ILLINOIS ECONOMIC
and
FISCAL COMMISSION

FY 2002: A Retrospective of Economic and General Revenue Performance

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EXECUTIVE SUMMARY

On June 30th, Illinois, like many other states, was relieved to see the book finally closed on FY 2002. Not in recent history have state finances been dealt such devastating blows as those experienced over the last twelve months. Estimates of nationwide deficits range from $40 billion to $50 billion. In Illinois, revenues fell over $1.6 billion short of what was assumed as the FY 2002 budget year began. While the fiscal year has ended, its impact will be felt for a number of years as states begin to crawl out of their budgetary quagmires.

Before all attention is focused on the new fiscal year just begun, since so much occurred over the last year, the Commission felt it worthwhile to conduct a retrospective analysis of FY 2002. This report is essentially divided into two parts; the beginning of the report includes a brief history of general revenues and balances and then moves into a detailed chronology of the FY 2002 revenue shortfall, including both economic and revenue observations. This section utilizes excerpts from the Commission's monthly briefings and other reports, coupled with doses of hindsight to provide an accounting of what transpired.

The question that many states were asking as their revenue picture continued to deteriorate was, "If this is such a mild recession, why are revenues being so severely impacted". The second part of the report offers some insight of the FY 2002 recession and provides some answers to "What was different this time?" The analysis looks at a number of different reasons why, despite being a classically-defined mild recession, its impact was particularly hard felt on state revenues.

A summary of some of the most significant comments and observations are found below.

- While the brunt of the State's fiscal difficulties occurred during FY 2002, the departure from the record growth experienced in the fiscal years of the late 1990s began to surface and cause concern midway through FY 2001.

- FY 2001 ended on a down note. Revenues failed to meet forecasts and would have been much worse hadn't federal sources dramatically exceeded expectations in the last month of the fiscal year. Also at that time, despite weakening revenues, a continued mixed bag of economic measurements gave some degree of optimism that a bottom may be nearing.

- Therefore, as FY 2001 concluded, a significant amount of uncertainty weighed on the economic and revenue forecasts. Were the numerous interest rate cutting moves by the Fed in conjunction with the just-passed Economic Growth and Tax Relief Reconciliation Act of 2001 going to be able to provide enough impetus to avoid a recession? Actually, in many regards, whether we were going to meet

the classical definition of a recession or not was irrelevant. We were clearly in a period of no growth. The larger question was how long would this downturn last as well as its severity.

- As a sign of things to come, July (2001) receipts started out on a down note as monthly revenues fell approximately $99 million from the prior year. As August ended, while receipts would fall another $45 million for the month, bringing the yearly decline to $144 million, signals were beginning to indicate that improvement might be coming as the manufacturing sector began to show improvement.

- Then the unimaginable occurred on September 11th. While the monetary effects of those events are debatable, it very well could have been the preverbal straw that broke the camel's back. While the National Bureau of Economic Research would not call an official recession for a couple of more months, it was obvious that the likelihood of such designation had increased significantly.

- While the FY 2002 forecast was predicated on a rather poor first half of the fiscal year followed by a second half rebound, there is no doubt that the first quarter had significantly under performed even those modest expectations. With the additional impact of the terrorist attacks and the economic uncertainty brought with it, the estimate would have to be adjusted downward. On October 23, 2001, the general funds estimated was lowered $300 million.

- In October, revenues gained $34 million followed by a $53 million upturn in November. At the same time revenues were signaling that the worst may be over, the NBER, the official designators of U.S. business cycle expansions and contractions, determined what many had expected, that is that the U.S. economy was in recession and had been since March 2001.

- Taken as a whole, there was beginning to be signs that the recession would indeed be of a mild composition whose term would end shortly after the beginning of the new year. Yet despite this view, a word of caution also was made regarding future revenues.

- December marked the third month of positive revenue performance as receipts grew $124 million. After starting off the fiscal year with a dismal first quarter that experienced a drop of $296 million, a surprising second quarter (surprising because of the events of September 11th), erased all but $85 million of that decline. With continued signs of improvement, it was hoped that the worse was over.

- As the third quarter of the year began, we entered into what was later described being as a "disconnect" between economic signals and actual revenue

performance. While the actual divergence likely started prior to this point, it was now that it began to fully manifest.

- While positives were being highlighted at the economic level, actual revenue performance began to take on a pall. In January 2001, receipts fell $90 million as income taxes began what would become a trend of underperformance. It was at this time that the Commission again stated that the revenue shortfall was continuing.

- On February 22nd 2002, the Commission met to discuss the deteriorating revenue picture for FY 2002. A downward revision of $330 million was made to the forecast and, in addition, the first official estimate for FY 2003 was also presented. It was during this February meeting that a brief glimpse of the shape that other states were in was presented. As of January, 46 states were experiencing revenues falling below projections; 30 had expenditures over budget; 39 had instituted budget cuts or holdbacks; 26 had used some of their reserves; and 30 were using other measures to balance their budgets. Clearly, Illinois was not alone in its mounting fiscal crisis.

- At the time the preliminary FY 2003 revenue forecast was presented, while base economic assumptions were forecast to improve in FY 2003, a number of other issues were discussed as significantly curtailing overall revenue growth. These items included losses in revenues do to the phase-out of the federal inheritance tax, lower transfers, lower federal source reimbursements due to program spending cuts, and increased income tax refunds.

- By the end of the third quarter it was clear that FY 2002 general revenues would fall short of last year's actuals. A stunning thought given the phenomenal growth of fiscal years just past, as well as revenue performance through much more severe recessionary cycles

- The fourth quarter of FY 2002 began with a Commission meeting on April 10th. While the Commission was not planning to meet in April, the seriousness of the continuing revenue shortfall justified its occurrence. At that meeting, given the dismal performance of the larger revenue sources, and the unlikelihood of an immediate turnaround, it was discussed that revenues could fall as much as $500 million less than last year.

- At the same time revenues continued to tank, the economic disconnect continued unabated as a number of positive signs were discussed. Specifically, the manufacturing sector as well as the service sector showed improvement, as did employment measures. Housing permits, buoyed by lower interest rates continued to soar in Illinois, inflation remained tame, and consumer optimism continued to strengthen.

- The Commission met on May 8th 2002, to hear the latest on the revenue falloff. At that meeting a number of items were discussed, including an attempt to explain how such a classically-defined mild recession (only one quarter of declining GDP) could be wreaking such havoc on State revenues.

- Due to the continued degradation of the revenue picture, the FY 2002 estimate was again substantially reduced, this time by $546 million bringing the total adjustments for the fiscal year to $1.176 billion. The revised estimate of $23.650 billion represented a yearly decline of $456 million and represented revenues falling $1.35 billion below the enacted FY 2002 budgeted level.

- As the month of May ended, with it ended any hopes of a late-stage receipt pickup as May revenues dropped $224 million. That marked the fifth consecutive monthly decline that translated into a year-to-date drop off of $673 million from the same period the year before.

- FY 2002 concluded with another down month for revenues as June receipts fell another $55 million bringing the total yearly decline to an unbelievable $728 million (excludes Budget Stabilization fund transfers of $226 million).

- In addition to the disappointing revenue performance to end the year, economic indicators have begun to signal that the recovery may be taking a breather. As mentioned in the June 2002 briefing, personal consumption expenditures fell to their weakest reading since November, and consumer confidence has started to retrench following the continued stock market deterioration.

- While base growth in the more closely tied economic revenue sources are expected to fare better next year, much of the anticipated growth for FY 2003 will come from legislative changes, rather than natural revenue growth. In large part due to the State's fiscal problems, a number of recent legislative changes will be in effect for FY 2003. They include increasing the cigarette tax, allowing significant interfund transfers, increasing riverboat gambling taxes, and decoupling from the bonus depreciation provision passed by the Federal Government. In total, these items will serve to increase general revenues by over $500 million what they otherwise would have been.

- To most economists the past recession was classified as mild. While certain statistics, including the usual GDP measurement would bear that out, digging deeper, a number of reasons surface as to why this recession may have been particularly difficult for state finances.

- **Measurements of GDP** - The effect on State revenues was much more dire than one would have expected because the downturn in activity measured in current, or non-deflated dollars was greater than that shown by changes in real GDP.

This recession, as measured in current dollars, while not as deep as the 1981-82 experience, was indeed more severe than that which occurred in the 1990-91 recession. This measurement of GDP is more relevant to State revenue performance as revenues are also measured in current dollars.

- **Downturn Concentrated in Business Sectors** - Another difference in the current period from that which occurred in the previous recessions is where the weakness has centered. In the current experience, consumer demand did not wane as much as in the past, instead the weakness was concentrated in business spending. This in turn reflected the much more severe downturn in business profits that occurred during this recession compared to earlier ones. The sharp downturn in profits in 2001 was unprecedented and undoubtedly was the major contributing factor to the retrenchment that occurred in business spending.

