ILLINOIS ECONOMIC
and
FISCAL COMMISSION

FY 2004 REVENUE ESTIMATE

and

UPDATED FY 2003 REVENUE OUTLOOK

MARCH 2003
703 STRATTON BUILDING
SPRINGFIELD, ILLINOIS 62706

ILLINOIS ECONOMIC and FISCAL COMMISSION

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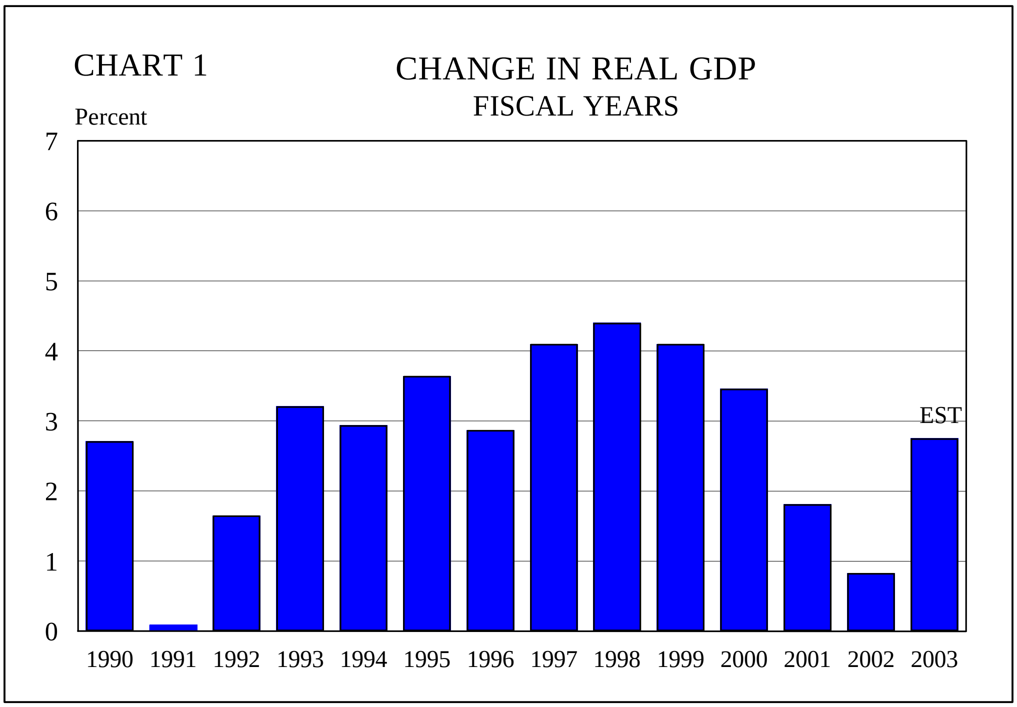
PRELIMINARY FY 2004 REVENUE ESTIMATE

REVIEW OF FY 2003:
Disappointing Recovery

The economy continued to recover from recession during FY 2003, but lacked the normal bounce associated with the early stages of an economic recovery. Indeed, as shown in Chart 1, FY 2003 marked the third consecutive year where growth in real gross domestic product (GDP) fell well below the rates seen in every year between FY 1993 and FY 2000. Moreover, the pace of growth was uneven during the year, rising at a 4% annual rate in the early months and only about half that pace in the last three quarters of the fiscal year. At times the economy hit a soft patch, with growth coming to a virtual halt.

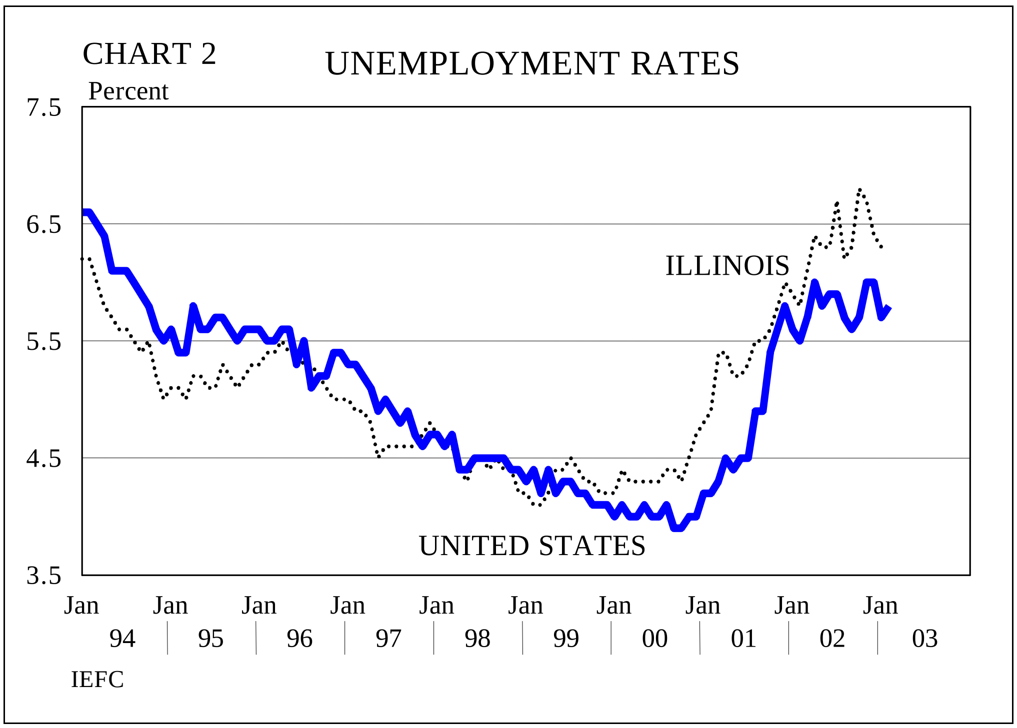


The consumer, which normally makes up about two-thirds of total spending, provided the basis for economic growth. Sparked by zero-percent financing, new car sales hit record levels, in sharp contrast to the recovery following the 1990-91 recession when low but stable levels of sales were the case. The lowest mortgage rates in forty years also led to continued strong increases in new housing activity while a record level of refinancing freed up funds for further gains in consumer spending.

In contrast, business spending remained weak. Indeed, the manufacturing sector, as measured by the Purchasing Manager's Index, had begun to recover in the last half of FY 2002 but then reversed course. The overall index slipped as FY 2003 began and by September manufacturing was actually in a state of contraction. The sector showed some signs of expansion again by January, but whether or not the recent improvement would be sustainable has been brought into question.

Consumer sentiment has turned sour as concerns over the impact of a likely conflict in Iraq mounts, the equity markets remain extremely depressed, winter storms virtually shut down some areas of the country, and oil prices have soared. Not only are consumer spending gains threatened, but rising energy prices cut into corporate profitability as weak demand made it impossible for businesses to raise prices. In February, corporate profit revenues in Illinois were down by more than 11% from the same period a year earlier.

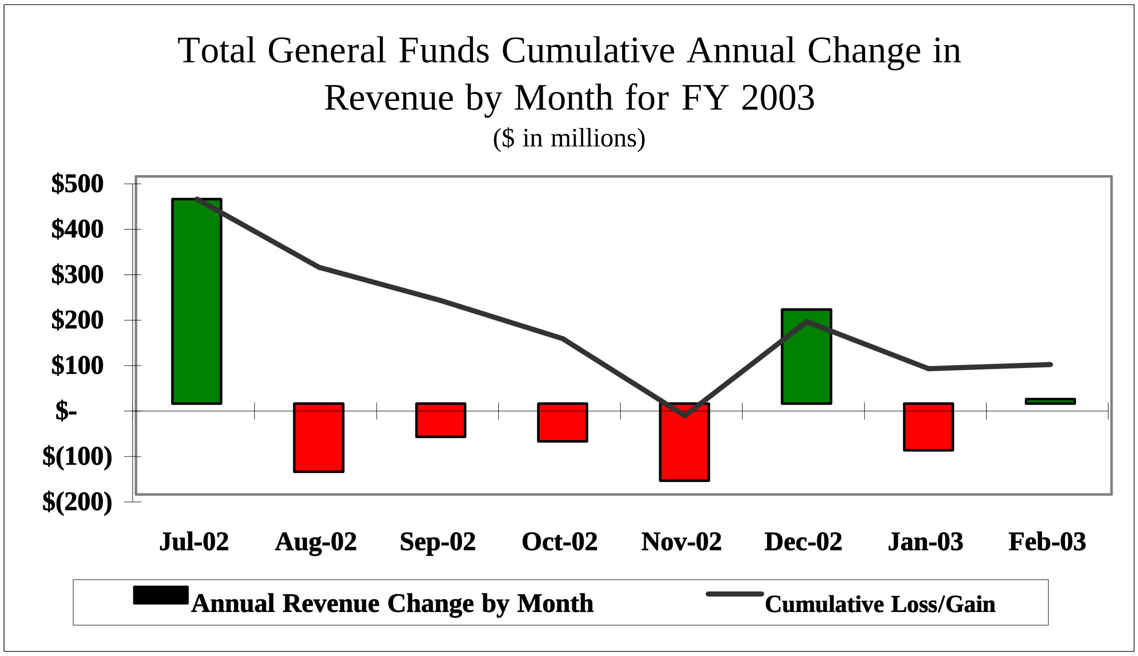
The weakness in business was evidenced by a worsening job picture. As shown in Chart 2, the national unemployment rate reached 6% before leveling out, while the Illinois rate hit a high of 6.8% in October and has shown little improvement since. Indeed, over the past three years Illinois' unemployment rate has exceeded national levels, in sharp contrast to the mid 1990s when the State consistently had a rate below that of the nation.



In the twelve months ended January 2003, employment declined by 29,700, one of the largest job losses of any state. Indeed, had it not been that the size of the labor force shrunk by over 16,700, the unemployment rate would have been even higher. The later decline undoubtedly reflected the hesitation of business to spend in increasingly uncertain times. As a result, both personal income and sales tax revenues were under severe pressure. Moreover, income tax collections were further reduced by the devastation in the equity markets which eliminated most of the revenues derived from capital gains.

In reviewing FY 2003, the economy showed only minor improvement in activity as it continued to emerge from recession at an agonizingly slow pace. Moreover, it has been a jobless recovery which when coupled with weak profits has led to further weakness in the major sources of State revenues – individual and corporate income and sales taxes. Overall, FY 2003 was another year of disappointment.

FY 2003 REVENUE RECAP



After a disastrous ending to the previous fiscal year that saw general revenues fall $727 million, FY 2003 began on a strong note as general revenues jumped up $450 million in July. A significant amount of that increase came from approximately $157 million in one-time interfund transfers. In addition, of the total $1 billion in short-term borrowing executed in July, $700 million of that amount was deposited into the General Revenue Fund. The borrowing enabled increases in reimbursable spending and, as a result, July federal source revenue was significantly higher (up $229 million) than what otherwise would have been. Excluding short-term borrowing, one-time transfers (including $226 million in Budget Stabilization Fund transfers), and federal source receipts, July revenue growth was a much more modest $64 million.

The increase in revenues was short lived, however, as August receipts fell by $150 million. While a large drop in federal sources contributed to the decline, the larger more economically-tied sources such as income and sales taxes again sputtered. The first quarter ended with another poor month as September revenues fell $73 million. Despite two consecutive months of decline, overall revenues were up $227 million, although excluding one-time transfers and federal sources, first quarter revenues were essentially flat. Despite the Commission's FY 2003 estimate that was $207 million lower than what the enacted FY 2003 budget assumed, growth rates needed to reach even the Commission's more conservative forecast were becoming a concern. As a result, the Commission scheduled a meeting for late November.

The second quarter began as the first ended, on a down note as revenues dropped approximately $83 million. Weakness in the larger sources continued and it became clear that the earlier estimate would not be reached. By November, the disappointing year-to-date revenue performance, continued poor outlook on the employment picture, fallen consumer confidence, and low rates of return, necessitated a $385 million downward revision in the Commission's estimate. November saw revenues continue to slide as weakness in virtually all sources resulted in a monthly decline of $170 million. Revenues finally had a positive month in December as $88 million in unanticipated tobacco settlement monies contributed to a gain of $207 million in monthly receipts. With two quarters of FY 2003 completed, revenues were up $180 million. However, after factoring out the one-time transfers and newly-receipted tobacco money, receipts were actually down approximately $65 million, and growth rates needed to reach certain estimates were already coming under downward pressure as the economic recovery stalled.

The third quarter started off poorly with revenues falling $103 million in January, reflecting the bleak employment situation as well as a disappointing holiday season for retailers. While overall revenues were up approximately $77 million, absent $249 million in one-time interfund and tobacco settlement monies, revenues were actually down $172 million. Clearly, the recovery phase continued weak, especially measured by job growth and business spending. Making matters worse were the looming clouds of war and uncertainties associated with its outcome and its impact on consumer activity. In the Commission's January monthly briefing, the specter of a second consecutive year of revenue decline was raised.

February receipts managed to eek out a $10 million gain, due to increases in intergovernmental transfers and a decent showing for personal income tax. However, despite the reprieve from yet another month of decline, once one-time transfers and tobacco monies are excluded, revenues were still down by approximately $163 million after two-thirds of the fiscal year.

REVISED FY 2003 GENERAL REVENUE FORECAST

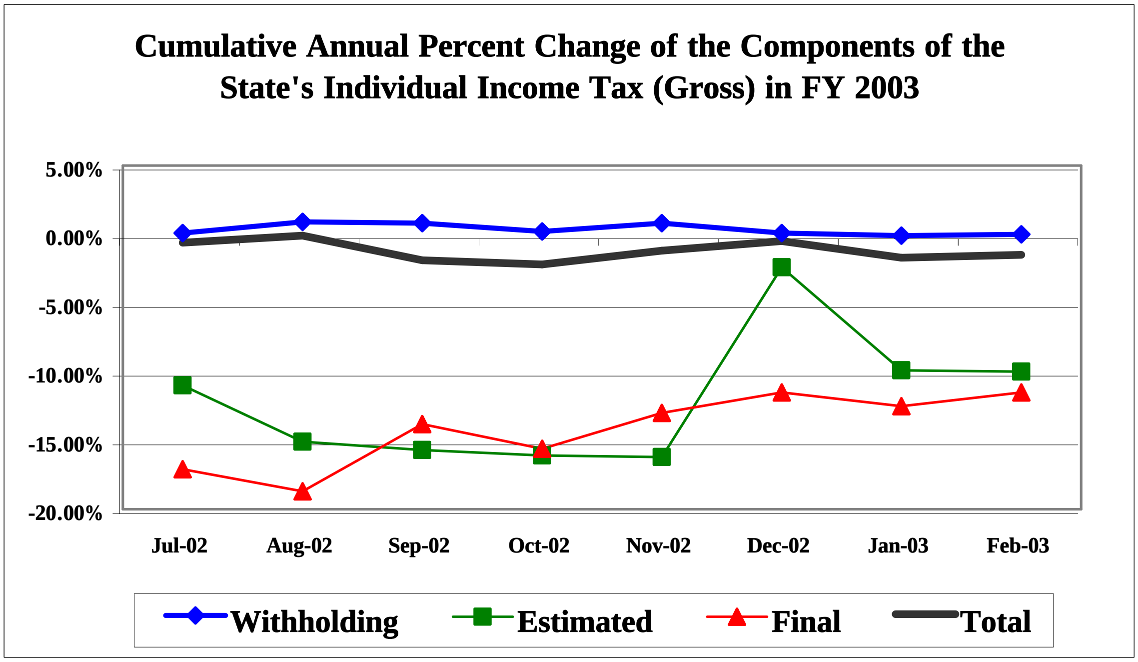
As shown in Table 1 on page 15, excluding short-term borrowing and Budget Stabilization Fund transfers, general revenues through February are up $86 million or 0.6%. However, even that very modest growth is not truly representative of this year's dismal revenue performance as it includes approximately $249 million in one-time interfund and tobacco settlement monies. Absent those items, revenues actually would be down approximately $163 million, reflecting the continued weak economic activity and uncertainty that prevails. In order to reach the Commission's November forecast, revenues would have to increase by 3.7% over the remaining four months.

Given the current weakness felt throughout the consumer and business sectors, the recent spike in energy prices, and continued weak employment picture, most required growth rates are not obtainable. It appears that any measurable revenue gains associated with the anemic recovery are still some time off. As a result, the Commission is revising its FY 2003 general funds forecast down by $739 million to $23.054 billion (see Tables 2 and 3 on pages 16 and 17). **The revised estimate reflects a $325 million decline from last year's actual and represents a second year of revenue decline, again illustrating that while the past recession was considered mild by some measures, its impact on state revenues has been especially hard.**

A discussion of the sources experiencing revisions include the following:

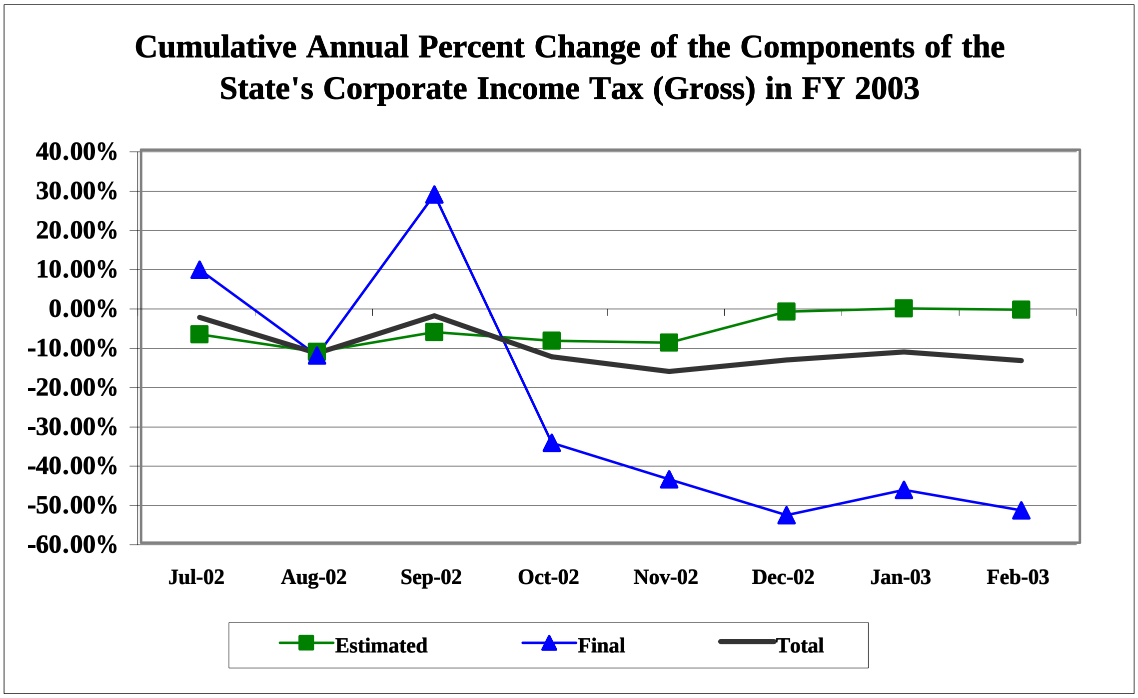
- Gross personal income tax receipts were down $39 million or 0.8% ($56 million or 1.2% net of refunds) through the first two-thirds of the year. Personal income taxes are comprised of withholding taxes, estimated payments, and final payments. Through February, withholding payments, which are based on current wages and employment and make up nearly 80% of total income taxes, are flat reflecting the fact that the employment picture has not yet shown much improvement. In fact, January marked the 25th consecutive month of unadjusted non-farm employment being below the same month of the year earlier. Since there appears to be an approximate 6-month lag between changes in levels of employment and resulting changes in withholding tax collections, it's unlikely that a dramatic reversal in withholding tax performance will occur before the end of the fiscal year.

