Commission on Government Forecasting and Accountability

MONTHLY BRIEFING DECEMBER 2007

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ECONOMY: New Year Enters on a Weak Note

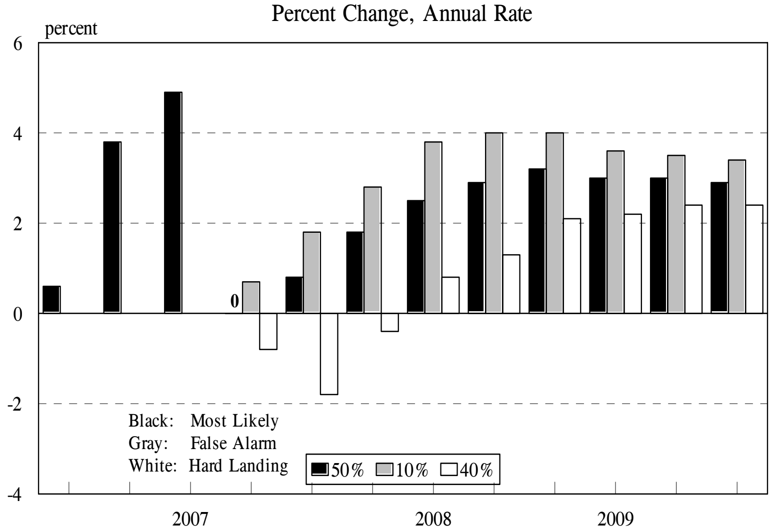
Edward H. Boss, Jr., Chief Economist

The economy is ending on a weak note by any measure and is likely to exhibit below trend growth at least through the first half of 2008. Chart 1 represents alternative scenarios of U.S. economic performance as measured by annual rates of change in real gross domestic product (GDP) projected in December by *Global Insight;* a well respected forecasting service used by the Commission. The three scenarios of the economy also are depicted by the odds of their occurrence: a 50% chance being the most likely; a 40% chance of a hard landing leading to a recession, and a slight 10% chance that the recent weakening in economic activity turns out to be a false alarm.

As shown, even the most likely scenario shows the economy recording no, or zero, growth in the final three months of 2007 while the next most likely, hard landing scenario, shows the

CHART 1

ALTERNATIVE SENARIOS OF U.S. ECONOMY
Percent Change, Annual Rate



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Source: Global Insight

economy declining for three consecutive quarters through the first half of 2008, clearly a recession, before a weak recovery occurs in the second half of the year. Moreover, it should be pointed out that the forecasting firm has upped the odds of a hard landing in recent months from a 20% chance in July and August, to 30% in September and October, to 35% in November and 40% in December. Similarly, the previous Federal Reserve Chairman, Alan Greenspan, as early as February stated that a recession could occur before the end of this year (2007); by September he said the odds of a recession were less than 50%, but in December, when asked if the economy would tip into recession, he said "It's too soon to say, but the odds are clearly rising."

Not only is there concern over the weakening pace of economic growth, but it is occurring at the same time that prices have shown an accelerated pace of increase. This combination suggests a period of "*stagflation*", the worse of both worlds as the economy stagnates while inflation increases, and the unemployment rate rises. The term stagflation described conditions in the 1970s. Inflation seemed to feed upon itself as consumers began to anticipate continuous price increases and increased spending. In return, this increased demand pushed up prices further, which led to higher wage demands, labor contracts that included cost of living increases, and government that pegged entitlement spending such as social security payments to increases in the consumer price index. The later increased government spending swelled the budget deficit that pushed up interest rates that increased costs for business and consumers even further. Together with high energy costs and interest rates, business spending weakened and unemployment rose.

While various government programs such as increasing government spending to ease a weakening economy and voluntary wage and price guidelines to control inflation were tried, both courses of action proved unsuccessful and it wasn't until the Federal Reserve took strong action to control the money supply that the back of inflation was broken. This, however, led to an abrupt slowing in business and consumer spending and to the twin recessions in the early 1980s, the worse economic period of decline in the post World War II period.

