State of Illinois

DANIEL W. HYNES
COMPTROLLER
www.ioc.state.il.us

Executive Summary

Fiscal Year 2002

DANIEL W. HYNES
COMPTROLLER
www.ioc.state.il.us

April, 2003

DANIEL W. HYNES

A Message to Illinois Taxpayers

The mission and priorities of my administration continue to include providing taxpayers with useful and understandable information about the fiscal operations of the State of Illinois. This presentation of the Executive Summary, also known by the financial community as Illinois' popular annual financial report, is written to enhance public understanding of the state's financial statements.

The report combines information based on the state's *Comprehensive Annual Financial Report* prepared in accordance with Generally Accepted Accounting Principles (GAAP) for government and cash basis budgetary information contained in the *Traditional Budgetary Financial Report*. Both of these other reports can be accessed at our Web site, www.ioc.state.il.us, or by calling at (217)782-6000 or (312) 814-2451.

Under the GAAP reporting system, revenues accrue to the period in which they are earned and expenditures are counted against the period in which the liability was obligated. Under the cash basis reporting system, revenues and expenditures are compared for the budgetary period regardless of when they were incurred. The State of Illinois budgets on a cash basis.

In this *Executive Summary*, as in past reports, we examine the economic and fiscal climate in which future budgets will be considered. It is valuable for policy-makers to understand these issues in order to make informed decisions. It is also a useful resource for taxpayers to measure the effectiveness of governmental programs.

This year's report highlights that for the fourth consecutive year, the General Funds GAAP balance has deteriorated after five years of deficit reduction. The state ended fiscal year 2002 with a negative General Funds balance of $3.306 billion indicating that the state's GAAP deficit had worsened by $1.941 billion compared to the prior year. The cash position also deteriorated as the available balance declined from $1.126 billion at the end of fiscal year 2001 to $256 million at the end of fiscal year 2002. Over the same period, the budgetary balance decreased by $1.520 billion, falling from a surplus of $300 million to a deficit of - $1.220 billion.

In addition to increased spending activity in fiscal year 2002 and reduced cash balances, for the fifth year in a row Section 25 liabilities experienced growth, standing at $1.436 billion as of June 30, 2002. The continuing economic recession coupled with these negative fiscal balances pose serious challenges for the future. Policy makers may be well-served to consider these issues carefully in crafting future budgets and to develop budgetary methods and practices that minimize the impact on state programs due to these phenomena. The Rainy Day Fund established in fiscal year 2000, long a policy objective of this office, is an example of a budget innovation that once properly funded, will permit the state to address these issues.

We hope you find this report to be both informative and useful. Please share with us any suggestions or comments you may have about this report and its contents.

Sincerely,

Daniel W. Hynes
Comptroller

Award for Outstanding Achievement in Popular Annual Financial Reporting

PRESENTED TO

STATE OF ILLINOIS

For the fiscal year ending
June 30, 2001

GOVERNMENT FINANCE OFFICERS ASSOCIATION OF THE UNITED STATES AND CANADA CORPORATION SEAL CHICAGO

President

Jeffrey L. Esser
Executive Director

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INTRODUCTION

State Government Background

Geographically located in the central portion of the United States, Illinois is a diverse state that covers almost 56,000 square miles of land. Many of Illinois' approximately 12.4 million inhabitants live in urban areas, although there is a strong rural presence in the state as well. Nearly one-fourth or approximately 2.9 million of the state's residents live in Chicago, the third largest city in the country. Six other municipalities including Rockford, Aurora, Naperville, Peoria, Joliet and the state's capitol of Springfield have populations in excess of 100,000 with another 19 municipalities' populations estimated to be in excess of 50,000.

The framework of government for Illinois and its 12.4 million residents is set forth by the Constitution. Since joining the Union in 1818, Illinois government has evolved through four Constitutions. The current Constitution, adopted and ratified in 1970, recognizes three main branches of state government. The Executive Branch has six elected officers: a Governor, Lieutenant Governor, Attorney General, Secretary of State, Comptroller, and Treasurer. The Legislative Branch includes two chambers, a Senate with one senator from each of the 59 Senate districts, and a House of Representatives with one representative from each of the 118 House districts. The Judicial Branch consists of a seven-member Supreme Court, Appellate Courts in five judicial districts and Circuit Courts in twenty-two judicial circuits.

Responsibility for most of the day-to-day operations of state government and its programs resides in the executive branch, with the Governor overseeing the largest portion. Under the purview of the Governor are twenty-three major departments including Human Services, Transportation, Public Aid, and Revenue. There are also approximately forty-five other agencies, and over one hundred miscellaneous boards and commissions under the jurisdiction of the Governor. In addition, the other six elected officers under the executive branch oversee their respective agencies. State government agencies combined directly employ approximately 88,500 persons. The Departments of Human Services (19,023), Corrections (17,047) and Transportation (8,028) account for nearly half of all direct government employees.

Oversight of the elementary and secondary education system in Illinois is the responsibility of the State Board of Education whose nine members are appointed by the Governor, with the consent of the Senate. The Board sets state educational policies and guidelines for schools, with local school boards administering educational services throughout 892 school districts and 4,238 schools. In fiscal year 2002, more than two million public school children were instructed by nearly 127,400 full-time, certified teachers throughout Illinois.

The 15-member Board of Higher Education plans and coordinates higher education policy for all sectors of Illinois Higher Education. Administration of Illinois' public universities and community colleges is conducted by ten boards including: the Boards of Trustees of the University of Illinois, Southern Illinois University, Chicago State University, Eastern Illinois University, Governors State University, Illinois State University, Northeastern Illinois University, Northern Illinois University, Western Illinois University, and the Community College Board. Approximately 753,000 students were enrolled in Illinois colleges and universities during the 2002 fiscal year.

In addition to education, medical assistance and highway maintenance and construction are the largest state programs. The Department of Public Aid's Division of Medical Programs administers the state's Medicaid and KidCare programs with more than 1.9 million people in Illinois covered by Medicaid health services. The Department of Transportation administers the state's highway program through nine district offices with responsibility for the state's 17,000-mile state highway system.

Total state spending for these major programs and all other operations of state government in fiscal year 2002 was $71.4 billion or approximately $5,738 for every person in Illinois. Total state revenues for the year were $69.5 billion with income taxes ($9.1 billion), sales taxes ($9.6 billion) and federal revenues ($10.2 billion) as the largest sources. The largest functions of spending included General Government ($31.1 billion), Health and Social Services ($15.2 billion) and Education ($12.8 billion).

ELECTORATE

- **Legislative Branch**
  - Senate
  - House of Representatives
- **Executive Branch**
  - Secretary of State
  - Treasurer
  - Lt Governor
  - Governor
    - Education
      - State Board of Education
      - Board of Higher Education
      - Illinois Community College Board
      - Student Assistance Commission
    - Administrative Code Departments
      - Aging
      - Agriculture
      - Central Management Services
      - Children and Family Services
      - Commerce and Community Affairs
      - Corrections
      - Employment Security
      - Financial Institutions
      - Human Rights
      - Human Services
      - Insurance
      - Labor
      - Lottery
      - Military Affairs
      - Natural Resources
      - Nuclear Safety
      - Professional Regulation
      - Public Aid
      - Public Health
      - Revenue
      - State Police
      - Transportation
      - Veterans' Affairs
    - Other Agencies, Boards and Authorities
  - Comptroller
  - Attorney General
- **Judicial Branch**
  - Supreme Court
  - Appellate Court
  - Circuit Court

Economic Outlook Fiscal Year 2002

Fiscal year 2002 was a disappointing year for the Illinois economy with employment conditions steadily deteriorating during the year. The average Illinois unemployment rate increased from 4.8% in fiscal year 2001 to 5.9% for 2002, its highest level since fiscal year 1994 when it reached 6.6%. Illinois' non-agricultural employment averaged 5.961 million workers in fiscal year 2002, a decrease of 82 thousand jobs or 1.4% below 2001 employment. The fiscal year 2002 employment decline followed nine consecutive years of employment growth. During that period, Illinois added 828 thousand nonagricultural jobs (a 15.9% increase).

Several sectors were particularly hard hit by the economic downturn. The cut back in travel following the 9/11 tragedy severely impacted certain segments of the travel and lodging sectors. The collapse of the high tech boom led to employment reductions in Illinois' large telecommunications sector. The decline in capital investments and increased foreign competition caused layoffs, plant closings, and reduced profits at Illinois steel and capital goods companies.

A more comprehensive measure of Illinois' economic performance is the change in state personal income adjusted for inflation. Personal income includes wage and salary income, income earned by property owners, and transfer payments such as social security. Illinois personal income adjusted for inflation declined 0.5% in fiscal year 2002 as a 1.2% increase in nominal personal income was more than offset by a 1.8% increase in the consumer price index. This was the first decrease in real Illinois personal income since fiscal year 1991 and followed a ten-year period where the Illinois economy grew at least 1.2% each year.

The Illinois labor market continued to worsen during the fiscal year. The average seasonally adjusted Illinois unemployment rate increased from 5.7% during the first half of the fiscal year to 6.1% for the second half of the year. Seasonally adjusted average employment declined from 5.975 million to 5.955 million, while the average number of unemployed increased from 359 thousand to 388 thousand between the first and second halves of the fiscal year.

Fiscal Year 2003 and Beyond

Although economic forecasters are expecting a recovery to begin during the latter part of fiscal year 2003, there was little sign of a recovery in Illinois during the first six months of the fiscal year. Through December, Illinois nonagricultural employment remained an average of 58 thousand workers below its prior level, while the average Illinois unemployment rate increased to 6.7%.

Persistent weakness in foreign economies and concerns about energy prices continue to delay the onset of the economic recovery. Illinois is a major participant in the international economy with exports valued at $31.8 billion in calendar 2001 ranking sixth highest among the states. For the previous decade, the U.S. economy had served as the engine that pulled much of the rest-of-the-World economy forward. The U.S. economic slowdown has contributed to a general lethargy of the World economy. As an integral part of the World economy, the beginning of the up tick in the Illinois economy awaits the recovery of the U.S. and other major World economies. As a net energy importer, uncertainty about oil and natural gas prices casts an additional pall over the Illinois economy.

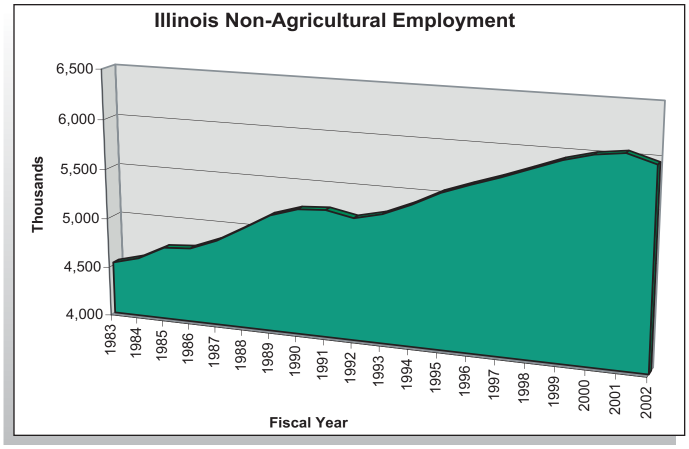
Previous recessions often had an especially severe impact on the Illinois economy, as the durable equipment industries in which Illinois specialized were crippled by high interest rates at the start of the recession. Increased diversification of the Illinois economy allows it to be more closely synchronized with the national economy. The impact of lessened demand for Illinois products has also been ameliorated during the current recession by lower interest rates which ease the impact of the recession on Illinois durable goods industries.

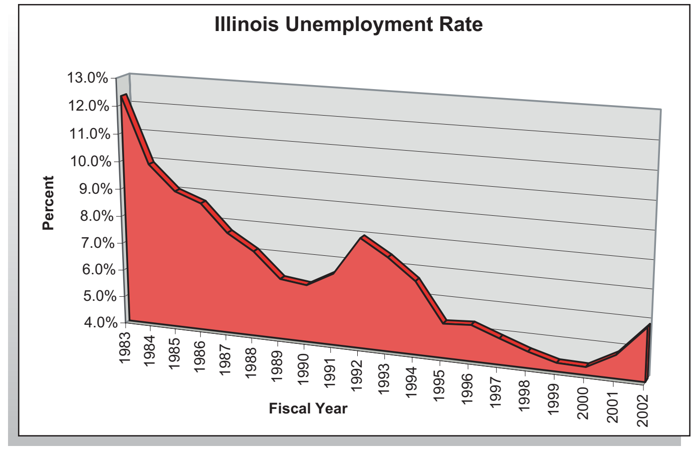
The collapse of high technology stocks has hurt Illinois' high technology sector, but the impact will probably not be as great on Illinois as some other areas. Illinois was never as dependent on dot.com startups as other regions and established manufacturing and service companies have taken advantage of technology to improve their operating efficiency. This will ease their ability to ride out the recession and improve their competitive position for the following recovery.