- **Cyclical Differences** - While a slowing economy and lack of inflation allowed an aggressive Federal Reserve policy which sharply reduced interest rates, the combination of reduced state balances and these abnormally-low interest rates decimated revenues derived from interest on investments. Another cyclical difference has been the performance of the equity markets. It is rare that an economic recovery has been met by a declining equity market.

- **Decimated Income Taxes** - A decline in the equity markets virtually decimated capital gains collections after several years where this had become an increasing source of revenue. In addition to precipitating layoffs, the recession greatly reduced bonuses and other compensation that had swelled during the boom years when equity prices had skyrocketed. Finally, record layoffs, rising unemployment rates, and falling profits not only have depressed individual incomes, but corporate income as well.

- **Terrorist Attacks Economy** - While it is disingenuous to blame the events of September 11th for the revenue shortfall; it nevertheless was the straw that broke the camel's back. It caused an economy that already was on the verge of recession to enter into a full-fledged recession—the first in a decade.

Brief Revenue History

In order to put the current revenue picture into a meaningful context, a brief history of revenues is provided. The following table depicts a history of general funds revenues dating back to FY 1981. Absent the growth in FY 1984 associated with the full fiscal year of the temporary income tax increase, the period of phenomenal revenue growth really manifested itself in FY 1995. From FY 1995 through FY 2000, revenues grew at an average annual amount of $1.277 billion. Very strong growth of the most closely-tied economic sources such as income taxes and sales taxes were the drivers behind those years.

TABLE 1: GENERAL FUNDS HISTORY OF REVENUES
FY 1981 to FY 2002
Excludes short-term borrowing ($ in millions)

Fiscal Year	Total General Funds	$ Change	% Change
1981	$8,100	$658	8.8%
1982	$8,265	$165	2.0%
1983	$8,287	$22	0.3%
1984*	$9,657	$1,370	16.5%
1985	$10,317	$660	6.8%
1986	$10,583	$266	2.6%
1987	$10,957	$374	3.5%
1988	$11,620	$663	6.1%
1989	$12,133	$513	4.4%
1990	$12,841	$708	5.8%
1991	$13,261	$420	3.3%
1992	$14,032	$771	5.8%
1993	$14,750	$718	5.1%
1994	$15,586	$836	5.7%
1995	$17,002	$1,416	9.1%
1996	$17,936	$934	5.5%
1997	$18,854	$918	5.1%
1998	$19,984	$1,130	6.0%
1999	$21,674	$1,690	8.5%
2000	$23,250	$1,576	7.3%
2001	$24,106	$856	3.7%
2002	$23,378	($728)	-3.0%

*Full fiscal year of temporary income tax increase

Not surprisingly, this period of significant revenue growth coincided with a dramatic improvement in the State's financial situation. One measure of that improvement is depicted in the following table which provides a history of the end-of-year general funds balances both before and after lapse period spending. As shown, just as revenue growth improved dramatically over the second half of the 1990s, so did end-of-year

balances as well as balances after lapse spending, which culminated in record amounts at the end of FY 2000.

TABLE 2: GENERAL FUNDS REVENUE & BALANCES – CASH BASIS Excludes Short-Term Borrowing ($ in millions)				
Fiscal Year	General Revenue	June 30 Balance	Lapse Spending	Balance After Lapse
1981	$8,100	$197	$278	($81)
1982	$8,265	$187	$497	($310)
1983	$8,287	$110	$467	($357)
1984	$9,657	$217	$389	($172)
1985	$10,317	$479	$434	$45
1986	$10,583	$288	$441	($153)
1987	$10,957	$154	$472	($318)
1988	$11,620	$246	$322	($76)
1989	$12,133	$541	$393	$148
1990	$12,841	$395	$586	($191)
1991	$13,261	$100	$766	($666)
1992	$14,032	$131	$1,018	($887)
1993	$14,750	$172	$802	($630)
1994	$15,586	$230	$652	($422)
1995	$17,002	$331	$672	($341)
1996	$17,936	$426	$718	($292)
1997	$18,854	$806	$761	$45
1998	$19,984	$1,202	$846	$356
1999	$21,674	$1,351	$848	$503
2000	$23,250	$1,517	$740	$777
2001	$24,106	$1,126	$826	$300
2002	$23,378	$256	$1,400*	($1,144)

*Estimated FY 2002 Lapse Spending
Balances Exclude $226 in Budget Stabilization Fund for FY 2001 and FY 2002

Then, quite suddenly, the State's fiscal fortunes turned. In FY 2001, the pace of revenue growth dramatically slowed and the measures of balances also fell. The pace of degradation continued to accelerate throughout FY 2002 to the point where revenues actually suffered a substantial year-over-year decline, and balance measures were dramatically weaker.

While these two tables are unable to provide a complete picture of the State's financial condition, they do a remarkable job of illustrating the speed at which things can change, both for the better and the worse. With that brief background, the following section focuses in a more detailed manner on how things deteriorated over the past year and one half. For consistency purposes, past Commission monthly briefings and other periodic reports were used to highlight these developments.

Chronology of FY 2002 Revenue Shortfall

While the brunt of the State's fiscal difficulties occurred during FY 2002, the departure from the record growth experienced in the fiscal years of the late 1990s began to surface and cause concern midway through FY 2001. In the Commission's December 2000 Monthly Revenue Briefing, the following was discussed.

> *Increasing Use of the "R" Word*
> *The dramatic slowing in the pace of the U.S. economy is raising the prospects of a possible recession in the year ahead. While most economists still feel a "soft landing" can be achieved—that is slower economic growth but no contraction, about all agree that chances for a recession are greater now than at any time in recent years.*
>
> ...the IEFC leading indicator has been on a downward path for almost a year. Whether this will lead to a recession, such as in the 1990 experience, or just a significant slowdown, such as followed the decline in 1995, will require further observation. Currently, the level of the indicator, while declining, is still well above that which proceeded the last recession. **One thing is clear, and that is whether a recession develops or can be avoided, growth in the future will be significantly less than that which dominated last year and, this in turn, suggests slower gains in State revenues derived from changes in economic conditions.**

Further evidence that a slowdown was looming was the quick and unusual Federal Reserve action taken in the next month and described in the January 2001 monthly briefing.

> *And the Rates Come Tumbling Down*
> *The Federal Reserve lowered its target rate on federal funds by one-half percent from 6% to 5 ½% at its end of January FOMC meeting, the second half-point reduction this month.* ***The speed and size of this January's rate declines are rare, particularly since they come after the Fed refused to cut interest rates as recently as at is December 19 , 2000 FOMC meting. The dual interest rate cuts reflect concern over the apparent sharp deterioration in the U.S. economic activity.***
>
> *The major question is whether or not these recent Fed actions will be sufficient to avoid a recession or whether the Fed has overdone credit restrain last year, killing the golden goose that kept the economy expanding for a record length of time.*

Moreover, it is generally acknowledged that monetary policy is more effective at reducing the pace of economic activity than stimulating it; the later compared to pushing on a string.

It was also at this time that the first signs of revenue slowing began to manifest itself.

Year 2001 Begins with Signs of Slowing Revenues
General funds revenue in January was up $97 million over the same month last fiscal year. However, some of that increase can be attributed to the timing of transfers as well as a very good month for public utility taxes. In addition, this January had one more receipting day than last year. Absent those items, revenue growth for the month would have been significantly less.

Sales tax receipts grew by a disappointing $10 million in January. It was hoped that reports of decent after Christmas sales would have bolstered sales tax receipts. This performance would seem to confirm reports that the holiday season fell below expectations and that consumer confidence is waning.

While most of the revenue sources are on pace to reach their estimates, the continued lagging of sales tax receipts would seem to indict that economic growth is indeed slowing.

On February 28th, 2001, the Commission presented its report entitled "Preliminary FY 2002 Revenue Estimate and Updated FY 2001 Revenue Outlook". The following are excerpts from that publication which not only reflected on how FY 2001 was performing, but offered the first official glimpse into FY 2002. With the aid of hindsight, it's interesting to see how many caution flags were being waved.

Review of FY 2001: Economy in Transition
The pace of economic activity slowed dramatically during the fiscal year, raising concerns that the record-long economic expansion began in 1991 finally may have come to an end.

In reviewing FY 2001, it is clear the U.S. economy was in transition from a period of rapid growth to one of severe slowing. The performance of the State's economy has been similarly affected. Whether or not the economy falls into recession before the end of the fiscal year will not be known until after the fact. The dramatic slowdown in growth, however, has curtailed natural revenue growth.

U.S. Economic Outlook
FY 2002: Restimulating the Economy
After coming to a near virtual halt toward the end of FY 2001, policymakers strove to restimulate the U.S. economy.

The major question is whether or not these recent actions [interest rate cuts] will be sufficient to restimulate the very economic activity it tried so hard to slow the year before.

A preliminary forecast of FY 2002 suggests still further diminution in economic growth next year following this year's sharp moderation.

