Commission on Government Forecasting and Accountability

MONTHLY BRIEFING **AUGUST 2007**

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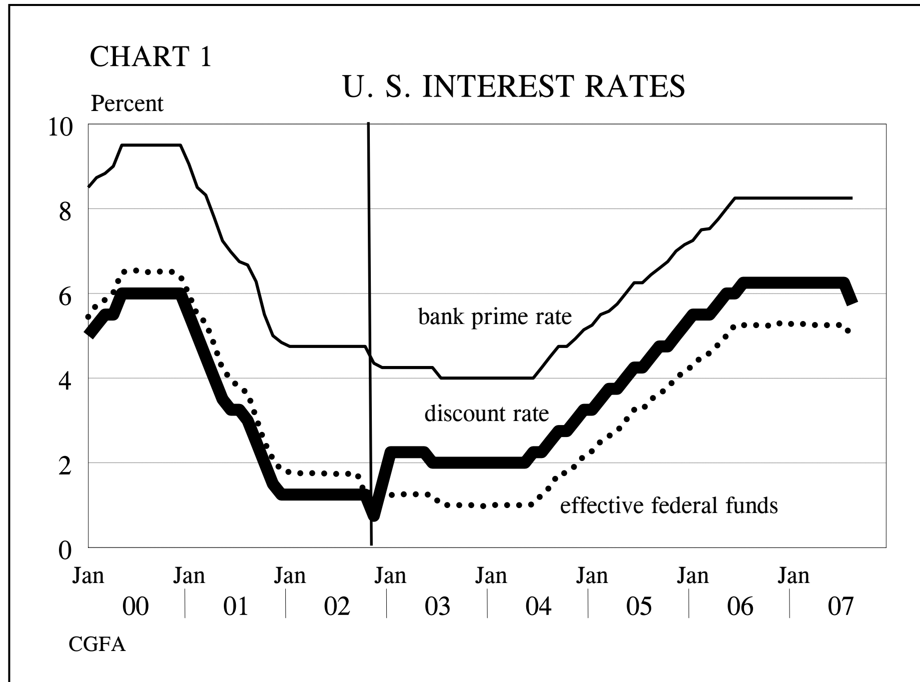
ECONOMY: Impact of the Credit Crisis

Edward H. Boss, Jr., Chief Economist

The current credit crisis is the fallout from the bursting of the housing bubble that was fueled by an explosion of sub prime loans; made by nonbank institutions; that were repackaged; rated as high-grade debt by the rating agencies; bought by nonbank institutions including hedge funds; which in turn were purchased on a global basis by corporations, state and other public and private pension funds, and individuals. Fallout from the intensifying credit crisis spread from the United States' largest mortgage lender that was already struggling with rising mortgage delinquencies and foreclosures and an increasing unwillingness among bankers to extend further credit, and almost total unwillingness among investors to buy the loans it makes. The first realization that this was a worldwide problem came in early August when a major French bank announced it was freezing three investment funds because of losses related to U.S. housing loans.

As uncertainties arose over the magnitude of the problem and its ultimate effects, world stock markets began to swoon as liquidity in the credit markets dried up. To ease liquidity concerns, major Central banks overseas began to infuse reserves. At home, the Federal Reserve began aggressive open market liquidity operations to supply reserves to U.S. banks that some pundits referred to as "stealth credit easing". The infusion of reserves also temporarily caused the effective federal funds rate to fall below its target of 5.25%. As shown in the accompanying chart, this was followed days later by the Federal Reserve lowering the discount rate by one half percent, from 6.25% to 5.75%, and extending loans from the Fed to banks from overnight to 30 days, renewable by the borrower. These actions were taken to increase the market for good assets such as commercial paper that were suffering from illiquidity. Toward month's end, banks increased their borrowing at the discount window and began lending again to brokerage firms and others that had been turned away only days earlier.



The markets began to anticipate an actual Fed announcement of a federal funds target rate cut. As shown in the Chart, the gap between the discount rate and the target federal funds rate narrowed with the discount rate reduction. Some even expect a funds rate cut prior to the next September 18th meeting. The Fed did issue a statement that downside risks to further growth had increased *appreciably* and did not mention inflation, which seemed to soften its previous statement that," *Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected."*

The Fed's job, however, is to stabilize the markets, not to reward investors and borrowers for bad financial decisions. At the same time, many feel it is important that the Federal Reserve continue to display its independence. Thus, while it is quite appropriate for Federal Board Chairman Bernanke to consult with the Treasury Secretary at the request of the Senate Banking Committee, it was unusual for the head of the Senate Banking Committee to hold a press conference immediately following the meeting relaying what was discussed and decided. Some observers feel this might be interpreted as infringing upon the Fed's long- standing independent role.