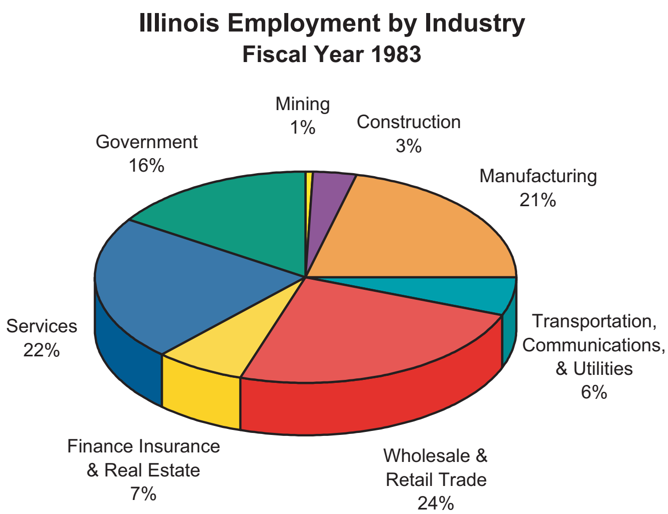
The key Illinois agriculture sector (Illinois farmers had cash receipts from farm marketings of $7.5 billion in 2001 with exports, largely corn and soybeans, valued at $3.1 billion) enters 2003 facing very volatile farm product markets. The tightest grain and oilseed supplies in several years are boosting prices and forcing adjustments for end users. Producers with normal or above average crops will see strong gains in revenue, while producers with poor crops will see sales revenues plunge. Despite healthier prices, the uncertainty facing the farm sector has tempered the recovery for Illinois' farm supply, equipment, and support industries.

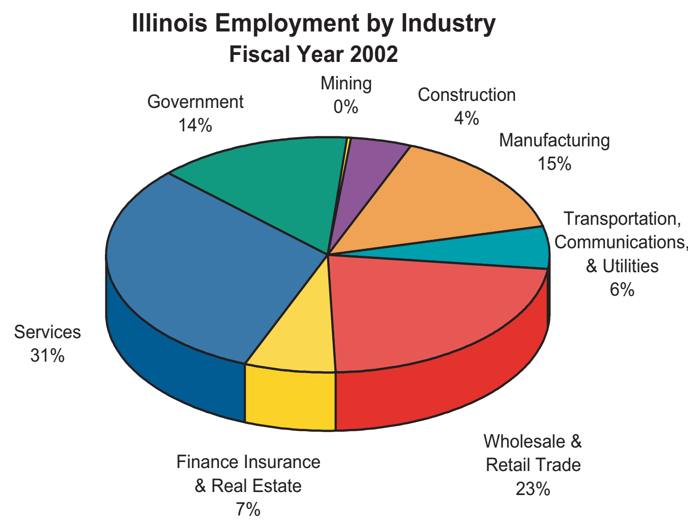
Most economists believe the worst of the current recession is over. Once the economic recovery begins, the Illinois economy remains well positioned to take advantage of the opportunities from the revolutionary developments occurring in communications and biotechnology. Illinois is working towards becoming a communications hub of the nation. Through expanding private networks and the state financed initiatives such as the Illinois Century Network which links educational institutions throughout the state, Illinois is moving toward an environment where high quality information links are universally available for educational, job training, commercial, and industrial purposes. Illinois can also take advantage of its role as a major center for scientific research. The state is home to major government research laboratories, such as the Argonne National Laboratory and the Fermi National Accelerator Lab, major private corporate research and development labs in electronics, mechanical engineering and the biosciences, several large private research universities and the state's network of nine public universities including the National Center for Supercomputing Applications housed at the University of Illinois.

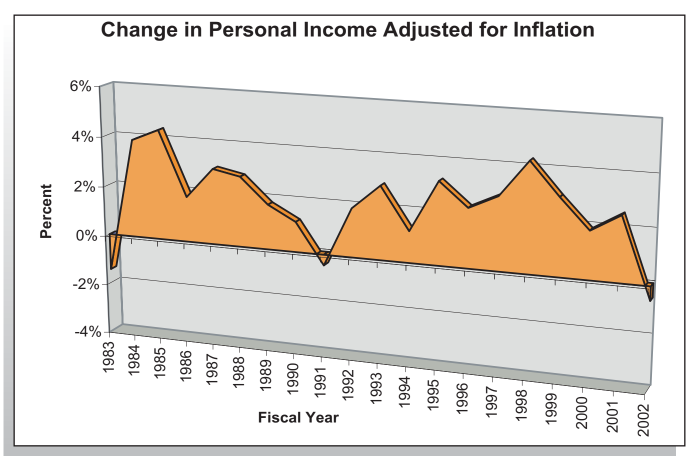
Year-End Economic Summary

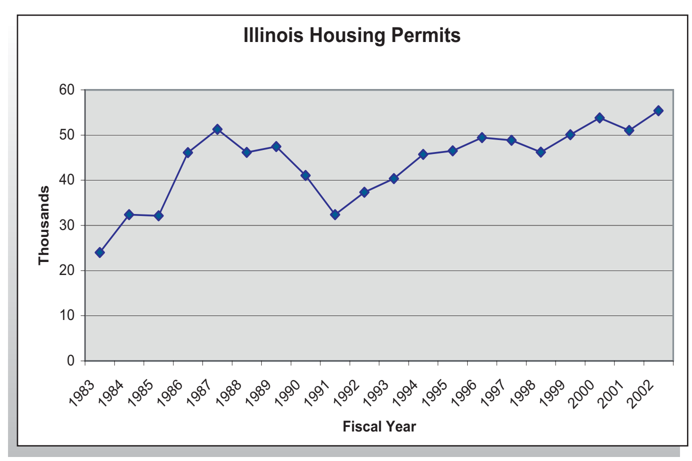












Fiscal Overview
Fiscal Year 2002

In just a little more than a decade, Illinois state finance has traveled full circle, falling to record lows, rising to all-time highs, and finally falling again to unprecedented lows. During fiscal year 2002, the state's General Funds turned in the worst performance on record, surpassing the previous lows set during the financial difficulties that spanned fiscal years 1991-1997.

Racked by recession and a falling stock market, the General Funds set several new record lows during fiscal year 2002. These include:

- A decline in "base" revenues for the first time in recent memory (down $727 million or 3.0%)
- Instead of growing $894 million as originally expected, "base" revenues for the year actually fell, coming in more than $1.6 billion lower than originally estimated
- The highest level of unpaid bills at the end of the year ($781 million)
- The highest ever lapse period spending ($1.476 billion)
- The largest ever budgetary deficit (-$1.220 billion)
- The largest ever GAAP deficit (-$3.306 billion)
- The highest level of unpaid bills during the year ($1.407 billion)

The state's eight-year string of budgetary (cash basis) improvements ended in fiscal year 2001. During the first half of the year, the combination of an extraordinary transfer out, a six-month sales tax exemption for motor fuel purchases, and higher spending demands resulted in the emergence of cash flow difficulties for the first time since the end of fiscal year 1997. These difficulties were concentrated in the General Revenue Fund (GRF), the state's largest operating fund.

As fiscal year 2001 progressed, slowing economic activity resulted in more payment delays between mid-February and late-April before improving toward the end of the year. When the books were closed on the year, the General Funds budgetary balance recorded its first drop since 1992 (down $477 million from 2000). At the same time, the state's General Funds GAAP deficit worsened for the third consecutive year (down $793 million).

Available data indicate that a recession was already well underway in Illinois as the state began fiscal year 2002. It also appears that the tragic events of September 11, 2001 exacerbated an already troublesome economic and fiscal situation.

Over the first quarter of the fiscal year, General Funds total revenues were $296 million below the prior year with wide-spread weakness in most revenue sources. Although revenue fell dramatically, spending demands continued to grow. As a result, cash flow difficulties emerged in late August. This marked the first time since 1995 that payment delays surfaced so early in the year. In order to alleviate at least some of the payment delays, the Comptroller ordered the balance in the Budget Stabilization Fund transferred to the GRF. On November 14, 2001, $226 million was transferred and paid out the same day. This action reduced unpaid bills to $350 million.

As fiscal year 2002 progressed, the General Funds budgetary financial condition worsened considerably as revenues declined in nine out of the twelve months and in each of the last six months of the year. For the year, "base" revenues (total revenues minus rainy day dollars) were $727 million or 3.0% below fiscal year 2001 and over $1.6 billion below the original estimates for fiscal year 2002. The year-over-year revenue decline was led by sources tied directly to economic activity. Hammered by falling employment (nonagricultural employment down 82,000 jobs), declining wage and salary income (down 0.1%), and a free-falling stock market, personal income tax receipts dropped $525 million. At the same time, the weakening economy and falling profits reduced corporate income tax revenues by $233 million.

Efforts to reduce spending appear to have had little effect and payment delays plagued the General Funds for nearly the entire fiscal year. Unpaid bills reached as high as $1.4 billion in mid-April and delays reached as much as 35 days in mid-June. At the end of June, the General Funds cash balance was $256 million, or $870 million less than what was in the bank at the end of fiscal year 2001. The dramatic drop in the cash balance was concentrated in the GRF where the cash balance dropped from $683 million to $0 over the year, accounting for nearly 79% of the drop in the General Funds balance. In addition to the lack of a balance on June 30, 2002, there were $781 million in bills on hand that could not be paid. The resulting effective GRF balance (available cash less unpaid bills) was almost $1.5 billion below last year's ending balance.

Since $781 million was carried over to July, fiscal year 2002 lapse period spending jumped to $1.476 billion, the highest ever. The budgetary balance also reached a record deficit, -$1.220 billion. At the same time, the GAAP deficit soared to -$3.306 billion. This is not only the worst GAAP deficit on record, it also represents the single largest deterioration (-$1.941 billion).

At the beginning of fiscal year 2003 the State entered into a $700 million short-term loan to prop up the GRF, transferred $156 million in surplus money from other funds, and transferred $226 million from the Budget Stabilization Fund. These revenues were used to pay bills carried over from June and to relieve a backlog of Medicaid bills. After less than a week, GRF payment delays began to accumulate again.

Unfortunately, the economy has continued to falter, and at the end of the first half of fiscal year 2003, the state's

Fiscal Overview *concluded*

GRF was still experiencing severe cash flow difficulties with more than $1.4 billion in unpaid bills. Without the one-time infusion of more than $1 billion in July, the GRF backlog would have been almost $2.5 billion.

The fiscal year 2003 budget was predicated on "base" revenue growth of $1.006 billion or 4.3%. However, growth through the first half of the year amounts to only 1.6% and includes weakness in the major sources tied most directly to the economy (personal income tax down 0.6%, corporate income tax down 16.1%, and sales taxes up 0.1%).

The state's cash flow over the rest of fiscal year 2003 will depend heavily on the performance of the economy and revenue sources tied most directly to economic activity. There does not appear to be any reason to believe that recovery will start soon enough to generate the magnitude of economic activity necessary to reach the current revenue estimates. Given the fact the employment levels continued to decline through December 2002 (manufacturing down more than 40,000 jobs and total nonagricultural employment down more than 55,000), there appears to be more reason to think that fiscal year 2003 revenues might fall below last year, marking the second consecutive annual decline. Even if employment picks up, it seems clear that personal income tax withholding and sales taxes cannot rebound enough to keep payment delays from growing worse, especially given the short-term and Budget Stabilization Fund repayment requirements.

If the description of the state's financial activity over the last 30 months sounds familiar, it is because we have been there before. As Illinois prepared to enter the 1990s, few observers would have guessed that, within two years, the state would begin sliding into its worst financial condition in memory. Even fewer would have guessed that by the end of that decade, the reversal of financial fortune would be so extreme as to put the state's budget in its best shape in memory, albeit temporarily.

One lesson that should have been learned from the difficulties of the early to mid 1990s is that it is easy to stumble into a fiscal crisis. Another is that it is far more difficult to dig out of a budgetary hole. Unfortunately, it is easy to get used to the kind of fiscal flexibility afforded by a strong economy. During fiscal year 2001, the prior year's budgetary surplus was reduced by more than half due to various taxing and spending decisions and the onset of recession in the spring.

When the fiscal year 2002 budget was enacted, the state was already in recession. Revenues declined for the first time in memory, and to make things worse, actual revenues fell short of original expectations by $1.621 billion. Efforts to regain control of the budget proved ineffective and the small budgetary surplus from fiscal year 2001 became the largest budgetary deficit on record by the end of 2002.

With the state's dismal financial performance in fiscal year 2002 and thus far in fiscal year 2003, policy-makers may be again tempted to push accrued liabilities into future year's appropriations. One of the largest components of those liabilities is Section 25 deferrals. After falling substantially from 1995 through 1997, Section 25 deferred liabilities increased in each of the last five years, reaching $752 million in 1998, $894 million in 1999, $1.075 billion in 2000, $1.118 billion in 2001, and $1.436 billion in 2002 – the third consecutive year that these deferrals have exceeded $1.0 billion. The $318 million growth in 2002 included a $260 million increase under the state's Medicaid program and a $58 million increase under the group health insurance program for employees, retirees, and their dependents administered by the Department of Central Management Services.

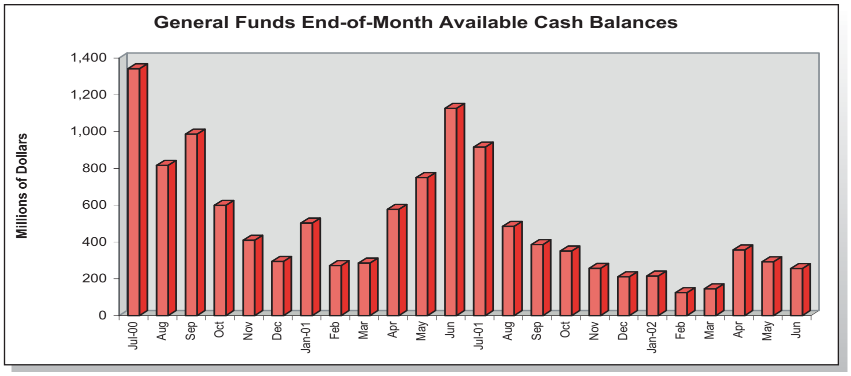
Barring sudden and catastrophic economic collapse, financial crises of the current magnitude do not appear out of nowhere. They take time to develop and are the result of economic cycles and state fiscal policy actions.