In terms of the largest percentage turnaround, business fixed investment is likely to be hardest hit. Business investment, which was cut in half in FY 2001, is expected to be halved again in FY 2002. The dramatic slowing in business has reduced capacity usage sharply, lessening the need to expand new investment in plant and equipment.

IEFC's forecast for FY 2002 is for continued moderation in economic growth but narrowly avoiding a full-fledged recession. IEFC essentially agrees with Standard and Poor's DRI that real growth will average a modest 2.8% in FY 2002, below the 3.2% rate for FY 2001, and well below that of most recent years.

The Outlook for Illinois
The sharp slowdown in national economic conditions has been felt pretty much proportionately at the State level. Although Illinois is the most diverse of the Great Lake States, its manufacturing component is still somewhat larger than that of the nation as a whole. And, there is no doubt that this sector is in recession.

The IEFC leading indicator has now slipped below that which occurred in 1995, prior to the 1996 economic slowdown, and is approaching that which proceeded the last recession. The outlook for the Illinois economy is closely tied to the outlook for the nation. Even so, although movement in the Illinois economy tracks the nation, the State has not benefited from upturns as much as the nation as a whole. ***Thus, even as the pace of economic activity bottoms out early in FY 2002 and begins to pick up, the State's performance may well lag.***

Revenue gains in FY 2002 should reflect these trends toward slower economic growth followed by a modest increase. Although a full-fledged recession is not forecast, it cannot be totally ruled out.

Preliminary FY 2002 General Funds Estimate

…the revenue forecast is predicated on continued slowing of economic growth through the first part of the up coming fiscal year followed by a modest increase. As a result, growth factors assumed for some of the larger tax sources are lower than that which has been experienced in recent years.

The Commission's FY 2002 estimate is $115 million lower than the BoB's estimate released in February. Essentially, the Commission is slightly more conservative in its forecast of future economic activity. In particular, the Commission is somewhat lower in its expectations for personal income tax and sales tax receipts.

During an April 18th, 2001 Commission meeting, while not on the agenda, staff briefly discussed revenue performance and indicated that sales tax receipts were falling short of estimates and that a downward revision would be forthcoming, in the likely range of $50 to $100 million. This announcement generated considerable interest from legislators and media alike, as this was the first time that the specter of a possible revenue shortfall was raised.

The month of April 2001, proved to be quite strong, yet due to issues regarding the timing of certain receipts, in addition to the increased concern regarding sales tax receipts, the overall estimate was decreased by $50 million. This revision was presented on May 8th, 2001 as well as the following observations.

Economic Forecast
The pace of economic activity nose-dived in FY 2001, recording the weakest performance since the last recession.

The most severely hit sector has been manufacturing. The deterioration in manufacturing is even more important to Illinois as it accounts for over 17% of its Gross State Product compared to about 15% for the nation as a whole.

The deterioration in the pace of economic activity has begun to be felt in the labor markets, which averaged a 30-year low in terms of the unemployment rate last year. While the rise in the unemployment rate has been only modest so far nationwide, it was a full percent higher in Illinois in March than a year earlier. This pattern reverses that seen during most of the expansion when Illinois' unemployment rate consistently held below the national average.

Rising unemployment and a mounting number of announced layoffs has soured consumer confidence. This is important since consumer spending makes up two-thirds of the economy.

Most observers feel this credit ease (multiple Fed rate cuts) will continue and, when coupled with proposed lower taxes, will stimulate the economy and cause growth to resume at a faster pace. Even so, this is unlikely to be felt till late this year at the earliest.

Indeed, many observers characterize the period ahead as a "growth recession". That is, even if the current rate of growth is sustained, it doesn't mean households will avert the pain usually associated with recession.

Overall, the IEFC projects that the economy will continue to struggle for several more months, but will not improve markedly until the second half of next fiscal year. Timing of a recovery aside, overall growth in FY 2002 still will be slower than that experienced in the late 1990s.

General Revenue Forecasts
FY 2001
The Commission's revised estimate for FY 2001 general revenue has been revised down by $50 million to $24.145 billion.

As discussed in previous meetings, growth in sales tax revenue has essentially stalled out in recent months. A weakened economy coupled with lackluster consumer confidence has resulted in several months of unimpressive sales tax receipts.

With the downward revision of $50 million, the Commission's FY 2001 general funds estimate is now $85 million less than the Bureau of the Budget's revised estimate released just last week.

FY 2002
The (revised) estimate represents an increase of $800 million, or 3.3%, over the revised FY 2001 estimate.

The Commission's revised FY 2002 estimate is $185 million lower than the BoB's estimate.

…the Commission's estimate represents growth of $800 million increase over the previous year's estimate, as compared to a $900 million increase forecast by the BoB.

In the May monthly briefing, disappointing economic and revenue items continued. However at that time, a number of positives were beginning to be factored in the 'pipeline'. A sampling of these mixed messages include:

May 2001 Monthly Revenue Briefing
Economy: Pace Remains Stagnant
Real GDP is now said to have risen at 1.3% annual rate last quarter, down from a 2% rate announced in its advance estimate and virtually the same as the 1% annual rate recorded in the previous quarter. This was the worst back-to-back quarterly performance sine the last half of fiscal 1995.

The risk of an even more severe correction has been recognized by the Federal Reserve, which in May lowered rates by one-half percent again, the fifth drop this year, as it felt the risk of recession outweighed the risk of inflation.

Nonetheless, there are positives for the economy on the horizon. Passage of sizable tax reduction legislation with rebate checks to be mailed out this summer, coupled with the positive lagged effects of a stimulative credit policy should begin to strengthen activity.

At this time, expectations are that the pace of economic activity will begin to improve later this year and continue this path next year. Indeed, FY 2002 may well be the mirror image of this year. This fiscal year things started off relatively strong but continued to weaken. Next year will start off weak, but should improve as the year unfolds.

Revenue: As Expected, Revenues Fall in May
As stated last month, while overall receipts rebounded significantly in April, that trend was expected to be short lived. In fact, in May, net income and sales taxes gave back $272 million from the $285 million those sources gained in April.

FY 2001 ended on a down note. Revenues failed to meet forecasts and would have been much worse hadn't federal sources dramatically exceeded expectations in the last month of the fiscal year. Also at this time, despite weakening revenues, a continued mixed bag of economic measurements gave some degree of optimism that a bottom may be nearing. Some key excerpts from the June briefing include:

Economy: Reaching Bottom?
The Federal Reserve reduced interest rates at month's end, the sixth downward adjustment this year. Even so, the drop in the key federal funds and discount rate was only a quarter-point rather than the one half-point cuts made earlier. This action, coupled with the release of the May 15 FOMC minutes showing the first dissent in two years among voting members with two favoring only a quarter point cut at the previous meeting, point to a possible end to the Federal Reserve cycle of credit easing. This is not to say that the Federal Reserve would not respond to further economic weakness, but rather that recent economic data coupled with more stimulative monetary and fiscal policies suggest an end to the period of economic weakening may in sight.

A rash of economic reports have begun to show some signs of strengthening. Consumer confidence measures have risen for two consecutive months suggesting a bottom may have been reached.

Home sales and durable goods orders both advanced in May, the leading indicator index rose 0.5, the third increase in the post six months and now stands 0.2% above the value of last November. Labor market conditions also show some signs of stabilizing. Instead of continuing to increase, initial claims for unemployment actually have edged down in each of the past three weeks. Energy prices are falling and even the weakest sector, manufacturing, may have reached bottom.

Whether or not the quarter just ended is the low point in the economic correction is uncertain. Recent data do suggest a bottoming, especially when coupled with acceleration in money supply growth, tax rebates coming soon, and six months of Federal Reserve credit easing which soon should begin to be felt.

June 2001 Monthly Revenue Briefing
Revenue: Despite boost from federal sources, June Revenues Disappoint; FY 2001 falls short of projections

Despite a surprisingly strong month for federal sources, a weak showing from income taxes and sales taxes resulted in another disappointing month for revenues.

FY 2001 general funds receipts rose $856 million over the previous year and totaled $24.106 billion. Overall revenues fell short of the Commission's estimate by only $39 million, while falling $124 million short of the Bureau of the Budget's forecast.

In the end, despite a large month in June, FY 2001 revenues were disappointing. Sales tax receipts suffered for much of the year and income taxes failed to make up the difference.

Therefore, as FY 2001 concluded, a significant amount of uncertainty weighed on the economic and revenue forecasts. Were the numerous rate cutting moves by the Fed, in conjunction with the just-passed Economic Growth and Tax Relief Reconciliation Act of 2001, going to be able to provide enough impetus to avoid a recession? Actually, in many regards, whether we were going to meet the classical definition of a recession or not was irrelevant. We were clearly in a period of no growth, the larger question was how long would this downturn last as well as its severity.

