U.S. and Illinois Economic Outlook for 2019—implications for local government

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The views expressed in this presentation are my own and do not necessarily reflect those of the Federal Reserve Bank of Chicago or of the Federal Reserve System.
Outline

• Review of 2018
• What to watch for in 2019
• Special issues—stock market, yield curve, productivity
• Issues facing Illinois and metro Chicago
2018

- Economy showed **real strength in 2018**. Growth for the year was around 3%, well above the recent trend.
- Growth was supported by the **tax package (TCJA)**, tight labor markets, consumer confidence and corporate profits.
- This led to a **demand driven expansion**.
2019

• Current outlook is for above trend growth but slower than 2018.
Why is growth projected to slow?

- The uniformed growth in the global economy is starting to fade—UK/Eurozone Brexit issues, China growth is fading
- The structural factors slowing US domestic growth have not changed—poor demographics, slow productivity growth
- The TCJA was front loaded—impact fades out and it appears there was little in the way of a “fiscal multiplier”
- Tighter Fed policy, higher cost of borrowing
The Tax Cuts and Jobs Act

• The Good News
  – Stronger economic growth boosted demand—consumers were a key part of the growth story in 2018.
  – Business tax structure is more competitive and in line with foreign rates and standards.
  – Initially the stock market responded to corporate profitability.
  – Manufacturing had a strong year.
The Tax Package

• The Less Good News
  – So far, the tax change doesn’t seem like it permanently shifted the US to faster growth path.
  – Increased the deficit. Combined with higher spending--approaching $1 trillion per year.
  – Corporate response—original surge in capital investment went from being up 11.5% in Q1 to 2.5% in Q3, big surge in stock buybacks (announcements up 64%, $1 trillion in volume). JP Morgan projects $800 million in 2019.
  – Q2 and Q3 strong GDP was influenced by some one-time factors. Q2 saw massive purchase of soybeans ahead of tariff and Q3 saw companies buying forward for steel and aluminum in anticipation of China trade problems. Q3 also driven by large gain in government spending

• Uncertain
  • First year of tax filing—SALT, charitable deductions, withholding. In high tax states, cost of government will rise. In 19 states taxpayers who itemize are above the $10,000 threshold. Not just the obvious—California, NY, Illinois, Connecticut and NJ but also Nebraska, Wisconsin and Ohio

• Assessment so far—spurred a “demand-driven” expansion. Supply response has been muted. Suggests once the demand response fades, economy falls back to slower trend growth. Evidence...
The GDP surge in Q2 and Q3 (4.2% and 3.4%)
Employment Continues to Tighten, including U-6
Unemployment rate at 3.9% and labor force participation at 63.1%—5 year high
Median wage growth surges—above 4% for prime-age workers
IMF World Economic Growth Projections—
World output was trimmed by 0.2 for both 2018 and 2019

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<tbody>
<tr>
<td>World Output</td>
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<td>3.7</td>
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<td>Advanced Economies</td>
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<tr>
<td>-- U.S.</td>
<td>2.2</td>
<td>2.9</td>
<td>2.5</td>
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<tr>
<td>-- EU</td>
<td>2.7</td>
<td>2.2</td>
<td>2.0</td>
</tr>
<tr>
<td>-- UK</td>
<td>1.7</td>
<td>1.4</td>
<td>1.5</td>
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<tr>
<td>Emerging Economies</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>-- Russia</td>
<td>1.5</td>
<td>1.7</td>
<td>1.8</td>
</tr>
<tr>
<td>-- China</td>
<td>6.9</td>
<td>6.6</td>
<td>6.2</td>
</tr>
<tr>
<td>-- India</td>
<td>6.7</td>
<td>7.3</td>
<td>7.4</td>
</tr>
<tr>
<td>-- Latin America</td>
<td>1.3</td>
<td>1.2</td>
<td>2.2</td>
</tr>
<tr>
<td>-- Middle East</td>
<td>2.2</td>
<td>2.4</td>
<td>2.7</td>
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</tbody>
</table>
The Current Forecast

• Last FOMC (December, 2018) central tendency projection for GDP growth in 2018 is 3.0% to 3.1%. Long-run 1.8% to 2.0%. Growth in 2019 at 2.3% to 2.5%. Median for 2018 is 3.0%, 2019, 2.3%.