While economic cycles are largely beyond the influence of state government, taxing and spending decisions are not. Although economic cycles can be long, and their impact dramatic, they seldom permanently change the fiscal landscape. Fiscal policy decisions, however, tend to have much more pronounced long-term impacts. Tax relief efforts of the last 25 years, for example, permanently reduced the state's revenue base. At the same time, spending decisions, some of which have been dictated by the courts or the federal government, have permanently increased the state's spending base. Because actions that reduce the state's revenue base or permanently raise the spending base have a cumulative effect, such actions must be taken with a view towards their long-term implications.

Over the years, this combination of reduced tax base, increased spending base, and the ever-present economic cycle have resulted in feast or famine budgets. During the feast, there is enough for everybody. But during the famine, Illinois has resorted to a variety of tactics to get back on track — temporary tax increases, permanent tax increases, inter-fund borrowing, inter-fund transfers, short-term borrowing, across-the-board spending cuts, and extended payment delays. These experiences make it increasingly important that any efforts to regain control of the budgetary process be examined carefully.

Note: A total of $1.0 billion in short-term borrowing was entered into in July 2002. Of that amount $700 million was dedicated to the GRF, $150 million to the Long-Term Care Provider Fund, and $150 million to the Income Tax Refund Fund.

Year-End Fiscal Summary



Taxes Receivable

(in millions)	6/30/01	6/30/02	Change
Gross Balance	$2,601	$2,435	($166)
Uncollectibles	$946	$836	($110)

Major Unfunded and Long Term Liabilities

(in millions)	FY 2001	FY 2002
Net Pension Obligation	$ 13,721	$ 14,633
General Obligation Bonds	$ 7,351	$ 8,405
Build Illinois and Civic Center Bonds	$ 1,932	$ 2,003

G.O. Bond Rating

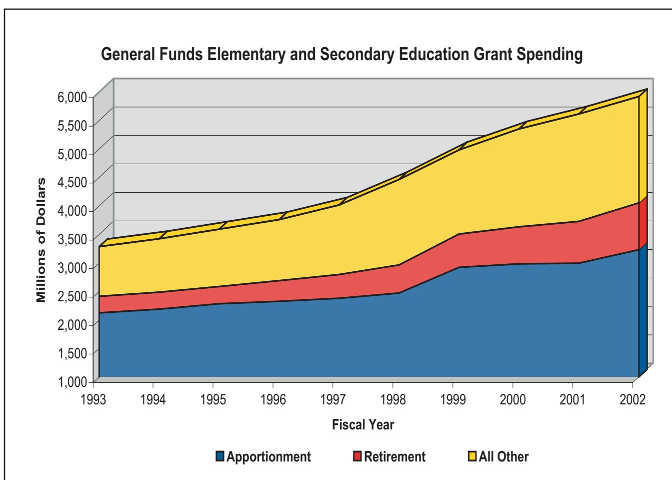
Moody's	Aa2
S&P	AA

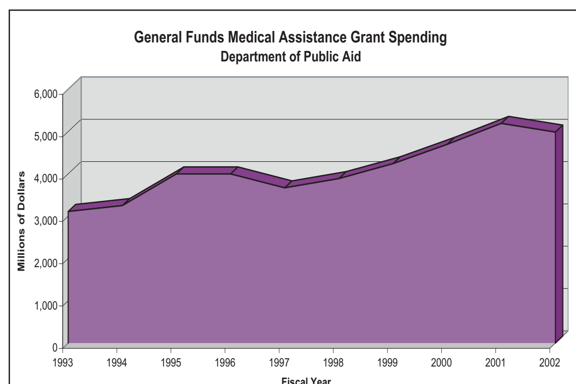
Section 25 Liabilities

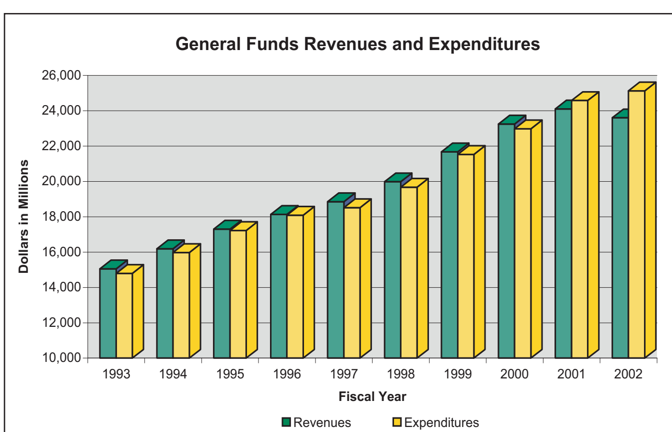
(in millions)	6/30/2001	6/30/2002	Change
Liabilities	$1,118	$1,436	$318

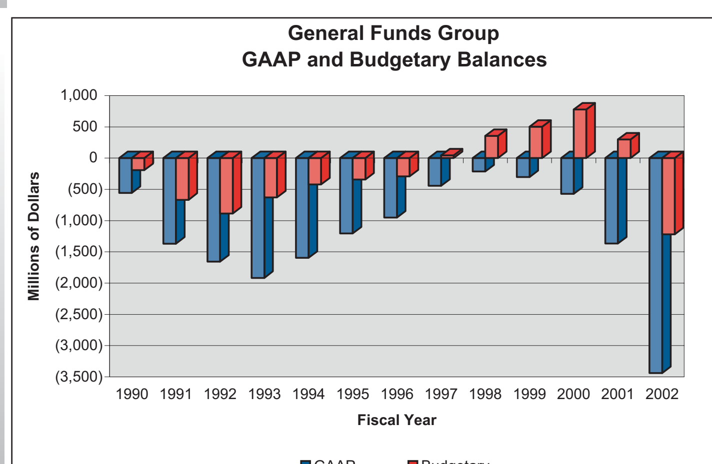
General Funds Fiscal Activity

(in millions)	FY 2001	FY 2002	Change
Beginning Balance	$ 1,517	$ 1,126	$ (391)
Revenues	$ 24,106	$ 23,605	$ (501)
Expenditures	$ 24,497	$ 24,475	$ (22)
Ending Balance	$ 1,126	$ 256	$ (870)
Lapse Period Warrants	$ 826	$ 1,476	$ 650
Budgetary Balance	$ 300	$ (1,220)	$ (1,520)







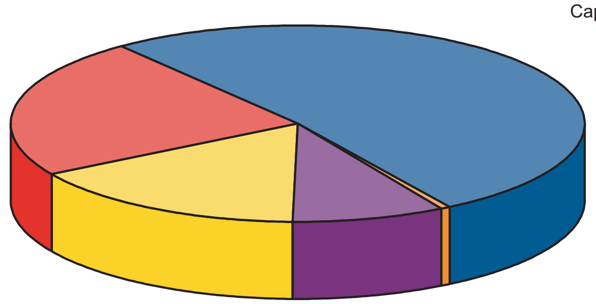


GAAP BASIS

GAAP Basis Financial Information Summary

The following information has been condensed from the statements included in the State of Illinois *Comprehensive Annual Financial Report* utilizing the total column of the primary government. During fiscal year 2002, the state implemented Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements–and Management's Discussion and Analysis–for State and Local Governments,* which restructured the required financial statements presented. Accordingly, some information discussed below does not have comparable information for the previous fiscal year.

Total Assets (Primary Government)
June 30, 2002
Millions of Dollars



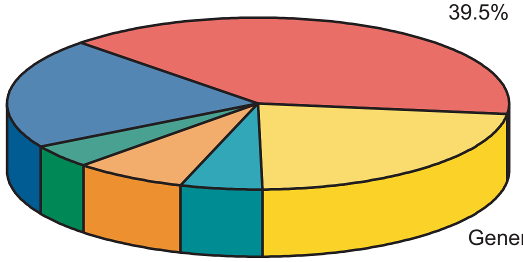
ASSETS

Total assets of the State of Illinois at June 30, 2002, were approximately $30.9 billion. Capital assets of the state consist of $15.9 billion (51.7%) of the state's assets.

LIABILITIES

Total liabilities of the state were approximately $37.0 billion at June 30, 2002. The state's largest liability balances are the pension liability and the general and special obligation debt liability.

Total Liabilities (Primary Government)
June 30, 2002
Millions of Dollars



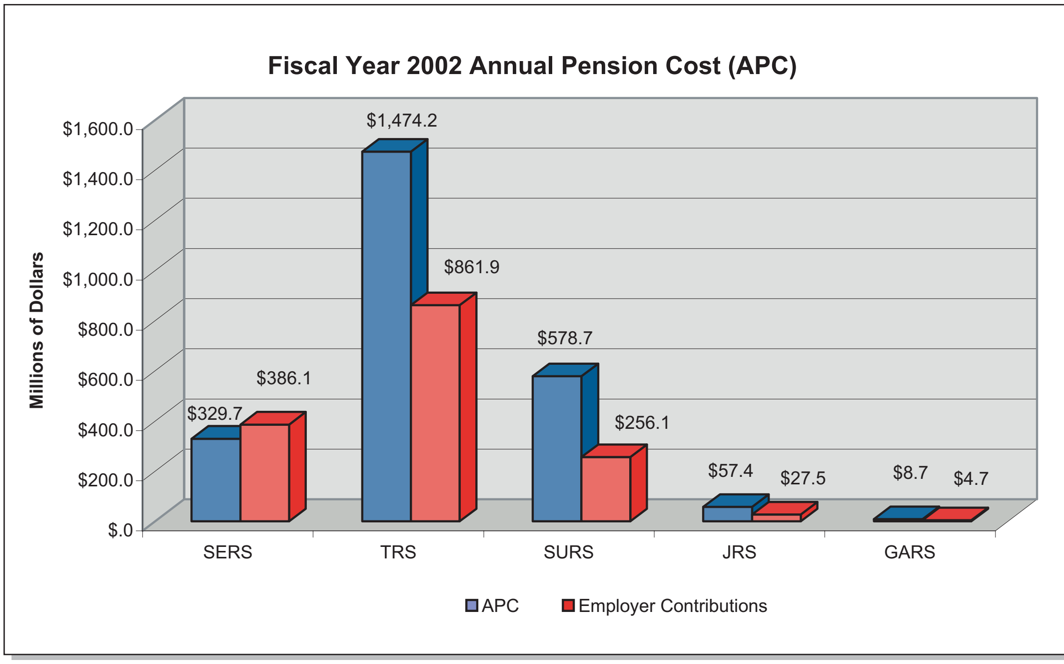
Pension Liability (APC)

The liability at June 30, 2002, for the state's five pension trust funds was over $14.6 billion, an increase of $912 million from fiscal year 2001. The pension liability compares the annual pension costs (APC) to the employer contributions received as can be seen in the bar chart.

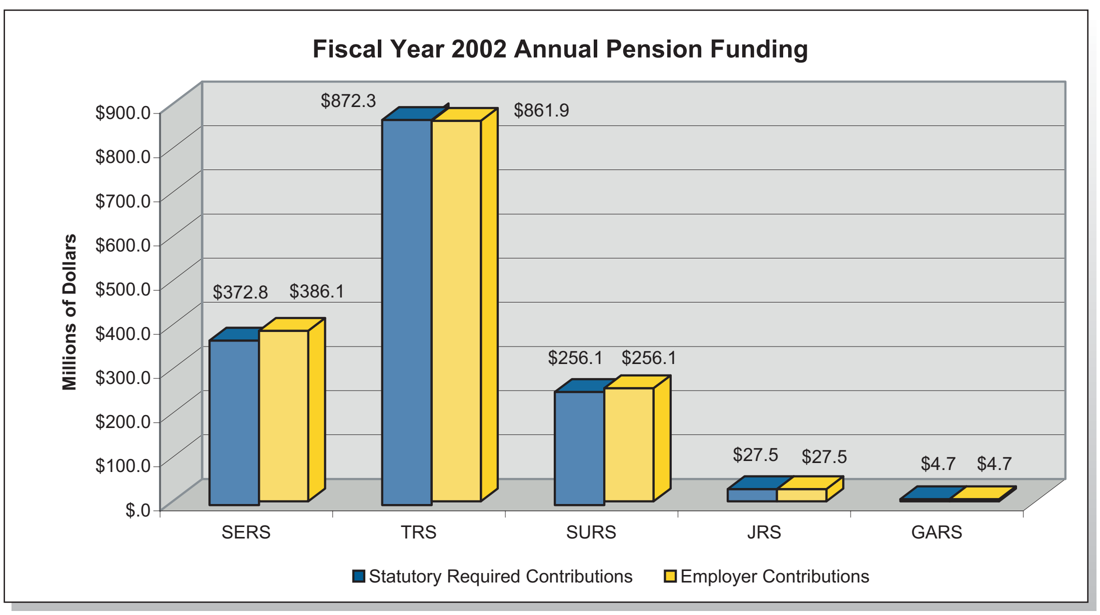
Funding Policy and Annual Pension Cost

Member contributions are based on fixed percentages set by statute ranging from 4.0% to 11.5%. The state's funding requirements have been established by statute (Public Act 88-593)