  Estimated payments, which are largely made up of non-wage income such as capital gains and other investment income and make up approximately 12% of total income tax receipts, are down 10.0% through February. The decline reflects the continued poor performance of the equity markets as well as the requirement that taxpayers only have to submit estimated payments in amounts similar to what they owed the year before. Subsequently, even if the financial markets rebound appreciably in the near future, it's impact on tax revenues may not be felt for some time, either in future estimated or final payments. Lastly, those final payments, which comprise the remainder of income tax collections, are final settlements that are made by the taxpayer. While the vast majority of final payments are not received until after the April 15th deadline, there doesn't appear to be many reasons to expect a dramatic rebound in future final payments, although they should be able to improve on last year's 30% decline.



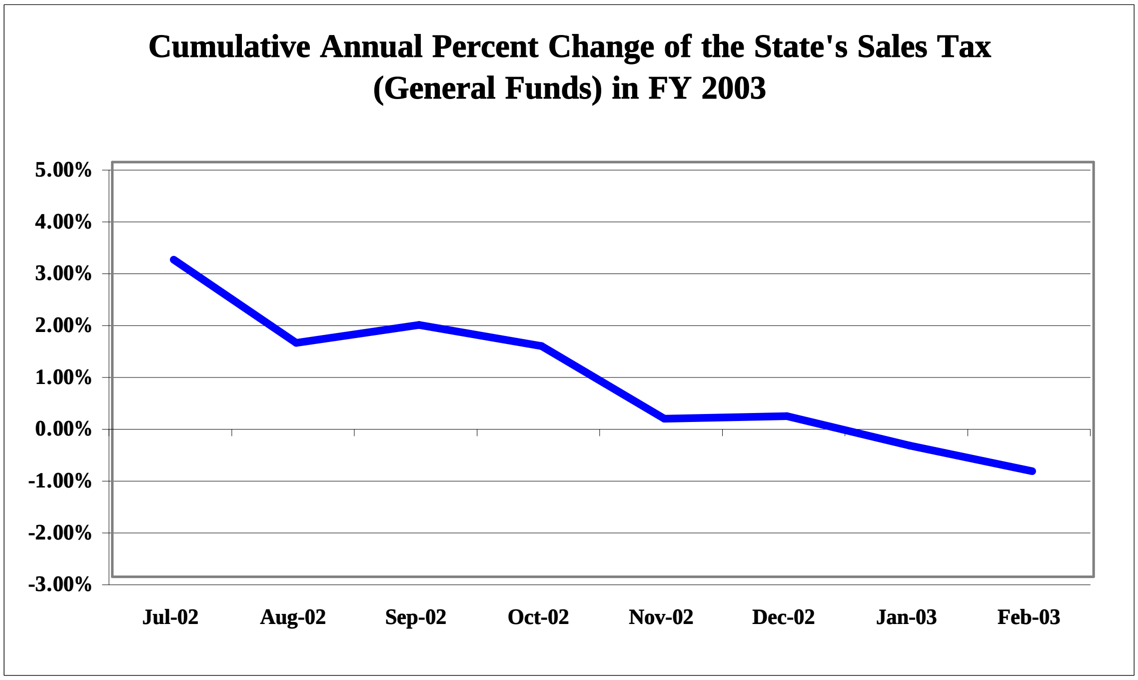
As a result of the disappointing performance to date, in addition to reduced expectations in the near future, the estimate of gross personal income tax revenues has been revised down $295 million ($271 net of refunds). The revised forecast represents a decline of $136 million or 1.7% ($157 million or 2.1% net of refunds) over the previous fiscal year. In order to reach the revised estimate, gross personal income taxes are expected to decline 3.3% over the remaining months reflecting flat withholding and continued poor estimated and final payments.

- Gross corporate income tax receipts were down $55 million or 11.2% ($60 million or 15.8% net of refunds) through February. Corporate income taxes are comprised of estimated and final payments. Through the first two-thirds of the year, estimated payments, which usually comprise slightly more than 60% of the total, are off 0.7%. Final payments make up the remainder, and once again are more heavily receipted after the April deadline. Corporate income taxes have been particularly hard hit over the last couple of years and, even though prospects for improvement are building, significant rebounds in profitability will likely be pushed off into the next fiscal year.



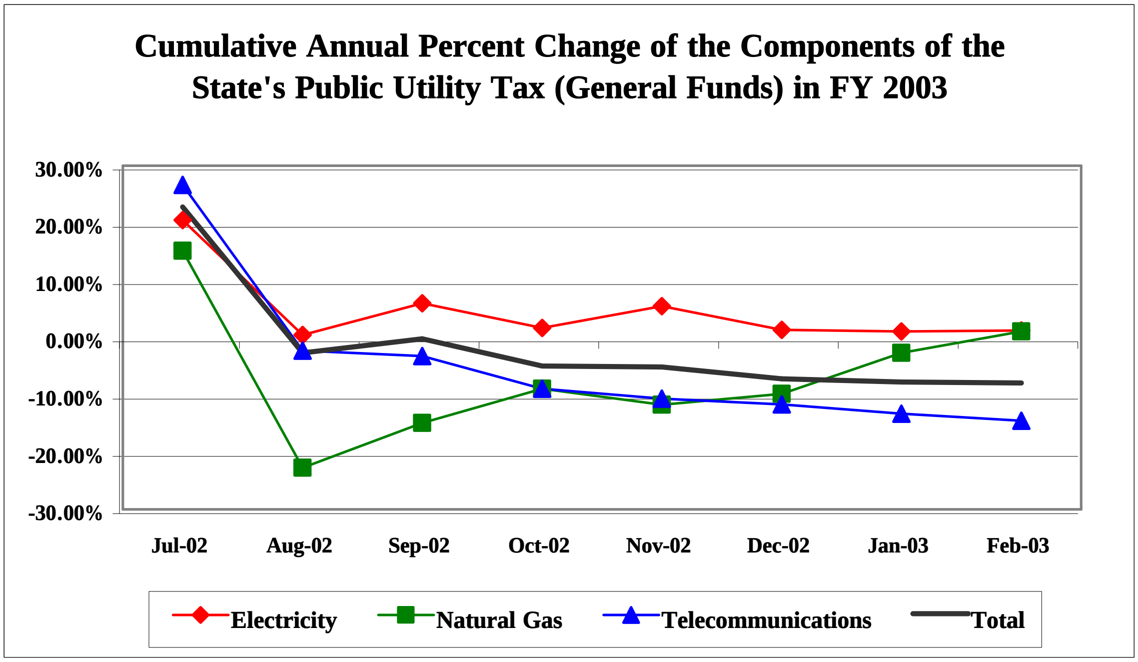
Current economic and geopolitical uncertainties are weighing heavily on business. Adding on increased costs associated with energy prices will further dampen any incentive business has to add workers as their bottom lines are pinched further. As a result, the estimate of gross corporate income tax revenues has been lowered $125 million ($92 million net of refunds). The revised estimate represents a decline of $93 million or 8.9% ($110 million or 13.7% net of refunds). Gross receipts are expected to fall 6.9% over the remainder of the fiscal year, reflecting continued poor receipting.

- Through the first two-thirds of the fiscal year, sales tax revenues are down $39 million or 1.0%. A very poor holiday shopping season contributed to the year-to-date decline. The consumer had held up the economy throughout the recession, but there doesn't appear to be much pent up spending pressure. While aggressive auto incentives over the past year have fueled purchases, their ability to attract buyers has begun to wane. Record levels of refinancing have freed up some disposable cash, but job and war fears appear to be taking their toll on consumer attitudes and purchasing decisions. The downside concern raised in November appears to have come true, that is the consumer seems to be taking a breather.



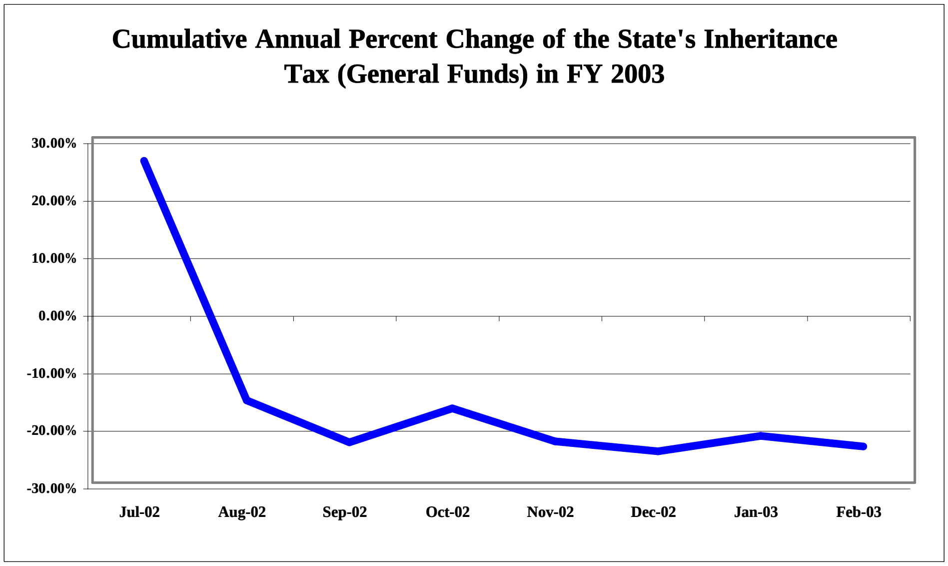
With receipts running below last year's levels for most recent months, absent an unforeseen pickup, it will be difficult to mount much of a charge over the last third of the fiscal year. While the fact that sales tax receipts performed very poorly over the last part of FY 2003 may be able to stave off a further decline on a comparative basis, it won't prove enough to prevent a reduction in the estimate thus the forecast has been revised down by $250 million. The revised forecast represents a $26 million or 0.4% decline from last fiscal year. Sales tax revenues are expected to remain flat over the remaining months of the fiscal year.

- Public utility taxes are down $56 million through February. Both natural gas and electricity tax receipts are up about 1% year-to-date, while telecommunications tax receipts thus far have lost about 14.5%.

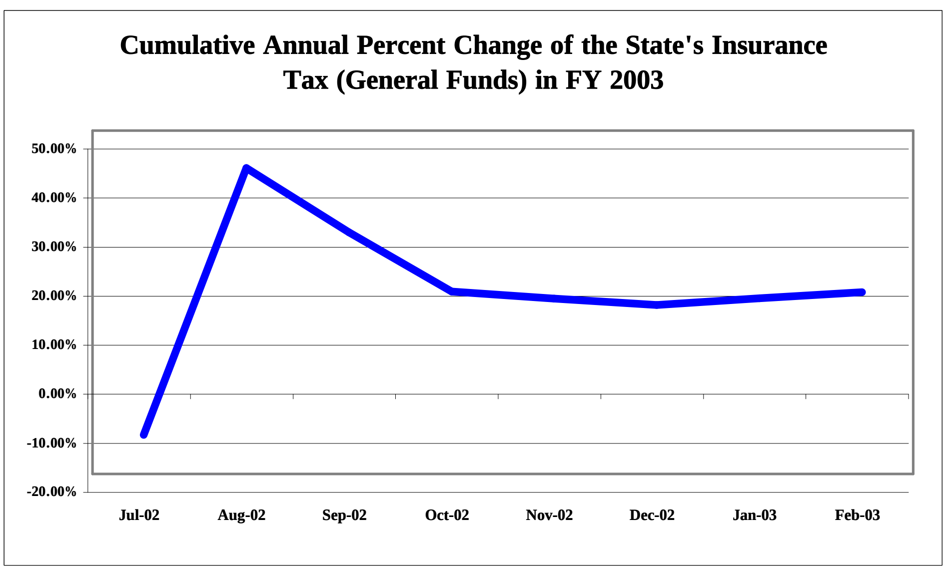


While a large factor impacting the performance of public utility taxes is weather fluctuations, economic conditions influencing the telecommunications industry are even more to blame. Competition and other factors have served to suppress that component of utility taxes and there is little reason to expect a near-term turn around. As a result, the estimate has been reduced by $105 million. The revised forecast assumes a continued falloff in overall public utility tax resulting in an overall loss from last year of $79 million or 7.2%.

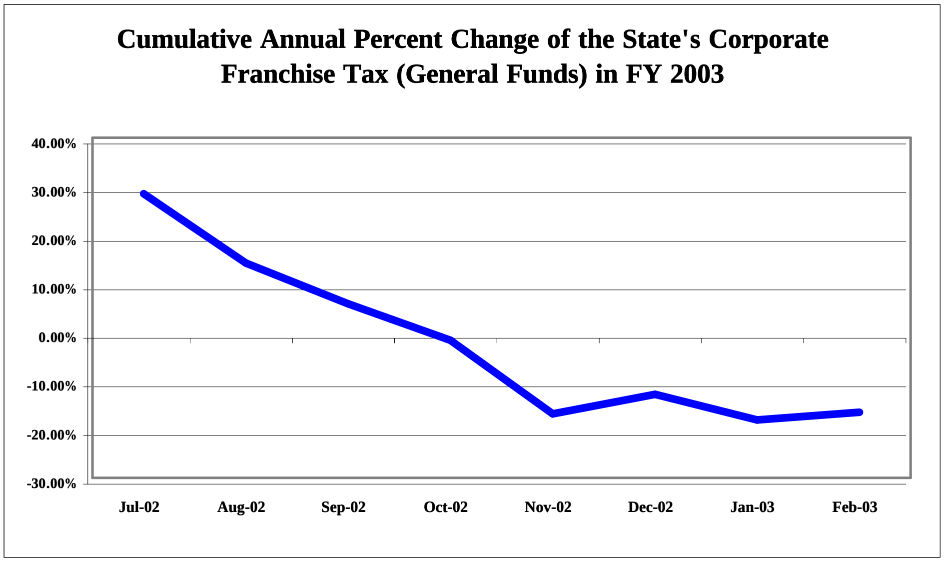
- As expected, inheritance tax receipts are down for the year, with receipts off $54 million or 23.6%. A decline was expected for FY 2003 as a result of the phase-out of the federal inheritance tax. However, the continued depressed financial markets apparently have contributed to reduced estate valuations that have reduced receipts to even lower-than-anticipated levels. Based on the performance to date, the estimate is being lowered $20 million. The estimate assumes that inheritance tax receipts will continue to fall approximately 25% below last year's levels.



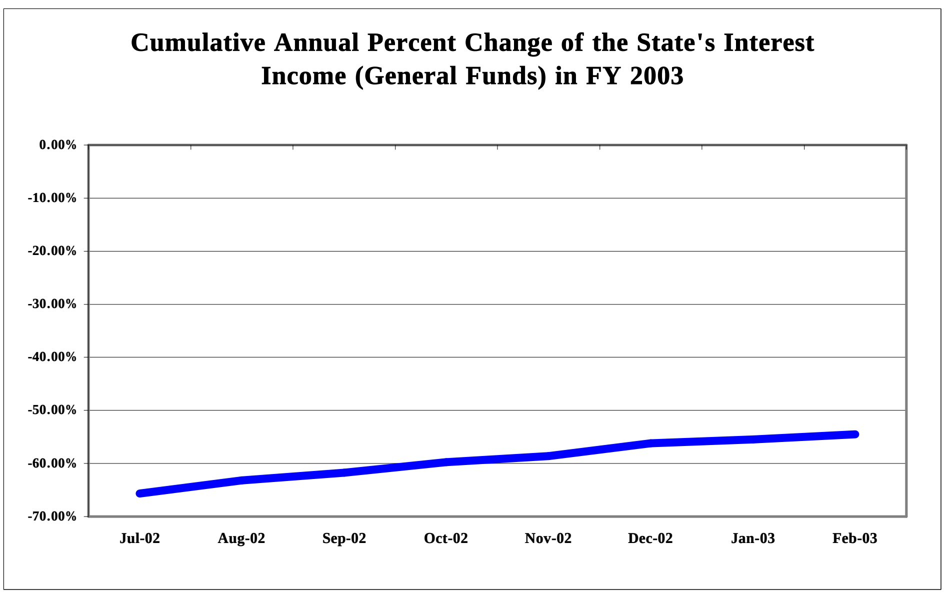
- Insurance taxes and fees is one of the only revenue sources that have managed to perform well throughout most of the fiscal year. Receipts are up approximately $20 million or 16.8% over the same period of last year and are exceeding earlier expectations. As a result, the estimate has been increased by $25 million and assumes that growth will temper somewhat over the last third of the fiscal year, finishing the year up $33 million or 12.1%.



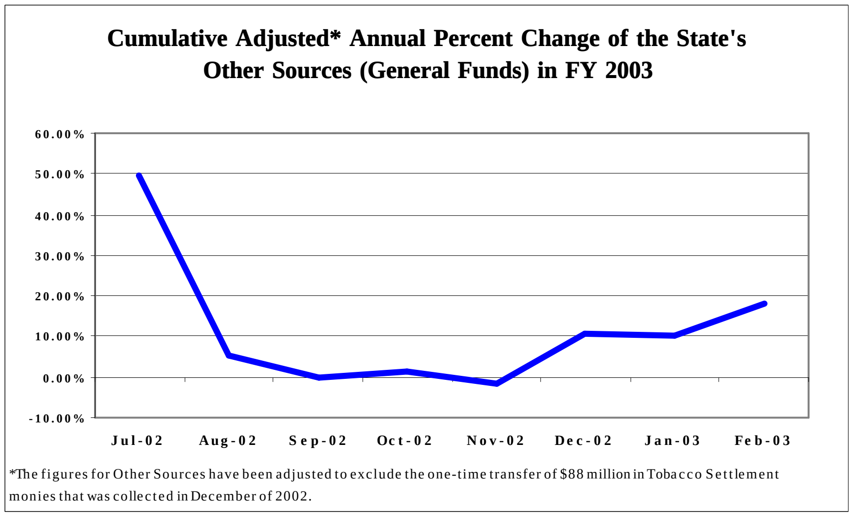
- Corporate franchise taxes have started to fall off in recent months and are yet another indicator of the poor corporate investment picture. Through February, receipts are down $17 million or 15.7%. It's unlikely that business activity will suddenly reverse and receipts will mount any substantial gains over the remaining months. The estimate has been lowered $24 million. The revised forecast assumes that the rate of decline will slow, but still fall approximately $19 million or 11.9% below last year's levels.



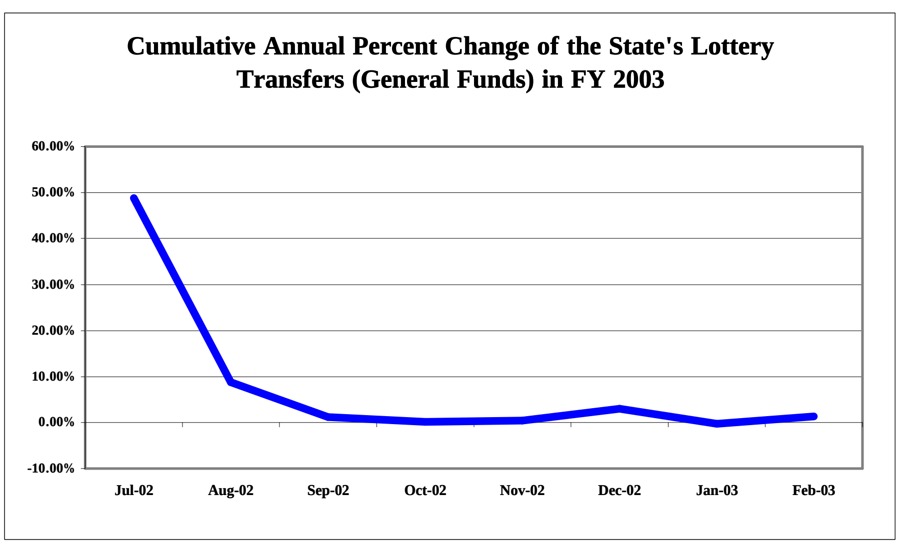
- Continued lower interest rates have dramatically reduced investment income. With the Fed likely to hold pat, or even lower interest rates again in the near future, it would seem unlikely that a significant gain in rates would be realized by fiscal year end. Therefore, the FY 2003 estimate has been reduced by $25 million, reflecting the expectation of continued very poor rates of return and low investable balances.