• Inflation close to the 2% target for PCE. FOMC forecast has PCE at 1.8% to 1.9% in 2018. Long-run estimate is at 2%, with 2019 projected at 1.8% to 2.0%. Median is 1.9% for 2018, 1.9% for 2019.

• FOMC forecast has unemployment at 3.7% (2018), 3.5% to 3.7% (2019). Long-run—4.2% to 4.5% Median for 2018 is 3.7, for 2019 is 3.5.

• Fed policy. December, 2018 was the ninth quarter point increase since 2008 (2.25% to 2.50% Fed Funds rate). Big issue will be the pace of potential future increases to get to “normalization” (now 2.8% to 3.0%). Expectation is for 2 more possible rate hikes in 2019 that will be “data dependent”. Other significant news was continuing to reduce the Fed balance sheet.

• Fed Funds Rate Projection—Median for 2018, 2.4%, 2019, 2.9% and 2020, 3.1%. Long-run is 2.8%
The “Dot-plot” pace of future increases appears to slow
Special Issues

• The Stock Market
• The Yield Curve
• Productivity
Stock market looked pretty good until October
Stock Market Welcomed Back Volatility in 2018
The “Yield Curve”—source of concern?
Is the yield-curve slope a good predictor of recessions?

- The yield curve slope has inverted before every economic recession since 1970.
- Question is why has this relationship held? Is something different this time?
- Yield curve appears to contain information about future monetary policy actions (the Fed Funds rate) however, it is influenced by more than monetary policy actions.
- In particular, it reflects attitudes toward various risks, particularly inflation—a decrease in the inflation risk-premium slope has been accompanied by a heightened risk of recession.
US (TFP) Productivity—not the trend you want

The long slowdown in productivity growth

Trend growth in US total factor productivity (% pa)

Source: N Crafts, T Mills (CEPR, July 2017)
Possible reasons for poor productivity—too many workers with low skills?

Both the UK’s older and younger generation have similar basic skill levels

Percentage of adults with low skills (literacy and/or numeracy below level 2) in different age groups

Source: OECD
© FT
Are we underspending on training?

Total public spending on worker training
Per cent of GDP (2015)

Source: OECD
© FT
Or maybe economists just don’t know how to measure productivity.

Mis-measurement gives to the tech sector

Growth in US total factor productivity in the high-tech sector (% pa)

- Official data
- Alternative prices

Source: D Byrne, D Sichel (CEPR, Aug 2017)
Turning to Illinois and Chicago

• The song remains the same. Performance still lags the US and Midwest region with Chicago as the potential bright spot.

• The overarching problem still appears to be fiscal issues—structural budget deficit since 2001 and $130 billion underfunded pension system without a clear plan to solve either.
  – The Fitch rating agency issued an assessment of Illinois in the wake of JB Pritzker’s election. The report justifies a BBB credit rating (with a negative outlook) by saying, “Illinois made various poor fiscal decisions including the issuance of pension obligation bonds primarily for budgetary relief, underfunding pension obligations and increasing reliance on building up accounts payables as a budgetary tool”. Analysts will be monitoring the new governors proposed budget for evidence of reversing these practices.

• However, Fitch discounted the impact of population out-migration on the state’s economy. They found that while the rate has accelerated recently, out-migration has been occurring for nearly a century and that current levels are similar to what the state experienced in the 1970s and 1980s. They suggest that this has not seemed to reduce economic growth in the state.

• How do recent fiscal studies rank Illinois? Hint—not good
Fiscal Studies Reflect Illinois Poor Condition—Mercatus Center Fiscal Conditions Ranking

<table>
<thead>
<tr>
<th>State</th>
<th>Fiscal condition (rank/index)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>50 (-1.97)</td>
</tr>
<tr>
<td>Indiana</td>
<td>21 (0.17)</td>
</tr>
<tr>
<td>Iowa</td>
<td>28 (-0.30)</td>
</tr>
<tr>
<td>Michigan</td>
<td>34 (-0.58)</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>31 (-0.47)</td>
</tr>
<tr>
<td>Best—South Dakota</td>
<td>1 (3.04)</td>
</tr>
<tr>
<td>Worst—Illinois</td>
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Mercatus Center/George Mason University, “Ranking the States by Fiscal Condition” (2018)
# Mercatus Center/George Mason University--subcomponents

