Commission on Government Forecasting and Accountability

MONTHLY BRIEFING *SEPTEMBER 2010*

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ECONOMY: Recovery in Doubt

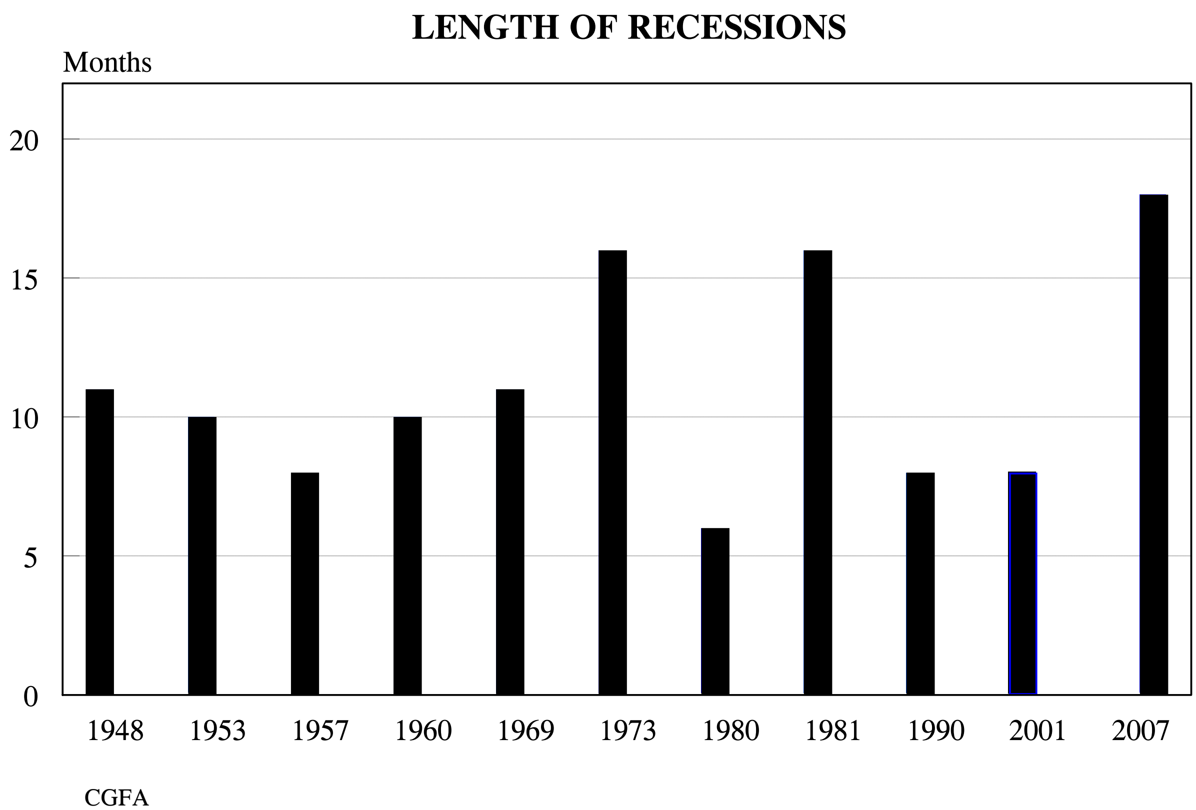
Edward H. Boss, Jr., Chief Economist

Now that the National Bureau of Economic Research, (NBER) the official determiner of cyclical dates, has declared that the recession that began in December of 2007 ended in June 2009, it was officially 18 months long. As shown in the chart on page 2, that was the longest of the eleven recessions that occurred in the post WWII period. The previous longest, being 16 months in length, was the recession that began in November 1973 and later the recession that started in July 1981. The shortest recessions were the prior two, the one that began in July 1990 and the one that started in March 2000, each which lasted only 8 months.

Some have called the past recession the Great Recession although the twin recessions in the 1980s by some measures, including the unemployment rate that reached 10.8% in the final two months of 1982, was more severe. Even these periods, however, cannot compare to the economic devastation that occurred during the Great Depression that included an economic downturn of 3 ½ years, ending in 1933, followed by another lasting more than a year ending in 1938.

The economic recovery that began in the summer of 2009 is now in its second year, although unlike previous recoveries from deep recessions, the gains have been disappointingly small and, as mentioned last month, the pace has begun to slow sharply. Therefore, few are feeling the benefits of an economy that by official standards now is in its second year. There is good reason for this lack of enthusiasm. More than 8 million jobs were lost during the recession and while there have been some months of modest gain recently; the level in August 2010 was below that of June 2009 when the recession ended. Moreover, the unemployment rate stands at 9.6%, up

CHART 1



from the 9.5% rate of the previous two months, with most economists forecasting further increases in the months ahead. At the same time, Realty Trac reported banks repossessed 95,364 properties in August 2010, up 3% from July and 25% higher than a year ago. This marked the ninth month in a row that the pace of foreclosure has increased on an annual basis. Therefore, it is not surprising that consumer sentiment remains at low levels with the University of Michigan survey showing a preliminary reading in September at its lowest level since August of last year.

