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INSIDE THIS ISSUE

PAGE 1 - **ECONOMY:** Interest Rates Headed Higher

PAGE 3: Illinois Economic Indicators

PAGE 3 - **TRANSFERS:** Update to Special Transfers

PAGE 4 - **REVENUE:** As Expected, Revenues dip in May

PAGE 7-10: Revenue Tables

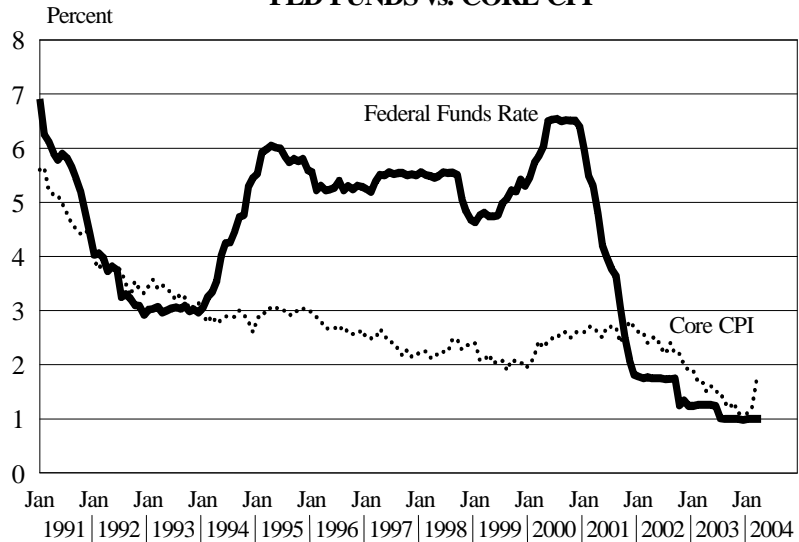
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ECONOMY: Interest Rates Headed Higher

Edward H. Boss, Jr., Chief Economist

Interest rates are headed higher in the United States following a prolonged decline that brought them to the lowest levels in more than four decades. As shown in Chart 1, the key short-term federal funds rate, after trading most of the time in the 5 1/2% to 6 1/2% range from 1995 to early 2001, began a steep decline that lowered it to 1% by late 2003 where it remains today. It should be noted that the interest rate on federal funds since mid-2001 has traded below the inflation rate as measured by the change over a year ago in the *core consumer price index*--consumer prices less changes in volatile food and energy prices. The last time there was such a *negative real interest rate*, that is an interest rate on federal funds that was below the rate of inflation, was late 1992 and 1993 and then as a stimulative Federal Reserve policy to foster growth in an economy that was emerging from recession. And, at that earlier time, the period in which the federal funds rate fell below the rate of inflation was much shorter with prices rising significantly faster than is the case currently.

CHART 1
FED FUNDS vs. CORE CPI



In the past few months the core inflation rate has begun to rise again following a two-year slide that brought the rate of price increase down to a shade over 1% in late 2003 and as 2004 began. Several economic studies have suggested the method by which the consumer price index is constructed overstates actual inflation by 1% or more. Thus, not only wasn't there any inflation, but concerns were expressed by the monetary authorities that a downwardly spiraling economy could begin. A period where deflation, or falling prices, could lead to lower wages that could cut back consumer spending, which would reduce demand, lead to layoffs, cut demand further, and so forth. While the risk of this downward spiral was low, the deleterious effects to the U.S. economy could have been severe. Thus, to some extent the Federal Reserve welcomes the recent uplift in prices.

The recent rise in the core inflation rate, however, has occurred at the same time there has been a sharp spike in energy prices, particularly prices for gasoline. This has spooked the credit markets, which fell in price as fears mounted of a return to more rapid price inflation and, in response, a change in Federal Reserve credit policy leading to substantially higher interest rates that could weaken the economic expansion. It has been more an increase in demand rather than a shortfall in supply that appears to be the main factor driving up oil prices at the moment. The U.S. economy has taken off with real or inflation-adjusted growth anticipated rising at about a 5% annual rate in the current quarter. This follows an annual rate of 4.4% in the previous quarter, 4.1% a quarter earlier, and a surging 8.25% the quarter before that. This is occurring as growth continues to soar in China, recovery takes hold in

Japan, and many countries abroad show increases in economic activity. Adding to the current energy price increase are concerns over future supplies due to the crises in the Middle East, the U.S. entering the heavy summer driving season, the lack of U.S. refining ability that is unable to handle increased oil supplies, and the myriad of different gasoline blends required by different states.

