

June 14, 2005

TO: CARLI Board of Directors

FROM: J. David Stewart
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SUBJECT: Economic and Budget Update Report

The following information has been compiled from multiple published sources and is intended to provide an update on the national and state economy, the Illinois revenue forecasts and budget status, and the legislative action on the FY 2006 state budget.

National Economy

At this time, the national economy shows some generally positive trends, but there are some mixed and even conflicting signals and underlying concerns as illustrated by some of the most recent economic data available.

- The Conference Board said its Composite Index of Leading Economic Indicators fell by 0.2 percent last month. This could signal a loss of momentum.
- Productivity and factor orders posted solid gains in April.
- Unemployment claims nationally have been dropping in recent weeks and jobs expansion is expected to continue overall; however, GM announced that it would begin to close plants and layoff about 25,000 workers over the next several years.
- Crude oil prices remain comparatively high (along with corresponding gasoline prices and other fuels) and to the extent that such increased costs affect discretionary consumer spending, the economic impact could be significantly unfavorable.
- Short-term interest rates, as set by the Federal Reserve, are expected to continue increasing in order to offset inflationary concerns. The Fed will meet June 29-30, and is widely expected to raise short-term rates for the ninth time by another quarter-point to 3.25%.
- Personal incomes in April rose at the fastest pace this year along with a corresponding jump in consumer spending. Disposable incomes, the amount of personal income left after paying taxes, rose by 0.5% in April.
- Analysts expect the Gross Domestic Product to expand by 3.4% in 2006, a respectable pace that should be consistent with stable inflationary trends.

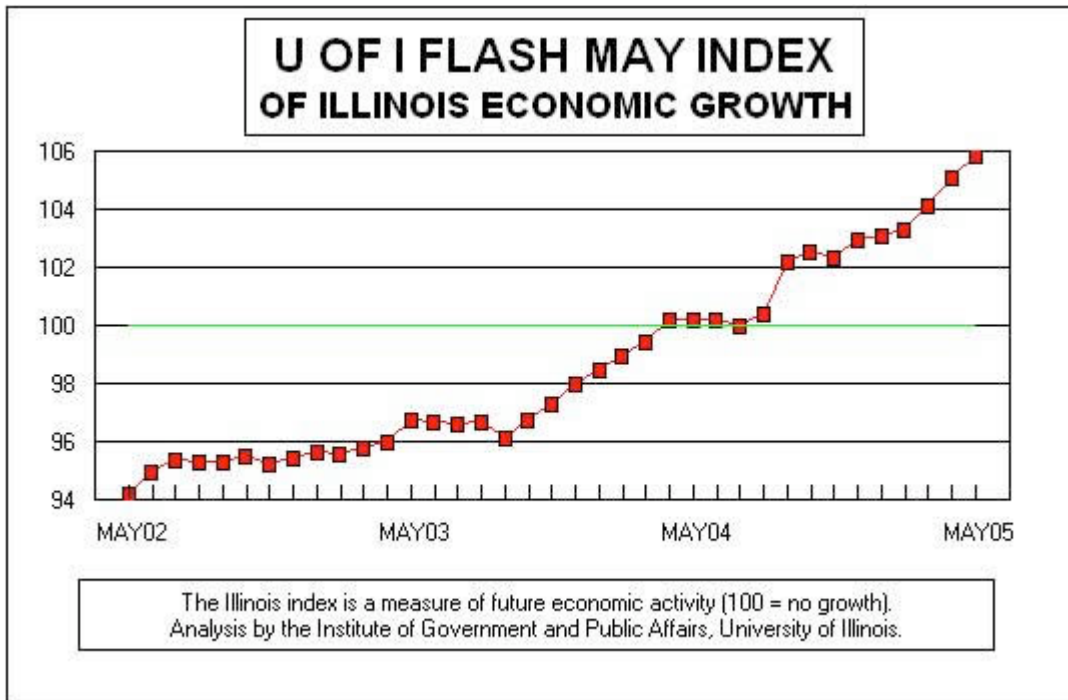
Illinois Economy

The Flash Index of Illinois economy indicates continued expansion taking place. The University of Illinois Flash Economic Index rose to 105.9 last month from its 105.2 level in April. This is the highest level registered for Illinois' economy in nearly seven years (i.e., since June 1998). May's results continue to confirm that the Illinois economy is expanding after a slow recovery from the 2001 recession.