The recent retrenchment in growth has led to increasing speculation over chances for a double-dip recession. Global Insight, a major economic forecasting service, has increased the odds of a double-dip in recent months from 15% to 20%, and more recently to 25%. Mark Zandi, Chief Economist of Moodys/economy.com and adviser to President Obama on the stimulus program puts the odds of a double-dip at one in three. Moreover, he feels the odds would go up sharply should *all* of the Bush tax cuts, including to those earning more than $250,000, not be extended. Should the economy gain strength later on, however, he feels the upper bracket reductions could be phased out without deleterious effects to the economy.

The Federal Reserve also recognized the weakening pace of economic activity in its late September 2010 FOMC minutes. *"Information received since the Federal*

Open Market Committee met in August indicates the pace of recovery in output and employment has slowed in recent months." It went on to say *"Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability."* As a result, while it held the key federal funds rate unchanged at a rate of 0-1/4 percent, it stated it "*is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."*

It has become quite clear that just as the economic recovery has been officially proclaimed, its sustainability is being questioned. In this climate, actions on both the fiscal and monetary policy fronts may prove crucial to its outcome.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	AUG. 2010	JULY 2010	AUG. 2009
Unemployment Rate (Average)	10.1%	10.3%	10.6%
Annual Rate of Inflation (Chicago)	1.4%	2.0%	0.6%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (August)	6,624	-0.1%	0.3%
Employment (thousands) August)	5,953	0.1%	0.8%
New Car & Truck Registration (August)	N/A	N/A%	N/A%
Single Family Housing Permits (August)	669	-0.9%	-12.8%
Total Exports ($ mil) (July)	4,069	-6.8%	24.4%
Chicago Purchasing Managers Index (Sept.)	60.4	6.5%	31.0%

Interfund Borrowing

Lynnae Kapp, Senior Bond Analyst

In September, $202 million was transferred from various funds to the General Revenue Fund through Interfund Borrowing. Including the almost $61 million in August, Interfund Borrowing transfers equal $263 million to date. The Governor has the authority through Public Act 96-0958, which allows this "cash flow" borrowing through January 9, 2011. Borrowing from any fund must be paid back within 18 months of the date borrowed. Below is a break out of amounts borrowed by Fund.

	FY2011 INTERFUND BORROWING	PA 96-0958		
No.	Fund	Aug	Sep	TOTAL
0021	Financial Institution Fund	$1,783,000		**$1,783,000**
0049	Industrial Hygiene Regulatory & Enforcement Fund	$8,000		**$8,000**
0057	IL State Pharmacy Disciplinary Fund	$77,000		**$77,000**
0113	Community Health Center Care Fund	$21,000		**$21,000**
0114	Emergency Response Reimbursement Fund	$33,000		**$33,000**
0151	Registered CPA Administration & Disciplinary Fund	$3,200,000		**$3,200,000**
0163	Weights and Measures Fund	$302,000	$500,000	**$802,000**
0189	Local Government Tax Fund		$100,000,000	**$100,000,000**
0197	Epilepsy Treatment & Education Grants-in-Aid Fund	$26,000		**$26,000**
0198	Diabetes Research Checkoff Fund	$33,000		**$33,000**
0215	CDB Revolving Fund	$185,000	$900,000	**$1,085,000**
0238	IL Health Facilities Planning Fund	$372,000	$300,000	**$672,000**
0241	Transmitters of Money Act (TOMA) Consumer Protection Fund	$198,000		**$198,000**
0265	State Rail Freight Loan Repayment Fund	$8,492,000		**$8,492,000**
0277	Pollution Control Board Fund	$61,000		**$61,000**
0279	Debt Collection Fund	$9,000		**$9,000**
0286	IL Affordable Housing Trust Fund		$15,000,000	**$15,000,000**
0287	Home Care Services Agency Licensure Fund		$25,000	**$25,000**
0299	Open Space Lands Acquisition & Development Fund		$15,000,000	**$15,000,000**
0306	I-FLY Fund	$45,000		**$45,000**
0310	Tax Recovery Fund	$184,000		**$184,000**
0316	IL Prescription Drug Discount Program Fund	$256,000		**$256,000**
0356	Law Enforcement Camera Grant Fund	$2,212,000	$99,000	**$2,311,000**
0375	Natural Heritage Fund		$45,000	**$45,000**
0378	Insurance Premium Tax Refund Fund	$567,000		**$567,000**
0386	Appraisal Administration Fund	$500,000		**$500,000**
0390	IL Habitat Endowment Trust Fund		$11,600,000	**$11,600,000**
0406	Comprehensive Regional Planning Fund	$150,000		**$150,000**
0418	University Grant Fund	$9,000		**$9,000**
0424	IL Power Agency Trust Fund	$12,500,000	$11,800,000	**$24,300,000**
0429	Multiple Sclerosis Research Fund	$818,000	$82,000	**$900,000**
0430	Livestock Management Facilities Fund	$30,000		**$30,000**
0435	Charitable Trust Stabilization Fund	$393,000	$1,049,000	**$1,442,000**

