Commission on Government Forecasting and Accountability

MONTHLY BRIEFING **SEPTEMBER 2007**

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703 Stratton Ofc. Bldg.
Springfield, IL 62706

ECONOMY: Slowdown or Recession

Edward H. Boss, Jr., Chief Economist

Bursting of the housing bubble; the impact of the credit crisis; a weak employment report last month; and some major retailers revising down their sales forecasts prior to the upcoming holiday season raise questions as to whether the economy, which already had slowed, is in the midst of a mid-course correction or on the verge of a full fledge recession. Early this year past-Chairman of the Federal Reserve, Alan Greenspan, stated there was a one-third probability of a recession this year. More recently, when asked if there was a recession on the horizon, he said in a T.V. interview that the odds were less than fifty percent. Certainly the Open Market Committee led by current Federal Reserve Chairman, Ben Bernanke, became increasingly concerned about the strength of the economy and lowered key monetary policy interest rates at their last meeting by a greater-than-expected ½% with follow up language that led to expectations of another reduction to come at their next meeting to be held on October 31st. Time will tell whether this Halloween meeting will result in a trick or a treat for the markets.

Prospects of a recession also have increased at Global Insight, a major forecasting service used as guidance by the Commission. Probability of their alternative scenario of a ***Hard Landing*** for the U.S. economy rose from a 20% likelihood in their August forecast to a 30% likelihood by September, with real Gross Domestic Product (GDP) declining modestly in both the 4th quarter of calendar 2007 and 1st quarter of 2008. A scenario where the economy strengthens, ***The Expansion Finds New Legs,*** was downgraded, given only a 15% chance. Major components of the forecast of the ***Most Likely Outcome***, with a 55% probability, are shown in the following table on an Illinois fiscal year basis.

The pace of growth represented by the change in real GDP slowed sharply in FY 2007 from that recorded in the previous

ECONOMIC FORECASTS – SEPTEMBER 2007
($ Change from prior year levels)

REAL (2000 $)	FY 2004 Actual	FY 2005 Actual	FY 2006 Actual	FY 2007 Actual	FY 2008 Estimated	FY 2009 Estimated
Gross Domestic Product	3.8	3.1	3.2	2.1	2.1	2.4
Personal Consumption	3.6	3.3	3.1	3.0	2.5	2.5
Durable	7.7	5.3	3.6	4.5	2.5	1.8
Nondurable	4.0	3.3	3.6	3.2	2.3	2.8
Services	2.6	3.0	2.8	2.7	2.5	2.5
Fixed Investment	7.9	8.1	5.0	-3.2	-3.7	0.6
Exports	3.4	8.9	7.4	7.9	9.9	8.5
Imports	10.1	7.4	6.3	2.3	2.1	4.4
Government	2.0	0.8	1.4	1.7	2.3	1.3
Federal	7.0	2.9	1.8	1.5	3.2	1.7
State & Local	0.0	-0.2	1.0	1.8	2.1	1.1
OTHER MEASURES						
Personal Income (Current $)	4.8	6.5	6.2	6.4	5.7	4.7
Personal Consumption (Current $)	5.9	6.2	6.4	5.5	4.6	4.3
Before Tax Profits (Current $)	20.7	17.5	9.6	8.9	0.1	5.3
Consumer Prices	2.2	3.0	3.8	2.6	2.3	1.7
Unemployment Rate (Average)	5.8	5.3	4.8	4.6	4.9	5.0

three years. Moreover, as shown in the table, last fiscal year's below-trend growth is likely to be repeated in FY 2008 with only modest improvement expected in FY 2009. Some of the changes in the components of growth over the next two years are of particular relevance to any revenue forecast. For example, the consumer, as represented by real personal consumption, is anticipated to slow sharply, particularly for long-lived durable goods such as autos and home furnishings, as current dollar personal income growth continues to slow over the next two years while unemployment rises. Since the consumer normally accounts for two-thirds of total spending, the softening here will offset the expected improvement in exports and the end of a decline in housing with some gain in business spending resulting in a leveling out in fixed investment in FY 2009 following two year's of decline. Finally, corporate profits in current dollars are expected to virtually disappear in FY 2008, after stellar growth in recent years, before improving somewhat in FY 2009.

