



Analysis of the House-Senate Budget Agreement

On February 21, the House and Senate passed an agreement that addressed Minnesota's 2002-03 budget deficit and made a dent in the deficit in 2004-05. The House-Senate plan is a good start toward solving the deficit without putting undue burden on those who are hurt most by the recession. Unfortunately, the just-released February Forecast shows that the deficit has grown to \$2.289 billion for 2002-03 and \$3.214 billion for 2004-05, which means additional work will be needed to balance the budget. The components of the House-Senate Budget Agreement are outlined in the table, and described in more detail and measured against our principles for fiscal decisions below.

General Fund Changes (\$ in millions)	FY 2002-03	FY 2004-05
One-Time Resources	1,464	0
Budget Reserve	653	
Cash Flow account	195	
Tax Relief Account	158	
Local Government Aid (LGA) reform account	14	
Assigned Risk Plan	95	
Workers Compensation Special Fund	230	
Tobacco Endowments	*	*
Delay Repeal of June Accelerated Sales Tax**	119	
One-Time Spending Reductions	131	0
TIF Grants cancellation	91	
St. Paul Busway	40	
Permanent Spending Reductions	374	721
K-12 Education	15	30
Family & Early Childhood	4	8
Higher Education	50	100
Human Services	96	192
Environment	14	27
Agriculture	3	5
Transportation	4	8
Judiciary/Corrections	26	53
Economic Development	7	14
State Government	42	58
TIF Grants (ongoing)	38	76
Hiring Freeze	40	80
Professional and Technical Contracts Moratorium	35	70
Additional Spending Reductions		1,127
Inflation not considered in forecast		1,127
Revenue Increases	0	0
TOTAL:	1,969	1,848
Balance vs. November Forecast	+16	-684
Balance vs. February Forecast	-439	-1,366

* Used for cash flow.

** This provision is incorporated into February Forecast.

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Plan Summary

Policy-makers have three budget-balancing tools available — using reserves, reducing spending, and raising revenues. The use of reserves and other one-time resources makes up the largest portion of the solution for 2002-03, with the remainder coming from one-time and permanent spending reductions. For 2004-05, a full solution has not been described (nor is one required by law), but the plan does outline \$1.8 billion in spending cuts achieved through specific reductions and by not allowing for any discretionary inflation growth. Revenue raising is not part of the plan for either biennium.

Reserves and Transfers from Other Funds

The largest component of the budget-balancing plan for 2002-03 is use of reserves and transfers from other funds. The House-Senate Agreement would use the following amounts from the state's reserve accounts:

- The entire \$653 million **Budget Reserve**, or “rainy day account,” which has been set aside to deal with budgetary shortfalls.
- \$195 million of the \$350 million **Cash Flow Account**, which normally is used to address short-term cash flow problems during the year.
- All of the **Tax Relief Account**, which contains \$158 million left from the 2000-01 biennium, and the \$14 million **LGA (Local Government Aid) Reform Account**, which was established by the 2001 omnibus tax bill for use in future reform to the LGA formula.

The state has approximately \$1.3 billion in funds from its tobacco settlement put aside in several **Tobacco Endowments**. Currently, the interest earned on these endowments is used to fund various purposes, including medical education and tobacco use prevention. The House-Senate budget plan would allow for access to the state's tobacco endowments for cash flow purposes.

The House-Senate plan taps a number of other one-time revenue sources, such as the **Assigned Risk Plan** and **Workers' Compensation Special Fund**. The Assigned Risk Plan provides workers' compensation coverage to employers who are unable to purchase coverage in the private insurance market. At the end of 1999, there was a \$553 million surplus in this fund, primarily due to returns on investments. In the 2000 session, \$450 million was transferred out of the Assigned Risk Plan and into the following funds: \$325 million to the Workers Compensation Special Fund to settle long-term claims, \$110 million to the state's General Fund, and \$15 million to the Minnesota Compensation Health Association (MCHA).¹ This agreement would use \$95 million from the Assigned Risk Plan² and \$230 million from the Workers Compensation Special Fund to address the 2002-03 general fund deficit.

The House-Senate Agreement repeals a portion of the 2001 tax bill that has not yet been implemented, called the **June Accelerated Sales Tax Payment**. Currently, merchants must remit a portion of their estimated sales tax collections for June in advance, which moves some sales tax revenues into the prior fiscal year. In the 2001 session, legislators decided that this provision should be repealed in June 2003. The House-Senate Agreement would delay the repeal until June 2004, which would keep \$119 million in the 2002-03 biennium instead of shifting it into 2004-05. This does not raise new money, but rather changes the timing of when it is collected by the state.³

¹ House Fiscal Analysis, *Assigned Risk Plan Surplus Grows by \$73 million*, October 2000.

