Fiscal Focus

Comptroller Daniel W. Hynes State of Illinois February/March 1999

Dear Friends:

Being elected as State Comptroller last November was truly an honor. As Comptroller, you have my sincere commitment to keep you informed of fiscal issues facing Illinois. I am especially pleased to begin this issue of *Fiscal Focus* by sharing with you my thoughts on a fiscally responsible proposal that is rapidly gaining bipartisan support, the creation of a **Rainy Day Fund**.

A **Rainy Day Fund** is a sound financial management tool currently being used in 45 of the 50 states and by thousands of families across Illinois who put money away each and every month to protect themselves against future financial hardships.

The time has never been better to establish such a fund while the state is enjoying a record cash balance estimated at $1.1 billion. Governor Ryan issued his public support of establishing a **Rainy Day Fund** in his recent Budget Address.

Speaker of the House, Michael Madigan introduced House Bill 417,which would create a reserve (**Rainy Day Fund**) with part of that balance. The legislation calls for a statutory transfer of $100 million during fiscal year 2000 to be divided equally into two new funds. After this initial transfer, the fund will receive transfers based on projected revenue growth.

In this issue of *Fiscal Focus* you will read about the Rainy Day Fund proposal contained in HB 417. You will read about the structure of the funds, the triggering mechanism for deposits, and the mechanism for spending the funds. This proposal will help reduce the need for future tax increases, maintain the highest possible bond rating, reduce short-term borrowing and provide a cushion against economic downturns.

Based on the Governor's estimates, the State is expected to end fiscal year 1999 with a General Funds surplus of about $390 million. Not saving at least some of that surplus for the future is shortsighted and forgetful of the past. As you are well aware, in the early 1990s, Illinois faced a serious financial crisis. Due to a nationwide recession, state revenues were unable to sustain our current liabilities and the effects were devastating. Health care providers, day care providers and small businesses waited months for payment. Many went bankrupt due in part to delinquent state payments. Across the board budget cuts were ordered by Governor Edgar, including cuts in education and childcare. And emergency short-term borrowing cost Illinois taxpayers tens of millions of dollars in interest charges and fees.

There simply has never been a better time, while we are enjoying a robust economy, to plan **now** to prevent such a reoccurrence. If we are faced with another economic rainstorm, Illinois can not rely on a credit card. We need to do what Illinois families have been doing for years, saving money during good times to protect themselves against financial troubles.

Public support of HB 417 is imperative for its passage. Please call our office and add your name to our list of Rainy Day Fund supporters. If you would like more information about this proposal, please visit our website to keep updated on its progress as budget negotiations get underway.

As Governor Ryan said in his Fiscal Year 2000 Budget Address, recent events have sent a clear message that citizens are weary of partisan bickering. This is an opportunity for people on both sides of the aisle to do something fiscally responsible that we can be proud of for years to come.

In This Issue...

Cover Story...

Saving For A Rainy Day

How often have individuals and businesses alike been advised to build financial reserves against future crises? Yet when it comes to saving for a rainy day, Illinois is one of only five states without a statutory provision for some sort of reserve or contingency fund. Illinois is also the only major industrial state without such a fund.

The National Conference of State Legislatures reports that 45 states now have such 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.

Legislation recently proposed by the Comptroller creates the Rainy Day Budget Stabilization and Children First Act. The

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Fiscal Focus

Fiscal Focus is one of the ways the Comptroller's Office strives to assist taxpayers and the people of Illinois. This monthly report is designed to provide fiscal information of general interest and in compliance with state statutes.

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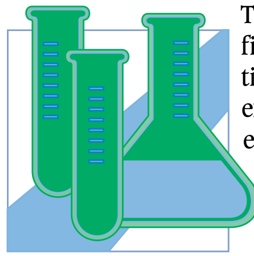
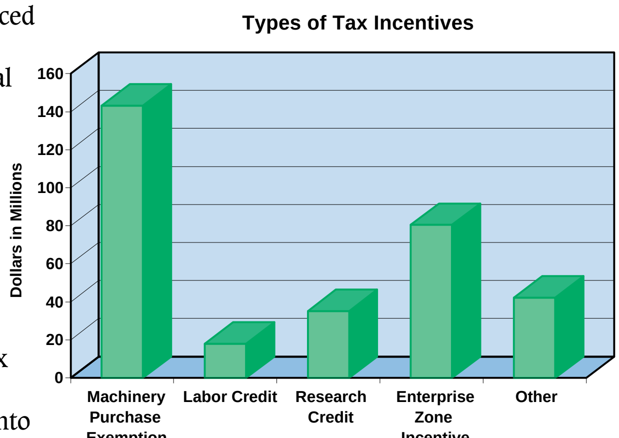
Tax Incentives for Business

The statutes of Illinois are full of tax breaks and other financial incentives for businesses intended to make Illinois a more attractive place for businesses to operate. A description and analysis of these various tax expenditures, as they are called, are found in the Comptroller's 1998 Tax Expenditure Report. A special study within the report calculated the cost of these incentives, divided the benefits between those that reduce equipment costs versus those that reduce labor and research costs, and traced the timing of their imposition.



Of the $4.1 billion in total reported tax expenditures in fiscal year 1998, $319 million resulted from incentives designed to improve the Illinois business climate. Although 47 such incentives were in effect during fiscal year 1998, a handful accounted for most of their cost with the four largest totaling $208 million or 65% of the total cost of business incentives.

A look at the four most expensive incentives also indicates the diversity of the tax incentives that are offered in Illinois. The sales tax exemption for manufacturing and assembling machinery and equipment is by far the most expensive Illinois business incentive. Begun as a partial exemption in 1979, this exemption reduced state revenues by $122 million in fiscal year 1998 and accounted for 38% of the total cost of tax incentives. Second most expensive is the research and development credit to the corporate income tax ($35 million). This credit, which went into effect in fiscal year 1991, is equal to 6.5% of increased research expenditures in Illinois.



The third and fourth most expensive are both enterprise zone benefits. In 1985, all purchases of merchandise for use by enterprise zone businesses designated as high impact by DCCA became exempt. The cost of this exemption was $28 million in fiscal year 1998. Electricity sales to DCCA-certified businesses within enterprise zones are exempt from public utilities taxes. This exemption, effective in 1986, cost $24 million in 1998.