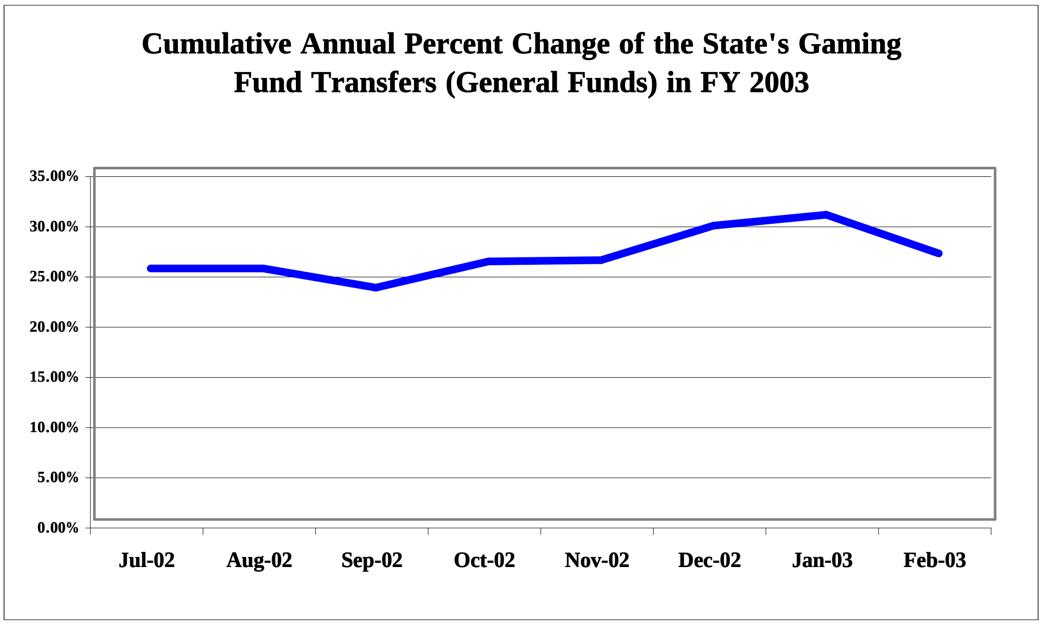
- Other sources to the general funds are up $110 million through February. The vast majority of that gain is the result of an unexpected deposit of $88 million in December stemming from the release of a portion of the tobacco settlement proceeds, which had been held in escrow pending agreement over a legal dispute. As a result, the estimate has been increased a net amount of $87 million. It should be noted that the FY 2003 forecast for other sources continues to assume a drop of approximately $214 million in Build Illinois general reserve account transfers.



- While Lottery transfers are up a modest 1.2% through the first two-thirds of the fiscal year, that performance is below expectations as it was forecasted that with New York choosing to participate in the Big Game, larger jackpots would translate into higher available transfers into the Common School Fund. While Big Game sales are up over 22% through January, overall sales are up only 3.2%. Based on overall sales and transfers to date as well as an extremely strong April of last year, it seems unlikely that substantial gains over the remaining four months will occur. Therefore, the estimate has been lowered by $25 million and reflects a flat final third of the fiscal year and minimal gains over last year's total.



- Transfers from the State Gaming Fund into the Education Assistance Fund are up $84 million or 26.7% through February. The large rate of growth is the result of the new graduated taxing structure that was changed at the beginning of FY 2003. Despite the increase in tax revenue and related transfers, revenues are falling short of expectations as the performances of the riverboats, as measured by the taxable component of adjusted gross receipts, are down 1.4% through February. Industry representatives point to competition from nearby Indiana boats as one of the main culprits, but also blame the increased tax rates as a cause for the reduction. The estimate has been reduced by $35 million, and assumes that the rate of growth will slow slightly over the last four months of the fiscal year, finishing up $120 million or 25.5% for the year.



The revised FY 2003 general funds forecast takes into account the previous two-thirds of the fiscal year as well as adjusts down expectations for the remaining months. In order to reach the revised estimate, overall revenues must decline $410 million or 4.6% over the remaining four months. That falloff is anticipated as result of poor income and sales tax expectations, as well as a scheduled falloff in other sources related to transfers and lower federal source receipts.

Unfortunately, uncertainties regarding this recovery still far outweigh the normal comfort level. High energy prices, a volatile stock market, and war worries add to the drags, while record refi's, increased tax refunds, and low borrowing rates add to the lifts. How these and other countervailing forces ultimately are resolved is simply not known. Whatever the outcome, however, it is doubtful they will occur in time to rescue FY 2003 revenues.

IEFC/BoB FY 2003 COMPARISON

As shown in Table 4 on page 18, the Commission's revised FY 2003 general funds estimate of $23.054 billion is $1.131 billion below the Bureau of the Budget's latest official estimate reflected in their October 2002 First Quarter Financial Report.

The two estimates reflect dramatic differences in most of the larger more economically-tied sources such as income and sales taxes. In addition, the Commission is lower in the estimates of many of the smaller lines as well. Since the Bureau has not published any official revisions since the first quarter, it's difficult to compare the estimates on the same basis. It is believed that when the FY 2004 budget is presented in early April, the Bureau will likely make significant downward revisions as well.

TABLE 1: GENERAL FUNDS RECEIPTS THROUGH FEBRUARY

FY 2003 vs. FY 2002

($ million)

Revenue Sources	FY 2003	FY 2002	CHANGE FROM FY 2002	% CHANGE
State Taxes				
Personal Income Tax	$5,064	$5,103	($39)	-0.8%
Corporate Income Tax (regular)	437	492	($55)	-11.2%
Sales Taxes	4,064	4,103	($39)	-1.0%
Public Utility Taxes (regular)	652	708	($56)	-7.9%
Cigarette Tax	266	266	$0	0.0%
Liquor Gallonage Taxes	86	84	$2	2.4%
Vehicle Use Tax	22	24	($2)	-8.3%
Inheritance Tax (Gross)	175	229	($54)	-23.6%
Insurance Taxes and Fees	139	119	$20	16.8%
Corporate Franchise Tax & Fees	91	108	($17)	-15.7%
Interest on State Funds & Investments	47	103	($56)	-54.4%
Cook County IGT	219	154	$65	42.2%
Other Sources	233	123	$110	89.4%
Subtotal	$11,495	$11,616	($121)	-1.0%
Transfers				
Lottery	335	331	$4	1.2%
Gaming Fund Transfer	399	315	$84	26.7%
Other	398	190	$208	109.5%
Total State Sources	$12,627	$12,452	$175	1.4%
Federal Sources	$2,531	$2,598	($67)	-2.6%
Total Federal & State Sources	$15,158	$15,050	$108	0.7%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($405)	($388)	($17)	4.4%
Corporate Income Tax	(118)	(113)	($5)	4.4%
Subtotal General Funds	$14,635	$14,549	$86	0.6%
Short-Term Borrowing	$700	$0	$700	N/A
Budget Stabilization Fund Transfer	$226	$226	$0	N/A
Total General Funds	$15,561	$14,775	$786	5.3%

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

IEFC 12-Mar-03

TABLE 2: ADJUSTMENTS TO THE FY 2003 GENERAL FUNDS ESTIMATE

(millions)

Revenue Sources	Nov-02 FY 2003	March-03 FY 2003	Difference
State Taxes			
Personal Income Tax	$8,245	$7,950	($295)
Corporate Income Tax	$1,075	$950	($125)
Sales Taxes	$6,275	$6,025	($250)
Public Utility (regular)	$1,130	$1,025	($105)
Cigarette Tax	$400	$400	$0
Liquor Gallonage Taxes	$125	$125	$0
Vehicle Use Tax	$39	$35	($4)
Inheritance Tax (gross)	$270	$250	($20)
Insurance Taxes & Fees	$280	$305	$25
Corporate Franchise Tax & Fees	$164	$140	($24)
Interest on State Funds & Investments	$90	$65	($25)
Cook County Intergovernmental Transfer	$395	$395	$0
Other Sources	$320	$407	$87
Subtotal	**$18,808**	**$18,072**	**($736)**
Transfers			
Lottery	$585	$560	($25)
Gaming Fund Transfer	$625	$590	($35)
Other	$650	$650	$0
Total State Sources	**$20,668**	**$19,872**	**($796)**
Federal Sources	**$4,075**	**$4,075**	**$0**
Total Federal & State Sources	**$24,743**	**$23,947**	**($796)**
Nongeneral Funds Distribution:			
Refund Fund			
Personal Income Tax	($660)	($636)	$24
Corporate Income Tax	($290)	($257)	$33
Subtotal General Funds	**$23,793**	**$23,054**	**($739)**
Change from Prior Year	**$414**	**($325)**	
Percent Change	**1.8%**	**-1.4%**	
Short-Term Borrowing	$700	$700	$0
Budget Stabilization Fund Transfer	$226	$226	$0
Total General Funds	**$24,719**	**$23,980**	**($739)**
Change from Prior Year	$1,114	$375	
Percent Change	4.7%	1.6%	
IEFC			**03/18/03**

TABLE 3: FY 2003 GENERAL FUNDS ESTIMATE

FY 2003 vs. FY 2002

($ million)

Revenue Sources	March-03 Revised Estimate FY 2003	Actual Receipts FY 2002	$ CHANGE FY 2002-2003	% CHANGE
State Taxes				
Personal Income Tax	$7,950	$8,086	($136)	-1.7%
Corporate Income Tax (regular)	950	1,043	($93)	-8.9%
Sales Taxes	6,025	6,051	($26)	-0.4%
Public Utility Taxes (regular)	1,025	1,104	($79)	-7.2%
Cigarette Tax	400	400	$0	0.0%
Liquor Gallonage Taxes	125	123	$2	1.6%
Vehicle Use Tax	35	38	($3)	-7.9%
Inheritance Tax (Gross)	250	329	($79)	-24.0%
Insurance Taxes and Fees	305	272	$33	12.1%
Corporate Franchise Tax & Fees	140	159	($19)	-11.9%
Interest on State Funds & Investments	65	135	($70)	-51.9%
Cook County Intergovernmental Transfer	395	245	$150	61.2%
Other Sources	407	512	($105)	-20.5%
Subtotal	$18,072	$18,497	($425)	-2.3%
Transfers				
Lottery	560	555	$5	0.9%
Gaming Fund Transfer	590	470	$120	25.5%
Other	650	454	$196	43.2%
Total State Sources	$19,872	$19,976	($104)	-0.5%
Federal Sources	$4,075	$4,258	($183)	-4.3%
Total Federal & State Sources	$23,947	$24,234	($287)	-1.2%
Nongeneral Funds Distribution:				
Refund Fund				
Personal Income Tax	($636)	($615)	($21)	3.4%
Corporate Income Tax	(257)	(240)	($17)	7.1%
Subtotal General Funds	$23,054	$23,379	($325)	-1.4%
Short-Term Borrowing	$700	$0	$700	N/A
Budget Stabilization Fund Transfer	$226	$226	$0	0.0%
Total General Funds	$23,980	$23,605	$375	1.6%
IEFC				14-Mar-03

TABLE 4: IEFC-BoB COMPARISON-FY 2003

(millions)

Revenue Sources	BoB Oct-02 FY 2003	IEFC March-03 FY 2003	Difference
State Taxes			
Personal Income Tax	$8,435	$7,950	($485)
Corporate Income Tax	$1,137	$950	($187)
Sales Taxes	$6,400	$6,025	($375)
Public Utility (regular)	$1,160	$1,025	($135)
Cigarette Tax	$400	$400	$0
Liquor Gallonage Taxes	$125	$125	$0
Vehicle Use Tax	$38	$35	($3)
Inheritance Tax (gross)	$290	$250	($40)
Insurance Taxes & Fees	$290	$305	$15
Corporate Franchise Tax & Fees	$165	$140	($25)
Interest on State Funds & Investments	$110	$65	($45)
Cook County Intergovernmental Transfer	$395	$395	$0
Other Sources	$322	$407	$85
Subtotal	**$19,267**	**$18,072**	**($1,195)**
Transfers			
Lottery	$575	$560	($15)
Gaming Fund Transfer	$600	$590	($10)
Other	$650	$650	$0
Total State Sources	**$21,092**	**$19,872**	**($1,220)**
Federal Sources	**$4,075**	**$4,075**	**$0**
Total Federal & State Sources	**$25,167**	**$23,947**	**($1,220)**
Nongeneral Funds Distribution:			
Refund Fund			
Personal Income Tax	($675)	($636)	$39
Corporate Income Tax	($307)	($257)	$50
Subtotal General Funds	**$24,185**	**$23,054**	**($1,131)**
Change from Prior Year	**$806**	**($325)**	
Percent Change	**3.4%**	**-1.4%**	
Short-Term Borrowing	$700	$700	$0
Budget Stabilization Fund Transfer	$226	$226	$0
Total General Funds	**$25,111**	**$23,980**	**($1,131)**
Change from Prior Year	$1,506	$375	
Percent Change	6.4%	1.6%	
IEFC			**03/18/03**

NATIONWIDE STATE FINANCES: WIDESPREAD PAIN

As the calendar edges closer to the final quarter of FY 2003, Illinois—along with approximately two-thirds of the country's states—continues to struggle with budget problems. This is the case as state revenues have stagnated over the past two fiscal years. Given sluggish revenues and increasing expenditures, many states are currently facing red ink that needs to be addressed by the end of the fiscal year. Given this situation, it is important to examine the fiscal conditions facing both Illinois and the nation.

The widespread nature of the crisis indicates that the underlying problems extend beyond state or regional boundaries. In fact, most states are struggling against a common set of circumstances that are combining to severely reduce revenue growth as expenditures increase. These circumstances include the faltering economy, the downturn in the stock market, the weakness in the manufacturing and high-tech industries, rising health care costs, and increasing unemployment benefit claims. Medicaid costs also are fueling state expenditure woes. However, all of these problems are magnified as they arrive on the heels of spending that accompanied the economic growth of the late 1990s. As a result, the National Governors Association and the National Association of State Budget Officers have called the current situation the worst budget mess since World War II.

The National Conference of State Legislatures (NCSL) released a study in late January aimed at assessing the scope and severity of the problem. Their study revealed that thirty-six states reported budget gaps midway through FY 2003. It further stated that the cumulative budget gap associated with state governments increased from $17.5 billion in November to $25.7 billion in January; this new amount is equal to 5.2 percent of total FY 2003 appropriations. Furthermore, the revision is significant as it occurred in spite of the fact that states had already scaled-back their FY 2003 spending plans. The report continued by stating that thirty-seven states reported expenditures exceeding budgeted levels. The report concluded by predicting that revenue growth will remain sluggish, and provided a worrisome outlook for future revenue performance.

In response to balanced budget requirements, several states have incorporated "stop-gap" budget cuts and other strategies aimed at realigning spending and revenues. To date, the majority of these efforts are focused on state spending. The NCSL report revealed that, through January, twenty-nine states imposed across-the-board budget cuts, nine states cut elementary/secondary education, thirteen states cut higher education, one state cut TANF, thirteen states cut Medicaid, nine states cut corrections, and nine states cut local revenue sharing. Furthermore, eight states laid-off employees, five states utilized furloughs, and nine states enacted travel bans. Other attempts at reducing the budget gaps revolved around utilizing rainy day funds, tapping other state funds, and delaying capital projects. Given the current fiscal climate, this deteriorating situation could prompt more drastic cuts and increase pressure on state lawmakers to raise taxes.

The combination of stagnant revenue growth and spending pressure is forcing states to replace short-term budget solutions with more creative, and long-term adjustments. Where tax increases appear unavoidable, “sin” taxes have become a politically popular “stop-gap” as they generate much-needed revenue without impacting income and sales taxes. A November survey released by the National Association of State Budget Officers revealed that nineteen states already have boosted taxes on cigarettes and alcohol, generating nearly $3 billion in new funds. Other states are selling bonds backed by future tobacco settlement payments to cover next year’s spending. However, borrowing against future payments will reduce the states overall portion of those revenues. Some states are examining gaming as a means of increasing revenue. Although it is difficult to accurately estimate the number of states that are seriously considering gaming, discussions are taking place in at least eighteen states. These conversations include allowing or adding new types of gaming, as well as increasing the number of electronic devices in existing venues.

Will FY 2004 provide any relief for states? According to a majority of professional organizations, the answer is no. In fact, the news may be worse for budget planners. NCSL estimates that state legislatures will face a FY 2004 budget shortfall of at least $68.5 billion. The report further reveals that thirty-six states are expecting FY 2004 budget gaps, with thirty-three expecting the gaps to exceed 5 percent and eighteen of those states expecting gaps exceeding 10 percent. In an attempt to address this problem, twenty-four states reported that either the governor or a member of the legislature has offered tax increase proposals.

A survey conducted by the National Governor’s Association revealed similar findings. The Association expects the FY 2004 state budget shortfall to reach $82 billion. Their survey found that twenty-eight states have proposed cuts to major programs in 2004, while twenty-eight states exempted education from FY 2004 budget cuts. Therefore, the affected programs include Medicaid, elementary/secondary education, and local aid programs. In addition, the Association’s survey found that fifteen states are calling for tax increases, which are focused on sales, personal and corporate income, cigarette, alcohol, and gaming.

So, where does the situation leave the states as they prepare FY 2004 budgets? With regards to sluggish revenues, a lot depends on how quickly the economy recovers. However, even an immediate recovery would not necessarily benefit states in the short-term, as states do not usually experience immediate revenue gains. It could be as much as twelve to eighteen months before the states feel the effects of a continued national economic recovery.

U.S. ECONOMIC OUTLOOK FY 2004:
Uncertainties Abound

The economy should continue to recover in FY 2004, although more than the usual number of uncertainties prevail at the current time. Indeed, it is geopolitical concerns that currently dominate the outlook, particularly expectations for near-term conflict in Iraq. Even the threat of such a conflict and varying possible outcomes slowed economic activity to a snail's pace in recent months. In an attempt to forecast the period ahead, assumptions must be made. Thus, the IEFC will use Global Insight's most-likely forecast of economic activity which assumes that the economy, while initially hampered by a plunge in consumer and business sentiment, is lifted thereafter by a successful conclusion to the war, tax cuts, and extra government spending.

This scenario of economic events appears consistent with the recent performance of the IEFC's leading economic indicator. As shown in Chart 3, the indicator, which is based upon measures of employment such as hours worked, new building permits, and surveys of manufacturer expectations, has been on an uptrend for more than a year. Even so, the path has not been smooth, reflecting wide swings in attitudes that have surrounded recent events. The trend, however, is upward, particularly in the past two months. While this measure does not accurately reflect the magnitude or strength of the economic expansion, it has been a good reflection of direction.