² An additional \$25 million will be used to cover the settlement of a lawsuit relating to this account.

³ Although the intent of the 2001 law was to repeal the June Accelerated Sales Tax in June 2003, due to an error in the bill, the law is now being interpreted so that the repeal takes place in June 2004. Therefore, this component of the House-Senate Plan is already incorporated into the February Forecast.

Expenditure Cuts

The House-Senate Agreement has permanent spending cuts of \$374 million in 2002-03, which comes in about the middle of the \$559 million in cuts previously outlined by the House and the \$225 million from the Senate. The House-Senate agreement also often comes down in the middle in individual spending areas where the House and Senate targets differ.

In each issue area, the reduction target can include both expenditure cuts and shifts of special revenues into the general fund. For example, the Agriculture target of \$2.7 million is reached by making \$1.7 million in expenditure reductions and by transferring \$1 million in special revenues relating to agriculture into the general fund. In some cases, transferring special revenues simply draws down an account balance that would not otherwise be used into the general fund. In others, it means that fewer funds are available for the specified purpose of the account.

The table below measures the reduction targets in each spending area as a percentage of that area's general fund expenditures under current law. In general, the percentage cut for 2004-05 is roughly twice that as for 2002-03, since the cuts for 2002-03 mainly occur in 2003 only, whereas cuts occur in both years of the 2004-05 biennium.

	Reduction as a Percentage of General Fund expenditures	
	2002-03	2004-05
Education Finance	-0.1%	-0.2%
Family & Early Childhood Education	-0.8%	-1.6%
Higher Education	-1.8%	-3.4%
Health & Human Services/Corrections	-1.5%	-2.7%
Environment & Agriculture	-3.1%	-6.0%
Economic Development	-1.8%	-3.8%
Transportation & Public Safety	-1.4%	-3.8%
State Government	-5.7%	-8.7%

This table includes reduction targets only; it does not include the impact of the hiring freeze, contracts moratorium, or elimination of inflationary growth.

Reductions in state aids to local government under this plan come by eliminating \$91 million in one-time funding and \$38 million in ongoing funds for TIF grants. The TIF grant program was created as part of last year's tax bill to help local governments who may encounter problems with their Tax Increment Financing (TIF) districts due to tax reform. There are no cuts to the general aid formulas.

While the majority of cuts in 2002-03 are specified in the targets for each issue area, an additional \$75 million reduction will come through a hiring freeze and a reduction in contract expenditures. The \$35 million saved through professional and technical service contracts would be achieved through reducing contracts and from a moratorium on entering into new contracts before July 1, 2003.⁴ The hiring freeze means that no employees can be hired on a permanent or temporary basis by executive or legislative branch employers before July 1, 2003.⁵ If the hiring freeze does not achieve \$40 million in savings during the 2002-03 biennium, the Governor must make proportional reductions in executive agency operating budgets in order to reach \$40 million. These reductions are *in addition to* the targeted cuts outlined in the various spending areas. Only time will tell where the impact of these provisions will be felt.

⁴ Exceptions are made for contracts relating to public health, welfare, or safety, and agencies may apply for a waiver.

⁵ An exception is made for MnSCU, and does not apply to work-study positions or positions that perform essential services.

The size of the expenditure cuts under this plan jumps from \$374 million in 2002-03 to \$1.858 billion in 2004-05. Of the spending reductions in 2004-05, \$721 million is the result of the specified reductions, hiring freeze, and contracts moratorium. It also eliminates \$1.127 billion of discretionary inflation in 2004-05, which represents 2.5% inflation each year of the biennium. Under current law, the Forecast provides an estimated inflation figure for the next biennium to approximate the pressure needed to keep up with inflation. The estimated inflation amount is not automatically spent on inflation adjustments in each spending area, but rather is only expended when appropriated by the legislature for a specific purpose. Since the legislature cannot pass an unbalanced budget, the inflationary increase cannot be included in the 2004-05 budget without having sufficient revenues to pay for it. On the other hand, this means that after program and state agency budgets are reduced through the specified cuts, the hiring freeze, and moratorium, their budgets will be further eroded by failure to keep up with inflation.