Liabilities



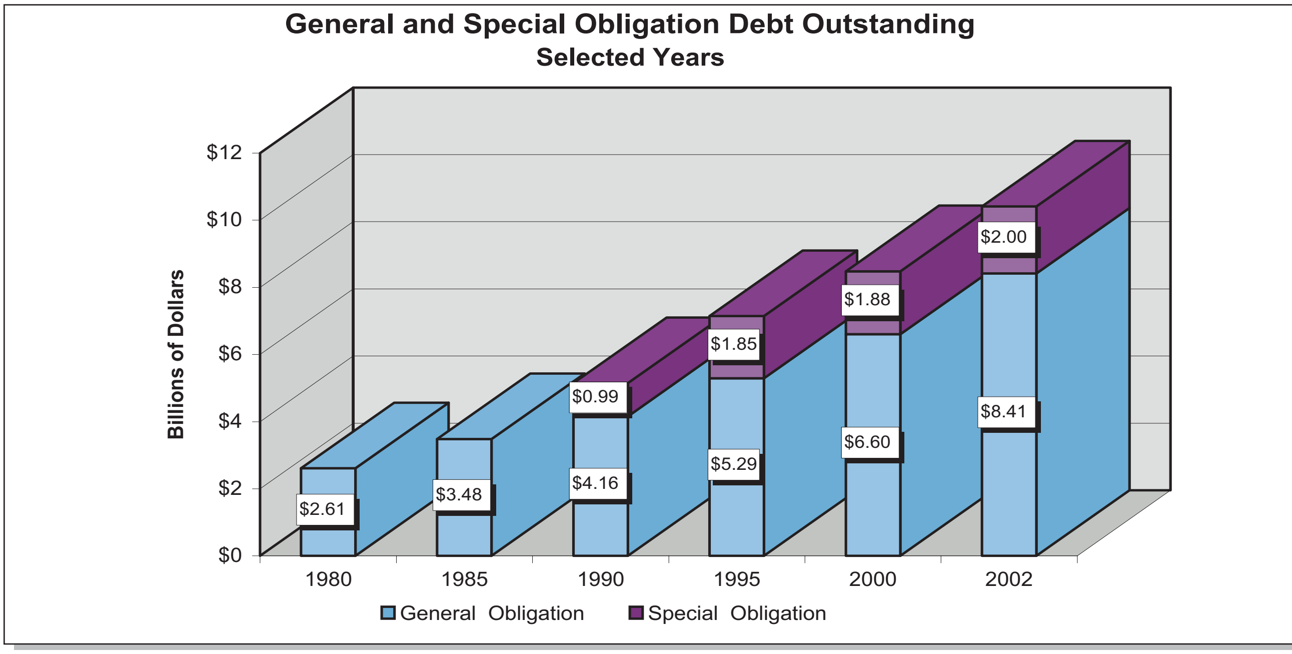
effective July 1, 1995, and provide for a systematic 50-year funding plan with an ultimate goal to achieve "90% funding" of the systems' liabilities. In addition, the funding plan provides for a 15-year phase-in period to allow the state to adapt to the increased financial commitment. Once the 15-year phase-in period is complete, the state's contribution will then remain at a level percentage of payroll for the next 35 years until the 90% funding level is achieved. As illustrated in the following chart, the state met its funding requirement established by statutory law for the fiscal year ended June 30, 2002.



Actual contributions varied slightly from contributions required by statute mainly because of differences between estimated and actual federal contributions. The current statutory law includes a "continuing appropriation" which means that the state must automatically provide funding to the pension systems based on actuarial cost requirements and amortization of the unfunded liability without being subject to the General Assembly's appropriation process. In addition, contributions to the Teachers' Health Insurance Security Fund can reduce required contributions to Teachers' Retirement System for school districts. Accordingly, although employer contributions are less than the statutory required contributions, Teachers' Retirement System met its funding requirement.

This statutory funding requirement differs significantly from the annual pension cost (APC) because the statutory plan does not conform with the GASB Statement 27 accounting parameters. The state's APC for the current year and related information for each plan are included in the chart.

Bonds/Debt



GAAP BASIS

General and Special Obligation Bonds

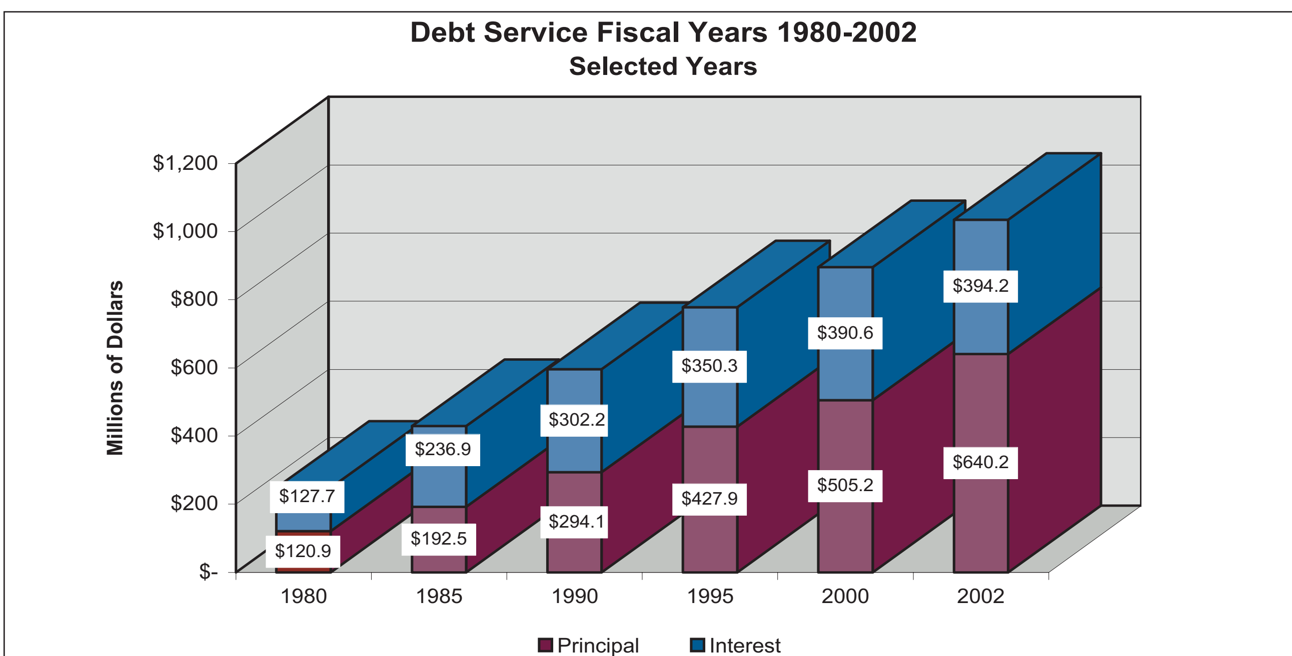
General and special obligation bonds, excluding refunding bonds, aggregating $1,500.0 million and $150.0 million, respectively, were issued during fiscal year 2002 at average interest rates ranging from 3.0% to 6.0%.

Debt Administration

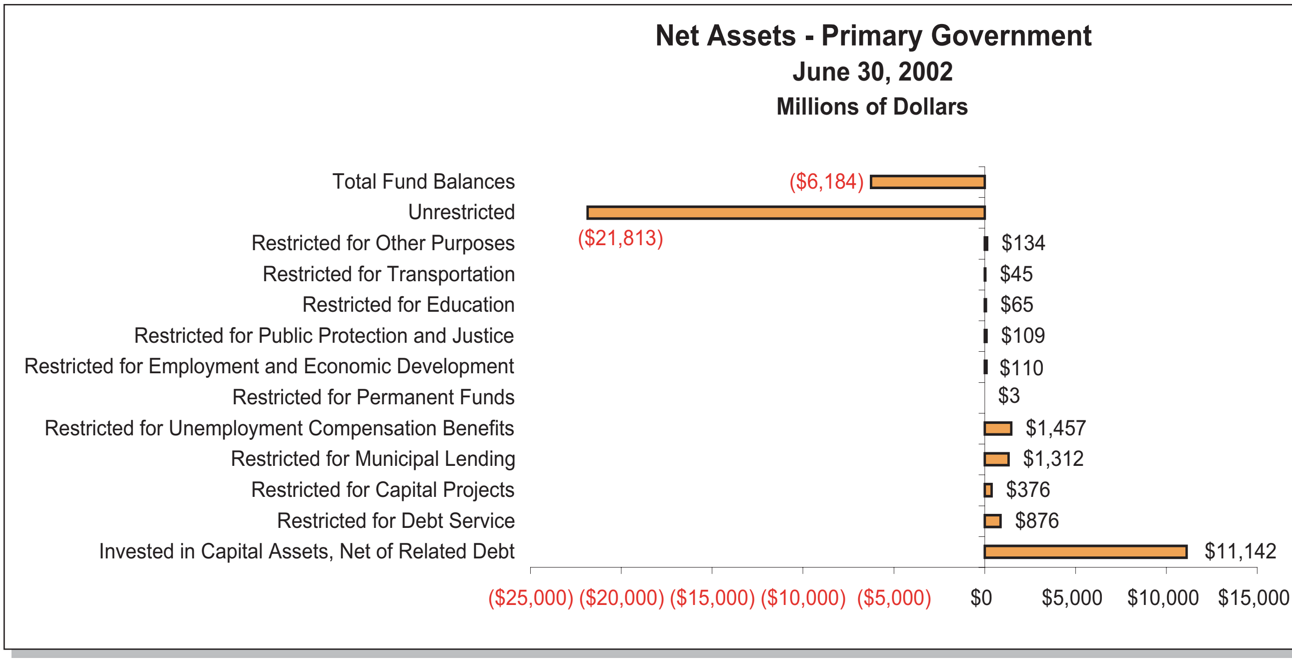
The state's general obligation bond rating by Moody's Investors Service is "Aa3" and by Standard & Poor's Corporation (S & P) is "AA". Special obligation bond ratings range from "AAA" by S & P for Build Illinois bonds to "A1" by Moody's for Civic Center bonds.

Debt Service

Debt service principal and interest costs of $640.2 million and $394.2 million, respectively, were paid in fiscal year 2002 for general and special obligation bonds. The dramatic increase since fiscal year 1980 is displayed in the chart below.



Governmental Activity Revenues



GAAP BASIS

NET ASSETS

Net assets for the state were ($6.2) billion at June 30, 2002. The state has $11.1 billion in invested in capital assets, net of related debt, $4.5 billion in restricted net assets, and ($21.8) billion in unrestricted net assets.

GOVERNMENTAL ACTIVITY REVENUES

The governmental activities of the state are presented in fund types (the general, special revenue, capital projects, debt service, and permanent funds) on the modified accrual basis of accounting.*

Revenues on the modified accrual basis are recognized when they are both measurable and available to finance current operations. Revenues from various sources for fiscal year 2002 for governmental funds are as follows.

Fiscal year 2002 governmental funds revenues decreased by $827 million (4%) over fiscal year 2001 revenues. State-imposed taxes including income, sales, motor fuel, public utility, and miscellaneous other taxes remained the largest overall revenue source for fiscal year 2002 and comprised nearly 59% of total state revenues.

Income Taxes

Income tax revenues for fiscal year 2002 were $8.6 billion which is a $964 million (10%) decrease from fiscal year 2001 income tax revenues of $9.6 billion. The decrease is generally the result of a slowing economy.

Sales Taxes

Sales taxes remained the second largest tax revenue source for fiscal year 2002 decreasing $19 million from fiscal year 2001.

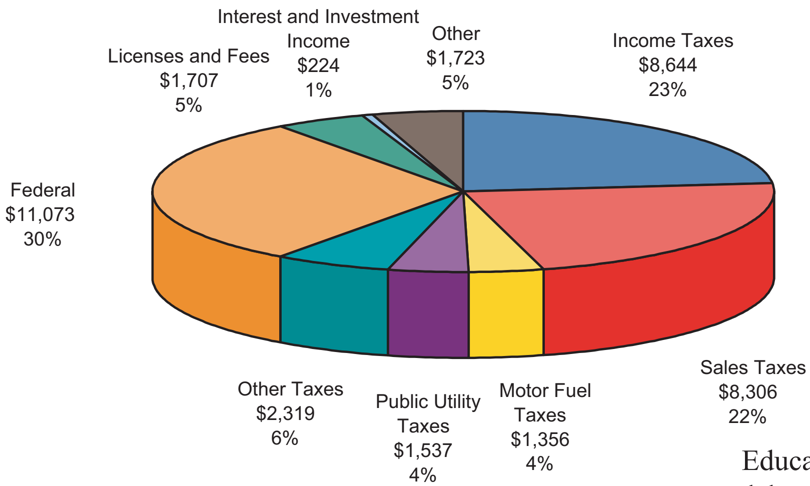
Federal Government Revenues

Federal government revenues increased $489 million from $10.6 billion in fiscal year 2001 to $11.1 billion, and continued as the state's second largest revenue source. The majority of the increase resulted from an increase of $386 million in Medicaid reimbursements received.

* Note: The Comptroller's Office publishes a number of reports, including sections of this *Executive Summary,* that summarize the status of General Fund revenues and expenditures on a cash basis. These reports are available on the web site at www.ioc.state.il.us or by request.

Governmental Activity Expenditures

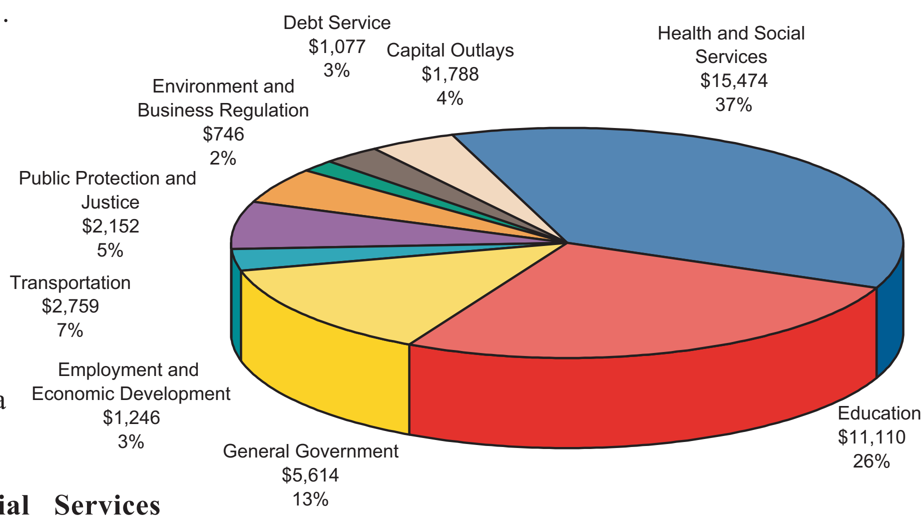
Fiscal Year 2002 Governmental Fund Revenues
Millions of Dollars



GOVERNMENTAL ACTIVITY EXPENDITURES

Expenditures for governmental activities are presented on the modified accrual basis of accounting and are generally recognized when the fund liability is incurred regardless of when payment is made except for long-term liabilities. Expenditures for long-term liabilities are recognized in the period in which the liability has matured. Governmental fund expenditures of $42.0 billion in fiscal year 2002 increased $3.8 billion (10%) over 2001 and were $5.1 billion more than revenues on a GAAP basis.