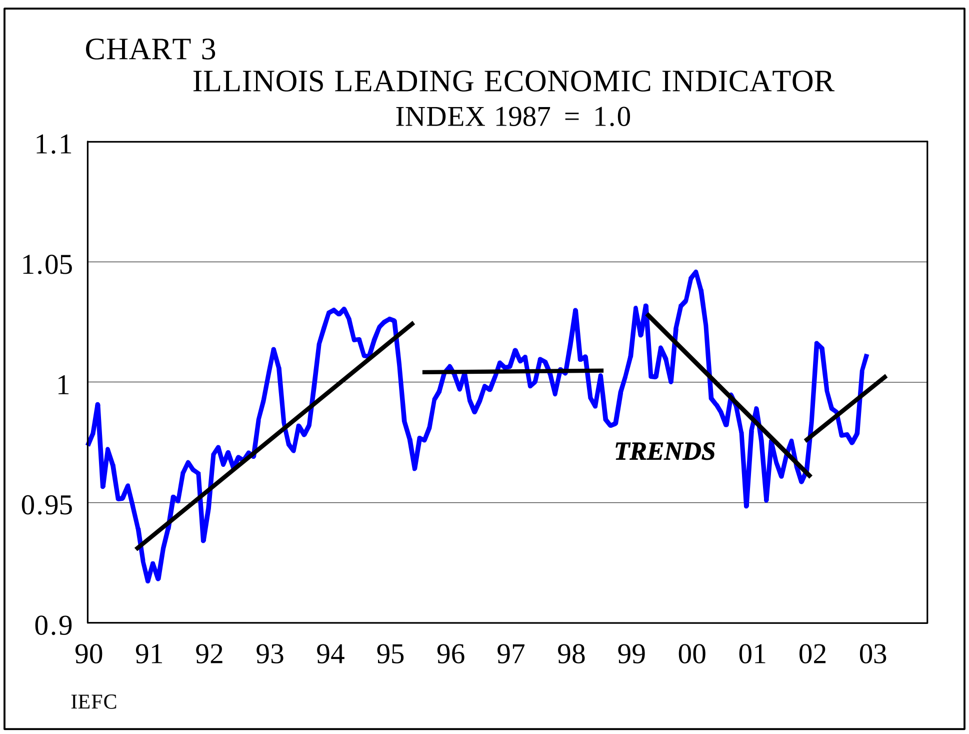


Chart 4 and Table 5, on pages 22 and 23, show Global Insight's most likely forecast of U.S. economic activity done in February 2003. Overall growth in FY 2004 is anticipated to reach 4.1% in real terms, up from 2.8% in FY 2003 and virtually no growth in FY 2002. This forecast would bring growth rates back to the levels reached in the late 1990s following three consecutive year's of much weaker performance.

Consumer spending is likely to increase only moderately as much of the impetus from zero percent financing and housing refinancings peter out, with spending falling more in line with incomes. The major change is anticipated to be in the area of business spending. After contracting sharply in FY 2001 and further in FY 2002, there was some renewed growth in FY 2003. Expectations are that such spending will approach a 10% rate of growth in real terms in FY 2004. This is predicated not only on expectations for increased domestic demand and the need to rebuild depleted inventory levels, but also stimulated by rising export demand and a sharp improvement in corporate profits.

Both monetary and fiscal policy will remain stimulative, although struggling state finances will offset much of the federal government impetus. Interest rates are likely to remain low, although with the pace of economic activity eventually improving and prices rising somewhat faster, the lows in interest rates likely should be reached in the weeks immediately ahead and rates should come under some upward pressure later in the year. The improvement in the economy is also likely eventually to reduce the unemployment rate as businesses begin to rehire employees and as the economic picture becomes clearer.

IEFC's forecast for FY 2004 is for some pickup in the pace of the economic recovery with real growth of 4.1%. This would be more in line with growth rates established in the late 1990s and well above those seen in the past three years. Even so, many uncertainties remain and severe financial problems in many states will continue.

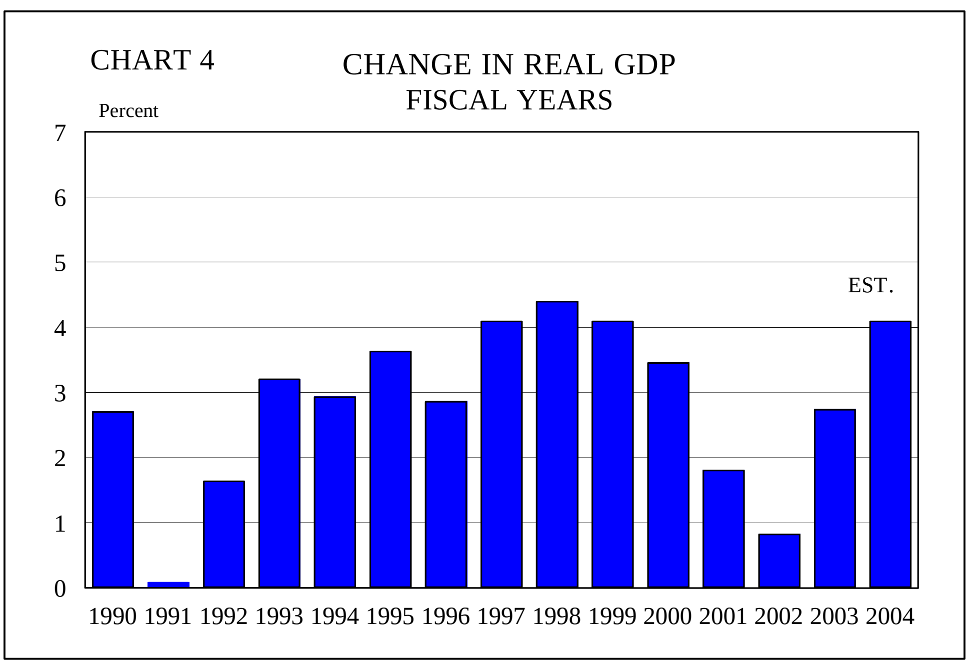


TABLE 5: ECONOMIC FORECASTS – FEBRUARY 2003

(% Change From Prior Year Levels)

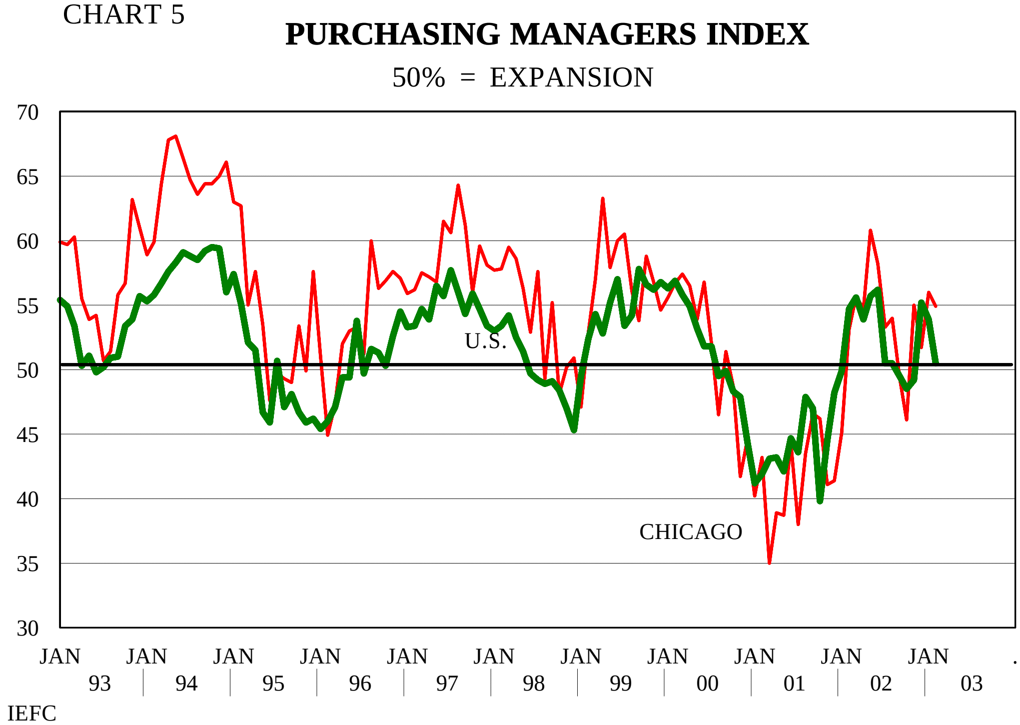
	FY 2001 Actual	FY 2002 Actual	FY 2003 Estimated	FY 2004 Estimated
REAL (1996 $)				
Gross Domestic Production	1.8	0.8	2.8	4.1
Personal Consumption	3.3	2.7	2.8	3.1
Durable	4.7	8.2	4.5	4.7
Nondurable	2.9	2.4	2.7	3.2
Services	3.1	1.7	2.5	2.8
Fixed Invest. (Business Spending)	-2.0	-8.6	4.2	9.9
Exports	4.7	-8.5	4.5	6.4
Imports	7.1	-4.2	6.5	4.7
Government	2.5	4.3	3.6	2.1
Federal	1.6	6.6	7.2	3.9
State & Local	2.9	3.2	1.4	1.3
OTHER MEASURES				
Personal Income (Current $)	6.4	2.1	4.7	5.0
Before Tax Profits (Current $)	-6.0	-13.8	7.3	19.7
Consumer Prices	3.4	1.8	2.7	3.0
Unemployment Rate (Average)	4.2	5.5	6.1	5.6

THE OUTLOOK FOR ILLINOIS IN FY 2004

The anticipated national economic expansion expected during FY 2004 should be felt at the State level and begin to ease some of the pent up difficulties that accumulated over the past few years. The Illinois economy often mirrors that of the nation as a whole, but over the past few years the recession and ensuing mild and sporadic recovery has had an even more negative impact on Illinois. As mentioned earlier in this report, this was reflected in an unemployment rate that consistently was at a higher level than for the nation as a whole for the past three years. In large part this divergence reflects the deterioration in business spending, particularly weakness in the manufacturing sector which represents a larger share of the Illinois economy than is true nationally.

Chart 5, shows the performance of the Purchasing Manager's Index issued by the Institute of Supply Management. The index is made up of eight key variables – new orders, production, employment, supplier deliveries, inventories, prices, export orders and imports – and is an important indicator of manufacturing activity. When 50% or more of those reporting indicate increases in activity, the sector is considered expanding and, conversely, when 50% or less report gains manufacturing is contracting.

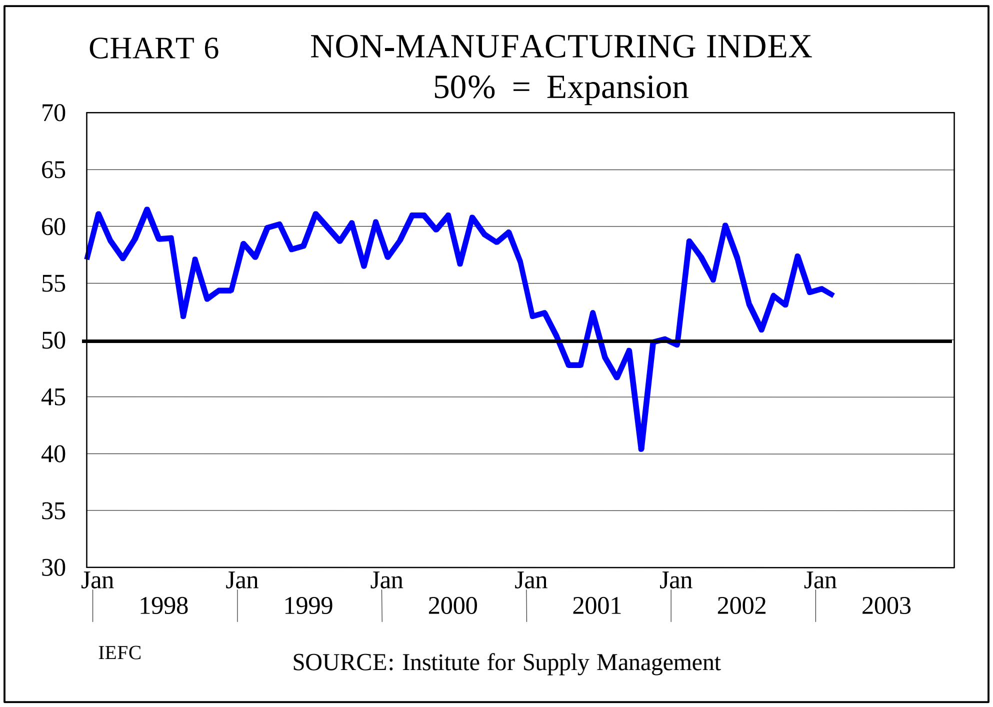
CHART 5



SOURCE: Institute for Supply Management

As illustrated in the chart, manufacturing was contracting during the second half of 2000 through most of 2001. Expansion resumed in early 2002 but quickly reversed and it wasn't until early 2003 that expansion resumed. Moreover, during most of this time, the Chicago measure was below the overall measure of manufacturing. Recently, both measures have softened again, although in the past month the Chicago area index held up better. If the forecast of economic activity proves out with business spending being a major player, than it may well be that Illinois will no longer underperform the nation as a whole in manufacturing.

While manufacturing is important, the U.S. services sector accounts for the bulk of the overall economy. The Institute of Supply Management published a non-manufacturing index similar to the Purchasing Manager's index to represent what is happening in the services sector. A shown in Chart 6, the services sector has been expanding since about the middle of 2002, although the path has not been smooth. Even so, the service area is expected to rise at a somewhat faster pace next fiscal year adding to those sectors that will improve overall economic growth.



More impetus will have to be shown from the manufacturing and services sectors as other areas become less robust. Chart 7, on the top of page 26, shows new car and truck registrations in Illinois which have been at record levels. Certainly zero percent financing and other incentives have been factors stimulating auto sales. Nevertheless, it is unlikely that such high levels of activity can be sustained in FY 2004 and auto production schedules already are being pared back. Other durable goods spending, however, is expected to remain strong and take up some of the slack. This is particularly true of expenditures for home furnishings and appliances, closely linked to continued strong gains in housing activity.

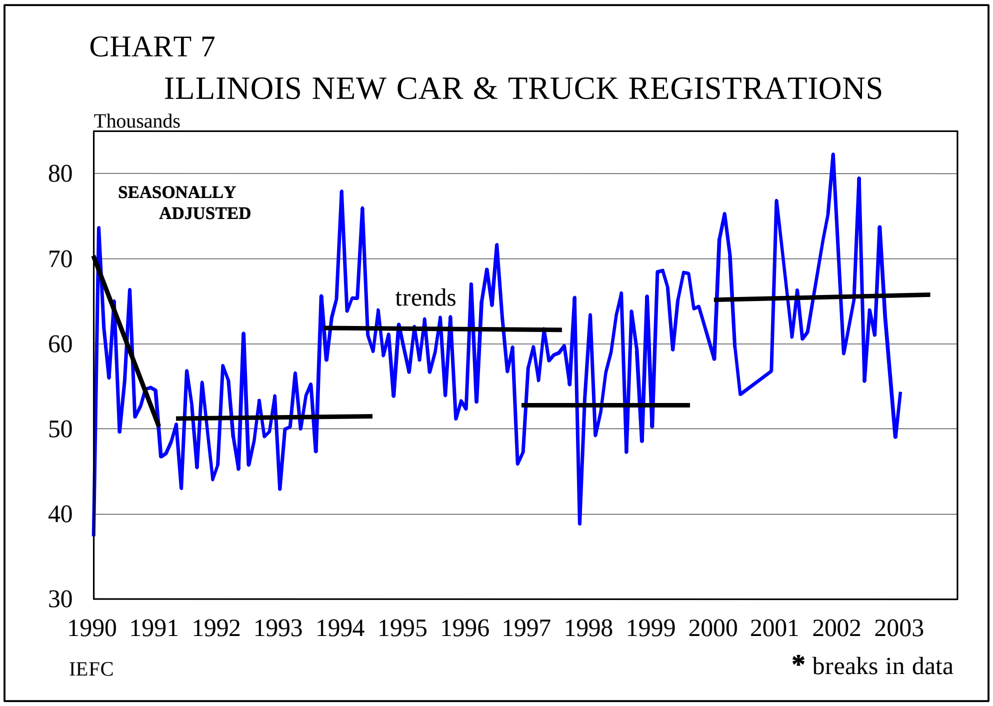
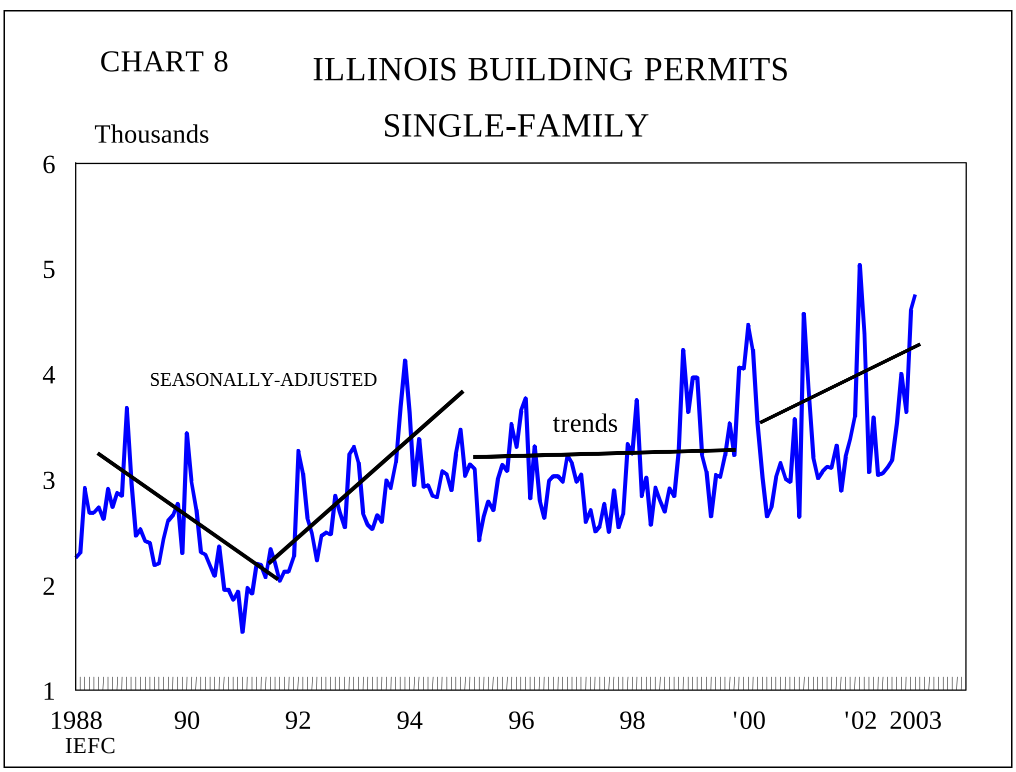
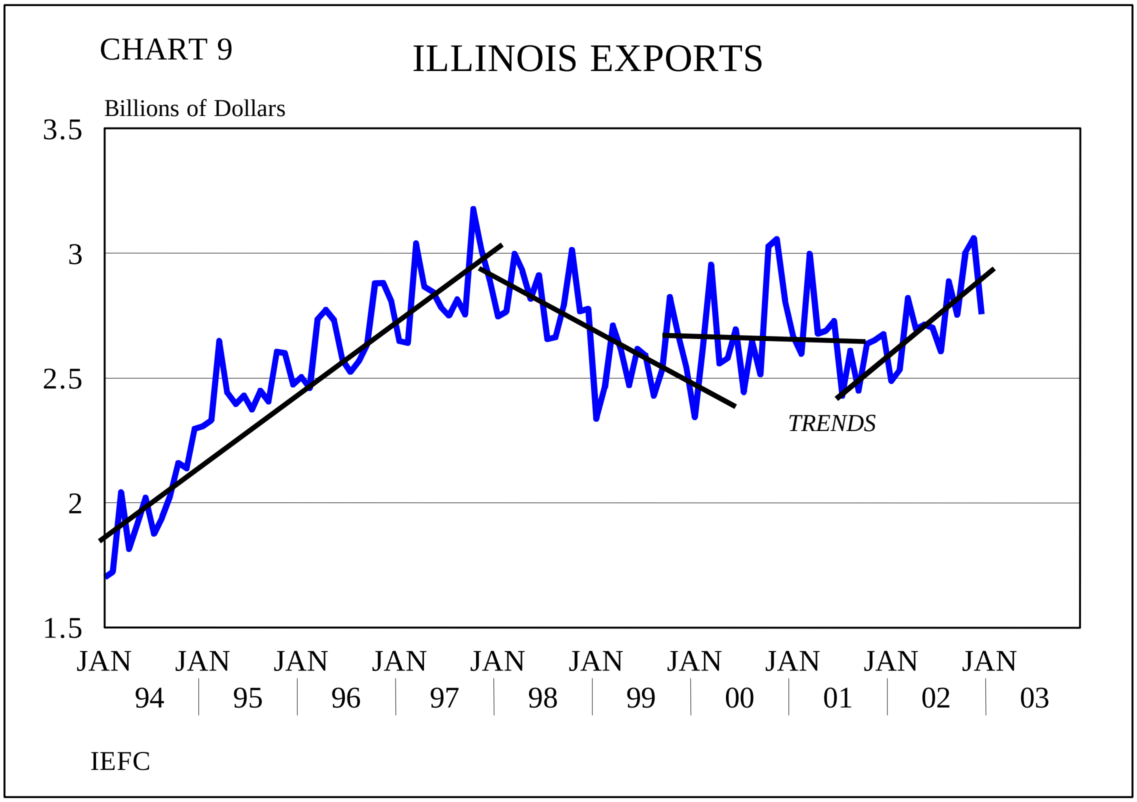


Chart 8 below depicts new single-family building permits issued in Illinois, a precursor to future housing activity. Certainly the lowest mortgage rates in over 40 years is one contributor to such a rapid expansion, but another is how well housing values have held up with prices rising. This is in contrast to the sharp decline in the stock market. The perception that housing is a better investment alternative than stocks is unlikely to end any time soon.



