

October 18, 2005

TO: CARLI Board of Directors via CARLI Finance Committee

FROM: J. David Stewart
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SUBJECT: Economic and Budget Update Report (Informational Item)

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

Several of the economic measures discussed in this report still do not yet reflect the full economic impacts of Hurricane Katrina. One government agency, the Congressional Budget Office, predicts that Katrina's aftermath will trim one percent from economic growth in the second half of the year, that job losses of 400,000 or more will occur in the coming months, and that September gas prices will average 40 % higher than before the hurricane hit.

National Economy

At this time, the national economy continues to show generally positive trends, but there are some underlying concerns as illustrated by some of the most recent economic data available.

- Consumer prices in September surged by the largest amount in more than 25 years—jumping by 1.3 per cent last month. As expected, most of the increase is attributable to higher energy costs. The resulting jump in the CPI also led to a higher 4.1% rate in the COLA for Social Security benefit recipients.
- In September consumer confidence experienced its biggest drop in 15 years. The Conference Board reported that the Consumer Confidence Index dropped from 105.5 in August to 86.6 for September. Analysts had expected the September index to come in at 98 points. The 18.9 point decrease is the biggest drop in the Index since October 1990.
- Short term interest rates increased from 3.5% to 3.75%. Federal funds rates of 3.75% are at their highest level in 4 years. These baseline short-term interest rate changes affect prime interest rates, mortgage and revolving credit card rates, ARMS and other variable rate types of interest adjusted debt. Mortgage rates, reflecting longer-term interest rate trends, also appear to be moving upward—and there are concerns that this may cause the current housing value bubble to burst at some point in the near future.
- The trade deficit rose by \$59 billion, about \$1.1 billion than the previous month--and is expected to go even higher as foreign oil imports increase to fill hurricane-related domestic pipeline supply and refining disruptions. The U.S. deficit with

China hit a monthly record of \$18.5 billion in August 2005, reflecting increased shipments of clothing and textiles.

- The Institute for Supply Management (ISM) has issued a report that is the first major report for September, and the first to show the full effects of Hurricanes Katrina and Rita on the Economy:
 - The ISM reported that its index of national factory activity rose to 59.4 for September, the highest index rating in over a year. The index had stood at 53.6 for August 2005 and economists had predicted a September index reading of 52.0. A reading above 50 denotes expansion in the factory sector. The ISM suggested that this increase is directly related to Hurricanes Katrina and Rita, i.e., new goods need to be produced to replace those damaged or destroyed by the hurricanes.
 - The ISM new orders component, a signal of future growth, rose to 63.8 from 56.4, its highest reading since July 2004.
 - The ISM prices paid index soared from 62.5 to 78.0, reflecting the high price of oil and other commodities
 - The ISM employment gauge increased slightly from 52.6 in August to 53.1 in September.
- The BLS reported that energy prices increased by 5% in August, the biggest increase since March 2003, with gas prices increasing by 8.3%, natural gas prices gaining 2.7%, and fuel oil going up by 4.1%. (Note: these August figures do not fully represent the impact of Katrina on fuel prices, as the storm did not hit until the end of August. This affects both consumers directly and indirectly through higher transportation costs and surcharges paid. Despite these increases, and the later increases attributed to Katrina and Rita, Federal Reserve Chairman Allen Greenspan noted on September 27 that the economy has handled the increased energy costs “reasonably well”.)
- The Commerce Department reports that durable goods orders rose 3.3% in August, after falling 5.3% in July. This rate of increase exceeded analysts’ expectations.
- The Commerce Department reported that U.S. housing starts dropped in August by 1.3%. This drop in housing starts was greater than expected. Multifamily housing starts decreased by 9.4%, while single-family housing starts showed a slight increase.
- Corporate cutbacks in R&D spending are also noteworthy—as funds are being diverted to shareholder dividends and share buybacks—all concerns that may have an adverse impact on future corporate profitability and competitiveness.
- Bankruptcy filing by Delphi, a major automotive components manufacturer, will lead to significant employee layoffs and will have a likely impact on GM operations.