As the credit markets seem to stabilize in recent days, many now feel if stability is maintained, the Federal Reserve will wait until its September 18th meeting to decide what action to take. Its decision is likely to depend not only on its outlook for inflation but how great an effect the deterioration in the mortgage market will have on the economy. Most agree that serious imbalances remain in the housing market and that conditions are likely to worsen in several parts of the country in the months ahead. According to Inter-

national Strategy & Investment, it's not just a financial crisis. It notes that real GDP growth has averaged below 2% for 5 quarters with declines in vehicle, heavy truck, appliance and furniture sales at a time when home prices are declining. Earlier this year Ex-Chairman of the Federal Reserve, Alan Greenspan, declared there was a one-third probability of a recession this year. While the majority of economists still seem to think a recession can be avoided, most also would agree the odds of having one have increased. This risk situation is likely to weigh heavily on the monetary authorities as they make their policy decisions in the months ahead.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	JULY 2007	JUNE 2007	JULY 2006
Unemployment Rate (Average)	5.2%	5.1%	4.4%
Annual Rate of Inflation (Chicago)	-3.1%	2.4%	3.1%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (July)	6,736	0.1%	1.7%
Employment (thousands) (July)	6,383	0.0%	0.9%
New Car & Truck Registration (July)	54,064	-10.7%	-0.3%
Single Family Housing Permits (July)	2,414	-10.4%	-30.8%
Total Exports ($ mil) (June)	4,248	-2.3%	17.4%
Chicago Purchasing Managers Index (August)	53.8	0.7%	-5.8%

Summary of P.A. 95-0233 The FY 2008 Budget Implementation (Revenue) Act

Eric Noggle, Senior Revenue Analyst

P.A. 95-0233 (SB 1544) creates the FY 2008 Budget Implementation (Revenue) Act. The purpose of the Act is stated in the Act's language as "to make changes in State programs concerning revenue that are necessary to implement the FY 2008 Budget". The Governor's Office estimates that these changes will increase State revenues by approximately **$250 million**. (The Commission has yet to receive a detailed breakout of this estimate). A brief summary of the changes in this Act follows.

Franchise Tax and License Fee Amnesty Act of 2007. This provision provides that the Secretary of State shall establish an amnesty program for all taxpayers owing any franchise tax or license fee. The amnesty program shall be for a period from February 1, 2008 through March 15, 2008. The amnesty program shall provide that, upon payment by a taxpayer of all franchise taxes and license fees due from that taxpayer to the State of Illinois for any taxable period, the Secretary shall abate and not seek to collect any interest or penalties that may be applicable, and the Secretary shall not seek civil or criminal prosecution for any taxpayer for the period of time for which amnesty has been granted to the taxpayer. According

to a press release on P.A. 95-0233, the Governor's Office stated that this provision is estimated to generate a one-time $25 million in unpaid back taxes in FY 2008.

Unitary Business Addition Modification. The Illinois Income Tax Act is amended to provide that a taxpayer must add to their adjusted gross income an amount equal to the amount otherwise allowed as a deduction in computing base income for interest paid, accrued, or incurred, directly or indirectly, for taxable years ending on or after December 31, 2008, to a person who would be a member of the same unitary business group but for the fact that the person is prohibited under Section 1501(a)(27) from being included in the unitary business group because he or she is ordinarily required to apportion business income under different subsections of Section 304. This income modification also pertains to intangible expenses and insurance premium expenses.

Federal/Municipal Bonds Deduction Change. The Illinois Income Tax Act is amended to provide that a taxpayer can deduct from their adjusted gross income an amount equal to all amounts included in such total which are exempt from taxation either by reason of its statutes or Constitution or by reason of the Constitution, treaties or statutes of the United States; provided that, in the case of any statute of Illinois or, for taxable years ending on or after December 31, 2008, of the United States, any treaty of the U.S., the Illinois Constitution, or the U.S. Constitution that exempts income derived from bonds or other obligations from the tax imposed under this Act, the amount exempted shall be the income net of bond premium amortization, and, for taxable years ending on or after December 31, 2008, interest expense incurred on indebtedness to carry the bond or other obligation, expenses incurred in producing the income to be deducted, and all other related expenses. The amount of the expenses to be taken into account under this provision may not exceed the amount of income that is exempted.