Four types of benefits are available through tax incentives. These are general exemptions for the purchase of machinery and other investment goods, credits reducing labor costs, credits encouraging research, and special benefits aimed at encouraging development in enterprise and foreign trade zones and investments in businesses having a high economic impact in Illinois.

The largest portion of Illinois business tax incentives reduces the cost of machinery purchases. In 1998, these incentives accounted for $143 million or 45% of the value of Illinois incentives. Besides the manufacturing and assembling machinery exemption, purchases of other equipment such as coal, oil, and distillation equipment, graphic arts equipment, and pollution control facilities also had sales tax exemptions.

Incentives available for enterprise and federally designated foreign trade zones and high economic impact businesses were intended to either help disadvantaged areas in Illinois that need special treatment to attract new business activity or for trade oriented businesses that have wide discretion in their location decisions and would be sensitive to cost savings. Special incentives accounted for $81 million or 25% of the value of Illinois tax incentives.

Among the remaining incentive categories, the $35 million research credit accounted for 11% of the total cost of incentives, while labor credits of $18 million accounted for 6%. The primary direct employment incentive is the training expense credit to the corporate income tax which is 1.6% of employer training expenses for Illinois employees or residents.

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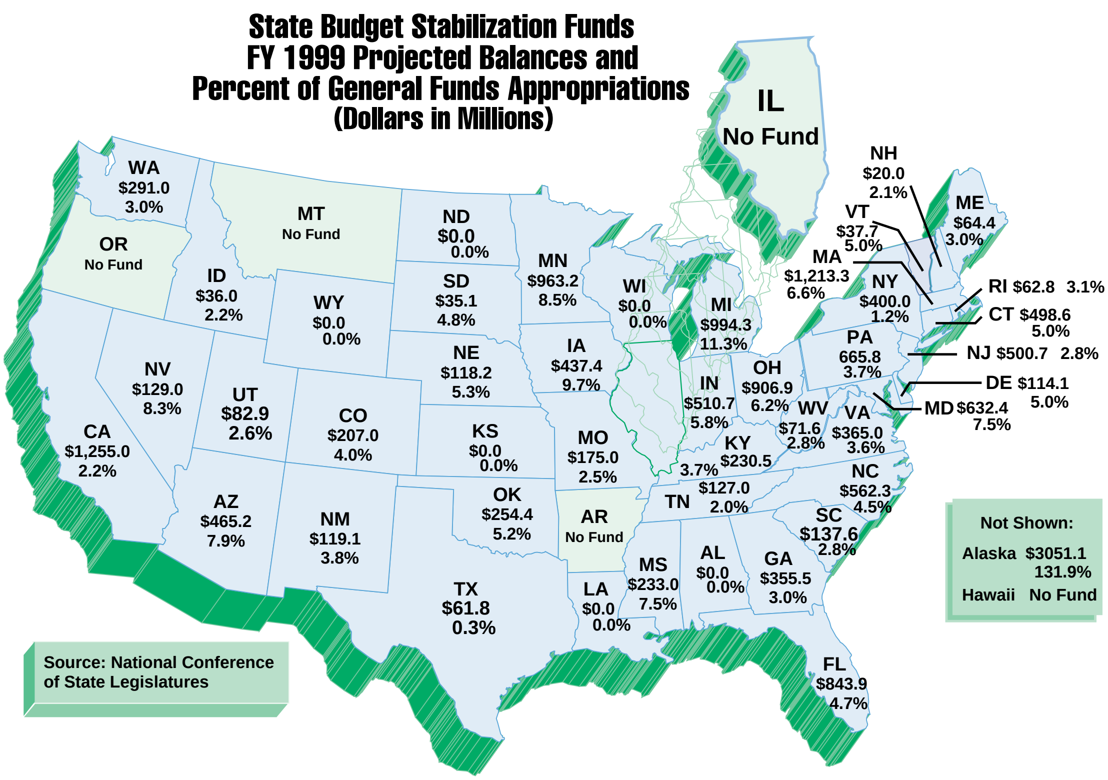
How Illinois Stacks Up

Despite healthy revenues and a robust economy, Illinois remains among a very few states that have not established a budget stabilization (commonly referred to as a rainy day or contingency) fund. Joining with Illinois in this distinction are the States of Arkansas, Hawaii, Montana, and Oregon. While other states are using these robust economic times to prepare for inevitable harder times ahead by filling up their rainy day funds, Illinois and her sister states without such funds remain vulnerable to unexpected fiscal crises. Of course, the existence of a rainy day fund does not automatically indicate fiscal preparedness — six of the remaining 45 states have no money in their funds. These states include Alabama, Kansas, Louisiana, Montana, North Dakota and Wisconsin. However, the vast majority (34) of states are taking advantage of these times to fill and, in some cases, increase their rainy day fund limits.

Fifteen states have fund limits exceeding the recommended 5% of general fund appropriations (some states set aside a percentage of their annual expenditures rather than appropriations) while 28 states have lower percentages. Of those states with rainy day fund balances, New Hampshire has the smallest projected FY 1999 balance ($20 million) and Texas designates the smallest percentage for contingency purposes (0.3 %). Alaska tops the list both in terms of projected FY 1999 contingency funds ($3.1 billion) and percent of general fund appropriations designated for the fund (131.9 %).

According to John E. Petersen, president of the Government Finance Group, a rainy day fund can "stave off herky-jerky tax increases or a painful trip to the short-term loan market. Even in good times, they are a good deal for a state's taxpayers."[1] Illinois has gone that route before and paid dearly. Now is the time for Illinois to join those fiscally responsible states that are preparing for the future and what is bound to be a less rosy financial picture.

1 "Don't Forget Your Umbrella," *Governing*, October, 1998, p. 70.



Focus On Revenue

The Telecommunications Tax

As part of the education funding package passed in December 1997, the telecommunications tax rate was increased from 5% to 7%. Revenues from the additional 2% were divided with one-half deposited into the School Infrastructure Fund and one-half deposited into the Common School Fund. The distribution of the original 5% remains with $1.0 million per month deposited into the Common School Fund and the remainder into the General Revenue Fund.