No.	FY2011 INTERFUND BORROWING Fund	Aug	PA 96-0958 Sep	TOTAL
0437	Quality of Life Endowment Fund	$1,112,000		**$1,112,000**
0446	Employee Classification Fund	$15,000		**$15,000**
0449	Interpreters for the Deaf Fund	$21,000		**$21,000**
0469	Autoimmune Disease Research Fund	$4,000		**$4,000**
0474	Human Services Priority Capital Program Fund	$1,648,000		**$1,648,000**
0478	Predatory Lending Database Program Fund	$550,000		**$550,000**
0510	IL Fire Fighters' Memorial Fund	$2,783,000		**$2,783,000**
0534	IL Workers' Compensation Commission Operations Fund		$10,000,000	**$10,000,000**
0535	Sex Offender Registration Fund	$45,000		**$45,000**
0559	Downstate Transit Improvement Fund		$17,000,000	**$17,000,000**
0562	Pawnbroker Regulation Fund	$29,000		**$29,000**
0588	September 11th Fund	$77,000		**$77,000**
0621	International Tourism Fund		$1,000,000	**$1,000,000**
0623	Special Olympics IL Fund	$23,000		**$23,000**
0637	State Police Wireless Service Emergency Fund	$985,000		**$985,000**
0638	IL Adoption Registry & Medical Information Exchange Fund	$4,000		**$4,000**
0643	Auction Recovery Fund	$288,000		**$288,000**
0660	Academic Quality Assurance Fund	$33,000	$100,000	**$133,000**
0661	Private College Academic Quality Assurance Fund	$35,000		**$35,000**
0669	Airport Land Loan Revolving Fund	$90,000		**$90,000**
0678	FY09 Budget Relief Fund	$14,000,000		**$14,000,000**
0697	Roadside Memorial Fund	$7,000	$17,000	**$24,000**
0705	State Police Whistleblower Reward and Protection Fund		$1,600,000	**$1,600,000**
0714	Spinal Cord Injury Paralysis Cure Research Trust Fund	$127,000		**$127,000**
0731	IL Clean Water Fund		$767,000	**$767,000**
0738	Alternative Compliance Market Account Fund	$202,000		**$202,000**
0740	Medicaid Buy-In Program Revolving Fund	$267,000		**$267,000**
0744	IL Animal Abuse Fund	$5,000		**$5,000**
0746	Home Inspector Admin Fund	$195,000		**$195,000**
0750	Real Estate Audit Fund	$151,000		**$151,000**
0753	IL Future Teacher Corps Scholarship Fund	$88,000		**$88,000**
0778	Dept. of Human Rights Training & Development Fund	$15,000		**$15,000**
0794	Metro-East Public Transportation Fund	$91,000		**$91,000**
0795	Bank and Trust Company Fund		$8,000,000	**$8,000,000**
0797	Dept. of Human Rights Special Fund	$136,000		**$136,000**
0823	Illinois State Dental Disciplinary Fund	$1,300,000		**$1,300,000**
0830	Dept. of Aging State Projects Fund		$53,000	**$53,000**
0836	IL Power Agency Renewable Energy Resources Fund		$2,000,000	**$2,000,000**
0845	Environmental Protection Trust Fund		$780,000	**$780,000**
0849	Real Estate Research and Education Fund	$241,000		**$241,000**
0888	Design Professionals Admin and Investigation Fund	$143,000		**$143,000**
0942	Low-level Radioactive Waste Facility Development and Operation Fund		$514,000	**$514,000**
0963	Vehicle Inspection Fund		$2,800,000	**$2,800,000**
0997	Insurance Financial Regulation Fund	$3,568,000	$1,271,000	**$4,839,000**
	Total	**$60,742,000**	**$202,302,000**	**$263,044,000**

REVENUE

Revenues Continue Mixed – Interfund Borrowing Results in Monthly Increase

Jim Muschinske, Revenue Manager

September revenues posted a gain of $198 million as a drop in federal sources was more than offset by a round of interfund borrowing. The economic sources continued mixed to end the first quarter of the fiscal year. September had the same number of receipting days as last year.

For the month, gross corporate income tax grew $23 million, or $19 million net of refunds. Public utility taxes also grew by $23 million, while inheritance taxes posted gains of $19 million. Corporate franchise taxes were up $9 million, other sources $9 million, insurance taxes $7 million, and cigarette taxes $1 million.

A few sources declined in September as liquor taxes fell $12 million [related to a "stock-piling" effect experienced last year in anticipation of higher liquor tax rates], gross personal income taxes fell $9 million [but the same net of refunds], sales taxes $2 million, and interest income $2 million.

Overall transfers in September were up $234 million. Other transfers rose $237 million because of $202 million from interfund borrowing. While lottery transfers rose $2 million, that gain was offset by a falloff of $5 million in riverboat transfers. As mentioned earlier, federal sources fell in September, down $107 million.

Year to Date

Excluding short-term borrowing, base general funds revenues are up $266 million through September. However, absent $263 million from first quarter interfund borrowing, revenues would be virtually flat over the same period of last year.