Another positive to the economy is derived from the export sector. As shown in Chart 9, after declining in 1998 into 2000, exports leveled during 2001, before establishing a rising pattern over the past year. This area is important to Illinois, which is fifth in the nation in terms of exports. The gain in exports is likely to strengthen during FY 2004 (see Table 5 on page 23) as other countries continue to follow the U.S. economic expansion and as the dollar relative to key foreign currencies has weakened, making U.S. exports more competitively priced.



As mentioned earlier, however, like the nation, Illinois also is facing uncertain times with possible conflict in Iraq and its final outcome overhanging progress. If the projected economic outcome is to surface, these uncertainties will have to be reduced and relatively soon. Currently they are having a severe impact on consumer attitudes that have reached the lowest level in nearly a decade. (Chart 10 on the following page). It is assumed, however, that there will be a successful conclusion to the war, tax cuts, and extra government spending. When those develop, confidence will improve in an otherwise fundamentally sound economy.

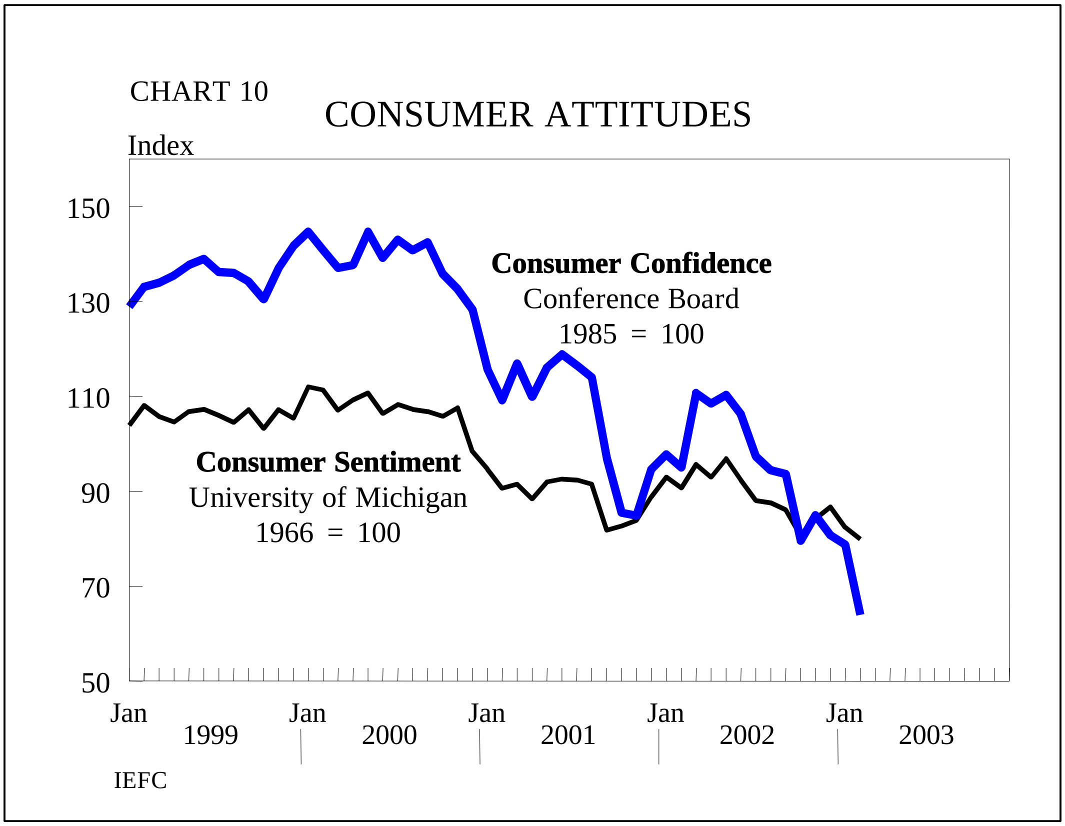


CHART 10
CONSUMER ATTITUDES
Index
150
130
110
90
70
50
Consumer Confidence
Conference Board
1985 = 100
Consumer Sentiment
University of Michigan
1966 = 100
Jan
1999
Jan
2000
Jan
2001
Jan
2002
Jan
2003
IEFC

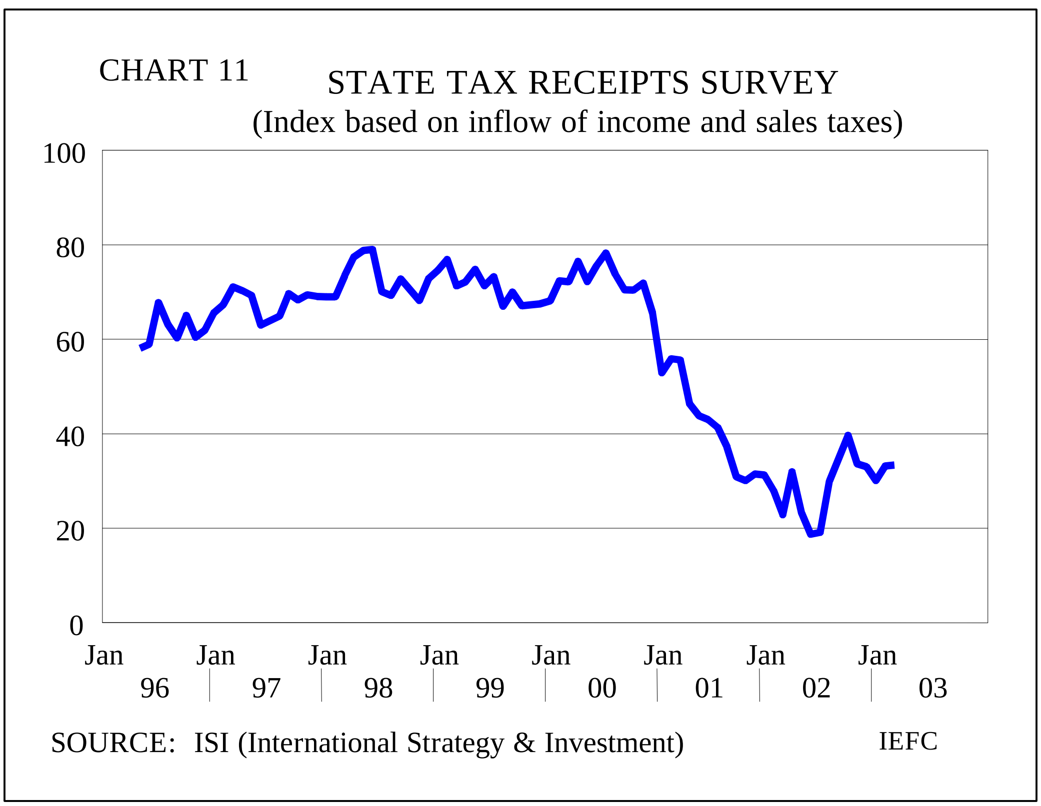


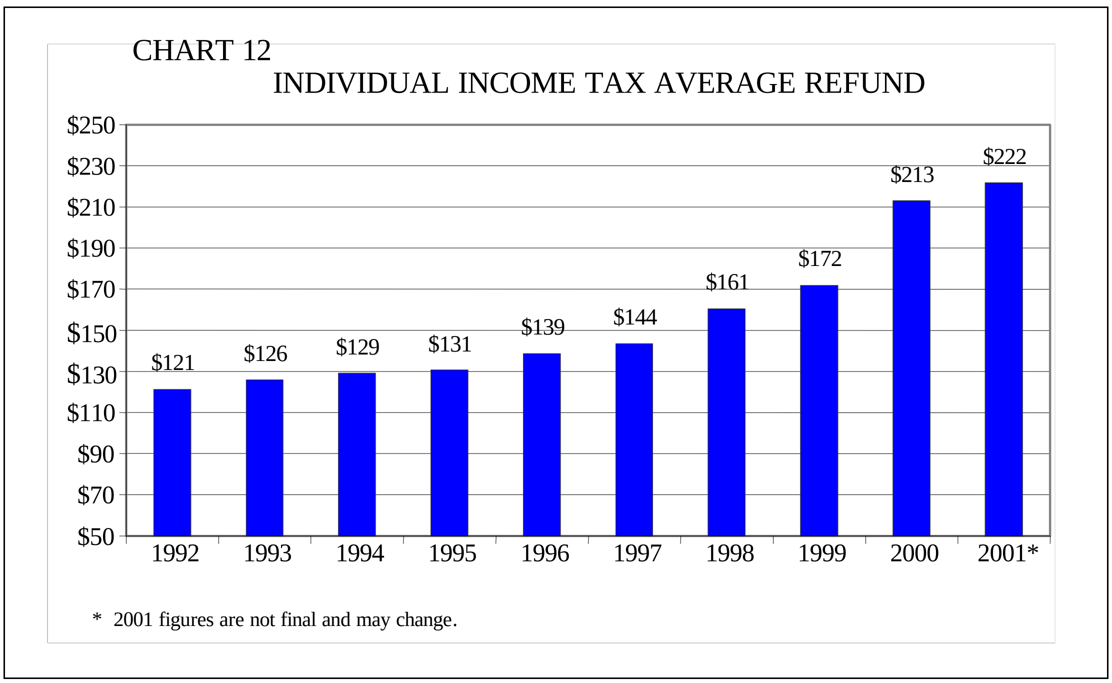
CHART 11
STATE TAX RECEIPTS SURVEY
(Index based on inflow of income and sales taxes)
100
80
60
40
20
0
Jan
96
Jan
97
Jan
98
Jan
99
Jan
00
Jan
01
Jan
02
Jan
03
SOURCE: ISI (International Strategy & Investment)
IEFC

The Illinois economy should expand further in FY 2004 in line with that of the nation. Even so, while major revenue sources may improve, a hangover of issues accumulated over the past three years will impede progress and it will be another difficult year for State finances. The weakness in State revenues is not confined to Illinois, however. As shown in Chart 11, on the previous page, State tax revenues continued at depressed levels into March 2003. This is based upon a survey of sixteen states that have diverse geographic and population characteristics, one of which is Illinois.

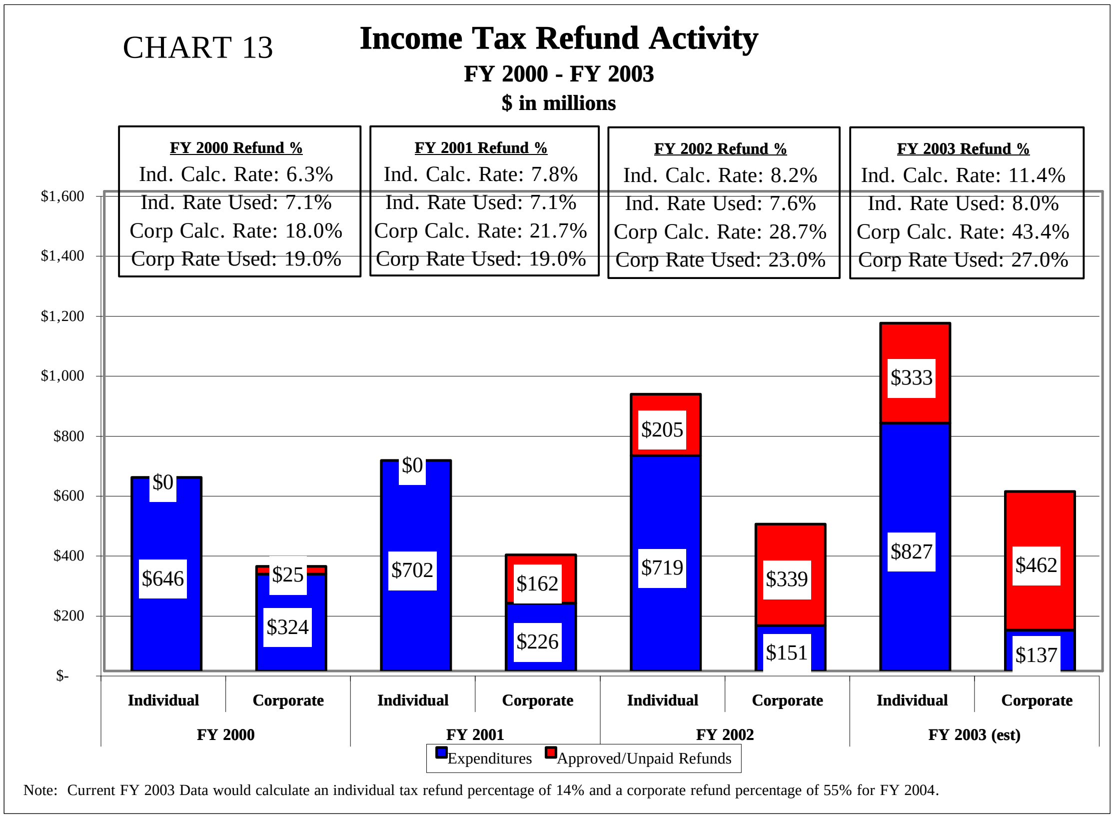
DISCUSSION OF INCOME TAX REFUND BACKLOG

Before an informed discussion of the FY 2004 revenue estimate can begin, its important to understand the problem the State is facing in regards to the mounting backlog in owed income tax refunds. In November, the Commission presented a brief explanation of the situation. With a few adjustments based on updated figures, that same discussion will be presented for background purposes.

Effective January 1, 1989, P.A. 85-1414 removed income tax refunds from the appropriation process by establishing a formula by which a percentage of income tax dollars would be deposited into the Income Tax Refund Fund for the sole purpose of paying refunds. Initially, the percent was established at 6% for personal and 18% for corporate. The refund percentage is set by the Department of Revenue on the last business day of each fiscal year, and is based on a formula detailed in statute which takes into account refunds approved and approved but not paid as well as total income tax collections. However, in recent fiscal years from 1999 through 2003, the percentage has been set statutorily rather than by formula. For fiscal years 1999 to 2001, the percentage was set statutorily due to the doubling of the personal income tax exemption.



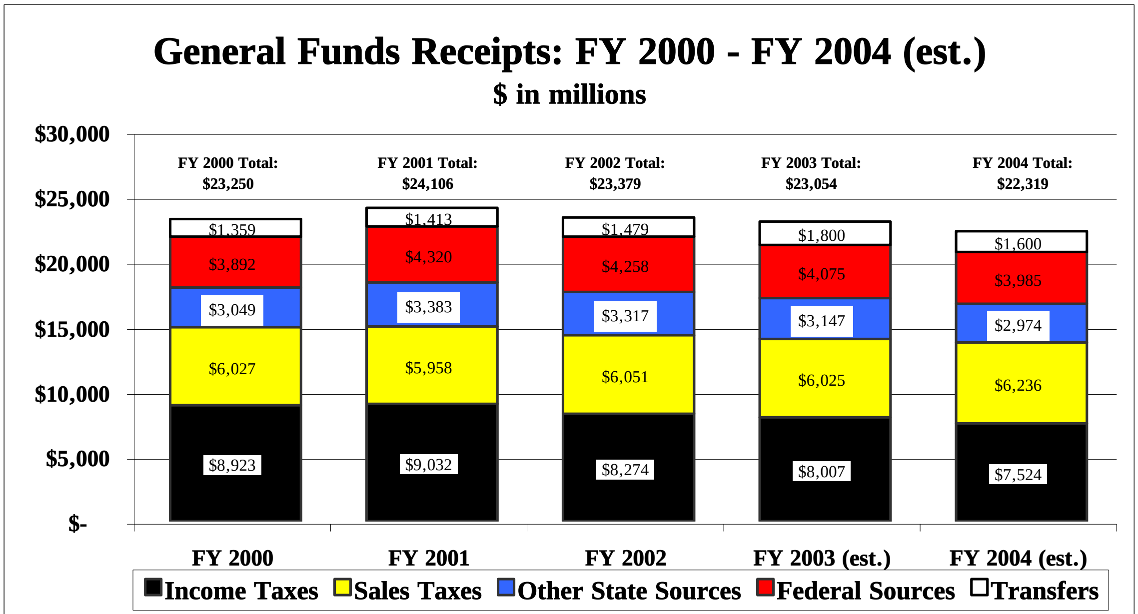
While there were a small amount of unpaid corporate income taxes at the end of FY 2000, that amount grew significantly in FY 2001 although individuals were kept current. However, FY 2002 ended with the State owing approximately $205 million in individual income tax refunds and $339 million in corporate income tax refunds. Of the $1 billion in short-term borrowing, $150 million was directed to speed repayment of refunds owed. As shown, the amount of owed refunds at the end of FY 2003 are estimated to climb to approximately $333 million in individual tax refunds and $462 million in corporate income tax refunds. As of early March, while no backlog exists for individual refunds owed, corporate refunds being held by the Department of Revenue on these unpaid refunds totaled approximately $640 million. The State is required by statute to pay six percent interest.



In addition to the above owed refunds, corporate replacement tax refunds were also behind by approximately $117 million in FY 2002 and that gap is expected to grow to $154 in FY 2003. Since corporate replacement tax is not deposited into the general funds, it was not included in the above chart. Of total revenues from the corporate replacement tax, 51.65% is distributed to Cook County and the remaining 48.35% to local governments in the other counties. While corporate replacement taxes are not deposited into the general funds, they are included in calculating the corporate refund percentage.

Under current statute, unless a fixed percentage is established in law, as has been the case in recent years, the formula used to calculate the refund percentage essentially reconciles past refunds owed, thereby eliminating the backlog. In other words, because the State will have such a large amount of unpaid refunds, the refund percentage will need to be extraordinarily high in FY 2004 to eliminate the anticipated backlog. Once that backlog is eliminated, the income tax percentage would fall back to normal levels in subsequent fiscal years. The result would be a sharp drop in revenues in FY 2004, followed by a dramatic jump in revenues in FY 2005.

FY 2004 GENERAL FUNDS ESTIMATE



Note: The above figures do not include funds from short-term borrowing or from the budget stabilization transfer.

Table 6 on page 47, provides a source-by-source estimate of the upcoming fiscal year. As shown, total general funds are estimated to be $735 million less next fiscal year, making a third consecutive year of revenue decline. The decrease is anticipated due to significant increases in the calculated income tax refund percentages. Absent those changes, base growth levels are forecast to gradually recover in the upcoming fiscal year as the fitful recovery finally produces some modest revenue gains. For comparison sake, it was assumed that similar short-term borrowing as well as Budget Stabilization transfers would occur in FY 2004.