Illinois' economy generally mirrors that of the nation as a whole. Even so, there can be significant differences at times. In the immediate period ahead, there are both positive and negative aspects of Illinois' performance relative to that expected for the nation as a whole. On the positive side, high commodity prices for agricultural products, including expanded use of ethanol, augur well for the State's farmers as well as for those firms manufacturing farm equipment in the State. Anticipated strength in exports, stemming from continued growth abroad and a more competitive dollar also should benefit Illinois which ranked 5th among the states in overall exports. While these expectations should aid growth in the State relative to the nation, other trends are less encouraging in that respect.

Particularly disturbing is the sharp deterioration in Illinois' employment situation in recent months. After recording a lower unemployment rate than that of the nation during the second half of 2006, Illinois' unemployment rate has jumped up and now well exceeds the national rate. Indeed, as reported in the **Regional and State Employment and Unemployment Summary,** released in September by the U.S. Department of Labor, *"Nine states registered significant unemployment rate increases from a year earlier. The largest of these occurred in Illinois (1.0 percentage point).* "Indeed, while the national unemployment rate was basically unchanged from 4.7% in August 2006 to 4.6% in August 2007, Illinois' unemployment rate rose from 4.4% to 5.4% during the same time period. Indeed, Illinois' unemployment rate in August matched that of the Midwest region as a whole, which posted the highest regional rate of 5.4%. The highest unemployment rate continued to be in Michigan with a rate of 7.4%. Continuation of current employment trends in Illinois will undoubtedly negatively affect sales and individual income tax revenues.

While the odds of a recession occurring any time soon have increased, there are several factors suggesting that one can be avoided. Certainly, the change in monetary policy with prospects for more to come seem to have quieted the credit crisis. In addition, the Commission's leading indicator for Illinois, while leveling out, has yet to enter a strong downward phase that typified entry into earlier recessions. Finally, inflation continues to ease, interest rates are low, inventories outside of the housing sector are modest, and economies abroad remain strong. It should be pointed out, however, that even should a recession be avoided, continued below-trend growth would provide an environment that would limit revenue gains from traditional sources.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	August 2007	July 2007	August 2006
Unemployment Rate (Average)	5.4%	5.2%	4.4%
Annual Rate of Inflation (Chicago)	1.5%	-3.1%	2.7%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (August)	6,719	-0.2%	1.0%
Employment (thousands) (August)	6,356	-0.4%	0.0%
New Car & Truck Registration (August)	69,871	29.0%	0.6%
Single Family Housing Permits (August)	2,278	-5.6%	-37.1%
Total Exports ($ mil) (July)	4,081	-3.9%	25.8%
Chicago Purchasing Managers Index (September)	54.2	0.7%	-12.7%

REVENUE
Receipts Sputter in September as Weakness Spreads

Jim Muschinske, Revenue Manager

Excluding $1.2 billion in short term borrowing, total general funds revenues fell $198 million in September. While the vast majority of the decline [$154 million] is attributed to a drop in federal sources, a number of revenue sources also fared poorly. In addition, one less receipting day in September likely contributed to the monthly decrease.

Sales tax receipts led the monthly decline with a loss of $33 million, further illustrating weakness in this source. Inheritance tax receipts fell by $13 million, while gross corporate income tax lagged by $12 million, or a drop of $10 million net of refunds. Public utility taxes eased by $11 million, insurance taxes fell by $5 million, and interest income dipped by $2 million.

Despite the overall monthly loss, gross personal income taxes were up $46 million, or $41 million net of refunds. Corporate franchise taxes posted a $15 million gain, and other sources managed to increase by $4 million.

Overall transfers fell by $30 million in September. Other transfers posted a loss of $40 million, while lottery transfers gained $10 million. A slowdown in reimbursable spending resulted in monthly federal sources declining $154 million.

