Commission on Government Forecasting and Accountability

MONTHLY BRIEFING FOR THE MONTH ENDED: JULY 2012

http://www.ilga.gov/commission/cgfa2006/home.aspx

INSIDE THIS ISSUE

703 Stratton Ofc. Bldg.
Springfield, IL 62706

ECONOMY: Is Another Recession Around the Corner?

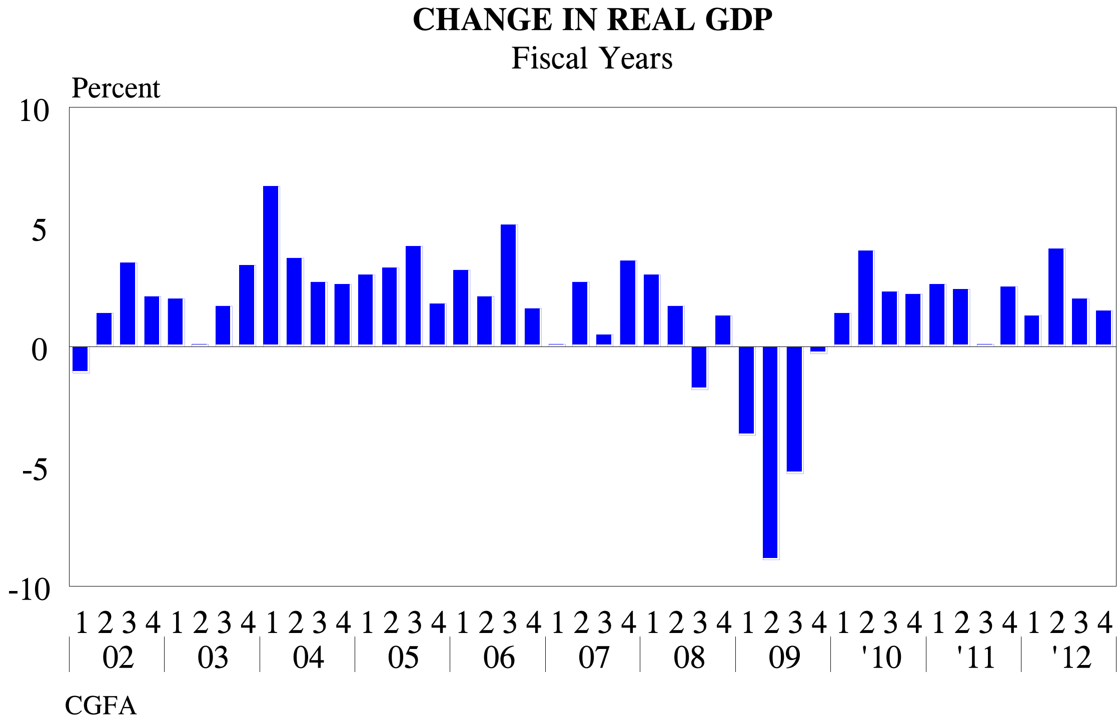
Edward H. Boss, Jr., Chief Economist

For the third year in a row, the hoped-for "***Summer of Recovery***" not only failed to develop, but the pace of activity, rather than improving, slowed sharply. With the economic recovery now entering its fourth year, having officially started in June 2009, not only is it the weakest expansion in at least the post World War II period, but at no time did it generated the type of growth normally associated with economic expansions despite massive fiscal stimulus and easy credit policies. Historically, the average length of all 33 expansions dating back to 1854 is only 42 months, although in the post war era the 11 cycles from 1945 to 2009 lasted on average a longer 59 months. During both periods, however, there have been wide variances.

The most recent slowdown has built up over the past four months as reflected in the past four Monthly Revenue Briefings: (April 2012, **Economy: Is it in Another Soft Patch?** May 2012, **Economy: Soft Patch Confirmed, What Now?** June 2012, **Economy: Growth Stagnates;** and July 2012, **Economy: Is Another Recession Around the Corner?)** As shown in the accompanying chart, real gross national product, GDP, slipped from an annual rate of 4.1% in the final quarter of calendar 2011, to 2.0% in the first quarter of this year, to 1.5% in the quarter just ended according to the advance report issued by the Commerce Department near the end of July. As a result, employment slowed. After rising by an average gain of 225,000 in payroll employment each month during the first quarter of 2012, the average gain in the second quarter plunged to 75,000.

