Commission on Government Forecasting and Accountability

703 Stratton Ofc. Bldg., Springfield, IL 62706

MONTHLY BRIEFING FOR THE MONTH ENDED: AUGUST 2014

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INSIDE THIS ISSUE

ECONOMY: Left to the Fed

Edward H. Boss, Jr., Chief Economist

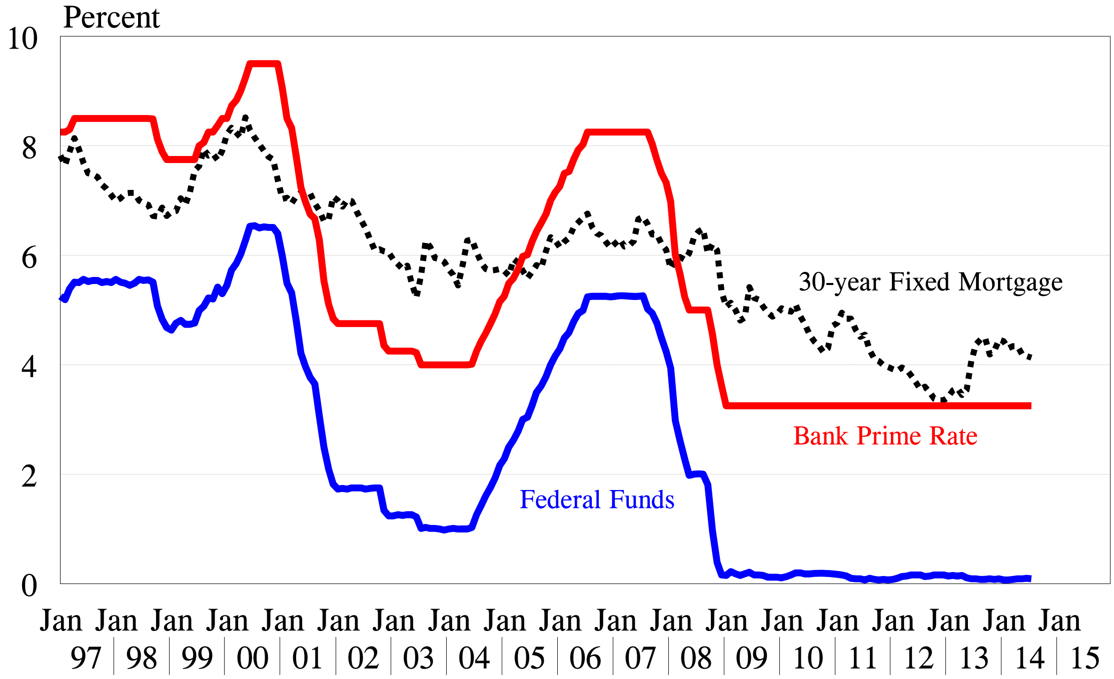
The fate of the economy once again appears mainly to rest in the hands of the seven members of the Federal Reserve, an institution created by Congress in 1913 and opened in 1914. Its objectives are "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." To achieve these goals, some of which may be in conflict, truly requires walking a fine line and sometimes can be met only by emphasizing one goal over another to obtain its overall objectives over the longer term.

Seldom will you find direct criticism of the Fed expressed by an Administration. The Fed was set up to focus achieving the goals expressed and not be subjected to political pressure. As an independent government agency, the Fed does not receive funding through the normal congressional budget process and elected officials and members of the Administration are not allowed to serve on the Board. Moreover, members are appointed for staggered 14-year terms with the Chairman to a four year term. Even so, over the years Congress wanted its influence heard and enacted the Humphrey Hawkins Full Employment Act in 1978 which instructs that the Federal Reserve Board must report to Congress twice a year outlining its monetary policy. In addition, as during the last financial crises as well as in past emergencies, there has been a great deal of coordination and cooperation between the Fed and the Treasury Department.

An example of Fed action to achieve one of its objectives can be illustrated by the steps taken to put an end to rampant inflation that began to develop in the late 1970s throughout 1980. The economy had hit a low point, or trough, in March 1975 followed by a recovery which reached a peak in January 1980, an expansion that lasted 58 months. However,

CHART 1

U. S. INTEREST RATES



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inflationary pressures had begun to build. Consumer prices ended 1976 at 5%, but more than doubled by year-end 1979 to 13.3%. Some blamed the rapid price gains on government spending for the Viet Nam War while simultaneously pursuing a War on Poverty. Rapid price increases, however, were not confined to the U.S. and were happening abroad as well. Many thought that governments had lost their ability to contain inflation.

