

# Options to Address Minnesota's Budget Deficit

According to the November Forecast, Minnesota faces a deficit of \$1.953 billion for the 2002-03 biennium and a structural deficit of \$1.234 billion in Fiscal Year 2005.<sup>1</sup> The state of Minnesota is required to have a balanced budget, and policy-makers must make adjustments to bring the 2002-03 budget back into balance.

Tough choices are ahead, but they can be smart choices. This document includes information on the state's budget reserves, outlines several revenue raising options, and provides a framework for thinking about expenditures at the state and local levels. This information can be used to inform and evaluate budget balancing proposals.

The policy options outlined below are guided by the following principles:

- 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.
- The state should use a combination of the three primary budget balancing tools available: raising revenue, using reserves, and cutting spending.
- 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.
- Federal stimulus plans will impact the state's efforts to balance the budget. The state should work with federal decision-makers to promote revenue sharing, and to oppose federal tax cuts that make it more difficult for the state to balance its budget.

## **The State's Budget Reserves**

One-time use of the state's reserves is an appropriate response to the budget shortfall in the short term. The state has several reserve accounts, but not all of them are immediately available to address the deficit. The reserves fall into two categories: undedicated reserves are available for general purposes, and dedicated reserves have been set aside for specific types of spending.

The two largest reserves are undedicated:

- The **Budget Reserve**, or "rainy day account," has been set aside to deal with budgetary shortfalls. The Budget Reserve contains \$653 million; it is projected to grow to \$684 million in 2004-05. It is appropriate to use a portion of the Budget Reserve to address the state's budget deficit.
- The **Cash Flow Account** of \$350 million can be thought of as a "minimum balance" in the state's checking account. It should not be spent down to address the deficit, except to the extent needed to address short-term cash flow problems.

Two dedicated reserves are potentially available to address the deficit. Given the state's budgetary situation, it is appropriate to consider use of these funds for budget balancing.

- \$158 million left from the 2000-01 biennium is set aside in a **Tax Relief Account**.

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<sup>1</sup> Minnesota Department of Finance, *November 2001 Forecast*.

- The 2001 omnibus tax bill set aside \$14 million in the **LGA (Local Government Aid Reform Account)** for use in future reform to the LGA formula. This account grows over time, and if unused, will reach \$84 million in 2004-05.

While the reserves can help address some of the short-term deficit, it is unfortunate that they were not given more attention during economic good times. The state’s Council of Economic Advisors has consistently warned that the Budget Reserve has been only about half of their recommended goal of 5% of biennial spending.<sup>2</sup> This 5% figure describes the amount considered adequate to cushion the blow in the event of a recession. The amount Minnesota would need to maintain existing service levels during a recession without raising taxes is significantly higher.<sup>3</sup>

Just as the Tax Relief Account is not immediately available to address the deficit, future surpluses may also be constrained by provisions that dedicate surpluses to tax relief and rebates. Once the recession is over, policy-makers may want greater flexibility than currently exists to decide whether surpluses should be used to increase reserves or for needed investments that were delayed in economic hard times. Decision-makers should consider repealing the rebate “trigger” and the provision that any positive unrestricted general fund balance at the end of a biennium be dedicated to the Tax Relief Account.<sup>4</sup>

### **Revenue Increases**

One of the principles for budget balancing articulated above is that the state should use a combination of the three primary budget balancing tools available: raising revenue, using reserves, and cutting spending. However, some have argued that tax increases are the “last thing” that should be done in a recession. There is no economic basis for this statement. As argued by Peter Orszag of the Brookings Institution and Joseph Stiglitz, recipient of the 2001 Nobel Prize in Economics, both spending cuts and tax increases take money out of the state economy. In a recession, the focus should be on consumption. While each \$1 cut in government spending immediately removes \$1 from the state economy, a \$1 tax increase is likely to be offset by a partial reduction of savings — for example, consumption may fall by 90 cents and savings will be reduced by 10 cents. Therefore, a tax increase may be less of a drag on the economy than would be an expenditure cut of the same size.<sup>5</sup>

A number of options for increasing state revenues are described below, along with their fiscal impact and the consequences for tax fairness. These options include:

- Freezing 2001 tax changes
- Enacting an income tax surcharge
- Closing corporate loopholes
- Expanding the sales tax
- Increasing excise taxes
- Federal revenue sharing

While we strongly endorse the principles that increased revenues must be part of any budget balancing plan and that increasing revenue should not lead to greater regressivity, the intent of this section is to present a range of revenue raising options, rather than endorse any particular

<sup>2</sup> For example, see *February 2000 Forecast*, p. 13.

<sup>3</sup> See Center on Budget and Priorities, *When It Rains It Pours* and *When It Rains It Pours – One Year Later*.

<sup>4</sup> These statutory provisions are described in the *February 2001 Forecast*, p. 55. Under current law, when the November Forecast of an even-numbered year or February Forecast in an odd-numbered year shows a positive unrestricted general fund balance for the close of the biennium that exceeds 0.5% of total general fund biennial revenues, the Commissioner of Finance designates the entire balance as available for rebate. It is not required that the surplus be rebated, but policy-makers must decide whether or not to do so.

