

At the end of the 2002 Legislative Session in May, lawmakers had passed a budget plan that appeared to balance the budget for the 2002-03 biennium but left a \$1.65 billion shortfall for the 2004-05 biennium.¹ However, the November 2002 Forecast shows that the state's budget outlook has become considerably worse since the end of the Legislative Session.

The Minnesota Department of Finance prepares Economic Forecasts twice a year, in November and February. For the current biennium (2002-03), the November Forecast shows a deficit of \$356 million. This means that based on current law and economic projections, by June 30, 2003, revenues are expected to be \$356 million less than spending. The 2002-03 deficit represents about 2.5% of total FY 2003 general fund spending.

For the 2004-05 biennium, the Forecast shows an additional \$4.204 billion deficit, based on current law, economic projections, and adjustments for caseload and enrollment changes. The deficit represents approximately 14% of the state's total general fund budget for 2004-05. Unlike past forecasts, estimated spending is not adjusted for the impact of inflation. If inflation were included, the deficit would be \$1.1 billion larger, or \$5.3 billion.²

Forecast Describes Both Declines in Revenues and Increases in Spending

Revenues continue to be less than expected at the end of the 2002 Legislative Session (hereafter called *end-of-session estimates*³), largely due to shortfalls resulting from the weak stock market and the fact that the economy has not bounced back as quickly as expected. At the same time, total spending is higher than end-of-session estimates, although the growth in spending is much smaller than the drop in revenues. The combination of lower revenues and higher spending results in deficits in both the current and upcoming biennia.

For the 2002-03 biennium, revenues have dropped 2.2% below end-of-session estimates (see Table 1). The largest percentage declines are in the individual income tax, which is 6.5% lower than end-of-session estimates, and the corporate income tax, which is down 7.5%. The large drop in income taxes is largely due to significantly lower returns on non-wage income. For example, capital gains realizations fell by 55% for tax year 2001 and are expected to drop another 16% for tax year 2002.

	Revenues & Transfers		Spending	
	Change in \$	Percent Change	Change in \$	Percent Change
2002-03	-\$574 million	-2.2%	\$76 million	0.3%
2004-05	-\$1.63 billion	-5.7%	\$926 million	3.1%

¹ Minnesota uses a two-year budget cycle called a biennium that covers two fiscal years. A fiscal year is from July 1 to June 30. For example, the 2003 fiscal year, abbreviated FY 2003 or FY 03, runs from July 1, 2002, to June 30, 2003.

² See Minnesota House of Representatives Research Department, *Planning Estimate Inflation in State Budget Forecasts*, www.house.leg.state.mn.us/fiscal/files/ibinflate.pdf.

³ End-of-session estimates are prepared by Minnesota Department of Finance and legislative fiscal staff based on the February 2002 Forecast but updated for decisions made by the 2002 Legislature.

Projected spending for 2002-03 is 0.3% above end-of-session estimates. The majority of the growth is in the area of Health Care, reflecting higher than expected health care costs and increased caseloads in publicly-funded programs.⁴

A similar pattern is shown for the 2004-05 biennium. As shown in Table 1, revenues have dropped 5.7% below end-of-session estimates, while total spending has grown 3.1%. Again, the decline in revenues is largely due to reductions in individual income taxes, which are down 9.9% from end-of-session estimates, although declines are also expected in the sales tax, corporate income tax, motor vehicle sales tax, and the statewide property tax.

The largest percentage increase in 2004-05 is in Health Care. Health Care is up 10.1% from end-of-session estimates, while overall spending is 3.1% higher. In all areas, spending has only been adjusted for enrollment, caseload, and inflationary increases as allowed in current law. Estimated spending does not reflect the impact of inflation on personnel costs or government purchases.

These changes mean that the state will have a smaller Budget Reserve. The Forecast projects a \$24 million balance in the state's Budget Reserve at the end of the 2002-03 biennium, down from \$318 million in end-of-session estimates. For 2004-05, an additional \$79 million will be added to the Budget Reserve. The Budget Reserve is not automatically applied towards the deficit, but it is available to policymakers for that purpose.