Year to Date

Through the first quarter of the fiscal year, overall receipts are up $158 million. However, all of that gain stems from an increase in federal receipts. Excluding $169 million in federal source growth, growth in all other sources actually fell $11 million.

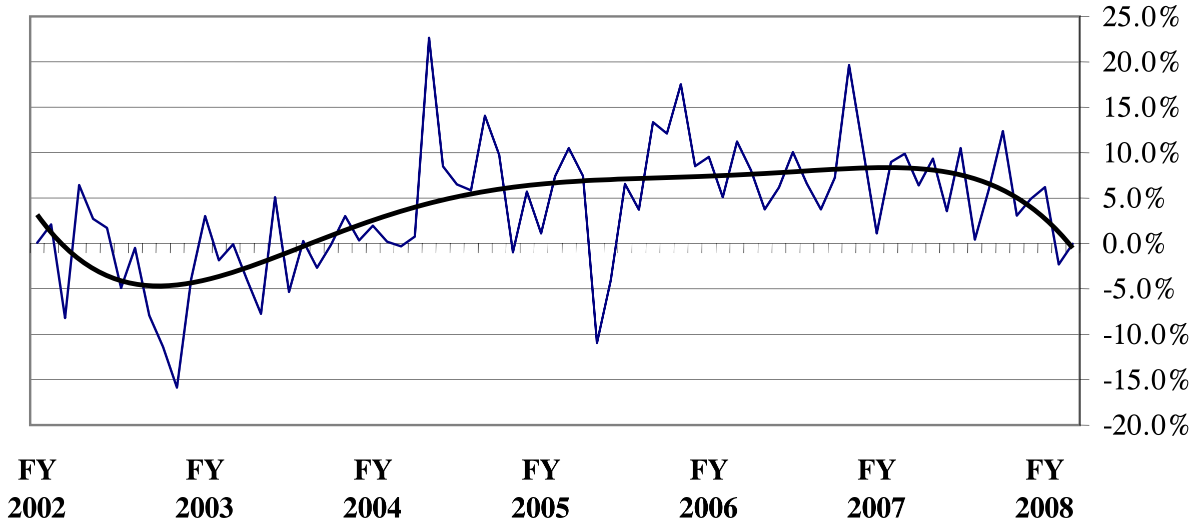
While gross personal income tax receipts continued to fare well, up $120 million or $108 million on a net of refund basis, sales tax receipts continue to wane and are down $55 million. In addition, gross corporate income taxes also ended down for the quarter, with receipts off $18 million, or $15 million net of refunds.

Overall transfers are down $79 million, as $19 million gains in lottery and $10 million gain in riverboat transfers were more than wiped out by a $108 million drop in other sources. Despite the September falloff in federal source receipts, an earlier jump in reimbursable spending resulted in a first quarter increase of $169 million in federal sources.

FY 2008 Revenue Outlook —Concern Grows

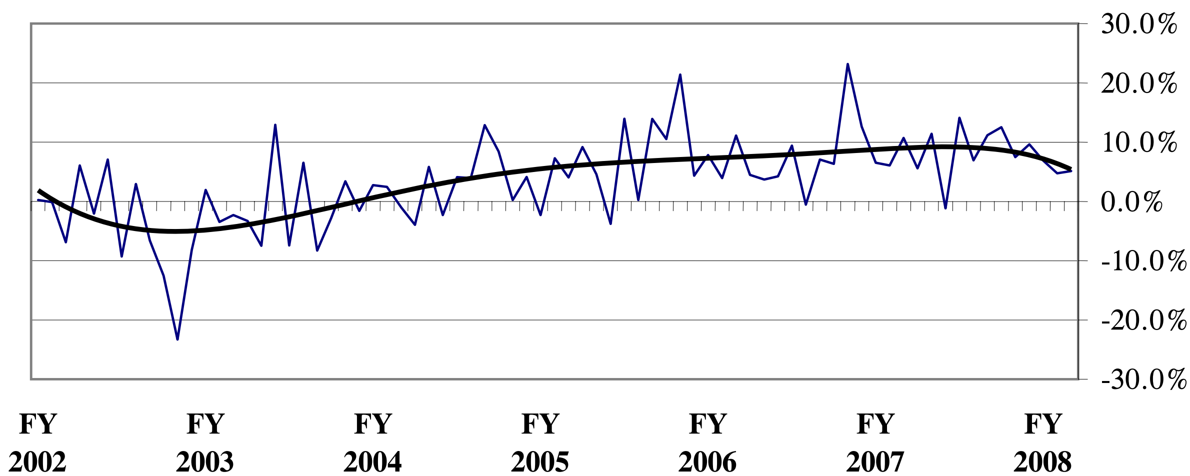
After good growth from the economically related revenue sources throughout the past several years, fortunes appear to have turned. **While personal income tax receipts continue to fare quite well, continued lack of growth in sales tax revenue and poor first quarter performance of corporate income taxes gives rise for concern**. The chart on the following page illustrates how these sources most closely tied to the economy have begun to change from recent trends. As shown, on a month over month percent change basis, the combined monthly revenues of personal, corporate, and sales taxes have seen growth slow significantly as of late.