FY 2002
First Quarter - Worsening Revenue Picture Ending with September 11th Disaster

As we entered FY 2002, in July the Commission revised its FY 2002 forecast to take into account the recently-established lower FY 2001 base, higher income tax refund percentages, new federal source estimates based on final appropriation level, and several other non-economically tied adjustments. The revised revenue forecast and base assumptions used were provided in the July 2001 monthly briefing.

> ***…the Commission's underlying economic assumptions regarding FY 2002 have remained essentially the same: those being for continued weakness during the first half of the fiscal year followed by a second half improvement.***
>
> *The revised FY 2002 estimate is $24.826 billion, which represents an increase of $720 million or 3.0% over the prior fiscal year. The Commission's estimate is $174 million lower than the Bureau of the Budget's latest official projection of $25.000 billion published in the July Quarterly Financial Report.* ***[Therefore, already in July, revenues were projected to fall $174 million short of the FY 2002 budget year just begun].***

As FY 2002 began, a number of alternative economic forecasts were being discussed. These were described in the July 2001 monthly briefing.

> *Economy: What Letter of the Alphabet?*
> *Many economists describe the future performance of the U.S. economy in terms of letters of the alphabet, primarily an L, U, or V. An L-shaped economy suggests a bottom has been reached but that the economy continues to drag along bottom for an extended period. A U-shaped economy suggests a bottom is reached followed by gradual, but steady, recovery. Finally, a V-shaped pattern indicates a severe drop followed by a sharp increase. While there are elements of each shape within the economy today, most forecasters project a U-shape or gradual recovery in economic activity in the months ahead.*
>
> *At this point, the odds favor the expected U-shape pattern of recovery. From a policy point of view, the combined impact of lower interest rates, falling energy costs, and tax rebates may well offset the effects of a stagnant stock market and likelihood of rising unemployment.*

As a sign of things to come, July receipts started out on a down note as monthly revenues fell approximately $99 million from the prior year.

As August ended, while receipts would fall another $45 million for the month, bringing the yearly decline to $144 million, signals were beginning to indicate that improvement might be coming as the manufacturing sector began to show improvement.

> *…in July overall production fell just 0.1% with the manufacturing component held unchanged after a sharp drop in June. More recently the important Purchasing Manager's Index (PMI), which is an indicator of manufacturing activity, after reaching a low point earlier this year continued to strengthen in August both nationally and in Illinois.*
>
> ***While layoffs are likely to continue, every turning point must start somewhere. An end to the sharp decline in manufacturing may be that signal. Should this occur at a time when tax rebate checks help sustain consumer spending and lower interest rates reduce borrowing costs, the glass indeed may prove to be half full rather than half empty.***

This would be a good time to interject the opinion that even prior to the events of September 11th, revenues were already a point of significant concern. Not only was the Commission's forecast $174 million lower than the budget as passed, but also now revenues were falling well off the pace of even our more conservative estimates.

Then the unimaginable occurred on September 11th. While the monetary effects of those events are debatable, it very well could have been the preverbal straw that broke the camel's back. While the National Bureau of Economic Research will not call an official recession for a couple of more months, it was obvious that the likelihood of such designation increased significantly. As commented on in the September monthly briefing:

> ***Just as it appeared that the U.S. economy had successfully skirted a full-fledged recession, the tragedies of September 11th appear to have overwhelmed the fundamentals.***
>
> *The nation came to a virtual halt. Since the attack, more than 100,000 layoffs have been announced in the airlines and related industries, new claims for unemployment benefits soared to a nine-year high in the week ended September 22nd.*
>
> *The sharp erosion in consumer confidence and in the job market are crucial to the outlook for consumer spending…Should the weakness in the business sector of the economy now spread to the consumer, one of the 3-D definition of a recession – diffusion – would have been met. Then it would depend on the other two – depth and duration – as to whether or not an official recession will be proclaimed.*

In September, revenues took the biggest blow to that point, falling another $152 million. As the first quarter of FY 2002 ended, revenues were down $296 million. What was even more alarming was that the impact of September 11th still had not yet shown up in receipts. It was clear that State finances were headed into uncharted territory, and a significant downward revision in revenues was needed.

Second Quarter - The Head Fake

While the current forecast was predicated on a rather poor first half of the fiscal year followed by a second half rebound, there is no doubt that the first quarter significantly under-performed even those modest expectations. With the additional impact of the recent terrorist attacks and the economic uncertainty brought with it, the current estimate would have to be adjusted downward in the near future.

And adjusted it was. Due to increased concern regarding the State's financial condition, a Commission meeting was held on October 23, 2001. At that meeting, the Commission presented its revised FY 2002 estimate which included a net reduction of $300 million which was comprised of $400 million reductions in non-federally related revenues offset by $100 million in additional federal receipts. After that revision, the estimate was $474 million less than the budget as passed. Even before the terrorist attacks revenues were suffering, but clearly the events of September 11th were going to make things worse, or at the very least accelerate the recession's nadir. The question of estimators was how much and when would the impact be felt.

> ***Even prior to the terrorist attacks, there were a number of items already in place i.e. tax rebate checks, numerous reductions in interest rates, lower inventory levels, etc. Unfortunately, those items were outweighed by the attacks. Nonetheless, those elements were in the "pipeline". Since the attacks, additional actions have been taken which also should serve as economic stimulus, i.e. rapid increase in government spending, additional sharp cuts in interest rates and increased liquidity provided by the Federal Reserve. Furthermore, it appears likely that some form of additional stimulus package will be passed by the federal government in the coming months.***

It was at this time, that the Alphabet analogy began to re-emerge as well as additional concerns over future revenues, opening the door for future downward revisions if improvement was not soon in coming.

> *While these elements [see above] alone do not signal an end to the current poor economic conditions, they do increase the likelihood that a turnaround will occur with more vigor i.e. "V" shape rather than "U" shape recovery.* ***Unfortunately, from a State revenue standpoint, the fiscal year clock is ticking. We have already experienced a disappointing first part of the fiscal***

> ***year and as time moves on it becomes less likely that lost revenues can be made up before the end of June.***

To a surprising degree, that's just what happened over the next several months. In October, revenues gained $34 million followed by a $53 million upturn in November. At the same time revenues were signaling that the worst may be over, the NBER, the official designators of U.S. business cycle expansions and contractions, determined what many had expected, that is that the U.S. economy was in recession and had been so since March 2001. Analysis then turned to the recessions expected duration, as presented in the Commission's November 2001 monthly briefing.

> ***Economy: How Long Will the Recession Last?***
>
> ***Indeed, in the post WWII era the average length of a recession was 11 months…***
>
> ***Another interesting characteristic is that, in observing individual cycles, there is a tendency that the longer the period of expansion, the shorter the following recession. Thus, barring another major shock to the economy, such as occurred on September 11th, history alone would suggest the recession should end sometime early next year. Certainly, both monetary and fiscal policies have been on a stimulative course for most of the year, and these steps should help boost economic activity.***

On December 12th, 2001, the Commission met in Chicago for an update on the revenue picture. At that meeting, the above observations regarding the length of recessions was reiterated as well as the cautionary mention that even while a recovery gets underway, it is not clearly evident immediately nor does it affect all sectors of the economy simultaneously.

A number of mixed observations were shared at this meeting. In particular, there appeared to be a leveling off in the decline of the manufacturing sector as well as a jump in service sector, indicating some degree of improvement. However, export data showed a significant decline, although it is lagged by several months. Of significant concern was the deterioration of the labor market, even when at the same time the consumer was holding up quite well.

A number of positive measures were presented including new vehicle sales as well as strength in consumer housing activity, both aided by sharp drops in interest rates and incentive programs. Finally, lower consumer prices added to the measures that were felt would assist the ensuing economic recovery. In fact, there was even an upward blip from a survey of state tax receipts. Taken as a whole, there was beginning to be signs that the recession would indeed be of a mild composition whose term would end

shortly after the beginning of the new year. Yet despite this view, a word of caution was also made regarding future revenues.

> ***In conclusion, a significant amount of uncertainties still are weighing on State revenues. Not only have economic conditions decreased growth rates in many of the revenue areas, but actions taken at the State level and those yet to be taken at the federal level, serve to add greater complexities. While a number of indicators point to a relatively mild and short recession, turning points have always proven difficult to predict. Clearly, if the forecast recovery is delayed in coming, budgetary pressures would continue to build.***

December marked the third month of positive revenue performance as receipts grew $124 million. After starting off the fiscal year with a dismal first quarter that experienced a drop of $296 million, a surprising second quarter (surprising because of events of September 11th), erased all but $85 million of that decline. With continued signs of improvement, it was hoped that the worse was over. In fact, the consumer continued to show resilience as described in the December 2001 monthly briefing.

> ***The consumer confidence measure by the Conference Board jumped more than eight points after a dramatic decline in the prior three months, whereas the Michigan Sentiment Survey continued to edge up following its low point reached in September. While both measures are well below the levels seen in recent years, the bottom may well have been reached.***
>
> *There are several factors suggesting that may be a reasonable expectation. Monetary policy has aggressively eased over the past year, inflation has abated sharply with energy prices falling, and federal government spending has been increased with taxes being lowered.*

Despite these and other positives a cautionary word regarding revenues was raised.