Since it was effective in January 1998, the increase impacted revenues for the last half of fiscal year 1998 with the first deposit occurring in February. Revenues from the telecommunications tax increased $88 million or 21.6%, from $407.3 million in fiscal year 1997 to $495.5 million in fiscal year 1998. Of this increase, $70.4 million or 79.8% was due to the increase in the tax rate.

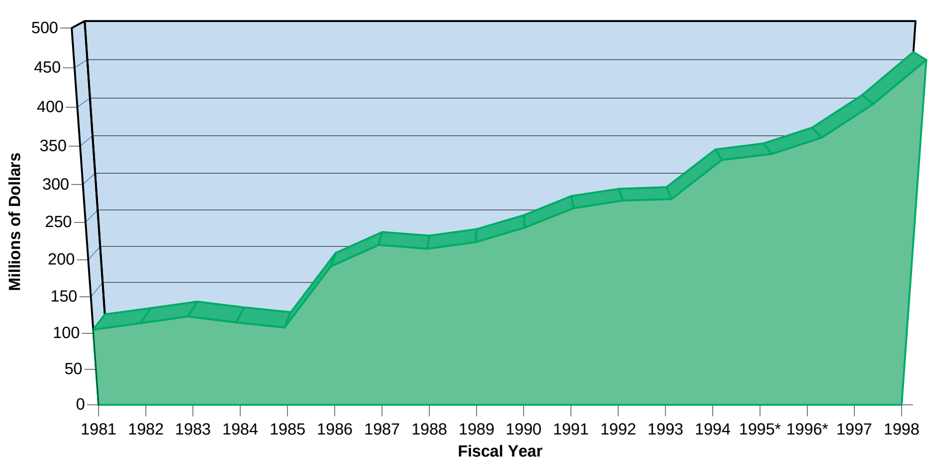
Fiscal year 1999 will be the first full year of the tax increase. Through seven months, revenues from the telecommunications tax are $392.8 million, up $122.1 million or 45.1%, with the tax increase accounting for $113.2 million or 92.7% of the growth.

Telecommunications Tax (Millions of Dollars)

	Fiscal Year 1997	Fiscal Year 1998	Seven Months FY 1998	Seven Months FY 1999
First 5% Distribution				
General Revenue Fund	$ 395.3	$ 413.1	$ 263.7	$ 272.6
Common School Fund	12.0	12.0	7.0	7.0
2% Increase Distribution				
Common School Fund	0.0	35.2	0.0	56.6
School Infrastructure Fund	0.0	35.2	0.0	56.6
Total	$ 407.3	$ 495.5	$ 270.7	$ 392.8

The telecommunications tax is one of the public utility taxes collected by the state along with electricity and natural gas. Over the past thirteen years, the growth in public utility taxes was due to the growth in telecommunications revenues. Since fiscal year 1985, public utility tax receipts have grown $266 million, with a $352 million increase in telecommunication tax receipts offsetting declines in electricity and natural gas revenues.

Telecommunications Tax Collections



* The tax collections have been adjusted to reflect a one time liability payment that should have been deposited in Fiscal Year 1995 instead of Fiscal Year 1996.

Source: Department of Revenue

In 1937, the Public Utilities Revenue Act imposed a 3% tax on businesses transmitting messages in Illinois making the telecommunications tax one of the state's oldest taxes. A separate Messages Tax Act was enacted in 1945 and the tax rate fluctuated over the years with the 5% rate established in 1967.

In 1985 the Messages Tax Act was substantially re-written and became the Telecommunications Tax Act. Although the tax rate remained at 5%, the tax base was expanded to include not only intrastate, but also interstate activity. Under the prior law, the tax was imposed on businesses transmitting *messages*. The new act imposes the tax on the privilege of transmitting or receiving *telecommunications*. The distinction between *messages* and *telecommunications* was critical because of the broader implication of *telecommunication*.

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Focus On Spending

General Funds Spending through Seven Months

Through January, fiscal year 1999 warrants issued from the General Funds totaled $10.491 billion - $1.027 billion or 10.9% higher than warrants issued against 1998 appropriations through seven months. Increased spending was widespread among state agencies. Of the twenty-one largest spending agencies, only the Department of Revenue experienced a decline in year-to-date spending compared to last fiscal year.

In terms of dollars, the $223 million increase at the Department of Public Aid is the largest of any individual agency while the 154.5% increase in General Funds seven-month spending at the Department of Commerce and Community Affairs (DCCA) is the largest percentage increase. Over $195 million or 90.4% of the increase in Public Aid spending is for medical assistance while the $34 million increase at DCCA is due primarily to a $29 million increase in spending authorization for community development grants.

The $1.027 billion or 10.9% increase in spending reflects the $1.541 billion jump (from $18.239 billion in 1998 to $19.780 billion in 1999) in appropriations from last year. Year-to-date spending of $10.491 billion accounts for 53.0% of fiscal year 1999 appropriations, slightly higher than fiscal year 1998 (51.9%) and 1997 (52.8%). Although the pace of General Funds spending this year is slightly ahead of the previous two years, the $9.289 billion in unexpended appropriations through seven months is $514 million more than at the same point in fiscal year 1998.

The comparison of spending to appropriations is based on appropriations through January of each year. These are not final appropriations as supplemental appropriations were subsequently passed in both 1997 and 1998.

A primary reason for the higher rate of spending through seven months is the sharp increase at several higher education entities. This jump is largely a matter of timing. Last year, low cash balances in the Education Assistance Fund (one of three education funds, which along with the General Revenue Fund comprise the General Funds) delayed spending from that fund until later in the year. For 1999, reduced appropriations and strong revenue performance, particularly from riverboat gambling, have improved the cash flow situation in the Fund and allowed spending to follow a more normal pattern. As a result, the University of Illinois has expended 65.5% of their authorized General Funds budget through seven months compared to just 53.8% in 1998. The same holds true for the Student Assistance Commission and the Community College Board. Those two entities have expended 64.3% and 58.3% of their General Funds appropriations respectively for fiscal year 1999 compared to 45.1% and 52.2% in 1998.