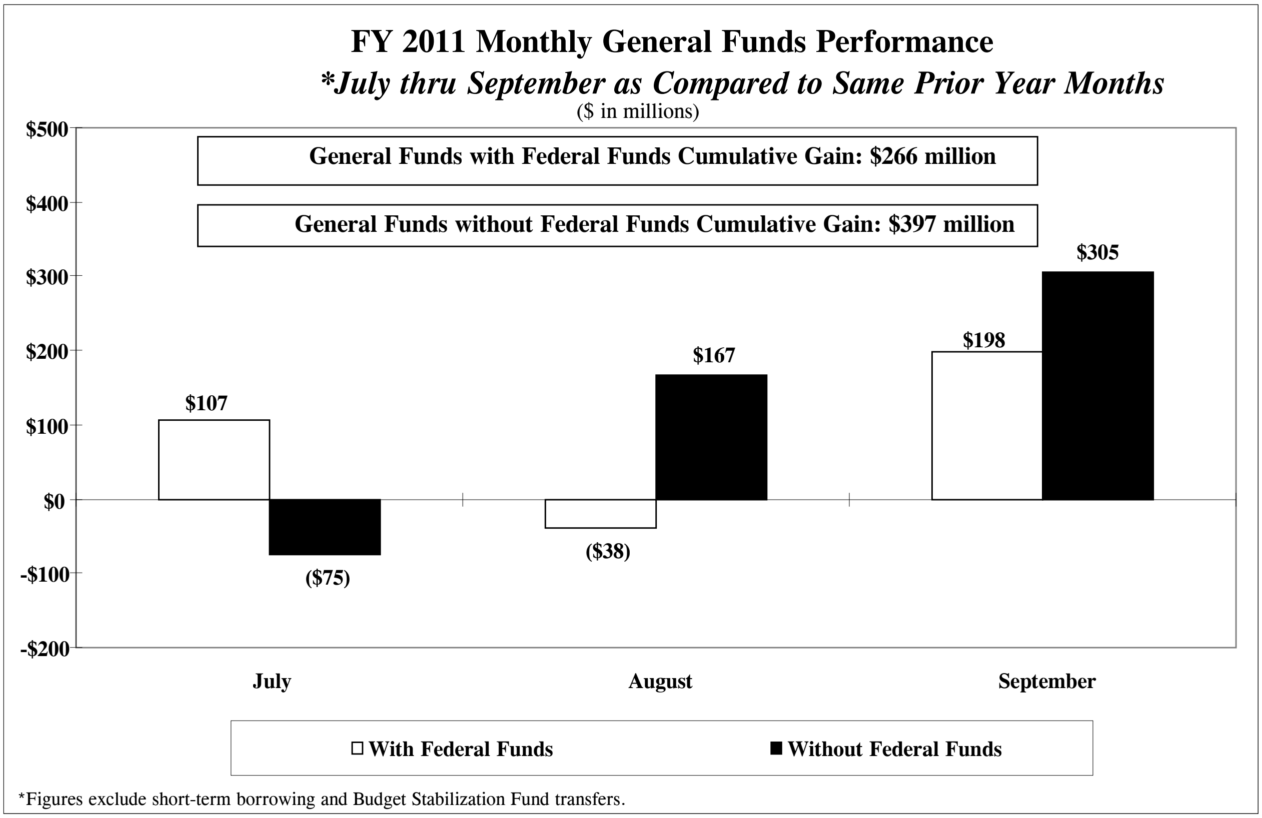
The various revenue sources are mixed to date. Gross personal income tax is up $31 million, or $49 million net of refunds. Inheritance tax is ahead by $34 million, gross corporate income tax $29 million, or $24 million net of refunds, while public utility tax is up $14 million.

A similar number of sources have experienced losses thus far in the new fiscal year. Liquor taxes are down $13 million related to "stock piling" sales of last year, interest income is off $8 million, other sources is down $8 million, sales taxes $1 million, and insurance taxes $1 million.

Overall transfers are up $298 million for the year, principally due to $263 million in interfund borrowing. Absent that activity, transfers would be up $48 million. Federal sources, after falling again in September, are now down $131 million for the year.