At this stage, while the odds of a recession may have increased, a period of sluggish growth seems more likely and any repeat of the conditions like the 1970s period of stagflation seem highly unlikely for a number of reasons. First, inflation expectations are not ingrained, the unemployment rate is still low, the budget deficit as a percent of GDP has been declining not rising, and interest rate levels are low and likely to fall further. Even so, a significant slowing in economic activity will impact revenues to the State from economically sensitive sources and limit the ability to increase spending.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS	NOV. 2007	OCT. 2007	NOV. 2006
Unemployment Rate (Average)	5.2%	5.3%	4.0%
Annual Rate of Inflation (Chicago)	6.5%	1.4%	5.0%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (November)	6,790	0.7%	1.8%
Employment (thousands) (November)	6,438	0.8%	0.6%
New Car & Truck Registration (November)	36,712	-38.5%	-11.3%
Single Family Housing Permits (November)	1,381	-35.8%	-39.1%
Total Exports ($ mil) (October)	4,522	9.7%	18.2%
Chicago Purchasing Managers Index (December)	56.6	7.0%	8.0%

REVENUE

December Revenues Up In Part Due To Receipt Reconciliations

Jim Muschinske, Revenue Manager

Overall receipts in December gained $95 million. While the economically related sources appeared to perform very well, receipt issues involving sales tax and corporate income taxes serve to mitigate most of those gains. December had the same number of receipting days as last year.

Gross personal income taxes continued to perform well in December, with receipts up $84 million or $76 million net of refunds. While sales tax receipts were up $76 million for the month, optimism must be tempered due to an earlier misallocation of sales tax revenue at the Department of Revenue. Evidently, over the first five months of the fiscal year, approximately $75 million in sales tax receipts were inadvertently directed to the Local Government Tax Fund rather than to the General Fund. As a result, most--if not all--of the jump in sales tax receipts appears due to subsequent reconciliations completed in December. This is the second time in the past year that a misallocation of sales tax revenues has taken place. The resulting artificial peaks and valleys that is caused by these occurrences makes tracking, reporting on, and predicting sales tax revenue difficult.

In addition, while gross corporate income tax was up $31 million, or $26 million net of refunds for the month, since no corporate income taxes were receipted in November due to a computer system conversion at the Department of Revenue, December revenue included the prior month as well. Therefore, after taking that into account, actual December corporate income tax receipts were basically flat. The Cook County IGT was up $16 million due to timing of receipts; inheritance had another very good month and gained $10 million; other sources grew $5 million; and, corporate franchise managed a $2 million increase.

Despite the overall gain in revenue, a few sources suffered monthly losses. Insurance taxes and fees fell $42 million, although timing of receipts may be the cause and will be known next month. Public utility taxes dropped $11 million, liquor taxes eased $3 million, and interest income dipped $2 million.

Overall transfers grew $39 million in December. While riverboat gambling transfers were flat, lottery transfers increased $16 million, and other transfers gained $23 million. Federal sources had another relatively poor showing as receipts fell $97 million for the month.

Year to Date

Through the first half of the fiscal year, overall base receipts were up $574 million. However, $206 million of those gains can be attributed to gains in federal sources associated with reimbursable spending. Excluding those gains, all other receipts have grown by $368 million, reflecting lack of growth in a number of the larger revenue sources.

One area that continues to fare well is gross personal income tax receipts. Through December, receipts are up $337 million or $304 million on a net of refund basis. While this revenue source continues to be fueled by gains in withholding, estimated, and final payments, it would not be surprising to see growth rates of all three components moderate in the coming months, perhaps even significantly. While the strength in personal income tax has been a welcomed surprise, weakness in corporate income tax has been expected, albeit not quite to the degree that has been experienced. Through the first six months of the year, gross corporate income tax has fallen $45 million or $36 million net of refunds. Also underperforming is sales tax, as receipts are only up $31 million, or less than one-percent. As indicated back in the September briefing, meaningful growth in corporate income taxes as well as sales taxes will be difficult to obtain, particularly as the near-term outlook offers few bright spots.