Personal, Corporate, and Sales Tax Revenues Year-Over-Year Percent Change by Month

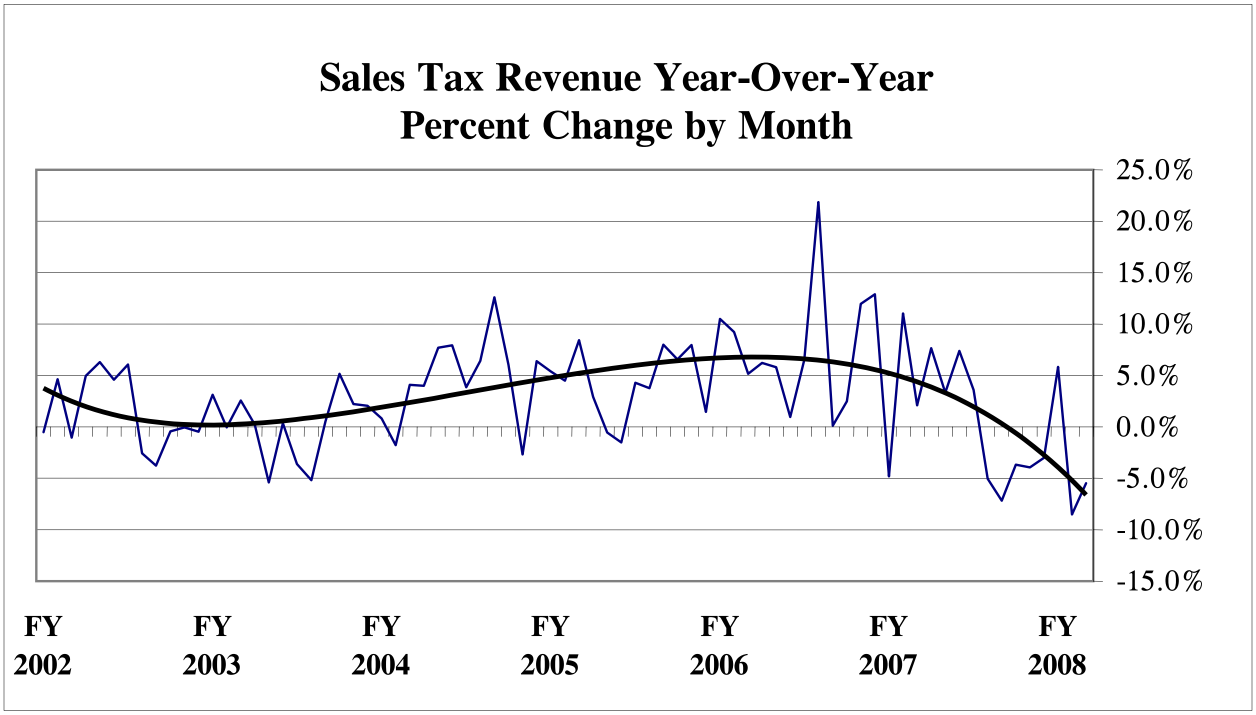


The following graphs break out each tax component on their own. As indicated earlier, personal income tax continues to post gains at what can be described as "above average rates" of growth. However, even this source appears to have reached its peak rate of growth and may now be ripe for a slowing period, particularly as the employment picture has eroded over recent months.