Whether or not the recent spike in energy prices is short-term or proves to be longer in nature is still uncertain. Saudi Arabia already has proposed substantially lifting OPEC oil production, although this has yet to be agreed upon. There also are some indications that soaring growth in China as well as in some other major countries is moderating, and U.S. growth, while expected to continue well above its historical pace, is anticipated to ease slightly from that shown in recent quarters. Even so, given the seasonal pick up in summer driving, gasoline prices are likely to continue near current high levels in the period immediately ahead.

There is still some uncertainty over how these various factors will influence interest rates. It is now widely assumed that, given the strength of U.S. demand and the recent surge in new job creation, the monetary authorities will raise the federal funds rate by $\frac{1}{4}$ of 1% at their late June meeting as a pre-emptive move to stem upward price pressure. This would still leave a negative real interest rate. According to IEFC's forecasting service, the Federal Reserve will raise the federal funds rate in $\frac{1}{4}\%$ increments at their June, August, September and December meetings, with the rate doubling to 2% by year-end. The next consumer price

report due out at mid-June, the success or upheaval associated with the turnover

of sovereignty to Iraq, changes in oil prices, and the next job report due out in early June will all be factors taken into account by the Federal Reserve as to when and how much further it will rise interest rates in upcoming meetings.

INDICATORS OF ILLINOIS ECONOMIC ACTIVITY			
<u>INDICATORS</u>	<u>April 2004</u>	<u>March 2004</u>	<u>April 2003</u>
Unemployment Rate (Average)	6.1%	6.0%	6.6%
Annual Rate of Inflation (Chicago)	5.8%	-0.6%	2.1%
—————			
	<u>LATEST MONTH</u>	<u>% CHANGE OVER PRIOR MONTH</u>	<u>% CHANGE OVER A YEAR AGO</u>
Civilian Labor Force (thousands) (April)	6,379	0.1%	1.0%
Employment (thousands) (April)	5,992	0.0%	1.5%
New Car & Truck Registration (April)	54,094	-8.7%	2.5%
Single Family Housing Permits (April)	4,320	1.6%	0.7%
Total Exports (\$ mil) (March)	2,655	20.0%	16.6%
Chicago Purchasing Managers Index (May)	68.0	6.4%	30.3%

TRANSFERS

Update to Special Transfers

Lynnae Kapp, Revenue/Bond Analyst

In the April monthly report, the Commission discussed special transfers to the General Revenue Fund as part of the FY 2004 budget resulting from Public Act 93-0032 and Executive Order 2003-10. These special transfers include: administrative chargebacks, increased fee revenues, and transfers by Executive Order. [Revenues from increased fees go directly into their specific funds or into the General Revenue Fund through Other Sources. The increased fee revenues reported here are transfers from these other

funds to the General Revenue Fund after the fees have been receipted.] May transfers included some **reversals** of executive orders and chargebacks. Funds with asterisks show that May reversals have canceled out any previous FY 2004 transfers, netting a zero balance for that fund. The Metropolitan Exposition Auditorium and Office Building Fund (MEA OB) was to transfer \$3 million in May but it was reversed a few days later. Total Chargebacks for May, including reverse transfers, netted a -\$4.1 million. This added with the net Executive Order transfers of \$43,605 and Fee Increase transfers of \$743,100, equaled a net -\$3.4 million for May.