The weakening pattern was not confined to employment, but was rather wide spread. The consumer, which accounts for

CHART 1



the largest sector of spending in excess of two-thirds, reversed course as depicted in retail sales which, after rising each month during the first three months of the year, declined in each month during the second quarter. Not surprisingly, given the employment slowdown and declining retail sales, consumer sentiment as measured by the University of Michigan fell to its lowest level of the year in the advance report issued in July.

Business activity also changed course. Manufacturing business actually contracted in June for the first time since July 2009, the first month after the start of the current recovery, as the Institute of Supply Manger's Index (ISM) hit 49.7%. (Anything less than 50% represents contraction). The non-manufacturing or service sector also has softened according to the ISM, falling in June to 52.1%, while still expanding, was at its lowest level since November 2010. With much of Europe in recession and a slowdown in China and India, U.S. exports have suffered while cutbacks in government spending have occurred at both at the federal, State, and local levels. Finally, even the long depressed housing sector, which has shown some indication of improvement, seems to have lost some momentum. In June there was a softening of new privately owned building permits, a precursor to new housing activity, and a decline in new single-family home sales to the lowest level in more than a year and prices resumed their downward trend.

The keys to whether the disturbing weakening in these key business reports continues, leading to an actual decline in activity and a recession, may well depend on policy decisions. This includes how the crisis in the Euro Zone develops. It has been first negative then positive developments in the viability of the union in Europe that has been a major factor leading to uncertainty and sharp swings in the equity markets. In the U.S., clarity is needed on whether the recent softening in the economy will spark yet another forced credit easing in terms of implementing QE3. Finally, and most importantly, is what becomes of the "Fiscal Cliff", that is the automatic increase in taxes, elimination of the payroll tax reduction, mandatory government spending cuts that will automatically take place at the end of the year, etc. which, if implemented, would most certainly raise the odds of another recession developing.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	June 2012	May 2012	June 2011
Unemployment Rate (Average)	8.7%	8.6%	9.9%
Annual Rate of Inflation (Chicago)	-0.6%	-0.8%	0.9%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (June)	6,583	-0.1%	0.4%
Employment (thousands) (June)	6,011	-0.2%	1.7%
New Car & Truck Registration (June)	50,524	-2.2%	4.2%
Single Family Housing Permits (June)	795	-17.1%	16.9%
Total Exports ($ mil) (May)	5,969	0.4%	6.1%
Chicago Purchasing Managers Index (July)	53.7	1.5%	-8.7%