Other large spending agencies which have a marked increase in their rate of spending from General Funds appropriations in 1999 include the Department of Human Services, Children and Family Services, Teachers Retirement System and Commerce and Community Affairs. Agencies with a significant slowdown from fiscal year 1998 spending include the Department on Aging and Natural Resources.

Comparison of General Funds Expenditures and Appropriations* Through Seven Months By Agency
(Dollars in Millions)

	Fiscal Year 1997			Fiscal Year 1998			Fiscal Year 1999		
Agency	Spending	Approp.	%	Spending	Approp.	%	Spending	Approp.	%
State Board of Education	$1,931	$3,795	50.9	$2,142	$4,175	51.3	$2,292	$4,570	50.2
Public Aid	2,795	5,347	52.3	2,172	3,986	54.5	2,395	4,430	54.1
Human Services	0	0	N/A	1,717	3,412	50.3	1,812	3,450	52.5
Corrections	441	863	51.1	471	946	49.8	536	1,054	50.9
Children and Family Services	535	942	56.8	466	922	50.5	486	897	54.2
University of Illinois	380	626	60.7	348	647	53.8	448	684	65.5
Central Management Services	322	494	65.2	298	514	58.0	319	558	57.2
Teacher's Retirement System	206	355	58.0	266	456	58.3	332	547	60.7
Student Assistance Commission	132	309	42.7	148	328	45.1	229	356	64.3
Community College Board	126	261	48.3	143	274	52.2	168	288	58.3
Supreme Court	108	212	50.9	115	222	51.8	123	240	51.3
Revenue	81	222	36.5	87	224	38.8	85	226	37.6
Southern Illinois University	120	194	61.9	143	200	71.5	145	210	69.0
State University Retirement System	85	147	57.8	109	186	58.6	120	206	58.3
State Police	69	174	39.7	74	184	40.2	78	201	38.8
Aging	67	146	45.9	77	160	48.1	88	199	44.2
Natural Resources	41	83	49.4	42	109	38.5	49	147	33.3
Public Health	81	149	54.4	46	98	46.9	47	104	45.2
Secretary of State	58	193	30.1	57	98	58.2	63	103	61.2
Northern Illinois University	60	94	63.8	60	97	61.9	62	101	61.4
Commerce and Community Affairs	13	43	30.2	22	68	32.4	56	100	56.0
Mental Health	799	1,448	55.2	0	0	N/A	0	0	N/A
All Other	630	1,096	57.5	461	933	49.4	558	1,109	50.3
Total	**$9,080**	**$17,193**	**52.8**	**$9,464**	**$18,239**	**51.9**	**$10,491**	**$19,780**	**53.0**
Unexpended Appropriations Through Seven Months		**$8,113**			**$8,775**			**$9,289**	

*Appropriation amounts are as of the end of January for each fiscal year and do no reflect supplemental appropriations.

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bill establishes two new funds in the State Treasury. The first is the Budget Stabilization Fund whose resources may be used to help the state meet its obligations whenever occasional deficits or failures in revenue occur. The second is the Children First Reserve Fund whose resources may be used to support spending on children's programs that have already been enacted by the General Assembly.

Neither of these funds will increase state spending, but are specifically intended to reduce the need for future tax increases, diminish the need for short-term borrowing, maintain the state's bond ratings, and protect programs aimed at educating and caring for the health and safety of children. The resources of these funds can be tapped only with the joint approval of the Governor, Comptroller, and Treasurer.

For fiscal year 2000, the bill requires that $50 million be transferred from the General Revenue Fund into each of the new "rainy day" funds ($100 million in total). Beginning in fiscal year 2001, the bill provides a "trigger" mechanism for determining the amount of money to be placed in the funds. That trigger is the Governor's revenue estimate for the upcoming budget year. For any year in which the Governor estimates that revenue into the General Funds will exceed last year's receipts by more than 4%, the Comptroller is required to transfer from the General Revenue Fund to the new rainy day funds an amount equal to 0.25% of anticipated revenue. These transfers would be made monthly and would be split equally between the funds.

At any time during the year, the Governor, Comptroller, and Treasurer can agree to suspend the movement of money from the General Revenue Fund to the rainy day funds. Resumption of transfers also takes the agreement of these three constitutional officers.

The bill also effectively caps transfers into the funds. If the balance in either fund exceeds 2% of the Governor's estimate of General Funds revenues for that year, subsequent transfers are suspended. This means that the rainy day funds are capped at 4% of General Funds revenues. For fiscal year 2001, that cap would be about $930 million.

The use of "rainy day" resources is limited and requires the agreement of the Governor, Comptroller, and Treasurer. In the case of the Budget Stabilization Fund, monies in the fund can be transferred back to the General Funds only after a joint determination that the resources available to the General Funds are insufficient to meet the obligations of the State.

The use of Children First Reserve Fund resources is more restricted. Following a similar joint determination regarding the availability of resources, transfers can be made to any fund of the state to support only programs for elementary and secondary education, child care, and other programs that provide a direct benefit to children.

Under the Hynes proposal, money in either fund can be used in two ways. The first is noted above and involves a declaration that there is not going to be enough revenue to pay the state's bills. This revenue shortfall might occur due to an economic downturn or because of an adverse court decision. Money used in this manner would not have to be repaid to the respective rainy day fund.

Transfers from either rainy day fund can also be made to facilitate cash flow within the same fiscal year. This can become necessary when fund balances at the beginning of the year are low and there is a seasonal mismatch between the flow of revenue and spending demands. In the case of the General Revenue Fund, spending demands are relatively steady throughout the year while the flow of revenue is heavily skewed to the last

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Estimated Transfers Under the Hynes Proposal
(Dollars in Millions)

Fiscal Year	Estimated Revenue		Maximum Annual Transfer	1/2 to Budget Stabilization Fund	1/2 to Children's First Reserve Fund	Cumulative
2000	$22,155		$100.00	$50.00	$50.00	$100.00
	x 1.05					
2001	$23,263	x .25% =	$58.16	$29.08	$29.08	$158.16
	x 1.05					
2002	$24,426	x .25% =	$61.06	$30.53	$30.53	$219.22
	x 1.05					
2003	$25,647	x .25% =	$64.12	$32.06	$32.06	$283.34
	x 1.05					
2004	$26,930	x .25% =	$67.32	$33.66	$33.66	$350.66
	x 1.05					
2005	$28,276	x .25% =	$70.69	$35.35	$35.35	$421.35
	x 1.05					
2006	$29,690	x .25% =	$74.22	$37.11	$37.11	$495.58
	x 1.05					
2007	$31,174	x .25% =	$77.94	$38.97	$38.97	$573.51
	x 1.05					
2008	$32,733	x .25% =	$81.83	$40.92	$40.92	$655.35
	x 1.05					
2009	$34,370	x .25% =	$85.92	$42.96	$42.96	$741.27

These calculations start with the Bureau of the Budget's FY 2000 General Funds revenue estimate (as of February 1999) and 5% revenue growth per year thereafter. Provisions of Hynes proposal effective in FY 2000.