Review of First Quarter Revenues

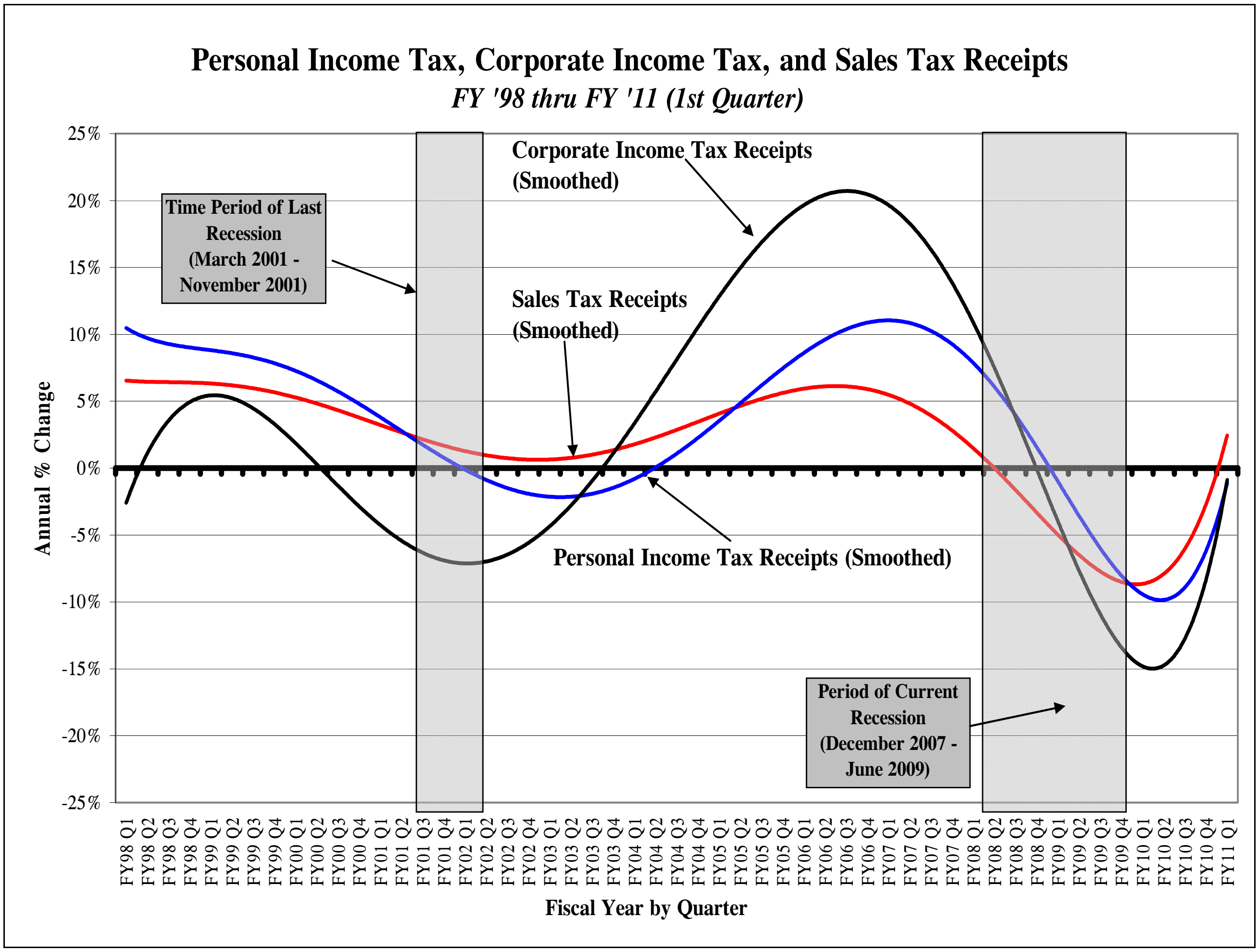
As shown on page 7, through the first quarter of FY 2011, overall base revenues are up $266 million. When the falloff in federal sources is excluded, the gain increases to $397 million. However, as mentioned earlier, much of the year to date increase is attributed to interfund borrowing, which throughout the first quarter totaled $263 million. Absent that action, receipts through the first three months of the fiscal year have been expectedly lackluster.



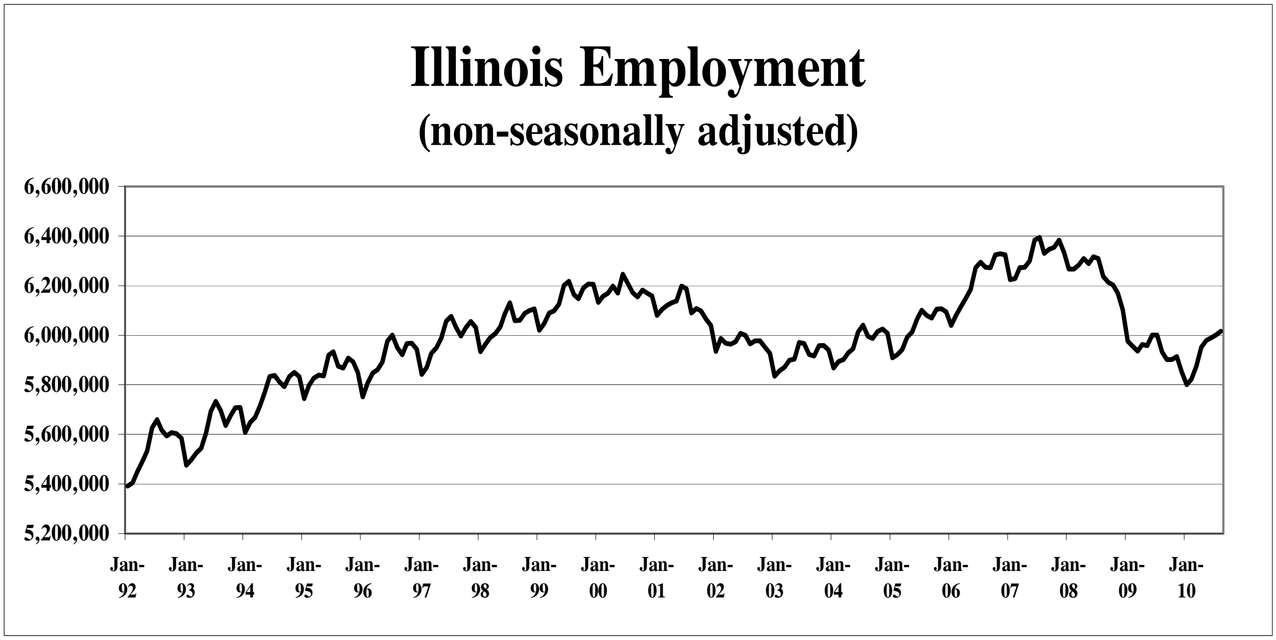
Thus far revenues have performed about as CGFA expected. Gross personal income taxes as well as gross corporate income taxes are almost identical to forecasted growth rates. Sales tax is basically flat, down slightly from where the year is expected to finish, but well within the forecast parameters at this early stage. All of the other smaller sources have performed about as expected, although inheritance tax has done surprisingly well. However, it is expected that inheritance tax will quickly fall off due to quirks in federal/state estate tax law which would preclude collection of estate tax in calendar year 2010. Due to an approximate 9-month delay in estate settlements, revenues should begin to decline substantially in the coming months.