The Flash Index edged above the 100 reading in April 2004 and has continued to improve from this base, which marks the divide between economic growth and contraction. A year ago last May, the Index was at 100.3.

According to J. Fred Giertz, the University of Illinois economist who compiles the data, all three components of the Index were up in real (inflation-adjusted) terms from the same month last year. Corporate and individual tax receipts were up significantly from May 2004, while sales tax receipts saw more moderate gains. Giertz further noted that "Despite lingering state budget problems, the Illinois economy has been expanding rapidly this year, while the pace of the national economy appears to be moderating"

The Flash Index is a weighted average of Illinois growth rates in corporate earnings, consumer spending and personal income. Tax receipts from corporate income, personal income and retail sales are adjusted for inflation before growth rates are calculated. The growth rate for each component is then calculated for the 12-month period using data through May 31.



While the state economy finally appears to be displaying a strong growth trend, the state budget reflects greater pressures and needs on the expenditure side and constrained within the moderate expected revenue growth. Expenditures for pension costs, Medicaid and other health-related employee benefits continue to outpace the growth in available state revenues.

In response to these pressures, many areas of state government staffing and operations have been cutback, and higher education, prisons (some new prisons are not being opened due to budget cuts), and other state services are not receiving any budget increases. Illinois' unemployment rate is 5.6%, down from 6.3% just a year ago. Sales tax receipts are up by 4.1%, corporate income tax yields are 4.9% greater, and the personal income tax is up 6.3%, all compared to a year ago.

State Revenue Estimates and Forecasts

The following information on state revenue estimates and forecasts for FY 2005 and 2006 was compiled by the University of Illinois Institute for Government and Public Affairs (IGPA). It provides comparison of state revenue forecasts made by IGPA, the Governor's Office of Management and Budget (OMB), and the Illinois Commission on Government Forecasting and Accountability (CGFA)—a legislative economic advisory agency under the Illinois General Assembly.

Illinois Revenue Forecasts

FY 2005 Revenue Forecast

Forecasts (\$ millions)	FY 2005 IGPA May - 05	FY 2005 OMB Feb - 05	FY 2005 CGFA May - 05
Net Revenue			
Net Personal Income Tax	\$ 7,972	\$ 7,781	\$ 7,823
Net Corporate Income Tax	\$ 1,116	\$ 1,073	\$ 1,118
Sales Tax	\$ 6,615	\$ 6,530	\$ 6,585
Public Utilities Tax	\$ 1,044	\$ 1,101	\$ 1,060
Other Tax Sources	\$ 2,432	\$ 2,385	\$ 2,395
Total Net Taxes	\$ 19,179	\$ 18,870	\$ 18,981
Transfers	\$ 2,233	\$ 2,233	\$ 2,234
Federal Aid	\$ 4,519	\$ 4,519	\$ 4,519
Grand total Net Revenue	\$ 25,931	\$ 25,622	\$ 25,734
Gross Revenue			
Gross Personal Income Tax	\$ 8,871	\$ 8,659	\$ 8,700
Gross Corporate Income Tax	\$ 1,482	\$ 1,424	\$ 1,477
Grand total Gross Revenue	\$ 27,196	\$ 26,852	\$ 26,970

FY 2006 Revenue Forecast

Forecasts (\$ millions)	FY2006 IGPA May - 05	FY 2006 OMB Feb - 05	FY 2006 CGFA May - 05
Net Revenue			