As the FY 2004 budget is discussed, negotiators will have to determine how best to address this backlog in owed refunds. If nothing is done, by default the formula will adjust next year's percentages to approximately 14% for individuals, and 55% for corporations, which would significantly contribute to the decline of $735 million in total general funds receipts. If instead, the refund percentages remain the same as this year, as demonstrated at the bottom of Table 6, net revenues would increase by $42 million rather than falling by $735 million. However, the backlog for personal and corporate income tax refunds would then grow to a combined $777 million (plus an additional estimated $218 million in owed corporate replacement tax refunds).

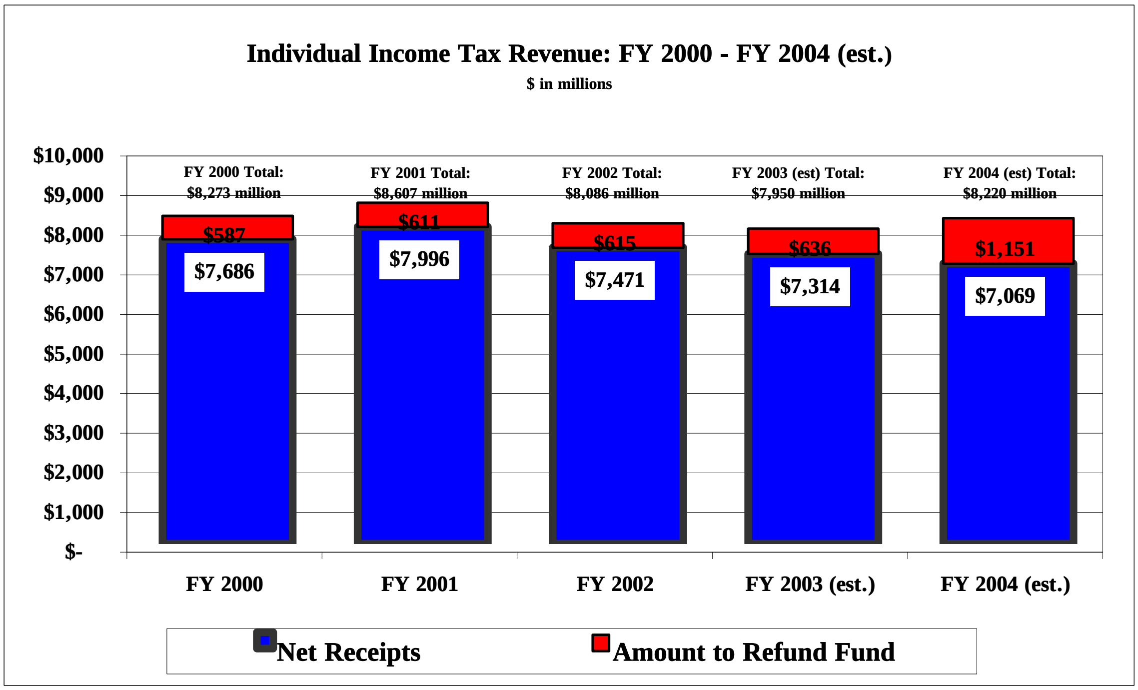
Besides the aforementioned declines associated with the refund percentages, a number of other items will serve to reduce growth in FY 2004. Specifically these are:

- A net loss of approximately $90 million in inheritance tax receipts due to the continued phase-out of the federal inheritance tax, from which Illinois' inheritance tax is derived.
- A reduction of approximately $50 million from lower available transfers from the Build Illinois general reserve account.

- The one-time receipt of $88 million in FY 2003 stemming from the tobacco settlement lawsuit.
- A decline of approximately $200 million in other transfers reflecting the $165 million in approved FY 2003 transfers as well as anticipated reductions in some other transfers.
- An estimated $90 million reduction in federal source receipts.

The following section provides background information on each major source.

PERSONAL INCOME TAX



The individual income tax is the largest revenue source, generating approximately one-third of all general funds revenue. Enacted in 1969 at the rate of 2.5%, the current individual income tax is imposed at a rate of 3.0% on the federal-adjusted gross income (AGI) for individuals with some adjustments.

Since tax year 2000, each taxpayer is permitted a $2,000 standard exemption plus an additional $2,000 for a spouse and each dependent. An additional exemption of $1,000 is available to taxpayers and their spouses who are blind or 65 years of age or older.

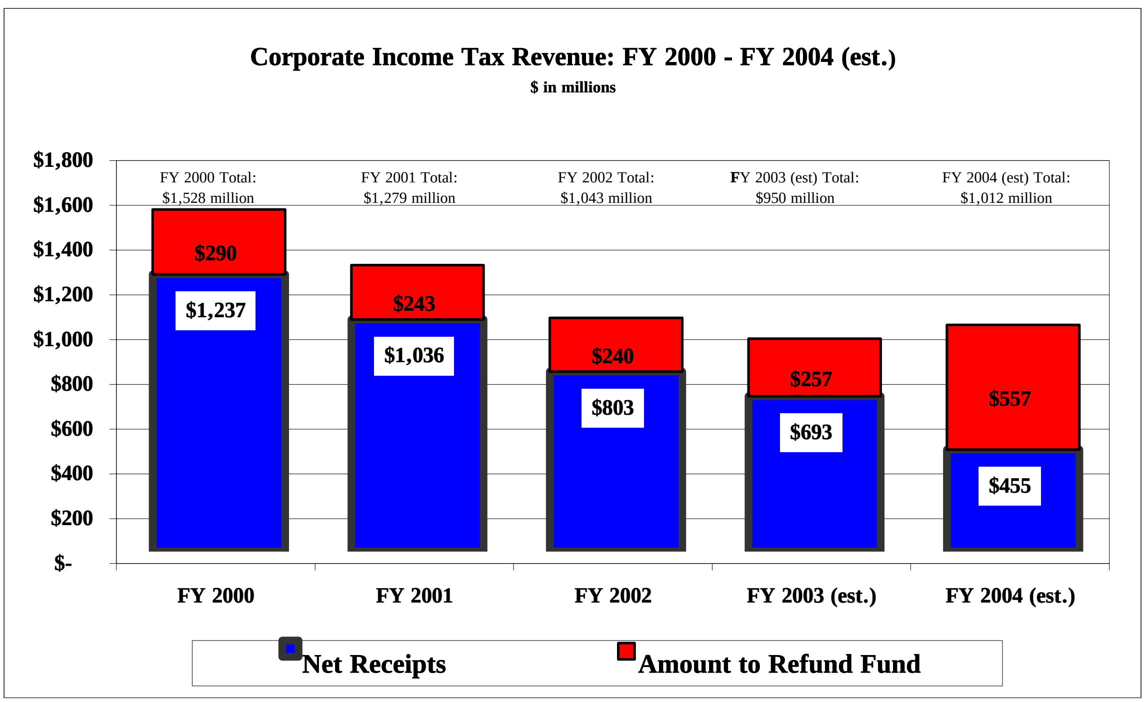
In addition to the personal exemptions, there are several tax credits available to assist individuals in reducing the amount of tax due. The most significant credit is based on 5% of property taxes paid on the taxpayer's principal residence. Recent credits that took effect in tax year 2000 include a qualified educational expense credit as well as an earned income tax credit.

Personal income tax receipts are deposited into the Income Tax Refund Fund and the Education Assistance Fund (EAF), with the remainder going to the General Revenue Fund. The EAF is considered general funds and, accordingly, receipts going to the EAF are shown as general funds receipts. The EAF receives 7.3% of receipts net of the Refund Fund deposits.

As discussed earlier, according to statute, the Department of Revenue at the beginning of each fiscal year determines the refund percentage. The FY 2004 estimate is based on an increased refund percentage of 14.0%. Any change in that percentage also will affect net personal income tax receipts.

The FY 2004 estimate of gross personal income tax receipts is $8.220 billion, an increase of $270 million or 3.4% over projected FY 2003 receipts. The forecast represents a degree of improvement in the employment picture as economic activity finally gains some momentum in the coming fiscal year.

CORPORATE INCOME TAX



The corporate income tax is the fourth largest general funds revenue source, generating approximately 4% of all general funds revenue. Enacted in 1969 at a rate of 4%, the current rate is 4.8% and is applied to a corporation's federal taxable income with several adjustments.

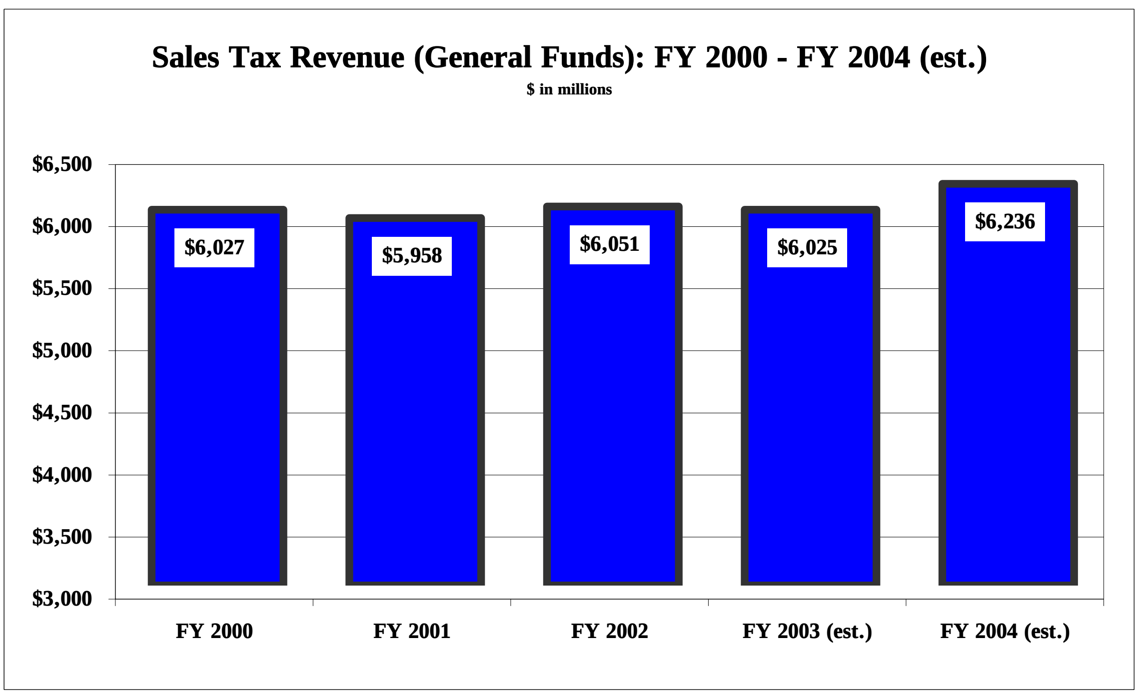
After a phased-in transition to a single-factor sales formula apportionment of business income, sales in Illinois are the only determinant of how much of a multistate firm's income is taxed.

Each business is entitled to a $1,000 standard exemption as well as various credits and deductions. Some of the deductions and credits may be carried forward against future liabilities or carried backward to obtain refunds against prior years' taxes. These items, in conjunction with fluctuation in the business climate and economic conditions, combine to make corporate income tax receipts potentially much more volatile than personal income tax revenue.

Like the personal income tax, corporate income tax receipts are deposited into the Income Tax Refund Fund and the Education Assistance Fund, with the remainder going to the General Revenue Fund. In FY 2004, the refund percentage is forecast to increase to 55%. Any change in that percentage also will affect net corporate income tax receipts.

The FY 2003 estimate of gross corporate income tax revenue is $1.012 billion. This represents 6.5% growth over FY 2003, and reflects significant improvement in corporate profitability that has suffered for a number of years. However, growth will be muted from before-tax expectations due to carry forward provisions which will likely negatively impact on corporate income tax for a number of years.

SALES TAX



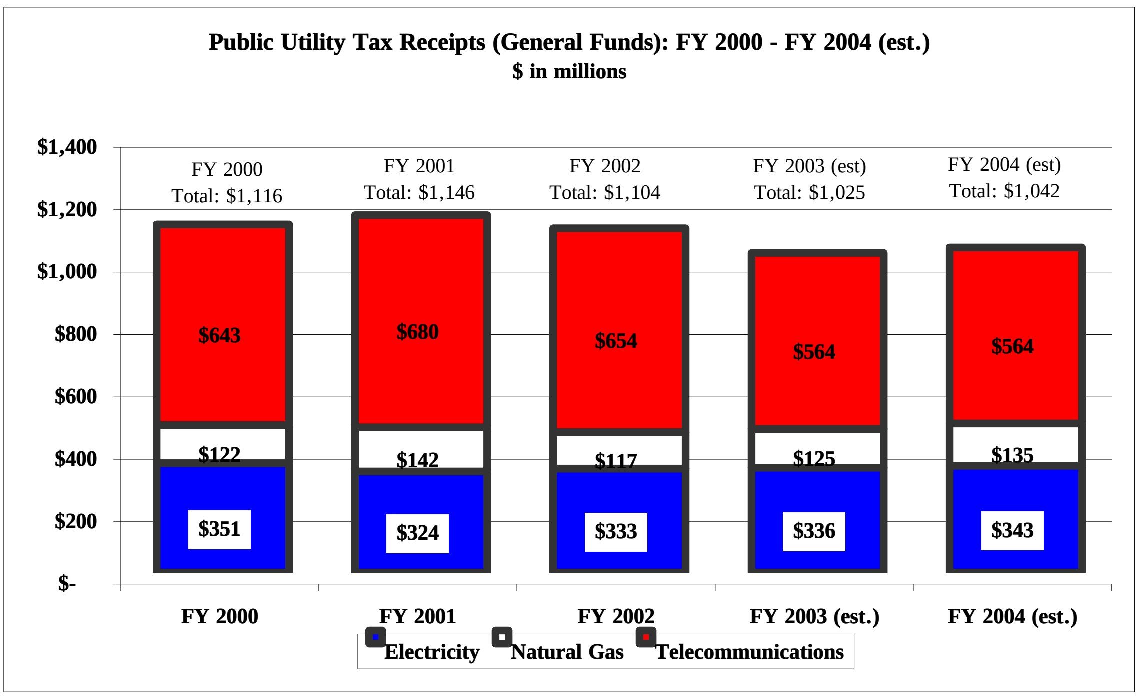
The sales tax rivals the personal income tax as one of the largest general funds sources, generating approximately 25% of total general funds revenue. The sales tax is composed of four individual taxes including the retailers' occupation tax, the use tax, the service occupation tax, and the service use tax.

These taxes are designed to capture most transactions involving tangible goods. The retailers' occupation tax is imposed on those persons engaged in the business of selling tangible personal property. The service occupation tax combined with the service use tax captures property acquired in connection with the performance of a service. Out-of-state sellers doing business in Illinois are liable for the use and occupation taxes.

Presently, the rate for all four sales taxes is 6.25% of either the purchase price or the fair market value. Rates may vary around the State depending on locally-imposed sales taxes. Of the 6.25% rate, 5.0% is collected for the State and 1.25% goes to local governments. The estimate of general funds sales tax receipts is based on a 5.0% rate.

Sales tax receipts are estimated to be $6.236 billion in FY 2004. This represents growth of $211 million or 3.5%. Consumer activity should improve as the economy strengthens and confidence gradually returns.

PUBLIC UTILITY TAXES



Public utility taxes deposited in the general funds consist of three separate taxes that are imposed on utilities providing electric, natural gas, and telecommunications service in Illinois. Public utilities are the third largest general funds revenue source, generating approximately 4.4% of all general funds revenue.

A telecommunications (messages) excise tax is imposed on businesses sending or receiving interstate and intrastate telecommunications. The rate and base of the telecommunications excise tax is 7.0% of the gross charges of businesses transmitting interstate or intrastate messages.

The natural gas revenue tax is imposed on utilities distributing natural gas in Illinois. The rate and base of the natural gas revenue tax is the lesser of 2.4 cents per therm of all gas sold to each customer or 5.0% of the gross receipts received from each customer.

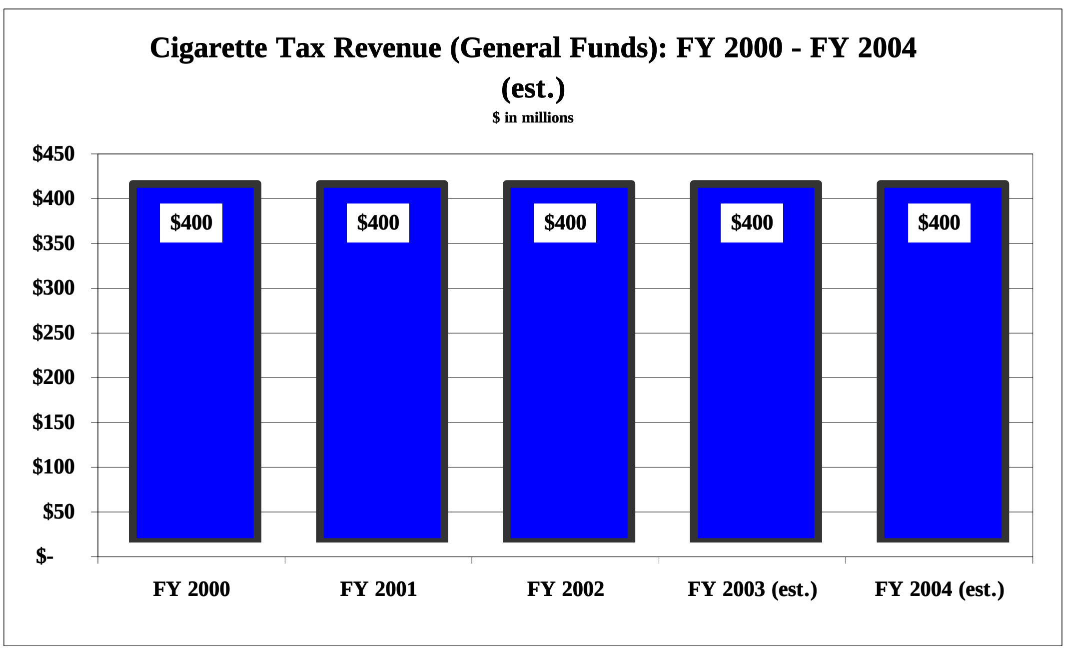
Since August 1, 1998, the rate and base of the public utilities electricity tax is calculated on the amount of kilowatt hours used in a month by a residential customer. The rate begins at 0.33 cents per kilowatt-hour and decreases as the amount of usage increases.

The tax on self-assessing (non-residential) customers equals 5.1% of their purchase price. Customers of municipal systems or rural electrical cooperatives pay the lesser of 0.32 cents per kilowatt-hour or 5% of their purchase price.

In FY 2002, public utility tax receipts accounted for approximately 4.7% of total general funds receipts.

The FY 2004 estimate of public utility tax receipts is $1.042 billion, an increase of $17 million or 1.7% over the previous fiscal year. While unpredictable factors make forecasting difficult, little growth is anticipated for the coming fiscal year.