FUND #	FUND NAME	Chargebacks	Executive Order 10	Fee Increase	May TOTAL
0011	Road Fund		\$4,398		\$4,398
0041	Wildlife & Fish Fund*		-\$1,220		-\$1,220
0053	MEAOb*	\$0			\$0
0078	Solid Waste Management Fund		\$1,094		\$1,094
0089	Subtitle D Management Fund			\$743,100	\$743,100
0129	State Gaming Fund		\$128		\$128
0215	Capital Development Board Revolving		\$11,197		\$11,197
0218	Professions Indirect Cost Fund		\$24,783		\$24,783
0452	IL Tourism Tax	\$233,123			\$233,123
0617	CDB Contributory Trust*	-\$3,495,764			-\$3,495,764
0632	Horse Racing Fund		\$606		\$606
0711	State Lottery Fund		\$148		\$148
0765	Federal Surface Mining Control & Reclamation Fund*		-\$3,435		-\$3,435
0795	Bank & Trust Company Fund		\$5,906		\$5,906
0940	Self-Insurers Security Fund*	-\$1,375,182			-\$1,375,182
0997	Insurance Financial Regulation Fund	\$500,000			\$500,000
TOTAL	Special Transfers in May 2004	-\$4,137,823	\$43,605	\$743,100	-\$3,351,118

To date, net transfers from chargebacks to the General Revenue Fund have totaled \$197.8 million, while increased fee revenue transfers equal \$44.7 million and

Executive Order transfers are \$5.5 million. Total special transfers year-to-date, including statutory transfers from the beginning of the fiscal year, total \$406.5 million.

REVENUE

As Expected, Revenues dip in May Jim Muschinske, Revenue Manager

Excluding last year's short-term borrowing, May's general revenue receipts fell \$68 million for the month. An anticipated falloff in federal sources was the primary reason for the decline. Excluding federal sources, revenues were mixed. May had one less receipting day than last year. If last May's \$975 million in short-term borrowing was included, overall May receipts were down \$1.043 billion. [The short-term borrowing last May enabled a significant amount of reimbursable spending on Medicaid to

take place. As a result, federal source receipts were exceptionally high last May].

A number of tax sources experienced a monthly falloff. Sales tax receipts ended eight months of consecutive growth, dropping \$14 million, while public utility taxes also declined \$14 million. Liquor taxes declined by \$2 million and insurance taxes and fees dipped by \$1 million.

While overall revenues fell, a number of sources managed to post gains. Other sources rose by \$31 million due to increased fees as well as

contributions per P.A. 93-665 (related to changes in Pension Contribution Fund transfers—see March Monthly Revenue Briefing). In addition, the Cook County IGT increased by \$23 million. Inheritance tax revenue rose by \$11 million, possibly reflecting decoupling from the federal phase-out. Corporate franchise tax grew by \$2 million, while interest income increased by \$1 million. Gross personal income taxes grew by \$1 million, although on a net of refund basis receipts actually fell \$24 million. Likewise, while gross corporate income taxes also grew by \$1 million, on a net of refund basis revenues dipped by \$1 million.

Overall transfers were down \$20 million for the month. While lottery transfers were flat, the increase of \$13 million in riverboat transfers and receipts were more than offset by a \$33 million reduction in other transfers. As anticipated, federal sources fell in May, but the \$60 million drop was surprisingly small given last May's short-term borrowing that allowed a great deal of reimbursable spending. Apparently, May federal sources included some reconciliation from prior quarter(s) spending.

Year to Date

With one month remaining in the fiscal year, excluding revenues attributed to short-term borrowing and Budget Stabilization and Pension Contribution funds transfers, receipts are up \$2.155 billion over the same period last fiscal year. The increase in federal source receipts still represents the majority of the revenue gain—54%, but the acceleration of monies due to the tax

amnesty program as well as administrative chargebacks and other funds transfers have contributed significantly to the increase.

In large part due to tax amnesty, gross corporate income taxes are up \$352 million, or \$196 million net of refunds. Approximately \$225 million in gross corporate income taxes (\$152 million net of refunds) were coded and reported under tax amnesty designation. Sales taxes are up \$238 million through May, with approximately \$94 million of that coded as tax amnesty. Gross personal income taxes are up \$227 million, although on a net of refund basis are actually down \$70 million. Cook County intergovernmental transfers are up \$73 million, while insurance taxes and fees rose \$40 million. All other sources experiencing gains total an additional \$81 million.

A couple of sources are down through eleven months of the fiscal year. Inheritance taxes, despite decoupling, are still lagging and are lower by \$19 million, while interest from investments are down \$8 million due to low rates of return.