What might have been the impact of the Hynes Rainy Day Proposal if it had been in effect over the last ten fiscal years? This analysis assumes that the Governor's original Budget Book revenue estimate for the General Funds would be the basis for making transfers into the Budget Stabilization Fund and the Children's First Reserve Fund. Estimated transfers would be made from the General Revenue Fund and split evenly between the two new funds. All dollar estimates are presented in millions.

Fiscal Year	Budget Book Estimates		Percent Change	Estimated Transfer	6-month Actual		Percent Change	Actual		Percent Change
1991	FY 1990	FY 1991			FY 1990	FY 1991		FY 1990	FY 1991	
	$13,009	$13,770	5.8%	**$34.4**	$5,856	$6,237	6.5%	$12,841	$13,261	3.3%

Although revenues increased 6.5% over the first six months of the year, growth slowed dramatically during the final four months. As a result, the Governor, Comptroller and Treasurer could have agreed to stop transfers during that time. It is likely that transfers through February (eight months of the year) would have totaled $22.9 million (approximately $11.5 million to each fund). With agreement of the Governor, Comptroller and Treasurer, the amounts in either fund could have been used to support state programs.

Fiscal Year	Budget Book Estimates		Percent Change	Estimated Transfer	6-month Actual		Percent Change	Actual		Percent Change
1992	FY 1991	FY 1992			FY 1991	FY 1992		FY 1991	FY 1992	
	$13,453	$14,278	6.1%	**$35.7**	$6,237	$6,601	5.8%	$13,261	$14,032	5.8%

Budgetary difficulties developed during the first half of the fiscal year. With agreement, transfers could have been stopped early in the year. At the least, transfers probably would have stopped by January. Because of the severity of the problem, it is assumed that any money in both funds would have been used to mitigate the fiscal difficulties.

Fiscal Year	Budget Book Estimates		Percent Change	Estimated Transfer	6-month Actual		Percent Change	Actual		Percent Change
1993	FY 1992	FY 1993			FY 1992	FY 1993		FY 1992	FY 1993	
	$14,200	$14,546	2.4%	0	$6,601	$6,732	2.0%	$14,032	$14,750	5.1%

Even though revenue increased 5.1% over the year, no transfers would have been made. Revenue growth began to accelerate during the last half of the year.

Fiscal Year	Budget Book Estimates		Percent Change	Estimated Transfer	6-month Actual		Percent Change	Actual		Percent Change
1994	FY 1993	FY 1994			FY 1993	FY 1994		FY 1993	FY 1994	
	$14,723	$15,348	4.2%	**$38.4**	$6,732	$7,231	7.4%	$14,750	$15,586	5.7%
1995	FY 1994	FY 1995			FY 1994	FY 1995		FY 1994	FY 1995	
	$15,430	$16,149	4.7%	**$40.4**	$7,231	$7,846	8.5%	$15,586	$17,002	9.1%
1996	FY 1995	FY 1996			FY 1995	FY 1996		FY 1995	FY 1996	
	$16,832	$17,577	4.4%	**$43.9**	$7,846	$8,333	6.2%	$17,002	$17,936	5.5%
1997	FY 1996	FY 1997			FY 1996	FY 1997		FY 1996	FY 1997	
	$17,890	$18,407	2.9%	0	$8,333	$8,783	5.4%	$17,936	$18,854	5.1%
1998	FY 1997	FY 1998			FY 1997	FY 1998		FY 1997	FY 1998	
	$18,618	$19,349	3.9%	0	$8,783	$9,470	7.8%	$18,854	$19,984	6.0%
1999	FY 1998	FY 1999			FY 1998	FY 1999				
	$19,831	$20,898	5.4%	**$52.2**	$9,470	$10,312	8.9%			
2000	FY 1999	FY 2000								
	$21,314	$22,155	3.9%	0						

From fiscal year 1994 through 1999, it is estimated that $174.9 million could have accumulated in the "rainy day" funds with approximately $87.5 million in each fund.

Note: The six-month and annual revenue figures are presented for reference.

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half of the year. During the cash crisis of the early to mid 1990s, the combination of low beginning balances and this seasonal mismatch resulted in the need for short-term borrowing early in the year. Since these loans were repaid by the end of the year, this effectively shifted revenue from the end of the year to the beginning.

Any transfers made from either rainy day fund solely to facilitate cash flow are to be repaid to the respective fund by the end of the same fiscal year or as soon as possible. In effect, the use of resources in this manner amounts to the state borrowing from itself in the short-term rather than going to the credit markets.

If the Hynes proposal had been in effect since 1991, many of its provisions would have been tested by now. For example, it is likely that transfers would have been initiated in both 1991 and 1992. However, these transfers would probably have been stopped by mid-year and money moved back to the General Funds due to the financial crisis. Transfers would have resumed in fiscal year 1994 and by this year (fiscal year 1999), an estimated $175 million could have been set aside in the rainy day funds ($87.5 million in each fund).

While there is abundant good news about the state's fiscal condition, there remains a nagging concern about whether the state is adequately prepared to deal with the next financial cycle. One lesson to be 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 recover from such a crisis.

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. In the real world, however, no system of estimating revenues and liabilities is perfect. Obviously, no one wants to see the economy turn sour, but in and of itself, an economic slump is not the problem. The real problem is that most forecasts will not accurately predict the slump in the first place. If economic conditions occur as anticipated, the budget will still be sound, even in the middle of a recession.

The state entered the recession 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.