In mid-1979 President Carter appointed Paul Volker, President of the New York Fed, to succeed William Miller as Chairman of the Federal Reserve. Soon after taking office in August, Chairman Volker altered policy actions by directly limiting money in circulation through tighter control over private banking reserves, an alternative to raising or lowering interest rates through open market operations. In other words, limit the amount of money and let interest rates be determined by the market's response. Interest rates such as the bank prime rate soared to exceed 20% and as a result the 1980 recession lasted only 6 months before another recession began in 1981. It was only when the Fed refused to loosen policy even as the economy was mired in another recession that the back of inflation finally was broken.

While inflation dominated the early 1980s, in the current expansion the emphasis has been to stimulate below-par economic growth, create jobs, pep up weak employment numbers, and increase labor force participation which remains at the lowest rate in decades even as inflation remains well contained. To meet these objectives, the Fed began an unconventional approach, instituting a program of "Quantitative Easing". It began to purchase government securities and other securities such as those backed by mortgages in large amounts on a regularly scheduled basis. This lowered short-term interest rates and increased the money supply by flooding financial institutions with capital in an effort to increase lending and liquidity. As illustrated in the attached chart, under this program the federal funds rate was kept near zero with the bank prime lending rate having remained unchanged at 3.25% since the end of 2008. At the same time long term interest rates have shown no upward trend and remain well below the levels seen prior to the quantitative easing program. Economic growth continued to grow which, while better than in most developed countries, still remained the weakest period of growth coming out of a recession since the end of WW II.

While recent Federal Reserve actions seem to have helped in advancing its objectives of assisting economic growth while conditions in the labor markets have improved without igniting inflation, the degree of improvement has been limited. Moreover, using monetary policy as the major tool in directing the course of the economy is awkward. Monetary policy works with a significant lag, and history has shown that often when a change in direction is finally undertaken, it is too late. This can lead to a sharp reversal in policy causing market disruption and put upward pressure on prices. However, because previous actions by the federal government have ballooned debt to a point that may preclude any substantial fiscal stimulus spending, monetary policy has been looked upon as the major implement to meet today's objectives. How successful the policy is in the end will be judged on how the recovery develops, inflation behaves, and jobs are created in the months ahead, first as quantitative easing purchases end and later as they are unwound.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY

INDICATORS *	July 2014	June 2014	July 2013
Unemployment Rate (Average)	6.8%	7.1%	9.2%
Annual Rate of Inflation (Chicago)	-4.3%	4.5%	1.9%

	LATEST MONTH	% CHANGE OVER PRIOR MONTH	% CHANGE OVER A YEAR AGO
Civilian Labor Force (thousands) (July)	6,512	-0.3%	-0.4%
Employment (thousands) (July)	6,067	0.0%	2.1%
New Car & Truck Registration (July)	62,755	2.0%	20.5%
Single Family Housing Permits (July)	944	3.2%	-1.3%
Total Exports ($ mil) (June)	5,790	-0.8%	9.6%
Chicago Purchasing Managers Index (August)	64.3	22.2%	21.3%

* Due to monthly fluctuations, trend best shown by % change from a year ago

REVENUE

August Revenues Fall With Weaker Transfers And Federal Sources

Jim Muschinske, Revenue Manager

Overall base revenues declined $463 million in August. The large drop was not surprising as it reflected the lower anticipated transfer from the Income Tax Refund Fund as compared to last year. An extremely weak month for federal source reimbursements contributed to the large monthly decline. Most other revenue sources were either flat or suffered minor declines. One less receipting day in August also likely contributed to the mundane revenue performances.

Gross corporate income tax fell $13 million, or $11 million net of refunds. Public utility taxes were down $11 million. Other sources dropped $3 million, while both insurance taxes and corporate franchise taxes each experienced a $2 million dip.

Despite a number of revenue declines, a few sources managed to post a gain for the month. Sales tax receipts grew $10 million, while inheritance tax rose $6 million. Gross personal income tax increased $5 million, although on a net of income basis it actually suffered a decline of $2 million. Liquor taxes increased by $1 million as did interest earned on investments.

Overall transfers dropped significantly in August, falling $358 million. The large drop reflected a planned reduction in the amount of transfers from the Income Tax Refund Fund. In FY 2014, $397 million was transferred as a result of a surplus in the Fund's balance [per law, any surplus is transferred into GRF]. While the FY 2015 budget assumed $100 million being available for such transfer, only $63 million was actually transferred. Riverboat transfers fell $21 million, while other transfers dipped $4 million. Only lottery transfers were able to post a minor $1 million gain. As mentioned, federal sources contributed to the overall monthly drop as federal reimbursements fell $92 million in August.

Year to Date

Through the first two months of the fiscal year, overall base revenues are down $279 million. However, much of that decline was expected and is due to the much lower Refund Fund transfer into GRF. In addition, weaker federal sources to begin the year contributed to the fall off.

Other sources are up $125 million but as explained in the July briefing, approximately $119 million of the increase was related to one-time court settlement proceeds. Sales tax continues to fare quite well and grew $48 million early in the fiscal year. Inheritance tax has added $30 million, insurance taxes $2 million, interest income $2 million, and liquor taxes $1 million.