Through May, overall transfers are up \$457 million. While lottery transfers are up \$35 million and riverboat transfers and receipts have increased \$84 million as the result of the increased wagering and admission tax, \$338 million of the increase is due to other transfers. Of that amount, approximately \$198 million is due to administrative chargebacks, \$45 million due to requested transfers related to fee increases, and \$6 million due to Executive Order 2003-10, \$48 million due to P.A. 93-665. Finally, federal sources continue to be up dramatically

for the year-- \$1.167 billion. That remarkable increase is due to \$422 million in flexible federal grants, a higher Medicaid reimbursement rate, and a concerted effort to spend down the Medicaid payment cycle earlier in the fiscal year.

Excluding short-term borrowing and Pension Contribution Fund transfers, overall revenues still must grow by \$281 million or 14.2% over the remaining month of the fiscal year to reach the Commission's estimate. While the more closely tied economic sources have performed quite well over the second half of the fiscal year, a number of uncertainties still exist with only one month to go. Namely, the FY 2004 budget was predicated on \$421 million from increased revenues from fees, based on performance to date it appears that fee revenues will fall short of those expectations (the Commission's latest estimate of these fees revenues was revised down by \$60 million in March to a total of \$351 million, but even that estimate may be in jeopardy of being reached). In

addition, the FY 2004 budget was based on \$422 million in administrative fund chargebacks. Through May those chargebacks total approximately \$198 million, meaning that over the remaining month they must increase substantially from their current rate. Since the beginning of the fiscal year, the Commission's estimate of these chargebacks has been a more conservative \$347 million, but even that forecast calls for a significant pick-up in such transfers over the remaining month. Also, both the Commission's and the GOMB's forecast for FY 2004 included \$233 million from the sale/lease/mortgage of various State properties. As of now, only \$200 million from the mortgage agreement on the Thompson Center seems likely, although to date even that has not been finalized. On the positive side, it appears quite likely that a long-going court case involving liquor taxes may be finally resolved in early June. If resolved, this would release approximately \$76 million, in protested liquor taxes from the Protest Fund. This money has been anticipated for a number of months, but due to delays and other uncertainties, it was never officially included in the forecast.

GENERAL FUNDS RECEIPTS: MAY

FY 2004 vs. FY 2003

(\$ million)

Revenue Sources	MAY FY 2004	MAY FY 2003	\$ CHANGE	% CHANGE
State Taxes				
Personal Income Tax	\$686	\$685	\$1	0.1%
Corporate Income Tax (regular)	36	35	\$1	2.9%
Sales Taxes	507	521	(\$14)	-2.7%
Public Utility Taxes (regular)	73	87	(\$14)	-16.1%
Cigarette Tax	33	33	\$0	0.0%
Liquor Gallonage Taxes	9	11	(\$2)	-18.2%
Vehicle Use Tax	3	3	\$0	0.0%
Inheritance Tax (Gross)	26	15	\$11	73.3%
Insurance Taxes and Fees	1	2	(\$1)	-50.0%
Corporate Franchise Tax & Fees	17	15	\$2	13.3%
Interest on State Funds & Investments	5	4	\$1	25.0%
Cook County IGT	67	44	\$23	52.3%
Other Sources	58	27	\$31	114.8%
Subtotal	\$1,521	\$1,482	\$39	2.6%
Transfers				
Lottery	42	42	\$0	0.0%
Riverboat transfers & receipts	53	40	\$13	32.5%
Other	29	62	(\$33)	-53.2%
Total State Sources	\$1,645	\$1,626	\$19	1.2%
Federal Sources	\$548	\$608	(\$60)	-9.9%
Total Federal & State Sources	\$2,193	\$2,234	(\$41)	-1.8%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	(\$80)	(\$55)	(\$25)	45.5%
Corporate Income Tax	(\$11)	(9)	(\$2)	22.2%
Subtotal General Funds	\$2,102	\$2,170	(\$68)	-3.1%
Short-Term Borrowing	\$0	\$975	(\$975)	N/A
Budget Stabilization Fund Transfer	\$0	\$0	\$0	N/A
Pension Contribution Fund Transfer	\$0	\$0	\$0	N/A
Total General Funds	\$2,102	\$3,145	(\$1,043)	-33.2%

IEFC SOURCE: Office of the Comptroller: Some totals may not equal, due to rounding

