Commission on Government Forecasting and Accountability

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MONTHLY BRIEFING FOR THE MONTH ENDED: FEBRUARY 2017

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INSIDE THIS ISSUE

ECONOMY: Inflation May Be Key to Fed Policy

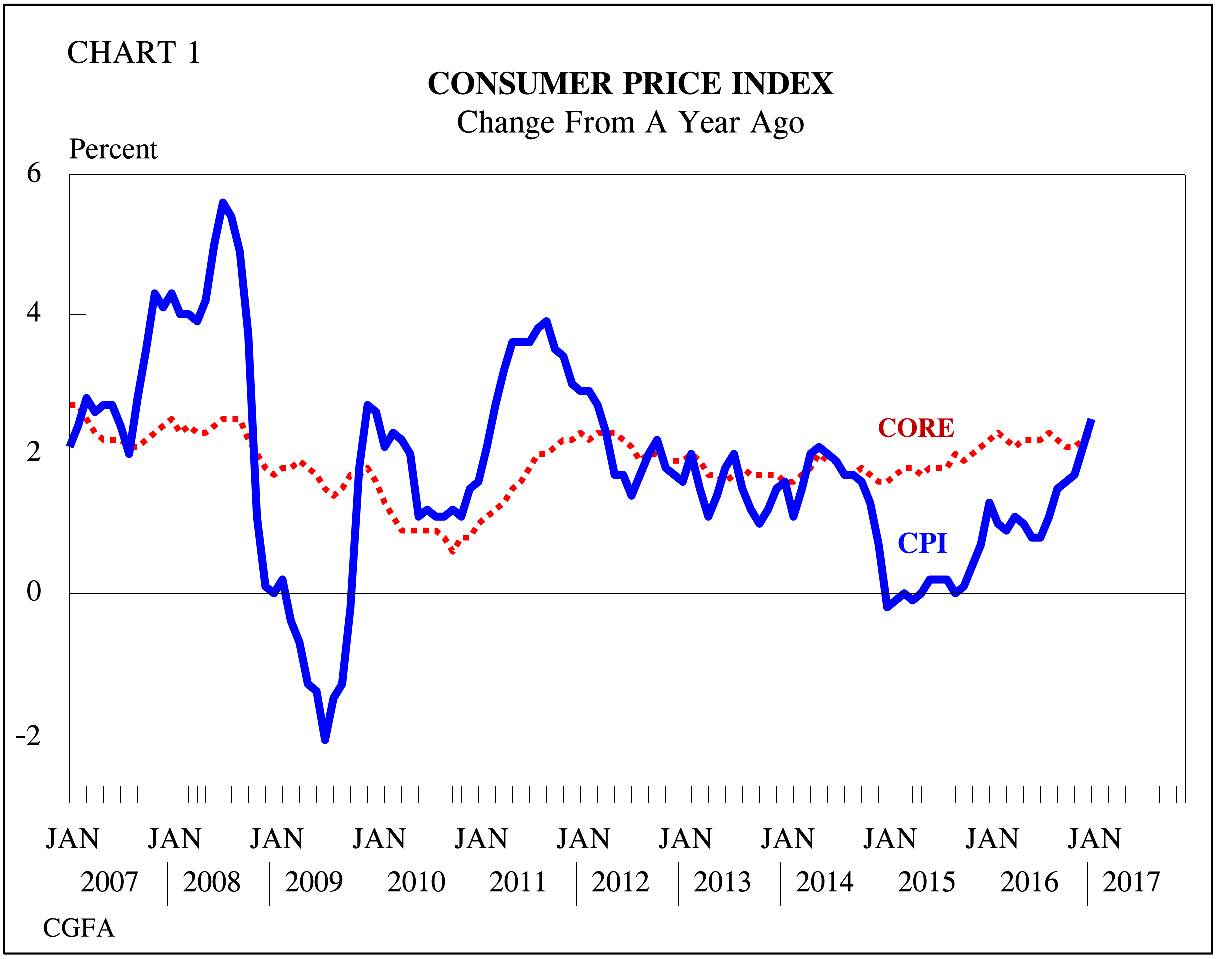
Edward H. Boss, Jr., Chief Economist

The rise in the federal funds rate from 0.5% to 0.75% at the end of last year brought with it the conclusion to the accommodative near zero interest rate policy the Federal Reserve had pursued since 2009 to stimulate the economy from recession. While the economy recovered, beginning in June 2009, it has been the weakest recovery in the post WWII period. Recently, however, signs of an improving pace of growth emerged that are raising questions as to what additional steps the Fed may make toward "normalizing" interest rates.