> **Overall, there is growing confidence that the worst of the economic decline is behind us and that a turnaround is only months away. When this improvement is reflected in increased State revenues, however, will be dependent not only on economic trends, but also tax and spending decisions yet to be made in Washington (referring to an economic stimulus package which would impact of states revenues).**

Third Quarter - Period of Economic and Revenue Disconnect

As the third quarter of the year began, we entered into what was later described as being as a "disconnect" between economic signals and actual revenue performance. While the actual divergence likely started prior to this point, it was now that it began to

fully manifest. As indicated in the January 2002 monthly briefing, while economic news focused on recovery, actual revenues were painting an altogether different picture.

> *Economy: End of Recession: Near or Here?*
> *Preliminary data on the economy for the last three months of 2001 show that it grew in real terms at a 0.2% annual rate…while the figure will be revised twice, should a positive number hold up, it will break the old rule of thumb that recessions have at least two consecutive quarters of negative changes in real GDP.*
>
> *The tax cuts, rebates, and a year-long drop in key interest rates appear to have taken hold, sharply reducing the impact of the recession. If the recession is ending, it will have proven to be extremely mild by historical standards.*
>
> *The effect of the recession's end, however, may not be felt soon at the State level. It took until November to officially declare that a recession had begun last March. Thus, it could take months of positive growth before the recession would be declared officially ended.*

Indeed, while positives were being highlighted at the economic level, actual revenue performance began to take on a pall. In January 2001, receipts fell $90 million as income taxes began what would become a trend of underperformance. It was at this time that the Commission again stated that the revenue shortfall was continuing.

> ***Despite signs that the economy may be beginning the recover phase, time is working against reaching the estimate with only five months remaining in the fiscal year.***

On February 22nd 2002, the Commission again met to discuss the deteriorating revenue picture for FY 2002. A downward revision of $330 million was made to the forecast, and in addition, the first official estimate for FY 2003 was also presented. Economic and revenue highlights of that meeting are as follows:

> *Review of FY 2002: Economy in Recession*
> *In reviewing FY 2002, the overall economy and relative position of the State suffered the first period of recession in a decade. The overall performance was substantially weaker than originally projected in part due to the added effects of the September 11th attacks and reaction to them. Thus, revenue growth fell substantially below earlier projections.*
>
> *As a result, the FY 2002 estimate of general funds revenue has been decreased $330 million to $24.196 billion [this would mark a total year to date downward*

revision of $630 million and represent $804 million less in revenues than what the '02 budget assumed].
However, despite an estimated drop in revenues of $330 million, it should be noted that the Commission's revised forecast should not be considered as the worst-case scenario.

It was during this February meeting that a brief glimpse of the shape that other states were in was presented. As of January, 46 states were experiencing revenues falling below projections; 30 had expenditures over budget; 39 had instituted budget cuts or holdbacks; 26 had used some of their reserves; and 30 were using other measures to balance their budgets. Clearly, Illinois was not alone in its mounting fiscal crisis.

As FY 2002 continued to deteriorate, Illinois and other states started to look towards FY 2003. While expected to improve, the national economy was not forecasted to skyrocket, but rather experience a moderate pace of recovery.

U.S. Economic Outlook- FY 2003: Recovery Takes Hold
IEFC's forecast for FY 2003 is for economic recovery with real growth approaching 3%. While this is substantially better than FY 2002, it is similar to that recorded in FY 2001, although well below that in each of the previous three fiscal years.

The Outlook for Illinois in FY 2003
Indeed, Illinois is expected to fare at least as well as the nation as a whole. Even so, the fact that the consumer, which makes up about two-thirds of total spending, held up well suggests there is little pent-up demand. Indeed, it is the business sector that will be counted on to spur growth and this may come about only moderately as profits improve. Thus, the recovery may be restrained in its early phase.

Thus, FY 2003 should be another difficult year for State finances.

At the time the preliminary FY 2003 revenue forecast was presented, while base economic assumptions were forecast to improve in FY 2003, a number of other issues were discussed as significantly curtailing overall revenue growth. These items included losses in revenues due to the phase-out of the federal inheritance tax, lower transfers, lower federal source reimbursements due to program spending cuts, and increased income tax refunds. All told, these factors limited the expected growth in FY 2003 revenues to $433 million, or 1.8%. At that time, the Commission's estimate was $201 million lower than the BoB and reflected a lower FY 2002 base, as well as lower annual growth expectations.

Despite the second significant downward revision in FY 2002 revenues, the revised estimate came under instant pressure as February revenues fell by $88 million. The

economic and revenue disconnect was even more pronounced in the following month as evidenced by the March 2002 revenue briefing.

> *Economy: How Strong a Recovery?*
> *It is increasingly clear that the U.S. economic recession, which begun a year ago this month, is over and that the recovery phase of the business cycle is underway.*
>
> *The strength of the economy can be measured in terms of the growth rate of GDP and in term of final sales—real GDP less the change in inventories.*
>
> *…both measures resumed growth in the final quarter of FY 2002, with revised real GDP up at a 1.7% annual rate and final demand rising at a strong 3.8% annual pace.*

Despite those measurements showing improvement, there were other indicators that cautioned that the recovery cycle might be less vigorous than in the past.

> *Earlier declines in initial unemployment claims have stalled, suggesting future gains in the labor market may be more restrained; oil prices have begun to rise again reversing earlier declines; gold prices have risen; and the stock market has shown no sustained upward trend.*

All of those negatives formulated a more muted stance on the recovery than what was previously hoped for. Despite this more conservative outlook on the recovery, actual revenue performance continued to be considerably weaker.

> *Revenues suffered another down month in March with receipts falling $149 million compared to the same month on year earlier. The March decline marked the third consecutive monthly retreat as third quarter revenues fell a total of $328 million.*

It now became clear that FY 2002 general revenues would fall short of last year's actuals. A stunning thought given the phenomenal growth of fiscal years just past, as well as revenue performance through much more severe recessionary cycles.

Fourth Quarter - From Bad to Worse

The fourth quarter of FY 2002 began with a Commission meeting on April 10th. While the Commission was not planning to meet in April, the seriousness of the continuing revenue shortfall justified its occurrence. At that meeting, given the dismal performance of the larger revenue sources, and the unlikelihood of an immediate turnaround, it was discussed that revenues could fall as much as $500 million less than last year. The following statement summed things up best.

In summary, while some revenue sources are expected to increase over the remainder of the fiscal year, a significant improvement is unlikely in most of the economically-related lines. Clearly, FY 2002 will go down as a disastrous year in terms of State revenues.

At the same time revenues continued to tank, the economic disconnect continued unabated as a number of positive signs were discussed. Specifically, the manufacturing sector as well as the service sector showed improvement, as did employment measures. Housing permits, buoyed by lower interest rates continued to soar in Illinois. Inflation remained tame and consumer optimism continued to strengthen.

Revenues in the month of April continued to falter, falling $36 million and bringing the year to date decline to $449 million. The decline would have been much worse if it weren't for the timing of certain transfers. Otherwise, those sources most closely tied to the economy, such as income and sales taxes, continued to lose substantial ground.

April also provided more evidence that the recovery, which just recently was doing quite well, might be entering a period of moderation. As explained in the April monthly briefing:

> *Economy: Pace of Activity Moderates*
> *Even as evidence increases that the U.S. economy is in a recovery phase, prospects for some moderation in its current performance abound.*
>
> *Weakness was reported in durable goods orders, home sales, and heavy truck sales. Continuing claims for unemployment insurance rose and money growth declined. Finally, the employment situation apparently weakened following some strengthening earlier this year.*

The Commission met on May 8th 2002, to hear the latest on the revenue falloff. At that meeting a number of items were discussed, including an attempt to explain how such a classically defined mild recession (only one quarter of declining GDP) could be wreaking such havoc on State revenues. The most plausible explanations were given to be:

> *Corporate profits…quickly plunged about 16% in 2001. This rapid deterioration of corporate profits caused a sharp decline in business spending. Moreover the manufacturing sector was hardest hit and was particularly reflected in states like Illinois which have a higher-than-average concentration of manufacturing jobs.*

The composition of the work force accelerated its rate of change. A continued sharp drop in manufacturing employment, which tend to be higher-paying jobs, had an impact particularly in states like Illinois.
The decline in corporate financial positions was reflected in a sharp correction in the stock market, particularly in high-tech stocks. The sharp drop in equity values: virtually eliminated capital gains which had been flowing into both federal and state tax coffers; reduced dividend payments which, together with a drop in market interest rates, dried up interest and dividend income and related tax receipts; and, greatly reduced the wealth of consumers.