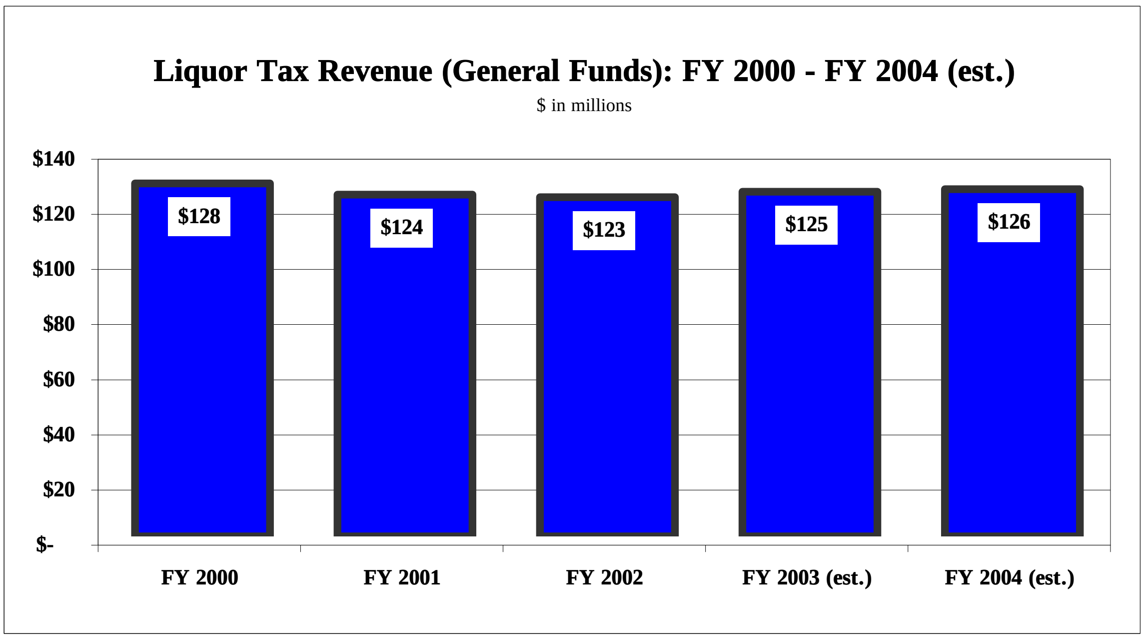
CIGARETTE TAXES



There are two taxes on cigarettes: the cigarette tax and the cigarette use tax. Wholesale distributors collect the taxes from retailers and are ultimately responsible for sending collections to the State. The taxes are mutually exclusive in that they are not levied on the same transaction, thereby avoiding double taxation. The current tax rate for both taxes is 98 cents per pack of 20 cigarettes. In FY 2002, cigarette tax receipts were 1.7% of total general funds receipts.

The FY 2003 estimate of general funds cigarette tax receipts is $400 million. This revenue source, absent legislative change, should result in an annual amount of $400 million as $33.3 million in cigarette tax is deposited each month by statute into the general funds. The increased revenue from the recent 40 cent per pack increase in the cigarette tax is deposited into the Long Term Care Provider Fund, not the general funds.

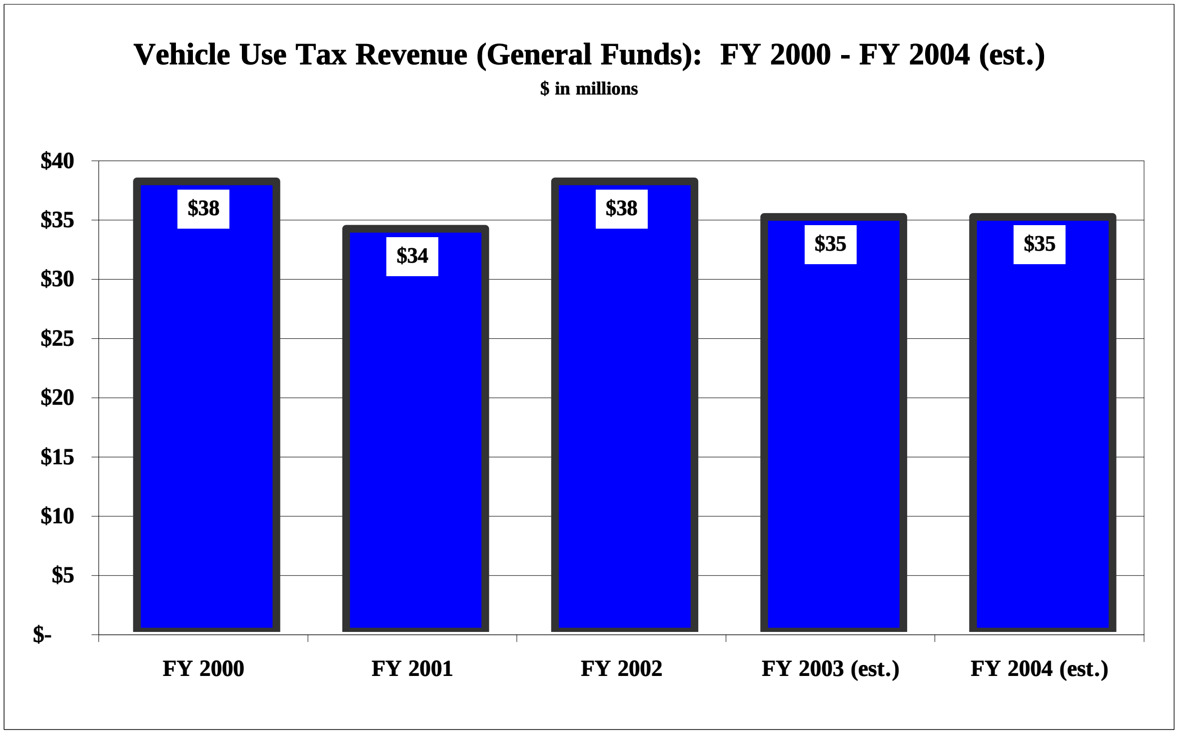
LIQUOR GALLONAGE TAXES



Illinois imposes a tax on the privilege of manufacturing or distributing alcoholic beverages in the State, measured by the number of gallons produced or distributed. The rates vary based on the type of alcohol. The tax per gallon of beer is 18.5 cents, wine and other fortified beverages with less than 20% alcohol is 73 cents, and on distilled liquor $4.50.

The FY 2004 estimate of liquor gallonage taxes is $126 million, reflecting $1 million in anticipated growth over the prior fiscal year.

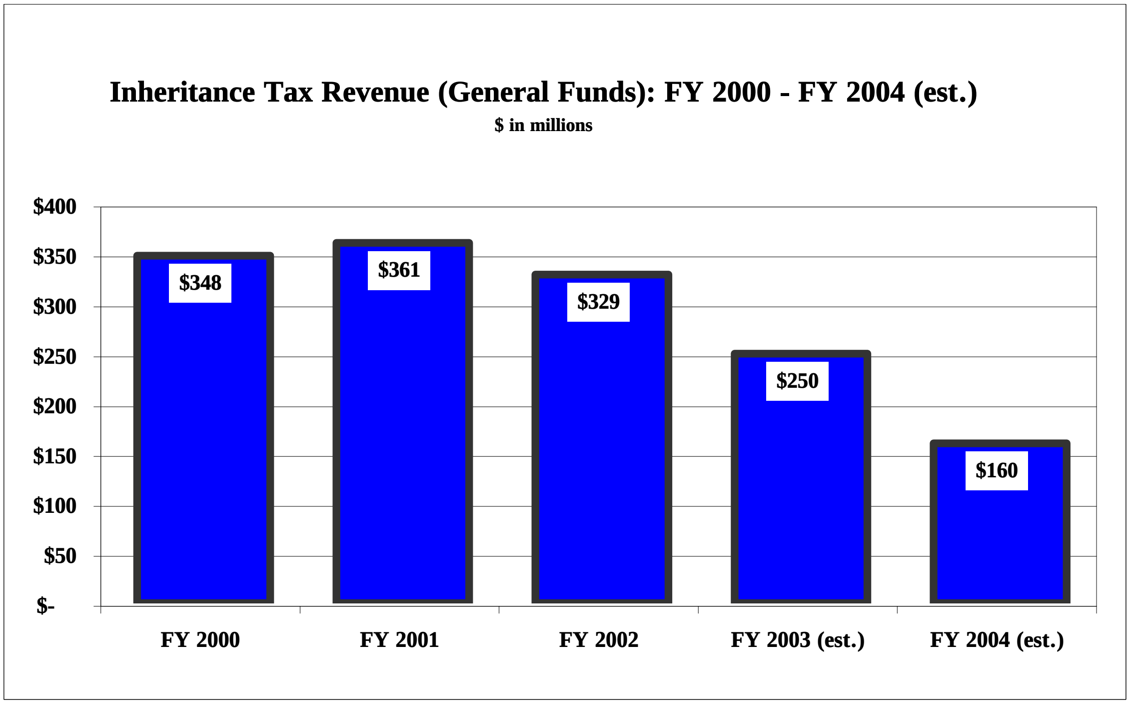
VEHICLE USE TAX



The vehicle use tax is collected on the transfer of ownership of motorized vehicles between private parties. The current rate is based on a statutory schedule that is determined by the age of the vehicle or the purchase price.

The FY 2004 general funds estimate for vehicle use tax is $35 million. Receipts from this source have been virtually unchanged for many years.

INHERITANCE TAX

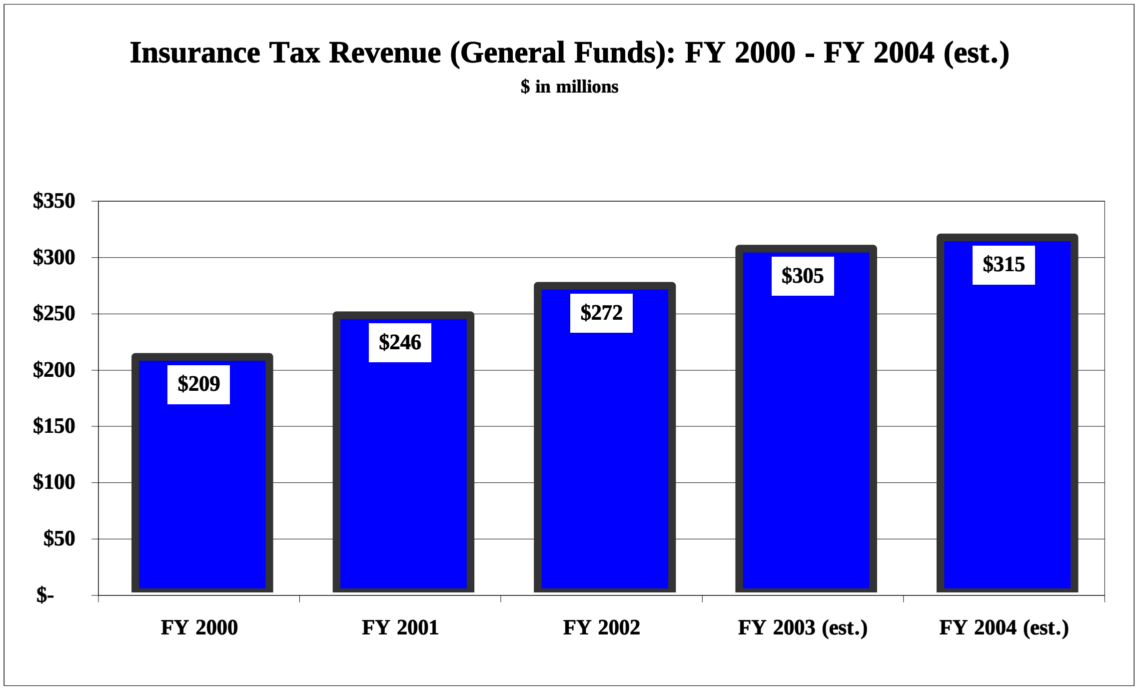


The State of Illinois currently administers an estate tax and a generation-skipping transfer tax. The Illinois estate tax is imposed on a decedent's estate prior to its distribution. The State generation-skipping transfer tax is imposed on bequests in which the transferor is two or more generations removed from the transferee. These taxes are commonly referred to as "pick-up" taxes, because the State taxes equal the maximum state credit permitted against deferral estate and generation-skipping tax liability. This type of tax provides revenue to the State without increasing the estate's total tax burden.

On June 7, 2001, Congress passed H.R. 1836 which completely overhauled the federal estate tax. It repeals federal estate and gift taxes over a ten-year period, it increases the unified credit associated with a decedent's estate, and it reduces the state death credit by 25% per calendar year until it is completely eliminated in 2005. The federal estate tax repeal ultimately will eliminate Illinois' estate tax revenue due to the nature of the pick-up taxes.

The FY 2004 estimate of inheritance tax is $160 million, a reduction of $90 million from the current fiscal year. For a more in-depth analysis of the impact of H.R. 1836, please see the Commission's September 2001 publication entitled "Federal and State Estate Tax Report, Impact of Federal H.R. 1836".

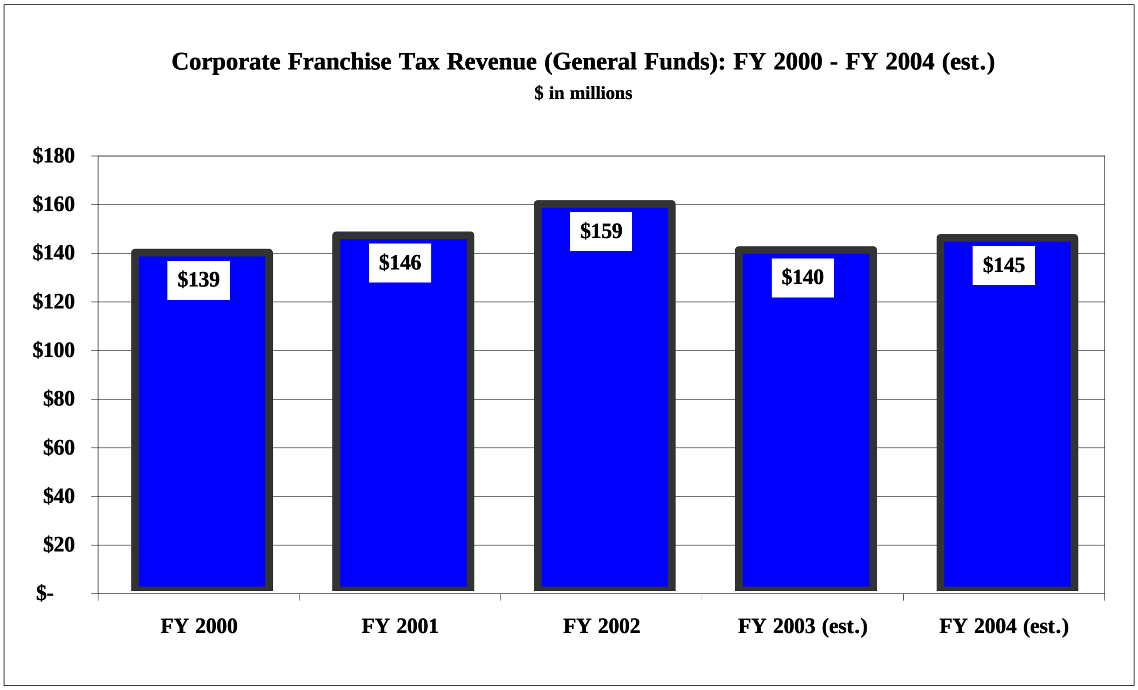
INSURANCE TAXES AND FEES



The State imposes a number of taxes and fees on insurance companies. The tax is based on the net taxable premiums written and is applied at the rate of either 0.4% for accident or health insurance, or 0.5% for other insurance policies. There are numerous other fees levied on particular types of insurance activities.

The FY 2004 general funds estimate of insurance taxes and fees is $315 million, which reflects growth of 3.3% from the prior year.

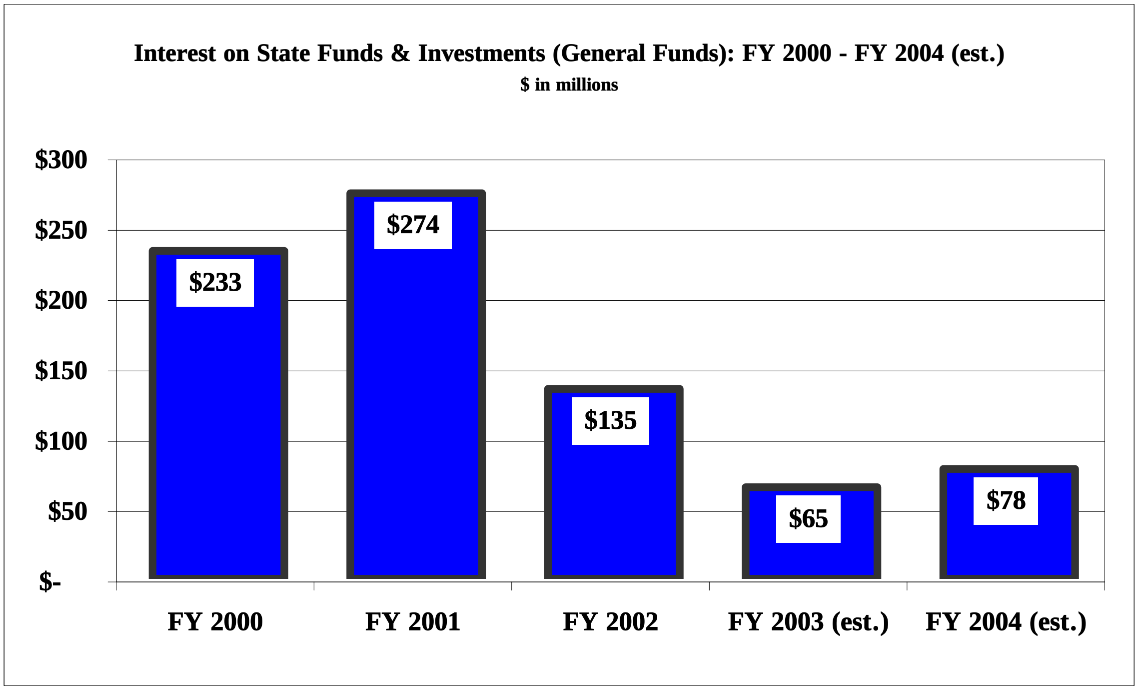
CORPORATE FRANCHISE TAXES AND FEES



All domestic corporations (headquartered in Illinois) and foreign corporations (headquartered in another state or foreign county) are required to pay an annual franchise tax at the rate of 0.1% of paid-in capital. Also, an initial franchise tax based on 0.15% of paid-in capital is levied when a corporation begins to conduct business in Illinois. An additional franchise tax of 0.15% is imposed on any increases in paid-in capital during the year (such as occurs in a capital restructuring, merger, or consolidation).

The FY 2004 estimate of corporate franchise taxes is $145 million, $5 million greater than in FY 2003.

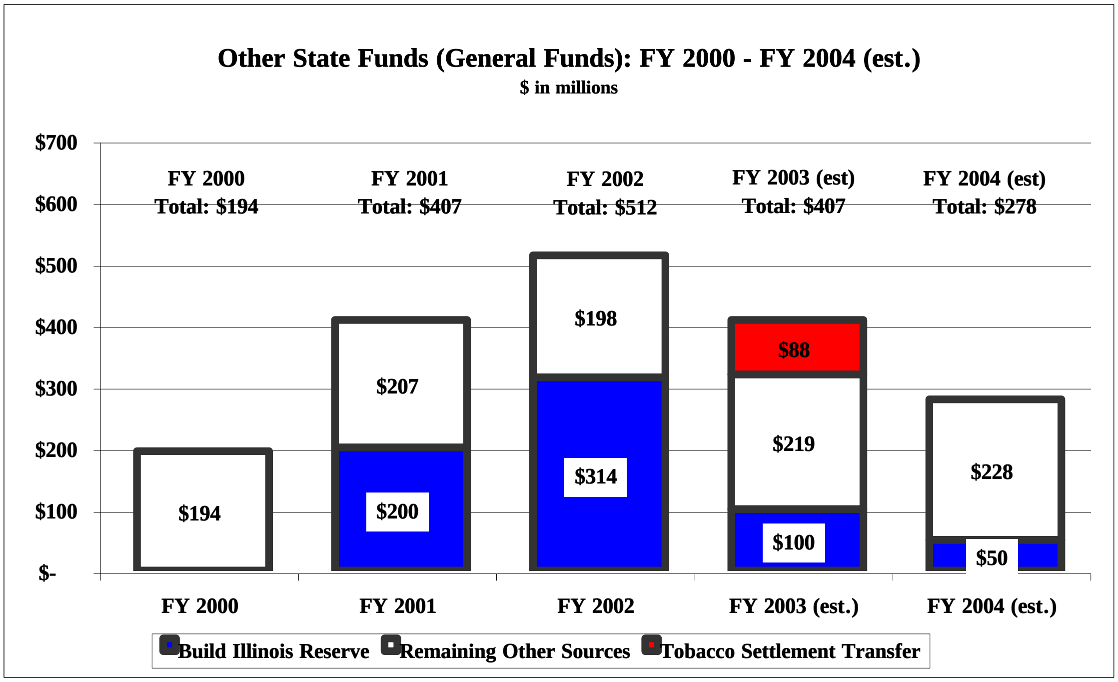
INTEREST



Interest income is earned on the investable balances of various state funds. Interest income is apportioned between the funds based upon each fund's pro ration of the total balance of all invested funds, or by specific statutory direction. The general funds receive the largest share of investment income.