2-Jun-04

GENERAL FUNDS RECEIPTS: YEAR TO DATE

*FY 2004 vs. FY 2003
(\$ million)*

Revenue Sources	FY 2004	FY 2003	CHANGE FROM FY 2003	% CHANGE
State Taxes				
Personal Income Tax	\$7,521	\$7,294	\$227	3.1%
Corporate Income Tax (regular)	1,207	855	\$352	41.2%
Sales Taxes	5,774	5,536	\$238	4.3%
Public Utility Taxes (regular)	977	953	\$24	2.5%
Cigarette Tax	366	366	\$0	0.0%
Liquor Gallonage Taxes	114	113	\$1	0.9%
Vehicle Use Tax	32	31	\$1	3.2%
Inheritance Tax (Gross)	201	220	(\$19)	-8.6%
Insurance Taxes and Fees	292	252	\$40	15.9%
Corporate Franchise Tax & Fees	148	132	\$16	12.1%
Interest on State Funds & Investments	52	60	(\$8)	-13.3%
Cook County IGT	405	332	\$73	22.0%
Other Sources	324	285	\$39	13.7%
Subtotal	\$17,413	\$16,429	\$984	6.0%
Transfers				
Lottery	504	469	\$35	7.5%
Riverboat transfers & receipts	594	510	\$84	16.5%
Other	879	541	\$338	62.5%
Total State Sources	\$19,390	\$17,949	\$1,441	8.0%
Federal Sources	\$4,838	\$3,671	\$1,167	31.8%
Total Federal & State Sources	\$24,228	\$21,620	\$2,608	12.1%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	(\$880)	(\$583)	(\$297)	50.9%
Corporate Income Tax	(\$387)	(\$231)	(\$156)	67.5%
Subtotal General Funds	\$22,961	\$20,806	\$2,155	10.4%
Short-Term Borrowing	\$0	\$1,675	(\$1,675)	N/A
Budget Stabilization Fund Transfer	\$226	\$226	\$0	0.0%
Pension Contribution Fund Transfer	\$1,395	\$0	\$1,395	N/A
Total General Funds	\$24,582	\$22,707	\$1,875	8.3%

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

IEFC

2-Jun-04

GENERAL FUNDS GROWTH NEEDED TO MEET ESTIMATE

FY 2004 ESTIMATE vs. FY 2003 ACTUAL

(\$ million)

	March-04 ESTIMATE	FYTD 2004	AMOUNT NEEDED FY 2004 EST.	FYTD 2003	GROWTH NEEDED	% CHANGE
Revenue Sources						
<i>State Taxes</i>						
Personal Income Tax	\$8,110	\$7,521	\$589	\$7,294	(\$96)	-14.0%
Corporate Income Tax (regular)	1,302	1,207	\$95	855	(\$61)	-39.1%
Sales Taxes	6,265	5,774	\$491	5,536	(\$32)	-6.1%
Public Utility Taxes (regular)	1,030	977	\$53	953	\$0	0.0%
Cigarette Tax	400	366	\$34	366	\$0	0.0%
Liquor Gallonage Taxes	122	114	\$8	113	(\$2)	-20.0%
Vehicle Use Tax	35	32	\$3	31	\$0	0.0%
Inheritance Tax (Gross)	215	201	\$14	220	(\$3)	-17.6%
Insurance Taxes and Fees	342	292	\$50	252	(\$11)	-18.0%
Corporate Franchise Tax & Fees	160	148	\$12	132	\$2	20.0%
Interest on State Funds & Investments	50	52	(\$2)	60	(\$8)	-133.3%
Cook County IGT	440	405	\$35	332	\$12	52.2%
Other Sources	878	324	\$554	285	\$490	765.6%
<i>Subtotal</i>	\$19,349	\$17,413	\$1,936	\$16,429	\$291	17.7%
<i>Transfers</i>						
Lottery	550	504	\$46	469	(\$25)	-35.2%
Riverboat transfers & receipts	654	594	\$60	510	\$16	36.4%
Other	1,048	879	\$169	541	\$121	252.1%
<i>Total State Sources</i>	\$21,601	\$19,390	\$2,211	\$17,949	\$403	22.3%
<i>Federal Sources</i>	\$4,987	\$4,838	\$149	\$3,671	(\$120)	-44.6%
<i>Total Federal & State Sources</i>	\$26,588	\$24,228	\$2,360	\$21,620	\$283	13.6%
Nongeneral Funds Distribution:						
<i>Refund Fund</i>						
Personal Income Tax	(\$949)	(\$880)	(\$69)	(\$583)	(\$14)	25.5%
Corporate Income Tax	(417)	(\$387)	(\$30)	(231)	\$12	-28.6%
<i>Subtotal General Funds</i>	\$25,222	\$22,961	\$2,261	\$20,806	\$281	14.2%
<i>Short-Term Borrowing</i>	\$0	\$0	\$0	\$1,675	\$0	N/A
<i>Budget Stabilization Fund Transfer</i>	\$226	\$226	\$0	\$226	\$0	N/A
<i>Proceeds from Pension Obligation Bonds</i>	\$1,395	\$1,395	\$0	\$0	(\$300)	-100.0%
<i>Total General Funds</i>	\$26,843	\$24,582	\$2,261	\$22,707	(\$19)	-0.8%
IEFC						2-Jun-04