Gross corporate income taxes are down $19 million through August, or $17 million net of refunds. Public utility taxes are off by $16 million. Gross personal income taxes have declined by $2 million, or $14 million net of refunds. And, corporate franchise taxes are down a modest $1 million.

As mentioned, overall transfers are down $344 million due to the much lower Refund transfer which accounts for $334 million of that falloff. Riverboat transfers are down $19 million, but other transfers have posted a $8 million gain while lottery transfers eked out a $1 million increase. Federal sources are down $95 million thus far in the fiscal year, reflecting lower reimbursable spending from the GRF.

GENERAL FUNDS RECEIPTS: AUGUST

FY 2015 vs. FY 2014

($ million)

Revenue Sources	Aug. FY 2015	Aug. FY 2014	$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	$1,207	$1,202	$5	0.4%
Corporate Income Tax (regular)	51	64	($13)	-20.3%
Sales Taxes	658	648	$10	1.5%
Public Utility Taxes (regular)	73	84	($11)	-13.1%
Cigarette Tax	29	29	$0	0.0%
Liquor Gallonage Taxes	13	12	$1	8.3%
Vehicle Use Tax	3	3	$0	0.0%
Inheritance Tax (Gross)	28	22	$6	27.3%
Insurance Taxes and Fees	19	21	($2)	-9.5%
Corporate Franchise Tax & Fees	16	18	($2)	-11.1%
Interest on State Funds & Investments	2	1	$1	100.0%
Cook County IGT	0	0	$0	N/A
Other Sources	30	33	($3)	-9.1%
Subtotal	$2,129	$2,137	($8)	-0.4%
Transfers				
Lottery	48	47	$1	2.1%
Riverboat transfers & receipts	25	46	($21)	-45.7%
Proceeds from Sale of 10th license	0	0	$0	N/A
Refund Fund transfer	63	397	($334)	N/A
Other	33	37	($4)	-10.8%
Total State Sources	$2,298	$2,664	($366)	-13.7%
Federal Sources	$82	$174	($92)	-52.9%
Total Federal & State Sources	$2,380	$2,838	($458)	-16.1%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($121)	($114)	($7)	6.1%
Corporate Income Tax	($7)	(9)	$2	-22.2%
Subtotal General Funds	$2,252	$2,715	($463)	-17.1%
Short-Term Borrowing	$0	$0	$0	N/A
FY'13/14 Backlog Payment Fund	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$0	$0	$0	N/A
Total General Funds	$2,252	$2,715	($463)	-17.1%

CGFA SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding 2-Sep-14

GENERAL FUNDS RECEIPTS: YEAR TO DATE

FY 2015 vs. FY 2014

($ million)

Revenue Sources	FY 2015	FY 2014	CHANGE FROM FY 2014	% CHANGE
State Taxes				
Personal Income Tax	$2,410	$2,412	($2)	-0.1%
Corporate Income Tax (regular)	130	149	($19)	-12.8%
Sales Taxes	1,354	1,306	$48	3.7%
Public Utility Taxes (regular)	153	169	($16)	-9.5%
Cigarette Tax	59	59	$0	0.0%
Liquor Gallonage Taxes	30	29	$1	3.4%
Vehicle Use Tax	6	6	$0	0.0%
Inheritance Tax (Gross)	64	34	$30	88.2%
Insurance Taxes and Fees	25	23	$2	8.7%
Corporate Franchise Tax & Fees	30	31	($1)	-3.2%
Interest on State Funds & Investments	4	2	$2	100.0%
Cook County IGT	0	0	$0	N/A
Other Sources	194	69	$125	181.2%
Subtotal	$4,459	$4,289	$170	4.0%
Transfers				
Lottery	88	87	$1	1.1%
Riverboat transfers & receipts	43	62	($19)	-30.6%
Proceeds from Sale of 10th license	0	0	$0	N/A
Refund Fund transfer	63	397	($334)	N/A
Other	112	104	$8	7.7%
Total State Sources	$4,765	$4,939	($174)	-3.5%
Federal Sources	$382	$477	($95)	-19.9%
Total Federal & State Sources	$5,147	$5,416	($269)	-5.0%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($241)	($229)	($12)	5.2%
Corporate Income Tax	($18)	($20)	$2	-10.0%
Subtotal General Funds	$4,888	$5,167	($279)	-5.4%
Short-Term Borrowing	$0	$0	$0	N/A
FY'13/14 Backlog Payment Fund Transfer	$0	$50	($50)	N/A
Tobacco Liquidation Proceeds	$0	$0	$0	N/A
Pension Contribution Fund Transfer	$0	$0	$0	N/A
Budget Stabilization Fund Transfer	$275	$275	$0	0.0%
Total General Funds	$5,163	$5,492	($329)	-6.0%

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

CGFA 2-Sep-14