It has taken six consecutive years of budgetary improvement to bring the state to a strong financial footing. While improved fiscal discipline played a major role in Illinois' financial recovery, the impact of lower growth in medical costs and rapid economic growth has been nothing short of remarkable.

Without financial reserves of some kind, Illinois is effectively trusting that extraordinary positive factors will offset government's tendency to react slowly to fiscal adversity. That approach has not worked in the past, and there is no reason to believe that it will work in the future. In fact, over the last 22 years, the state has had a budgetary surplus only four times. Each time, within two years, the state's fiscal condition deteriorated due to a combination of slow economic growth, tax breaks, and spending increases. And each time, Illinois got back on track by using a variety of tools — temporary tax increases, permanent tax increases, inter-fund borrowing, inter-fund transfers, and short-term borrowing.

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 mid-year budget cuts will be needed and reduces the magnitude of such cuts if they cannot be avoided. Rainy day funds 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.

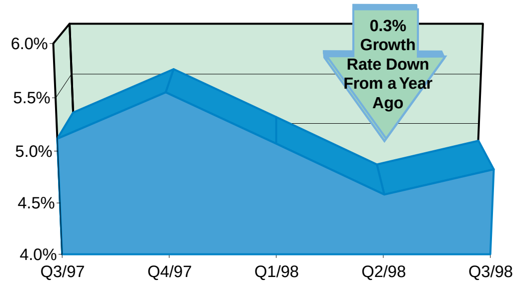
A rainy day fund can also serve as what economists call an automatic economic stabilizer. Revenues can be deposited into the fund during periods of strong economic growth and re-injected into the economy when an economic downturn causes revenues to lag.

In addition, a rainy day fund could 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. Although Illinois' bond ratings have been upgraded over the past year, analysts caution that the state's lack of reserves should be monitored closely.

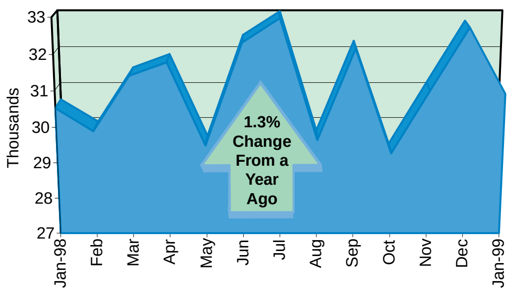
Prudent financial management requires not only paying today's bills in a timely manner, but also providing for an uncertain future. For a state government, that uncertainty can include more than economic downturns. It also includes the potential for natural disasters, cutbacks in federal support for vital state programs, and adverse court decisions. Although Illinois is in its best financial shape since 1989, it is still unprepared for uncertainty. The state's lack of reserves could mean that it will again suffer severe fiscal distress in the future.

Illinois Stats: Economic and Financial

Illinois Personal Income
Change From Prior Year (Reported Quarterly)

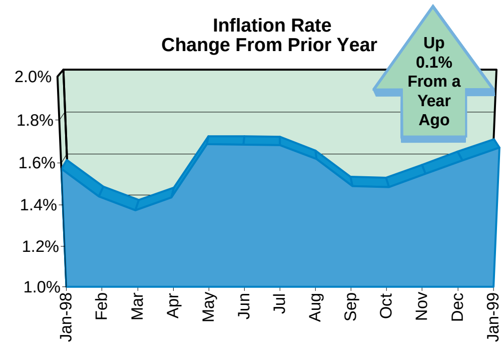


New Claims Unemployment Insurance

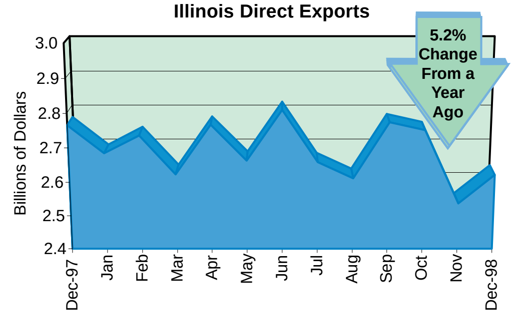


The Illinois economy continues to enjoy the ideals of both low unemployment and low inflation. The Illinois unemployment rate was 4.0% in January, its lowest level in nearly 25 years. The Illinois rate was 0.3% less than the January national rate, 0.2% less than the December Illinois rate, and 0.6% below its year earlier level. With respect to inflation, the January consumer price level was only 1.7% above its year earlier level. Among other economic indicators, average hours worked in manufacturing in January were 0.5 hours below their prior year level, while the February Chicago Purchasing Managers Index (52.9) was above the 50 level that indicates equal numbers of reports of increasing economic activity and decreasing activity.