Recovery Phase Continues But Progress Slow

As evidenced by the following graph, the larger economically tied sources continue off of lows experienced during the recession. However, given the continued weak employment forecast, as well as continued likelihood of consumer hesitancy to spend, the best that can be hoped for is continued very modest growth over the remainder of the fiscal year.



The charts on the following page demonstrates that the employment picture appears to have come off its lows experienced last fiscal year. While just barely into positive territory on a year over year percentage basis, at least we appear to have escaped the many months of negative growth. However, it should be cautioned again that the future employment picture is not expected to rapidly improve.


Illinois Employment
(non-seasonally adjusted)
6,600,000
6,400,000
6,200,000
6,000,000
5,800,000
5,600,000
5,400,000
5,200,000
Jan-92
Jan-93
Jan-94
Jan-95
Jan-96
Jan-97
Jan-98
Jan-99
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Jan-01
Jan-02
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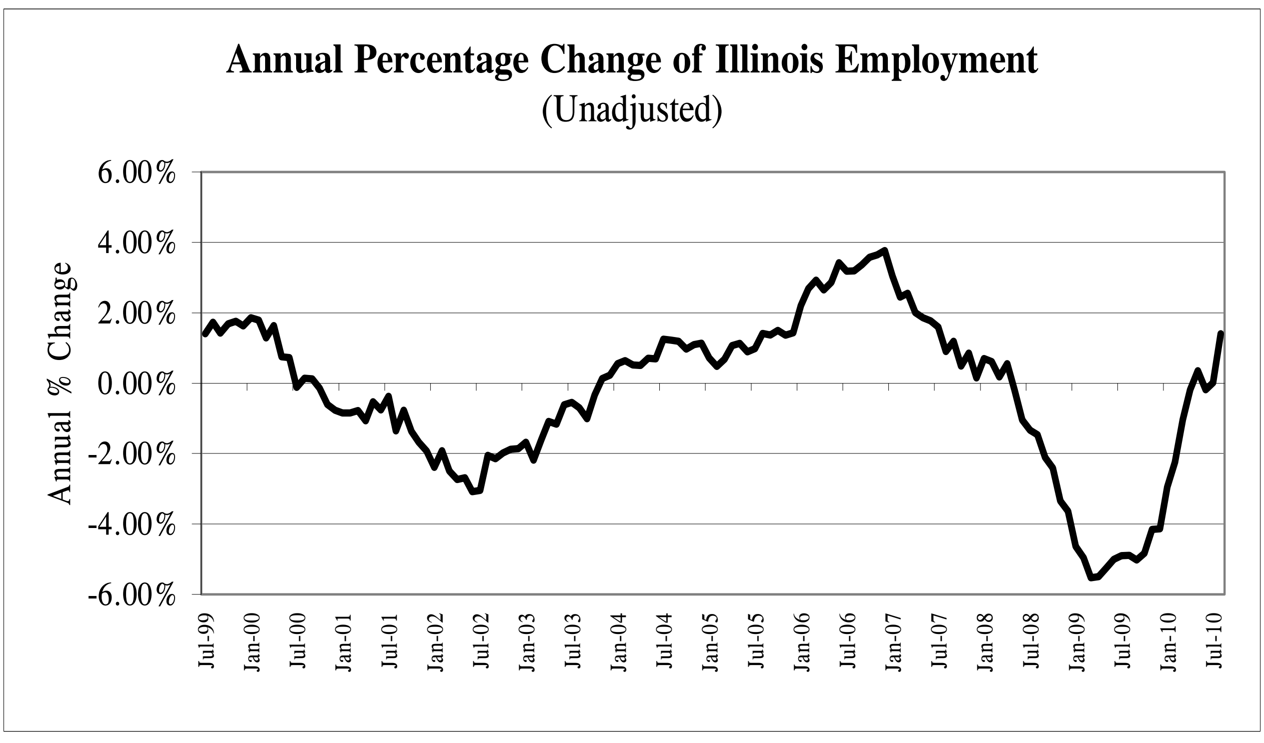
Jan-08
Jan-09
Jan-10


Annual Percentage Change of Illinois Employment
(Unadjusted)
Annual % Change
6.00%
4.00%
2.00%
0.00%
-2.00%
-4.00%
-6.00%
Jul-99
Jan-00
Jul-00
Jan-01
Jul-01
Jan-02
Jul-02
Jan-03
Jul-03
Jan-04
Jul-04
Jan-05
Jul-05
Jan-06
Jul-06
Jan-07
Jul-07
Jan-08
Jul-08
Jan-09
Jul-09
Jan-10
Jul-10

GENERAL FUNDS RECEIPTS: SEPTEMBER
FY 2011 vs. FY 2010
($ million)