In FY 2004, it is assumed that rates of return will rebound somewhat as the recovery progresses, although balances will continue to be low. The estimate is $78 million, a gain of $13 million from the previous year.

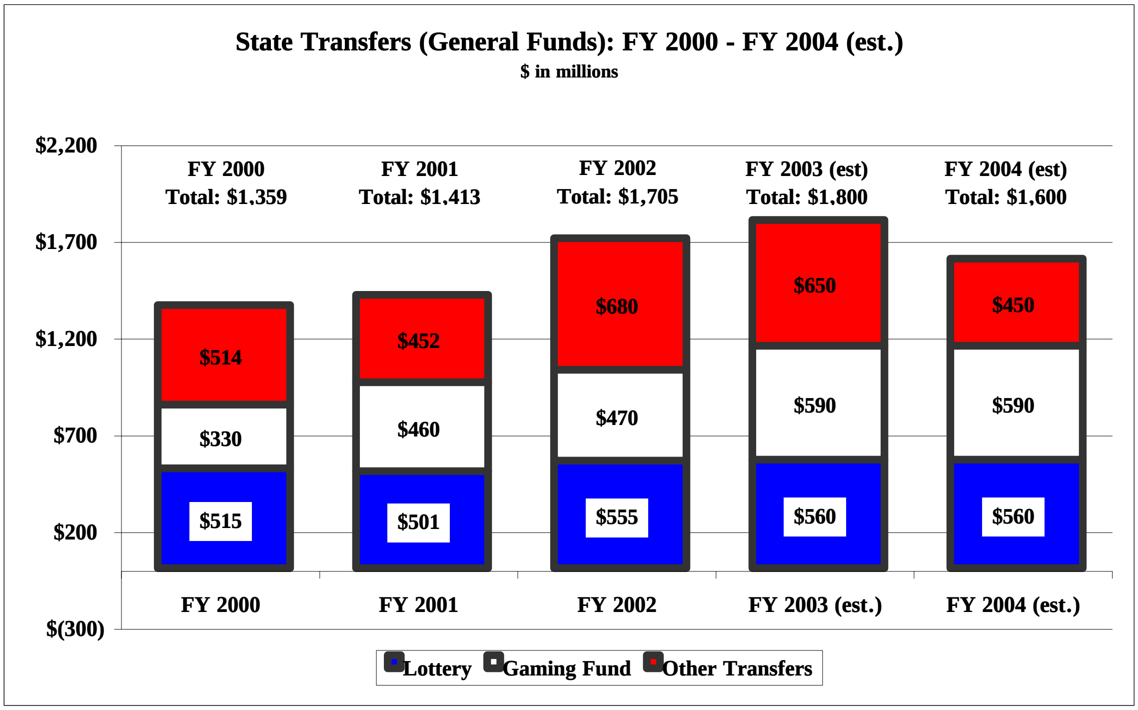
OTHER SOURCES



Other sources to the general funds include various taxes and fees such as the hotel operator's occupation tax and other license and registration fees. In addition, in some years other sources also receive monies in the form of a transfer from the Build Illinois general reserve account. This transfer takes place at the discretion of the Governor between June 15th –30th of any fiscal year.

The FY 2004 estimate of other sources to the general funds is $278 million, a reduction of $129 million from the previous fiscal year. The decrease results from an expected reduction in Build Illinois reserve account transfers as well as the unexpected $88 million in one-time tobacco settlement monies receipted in FY 2003.

TRANSFERS TO THE GENERAL FUNDS



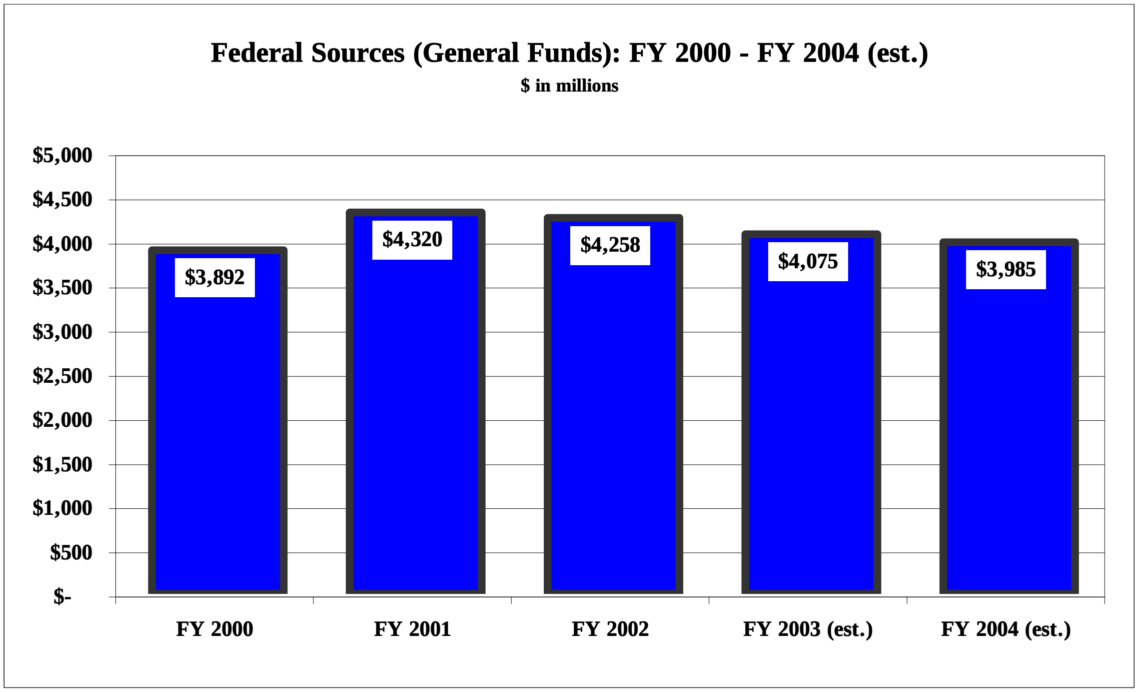
Transfers to the general funds are monies that are deposited in other State funds that are subsequently transferred into one of the four general funds. Included are transfers from the Lottery Fund to the Common School Fund as well as transfers from the State Gaming Fund to the Education Assistance Fund. Due to the size of those transfers, they are itemized separately.

Lottery. ***The estimate of Lottery transfers for FY 2004 is $560 million and reflects no growth from the prior fiscal year.***

Gaming Fund. Receipts from riverboat license fees and taxes are deposited into the State Gaming Fund. From the State Gaming Fund, transfers are made to the Education Assistance Fund. ***The FY 2004 estimate of gaming transfers is $590 million, reflecting no growth from the prior fiscal year. In the event the dormant 10 license is bid or sold, it is possible a considerable windfall would result in FY 2004.***

Other transfers. ***In FY 2004, transfers to the general funds from sources other than the Lottery and the Gaming Fund are expected to be $450 million, a $200 million drop from the prior fiscal year, primarily reflecting the $165 million in one-time interfund transfers made in FY 2003.***

FEDERAL SOURCES



Federal source receipts to the general funds primarily consist of Medicaid reimbursements, the Social Services Block Grant, TANF monies, food stamp administrative cost reimbursements and direct receipts, and transfers from the Children's Services Fund.

The FY 2004 estimate of total federal source receipts to the general funds is $3.985 billion, $90 million less than the previous year. Federal source receipts are largely based on appropriation levels and subsequent spending activity. The negative growth anticipated for FY 2003 reflects earlier Bureau of the Budget estimates, and are subject to revision. The estimate likely will change once appropriation levels have been established.

In conclusion, while the base growth projections for most of the major tax sources are anticipated to finally return to more respectable levels, a number of issues will significantly impact on the bottom line for FY 2004. How these issues will be dealt with will no doubt highlight upcoming budget discussions. The Commission will continue to report back with any significant changes to these projections, or other issues which would either add to or alleviate the budget pressures.

TABLE 6: FY 2004 GENERAL FUNDS ESTIMATE

FY 2004 vs. FY 2003
($ million)

Revenue Sources	March-03 Estimate FY 2004	March-03 Estimate FY 2003	$ CHANGE FY 2003-2004	% CHANGE
State Taxes				
Personal Income Tax	$8,220	$7,950	$270	3.4%
Corporate Income Tax (regular)	1,012	950	$62	6.5%
Sales Taxes	6,236	6,025	$211	3.5%
Public Utility Taxes (regular)	1,042	1,025	$17	1.7%
Cigarette Tax	400	400	$0	0.0%
Liquor Gallonage Taxes	126	125	$1	0.8%
Vehicle Use Tax	35	35	$0	0.0%
Inheritance Tax (Gross)	160	250	($90)	-36.0%
Insurance Taxes and Fees	315	305	$10	3.3%
Corporate Franchise Tax & Fees	145	140	$5	3.6%
Interest on State Funds & Investments	78	65	$13	20.0%
Cook County Intergovernmental Transfer	395	395	$0	0.0%
Other Sources	278	407	($129)	-31.7%
Subtotal	$18,442	$18,072	$370	2.0%
Transfers				
Lottery	560	560	$0	0.0%
Gaming Fund Transfer	590	590	$0	0.0%
Other	450	650	($200)	-30.8%
Total State Sources	$20,042	$19,872	$170	0.9%
Federal Sources	$3,985	$4,075	($90)	-2.2%
Total Federal & State Sources	$24,027	$23,947	$80	0.3%
Nongeneral Funds Distribution (Assumes Use of Statutory Refund Fund Formula):				
Refund Fund				
Personal Income Tax (14.0%)	($1,151)	($636)	($515)	81.0%
Corporate Income Tax (55.0%)	(557)	(257)	($300)	116.7%
Subtotal General Funds	$22,319	$23,054	($735)	-3.2%
Short-Term Borrowing	$700	$700	$0	N/A
Budget Stabilization Fund Transfer	$226	$226	$0	0.0%
Total General Funds	$23,245	$23,980	($735)	-3.1%

Nongeneral Funds Distribution (Assumes Refund Fund Percentages Stay at FY 03 Levels): ***Excludes Short-Term Borrowing and Budget Stabilization Fund Transfers***				
Refund Fund				
Personal Income Tax (8.0%)	($658)	($636)	($22)	3.4%
Corporate Income Tax (27.0%)	(273)	(257)	($16)	6.3%
Subtotal General Funds	$23,096	$23,054	$42	0.2%
Remaining Refund Backlog	**($777)**			

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TABLE 7: ALL APPROPRIATED FUNDS REVENUE FY 2002 to FY 2004

($ millions)

REVENUE SOURCES	ACTUAL RECEIPTS FY 2002	Mar-03 Estimate FY 2003	$ CHG. FROM FY 2002	% CHG. FROM FY 2002	Mar-03 Estimate FY 2004	$ CHG. FROM FY 2003	% CHG. FROM FY 2003
State Taxes							
Personal Income Tax	$8,086	$7,950	($136)	-1.7%	$8,220	$270	3.4%
Corporate Income Tax							
Regular	$1,043	$950	($93)	-8.9%	$1,012	$62	6.5%
Replacement	$755	$730	($25)	-3.3%	$780	$50	6.8%
Sales	$7,056	$7,028	($28)	-0.4%	$7,275	$247	3.5%
Public Utility							
Regular	$1,353	$1,275	($78)	-5.8%	$1,292	$17	1.3%
Replacement	$213	$200	($13)	-6.1%	$205	$5	2.5%
Motor Fuel (gross)	$1,400	$1,440	$40	2.9%	$1,450	$10	0.7%
Cigarette	$469	$615	$146	31.1%	$615	$0	0.0%
Liquor Gallonage Taxes	$127	$129	$2	1.6%	$130	$1	0.8%
Vehicle Use Tax	$43	$40	($3)	-7.0%	$40	$0	0.0%
Inheritance Tax	$329	$250	($79)	-24.0%	$160	($90)	-36.0%
Insurance Taxes and Fees	$315	$350	$35	11.1%	$360	$10	2.9%
Horse Racing Taxes & Fees	$13	$12	($1)	-7.7%	$12	$0	0.0%
Corporate Franchise Taxes	$165	$146	($19)	-11.5%	$151	$5	3.4%
Other Privilege Taxes	$231	$217	($14)	-6.1%	$230	$13	6.0%
Riverboat Gambling Taxes & Fees	$580	$700	$120	20.7%	$700	$0	0.0%
SUBTOTAL	$22,178	$22,032	($146)	-0.7%	$22,632	$600	2.7%
State Nontax Sources							
Motor Vehicle & License Fees	$1,178	$1,178	$0	0.0%	$1,178	$0	0.0%
Cigarette Settlement Distributions	$312	$316	$4	1.3%	$264	($52)	-16.5%
Other Fees	$312	$330	$18	5.8%	$345	$15	4.5%
Provider Assessment Fees	$656	$807	$151	23.0%	$913	$106	13.1%
Receipts From State Hospital Patients	$25	$32	$7	28.0%	$35	$3	9.4%
Interest on State Funds & Investments	$216	$115	($101)	-46.8%	$138	$23	20.0%
Reimbursements & Repayments	$270	$250	($20)	-7.4%	$250	$0	0.0%
Revolving Fund Receipts	$290	$271	($19)	-6.6%	$275	$4	1.5%
Lottery (net gross)	$827	$850	$23	2.8%	$850	$0	0.0%
All Other Nonfederal Receipts	$4,179	$4,388	$209	5.0%	$4,607	$219	5.0%
Income from Sale of Bonds	$2,566	$1,900	($666)	-26.0%	$2,000	$100	5.3%
Local Government Health Plan	$87	$85	($2)	-2.3%	$87	$2	2.4%
SUBTOTAL	**$33,096**	**$32,554**	**($542)**	**-1.6%**	**$33,574**	**$1,020**	**3.1%**
State Transfers In	$32	$35	$3	9.4%	$35	$0	0.0%
TOTAL STATE SOURCES	**$33,128**	**$32,589**	**($539)**	**-1.6%**	**$33,609**	**$1,020**	**3.1%**
Federal Sources	$10,168	$10,594	$426	4.2%	$10,998	$404	3.8%
SUBTOTAL ALL APPROPRIATED	**$43,296**	**$43,183**	**($113)**	**-0.3%**	**$44,607**	**$1,424**	**3.3%**
Short Term Borrowing	**$0**	**$1,000**	**$1,000**	**N/A**	**$1,000**	**$0**	**0.0%**
TOTAL ALL APPROPRIATED	**$43,296**	**$44,183**	**$887**	**2.0%**	**$45,607**	**$1,424**	**3.2%**

IEFC 17-Mar-03

BUSH'S ECONOMIC PLAN AND ITS IMPACT ON THE STATE OF ILLINOIS

In an effort to strengthen the American economy, President Bush in January of 2003 proposed a new economic plan. The intended goals of the proposal are to encourage consumer spending, to promote investment by individuals and businesses, and to deliver help to the unemployed. To accomplish these goals, the President submitted the following initiatives:

- Speed up the 2001 tax cuts to increase the pace of the recovery and job creation.
- Encourage job-creating investment in America's businesses by eliminating the double taxation of dividends and giving small businesses incentives to grow.
- Provide help for unemployed Americans, including extending unemployment benefits and creating new re-employment accounts to help displaced workers get back to work.

White House officials state that the proposal would inject approximately $98 billion into the country's economy over the next 16 months, with 92 million individual taxpayers getting an average of $1,083 in tax relief this year. However, as with any tax relief plan, this proposal does come at a cost. The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimate that the proposals would reduce federal revenues "by $35 billion and increase outlays by $4 billion – through their effects on refundable credits – in 2003. For the 2004-2013 period, CBO and the JCT anticipate that the proposals would reduce revenues by $1.5 trillion and increase outlays by $96 billion."

Not only would Bush's economic plan affect federal revenues, but it would also have an effect on State revenues as well. According to the Center on Budget and Policy Priorities (CBPP), there are three main elements of the President's plan that would reduce state revenues: the exclusion of corporate dividends from individual taxation, the reduction in taxation of capital gains income derived from investments in corporations that reinvested their earnings, and the increase in amount of investments that small businesses can write off as an expense in the year the investment is made. The CBPP claims that the President's proposal could cause states to lose up to $64 billion over the next 10 years. This is because most states with an income tax use the federal definition of adjusted gross income as the basis for their own income taxes, thereby allowing the proposed federal tax cuts to flow through to the states and reduce state income tax revenues.

The largest effect on states, including Illinois, would come from the proposed exclusion of corporate dividends from the taxable income of individuals. Currently, income from corporate activity is subject to being taxed twice, once under the corporate income tax and then again when taxpayers receive dividends or realize capital gains on their corporate stock. Under the President's plan, taxpayers would be able to exclude from their individual income tax liability dividends on which corporate taxes had already been paid. In addition, shareholders would receive an increase in their cost basis for tax purposes for amounts of corporate earnings not distributed as dividends but on which corporate taxes had been paid.

The CBO estimates that this proposal, which would become effective for corporate distributions beginning January 1, 2003, would reduce the nation's federal revenues by nearly $8 billion in 2003 and by $388 billion over the 2004-2013 period. The CBPP reports that the dividend exclusion proposal could annually cost the state of Illinois approximately $132 million. The Federation of Tax Administrators estimate a similar amount, approximately $140 million.

There is much concern on how this proposal would affect state budgets throughout the country. An analysis from Standard & Poor writes, "to preserve the state revenues coming from dividends, states would be required to decouple current state income tax structures from the federal system." They also point out, "…if the proposal moves forward in its current form, fiscal pressure will be even more acute for state governments already facing estimated fiscal 2004 budget deficits totaling more than $60 billion. As a result, further credit deterioration over the next year is likely." The CBPP adds, "lower ratings mean immediately higher interest costs for states, which will further increase fiscal stress."

In addition to these possibilities, some are concerned over other unintended consequences of eliminating the dividend tax. A report from MSNBC states, "If dividends were tax-free, stocks with high payout ratios could become so attractive they would compete with tax-free municipal bonds, hurting a major source for funding for states and municipalities that already are strapped for cash."

However, proponents to the plan contend that the costs associated with the proposal would eventually be offset by increased revenues stemming from the effects of the President's plan. The Administration believes that this proposal "is a focused effort designed to remove the obstacles standing in the way of faster growth and greater progress." If the proposal works as intended, the economy would get a boost from increased consumer spending, better investment opportunities, and lower unemployment rates. This increase in economic activity would translate to increases in both federal and State tax revenues. The extent of the revenue increase would, of course, depend on the budget that finally is passed. The hope is that the economy is stimulated enough that any state or fiscal costs associated with the President's proposal would be more than offset by these increased revenues.

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