Several recent business reports portray an improving economic environment. Perhaps most dramatic of these has been the performance of the stock market which has been in a post-election surge, setting new record after new record. At the same time the consumer, which accounts for about 70% of total spending, showed renewed vigor as nominal retail sales accelerated, rising 5.6% in January 2017 compared to a year earlier reaching to a five-year high.

The improvement in sales was accompanied by rising consumer optimism. Both the Conference Board's Consumer Sentiment and the University of Michigan's Consumer Sentiment Indices moved up sharply in the past three months. And, manufacturing as measured by the Institute of Supply Management's Purchasing Manager's Index, after a weakening trend from mid-2015 into early 2016, began to increase. By January 2017 it had reached its highest level since November 2014. These reports led many forecasters to up their expectations for first quarter real GDP growth to the 2.1% - 2.3% range, up from 1.9% in the fourth quarter and a meager 1.6% growth for all of 2016.

The labor markets also have begun to show improvement. The unemployment rate nationally was 4.8% in January (the latest Illinois' rate stands at 5.7%). After years of decline, manufacturing employment began to rise and helped contribute to an improving job picture. After reaching a low at the



beginning of 2010, manufacturing employment began to increase, reaching a high in January of 2016 before leveling out. In Illinois, a recovery in manufacturing jobs also began to improve by 2010. A few years later, however, it had leveled out, and was followed by a renewed weakening which lasted throughout last year. By year end the number of manufacturing jobs in Illinois had fallen to the lowest level since the fall of 2010. Indeed, the pattern of Illinois' manufacturing employment is in sharp contrast to the improvement seen in surrounding states in the Midwest "rust belt".

Recently-released minutes of the FOMC (Federal Open Market Committee) stated "many participants expressed the view that it might be appropriate to raise the federal funds rate again fairly soon if information on the labor market and inflation was in line with or stronger than their current expectations or if the risks of overshooting the Committee's maximum employment and inflation objectives increased." Many observers now anticipate three modest increases in the federal funds rate this year. The next FOMC meetings are in March, May, and June. The next increase will be dependent on the strength of the upcoming employment numbers and inflation data. Some analysts foresee a flat distribution across the next three meetings, from comments made by Chairman Janet Yellen. An increase as early as March, which many feel is unlikely but cannot be ruled out entirely, raises the prospect of four moves this year. A May rise could serve as a compromise while a June move would suggest more modest employment and inflation gains.

It is well understood that the impact of Federal Reserve policy on the economy operates with a significant lag sometimes up to 18 months. And, because of that lag, policy actions to achieve certain employment and inflation objectives are often overshot. Currently, the unemployment rate stands at 4.8% which indicates there is less slack in the labor markets. Even so, while progress has begun to be made, the labor force participation rate is still extremely low by historical standards even considering an aging population. Perhaps more concern to the Fed may be appearing on the inflation target set at 2%.

The Federal Reserve looks at many price measures, two of which are displayed in the attached chart - - the consumer price index **CPI** and the core CPI which excludes the volatile food and energy components. In January the CPI rose 2.5% from a year earlier and the core rate, which has shown much less volatility, was up 2.3% over January last year. On this basis, if continued, it opens the possibility that the Fed's 2% inflation was on the way to being achieved. The major price inflation measure used by the Fed is for Personal Consumer Expenditures (PCE) largely because it covers a wide range of household spending. Moreover, because inflation numbers can vary erratically month to month policymakers consider average inflation over longer periods of time. In January of this year the PCE rose 1.7% over a year earlier, up from 1.5% in January 2016. Thus, while below the Fed's 2% inflation rate by this measure, inflation bears watching as other measures may be signaling a new strengthening. History shows us that once ignited, inflation has proven hard to reign in.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS *	Month 2016	Month 2016	Month 2015
Unemployment Rate (Average)	*N/A due to additional time needed to revise historical monthly, annual data (Benchmarking)		
Annual Rate of Inflation (Chicago)	1.8%	-0.2%	0.5%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (Jan)	*N/A due to additional time needed to Revise historical monthly, annual data (Benchmarking)		
Employment (thousands) (Jan)			
NonFarm Payroll Employment (Jan)			
New Car & Truck Registration (Jan)	52,111	10.4%	10.3%
Single Family Housing Permits (Jan)	497	-11.1%	-6.6%
Total Exports ($ mil) (Dec)	5,102.1	1.4%	-0.2%
Chicago Purchasing Managers Index (Feb)	57.4	14.1%	20.3%