Fiscal Year 2002 Governmental Fund Expenditures
Millions of Dollars



Health and Social Services Expenditures

Health and social services expenditures of $15.5 billion were the largest expenditure function for fiscal year 2002, increasing by $980 million (7%) over fiscal year 2001. This expenditure function is 37% of total spending on a GAAP basis. A $312 million increase in governmental fund expenditures at the Department of Human Services (DHS) represents an increase in Health and Social Services programs. The Department of Public Aid showed a $354 million increase in governmental fund spending for the Medicaid Program.

Education Expenditures

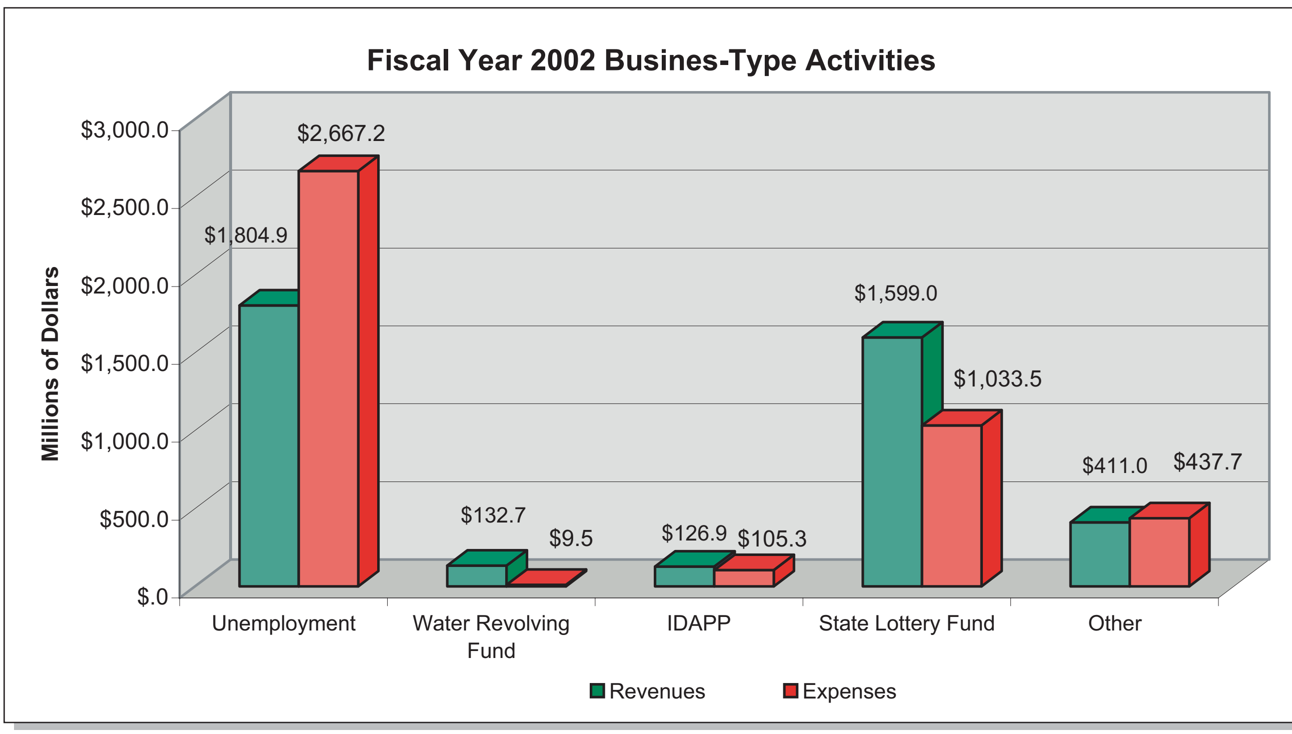
Education expenditures were once again the second largest expenditure function in the governmental funds for fiscal year 2002. Education expenditures increased $2.2 billion (24%) from fiscal year 2001 on a GAAP basis. The majority of this increase is a due to the treatment under GASB Statement No. 34 of appropriations for component units. Expenditures of $1.4 billion in state appropriations by state universities in the previous year were reported as transfers to component units. Expenditures of state appropriations by state universities increased by $26 million during fiscal year 2002. The remaining increase reflects the state's continuing budgetary emphasis on education.

Business-Type Activities

BUSINESS-TYPE ACTIVITY REVENUES AND EXPENDITURES

Revenues and expenditures for the state's business-type activities are accounted for in proprietary fund types. Proprietary fund types (enterprise funds and internal service funds) are accounted for on the accrual basis. Enterprise funds are used to report activities for which a fee is charged to external users for goods or services. Internal Service funds are used to report activities that provide goods or services to other funds of the state on a cost-reimbursement basis. Revenues and expenses of internal service funds are eliminated in the Statement of Activities.
The state's main business-type activities are providing unemployment insurance benefit claims, lending to local governments for drinking water and wastewater infrastructure facilities (Water Revolving Fund), lending to full-time college students (Illinois Designated Account Purchase Program), and operation of the State Lottery. The revenues and expenses of each of these activities are presented in the chart below.

The large excess of expenses over revenues for unemployment business-type activities results from the increase in claims for unemployment for fiscal year 2002. Expenditures increased $1.2 billion during fiscal year 2002. As a result, the state has received approval and is borrowing from the federal government in order to pay unemployment benefits to claimants.



GAAP BASIS

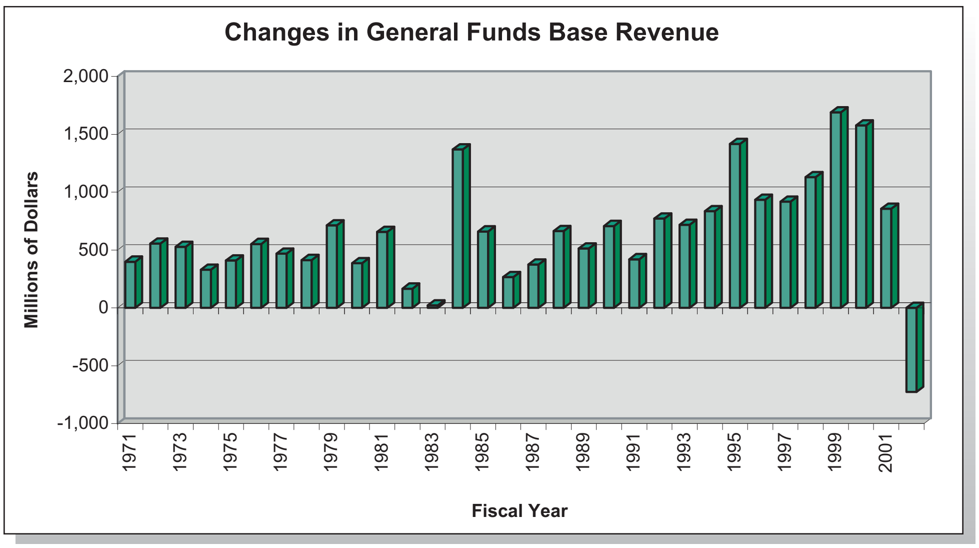
BUDGETARY BASIS

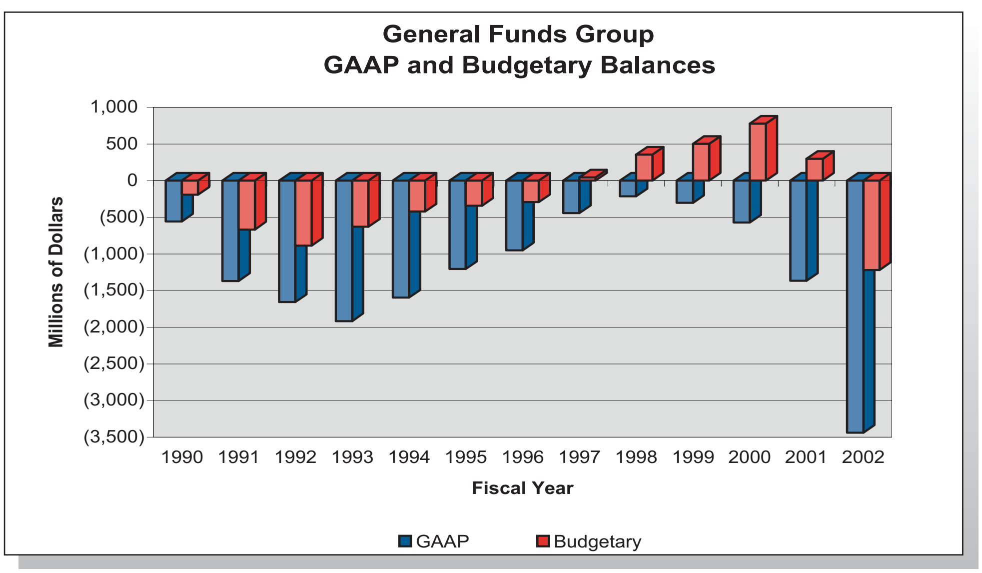
Fiscal Summary

For fiscal year 2002, General Funds base revenues decreased $727 million. This was the first decline in revenues in modern history. This revenue performance was the result of an economic recession exacerbated by the terrorist attack on 9/11/01.

Fiscal year 2002 marked the end of four straight years of positive General Funds budgetary balances (measured on a cash basis). The balance fell from a $300 million *surplus* in 2001 to a $1.220 billion *deficit*, the largest deficit ever recorded.

In addition, the state's General Funds GAAP balance fell from a $1.365 billion deficit in fiscal year 2001 to a $3.306 billion deficit in fiscal year 2002, also the largest on record. This marks the fourth consecutive drop in the GAAP balance.





General Funds "Base" Revenue-Down 3.0% in Fiscal Year 2002

General Funds revenue decreased $501 million or 2.1% in fiscal year 2002, declining to $23.605 billion from $24.106 billion in fiscal year 2001. Excluding the transfer of $226 million from the Budget Stabilization Fund, base revenues fell $727 million or 3.0%. This is the first decline in revenues in modern history. An economic recession, exacerbated by the terrorist attack, was the factor responsible for the decrease in revenues.

State sources fell $439 million, led by a $525 million (6.6%) decrease in personal income taxes. Over the year, employment in Illinois fell by 82,000 jobs as wage and salary income declined 0.1%. In addition, the stock market experienced a decline and interest rates fell, which can result in decreased capital gains and dividend income. Obviously, these economic factors had a major impact on income and the decline in personal income tax receipts. Corporate income tax receipts decreased $233 million or 22.5%. This was also due to the weakening of the economy as before tax corporate profits fell 13.8%.

The slowing of the economy is also reflected in retail sales for the year. Revenues from the state sales tax totaled $6.051 billion in fiscal year 2002, an increase of $93 million or 1.6%. The growth in sales taxes reflects the loss of an estimated $150 million due to the temporary exemption of motor fuel sales from the tax base for the first half of last fiscal year. Adjusting for this loss, sales tax receipts would have declined approximately $57 million or almost 1.0%. Dealer incentives spurred auto sales tax collections which were offset by declines in other areas such as manufacturing, apparel, and restaurants.

Gaming revenues grew $73 million or 7.5% to $1.041 billion for the year. Lottery transfers grew by $54 million due to rollovers and a large jackpot resulting in increased lottery revenues of $62 million for the year. Riverboat receipts increased $51 million in fiscal year 2002, while riverboat gambling transfers increased $10 million due to the timing of transfers last year which inflated fiscal year 2001 transfers.

For fiscal year 2002, public utility taxes declined 3.7% with revenues from the natural gas tax down $25 million, telecommunications tax revenues $23 million lower, while electric tax receipts increased $6 million. Lower natural gas prices as well as a mild winter and continued discounts in phone services spurred the declines in receipts.