While revenues would have likely struggled mightily anyway, its impact [September 11th] most assuredly exacerbated many of the above factors. In addition, its effect on travel and summer spending probably played a part in reduced sales tax revenues.

Due to the continued degradation of the revenue picture, the FY 2002 estimate was again substantially reduced, this time by $546 million bringing the total adjustments for the fiscal year to $1.176 billion. The revised estimate of $23.650 billion represented a yearly decline of $456 million and represented revenues falling $1.35 billion below the enacted FY 2002 budgeted level.

Clearly, despite the past recession being classified as the one of the mildest on record, revenues were particularly hard hit and early signs of an economic recovery have yet to manifest into increased tax revenues.

Of course the lowering of the FY 2002 forecast also impacted on the FY 2003 outlook as a lower base would equate into less revenue for next fiscal year. In addition, non-economically related items still remained which would curtail overall growth in FY 2003, i.e. federal phase-out of the inheritance tax, lower transfers, lower federal sources, and higher refund percentages. Plus, in March the federal government passed an economic stimulus package aimed at boosting the nation's fledgling recovery. One of the provisions was to allow an additional first-year depreciation deduction. It was estimated that the provision would decrease FY 2003 net income tax revenues by approximately $160 million. As a result of the lower base and these other factors, growth for FY 2003 was expected to be only $300 million.

As the month of May ended, with it ended any hopes of a late stage receipt pickup as May revenues dropped $224 million. That marked the fifth consecutive monthly decline and translated into a year-to-date drop off of $673 million from the same period last year.

This is being classified by many as a business recession, that is, centered on the business side in the form of reduced capital expenditures and inventories.

Because of this, it is the business side where the economy has the most room to affect the pace of economic recovery.

The speed and magnitude of the [business] investment improvement that occurs will hold the key to the strength of the overall economic recovery in the months ahead.

Unfortunately, recent market scandals involving accounting fraud continue to hamper any sustained market improvement. That in turn makes corporations nervous in pursuing any meaningful investment, even with the recently-passed stimulus package.

FY 2002 concluded with another down month for revenues as June receipts fell another $55 million bringing the total yearly decline to an unbelievable $728 million (excludes Budget Stabilization fund transfers of $226 million). Actually, June performed somewhat better than anticipated as some unexpected federal sources and increased transfers tempered what could have easily been a worse month.

In addition to the disappointing revenue performance to end the year, economic indicators have begun to signal that the recovery may be taking a breather. As mentioned in the June 2002 briefing, personal consumption expenditures fell to their weakest reading since November, and consumer confidence has started to retrench following the continued stock market deterioration. The briefing concluded by continuing to sound alarms as:

Thus, the recent hesitation seen in the pace of economic activity is likely to continue in the months ahead. The resulting moderate pace of the advance suggests that State revenue improvement also is likely to show only a gradual improvement as the new fiscal year unfolds.

While base growth in the more closely tied economic revenue sources are expected to fare better next year, much of the anticipated growth for FY 2003 will come from legislative changes, rather than natural revenue growth. In large part due to the State's fiscal problems, a number of recent legislative changes will be in effect for FY 2003. They include increasing the cigarette tax, allowing significant interfund transfers, increasing riverboat gambling taxes, and decoupling from the bonus depreciation provision passed by the Federal Government. In total, these items will serve to increase general revenues by over $500 million what they otherwise would have been. Add to that an improved outlook for base economic assumptions and the growth for next fiscal year should in the range of $800 million to $1 billion. While that rate of growth may seem substantial, the fact remains that total revenues will be only marginally higher than those experienced in FY 2001, illustrating the continued pain served up by FY 2002.

In summary, it should be clear from this chronological retrospective of FY 2002, that economic and revenue forecasters, both in Illinois as well as other states, faced a number of challenges throughout this time period. A number of things made estimating difficult:

- A sudden departure from a number of exceptionally strong years of growth – For a number of fiscal years in the late 1990s, revenues continued to exceed expectations. The speed at which revenues deteriorated, even in hindsight, was surprisingly quick. Downward revisions to the forecasts were met with almost immediate pressure as the rate of decline exceeded all expectations.

- Mixed messages – As FY 2001 ended, uncertainty was clearly the theme as mixed economic signals coupled with unknown reactions to monetary policy and federal legislation made pinpointing the timing and depth of the economic cycle difficult.

- Disastrous first quarter followed by surprising second quarter – State revenues began the fiscal year on a decidedly down note which was highlighted by events of September 11th. Then, surprisingly, second quarter receipts erased most of the first quarter decline. This "head fake" falsely indicated that perhaps the worst-case scenario would be avoided.

- Period of economic and revenue disconnect – Just as economic signals were beginning to surface that the economy was mending and beginning the recovery phase; revenues again began to deteriorate, even more significantly than earlier in the fiscal year. While a lag in economic activity and actual revenue performance is not unusual and in fact assumed, the degree of disconnect made projecting the depth of the problem more challenging.

While these factors provide an overview of issues which served to make forecasting difficult, the next section provides further evidence why FY 2002 seemed to disproportionately impact on state revenues.

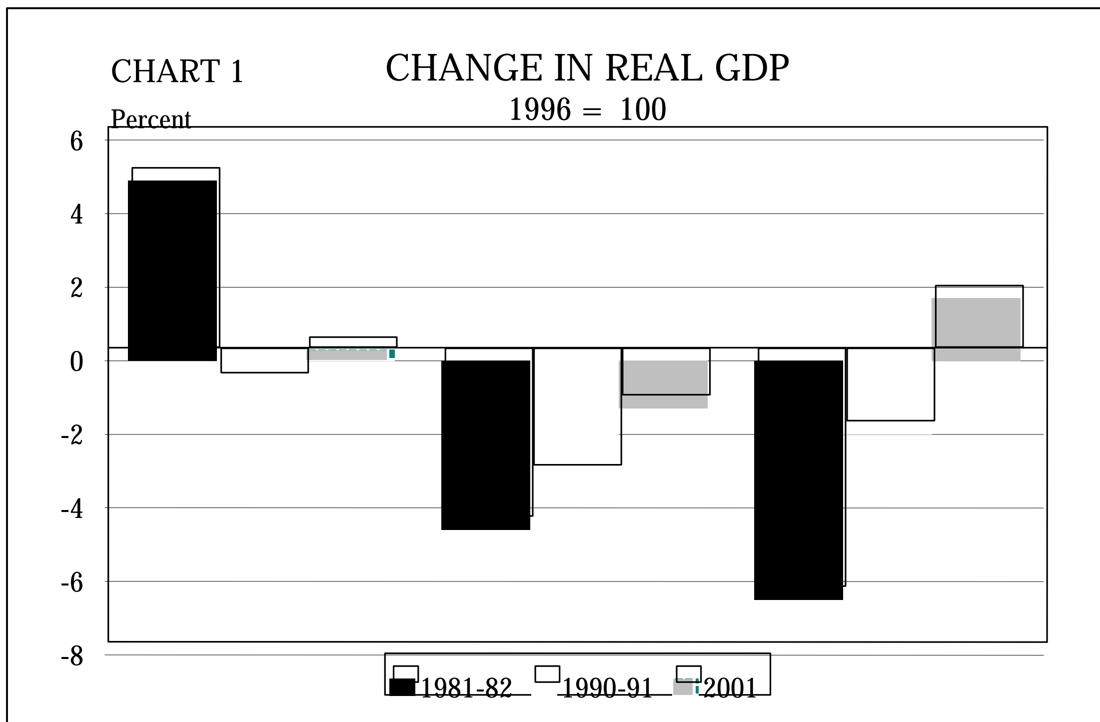
THE ECONOMY – WHAT WAS DIFFERENT THIS TIME?

To most casual observers, as well as most economists, the past recession was classified as mild. While most statistics, including the usual GDP measurement would bear that out, digging deeper, a number of reasons surface as to why this recession may have been particularly difficult for state finances.

Measurements of GDP

The pace of economic activity is customarily measured in real, or inflation-adjusted, terms. The reason for this is to judge the extent of improvement in the economy, not gains that arise because of increasing prices.

Chart 1 shows the quarterly growth rates of real GDP during the majority of the period encompassing each of the previous three recessions. In these terms, the 2001 recession was by far the mildest, contracting modestly only one quarter with real growth resuming immediately thereafter. Indeed, the 2001 recession will go down in U.S. economic history as the mildest period ever so designated as a recession.