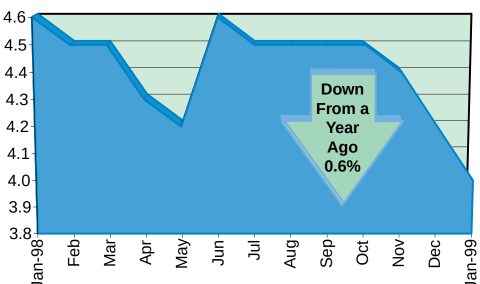
Inflation Rate
Change From Prior Year



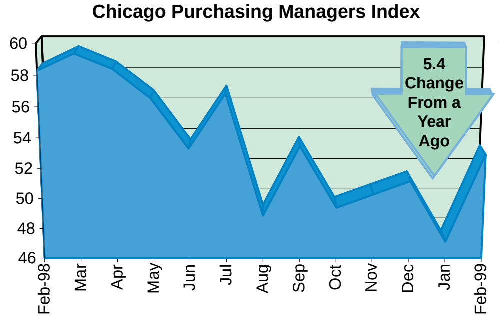
Illinois Direct Exports



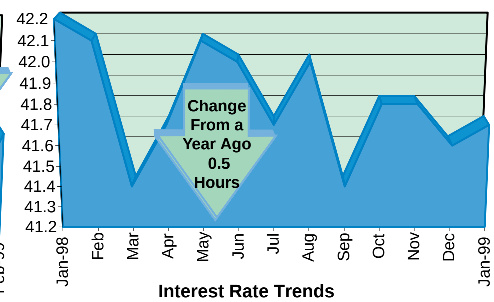
Illinois Unemployment Rate



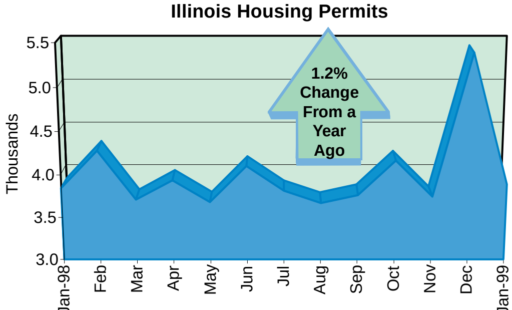
Chicago Purchasing Managers Index



Average Hours Worked Illinois Manufacturing

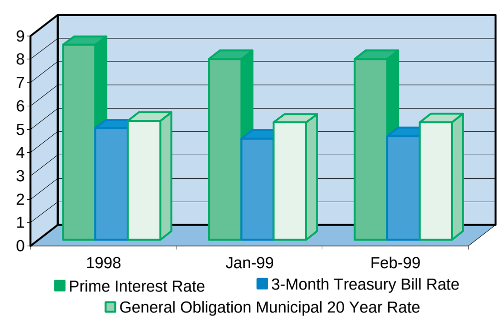


Illinois Housing Permits

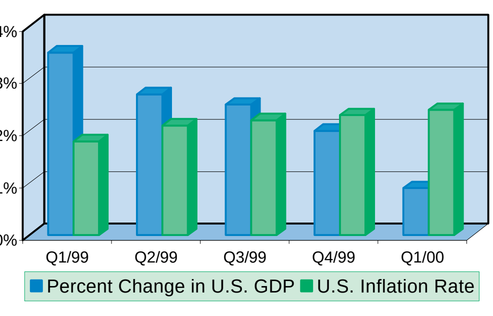


The U.S. economy continues to thrive despite recessions in many parts of the World. With purchasing power benefiting from low interest rates and a strong stock market, the latest DRI/McGraw-Hill economic forecast is for the quarterly U.S. growth rate to vary between 2.0% and 3.5% during 1999. Weak world commodity markets and competition from lower priced Asian goods will keep inflation under control as the inflation rate is forecast to remain below 3% through the first quarter of 2000.

Interest Rate Trends



Economic Outlook



Sources:

Illinois Department of Employment Security:
Hours Worked in Manufacturing, Unemployment Insurance Claims

U.S. Census Bureau:
Direct Exports, Housing Permits

U.S. Bureau of Labor Statistics:
Unemployment Rates, Consumer Price Index

U.S. Bureau of Economic Analysis:
Personal Income

Purchasing Managers Association of Chicago:
Purchasing Mangers Index

DRI/McGraw-Hill:
Economic Forecasts

Federal Reserve System:
Interest Rates

A Monthly Look At State Finance

Vital Statistics

The Heartbeat of Illinois' Finance

String of Record End-of-Month Balances Reaches 21!

Despite a $281 million or 25.4% decline in the General Funds cash balance from the end of January to the end of February, the $825 million balance at the end of February marks the twenty first consecutive month in which the General Funds balance set a record when compared to the same month in previous fiscal years. The decline in the balance was not unexpected, as spending typically outpaces revenue during the month of February due to the fact that there are fewer processing days than in a typical month.

General Funds Revenues Through Eight Months - Up 8.3%

Through eight months of fiscal year 1999, General Funds revenues totaled $13.705 billion, $1.051 billion or 8.3% higher than last year. Personal income taxes along with sales tax receipts and federal source revenues accounted for nearly two-thirds of the increase. Compared to the first eight months of fiscal year 1998, personal income taxes are up $231 million (5.6%) while sales taxes are up $167 million (4.7%) and federal revenues are up $287 million (12.6%).

Other sources contributing to the revenue increase over last fiscal year include: cigarette taxes (up $50 million or 23.0%); inheritance taxes (up $75 million or 42.6%); Gaming Fund transfers from riverboat gambling proceeds (up $60 million or 53.1%); insurance taxes and fees (up $65 million or 116.1%); and Cook County intergovernmental transfers (up $40 million or 37.4%). The increase in cigarette tax receipts is due to a tax rate increase while the growth in insurance taxes and fees and riverboat gambling taxes is due to rate restructuring.

Only three major sources of revenue to the General Funds have declined from last fiscal year. Corporate income taxes are down $1 million for the year while corporation franchise taxes and fees are down $4 million and lottery transfers are down $47 million including a $14 million decline in January and a $7 million decline in February.

For the month, individual income tax receipts of $484 million were down $24 million or 4.7% from last February due primarily to the timing of deposits. Sales taxes also declined for the month (down $1 million) and appear to be a matter of timing as well. The biggest surprise for the month was in inheritance tax receipts, which increased $42 million or 150.0% over last February due to the tax payment from a large estate in Cook County.

General Funds Spending Up 9.7% Through Eight Months

After eight months, General Funds cash expenditures totaled $14.082 billion, $1.246 billion or 9.7% higher than last year. For the year, total spending exceeds revenues by $377 million resulting in a drop in the available cash balance from $1.202 billion at the beginning of the fiscal year to $825 million at the end of February.

Compared to last fiscal year, total grant spending from the General Funds has increased $907 million or 11.2%. Awards and grants spending by the Department of Human Services is up $276 million (19.8%), accounting for 22.2% of the increase in total spending and 30.4% of the increase in total grant spending. This increase is primarily due to the fact that the Department was newly formed in fiscal year 1998 and as a result had no carryover lapse period spending from the prior year. Of the $276 million increase in grant spending by the Department, $184 million is for lapse period spending occurring in fiscal year 1999 against fiscal year 1998 appropriations.

Other increases in grant spending include the Department of Public Aid (up $207 million or 8.2%), the State Board of Education (up $116 million or 4.4%), Higher Education (up $115 million or 27.4%), and Teacher's Retirement (up $107 million or 37.3%).

Spending for operations totaled $3.938 billion through February, $360 million (10.1%) higher than comparable expenditures last year. Higher education operations are up 14.4% or $141 million, while all other operations increased $219 million (8.4%).