General Funds Revenue
(Millions of Dollars)

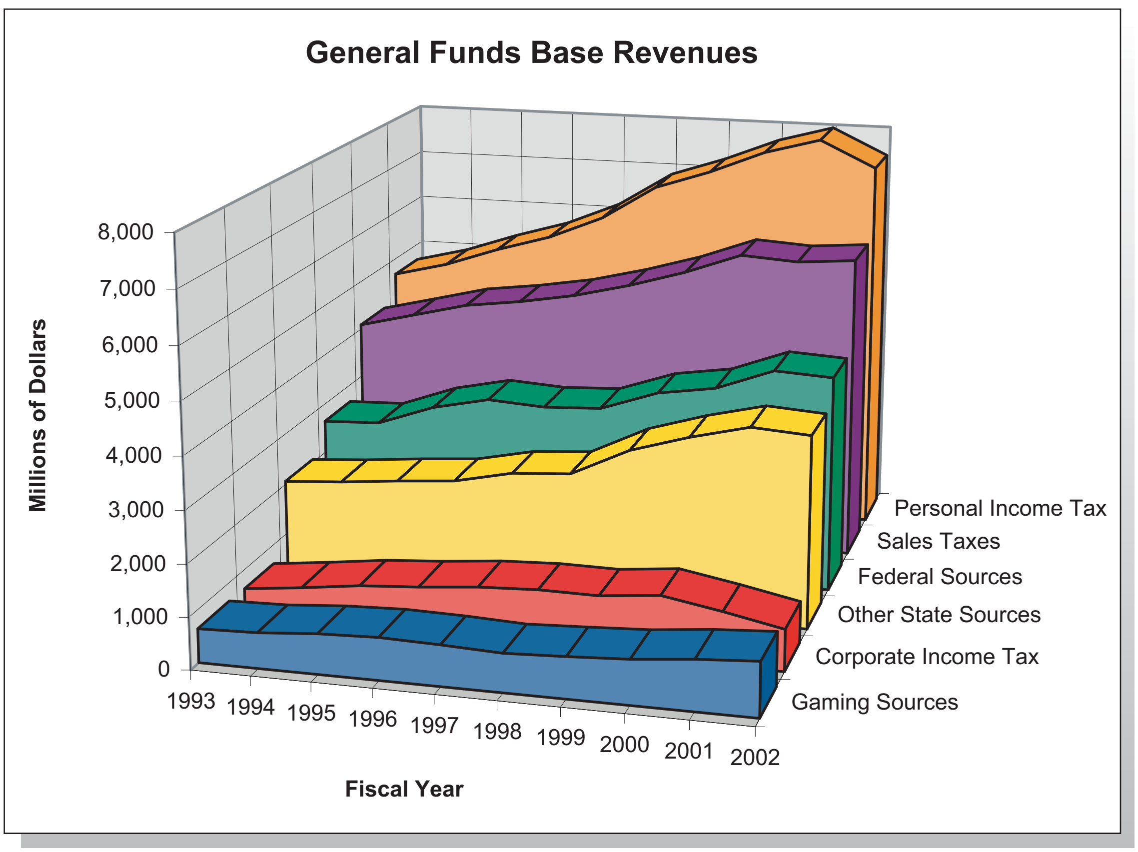
	Fiscal Year										Change From FY1993 to FY2002	
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Amount	Percent
Personal Income Tax	$ 4,665	$ 4,947	$ 5,333	$ 5,669	$ 6,139	$ 6,847	$ 7,226	$ 7,686	$ 7,996	$ 7,471	$ 2,806	60.2 %
Corporate Income Tax	631	755	898	978	1,085	1,136	1,121	1,237	1,036	803	172	27.3
Sales Taxes	4,094	4,371	4,651	4,798	4,992	5,274	5,609	6,027	5,958	6,051	1,957	47.8
Gaming Sources:												
Lottery Fund	587	552	588	594	590	560	540	515	501	555	(32)	(5.5)
Riverboat Gaming	54	118	171	205	185	170	240	330	460	470	416	N/A
Miscellaneous	12	12	12	12	12	11	11	9	7	16	4	33.3
Total, Gaming	653	682	771	811	787	741	791	854	968	1,041	388	59.4
Public Utility Taxes	735	784	743	833	873	912	1,019	1,116	1,146	1,104	369	50.2
Other Tax Sources	1,132	1,123	1,170	1,181	1,400	1,404	1,779	1,924	2,230	2,207	1,075	95.0
Other Transfers In	194	234	338	327	309	346	411	514	452	444	250	128.9
Base State Sources	$ 12,104	$ 12,896	$ 13,904	$ 14,597	$ 15,585	$ 16,660	$ 17,956	$ 19,358	$ 19,786	$ 19,121	$ 7,017	58.0 %
Federal Sources	2,646	2,690	3,098	3,339	3,269	3,324	3,718	3,892	4,320	4,258	1,612	60.9
Total Base Revenue	$ 14,750	$ 15,586	$ 17,002	$ 17,936	$ 18,854	$ 19,984	$ 21,674	$ 23,250	$ 24,106	$ 23,379	$ 8,629	58.5 %
Transfer from Budget Stabilization Fund	0	0	0	0	0	0	0	0	0	226	226	N/A
Short-Term Borrowing	300	600	300	200	0	0	0	0	0	0	(300)	(100.0)
Total Revenue	$ 15,050	$ 16,186	$ 17,302	$ 18,136	$ 18,854	$ 19,984	$ 21,674	$ 23,250	$ 24,106	$ 23,605	$ 8,555	56.8 %

Receipts from other tax sources were down $23 million or 1.0% for the year. Investment income fell $138 million or 50.4% because of lower investable balances and interest rates as the Federal Reserve lowered interest rates in an effort to stimulate the economy. Inheritance taxes decreased $32 million (8.9%) and are expected to decline next year as the federal estate tax is phased out over the next few years. Some of this decline was offset by a $114 million increase in the transfer from the Build Illinois escrow account, which will decline next year as the unused surplus has been depleted, and insurance taxes and fees which increased ($26 million) due to the decline in corporate profits which are allowed as a deduction.

The $8 million decrease for other transfers in reflects a drop in transfers from the Public Aid Recoveries Trust Fund which was offset by transfers from the Tobacco Settlement Fund. Transfers from the Public Aid Recoveries Trust Fund were diverted to the Drug Rebate Fund while the Tobacco Settlement Fund transfers were a repayment of the transfers to the fund.

Federal sources decreased $62 million or 1.4% in fiscal year 2002. This drop was due in part to the shifting of federally reimbursable spending from the General Funds to other funds.

For fiscal year 2002, income and sales taxes brought in 60.7% of total General Funds revenues, while federal sources and other sources accounted for 18.0% and 21.3%, respectively. The reliance on sources driven by the economy makes the slowing economy the major factor determining General Funds revenue growth next year.



BUDGETARY BASIS

General Funds "Base" Spending- Up 1.3% in Fiscal Year 2002

General Funds "base" expenditures for fiscal year 2002, which excludes a $226 million repayment to the Budget Stabilization Fund, totaled $24.899 billion, an increase of $316 million or 1.3% over fiscal year 2001 spending. The $316 million increase in spending is the smallest increase since fiscal year 1988. General Funds spending had increased by an average of $1.517 billion in the four previous fiscal years. Among the various categories of spending, operations increased by $326 million, awards and grants increased $55 million, and regular transfers out declined $58 million. All other spending declined slightly from the prior year.

For fiscal year 2002, General Funds awards and grants spending totaled $15.731 billion, $55 million or 0.4% above fiscal year 2001. Grants accounted for 63.2% of total base spending from the General Funds for the fiscal year, down from 63.8% in 2001.

Prior to fiscal year 1998, the largest grant spending agency had been the Department of Public Aid. However, due to reorganization in the delivery of social services, Public Aid became the second largest grant spending agency behind the State Board of Education. Due to rapidly increasing medical costs, Public Aid once again became the largest grant spending agency from the General Funds in fiscal year 2001. Public Aid's distinction as the largest grant spending agency lasted only one year however, as a continuing emphasis on elementary and secondary education, along with the transfer of some Medicaid programs to other funds, vaulted the State Board of Education back to the top in fiscal year 2002. State Board grant spending of $5.096 billion in fiscal year 2002 is $216 million or 4.4% higher than fiscal year 2001 and accounts for 32.4% of total General Funds grant spending. General state aid to school districts accounts for the largest portion

General Funds Expenditures (From Current Year Appropriations)
By Category and Major Agency
(Millions of Dollars)

	Fiscal Year										Change from FY 1993 to FY 2002	
Operations:	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Amount	Percent
Higher Education	$ 1,066	$ 1,091	$ 1,139	$ 1,232	$ 1,308	$ 1,392	$ 1,478	$ 1,574	$ 1,662	$ 1,765	$ 699	65.6 %
Corrections	598	659	700	771	832	908	1,019	1,095	1,168	1,222	624	104.3
Human Services	0	0	0	0	0	958	1,008	1,015	1,067	1,101	1,015	N/A
Central Management Services	400	465	425	391	475	515	560	645	698	733	333	83.3
Children and Family Services	113	149	181	247	254	261	273	285	286	298	185	163.7
Public Aid	363	382	396	413	455	102	113	208	126	166	(197)	(54.3)
Mental Health	495	514	520	535	546	0	0	0	0	0	(495)	(100.0)
Other Operations	876	942	982	1,091	1,245	1,183	1,276	1,476	1,623	1,671	795	90.8
Total, Operations	$ 3,911	$ 4,202	$ 4,343	$ 4,680	$ 5,115	$ 5,319	$ 5,727	$ 6,298	$ 6,630	$ 6,956	$ 3,045	77.9 %
Awards and Grants:												
State Board of Education:												
Apportionment	$ 2,121	$ 2,186	$ 2,285	$ 2,326	$ 2,378	$ 2,471	$ 2,922	$ 2,983	$ 2,995	$ 3,232	$ 1,111	52.4 %
Categoricals	854	905	979	1,032	1,190	1,466	1,411	1,657	1,809	1,818	964	112.9
Other	303	325	323	101	93	96	66	59	76	46	(257)	(84.8)
Total, State Board of Education	3,278	3,416	3,587	3,459	3,661	4,033	4,399	4,699	4,880	5,096	1,818	55.5
Public Aid:												
Medical Assistance	3,110	3,249	3,997	3,997	3,668	3,887	4,239	4,695	5,192	4,986	1,876	60.3
Aid to Families with Dependent Children	890	938	963	956	878	0	0	0	0	0	(890)	(100.0)
Other	168	177	185	143	140	0	0	0	0	0	(168)	(100.0)
Total, Public Aid	4,168	4,364	5,145	5,096	4,686	3,887	4,239	4,695	5,192	4,986	818	19.6
Human Services	0	0	0	0	0	2,287	2,392	2,420	2,660	2,566	2,566	N/A
Higher Education	520	542	599	599	638	670	730	758	807	872	352	67.7
Teachers Retirement	5	5	4	299	354	429	584	649	732	821	816	N/A
Children and Family Services	433	521	598	657	689	660	616	635	634	607	174	40.2
Aging	100	109	118	123	142	159	182	202	220	227	127	127.0
Mental Health	371	418	470	791	893	0	0	0	0	0	(371)	(100.0)
Alcoholism and Substance Abuse	81	88	137	99	97	0	0	0	0	0	(81)	(100.0)
Other Awards and Grants	433	467	485	496	549	425	507	509	551	556	123	28.4
Total, Awards and Grants	$ 9,389	$ 9,930	$ 11,143	$ 11,619	$ 11,709	$ 12,550	$ 13,649	$ 14,567	$ 15,676	$ 15,731	$ 6,342	67.5 %
Other General Funds Warrants Issued	18	12	13	11	27	35	45	82	60	53	35	194.4
Total, General Funds Warrants Issued	$ 13,318	$ 14,144	$ 15,499	$ 16,310	$ 16,851	$ 17,904	$ 19,421	$ 20,947	$ 22,366	$ 22,740	$ 9,422	70.7 %
Regular Transfers Out	1,169	1,225	1,414	1,572	1,666	1,768	2,106	2,029	2,217	2,159	990	84.7
Base General Funds Expenditures	$ 14,487	$ 15,369	$ 16,913	$ 17,882	$ 18,517	$ 19,672	$ 21,527	$ 22,976	$ 24,583	$ 24,899	$ 10,412	71.9 %
Short-Term Borrowing Repayment	306	609	308	205	0	0	0	0	0	226	(80)	(26.1)
Total, General Funds Expenditures	$ 14,793	$ 15,978	$ 17,221	$ 18,087	$ 18,517	$ 19,672	$ 21,527	$ 22,976	$ 24,583	$ 25,125	$ 10,332	69.8 %

(63.4%) of State Board grant spending with $3.232 billion expended in 2002.

The second largest portion (31.7% in fiscal year 2002) of General Funds awards and grants expenditures were by the Department of Public Aid. Grant spending by Public Aid totaled $4.986 billion in fiscal year 2002, $206 million or 4.0% below 2001. All of the grant spending by the Department was for medical assistance payments as the Aid to Families with Dependent Children Program along with other grant award programs were transferred into the newly formed Department of Human Services at the beginning of fiscal year 1998.

The Department of Human Services consolidated all or parts of six state social service agencies with the goal of achieving a more efficient and effective delivery of social services in Illinois. Merged in whole into Human Services were the Departments of Mental Health, Alcoholism and Substance Abuse, and Rehabilitation Services while components of the Departments of Children and Family Services, Public Health, and Public Aid were also merged. In the fifth year of operation for the Department, grant spending totaled $2.566 billion, $94 million or 3.5% below 2001. Together, the State Board of Education and the Departments of Public Aid and Human Services accounted for 80.4% of all General Funds awards and grant expenditures in fiscal year 2002.

Two other sectors of government education spending garner a significant amount of General Funds grant dollars. Higher education had awards and grants spending of $872 million in fiscal year 2002, $65 million or 8.1% higher than fiscal year 2001. Grant spending for teachers’ retirement of $821 million in fiscal year 2002 represented an increase of $89 million or 12.2% over the prior year. Since fiscal year 1996, when grant spending for teachers’ retirement was shifted from the State Board of Education to the Teachers’ Retirement systems, expenditures have increased by $522 million or 174.6%. Altogether, education grant spending from the General Funds in fiscal year 2002 totaled $6.789 billion and accounted for 43.2% of total General Funds grant spending.

Spending for operations from the General Funds in fiscal year 2002 totaled $6.956 billion, $326 million or 4.9% higher than fiscal year 2001. Operations accounted for 27.9% of total General Funds base expenditures in 2002.

Higher education institutions accounted for the largest amount of spending for operations. In fiscal year 2002, higher education operations expenditures of $1.765 billion were $103 million or 6.2% higher than fiscal year 2001 and accounted for 25.4% of total operations. Illinois’ flagship university, the University of Illinois, accounted for $794 million or 45.0% of higher education operations in fiscal year 2002.