While the House and Senate may want to agree that there will be no inflationary increases in 2004-05, it is unfortunate that they chose to do so by changing Forecast methodology. The Forecast only describes the economic and budgetary conditions that should guide budget decisions; it is not the budget itself. The state will face inflationary pressures whether or not those pressures are specified in the Forecast document. Both policy-makers and the public benefit when the Forecast provides complete and accurate information. The Forecast will be a less useful tool to guide budget decisions if the inflationary calculation is removed.

The total spending reductions in any issue area for 2004-05 under this plan will be the specified reduction target, *plus* that area's share of cuts through the hiring freeze and contracts moratorium, *plus* lost inflationary adjustments.

How Does This Plan Measure Up?

We have argued that tough choices are needed to address the state's budget deficit, but they can be smart choices. The House-Senate plan is a good start toward solving the deficit without putting undue burden on those who are hurt most by the recession. For 2002-03, the plan largely avoids making dramatic cuts in programs serving low-income and other vulnerable populations. For 2004-05, the plan is less positive. As it currently stands, the plan makes \$1.8 billion in cuts in 2004-05. It is unclear what kind of cuts to programs for low-income and other vulnerable populations will be needed to reach this level of savings. As they make additional decisions to respond to the larger deficit described in the February Forecast, policy-makers should recognize the importance of revenue raising to address the deficit and to help rebuild the reserves when the economy improves.

The state's budget-balancing decisions should not make the recession worse for those Minnesotans least able to weather the downturn, including low-income families, laid-off workers, and other vulnerable populations.

Compared to other budget-balancing plans that relied more heavily on expenditure cuts, the House-Senate agreement mainly avoids serious reductions in programs helping low-income families, laid-off workers, and other vulnerable populations. The expenditure reductions for 2002-03 also appear to meet our guidelines for being made thoughtfully and taking the state's needs into account, with counter-cyclical programs being allowed to play their needed role during a downturn. The plan even makes needed investments in the Dislocated Worker Fund.

The House-Senate budget agreement strives to cut the budget through reductions in state government and administration and less through program cuts. However, it should also be

recognized that this plan will lead to lay-offs of state workers. It is unclear how the reductions in state agencies may impact the provision of services.

It is less certain what the impact of cuts will be in 2004-05. Of the \$1.8 billion of cuts, only \$571 million is specified at this point, with the remainder resulting from the hiring freeze, contract moratorium, and lack of inflation increases. We cannot say at this point whether the goals of not harming low-income and other vulnerable populations will be achieved in the next biennium. Those decisions will ultimately be made by the 2003 legislature when they pass the 2004-05 budget.

The state should use a combination of the three primary budget-balancing tools available: raising revenue, using reserves, and cutting spending.

Only two of the three tools available are used in this plan in 2002-03: use of reserves and reductions in spending. For 2004-05, only spending reductions are used. The revenue side is not currently part of the solution, unless one considers the one-time shift provided by the delay of the June Accelerated Sales Tax repeal.

The long-term budget deficit is too large to solve through spending cuts alone, and few reserves remain in 2004-05. Revenue raising should be part of the response to the February 2002 forecast, and has a crucial role to play in rebuilding the reserves.

Budget-balancing should be informed by past budget decisions, including how surpluses were divided between tax cuts and new spending, who benefited from recent tax cuts, and how certain programs were underfunded even in times of surplus.

In the past five legislative sessions, over \$13 billion in surpluses were allocated. The majority (53%) went for rebates and permanent tax reductions. Given that tax cuts were such a large part of the budget agreements in times of surplus, it is strange that tax increases are not part of the agreement to address the deficit.⁶

On the positive side, those spending areas that were unable even to keep up with inflation in the 2002-03 budget as originally passed — Family & Early Childhood Education and Economic Development — were not singled out for large cuts under the House-Senate Agreement.

Next Steps

The Legislature still has work to do to balance the 2002-03 budget. The additional \$336 million deficit in the February Forecast and the fact that the June Accelerated portion of the budget plan has already been taken into account means that legislators have a \$439 million hole to fill in bringing the 2002-03 budget into balance. The House-Senate Budget Agreement makes a good start, but legislators should be mindful as they move forward to ensure that expenditure cuts do not make things worse for those hurt most by the recession. They should look to progressive revenue raising — such as a temporary income tax surcharge — so that their complete budget solution uses all three of the tools available.⁷ In addition, after using so much of the reserves to address the 2002-03 deficit, a plan must be developed to rebuild these reserves when economic conditions improve.

⁶ Children's Defense Fund-Minnesota and Minnesota Budget Project, *Wasted Opportunities: How We Used Our Surpluses 1997-2001*.

⁷ See Minnesota Budget Project, *Options to Address Minnesota's Budget Deficit*.