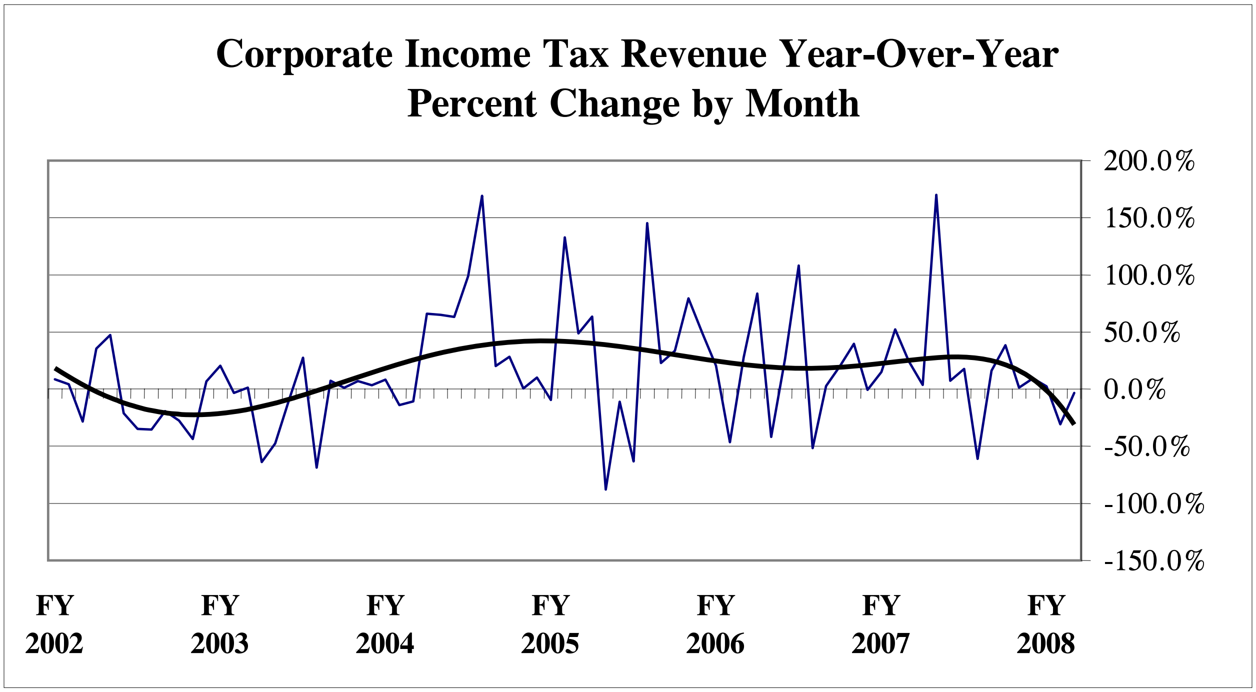
Personal Income Tax Revenue Year-Over-Year Percent Change by Month



Most concerning is the continued poor performance of sales tax receipts, as it was this source that first signaled the dramatic revenue slowdown in fiscal years 2001-2003. As shown below, sales tax has been suffering month over month declines for a number of months. While a portion of that decline can be explained by an earlier misallocation of sale tax revenues, that issue wouldn't fully account for the fact that State sales tax has been disappointing.



The decline in sales tax has been occurring for some time now. However, a very recent slowdown has begun to occur in corporate income taxes. By its very nature, corporate income tax is quite volatile and double digit swings in performance are not uncommon and have occurred in seven out of the last ten years. [Although, in recent years, those double digit swings have been positive]. This phenomenal growth over the last few years, while certainly welcomed, has "risen the bar" on a comparative basis. As a result, corporate income taxes will likely struggle to hold at last years levels given current economic uncertainty.