<table>
<thead>
<tr>
<th></th>
<th>Cash Solvency(1)</th>
<th>Budget Solvency(2)</th>
<th>Long-run Solvency(3)</th>
<th>Service-level Solvency(4)</th>
<th>Trust Fund Solvency(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Alaska</strong></td>
<td>11.12</td>
<td>2.30</td>
<td>10.98</td>
<td>4.36</td>
<td>5.62</td>
</tr>
<tr>
<td><strong>Illinois</strong></td>
<td>49 (-3.17)</td>
<td>46 (-1.36)</td>
<td>49 (-5.14)</td>
<td>14 (1.31)</td>
<td>46 (-1.49)</td>
</tr>
<tr>
<td><strong>Indiana</strong></td>
<td>27 (-1.08)</td>
<td>36 (-0.06)</td>
<td>31 (-0.44)</td>
<td>18 (0.71)</td>
<td>5 (1.75)</td>
</tr>
<tr>
<td><strong>Iowa</strong></td>
<td>26 (-1.02)</td>
<td>23 (0.47)</td>
<td>12 (0.74)</td>
<td>41 (-1.58)</td>
<td>25 (-0.23)</td>
</tr>
<tr>
<td><strong>Michigan</strong></td>
<td>35 (-1.72)</td>
<td>25 (0.46)</td>
<td>26 (-0.23)</td>
<td>31 (-0.68)</td>
<td>30 (-0.50)</td>
</tr>
<tr>
<td><strong>Wisconsin</strong></td>
<td>39 (-2.12)</td>
<td>18 (0.68)</td>
<td>24 (-0.18)</td>
<td>32 (-0.69)</td>
<td>6 (1.18)</td>
</tr>
<tr>
<td><strong>Connecticut</strong></td>
<td>-3.26</td>
<td>Alaska (-12.25)</td>
<td>New Jersey (-5.35)</td>
<td>New Mexico (-4.43)</td>
<td>Alaska (-1.93)</td>
</tr>
<tr>
<td><strong>US average</strong></td>
<td>2.22</td>
<td>1.01</td>
<td>-0.17</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: Eileen Norcross and Olivia Gonzalez, “Ranking the States by Fiscal Condition” (2018). Mercatus Center, George Mason University

• The following table shows the rankings for the five seventh district states for each sub-category as well as the best and worst performing state in the category
• Cash solvency = cash ratio + quick ratio + current ratio
• Budget solvency = operating ratio + surplus (or deficit) per capita
• Long-run solvency = net asset ratio + long-term liability ratio + long-term liability per capita ratio
• Service-level solvency = tax to income ratio + revenue to income ratio + expense to income ratio
• Trust fund solvency = pension to income ratio + OPEB to income ratio
Volcker Alliance Study Suggests Our Budgeting Practices Aren’t Much Better

Seventh District State Budget Report Card for 2018 (Volcker Alliance)

<table>
<thead>
<tr>
<th>State</th>
<th>Budget Forecasting</th>
<th>Budget Maneuvers</th>
<th>Legacy Costs</th>
<th>Reserve Funds</th>
<th>Transparency</th>
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</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>B</td>
<td>D-</td>
<td>D-</td>
<td>D</td>
<td>B</td>
</tr>
<tr>
<td>Indiana</td>
<td>C</td>
<td>A</td>
<td>B</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>Iowa</td>
<td>C</td>
<td>A</td>
<td>A</td>
<td>B</td>
<td>C</td>
</tr>
<tr>
<td>Michigan</td>
<td>B</td>
<td>A</td>
<td>B</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>D</td>
<td>B</td>
<td>A</td>
<td>B</td>
<td>B</td>
</tr>
</tbody>
</table>
Do Employment Trends Tell Us Anything About Illinois Economic Condition?