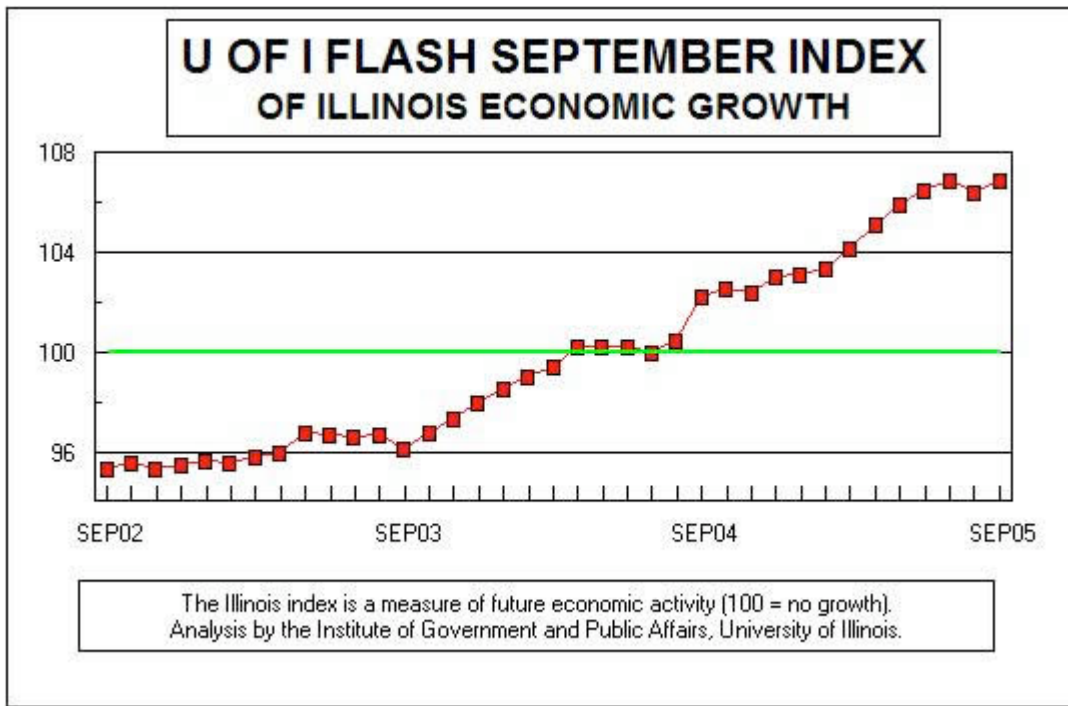
Illinois Economy

In general, the Illinois economy is showing steady improvement, although at a slower rate than in the recent past. Real economic indicators point to solid progress in economic recovery.

The University of Illinois Flash Economic Index continued its strong performance, with the September Index rebounding from a slight drop in August. The Flash Index was 106.9 for September, up from the 106.5 reading in August, and equal to the 106.9 level recorded for July 2005. 2005. Just a year ago, the Index was at 102.2. In September 2005, all components of the Index were up in “real” (inflation-adjusted) terms from the same month a year ago, with corporate tax receipts being especially strong.

The September reading suggests that the Illinois economy was not affected by the aftermath of hurricanes Katrina and Rita and, at least for now, the related increase in gasoline and other energy prices according to J. Fred Giertz, the Illinois professor who compiled the Index. “The hurricanes have had a major impact on consumer confidence readings, but apparently had little effect on the behavior of Illinois consumers,” Giertz said.

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 September 30.