Impact of Higher Income Tax Rates on State Income Tax Revenues

Eric Noggle, Senior Revenue Analyst

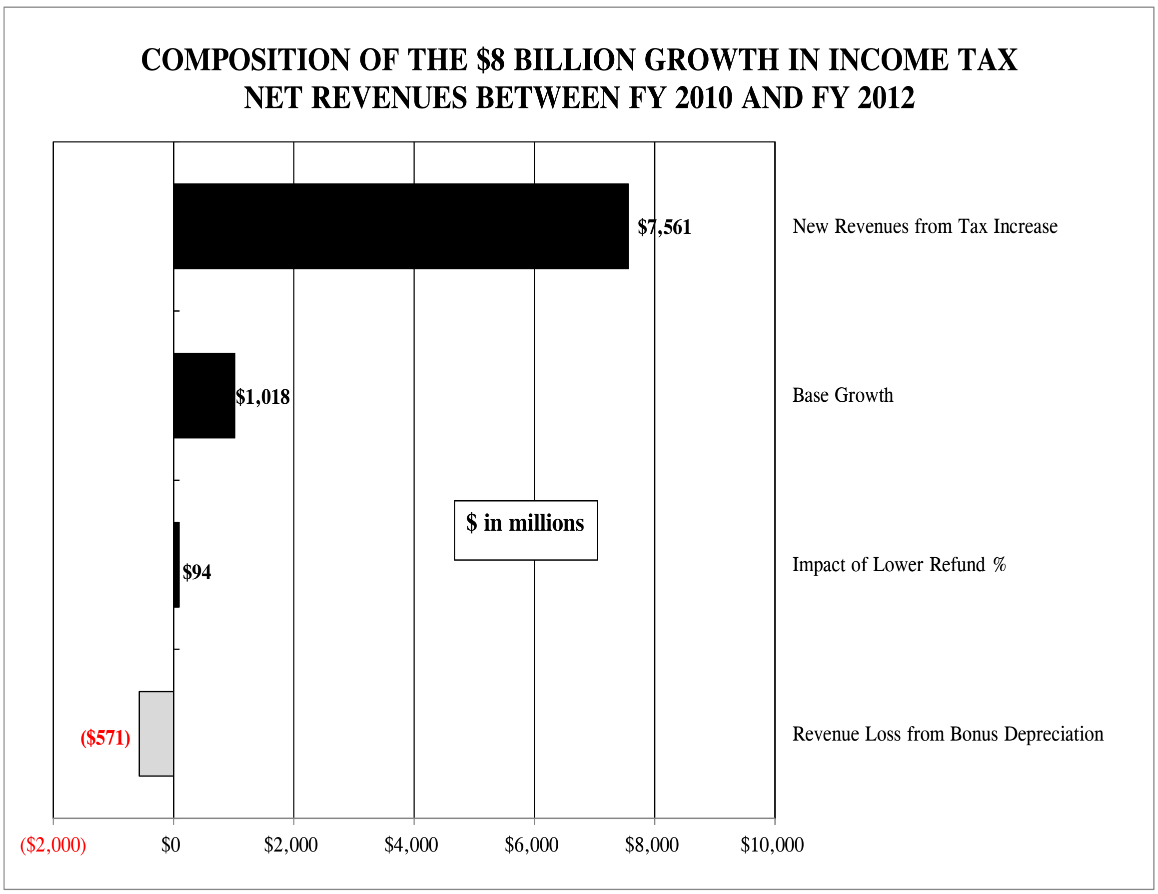
In January 2011, P.A. 96-1496 was signed into law creating the first income tax rate increase in many years. The Public Act altered the Illinois Income Tax by making the following changes:

- **Increase Individual Income Tax Rate.** Increases the personal income tax rate from 3% to 5% in tax year 2011; to 3.75% in tax year 2015; and, to 3.25% in tax year 2025.

- **Increase Corporate Income Tax Rate.** Increases the corporate income tax rate from 4.8% to 7% in tax year 2011; to 5.25% in tax year 2015; and, to 4.8% in tax year 2025.

- **Temporarily Eliminate Net Operating Loss Deduction.** In the case of a corporation (other than a Subchapter S corporation), P.A. 96-1496 provides that no carryover deduction shall be allowed for tax years 2011, 2012, and 2013; provided that, for purposes of determining the taxable years to which a net loss may be carried, no taxable year for which a deduction is disallowed shall be counted.

With FY 2012 now complete, an examination of the annualized impact of the tax changes on State revenues can be conducted. To do this, the Commission compares FY 2010 revenues (last fiscal year before tax increase) with FY 2012 revenues (first full year of tax increases, as FY 2011 was a transition year). Complicating any analysis of income tax revenues since FY 2010 (base year) is the revenue impact of the tax amnesty program (and its impact on future revenues), the effect of federal depreciation provisions that the State elected not to decouple from, and the lowering of the income tax refund percentage that is used to pay income tax refunds. With these mitigating factors in mind, the following chart displays the estimated composition of the $8.008 billion in net income tax revenue growth (personal and corporate combined) between FY 2010 and FY 2012.



As the previous chart shows, of the $8.008 billion in growth in income tax revenues between FY 2010 and FY 2012, approximately $7.561 billion of this growth was believed due to the tax rate increases. Also included in this amount is the impact of the suspension of the net operating loss deduction, valued at approximately $313 million, (net of refunds in FY 2012). This figure of nearly $7.6 billion in new revenues falls within the range of $7 billion to $8 billion commonly used by many in anticipation of this tax increase.