Real Estate Trust Income Addition Modification. The Illinois Income Tax Act is amended to provide that a corporate taxpayer must add to their adjusted gross income, for taxable years beginning after December 31, 2008, any deduction for dividends paid to a corporation by a captive real estate trust that is allowed to a real estate investment trust under Section 857(b)(2)(B) of the Internal Revenue Code for dividends paid.

Net Operating Loss Modification. The Illinois Income Tax Act is amended to provide that, for each taxable year ending on or after December 31, 2008, for purposes of computing the loss for the taxable year and the deduction taken account for the taxable year for a net operating loss carryover, the loss and net operating loss carryover shall be reduced in an amount equal to the reduction to the net operating loss and net operating loss carryover to the taxable year, respectively, required under Section 108(b)(2)(A) of the Internal Revenue Code, multiplied by a fraction, the numerator of which is the amount of discharge of indebtedness income that is excluded from gross income for the tax-

able year, and the denominator of which is the total amount of discharge of indebtedness income excluded from gross income for the taxable year.

Single Sales Factor Changes. For taxable years ending on or after December 31, 2008, sales, other than certain sales described in the legislation, are in this State if the purchase is in Illinois or the sales is otherwise attributable to this State's marketplace. Examples of these sales are provided in the language of the public act and include: sales from the sale or lease of real property are in this State if the property is located in this State; sales from the lease or rental of tangible personal property are in this State if the property is located in this State during the rental period; Sales of intangible personal property are in this State if the purchaser realizes benefit from the property in this State; sales of services are in this State if the benefit of the service is realized in this State.

For taxable years ending on or after December 31, 2008, the business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its gross receipts from sources in this State or otherwise attributable to this State's marketplace and the denominator of which is its gross receipts everywhere during the taxable year. Examples of these are provided in the language of the public act. The public act also defines business income derived from providing transportation services other than airline services.

Withholding by Partnerships, Subchapter S Corporations, and Trusts. For each taxable year ending on or after December 31, 2008, certain partnerships, Subchapter S corporations, and trusts must withhold from each nonresident partner, shareholder, or beneficiary an amount equal to the distributable share of the business income of the partnership, Subchapter S corporation, or trust apportionable to Illinois of that partner, shareholder, or beneficiary under Sections 702 and 704 and Subchapter S of the Internal Revenue Code, whether or not distributed, multiplied by the applicable rates of tax for that partner or shareholder under subsections (a) through (d) of Section 201 of Illinois Income Tax Act.

Elimination of Car Rental Sales Tax Exemption. P.A. 95-0233 (SB 1544) amends the Retailers' Occupation Tax Act by eliminating the sales tax exemption for certain vehicles that are used for automobile renting. These vehicles include those vehicles of the first division, a vehicle of the second division that is a self contained motor vehicle designed or permanently converted to provide living quarters for recreational, camping, or travel use, with direct walk through access to the living quarters from the driver's seat, or a motor vehicle of the second division that is of the van configuration designed for the transportation of not less than 7 nor more than 16 passengers. According to the Comptroller's *Tax Expenditure Report*, this exemption cost the State approximately $52 million in FY 2006.

REVENUE
Receipts Mixed in August – Post Modest Gain

Jim Muschinske, Revenue Manager

General funds revenues grew $55 million in August. However, virtually all of that gain was attributed to federal reimbursement from Medicaid spending. Absent the $50 million gain in federal sources, all other revenues were basically flat. August had the same number of receipting days as last year.

Gross personal income taxes were up $32 million, or $29 million net of refunds. Inheritance tax posted a $16 million gain, while public utility taxes increased by $6 million. Insurance taxes and fees grew by $5 million, other sources $3 million, and corporate franchise fees $1 million.

Despite the overall monthly gain, a number of sources experienced declines. Sales taxes fell by $56 million, gross corporate income taxes by $7 million, liquor taxes by $2 million, vehicle use tax $1 million, and interest income by $1 million.