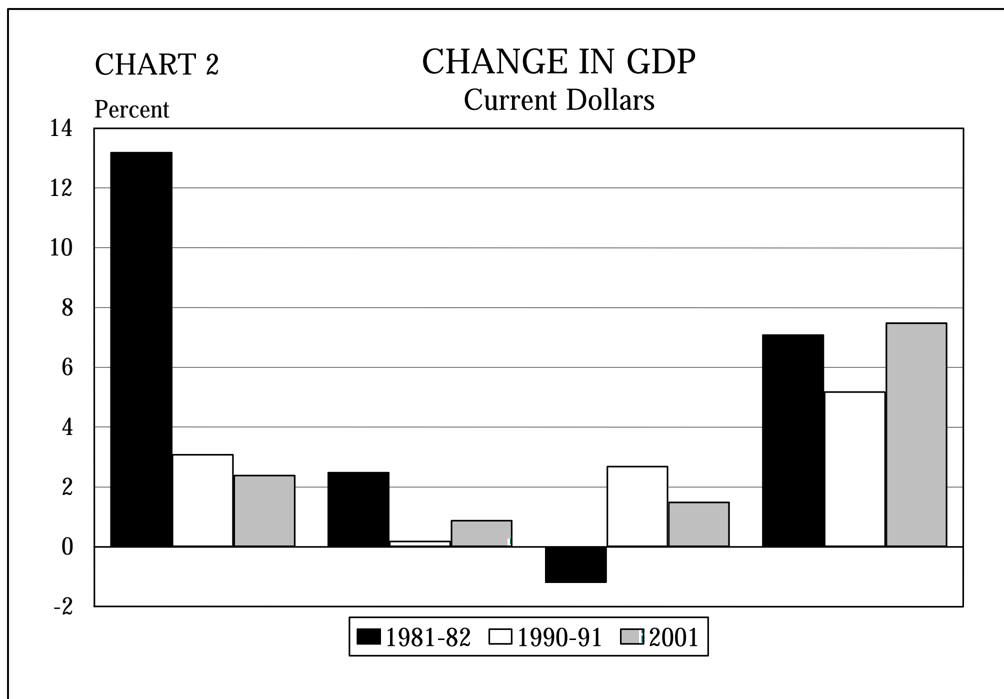


There have been ten recessions since the end of World War II, the latest being between March 2001 and probably the end of that year. Recessions are determined only after the fact by the National Bureau of Economic Research using a complicated definition based on the duration, depth, and diffusion, or how widespread the weakness becomes. As a general rule of thumb, however, economists have noted that there had never been

a recession without at least two consecutive quarters of declining real GDP, that is until the latest recession.

The average recession has lasted 11 months, with the average decline in real growth being 2.1%, stock prices declining by 25%, industrial production down by 9%, and unemployment rising 3.2 percentage points. There also is a greater correlation between the length of expansions and the depth of the ultimate recession. Long economic expansions tend to be followed by modest recessions, while the two deepest recessions, 1974 and 1982, followed short expansions.

Technically, the above facts are all true. However, the effect on State revenues was much more dire than one would have expected from the above analysis. In large part, that is because the downturn in activity in current, or measured in non-deflated, dollars was greater than that shown by changes in real GDP. As illustrated in Chart 2, the last recession measured in current dollars, while not as deep as that in the 1981-82 experience, was indeed more severe than that which occurred ten years earlier in the 1990-91 recession.



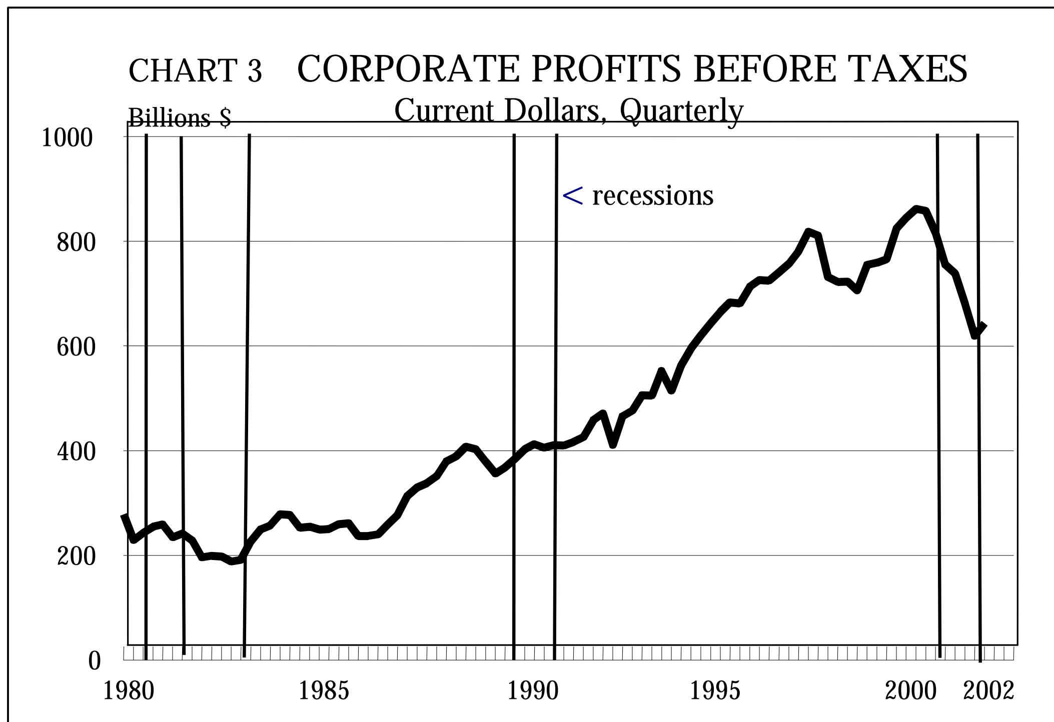
This measure of GDP is more relevant to State revenue performance as revenues are also measured in current dollars. Indeed, states initially benefit from rapid inflation which boosts overall prices, which a state takes a percentage of, and as cost-of-living adjustments are made to wages which also inflate State income taxes. Similarly as demand is strong and businesses are able to pass on higher prices to consumers, profits rise which boost State tax receipts.

Downturn Concentrated in Business Sectors

Another difference in the current period from that which occurred in previous recessions is where the weakness has centered. Virtually all recessions incorporate an inventory cycle and the latest is no exception; that is to say businesses build inventories, consumer demand wanes resulting in excess inventory levels, and businesses respond by reducing production, decrease employment, and take other measures to reduce excess stocks. Only after consumer demand picks up and excess inventories are liquidated do businesses increase production again.

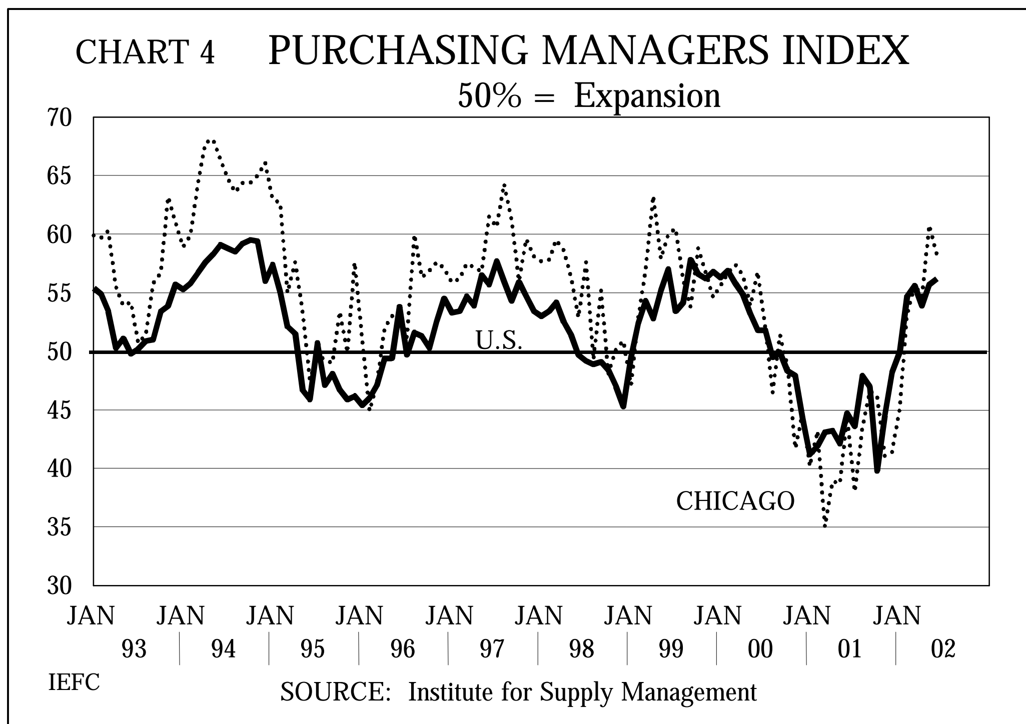
In the current experience, consumer demand did not wane as much as in the past, instead the weakness was concentrated in business spending. This, in turn, reflected the much more severe downturn in business profits that occurred during this recession compared to earlier ones.

Chart 3 shows the level of corporate profits before taxes measured in current dollars since 1980, with previous recessions noted between the vertical lines. Again, the sharp downturn in profits in 2001 was unprecedented and undoubtedly was the major contributing factor to the retrenchment that occurred in business spending. Again, this was a period where competitive forces were such as to prevent price increases from sticking. While this kept inflation low, it also inhibited profit gains.