Revenue Sources	Sept. FY 2011	Sept. FY 2010	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$807	$816	($9)	-1.1%
Corporate Income Tax (regular)	246	223	$23	10.3%
Sales Taxes	527	529	($2)	-0.4%
Public Utility Taxes (regular)	107	84	$23	27.4%
Cigarette Tax	30	29	$1	3.4%
Liquor Gallonage Taxes	13	25	($12)	-48.0%
Vehicle Use Tax	3	3	$0	0.0%
Inheritance Tax (Gross)	36	17	$19	111.8%
Insurance Taxes and Fees	69	62	$7	11.3%
Corporate Franchise Tax & Fees	30	21	$9	42.9%
Interest on State Funds & Investments	2	4	($2)	-50.0%
Cook County IGT	0	0	$0	N/A
Other Sources	27	18	$9	50.0%
Subtotal	$1,897	$1,831	$66	3.6%
Transfers				
Lottery	53	51	$2	3.9%
Riverboat transfers & receipts	20	25	($5)	-20.0%
Proceeds from Sale of 10th license	0	0	$0	N/A
Other	259	22	$237	1077.3%
Total State Sources	$2,229	$1,929	$300	15.6%
Federal Sources	$511	$618	($107)	-17.3%
Total Federal & State Sources	$2,740	$2,547	$193	7.6%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($71)	($80)	$9	-11.3%
Corporate Income Tax	($43)	(39)	($4)	10.3%
Subtotal General Funds	$2,626	$2,428	$198	8.2%
Short-Term Borrowing	$0	$0	$0	N/A
Pension Contribution Fund Transfer	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$2,626	$2,428	$198	8.2%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 4-Oct-10

GENERAL FUNDS RECEIPTS: YEAR TO DATE

FY 2010 vs. FY 2009

($ million)

Revenue Sources	FY 2011	FY 2010	CHANGE FROM FY 2010	% CHANGE
State Taxes				
Personal Income Tax	$2,135	$2,104	$31	1.5%
Corporate Income Tax (regular)	321	292	$29	9.9%
Sales Taxes	1,606	1,607	($1)	-0.1%
Public Utility Taxes (regular)	265	251	$14	5.6%
Cigarette Tax	88	88	$0	0.0%
Liquor Gallonage Taxes	42	55	($13)	-23.6%
Vehicle Use Tax	8	8	$0	0.0%
Inheritance Tax (Gross)	90	56	$34	60.7%
Insurance Taxes and Fees	85	86	($1)	-1.2%
Corporate Franchise Tax & Fees	58	49	$9	18.4%
Interest on State Funds & Investments	3	11	($8)	-72.7%
Cook County IGT	0	0	$0	N/A
Other Sources	90	98	($8)	-8.2%
Subtotal	$4,791	$4,705	$86	1.8%
Transfers				
Lottery	135	128	$7	5.5%
Riverboat transfers & receipts	80	100	($20)	-20.0%
Proceeds from Sale of 10th license	0	0	$0	N/A
Other	485	174	$311	178.7%
Total State Sources	$5,491	$5,107	$384	7.5%
Federal Sources	$1,462	$1,593	($131)	-8.2%
Total Federal & State Sources	$6,953	$6,700	$253	3.8%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($187)	($205)	$18	-8.8%
Corporate Income Tax	($56)	($51)	($5)	9.8%
Subtotal General Funds	$6,710	$6,444	$266	4.1%
Short-Term Borrowing	$1,300	$1,250	$50	N/A
Pension Contribution Fund Transfer	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$276	($276)	-100.0%
Total General Funds	$8,010	$7,970	$40	0.5%

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

CGFA 4-Oct-10

Lottery Hires a Private Manager

Ben Varner, Revenue Analyst

On September 15, 2010, Governor Quinn selected the Northstar Lottery Group to manage the Illinois lottery. As part of Public Act 096-0034, the Illinois lottery was to be operated with the assistance of a private manager. The private management agreement was to be entered into by March 1, 2010. Due to delays, this date was pushed back to September 15, 2010 by Public Act 096-0840. This proposed agreement allows for State oversight of the lottery through the creation of the Illinois Lottery Advisory Board that will evaluate the lottery's performance on such topics as employment opportunity, minority business opportunity planning, responsible gaming, consumer protection, charitable and philanthropic progress and overall performance review. The management agreement will be finalized in the coming weeks. A transition period will likely begin in October of 2010, leading to a ramp up period that starts in February, 2011. Northstar will fully take over management of the lottery on July 1 of 2011.

Responses to the Lottery's request for proposal related to the private management agreement were due on July 30, 2010. Three groups submitted formal bids for the private management contract. Those bidders included Intralot, Camelot Group, and Northstar Lottery Group. Intralot is a lottery vendor and operator most well known for running the Greek lottery. The Camelot Group is the operator of the UK National Lottery. The Northstar Lottery Group is a consortium made up of current Illinois lottery vendors including Gtech, Scientific Games, and Energy BBDO. On August 30, 2010, the Illinois Lottery announced that the Camelot Group and the Northstar Lottery Group were the finalists for the management contract. Final binding offers were due on August 30, 2010 with meetings with Finalist's management teams to follow. A public hearing was held on September 8, 2010 to allow for the finalists to present their proposals and allow the public to comment on the proposals. Both Intralot and Camelot filed formal protests with the Illinois Department of Revenue concerning the bidding process following the selection of the Northstar Group as the winner. This protest will be reviewed by the Department of Revenue and an additional review by the Illinois State courts can be requested.

Northstar's business plan anticipates annual growth of 10.6% over the first five years. The group will receive an annual $15 million management fee over the course of the 10-year contract. Additional revenue bonuses or penalty payments could be warranted depending upon net income results. The table on the next page outlines net income target levels and the potential bonuses or penalties. The table contains two Net Income Target columns; one net income target with lottery sales from the internet included and one without. This was done as the legality of internet sales of the lottery remains in doubt. Initial discussions with the Department of Justice regarding internet sales of lottery tickets have occurred but no timeframe has been offered as to when an actual opinion would be given.