Overall transfers rose by $11 million in August. Other transfers posted a gain of $6 million, while riverboat transfers grew by $5 million. *As in the prior year, $276 million was transferred from the Budget Stabilization Fund to the General Fund to aid in cash flow. Those monies will be transferred back by the end of the fiscal year.*

Year to Date

Through the first two months of the fiscal year, overall receipts are up $357 million. However, almost all of that gain stems from an increase in federal receipts. Excluding $323 million in federal source growth, leaves a very modest gain of $34 million.

While gross personal income tax receipts continued to fare well, up $74 million or $66 million on a net of refund basis, sales tax receipts waned and are down $21 million. All of the other tax sources have posted a net gain of $36 million. Overall transfers are down $49 million, as $10 million gains in lottery and riverboat transfers were more than wiped out by a $69 million drop in other sources.

GENERAL FUNDS RECEIPTS: AUGUST

FY 2008 vs. FY 2007
($ million)

Revenue Sources	August FY 2008	August FY 2007	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$709	$677	$32	4.7%
Corporate Income Tax (regular)	16	23	($7)	-30.4%
Sales Taxes	597	653	($56)	-8.6%
Public Utility Taxes (regular)	112	106	$6	5.7%
Cigarette Tax	29	29	$0	0.0%
Liquor Gallonage Taxes	13	15	($2)	-13.3%
Vehicle Use Tax	4	5	($1)	-20.0%
Inheritance Tax (Gross)	37	21	$16	76.2%
Insurance Taxes and Fees	18	13	$5	38.5%
Corporate Franchise Tax & Fees	15	14	$1	7.1%
Interest on State Funds & Investments	18	19	($1)	-5.3%
Cook County IGT	0	0	$0	N/A
Other Sources	39	36	$3	8.3%
Subtotal	$1,607	$1,611	($4)	-0.2%
Transfers				
Lottery	47	47	$0	0.0%
Riverboat transfers & receipts	75	70	$5	7.1%
Other	31	25	$6	24.0%
Total State Sources	$1,760	$1,753	$7	0.4%
Federal Sources	$574	$524	$50	9.5%
Total Federal & State Sources	$2,334	$2,277	$57	2.5%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($69)	($66)	($3)	4.5%
Corporate Income Tax	($3)	(4)	$1	-25.0%
Subtotal General Funds	$2,262	$2,207	$55	2.5%
Short-Term Borrowing	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$276	$276	$0	N/A
Total General Funds	$2,538	$2,483	$55	2.2%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 4-Sep-07

GENERAL FUNDS RECEIPTS: YEAR TO DATE FY 2008 vs. FY 2007 ($ million)				
Revenue Sources	**FY 2008**	**FY 2007**	**CHANGE FROM FY 2007**	**% CHANGE**
State Taxes				
Personal Income Tax	$1,369	$1,295	$74	5.7%
Corporate Income Tax (regular)	65	71	($6)	-8.5%
Sales Taxes	1,223	1,244	($21)	-1.7%
Public Utility Taxes (regular)	183	175	$8	4.6%
Cigarette Tax	58	58	$0	0.0%
Liquor Gallonage Taxes	28	27	$1	3.7%
Vehicle Use Tax	7	7	$0	0.0%
Inheritance Tax (Gross)	56	47	$9	19.1%
Insurance Taxes and Fees	26	20	$6	30.0%
Corporate Franchise Tax & Fees	29	28	$1	3.6%
Interest on State Funds & Investments	41	35	$6	17.1%
Cook County IGT	15	6	$9	150.0%
Other Sources	76	74	$2	2.7%
Subtotal	$3,176	$3,087	$89	2.9%
Transfers				
Lottery	92	82	$10	12.2%
Riverboat transfers & receipts	115	105	$10	9.5%
Other	131	200	($69)	-34.5%
Total State Sources	$3,514	$3,474	$40	1.2%
Federal Sources	$1,148	$825	$323	39.2%
Total Federal & State Sources	$4,662	$4,299	$363	8.4%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($134)	($126)	($8)	6.3%
Corporate Income Tax	($11)	($13)	$2	-15.4%
Subtotal General Funds	$4,517	$4,160	$357	8.6%
Short-Term Borrowing	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$276	$276	$0	N/A
Total General Funds	$4,793	$4,436	$357	8.0%

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

CGFA 4-Sep-07

PENSIONS
U.S. House Passes Sudan Divestment Bill

Bukola Bello, Pension Analyst

In response to the widening movement in the United States for states, cities and universities to divest from or restrict investments in companies doing business in Sudan, the U.S. House of Representatives passed House Resolution 180, sponsored by Representative Barbara Lee [CA-9], on July 31, 2007 by a vote of 418-1. The bill requires the Secretary of the Treasury, in consultation with other federal agencies, to publish a list in the Federal Register of both foreign and domestic companies that conduct business operations in Sudan's power production, mineral extraction, oil-related, or military equipment industries. The bill prohibits the federal government from contracting with companies identified on the list.