Some positive news continues to come from the strength of inheritance tax—up $51 million, corporate franchise tax $20 million, and interest earnings $14 million. However, while lottery and riverboat transfers are up $36 million and $15 million, respectively, other transfers more than erased those gains and are down $57 million. Finally, despite the recent drop off in federal sources, due to significant earlier reimbursable spending, federal sources are still up $206 million for the year.

GENERAL FUNDS RECEIPTS: DECEMBER

FY 2008 vs. FY 2007
($ million)

Revenue Sources	Dec. FY 2008	Dec. FY 2007	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$773	$689	$84	12.2%
Corporate Income Tax (regular)	320	289	$31	10.7%
Sales Taxes	714	638	$76	11.9%
Public Utility Taxes (regular)	85	96	($11)	-11.5%
Cigarette Tax	29	29	$0	0.0%
Liquor Gallonage Taxes	14	17	($3)	-17.6%
Vehicle Use Tax	2	2	$0	0.0%
Inheritance Tax (Gross)	28	18	$10	55.6%
Insurance Taxes and Fees	21	63	($42)	-66.7%
Corporate Franchise Tax & Fees	15	13	$2	15.4%
Interest on State Funds & Investments	15	17	($2)	-11.8%
Cook County IGT	16	0	$16	N/A
Other Sources	27	22	$5	22.7%
Subtotal	$2,059	$1,893	$166	8.8%
Transfers				
Lottery	59	43	$16	37.2%
Riverboat transfers & receipts	60	60	$0	0.0%
Other	41	18	$23	127.8%
Total State Sources	$2,219	$2,014	$205	10.2%
Federal Sources	$233	$330	($97)	-29.4%
Total Federal & State Sources	$2,452	$2,344	$108	4.6%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($75)	($67)	($8)	11.9%
Corporate Income Tax	($56)	(51)	($5)	9.8%
Subtotal General Funds	$2,321	$2,226	$95	4.3%
Short-Term Borrowing	$0	$0	$0	N/A
Hopital Provider Fund (cash flow transfer)	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$2,321	$2,226	$95	4.3%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 2-Jan-08

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	$4,531	$4,194	$337	8.0%
Corporate Income Tax (regular)	775	820	($45)	-5.5%
Sales Taxes	3,726	3,695	$31	0.8%
Public Utility Taxes (regular)	514	530	($16)	-3.0%
Cigarette Tax	175	175	$0	0.0%
Liquor Gallonage Taxes	82	80	$2	2.5%
Vehicle Use Tax	18	17	$1	5.9%
Inheritance Tax (Gross)	200	149	$51	34.2%
Insurance Taxes and Fees	114	147	($33)	-22.4%
Corporate Franchise Tax & Fees	116	96	$20	20.8%
Interest on State Funds & Investments	117	103	$14	13.6%
Cook County IGT	87	62	$25	40.3%
Other Sources	196	185	$11	5.9%
Subtotal	$10,651	$10,253	$398	3.9%
Transfers				
Lottery	307	271	$36	13.3%
Riverboat transfers & receipts	370	355	$15	4.2%
Other	301	358	($57)	-15.9%
Total State Sources	$11,629	$11,237	$392	3.5%
Federal Sources	$2,367	$2,161	$206	9.5%
Total Federal & State Sources	$13,996	$13,398	$598	4.5%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($442)	($409)	($33)	8.1%
Corporate Income Tax	($135)	($144)	$9	-6.3%
Subtotal General Funds	$13,419	$12,845	$574	4.5%
Short-Term Borrowing	$1,200	$0	$1,200	N/A
Hospital Provider Fund (cash flow transfer)	$300	$0	$300	N/A
Budget Stabilization Fund Transfer	$276	$276	$0	0.0%
Total General Funds	$15,195	$13,121	$2,074	15.8%

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

CGFA 2-Jan-08