* Due to monthly fluctuations, trend best shown by % change from a year ago

REVENUE

February Freefall—Significant Downward Adjustment Coming in March

Jim Muschinske, Revenue Manager

Overall base revenues fell $423 million in February. Like a broken record, monthly declines reflected weaker income taxes along with poor federal sources. Unfortunately, February's lackluster performance was widespread with only a couple sources managing to show gains. One less receipting day likely contributed to the decline, though certainly not the primary culprit.

Gross personal income tax receipts dropped by $129 million, or $125 million net of refunds and diversions to the Fund for Advancement of Education and Commitment to Human Services Fund. After posting gains in Dec/Jan, weakness snuck back into the picture as sales tax receipts fell $42 million in February. The poor year for gross corporate income taxes continued unabated with monthly receipts falling $42 million, or $36 million net of refunds. Public utility taxes fell $37 million, likely due to timing, while corporate franchise taxes actually suffered a $20 million decline. An adjustment was made by the Secretary of State rectifying earlier corporate franchise tax distribution discrepancies. Inheritance taxes were down $7 million, insurance taxes fell $6 million, cigarette taxes dropped $2 million, and liquor taxes dipped $1 million.

Only a couple of sources fared positively as other sources were up $30 million, and interest income gained $4 million.

Overall transfers fell $7 million in February. No riverboat transfers were recorded for the month, resulting in a $5 million year over year decline. [Since the graduated rate structure governing riverboat gaming is reset each January, early months are historically quite weak.] Other transfers dipped $3 million, while lottery transfers eked out a $1 million gain. Per usual this fiscal year, federal sources experienced another poor month, this time falling a whopping $178 million below last year. Federal sources continue to reflect low levels of reimbursable general funds spending.

Year To Date

Through the first two-thirds of the fiscal year, base receipts are off $1.453 billion, or 7.5%. Weakness is widespread, and has resulted in year over year losses in key areas such as income taxes and federal sources. With renewed uncertainty of sales tax performance, and with only four months left in FY 2017, it will be very difficult to alter the trajectory of what has turned into a dismal year for revenues.

To date, gross corporate income taxes are off $482 million, or $422 million net of refunds. Gross personal income tax is down $375 million, or $456 million if refunds and diversions to the education and human service funds are included. Public utility taxes are down $67 million, in part due to a one-time accounting change at IDoR. The highly volatile inheritance tax is down $58 million. Vehicle use tax is behind $3 million, while cigarette tax is off $2 million.

Other sources are ahead by $125 million, due mostly to the one-time nature of a SERS repayment worth $84 million. Sales taxes are up a disappointing $52 million, indicative of weak consumer activity. Insurance taxes are ahead by $19 million, interest income up $6 million, corporate franchise $5 million and liquor taxes $1 million.

To repeat comments from previous briefings, with continued dramatic falloffs month after month in federal sources, receipts are behind last year's dismal pace by $565 million. Absent an infusion of resources that could be committed to reimbursable spending, the outlook for a meaningful recovery for federal sources remains grim. [That being said, to the extent reimbursable spending is pushed into next year, so too would the reimbursement, provided there are sufficient resources to effectuate the spending].

MARCH REVISION SCHEDULED

The Commission has scheduled a meeting on March 7th 2017 to discuss the economic and revenue outlook for FY 2018. In addition, a revised forecast for FY 2017 will be prepared and presented. Readers of the monthly revenue briefings will not be surprised with the likely outcome showing a significant downward revision necessitated by year to date performance.