The Commission estimates that approximately $1.018 billion of the growth between FY 2010 and FY 2012 was due to natural base growth. An additional $94 million of the increase was due to the use of a lower refund percentage in FY 2011 and FY 2012 (8.75%) compared to FY 2010 (9.75%). Offsetting a portion of this growth was a $571 million reduction in revenues due to Illinois' decision not to decouple from the federal government's depreciation provisions.

The upper portion of the table below walks from the FY 2010 actual (personal, corporate, and combined) to the FY 2011 actual and then to the FY 2012 actual (net of refunds) while identifying the source of the components of these additional revenues. The lower portion simply combines the components of the two years into one to identify the estimated impact of the income tax rate increases since its inception.

WALKUP OF INCOME TAX NET REVENUES
FY 2010 TO FY 2012
($ Millions)

	Personal	Corporate	Total
FY 2010 Actual (Net):	**$8,511**	**$1,360**	**$9,871**
Base Growth*:	$366	$371	$737
Revenue Loss from Bonus Depreciation:	($34)	($45)	($79)
New Revenues from Tax Increase:	$2,288	$164	$2,452
Impact of Lower Refund %:	$94	$0	$94
FY 2011 Actual (Net):	**$11,225**	**$1,851**	**$13,076**
Base Growth*:	$292	($11)	$281
Revenue Loss from Bonus Depreciation:	($229)	($262)	($491)
New Revenues from Tax Increase**:	$4,225	$884	$5,109
Impact of Lower Refund %:	$0	$0	$0
FY 2012 Actual (Net):	**$15,512**	**$2,461**	**$17,973**

COMPOSITION OF GROWTH IN NET INCOME TAXES
FY 2010 TO FY 2012
($ Millions)

	Personal	Corporate	Total
FY 2010 Actual (Net):	**$8,511**	**$1,360**	**$9,871**
Base Growth*:	$658	$361	$1,018
Revenue Loss from Bonus Depreciation:	($263)	($308)	($571)
New Revenues from Tax Increase**:	$6,513	$1,049	$7,561
Impact of Lower Refund %:	$94	$0	$94
FY 2012 Actual (Net):	**$15,512**	**$2,461**	**$17,973**

*Base Growth Includes Impact of Accelerated Tax Amnesty Revenues into FY 2011 ** New Revenues Include Impact from the Suspension of the Net Operating Loss Deduction.

REVENUE
FY 2013 Begins With Mixed Results – Overall Revenues Up
Jim Muschinske, Revenue Manager

Overall base revenues grew $183 million in July. While income taxes posted good gains, sales tax growth was minimal. Transfers for the month were down considerably, but that falloff was more than offset by growth in federal sources. An extra receipting day in July was at least partially responsible for the monthly growth.

Gross personal income tax revenues rose $80 million or $61 million net of refunds. Gross corporate income tax performed well—up $25 million or $24 million net of refunds. While inheritance tax receipts were expected to jump as a consequence of tax changes that went into effect January 2011 [and which was accompanied with an approximate ten month timing delay], the $50 million increase was surprising. Sales tax continues to soften but still grew $9 million in July. Interest income and other sources both managed to post a $1 million gain.

Despite a recent increase in the tax rate, cigarette taxes fell by $17 million. The falloff was likely due to the stockpiling effect prior to the increase as well as receipt timing, although more study will be necessary to clarify. Public utility taxes dropped $10 million to begin the fiscal year, while insurance taxes and fees dipped $1 million.

Overall transfers fell $187 million in July. The $7 million increase in lottery transfers was offset by a $7 million fall off in riverboat transfers. In addition, other transfers were down $187 million primarily due to last year's large transfers related to release of protested liquor taxes.

After experiencing a very poor month to begin last fiscal year, this July saw Federal sources posting a sizable gain of $253 million.