Net Personal Income Tax	\$ 8,141	\$ 8,120	\$ 8,154
Net Corporate Income Tax	\$ 1,038	\$ 1,161	\$ 1,230
Sales Tax	\$ 6,944	\$ 6,778	\$ 6,848
Public Utilities Tax	\$ 1,123	\$ 1,096	\$ 1,060
Other Tax Sources	\$ 2,456	\$ 2,182	\$ 2,210
Total Net Taxes	\$ 19,703	\$ 19,337	\$ 19,502
Transfers	\$ 2,240	\$ 2,240	\$ 1,915
Federal Aid	\$ 4,834	\$ 4,834	\$ 4,834
Grand total Net Revenue	\$ 26,777	\$ 26,411	\$ 26,251
Gross Revenue			
Gross Personal Income Tax	\$ 9,060	\$ 9,036	\$ 9,035
Gross Corporate Income Tax	\$ 1,378	\$ 1,541	\$ 1,538
Grand total Gross Revenue	\$ 28,036	\$ 27,708	\$ 27,440

OMB is the Illinois Office of Management of Budget formerly the Bureau of the Budget.

CGFA is the Illinois Commission on Government Forecasting and Accountability formerly the Illinois Economic and Fiscal Commission.

Source: Institute of Government and Public Affairs, University of Illinois.

The chart above shows very moderate expected growth in state revenues between FY 2005 and 2006 (between \$470 million and \$856 in total state gross revenues or a 1.7% to 3.2% assumed growth). A number of proposals for new and expanded revenue sources in the FY 2006 budget were not enacted (e.g. expansion of casino gambling licenses, tax on computer software, increased cigarette and tobacco products taxes, etc.) The most conservative forecasts, offered by the Illinois Commission on Government Forecasting and Accountability (CGFA) reflect underlying concerns about the future pace of business expansion, weakening consumer attitudes, rising inflation and interest rates, and crude oil/energy prices.

The rate of growth in traditional state tax sources continues to lag core expenditure requirements, despite reductions in state agency staffing levels and other cutbacks. There is also some uncertainty regarding the legality of funds transfers or fund sweeps, and increased special fees that generate revenue in excess of needs for transfer to the state's general fund. Several court cases supported by the state chamber of commerce and business plaintiffs are currently pending.

The much publicized "pension holiday", where the state will over the next two years (by diverting over \$2 billion in state budgeted funds that otherwise would be earmarked for pension contributions over the next 2 years) reduce employer contributions going into the several state pension funds, has provided the impetus for passing a new budget that calls for increasing state spending in FY 2006. The total unfunded liability of the pension systems stood at \$35 billion before the diversion. It has been estimated that the overall cost of the diversion would widen the unfunded deficit by \$38.5 billion over the next 40 years, imposing a very heavy burden on future taxpayers and inhibiting additional spending for other state purposes like education.

Higher Education Budget

On May 31 the Illinois General Assembly completed its work on the fiscal year 2006 budget for the state of Illinois. The Illinois higher education budget includes:

- \$2.2 billion in state general funds for higher education operations and grants, \$7.5 million less than what was in the Governor's proposed budget for FY 2006. The \$2.2 billion represents an increase of \$44.1 million, or two percent, over the FY 2005 appropriation.
- \$1.3 billion in state general funds for public university operations, an increase of \$3.3 million, or 0.3%, over the FY 2005 appropriation.
- \$301 million in state general funds for community colleges, an increase of \$1.8 million, or 0.6%, from the FY 2005 base.
- \$130 million in capital funds appropriated directly to the Capital Development Board for public universities and community colleges.
- \$390.3 million in general funds for operations and grants for the Illinois Student Assistance Commission (ISAC), representing a decrease of \$2 million, or 0.5%, from FY 2005 appropriations.
- \$170.0 million for the State Universities Retirement System (SURS). Of that amount, \$166.6 million is for pension contributions, which is roughly half of the state appropriated requirement of \$324.9 million that was certified by SURS to satisfy the minimum funding requirements for the System under Public Act 88-0593. State appropriations are decreased by \$103.3 million, or 38.3 percent, from the fiscal year 2005 appropriation, including amounts received from state general funds and the State Pension Fund. This does not reflect amounts to be received by SURS from Federal/Trust/Other funds; it is assumed that these will total \$40 million in fiscal year 2006.

Please let me know if you have any questions regarding this report.