In conclusion, it appears that recent robust performance of the most closely tied economic sources has ended. While personal income tax should continue to grow, albeit at a more modest pace, both sales tax and corporate income tax receipts may well find growth elusive over the remainder of the fiscal year. As discussed in the earlier section, it appears we have entered a precarious time as it relates to the economy. With this heightened state of uncertainty, it would not be surprising to see revenues struggle in FY 2008.

A more detailed revenue forecast is planned to be provided in an upcoming monthly briefing. At that time it is hoped that any final revenue changes related to the ongoing legislative session can be incorporated. The Commission will continue to monitor the revenue picture and provide periodic updates.

GENERAL FUNDS RECEIPTS: SEPTEMBER

FY 2008 vs. FY 2007

($ million)

Revenue Sources	Sept. FY 2008	Sept. FY 2007	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$927	$881	$46	5.2%
Corporate Income Tax (regular)	334	346	($12)	-3.5%
Sales Taxes	581	614	($33)	-5.4%
Public Utility Taxes (regular)	75	86	($11)	-12.8%
Cigarette Tax	29	29	$0	0.0%
Liquor Gallonage Taxes	14	14	$0	0.0%
Vehicle Use Tax	3	3	$0	0.0%
Inheritance Tax (Gross)	14	27	($13)	-48.1%
Insurance Taxes and Fees	56	61	($5)	-8.2%
Corporate Franchise Tax & Fees	38	23	$15	65.2%
Interest on State Funds & Investments	14	16	($2)	-12.5%
Cook County IGT	0	0	$0	N/A
Other Sources	26	22	$4	18.2%
Subtotal	$2,111	$2,122	($11)	-0.5%
Transfers				
Lottery	57	47	$10	21.3%
Riverboat transfers & receipts	60	60	$0	0.0%
Other	13	53	($40)	-75.5%
Total State Sources	$2,241	$2,282	($41)	-1.8%
Federal Sources	$213	$367	($154)	-42.0%
Total Federal & State Sources	$2,454	$2,649	($195)	-7.4%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($91)	($86)	($5)	5.8%
Corporate Income Tax	($58)	(60)	$2	-3.3%
Subtotal General Funds	$2,305	$2,503	($198)	-7.9%
Short-Term Borrowing	$1,200	$0	$1,200	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$3,505	$2,503	$1,002	40.0%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 1-Oct-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	$2,296	$2,176	$120	5.5%
Corporate Income Tax (regular)	399	417	($18)	-4.3%
Sales Taxes	1,804	1,859	($55)	-3.0%
Public Utility Taxes (regular)	258	261	($3)	-1.1%
Cigarette Tax	88	87	$1	1.1%
Liquor Gallonage Taxes	42	41	$1	2.4%
Vehicle Use Tax	10	10	$0	0.0%
Inheritance Tax (Gross)	70	74	($4)	-5.4%
Insurance Taxes and Fees	81	81	$0	0.0%
Corporate Franchise Tax & Fees	67	51	$16	31.4%
Interest on State Funds & Investments	55	51	$4	7.8%
Cook County IGT	15	6	$9	150.0%
Other Sources	102	96	$6	6.3%
Subtotal	$5,287	$5,210	$77	1.5%
Transfers				
Lottery	148	129	$19	14.7%
Riverboat transfers & receipts	175	165	$10	6.1%
Other	145	253	($108)	-42.7%
Total State Sources	$5,755	$5,757	($2)	0.0%
Federal Sources	$1,361	$1,192	$169	14.2%
Total Federal & State Sources	$7,116	$6,949	$167	2.4%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($224)	($212)	($12)	5.7%
Corporate Income Tax	($70)	($73)	$3	-4.1%
Subtotal General Funds	$6,822	$6,664	$158	2.4%
Short-Term Borrowing	$1,200	$0	$1,200	N/A
Budget Stabilization Fund Transfer	$276	$276	$0	N/A
Total General Funds	$8,298	$6,940	$1,358	19.6%