FY 2013 General Funds Revenue Outlook--Little Growth Expected in Revenues as Slowing Economy, Lower Transfers, and Timing Issues Impact Receipts

As shown in the table on page 9, the Commission's estimate of FY 2013 base general funds revenues is projected to be $33.880 billion. The forecast represents growth of only $83 million over FY 2012 and reflects a significant slowing in underlying growth rates of the larger economic related sources, a drop off in transfers, and a negative impact on year over year growth due to timing of certain FY 2012 receipts. In addition, the table on page 10, compares the Commission's FY 2013 estimate with HJR 68, which was the official revenue estimate adopted by the General Assembly and utilized in constructing the FY 2013 budget. As shown, the Commission's estimate is slightly higher than that of $33.719 billion in HJR 68, but represents less than one-half of one percent difference. A more detailed discussion of the Commission's forecast follows.

<u>Economic Sources</u>

After exceeding expectations in FY 2012, the larger economically related sources are forecast to slow significantly as the recovery appears to be stalling out. With most econometric prognosticators anticipating little growth, coupled with the continuing disappointing jobs picture, there is little reason to believe underlying revenue growth will be able to match last fiscal year's pace.

Base growth for personal income tax is expected to be only 2.2% in FY 2013. However, due to the timing of final payments in the spring of 2012 [valued at approximately $500 million and related to FY 2011 implementation of higher tax rates] gross personal income tax receipts are expected to grow only $25 million. In fact, when a higher refund percentage is used [FY 2012 was 8.75%, while FY 2013 will be 9.75%], net personal income tax is projected to fall $147 million. Base corporate income taxes are expected to be flat. However, in this instance, receipt timing related to year-over-year change in bonus depreciation actually serves to increase growth rates—to 4.1%. Further positively affecting corporate income tax receipts in FY 2013 is the usage of a lower refund percentage [dropping from 17.5% in FY 2012 to 14% in FY 2012]. As a result, net corporate income taxes are expected to grow $214 million. Sales tax, after repeatedly outperforming projections in FY 2012, are expected to cool as the stalled economy and poor employment picture finally manifests in reduced consumer activity. For the year, sales tax receipts are expected to grow only 1.6%.

Transfers

Overall transfers are anticipated to drop $167 million in FY 2013. While lottery and base riverboat transfers are expected to generate modest growth, other transfers will drop significantly due to timing. Namely, in FY 2012, transfers from the Capitol Projects Fund were strengthened due to repayment of owed transfers from previous year's delinquencies. With the "catch up" now complete, transfers from the CPF will return to statutory levels, but will cause a drop in year over year transfers. In addition, FY 2012 was also the beneficiary of $73 million related to the sale of the 10th riverboat license. Only $10 million a year from that sale is expected from now on—resulting in a year over year drop.

Federal Sources

Federal sources fell precipitously in FY 2012—dropping $1.704 billion due to lower reimbursement rates as well as related spending. While federal sources are governed by a combination of appropriation limits, Administration spending plans, and ultimately by available resources, it becomes quite difficult to anticipate precisely what the new fiscal year holds. However, given little change in general funds appropriations for reimbursable spending, for the time being the estimate remains the same as FY 2012, at $3.682 billion. Future adjustments may be needed as the fiscal year unfolds and the Administration's budget plan is detailed.

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

Revenue Sources	July FY 2013	July FY 2012	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$1,167	$1,087	$80	7.4%
Corporate Income Tax (regular)	87	62	$25	40.3%
Sales Taxes	615	606	$9	1.5%
Public Utility Taxes (regular)	71	81	($10)	-12.3%
Cigarette Tax	12	29	($17)	-58.6%
Liquor Gallonage Taxes	17	18	($1)	-5.6%
Vehicle Use Tax	2	2	$0	0.0%
Inheritance Tax (Gross)	52	2	$50	N/A
Insurance Taxes and Fees	3	4	($1)	-25.0%
Corporate Franchise Tax & Fees	13	13	$0	0.0%
Interest on State Funds & Investments	1	0	$1	N/A
Cook County IGT	0	0	$0	N/A
Other Sources	37	36	$1	2.8%
Subtotal	$2,077	$1,940	$137	7.1%
Transfers				
Lottery	48	41	$7	17.1%
Riverboat transfers & receipts	28	35	($7)	-20.0%
Proceeds from Sale of 10th license	0	0	$0	N/A
Other	46	233	($187)	-80.3%
Total State Sources	$2,199	$2,249	($50)	-2.2%
Federal Sources	$403	$150	$253	168.7%
Total Federal & State Sources	$2,602	$2,399	$203	8.5%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($114)	($95)	($19)	20.0%
Corporate Income Tax	($12)	(11)	($1)	9.1%
Subtotal General Funds	$2,476	$2,293	$183	8.0%
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	N/A
Total General Funds	$2,751	$2,568	$183	7.1%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 2-Aug-12