GENERAL FUNDS PERFORMANCE TO DATE
GOVERNOR'S OFFICE OF MANANGEMENT AND BUDGET

FY 2004 ESTIMATE vs. FY 2003 ACTUALS

(\$ million)

	*GOMB FEB-04 Estimate FY 2004	FYTD 2004	AMOUNT NEEDED FY 2004 Est.	FYTD 2003	GROWTH NEEDED	% CHANGE
Revenue Sources						
State Taxes						
Personal Income Tax	\$8,051	\$7,521	\$530	\$7,294	(\$155)	-22.6%
Corporate Income Tax (regular)	1,296	1,207	\$89	855	(\$67)	-42.9%
Sales Taxes	6,280	5,774	\$506	5,536	(\$17)	-3.3%
Public Utility Taxes (regular)	1,062	977	\$85	953	\$32	60.4%
Cigarette Tax	450	366	\$84	366	\$50	147.1%
Liquor Gallonage Taxes	123	114	\$9	113	(\$1)	-10.0%
Vehicle Use Tax	35	32	\$3	31	\$0	0.0%
Inheritance Tax (Gross)	240	201	\$39	220	\$22	129.4%
Insurance Taxes and Fees	333	292	\$41	252	(\$20)	-32.8%
Corporate Franchise Tax & Fees	175	148	\$27	132	\$17	170.0%
Interest on State Funds & Investments	50	52	(\$2)	60	(\$8)	-133.3%
Cook County IGT	440	405	\$35	332	\$12	52.2%
Other Sources	1,187	324	\$863	285	\$799	1248.4%
Subtotal	\$19,722	\$17,413	\$2,309	\$16,429	\$664	40.4%
Transfers						
Lottery	540	504	\$36	469	(\$35)	-49.3%
Gaming Fund Transfer	639	594	\$45	510	\$1	2.3%
Other	1,128	879	\$249	541	\$201	418.8%
Total State Sources	\$22,029	\$19,390	\$2,639	\$17,949	\$831	46.0%
Federal Sources	\$4,987	\$4,838	\$149	\$3,671	(\$120)	-44.6%
Total Federal & State Sources	\$27,016	\$24,228	\$2,788	\$21,620	\$711	34.2%
Nongeneral Funds Distribution:						
Refund Fund						
Personal Income Tax	(\$942)	(\$880)	(\$62)	(\$583)	(\$7)	12.7%
Corporate Income Tax	(415)	(387)	(\$28)	(231)	\$14	-33.3%
Subtotal General Funds	\$25,659	\$22,961	\$2,698	\$20,806	\$718	36.3%
Short-Term Borrowing	\$0	\$0	\$0	\$1,675	\$0	N/A
Budget Stabilization Fund Transfer	\$226	\$226	\$0	\$226	\$0	N/A
Proceeds from Pension Obligation Bonds	\$1,600	\$1,395	\$205	\$0	(\$95)	-31.7%
Total General Funds	\$27,485	\$24,582	\$2,903	\$22,707	\$623	27.3%

* GOMB forecast based on information provided in FY 2005 Budget Book. For comparison sake, the GOMB figure of \$27.115 billion was adjusted by \$144 million (in other transfers) per actual FY 2004 "fund sweep" receipt experience. In addition, \$226 million was included for Budget Stabilization Fund transfers.