State Revenues

The Illinois Commission on Government Forecasting and Accountability (CGFA) has issued a report summarizing revenues for the first quarter of FY 2006. While there were some items that served to suppress revenue growth for the quarter “most of the economically related sources such as income and sales have continued to perform well and are actually running somewhat ahead of expectations.” Following are some excerpts from this report:

- Through the first quarter of the fiscal year, excluding Budget Stabilization transfers, general revenues are off \$165 million. The loss is due to the timing and magnitude of fund sweeps as well as last year’s significant jump in federal sources related to earlier short-term borrowing. Absent those items, revenues for the most part, continue to perform fairly well.
- Gross personal income taxes are up \$145 million, or \$143 million net of refunds. Sales tax receipts are up \$138 million, while gross corporate income taxes have increased \$54 million, or \$59 million net of refunds. Interest income continues to perform well as rates of return continue to rise, with receipts gaining \$23 million over the first three months. All other sources experiencing year to date gains added an additional \$22 million.
- A number of sources are down in comparison to the same period of a year ago. Cigarette taxes are down \$41 million due to a temporary tax distribution change made last fiscal year. As expected, the Cook County Intergovernmental Transfer is down, falling \$37 million. Insurance taxes are off by \$12 million, and inheritance tax receipts stumbled by \$10 million.
- Overall transfers are down \$167 million year to date due to a falloff in other transfers stemming from less statutory fund sweeps and less chargeback activity. While riverboat transfers and direct receipts are down \$27 million, lottery transfers are ahead by an equal amount. Federal sources are down by \$282 million, which is due to \$434 million in transfers in 2004 to the general funds stemming from short-term borrowing used to pay down the backlog in Medicaid bills.
- While overall revenues, excluding Budget Stabilization Fund transfers, are down thus far in FY 2006, most of those declines were anticipated. For example, due to timing of federal related sources last year, it is not at all surprising to be down early this fiscal year. Similarly, due to a temporary change in cigarette tax distribution experienced last year, a falloff in the first quarter was anticipated. In addition, the decline in other transfers early in the year was also forecast, based on the statutory timing of fund sweeps.

The State of Illinois Comptroller’s Office has also released its overview of the recently completed quarter. The Comptroller’s report echoed the CGFA quarterly report in some respects: Noting a 70% increase in Medicaid spending compared to the same time last year the report notes: “This growth in Medicaid spending, due in part to unusual spending patterns associated with the program last year, offset an impressive increase in economic revenues.” Some excerpts from the report follow:

- Department of Healthcare and Family Services grant expenditures (Medicaid) from the General Funds in the first quarter of fiscal year 2006 increased \$897 million or 70.0% compared to the same time last year. The increase in health care spending was somewhat anticipated. At the end of fiscal year 2004, the state borrowed \$850 million to take advantage of the temporary increase in reimbursement rates. This borrowing reduced Medicaid expenditures in the first quarter of last year.

- At the end of September, the adjusted General Revenue Fund (GRF) balance was negative \$919 million. The GRF balance on September 30, 2005 was \$207 million with a backlog of \$1.126 billion in unpaid bills. It should be noted that the GRF balance includes \$194 million in charge-back and fee transfers which have not been recognized by the State Treasurer due to that office's concerns about the constitutionality of these transactions.
- On the revenue side, there has been better than expected growth in economic driven revenues. Income taxes are up 10.7% and sales taxes grew 8.2%. These increases exceed revenue estimates used to construct the FY 2006 budget.
- At the end of the first quarter, base revenues declined from \$6.558 billion to \$6.393 billion (\$165 million or 2.5%). Most of the decline is due to an expected decrease in other transfers while economic driven revenues exceeded expectations.
- Through September, base General Funds spending increased \$118 million or 1.8%. The expected large increase in Medicaid spending over the first quarter of last fiscal year was mostly offset by the large decrease in transfers out. General Funds appropriations are up \$546 million or 2.3% over last year.

There are continuing concerns even with the stronger growth in state revenues relative to increasingly fixed higher state expenditure trends, the backlog of unpaid Medicaid costs to pharmacies and other providers, and cash flow availability that may require short-term borrowing by the state to meet its ongoing obligations. Please let me know if you have any questions.