Deficit Exists Despite Expected Economic Recovery

The effects of the 2001 recession are still being felt, and Minnesota was hit harder than the nation as a whole. In October 2002, employment in Minnesota was down 2.0% from its peak in February 2001, while nationally employment was down 1.2%.

	February 2002 Forecast	November 2002 Forecast
2002	1.0%	2.3%
2003	4.0%	2.6%
2004	3.9%	4.1%
2005	3.2%	3.8%

However, the Forecast is based on an economic model that expects strong growth through 2007, although growth in 2003 is less than predicted in the previous forecast (see Table 2). The growth rates in the Forecast are not as high as seen in the late 1990s, but are above those of the late 1980s and mid-1990s. In other words, the projected deficits already assume substantial economic growth. The economy would have to grow even faster than predicted in order for the Forecast scenario to improve.

Forecast May Be Too Optimistic

There are several areas of risk that may cause actual economic growth to be less than projected by the Forecast. The state's national economic consultants, Global Insight, assign a 55% probability that the scenario used to prepare the Forecast is correct, and a 30% probability for a

⁴ It is important to distinguish between **Health Care** and **Health and Human Services** as they are defined by the Forecast. **Health Care** is "state payments for direct health care services, such as hospital and physician visits, nursing home services, home care, and other medical and long-term care services" and includes the Medical Assistance program for the frail elderly, disabled, and low-income families, and General Assistance Medical Care. **Health and Human Services** includes cash welfare and food stamps (MFIP), child care assistance, prescription drug benefits, assisted living supports, child welfare grants to counties, adoption grants, operating funds for state residential treatment centers, operating funds for Veterans Nursing Homes, and public health grants to cities and counties. This area of the budget is growing more slowly than Health Care.

more pessimistic scenario including a “double dip” recession. The chance for a slightly more optimistic scenario is set at 15%.

One significant unknown element is the U.S.’s relations with Iraq. Global Insight has followed the practice of most forecasters and has not incorporated hostilities in Iraq in their forecast scenario. However, the state’s Council of Economic Advisors and the Minnesota Department of Finance note that an outbreak of hostilities would “almost certainly” mean lower economic growth and an additional shortfall in revenues.

Given the significant level of risk in the Forecast, the Council of Economic Advisors warns against assuming that future forecasts will show better results, and advise that creating a plan to rebuild the state’s Budget Reserve should be part of the budget solution.

How is State Spending Growing?

The Forecast uses two different methods of comparison to describe the projected 2004-05 budget. The first method compares November 2002 Forecast projections to estimates prepared at the end of the 2002 Legislative Session. The November Forecast shows a 3.1% increase in spending and a 5.7% drop in revenues in 2004-05 compared to end-of-session estimates. These changes reflect new information about the economy and its impact on enrollment, caseloads, and other formula or program changes currently in law.

The second method compares the 2004-05 projected budget to the current budget for 2002-03. Measured this way, the Forecast shows a 14.3% increase in spending in 2004-05 and a 6.6% increase in revenues. Growth in spending slows considerably in the next biennium, once policy changes contributing to distortions in 2004-05 are fully implemented. FY 2006-07 spending is projected to be only 4.1% more than 2004-05, or just over 2% growth each year of the biennium (not including inflation).

Decisions made in the 2001 and 2002 Legislative Sessions make it difficult to compare total spending in the 2004-05 biennium to the 2002-03 biennium. The two most significant “accounting issues” come in the area of Education Finance, the largest part of the state’s general fund budget. They are:

- **Property tax and education finance reform.** In the 2001 Legislative Session, the state took over a significant portion of general education funding, which had previously been funded by local property taxes. \$1 billion of the increase in spending from 2002-03 to 2004-05 comes from the impact of this change.
- **Education aid payment shifts.** The 2002 Legislature chose to shift a portion of education aid payments from one fiscal year to the next as part of its budget solution. This means that education spending for the 2004-05 biennium is being compared to a 2002-03 figure in which FY 2003 spending is \$454 million lower than it otherwise would be.

Although they contribute to an apparent increase in Education Finance from 2002-03 to 2004-05, these two items do not represent new funding for schools, but instead are a shift in funding responsibility and a timing change. Removing the impact of these two items changes the growth in Education Finance from an apparent 19.8% to 6.3%. Overall expenditure growth drops from 14.3% to 9%, or about 4.5% growth in each year of the 2004-05 biennium.