Overall, the General Funds financial position appears sound through the first eight months of fiscal year 1999. Balances continue running ahead of last year, and with a few exceptions, the major sources of revenue to the General Funds are performing at or above expectations. On the spending side, the General Funds currently has $323 million more of unexpended appropriations than at this time last year. All things considered, the General Funds outlook for the remainder of the fiscal year is positive.

GENERAL FUNDS TRANSACTIONS
(Dollars in Millions)

	February 1998	February 1999	Change	Eight Months FY 1998	Eight Months FY 1999	Change Amount	Change Percent
AVAILABLE CASH BALANCE, BEGINNING	$ 797	$ 1,106	$ 309	$ 806	$ 1,202	$ 396	49.1 %
Revenues:							
State Sources:							
Cash Receipts:							
Income Taxes:							
Individual	$ 508	$ 484	$ (24)	$ 4,133	$ 4,364	$ 231	5.6 %
Corporate	13	27	14	505	504	(1)	(0.2)
Total, Income Taxes	521	511	(10)	4,638	4,868	230	5.0
Sales Taxes	371	370	(1)	3,536	3,703	167	4.7
Other Sources:							
Public Utility Taxes	73	64	(9)	585	611	26	4.4
Cigarette Taxes	33	31	(2)	217	267	50	23.0
Inheritance Tax (gross)	28	70	42	176	251	75	42.6
Liquor Gallonage Taxes	4	2	(2)	39	39	0	0.0
Insurance Tax and Fees	6	4	(2)	56	121	65	116.1
Corporation Franchise Tax and Fees	8	8	0	80	76	(4)	(5.0)
Investment Income	12	14	2	121	150	29	24.0
Cook County IGT	0	0	0	107	147	40	37.4
Other	14	9	(5)	154	149	(5)	(3.2)
Total, Other Sources	178	202	24	1,535	1,811	276	18.0
Total, Cash Receipts	$ 1,070	$ 1,083	$ 13	$ 9,709	$ 10,382	$ 673	6.9 %
Transfers In:							
Lottery Fund	$ 52	$ 45	$ (7)	$ 345	$ 298	$ (47)	(13.6) %
State Gaming Fund	11	14	3	113	173	60	53.1
Protest Fund	0	0	0	4	11	7	175.0
Other Funds	31	10	(21)	211	282	71	33.6
Total, Transfers In	$ 94	$ 69	$ (25)	$ 673	$ 764	$ 91	13.5 %
Total, State Sources	$ 1,164	$ 1,152	$ (12)	$ 10,382	$ 11,146	$ 764	7.4 %
Federal Sources:							
Cash Receipts	$ 278	$ 308	$ 30	$ 2,235	$ 2,449	$ 214	9.6 %
Transfers In	0	4	4	37	110	73	197.3
Total, Federal Sources	$ 278	$ 312	$ 34	$ 2,272	$ 2,559	$ 287	12.6 %
Total, Revenues	$ 1,442	$ 1,464	$ 22	$ 12,654	$ 13,705	$ 1,051	8.3 %
Expenditures:							
Awards and Grants:							
State Board of Education	$ 275	$ 315	$ 40	$ 2,612	$ 2,728	$ 116	4.4 %
Public Aid	307	369	62	2,536	2,743	207	8.2
Human Services	171	196	25	1,395	1,671	276	19.8
Teachers Retirement	36	46	10	287	394	107	37.3
Higher Education	100	113	13	420	535	115	27.4
All Other Grants	94	108	14	851	937	86	10.1
Total, Awards and Grants	983	1,147	164	8,101	9,008	907	11.2
Operations:							
Other Agencies	317	357	40	2,596	2,815	219	8.4
Higher Education	129	142	13	982	1,123	141	14.4
Total, Operations	446	499	53	3,578	3,938	360	10.1
Transfers Out	162	159	(3)	1,166	1,170	4	0.3
All Other (Includes Prior Adjustments)	0	1	1	19	20	1	5.3
Total, Expenditures	$ 1,591	$ 1,806	$ 215	$ 12,864	$ 14,136	$ 1,272	9.9 %
Adjustment for Vouchers Payable	24	(61)	(85)	(28)	(54)	(26)	N/A
Total, Cash Expenditures	1,615	1,745	130	12,836	14,082	1,246	9.7
AVAILABLE CASH BALANCE, ENDING	$ 624	$ 825	$ 201	$ 624	$ 825	$ 201	32.2 %

Fiscal Smarts Cont...

The Illinois tax incentive program is largely a product of the 1980's when over three-quarter (36) became effective. The severe recession of the early 1980's made policy makers desperate to find ways to attract new business to the state. The result was the emergence of tax incentives as a tool to rejuvenate the state's economy.

Although the Illinois economy is markedly different from the early 1980's and has long since recovered from the recession, the portfolio of tax incentives developed during the 1980's remains largely unchanged. Illinois business incentives continue to place a major emphasis on reducing the cost of business investment in machinery and equipment with much smaller portions reducing the costs of research and hiring new employees.

In its entirety, the 1998 Tax Expenditure Report is located on our web site.

Focus On Revenues Cont...

In the new law, definitions were established to include emerging technologies. Telecommunications was defined in such a way as to capture a broad array of both messages and information transmitted over a wide variety of mediums. Methods of communication subject to the tax include any form of mobile or stationary communication such as computer exchange services, cellular services and paging services. Mediums include wire, cable, fiber optics, laser, microwave, radio, satellite or similar facilities.

It has been the explosive growth in the use of telecommunications and the change in the law that lead to the dramatic increase in telecommunication tax revenue. After remaining stagnant for several years, telecommunication tax collections jumped $83 million or 76.9% in fiscal year 1986 following the 1985 changes. Since fiscal year 1985, telecommunications tax revenues have experienced an average annual growth of nearly 12%.
When the education reform legislation was passed, estimates of the revenue generated by the increase in the telecommunications tax rate for fiscal year 1999 were $172 million. Currently, it appears that revenues will surpass this estimate. Continued growth in telecommunications means that the telecommunications tax should provide a small but growing revenue stream for education for the next few years.

Contact us at our web address: http://www.comptroller.state.il.us

Fiscal Focus

Daniel W. Hynes

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