- BLS issued labor statistics for the end of FY18 for Illinois.
- Employment grew by 0.8% over FY17 and weekly earnings increased 2.3%. While Illinois has added jobs for 8 consecutive years, it has underperformed the US.
- Over the last 4 fiscal years annual job growth was 1.5%, 1.3%, 0.7% and 0.8%. Since FY10, Illinois has added 488,000 jobs or 8.7%.
- The sectors with the fastest employment growth have been Education and Health Services (17.6%), Leisure and Hospitality (15.1%) and Professional and Business Services (8.8%). However, 7 of the 11 major industry sectors still have employment levels below 2008 levels.
- Illinois weekly earnings since FY10 have increased 16.6% from $794 to $926. The highest earnings are in the Financial Sector which average $1,396 a week. However, the Financial Sectors total employment is down 2.5% since 2008. In contrast, wage levels are relatively poor in the fastest growing sectors. Weekly earnings in Education and Health Services are $805, and Leisure and Hospitality are $396.
Another Aspect of Slow Recovery—Housing—Bad News for Future Property Tax Revenues?

- Indexed housing prices for major cities (2000=100)
Chicago’s housing performance has been lackluster—this suggests its market based
Retail isn’t much better

**SHRINKAGE**

Amid falling demand for store space, Chicago-area retail development is expected to hit an all-time low this year.

**SQUARE FEET COMPLETED (IN MILLIONS)**

- Note: 2018 is projected
- Source: Mid-America Real Estate
Is this the reason for hope for the Chicago metro economy? (the human capital argument)
Wildcards for Illinois and Chicago in 2019

- **New Governor** with legislative majorities— theoretically no more budget impasses, question will be how will pensions and a structural budget deficit be dealt with absent significant new revenues.
- **New mayor**—will they be business/development friendly?
- **Infrastructure backlog.** Can/will Illinois follow other states in expanding infrastructure spending absent any Federal action?
- **Slow tax base growth**—for locals, slow house price growth and population declines suggest less new development.
Final Thoughts

• Is there any fiscal room to increase revenues and improve fiscal solvency
  – Studies of tax capacity suggest that user fees have the most slack capacity for Illinois.
  – New revenues—marijuana, sports betting, increased online sales tax receipts will all help, online sales tax receipts.
  – Most economists still prefer base broadening over rate increases and Illinois has narrower tax bases for income and sales than many. Tax retiree income, tax services.
  – Is there room for higher taxes? Property taxes, particularly for high-income communities with SALT limitation seem maxed out.
Mean effective property tax rates suggest not much room for property tax increases
What about a graduated rate income tax?

Current rate comparisons

<table>
<thead>
<tr>
<th></th>
<th>Tax rate</th>
<th>Bracket—lowest</th>
<th>Bracket—highest</th>
<th>Exemption -- single</th>
<th>Exemption -- married</th>
<th>Exemption -- dependents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>4.95</td>
<td>Flat</td>
<td>Flat</td>
<td>2,000</td>
<td>4,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Indiana</td>
<td>3.23</td>
<td>Flat</td>
<td>Flat</td>
<td>1,000</td>
<td>2,000</td>
<td>2,500</td>
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<tr>
<td>Iowa*</td>
<td>0.36 to 8.98</td>
<td>1,598</td>
<td>71,910</td>
<td>40</td>
<td>80</td>
<td>40</td>
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<tr>
<td>Michigan</td>
<td>4.25</td>
<td>Flat</td>
<td>Flat</td>
<td>4,000</td>
<td>8,000</td>
<td>4,000</td>
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<tr>
<td>Wisconsin</td>
<td>4.0 to 7.65</td>
<td>11,450</td>
<td>252,150</td>
<td>700</td>
<td>1,400</td>
<td>700</td>
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</table>

Source: Federation of Tax Administrators as of 7/1/2018. Iowa allows Federal income tax deductability
Final Possibility--Funding Infrastructure—the Gas Tax?

<table>
<thead>
<tr>
<th>State</th>
<th>Tax (cents per gallon)</th>
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<tbody>
<tr>
<td>Illinois</td>
<td>20.1*</td>
</tr>
<tr>
<td>Indiana</td>
<td>28.0</td>
</tr>
<tr>
<td>Iowa</td>
<td>30.5</td>
</tr>
<tr>
<td>Michigan</td>
<td>26.3</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>32.9</td>
</tr>
</tbody>
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*excludes local option tax of 5 cents per gallon in Chicago