deficit emerged in FY2001
- Estimates that FY17 deficit is \$13 billion
- Projected gap of \$14 billion per year for next five years
- Legacy liabilities (mostly pensions) are \$174 billion
- Unpaid bills of roughly \$10 billion

### Can the gap be solved in 10 years?

#### IGPA options

- Spending cut of 2% for all discretionary spending (32% reduction in gap)
- Income tax rate hike (4.75% for personal, 6.65% for corporate), (40% reduction in gap)
- Expand income tax base by 10%, (12% reduction)
- Increase sales tax base by 15% (tax more services), \$2
   billion revenue gain)
- Supply-side—get ½ of 1% faster personal income growth, (only produces \$100 million in tax income)

### What if you do everything?

- Most of the budget gap would be gone in 10 years (2027). Gap would decline to \$9.4 billion in FY17 to \$2 billion by FY21 and near 0 by 2027.
- Caveats—
  - Doesn't address current bill backlog
  - Need to fund the annual deficits by either decreasing assets or increasing liabilities
  - Assumes pension contributions are based on current actuarial projections to have pensions funded to 90% by 2045.
- What is needed is a "Grand Plan".

### Turning to Chicago

- Economic growth has recently picked up as business and professional services have roared back.
- Real estate has been a positive but that may be slowing into 2017
- Big issue is the fiscal headwind...underfunding of pensions is as bad as it is at the state level.

### Chicago's Recent GDP growth



Source: Thomson Reuters Datastream

## Views about Chicago Real Estate from the annual ULI/PWC survey

- 26<sup>th</sup> ranked market in the US—ranked as improving for investment, development and homebuilding
- Driving the improvement is the urban core—HQs moving downtown attract smart, affluent workers which in turn drives multi-family.
- Also, "the urban core remains attractive to tech company growth, which is driving demand for downtown office space."
- "...the Chicago market offers a level of stability that a number of investors see as a benefit at this point in the national economic cycle. Chicago is still a core market with one of the top regional infrastructure systems in the United States".
- Chicago real estate outlook for 2017, apartments are still top, followed by industrial, for-sale housing, retail, office and hotels.

#### Downside risks?

- Recovery is getting a little long in the tooth...while they don't die of old age...
- Higher financing costs.
- Some types of real estate has been heavily built over the last few years with more in the pipeline...Hotels and Office?
- Unfavorable trends for brick and mortar retail?

### The future for Chicago Real Estate

- Strengths—only world class city in the Midwest means it can attract different kinds of investment.
   Better able to attract physical and human capital.
   Plus given its stature, Chicago is cheap.
- Over the longer cycle, Chicago is still a good market but it needs to generate more internal growth. Growth that is generated by expansion and not just moving the same companies to different buildings. CBD and near adjacent areas are the hottest markets.

### But, Fiscal Risk Loom

- Arguably in worse shape (fewer options to solve problem).
   Pensions are woefully underfunded and the city has already used questionable practices such as issuing taxable debt to cover judgments and operating costs and refunding debt through "scoop and toss".
- The partial solution is the \$543 million property tax increase which will be phased in over 4 years. Even after factoring in the increase, S & P called Chicago's fiscal problem "substantial".
- Further problem is Chicago Public Schools. Solving their pension problem will likely require another property tax hike.
- Does a problem like this exist in other large cities?

## Dimensions of the Problem—Pension Unfunded Actuarial Accrued Liability Per Capita

(Morningstar Municipal Credit Research, January, 2014)

| City         | Direct Liability | Total Liability (includes overlapping governments) |
|--------------|------------------|--|
| Washington   | -\$409           | -\$409   |
| Indianapolis | \$1,011          | \$3,426  |
| Detroit      | \$911            | \$3,758  |
| Los Angeles  | \$1,895          | \$6,426  |
| New York     | \$8,726          | \$9,842  |
| Chicago      | \$7,149          | \$18,596   |

## More Dimensions of the Problem—Unfunded Liabilities—City and Overlapping Governments

(Civic Federation, January 30, 2014, includes OPEB if paid by pension fund)

| Fund                              | Unfunded Liability Per<br>Capita | Funded Ratio |
|-----------------------------------|----------------------------------|--------------|
| Chicago Fire                      | \$1,132                          | 24.4%        |
| Chicago Police                    | \$2,606                          | 30.8%        |
| Chicago Municipal                 | \$3,155                          | 37.2%        |
| Chicago Laborers                  | \$390                            | 55.4%        |
| Subtotal (4 city funds)           | \$7,281                          |              |
| MWRD                              | \$203                            | 50.4%        |
| Cook County                       | \$1,299                          | 53.5%        |
| Forest Preserve                   | \$25                             | 56.7%        |
| СТА                               | \$330                            | 59.4%        |
| Chicago Teachers                  | \$2,939                          | 54.1%        |
| Chicago Park District             | \$157                            | 50.9%        |
| Subtotal (4 city + 6 local funds) | \$12,233                         |              |

#### Conclusions???

- A year of uncertainty
  - A slow but long-term recovery keeps plodding along
  - Can a focus on fiscal policy unlock faster growth?
  - For Illinois and Chicago, the continued uncertainty surrounding fiscal matters will act as a drag on potential.