The largest state agency in terms of operations expenditures from the General Funds and the second largest in terms of employee headcount is the Department of Corrections. Fiscal year 2002 expenditures by the Department for operations totaled $1.222 billion, $54 million or 4.6% over the previous year. The number of employees at Corrections totaled 17,047 at the end of fiscal year 2002.

With the largest headcount of any single state agency, the Department of Human Services recorded operations expenditures of $1.101 billion in fiscal year 2002. At the end of the fiscal year the Department’s employee headcount was 19,023, a decrease of 1,021 or 5.1% from the previous year.

Although employee salaries drive most state agency operational expenditures, this is not the case at the Department of Central Management Services (CMS). CMS is the third largest state agency in terms of operational expenditures, however, their employee headcount is not even among the top ten agencies. Fiscal year 2002 General Funds expenditures of $733 million included $685 million for group insurance contributions to pay for the health benefits of state employees. The $733 million expended by CMS in fiscal year 2002 for operations was $35 million or 5.0% higher than 2001. Group insurance contributions were up $35 million or 5.4% while the remainder of CMS operations experienced no growth from 2001.

Over the last ten years, General Funds base expenditures grew $10.412 billion or 71.9%. Of this growth, awards and grants represented 60.9% while operations accounted for 29.2% and transfers out accounted for 9.5%.

Fiscal Climate Fiscal Year 2002

In just a little more than a decade, Illinois state finance has traveled full circle, falling to record lows, rising to all-time highs, and finally falling again to unprecedented lows. During fiscal year 2002, the state's General Funds turned in its worst performance on record, surpassing the previous lows set during the financial difficulties that spanned fiscal years 1991-1997.

Racked by recession and a falling stock market, the General Funds set several new record lows during fiscal year 2002. These include:

- A decline in "base" revenues for the first time in recent memory (down $727 million or 3.0%)
- Instead of growing $894 million as originally expected, "base" revenues for the year actually fell, coming in more than $1.6 billion lower than originally estimated
- The highest level of unpaid bills at the end of the year ($781 million)

General Funds GAAP Balance and Cash-Basis Budgetary Balance
(Millions of Dollars)

	General Funds				General Revenue Fund	
Fiscal Year	GAAP Balance	Change	Budgetary Balance	Change	Budgetary Balance	Change
1986	(261)		(153)		(185)	
1987	(587)	(326)	(319)	(166)	(360)	(175)
1988	(355)	232	(76)	243	(143)	217
1989	(74)	281	148	224	7	150
1990	(557)	(483)	(191)	(339)	(242)	(249)
1991	(1,368)	(811)	(666)	(475)	(702)	(460)
1992	(1,656)	(288)	(887)	(221)	(828)	(126)
1993	(1,916)	(260)	(630)	257	(607)	221
1994	(1,595)	321	(422)	208	(447)	160
1995	(1,204)	391	(341)	81	(354)	93
1996	(952)	252	(292)	49	(299)	55
1997	(443)	509	45	337	106	405
1998	(213)	230	356	311	281	175
1999	(303)	(90)	503	147	184	(97)
2000 *	(572)	(269)	777	274	278	94
2001 *	(1,365)	(793)	300	(477)	(124)	(402)
2002	(3,306)	(1,941)	(1,220)	(1,520)	(1,470)	(1,346)

* GAAP balance as restated.

- The highest ever lapse period spending ($1.476 billion)
- The largest ever budgetary deficit (-$1.220 billion)
- The largest ever GAAP deficit (-$3.306 billion)
- The highest level of unpaid bills during the year ($1.407 billion)

The state's eight year string of budgetary (cash basis) improvements ended in fiscal year 2001. During the first half of the year, the combination of an extraordinary transfer out, a six-month sales tax exemption for motor fuel purchases, and higher spending demands resulted in the emergence of cash flow difficulties for the first time since the end of fiscal year 1997 (see graph). These difficulties were concentrated in the General Revenue Fund (GRF), the state's largest operating fund.

As fiscal year 2001 progressed, slowing economic activity resulted in more payment delays between mid-February and late April before improving toward the end of the year. When the books were closed on the year, the General Funds budgetary balance recorded its first drop since 1992 (down $477 million from 2000). At the same time, the state's General Funds GAAP deficit worsened for the third consecutive year (down $793 million).

Available data indicate that a recession was already well underway in Illinois as the state began fiscal year 2002. It also appears that the tragic events of September 11, 2001 exacerbated an already troublesome economic and fiscal situation.

Over the first quarter of the fiscal year, General Funds total revenues were $296 million below the prior year with widespread weakness in most revenue sources. Although revenue fell dramatically, spending demands continued to grow. As a result, cash flow difficulties emerged in late August. This marked the first time since 1995 that payment delays surfaced so early in the year.

In order to alleviate at least some of the payment delays, the Comptroller ordered the balance in the Budget Stabilization Fund transferred to the GRF. On November 14, 2001, $226 million was transferred and paid out the same day. This action reduced unpaid bills to $350 million.

As fiscal year 2002 progressed, the General Funds financial condition worsened considerably as revenues declined in nine out of the twelve months and in each of the last six months of the year. On a quarterly basis, General Funds revenues declined by $328 million or 5.6% in the third quarter and $315 million or 4.4% in the fourth quarter. For the year, "base" revenues (total revenues minus rainy day dollars) were $727 million or 3.0% below fiscal year 2001 and over $1.6 billion below the original estimates for fiscal year 2002.

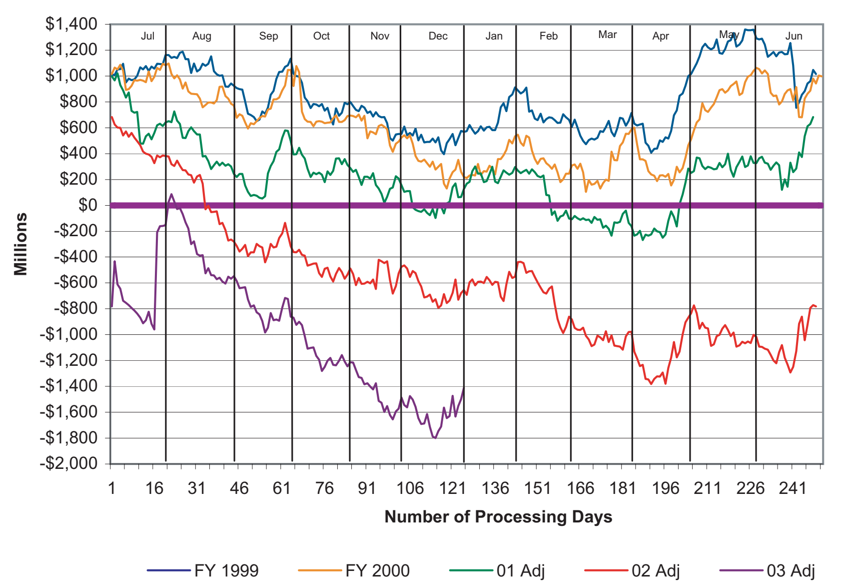
The year-over-year revenue decline was led by sources tied directly to economic activity. Hammered by falling employment (nonagricultural employment down 82,000 jobs), declining wage and salary income (down 0.1%), and a free-falling stock market, personal income tax receipts dropped $525 million. At the same time, the weakening economy and falling profits reduced corporate income tax revenues by $233 million.

Efforts to reduce spending appear to have had little effect and at the end of June, a $781 million backlog of unpaid bills was carried into the new fiscal year for the first time since the end of fiscal year 1993. Payment delays plagued the General Funds for nearly the entire fiscal year. Unpaid bills reached as high as $1.4 billion in mid-April and delays reached as much as 35 days in mid-June. The delays going into fiscal year 2003 totaled 28 business days, or almost six weeks. This does not include delays or processing time at the agency level, which in some instances can add up to two months to the payment cycle.

At the end of June, the General Funds cash balance was $256 million, or $870 million less than what was in the bank at the end of fiscal year 2001. The dramatic drop in the cash balance was concentrated in the GRF where the cash balance dropped from $683 million to $0 over the year, accounting for nearly 79% of the drop in the General Funds balance. In addition to the lack of a balance on June 30, 2002, there were $781 million in bills on hand that could not be paid. The resulting effective GRF balance (available cash less unpaid bills) was almost $1.5 billion below last year's ending balance.

Under state law, the amount transferred from the Budget Stabilization Fund is effectively a loan and must be repaid by the end of the fiscal year. One reason that $781 million in unpaid bills were carried over to July 2002 is that the $226 million loan from the Budget Stabilization Fund was repaid in June. Since $781 million was carried over to July, fiscal year 2002 lapse period spending jumped to $1.476 billion, the highest ever. The budgetary balance also reached a record deficit, -$1.220 billion. At the same time, the GAAP deficit soared to -$3.306 billion. This is not only the worst GAAP deficit on record, it also represents the single largest deterioration (-$1.941 billion).

Comparison of General Revenue Fund Daily Cash Balances
FY 2001-FY 2003 Adjusted to Reflect Unpaid Bills



A Look At Fiscal Year 2003

At the beginning of fiscal year 2003 (July 2002), the State entered into a $700 million short-term loan to prop up the GRF, transferred $156 million in surplus money from other funds, and transferred $226 million from the Budget Stabilization Fund. These revenues were used to pay bills carried over from June and to relieve a backlog of Medicaid bills. After less than a week, GRF payment delays began to accumulate again.

The fiscal year 2003 General Funds budget was based on the assumption that economic growth would generate "base" revenue growth of $1.006 billion, or 4.3%. Unfortunately, the economy has continued to falter. Except for a brief reprieve following the cash infusion last July, the effective cash balance has shown a steady worsening (see graphs).

At the end of the first half of fiscal year 2003, the state's GRF was still experiencing severe cash flow difficulties with more than $1.4 billion in unpaid bills. Without the one-time infusion of more than $1 billion in July, the GRF backlog would have been almost $2.5 billion. Through the first half of last fiscal year, unpaid bills reached $800 million and payments were delayed up to 18 business days. During December 2002, overdue payments topped $1.8 billion and delays reached 37 days.

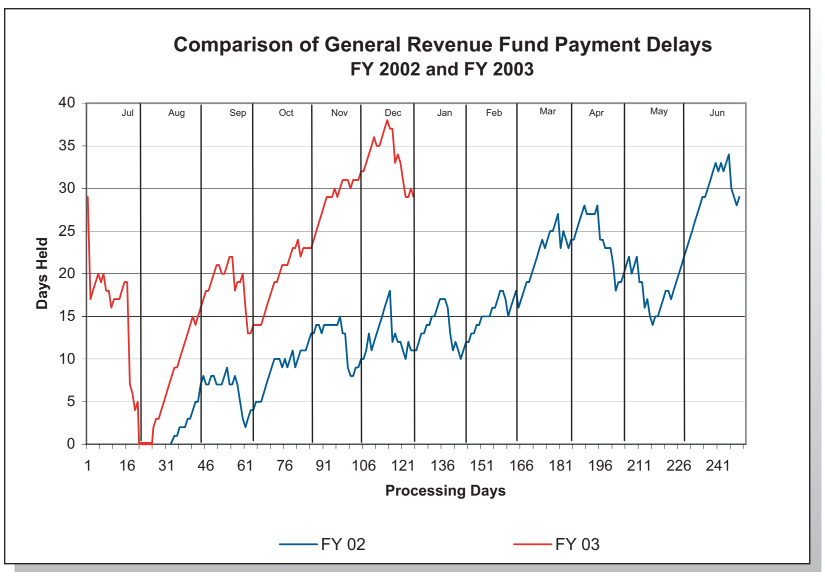
After the first six months of fiscal year 2002, the GRF effective cash balance stood at a negative $655 million. Over the comparable time period this year, the effective cash balance dropped to a minus $1.411 billion.

This deterioration is due to underperforming revenue sources tied to the economy and a surge in spending during the first quarter. In order for the second half to show noticeable improvement, revenue growth must accelerate and spending growth slow dramatically.

The fiscal year 2003 budget was predicated on base revenue growth of 4.3%. That year-over-year growth estimate has since been reduced to 3.5%. Unfortunately, growth through the first half of the year amounts to only 1.6% and includes weakness in the major sources tied most directly to the economy (personal income tax down 0.6%, corporate income tax down 16.1%, and sales taxes up 0.1%). In order to reach the current revenue estimate, General Funds revenues need to increase 5.0% during the last half of the year. This includes 8.5% in personal income taxes and double-digit growth in corporate income (+17.8%), sales (+11.7%), public utility taxes (+15.7%), and interest income (+37.7%).

Spending from current year appropriations will likely slow somewhat over the last half of the year, if for no other reason than the fact that there are considerably less appropriations left than in previous years. That assumes no supplemental appropriations are enacted. In addition to spending from current-year appropriations, second-half spending demands will reflect the repayment of the $700 million in short-term borrowing proceeds deposited in the GRF, as well as the repayment of $226 million borrowed from the Budget Stabilization Fund.

The state's cash flow over the rest of fiscal year 2003 will depend heavily on the performance of the economy and revenue sources tied most directly to economic activity. There does not appear to be any reason to believe that recovery will start soon enough to generate the magnitude of economic activity necessary to reach the current revenue estimates. Given the fact the employment levels continued to decline through December 2002 (manufacturing down more than 40,000 jobs and total nonagricultural employment



Note: A total of $1.0 billion in short-term borrowing was entered into in July 2002. Of that amount $700 million was dedicated to the GRF, $150 million to the Long-Term Care Provider Fund, and $150 million to the Income Tax Refund Fund.

down more than 55,000), there appears to be more reason to think that fiscal year 2003 revenues might fall below last year, marking the second consecutive annual decline. Even if employment picks up, it seems clear that personal income tax withholding and sales taxes cannot rebound enough to keep payment delays from growing worse, especially given the short-term and Budget Stabilization Fund repayment requirements.