FEBRUARY

FY 2017 vs. FY 2016

($ million)

Revenue Sources	Feb. FY 2017	Feb. FY 2016	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$933	$1,062	($129)	-12.1%
Corporate Income Tax (regular)	9	47	($38)	-80.9%
Sales Taxes	519	561	($42)	-7.5%
Public Utility Taxes (regular)	71	108	($37)	-34.3%
Cigarette Tax	35	37	($2)	-5.4%
Liquor Gallonage Taxes	8	9	($1)	-11.1%
Vehicle Use Tax	2	2	$0	0.0%
Inheritance Tax	15	22	($7)	-31.8%
Insurance Taxes and Fees	18	24	($6)	-25.0%
Corporate Franchise Tax & Fees	(5)	15	($20)	-133.3%
Interest on State Funds & Investments	5	1	$4	400.0%
Cook County IGT	94	94	$0	0.0%
Other Sources	58	28	$30	107.1%
Subtotal	$1,762	$2,010	($248)	-12.3%
Transfers				
Lottery	43	42	$1	2.4%
Riverboat transfers & receipts	0	5	($5)	-100.0%
Proceeds from Sale of 10th license	0	0	$0	N/A
Refund Fund transfer	0	0	$0	N/A
Fund sweeps	0	0	$0	N/A
Other	26	29	($3)	-10.3%
Total State Sources	$1,831	$2,086	($255)	-12.2%
Federal Sources	$53	$231	($178)	-77.1%
Total Federal & State Sources	$1,884	$2,317	($433)	-18.7%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($104)	($104)	$0	0.0%
Corporate Income Tax	($1)	(7)	$6	-85.7%
Fund for Advancement of Education	($53)	(55)	$2	-3.6%
Commitment to Human Services Fund	($53)	(55)	$2	-3.6%
Subtotal General Funds	$1,673	$2,096	($423)	-20.2%
Short-Term Borrowing	$0	$0	$0	N/A
Interfund Borrowing	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$1,673	$2,096	($423)	-20.2%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 1-Mar-17

GENERAL FUNDS RECEIPTS: YEAR TO DATE FY 2017 vs. FY 2016 ($ million)				
Revenue Sources	FY 2017	FY 2016	CHANGE FROM FY 2016	% CHANGE
State Taxes				
Personal Income Tax	$9,288	$9,663	($375)	-3.9%
Corporate Income Tax (regular)	620	1,102	($482)	-43.7%
Sales Taxes	5,427	5,375	$52	1.0%
Public Utility Taxes (regular)	556	623	($67)	-10.8%
Cigarette Tax	233	235	($2)	-0.9%
Liquor Gallonage Taxes	117	116	$1	0.9%
Vehicle Use Tax	19	22	($3)	-13.6%
Inheritance Tax	180	238	($58)	-24.4%
Insurance Taxes and Fees	218	199	$19	9.5%
Corporate Franchise Tax & Fees	145	140	$5	3.6%
Interest on State Funds & Investments	21	15	$6	40.0%
Cook County IGT	150	150	$0	0.0%
Other Sources	386	261	$125	47.9%
Subtotal	$17,360	$18,139	($779)	-4.3%
Transfers				
Lottery	441	417	$24	5.8%
Riverboat transfers & receipts	199	210	($11)	-5.2%
Proceeds from Sale of 10th license	0	0	$0	N/A
Refund Fund transfer	4	77	($73)	-94.8%
Fund sweeps	0	0	$0	N/A
Other	354	382	($28)	-7.3%
Total State Sources	$18,358	$19,225	($867)	-4.5%
Federal Sources	$1,376	$1,941	($565)	-29.1%
Total Federal & State Sources	$19,734	$21,166	($1,432)	-6.8%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($1,041)	($942)	($99)	10.5%
Corporate Income Tax	($107)	($167)	$60	-35.9%
Fund for Advancement of Education	($294)	($303)	$9	N/A
Commitment to Human Services Fund	($294)	($303)	$9	N/A
Subtotal General Funds	$17,998	$19,451	($1,453)	-7.5%
Short-Term Borrowing	$0	$0	$0	N/A
Interfund Borrowing	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$125	($125)	-100.0%
Total General Funds	$17,998	$19,576	($1,578)	-8.1%

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

CGFA 1-Mar-17