The measure contains a statement of policy for the federal government to support the decision of any State or local government to divest from, or restrict investments in, companies that conduct business operations in Sudan. A State or local government may adopt and enforce measures to divest the assets of the State or local government from, or prohibit investment of the assets of the State or local government in: (a) persons that are included on the list most recently published in the Federal Register by the Secretary of the Treasury, and (b) persons having a direct investment in or carrying on a trade or business in Sudan or with the Government of Sudan. H.R. 180 contains a sunset clause that takes effect when the President certifies to Congress that the genocide in the Darfur region of Sudan has stopped for at least 12 months and the government of Sudan honors its commitments to cease attacks on civilians. The bill is currently before the Senate Committee on Banking, Housing, and Urban Affairs.

Illinois is among many states to follow suit with a bill that requires the State-funded retirement systems to divest from Sudan. Senate Bill 1169 passed both Houses on May 31, 2007 and was approved by Governor Blagojevich on August 28, 2007. SB 1169 provides that retirement funds shall not transfer or disburse funds to, acquire any bonds, loan, or invest in any entity unless a certifying company certifies to the retirement system that, (1) the certifying company has relied on information provided by an independent researching firm that specializes in global security and (2) 100% of the retirement system's assets for which the certifying company provides services or advice have not been invested or reinvested in any forbidden entity at any time 4 months after the effective date. The certifying company shall also make the certification required to a retirement system 6 months after the effective date of the Act and annually thereafter.

Governor Amendatorily Vetoes HB 3578

Summary of HB 3578 as enrolled

Currently, elected Cook County officers may elect to establish alternative credits by contributing an additional 3% of salary towards their pensions (in addition to the standard 8.5% contribution rate for members enrolled in the regular formula). In exchange for the additional employee contributions, elected county officers are entitled to have their retirement annuities

calculated at the following rate: 3% of final salary for the first 8 years of service credit, plus 4% of final salary for the next 4 years of service credit, plus 5% of final salary for each year in excess of 12 years, subject to a limitation of 80% of final salary. "Final salary" means the member's salary on his or her last day of service. Under the alternative formula, elected county officers may retire at age 60 with at least 10 years of service credit, or at age 65 with at least 8 years of service credit.

House Bill 3578 specifies that the foregoing plan of optional alternative benefits for elected Cook County officers applies only to those county officers who were elected by vote of the people on or before the effective date of this amendatory Act. Essentially, the enrolled bill eliminates the alternative formula for future elected Cook County officers.

Governor's Amendatory Veto

On August 14th, Governor Blagojevich exercised his amendatory veto power to broaden the scope of HB 3578. Rather than eliminating the optional alternative annuity only for future Cook County elected officials, the Governor would also eliminate the alternative formula for elected Cook County officers who have not yet met the 8-year vesting requirement. ("Vesting" refers to the minimum number of years that a person must work in order to be eligible for a retirement annuity at some future date). To illustrate, if the governor's veto is sustained by the General Assembly, a Cook County commissioner who was elected in 2002 with 5 years of service credit would no longer be eligible to receive a pension based on the alternative formula. Instead, the elected officer would receive a refund of his or her additional contributions and would receive a pension based on the regular formula (2.4% of final average salary for each year of service). It is unknown how many elected Cook County officers would be affected by the governor's veto.

Governor Amendatorily Vetoes SB 1553

Currently, the Downstate Firefighter Article of the Pension Code stipulates that a disability pension shall not be paid to a firefighter unless the firefighter has been examined by 3 physicians selected by the board of trustees of the pension fund. SB 1553, as enrolled, amends the Downstate Firefighter Article to specify that the 3 physicians need not agree as to the existence of any disability or the nature and extent of a disability. The Governor's Amendatory Veto, dated August 28, 2007, deletes the foregoing provision, and would, if sustained, retain the existing law.