What Lies Ahead?

If the description of the state's financial activity over the last 30 months sounds familiar, it is because we have been there before.

As Illinois prepared to enter the 1990s, few observers would have guessed that, within two years, the state would begin sliding into its worst financial condition in memory. Even fewer would have guessed that by the end of that decade, the reversal of financial fortune would be so extreme as to put the state's budget in its best shape in memory, albeit temporarily.

Fueled by past budgetary practices, economic recession, and exploding medical costs, Illinois experienced its worst cash shortage through the first half of the 1990s. The seeds of the state's extended cash shortage were planted with the fiscal year 1990 budget — the first of three consecutive years where actual revenues fell far short of expectations at the time the budgets were passed. It is important to note that revenues did not decline over this period, but simply fell short of estimates. From 1990 through 1992, actual revenue growth of $1.899 billion (excluding short-term borrowing) fell $878 million short of the $2.777 billion estimated. As the economic downturn that started in fiscal year 1991 stretched into 1992, the budget-makers nightmare came true. That year, General Funds revenue growth fell $500 million below expectations, even with the acceleration of sales tax collections and other revenue enhancement measures.

Payment delays continued for most of the next five years before being eliminated at the end of fiscal year 1997. By the end of fiscal year 2000, the General Funds produced a record-high budgetary surplus of $777 million. This period was generally characterized by improved budgetary practices and extraordinary economic growth. The strength of the economy is reflected in the fact that, between fiscal years 1995 and 2000, revenue growth exceeded $1.1 billion four times. Perhaps more importantly, actual revenue growth exceeded original expectations by a cumulative $2.257 billion.

General Funds Base Revenue Growth
Estimated vs Actual
(millions of dollars)

Fiscal Year	Estimated Revenue	Actual Revenue	Estimated Growth	Actual Growth	Difference
1989		12,133			
1990	13,009	12,841	876	708	(168)
1991	13,471	13,261	630	420	(210)
1992	14,532	14,032	1,271	771	(500)
1993	14,523	14,750	491	718	227
1994	15,410	15,587	660	837	177
1995	16,622	17,002	1,035	1,415	380
1996	17,713	17,936	711	934	223
1997	18,660	18,854	724	918	194
1998	19,504	19,984	650	1,130	480
1999	21,384	21,674	1,400	1,690	290
2000	22,560	23,250	886	1,576	690
2001	24,060	24,106	810	856	46
2002	25,000	23,379	894	(727)	(1,621)
2003	24,385	??	1,006	??	??

Fiscal Year	Estimated Growth	Actual Growth
1990	7.2%	5.8%
1991	4.9%	3.3%
1992	9.6%	5.8%
1993	3.5%	5.1%
1994	4.5%	5.7%
1995	6.6%	9.1%
1996	4.2%	5.5%
1997	4.0%	5.1%
1998	3.4%	6.0%
1999	7.0%	8.5%
2000	4.1%	7.3%
2001	3.5%	3.7%
2002	3.7%	-3.0%
2003	4.3%	??

Estimates reflect the first estimates for the fiscal year released by the Bureau of the Budget following enactment of the new year's budget.

One lesson that should have been learned from the difficulties of the early to mid 1990s is that it is easy to stumble into a fiscal crisis. Another is that it is far more difficult to dig out of a budgetary hole. Unfortunately, it is easy to get used to the kind of fiscal flexibility afforded by a strong economy. During fiscal year 2001, the prior year's budgetary surplus was reduced by more than half due to various taxing and spending decisions and the onset of recession in the spring.

When the fiscal year 2002 budget was enacted, the state was already in recession. Revenues declined for the first time in memory, and to make things worse, actual revenues fell short of original expectations by

$1.621 billion. Efforts to regain control of the budget proved ineffective and the small budgetary surplus from fiscal year 2001 became the largest budgetary deficit on record by the end of 2002.

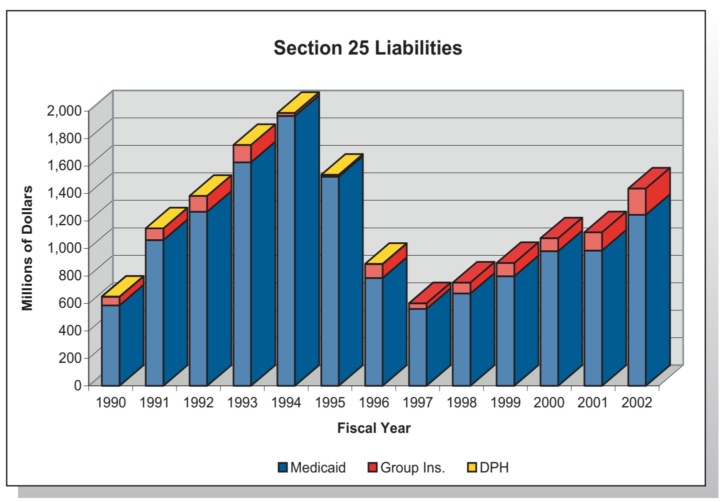
With the state's dismal financial performance in fiscal year 2002 and thus far in fiscal year 2003, it might be tempting to push accrued liabilities into future year's appropriations. One of the largest components of those liabilities is Section 25 deferrals. After falling substantially from 1995 through 1997, Section 25 deferred liabilities increased in each of the last five years, reaching $752 million in 1998, $894 million in 1999, $1.075 billion in 2000, $1.118 billion in 2001, and $1.436 billion in 2002 – the third consecutive year that these deferrals have exceeded $1.0 billion. The $318 million growth in 2002 included a $260 million increase under the state's Medicaid program and a $58 million increase under the group health insurance program for employees, retirees, and their dependents administered by the Department of Central Management Services.

Section 25 of the State Finance Act provides that the state's fiscal year lasts from July 1 through June 30 and that expenditures for liabilities incurred within a given fiscal year be paid for from that year's appropriation, with certain exceptions. These exceptions include liabilities for Medicaid, state employee and retiree health insurance, and certain spending from the Department of Public Health.

Payments made under these exceptions to Section 25 are similar to lapse period spending in that both sets of payments are for liabilities incurred before the end of the fiscal year, but paid after June 30th. For GAAP purposes, therefore, both types of payments are considered to be part of that year's spending. On a cash basis, however, the two types of expenditures are charged to different fiscal years. Lapse period spending is charged to an appropriation from the fiscal year in which the liability arose. Payments made for items covered by these exceptions to Section 25 are made from a subsequent year's appropriation, and therefore, are not counted as lapse period spending.

In theory, budgets are based on revenue estimates. That means that if revenues fall short of expectations, spending must be reduced to keep the two in relative balance. Through most of the early 1990s, Illinois was unable to adjust spending enough to match revenue shortfalls. The fact that budget cuts are problematic was compounded by court-ordered spending and increased medical costs. When the cash ran out, Illinois engaged in the practice of deferring payment of liabilities already incurred. Although the number of programs that are covered by exceptions to Section 25 are limited, the dollar amount of such deferrals is not. This practice exacerbated the fiscal difficulties experienced by the state in the early 1990s and could be just as troublesome in the current situation.

The growth of Section 25 deferrals is troublesome given the relationship between changes in those deferrals and changes in the General Funds GAAP financial position. Changes in Section 25 liabilities (which are essentially the changes in Medicaid liability) have been reflected in the state's GAAP deficit. Through the 1990s, the widening of the GAAP deficit closely matched the growth in deferrals under Section 25, while narrowing of that deficit tracked closely to the reductions in those deferrals.



Barring sudden and catastrophic economic collapse, financial crises of the current magnitude do not appear out of nowhere. They take time to develop and are the result of economic cycles and state fiscal policy actions.

While economic cycles are largely beyond the influence of state government, taxing and spending decisions are not. Although economic cycles can be long,

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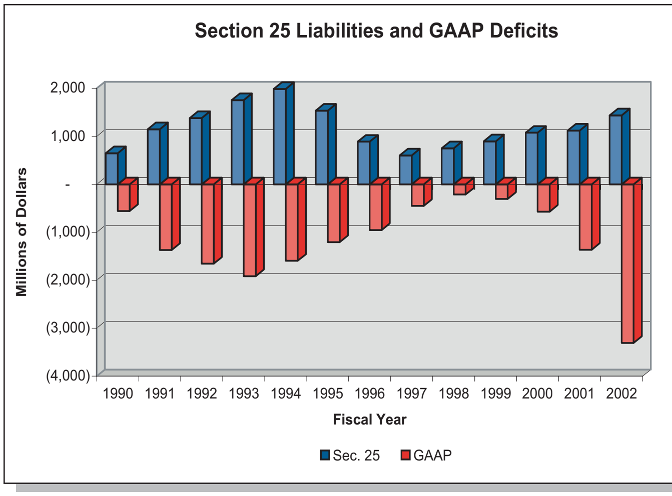
and their impact dramatic, they seldom permanently change the fiscal landscape. Fiscal policy decisions, however, tend to have much more pronounced long-term impacts. Tax relief efforts of the last 25 years, for example, permanently reduced the state's revenue base. At the same time, spending decisions, some of which have been dictated by the courts or the federal government, have permanently increased the state's spending base. Because actions that reduce the state's revenue base or permanently raise the spending base have a cumulative effect, such actions must be taken with a view towards the long-term implications.



Over the years, this combination of reduced tax base, increased spending base, and the ever-present economic cycle have resulted in feast or famine budgets. During the feast, there is enough for everybody. But during the famine, Illinois has resorted to a variety of tactics to get back on track — temporary tax increases, permanent tax increases, inter-fund borrowing, inter-fund transfers, short-term borrowing, across-the-board spending cuts, and extended payment delays. These experiences make it increasingly important that any efforts to regain control of the budgetary process be examined carefully.

Rainy Day Fund

Over the last several years, the Executive Summary has discussed the need for an adequately financed rainy day fund, stating that "there remains nagging concerns about whether the state is adequately prepared to deal with the next financial cycle." The State of Illinois discovered that, in part, because of the lack of a regularly funded rainy day fund, it was not prepared to deal with the extended aftermath of the economic downturn that started towards the end of fiscal year 2001.

In a perfect world, revenue estimates and economic forecasts would be completely accurate and program liabilities would be easily controlled and known well in advance. Obviously, no one wants to see the economy turn sour, but in and of itself, an economic downturn is not the problem. The real problem is failure to predict the downturn and adequately adjust revenue estimates accordingly in the first place. If economic conditions occur as anticipated, the budget will still be sound, even in the middle of a recession. But again, Illinois has fallen into the trap of overestimating revenues.

The state entered the economic slowdown of 1991 with relatively high General Revenue Fund balances and no payment delays, yet state government was totally unprepared for what was to come. Over the next two years, state finances went from bad to worse with record low balances, lengthy payment delays and record high lapse period spending before beginning to improve toward the end of fiscal year 1993. There are similarities in the fiscal climate that Illinois exists in today.

As indicated above, the current recession has produced revenue shortfalls and extended payment delays that began in mid-fiscal year 2001 and persist half-way through fiscal year 2003.

One of the methods used by states to deal with the unexpected is to build financial reserves by establishing rainy day (or budget stabilization) funds. Although the formulas used to determine deposits into and withdrawals from budget stabilization funds vary widely among the states, each has a common objective. During times of economic growth, revenue is set aside in these funds with the express purpose of providing a cushion to help states weather temporary fiscal emergencies. These states are simply following the common sense practice of putting money aside when revenue growth is healthy to help tide the state over during years of poor revenue growth.

By establishing reserves, rainy day funds provide more assurance that a budget plan can be accomplished and enhance budget stability. The existence of reserves reduces the likelihood that unexpected midyear budget cuts will be needed and reduces the magnitude of such cuts if they cannot be avoided. In addition to providing critical cash management tools, rainy day funds can also provide a formal plan for dealing with revenue shortfalls rather than forcing ad hoc methods such as across the board appropriation cuts, delays in spending, or deferrals of obligations. In other words, rainy day funds do not take the place of budgetary discipline, they only provide the time necessary to make reasoned choices.

A rainy day fund can also serve as what economists call an automatic economic stabilizer. Revenues can be deposited into the fund during periods of strong economic growth and reinjected into the economy when an economic downturn causes revenues to lag.

In addition, a rainy day fund might reduce the interest the state pays on its bond issues. Bond rating agencies consider states with effective mechanisms for building financial reserves to be exhibiting fiscal discipline and preparedness for dealing with economic downturns.

Illinois only recently enacted rainy day fund legislation. In order to serve its intended purpose, however, such a fund must have sufficient resources available and access to those resources. Unfortunately, the state's Budget Stabilization Fund was financed with a $226 million one-time transfer of leftover money from the state's Tobacco Settlement Recovery Fund at the beginning of fiscal year 2002.

Legislation passed at the end of fiscal year 2001 allowed the Comptroller to transfer funds from the Budget Stabilization Fund into the General Revenue Fund for cash flow purposes. Pursuant to this legislation, the fund has already been used twice as the entire $226 million balance in the fund was transferred in November 2001, repaid at the end of June 2002 and transferred again on July 1, 2002. Given the relatively small balance in the fund to start with, the November 2001 transfer only helped reduce unpaid bills to $350 million. The July 2002 transfer amounted to less than 30% of the $781 million in unpaid bills carried over from June.

The continuing wide spread weakness in most revenue sources has forced revenue estimates to be revised downward and prompted the Governor to initiate budget reduction measures. To regain control of the budgetary process, especially for next year, numerous budget cuts will likely be needed resulting in decreases in services provided to Illinois residents. That impact could have been at least mitigated had the state put in place a regular funding mechanism for its rainy day fund during the just ended economic expansion.