Northstar could earn up to 5% of net income in bonuses or penalties depending upon the lottery's performance. Illinois had net income of approximately $662 million in FY 2010. Five percent of this amount would equal just over $33 million. As part of the management agreement, Northstar will guarantee net income levels over the course of the agreement. If net income levels do not reach these levels, Northstar will be penalized. These penalties become less severe the closer net income is the target levels. It must also be noted that the $15 million management fee would be part of lottery operating expenses and not be based upon lottery performance.

LOTTERY PRIVATE MANAGEMENT INCOME TARGETS
($ Millions)

Fiscal Year	Base Level Income	Middle Level Income	Upper Level Income	Net Income Target (with Internet)	Net Income Target (without Internet)
FY 2012	$674	$714	$754	$851	$825
FY 2013	$651	$727	$804	$950	$916
FY 2014	$666	$771	$876	$980	$941
FY 2015	$682	$810	$938	$986	$923
FY 2016	$698	$833	$967	$1,000	$927
FY 2017	$712	$854	$995	*	*
FY 2018	$727	$871	$1,016	*	*
FY 2019	$742	$889	$1,037	*	*
FY 2020	$757	$908	$1,058	*	*
FY 2021	$773	$926	$1,080	*	*

* To be set by management pursuant to the Annual Business Plan process described in Article 5.3.3 of the management agreement

Private manager bonuses:

- 10% of any net income greater than base level but less than middle level
- 20% of any net income greater than middle level but less than upper level
- 30% of any net income greater than the upper level

Private manager penalties:

- If net income is above the net income target
  - None
- If net income is above the base level but below the net income target
  - 50% of the difference between net income target and net income
- If net income is below the base level
  - 100% of the difference between net income and base level and 50% of the difference between net income target and base level

Any bonuses or penalties are capped at 5% of net income.

A payout example assuming $700 million in net income in FY 2012 and no internet sales -
Northstar would:

- receive $15 million as part of operating expenses,
- receive $2.6 million for net income being above base level income of $674 million,
- and owe $35 million for net income being below the net income target of $825 million.

Note that Northstar would only owe $35 million as penalties are capped at 5% of net income.

SOURCE: Illinois Lottery

The proposed management agreement allows for a process, for either the State or Northstar, to request a change in the net income target amounts. This request would be based on potential changes in the market place that could significantly change lottery performance. Some examples of these changes might include the allowance of keno games or major changes in other wagering related industries such as casinos, video poker, or horse racing that would have a substantial effect on the lottery.

PENSIONS

Actuarial Assumptions Used in Pension Plan Actuarial Valuations

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The choice of actuarial assumptions plays a very important role in determining the results of an actuarial valuation of a pension plan. Actuarial assumptions are intended to be "best estimates" of future experience, generally derived from an extrapolation of past experience, with possible modification to take into account changes anticipated in the future. According to Section 1A-110 of the Illinois Pension Code, an actuary performing an actuarial valuation of an Illinois public pension fund is to use actuarial assumptions that are "reasonably related to the experience of the plan and to use reasonable expectations and represent in the aggregate the actuary's best estimate of anticipated experience under the plan".

Actuarial assumptions can be classified as being either decrement assumptions or economic assumptions. Decrement assumptions involve estimates regarding future events such as how long employees will stay in active service, the ages at which employees will retire, how long they will live after retirement, etc. Economic assumptions reflect the impact of economic forces on benefit amounts and costs, such as rates of investment return and general increases in salary levels. Mortality rates, termination rates, disability rates, and retirement rates all fall under the category of decrement assumptions. An actuary will generally base such assumption on a recent experience analysis of the plan covering a period of 3 to 5 years.

The rate of investment return assumption, also referred to as the interest rate assumption, is the most important economic assumption used by the actuary. The investment return assumption represents an estimate of the expected long-term average rate of return for the fund, including capital appreciation. In setting the investment return assumption, the recent experience of a fund is of limited value since the investment return assumption applies over a period of 50 to 60 years.

In setting the investment return assumption, the actuary will first examine the fund's target asset allocation policy and determine the percentage of assets the fund plans to invest in each asset class. The actuary will then adopt a long-term expected return assumption for each asset class, based on input from investment consultants and other investment experts. On this basis, the actuary will then determine the fund's long-term expected rate of return. The investment return assumption should be within a "best-estimate" range that is specified under actuarial standards of practice.

Changes in actuarial assumptions can have a significant impact on the results of an actuarial valuation. Valuation results are particularly sensitive to changes in the investment return assumption. A rough rule of thumb is that a 1% reduction in the interest rate assumption will increase actuarial liabilities and contribution requirements by approximately 25%. Therefore, it is estimated that a .5% reduction in the investment return assumption would increase actuarial liabilities and contribution requirements by approximately 12.5%.

The Actuarial Standards Board, established by the actuarial profession, sets actuarial standards of practice. Actuarial Standard of Practice No. 27 applies to the selection of economic assumptions for measuring pension obligations. Actuarial Standards of Practice No. 35 applies to the selection of demographic assumptions for measuring pension obligations. In preparing an actuarial report, an actuary will usually state that the report has been prepared in accordance with generally accepted actuarial principles and practices. An actuary who does not follow the standards established by the Actuarial Standards Board may be subject to disciplinary action by the actuarial profession.