SOURCE: Office of the Comptroller, State of Illinois: Some totals may not equal, due to rounding.
CGFA 1-Oct-07

Short-Term Borrowing
Lynnae Kapp
Bond/Senior Revenue Analyst

The State sold $1.2 billion in General Obligation Certificates in September 2007. The borrowing will provide liquidity to the Hospital Provider Fund to make supplemental inpatient and outpatient payments to certain public and non-public hospitals within Illinois. These payments to hospitals are a part of the Illinois Hospital Provider Assessment Tax Program. The State uses funds raised from this tax to leverage $600 million in additional funds from the federal government, of which $470 million will go back to hospitals, while the additional $130 million will be used by the State for other Medicaid services. Upon making the supplemental payments from the Hospital Provider Fund, the State will deposit Federal Medicaid Reimbursements and Hospital Assessment Tax Receipts into the Hospital Provider Fund. Those receipts will pay off the short-term borrowing and the residual balance will be transferred to the General Revenue Fund and other healthcare related Funds. The Certificates will mature November 9, 2007, when the State will make a $1.2 billion principal payment and a $6.2 million interest payment.

HISTORY OF SHORT TERM BORROWING

Date Issued	Amount (millions)	Date Retired
June-July 1983	$200	May 1984
February 1987	$100	February 1988*
August 1991	$185	June 1992
February 1992	$500	October 1992*
August 1992	$600	May 1993
October 1992	$300	June 1993
August 1993	$900	June 1994
August 1994	$687	June 1995
August 1995	$500	June 1996
July 2002	$1,000	June 2003
May 2003	$1,500	May 2004*
June 2004	$850	October 2004*
March 2005	$765	June 2005
November 2005	$1,000	June 2006
February 2007	$900	June 2007
September 2007	$1,200	November 2007

Source: Office of Management & Budget
*Across fiscal year borrowing

The Administration also competitively sold $900 million of General Obligation Certificates in February of 2007 for the Hospital Provider Assessment Tax Program. Previous Short-term borrowing occurred in March and November of 2005, for $765 million and $1 billion, respectively, to be spent on Medicaid bills. These types of borrowing are for cash flow purposes. In these cases, the State can borrow up to 5% of the State's appropriations for the fiscal year, but it must be repaid by the end of that fiscal year. The State can also use short-term borrowing for a deficit due to emergencies or failures of revenues. This "across fiscal year" borrowing allows for borrowing up to 15% of the State's appropriations for the fiscal year and must be repaid within one year.

PENSIONS
State Universities' Retirement System Self-Managed Plan
Bukola Bello, Pension Analyst

On August 16, 1997, Governor Edgar signed into law Public Act 90-448, which required the State Universities' Retirement System to offer its members a defined contribution plan alternative in addition to the traditional defined benefit plan. At the time, it was argued that a defined contribution plan option was needed to attract qualified personnel. The defined contribution plan, known as the Self-Managed Plan, establishes individual retirement accounts into which employee and employer (State of Illinois) contributions are placed. Participants are able to choose from a variety of investment options ranging from mutual funds to annuity contracts provided by vendors such as TIAA-CREF and Fidelity. Members become fully vested, or entitled to receive benefits that cannot be taken away, after earning 5 years of service credit. If a member terminates employment prior to becoming vested, the member receives all of their member contributions plus all investment returns directly. SURS members who select the Self-Managed Plan option contribute 8% of gross earnings, including earnings for overtime and summer sessions. The State of Illinois contributes 7.6% of employee earnings, 6.6% of which goes directly to the member's self-managed plan account, while the remaining 1% goes towards SURS disability benefits.

The table below shows the number of active participants in the Self-Managed Plan compared to total active SURS members for each fiscal year since the inception of the Self-Managed Plan.

Fiscal Year	Active SMP Participants	Total Active SURS Members
1998	845	77,156
1999	3,740	78,406
2000	5,405	77,770
2001	6,899	77,781
2002	6,384	79,133
2003	7,480	78,936
2004	8,250	81,242
2005	8,440	80,102
2006	9,110	80,869