FY 2013 GENERAL FUNDS REVENUE COMPARISON: CGFA vs. FY 2012 Actuals (millions)			
Revenue Sources	FY'13 CGFA July-12	FY 2012 Actuals	$ Difference
State Taxes			
Personal Income Tax	$17,025	$17,000	$25
Corporate Income Tax	$3,111	$2,983	$128
Sales Taxes	$7,340	$7,226	$114
Public Utility (regular)	$1,060	$995	$65
Cigarette Tax	$355	$354	$1
Liquor Gallonage Taxes	$164	$164	$0
Vehicle Use Tax	$30	$29	$1
Inheritance Tax (gross)	$235	$235	$0
Insurance Taxes & Fees	$345	$345	$0
Corporate Franchise Tax & Fees	$192	$192	$0
Interest on State Funds & Investments	$20	$21	($1)
Cook County Intergovernmental Transfer	$244	$244	$0
Other Sources	$402	$399	$3
Subtotal	**$30,523**	**$30,187**	**$336**
Transfers			
Lottery	$656	$640	$16
Riverboat transfers and receipts	$365	$340	$25
Proceeds from sale of 10th license	$10	$73	($63)
Other	$740	$885	($145)
Total State Sources	**$32,294**	**$32,125**	**$169**
Federal Sources	**$3,682**	**$3,682**	**$0**
Total Federal & State Sources	**$35,976**	**$35,807**	**$169**
Nongeneral Funds Distribution:			
Refund Fund			
Personal Income Tax [9.75%]	($1,660)	($1,488)	($172)
Corporate Income Tax [14.0%]	($436)	($522)	$86
Subtotal General Funds	**$33,880**	**$33,797**	**$83**

NOTE: Totals exclude Budget Stabilization transfers, and other cash flow transfers.
CGFA

FY 2013 GENERAL FUNDS REVENUE COMPARISON: CGFA vs. HJR 68

($ Millions)

Revenue Sources	FY 2013 CGFA July-12	FY 2013 HJR 68 March-12	$ Difference
State Taxes			
Personal Income Tax	$17,025	$16,776	$249
Corporate Income Tax	$3,111	$2,912	$199
Sales Taxes	$7,340	$7,335	$5
Public Utility (regular)	$1,060	$1,085	($25)
Cigarette Tax	$355	$355	$0
Liquor Gallonage Taxes	$164	$162	$2
Vehicle Use Tax	$30	$29	$1
Inheritance Tax (gross)	$235	$230	$5
Insurance Taxes & Fees	$345	$285	$60
Corporate Franchise Tax & Fees	$192	$195	($3)
Interest on State Funds & Investments	$20	$20	$0
Cook County Intergovernmental Transfer	$244	$244	$0
Other Sources	$402	$400	$2
Subtotal	**$30,523**	**$30,028**	**$495**
Transfers			
Lottery	$656	$649	$7
Riverboat transfers and receipts	$365	$340	$25
Proceeds from sale of 10th license	$10	$10	$0
Other	$740	$801	($61)
Total State Sources	**$32,294**	**$31,828**	**$466**
Federal Sources	**$3,682**	**$3,935**	**($253)**
Total Federal & State Sources	**$35,976**	**$35,763**	**$213**
Nongeneral Funds Distribution:			
Refund Fund			
Personal Income Tax [9.75%]	($1,660)	($1,636)	($24)
Corporate Income Tax [14.0%]	($436)	($408)	($28)
Subtotal General Funds	**$33,880**	**$33,719**	**$161**

NOTE: Totals exclude Budget Stabilization transfers, and other cash flow transfers.
CGFA