There also was no incentive to raise money through equity issues as, after soaring through the 1990s, the stock market took a dive. As mentioned earlier, the average decline in the stock market during recessions was 25%. This time the market is down about 35% with the technology-driven NASDAQ off a shocking 70% from its high. Most unusual, however, is that the performance of the stock market which usually leads a recovery is still declining well into the early stages of the recovery.

The hardest hit area of the business sector was manufacturing. As shown in Chart 4, the Purchasing Manager's Index started to contract, (fell below 50%) in the summer of 2000 and didn't show signs of expansion (above 50%) until early this year. Because Illinois has a larger-than-national share of the manufacturing sector, its sharp decline affected the State more severely. By May 2002, the State's manufacturing jobs totaled 884,500, a drop of about 93,000, or 9.5% since 1998. The loss of manufacturing jobs is particularly important since these typically are higher-paying jobs. For example, weekly earnings in manufacturing in 2001 were $603.58 compared to $489.75 per week in the private nonfarm sector as a whole, and $282.35 per week in the retail trade sector.

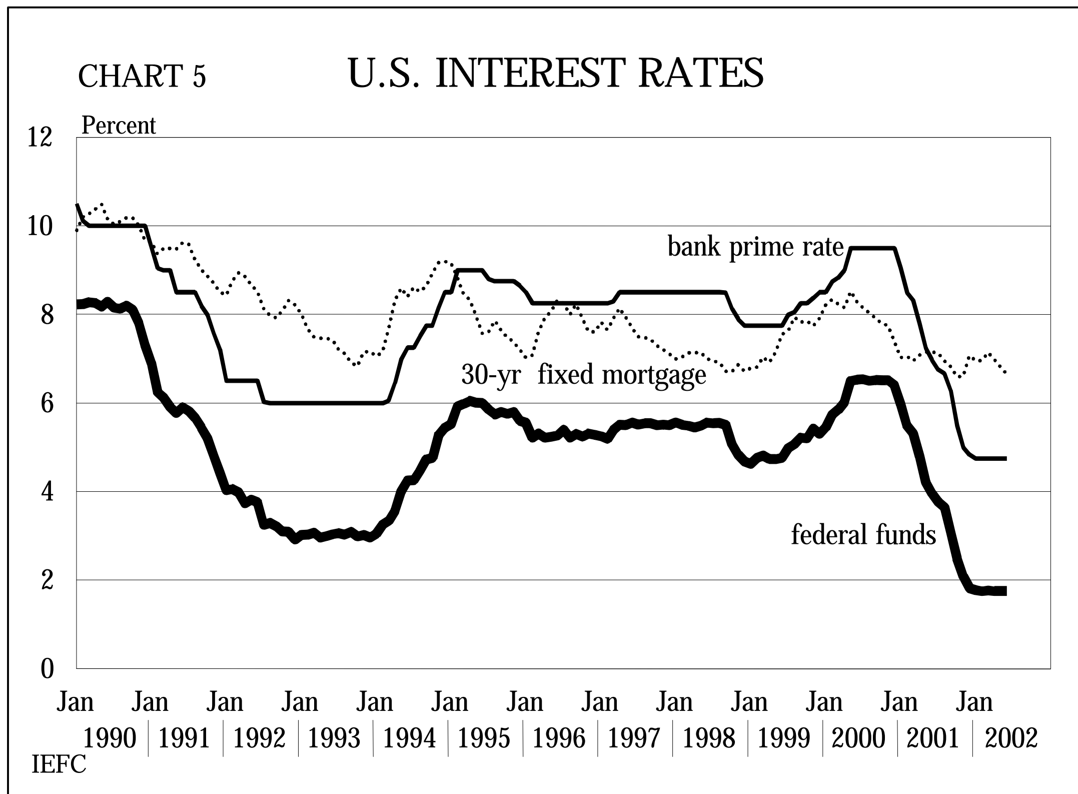


Finally, Illinois began to phase in a single-sales factor basis for establishing corporate profits in 1998 that was completed at the end of 2000. This shift to a single-sales factor may well have been a contributor to the sharp fall off in State corporate revenue. This is because as the recession was centered on the business sector, taxes based solely on weak sales would have had a more severe impact on corporate receipts than a more diverse measure that also incorporated a property factor and a payroll factor.

Cyclical Differences

An aggressive Federal Reserve dropped interest rates often and sharply beginning in 2001, reaching the lowest levels in a decade. (See Chart 5). While a slowing economy at the time and the lack of inflation allowed such reductions, the combination of reduced state balances and abnormally-low interest rates decimated revenues derived from interests on state funds and investments.

Another cyclical difference, as mentioned earlier, has been the performance of the equity markets. After rising from the 5,000 level in 1995 to 11,500 in December 1999, the Dow Jones Industrial Average recorded a low of 8,235 following the September 11th attacks. While the Dow recovered to over the 10,500 level in March, another downturn shaved 1,000 points by early Summer of 2002. This is rare that an economic recovery has been met by a declining equity market.



Income Taxes Decimated

A decline in the equity markets virtually decimated capital gains collections after several years where this had become an increasing source of income. (The number of tax returns reporting capital gains rose from under 10 million in 1985 to 22.5 million in 1999 with the dollar amount jumping from $72 billion to almost $517 billion over the

same period.) While tax data since 1999 are not available, undoubtedly given the stock market performance, those reporting capital gains and the amount have been greatly reduced.

The sharp deterioration in the financial markets and ensuing recession not only precipitated layoffs, but greatly reduced bonuses and other compensation rewards which had swelled during the boom years when equity prices had skyrocketed. Finally, record layoffs, rising unemployment rates, and falling profits not only have depressed individual incomes, but particularly corporate income as well. Indeed, while not the largest source, corporate income tax receipts showed the largest percentage decline of the major general revenue sources.

Terrorist Attacks Economy

While it is disingenuous to blame the events of September 11th for the revenue shortfall, it caused an economy that already was on the verge of recession to enter into a full-fledged recession—the first in a decade.

Again, Illinois was even harder hit given that it is a transportation hub. O'Hare Airport basically closed and traffic was sharply reduced. Moreover, its tourism, hotel, and convention businesses were greatly disrupted and played a major role in reduced sales tax revenues.

All of these factors discussed undoubtedly have played a part in what appears to be a disconnect between the economy and State revenues. With GDP growth in FY 2003 likely to be in the 3.5% area, up from an estimated 1% to 1.5% range this year, revenues should improve. Even so, this growth, while up from a 2.7% rate in FY 2001, remains below the 4.1% to 4.5% rates in each of the prior three fiscal years. Thus, improvement in State revenues are likely to be slow in coming and of a more moderate nature than in the boom years of FY 1998 through FY 2001.

Moreover, the improvement will be from a very low level. Chart 6, on the following page is based on a survey of a broadly-diverse group of 16 states and illustrates the long slide in State revenues that has predominated over the past two years. Hopefully, this measure may be bottoming out at the current time, although as shown there will be a long road back to recover to the revenue flows seen the mid-1990s.

CHART 6 STATE TAX RECEIPTS SURVEY
(Index based on inflow of income and sales taxes)
100
80
60
40
20
0
Jan
Jan
Jan
Jan
Jan
Jan
Jan
96
97
98
99
00
01
02
SOURCE: ISI (International Strategy & Investment)
IEFC

BACKGROUND

The Illinois Economic and Fiscal Commission, a bipartisan, joint legislative commission, provides the General Assembly with information relevant to the Illinois economy, taxes and other sources of revenue and debt obligations of the State. The Commission's specific responsibilities include:

1) Preparation of annual revenue estimates with periodic updates;
2) Analysis of the fiscal impact of revenue bills;
3) Preparation of "State Debt Impact Notes" on legislation which would appropriate bond funds or increase bond authorization;
4) Periodic assessment of capital facility plans; and
5) Annual estimates of the liabilities of the State's group health insurance program and approval of contract renewals promulgated by the Department of Central Management Services.

The Commission also has a mandate to report to the General Assembly ". . . on economic trends in relation to long-range planning and budgeting; and to study and make such recommendations as it deems appropriate on local and regional economic and fiscal policies and on federal fiscal policy as it may affect Illinois. . . ." This results in several reports on various economic issues throughout the year.

The Commission publishes two primary reports. The "Revenue Estimate and Economic Outlook" describes and projects economic conditions and their impact on State revenues. "The Illinois Bond Watcher" examines the State's debt position as well as other issues directly related to conditions in the financial markets. The Commission also periodically publishes special topic reports that have or could have an impact on the economic well being of Illinois.

These reports are available from:

Illinois Economic and Fiscal Commission
703 Stratton Office Building
Springfield, Illinois 62706
(217) 782-5320
(217) 782-3513 (FAX)

Reports can also be accessed from our Webpage:

http://www.legis.state.il.us/commission/ecfisc/ecfisc_home.html