State aids to units of government besides school districts also are affected by property tax reform. Intergovernmental aids are projected to increase 12.0% over 2002-03 levels. However, 80% of the growth is related to the 2001 property tax reform. In 2006-07, once property tax

reform is fully implemented, intergovernmental aids are projected to be 3.3% above 2004-05 levels.

In areas where there is real growth in spending, it is important to determine what factors are leading to growth. Much attention has been focused on Health Care, which is expected to grow by 23% in 2004-05 and 16% in 2006-07. The Forecast notes several factors that contribute to projected growth in Health Care spending, including:

- Medical cost inflation
- Increased and higher cost caseloads
- Increased use of services among participants
- Availability of high cost medical technology

Increases are both a result of more persons meeting eligibility requirements and medical costs growing faster than inflation. Overall, Health Care spending is projected to grow 10% annually between FY 2002 and FY 2007, with 4% projected annual growth in enrollments and 6% growth in cost per enrollee. Increases in Health Care costs are not limited to publicly funded programs. In 2002, private health insurance premiums increased an average of 12.7%.⁵

The majority of spending areas show little growth from 2002-03 to 2004-05. For example, Higher Education is projected to grow 3.7% over 2002-03 levels. About half of the growth reflects the ongoing impact of budget increases to the University of Minnesota and Minnesota State Colleges and Universities (MnSCU) between FY 2002 and FY 2003, the other half is due to growing enrollment. Some areas of spending will even be smaller than in the previous biennium, such as Economic and Workforce Development, which is projected to fall 10.3% below 2002-03 levels due to one-time spending not being continued in 2004-05.

Policymakers Must Act to Balance the Budget

The Forecast is an economic tool and does not reflect any policy proposals by the Governor or Legislature. Instead, the Forecast sets out the economic and budgetary context for decisions to be made in the 2003 Legislative Session.

Minnesota's constitution requires a balanced budget, so policymakers must adjust the state's budget for the current 2002-03 budget cycle. They also need to act quickly, since the 2003 fiscal year ends on June 30.

On January 14, Governor Pawlenty released his plan to address the 2002-03 budget deficit. It includes \$297 million in one-time savings made through financing certain construction projects with bonding rather than cash, spending down various fund balances, and delaying payments. An additional \$171 million in savings is made through permanent budget reductions. These include a \$50 million reduction in Higher Education, \$44 million in cuts to state agency operating budgets, and \$77 million in cuts to specific state agency grants and programs.

While the Legislature is working to make adjustments to the Governor's proposal and pass a budget-balancing plan, if the Legislature is unable to come to a budget-balancing agreement in a relatively short period of time, the Governor has authority to *unallot*,⁶ or reduce spending, to bring the 2002-03 budget into balance. The Governor can only unallot money out of funds with a deficit, so he has fewer choices available to him in the unallotment process than in the

⁵ Center on Budget and Policy Priorities, *Why Are States' Medicaid Expenditures Rising?*, www.cbpp.org/1-13-03health.htm.

⁶ See Minnesota House of Representatives Research Department, *Unallotment*, www.house.leg.state.mn.us/hrd/pubs/unallot.pdf.

Legislative process. For this reason, if the Governor must unallot, he will have to implement a different set of choices than those he outlined in the budget-balancing plan he proposed to the Legislature.

The larger task for policymakers will be to pass the 2004-05 budget. The Governor will release his proposed budget proposal on February 18, which will need to address the \$4.2 billion 2004-05 deficit. Policymakers will also be provided with updated budget figures when the new Economic Forecast is released at the end of February. The Legislature will then work throughout the spring to pass the appropriations bills that will enact the 2004-05 budget. With a deficit of such size, tough choices are ahead. However, by using responsible fiscal decision-making, looking at the full range of options available, and considering the impact of their decisions on vulnerable Minnesotans, policy-makers can make budget-balancing decisions that put the state on the right track while not placing disproportionate burden on those who are hurting most from the economic downturn.

*Except where noted, all data in this document are from the Minnesota Department of Finance's **November 2002 Economic Forecast**, which is available at www.finance.state.mn.us/ffeu*