<sup>5</sup> Center on Budget and Policy Priorities, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?*

proposal or provide an exhaustive list of all possibilities. Policy-makers will need to determine the amount of revenue to be raised and the best options for doing so.

### ***Freezing 2001 Tax Changes***

Since the deficit is largely due to lower revenues than expected at the end of the 2001 legislative session, it is reasonable to ask whether tax changes made in the 2001 session could be frozen or reversed in order to address the deficit. The 2001 reforms replaced a portion of local property taxes with state aids for schools. The cost to the state was largely in an increase of the state's share of spending for education.

The only significant part of the 2001 tax bill that has not yet been implemented is the elimination of the June Accelerated Sales Tax Payment, which is scheduled to be repealed on June 2003. Currently, merchants must remit a portion of their estimated sales tax collections for June in advance, which moves some of the sales tax revenues into the prior fiscal year. Delaying the repeal from June 2003 to June 2006, for example, would provide \$119 million in one-time revenue in FY 2003, and \$20 million in the 2004-05 biennium.<sup>6</sup> This strategy is more appropriately described as a shift, rather than a way to raise new revenue.

Policy-makers may also wish to consider whether a reversal of property tax cuts made in 2001 or income tax reductions made in previous sessions is a better approach than making changes to the existing tax system.

### ***Enacting an Individual Income Tax Surcharge***

Most of the state's taxes are regressive, meaning they take a larger percentage of income from lower-income Minnesotans than from those with higher incomes. In contrast, the state's income tax is a progressive tax that takes a higher percentage of income from those with a greater ability to pay.

Income tax surcharges were used as a response to the state's deficits in the early 1980s. An income tax surcharge can raise revenue in a progressive way and without much complexity. When a surcharge is in place, taxpayers calculate their income taxes following the existing tax laws, but then add an additional surcharge amount, such as 5% of taxes owed. A surcharge is a flexible tool, as the amount of surcharge can be chosen depending on the amount of revenue needed — for example, a 5% surcharge would raise approximately \$300 million in FY 2003.<sup>7</sup>

### ***Closing Corporate Tax Loopholes***

Given the budget situation, the state should close corporate loopholes. In particular, the state should consider provisions that address the problem of multi-state corporations having a portion of their income untaxed. A good step in this direction would be a throwback rule, which for purposes of the corporate franchise tax, treats sales made in a state in which a corporation is not taxable as if they were made to customers in the state from which it was shipped. This provision would raise roughly \$28 million in FY 2003.<sup>8</sup> The state should also reconsider existing tax provisions that provide special treatment for particular industries.

Policy-makers could consider a corporate tax surcharge in conjunction with an individual income tax surcharge. A 5% corporate tax surcharge would raise approximately \$30 million in FY 2003.<sup>9</sup>

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<sup>6</sup> Minnesota Department of Revenue estimate.

<sup>7</sup> Author's calculation based on the *November 2001 Forecast*.

<sup>8</sup> Minnesota Department of Revenue, *Tax Expenditure Budget 2000-2003*.

<sup>9</sup> Author's calculation based on the *November 2001 Forecast*.

## ***Expanding the Sales Tax***

There has been some discussion of expanding the sales tax base, and there are many ways this could be done. The sales tax is a regressive tax, so attention should be paid to the impact on tax fairness. Generally, it is believed that extending the sales tax to services reduces the regressivity of the sales tax, but it would depend on the particular package of services. In addition, making the sales tax a larger portion of total taxes paid could make the overall tax system more regressive.

Three options for base broadening are described below. The fiscal impacts listed provide an approximate amount of revenue to be raised in FY 2003.<sup>10</sup>

- Option 1: Eliminate exemption on clothing: \$444 million
- Option 2: Eliminate exemptions on many products and services (not including clothing) purchased by consumers and businesses: \$1.27 billion
- Option 3: Eliminate exemptions on products and services purchased by mainly by consumers: \$413 million

The three options above illustrate the range of revenue that could be raised through base expansions. These options would have a different impact on tax fairness. The *Tax Expenditure Budget* suggests that under Option 1, the sales tax itself would become less regressive, as those with higher incomes spend a higher percentage of their incomes on clothing.

Option 2 takes a different approach, and rather than eliminate one exemption, would tax a wide range of goods and services that are purchased both by consumers and businesses. Items that would become taxable include publications, beauty and barber services, advertising, computer and data processing, legal services, accounting, and vehicle repair.<sup>11</sup> Exemptions would remain on essentials including food, drugs and medicines, baby items, and funeral services. This option does not include removing the exemption on clothing.

The argument has been made that the sales tax should only be paid on final consumption, and that sales taxes on business inputs are just passed on as a higher final price for a product. Option 3 takes this argument into account, and removes from Option 2 services purchased mainly by businesses.

## ***Increasing Excise Taxes***

Excise taxes — such as those on alcohol, cigarettes, and motor fuels — do not keep up with inflation, because they are usually a flat amount rather than a percentage of the retail price. In light of the state's budget situation, it may be time to take another look at excise taxes. The alcohol excise tax was last increased in 1987, the gas tax in 1988, and tobacco taxes in 1992.

Adjusting the cigarette tax for inflation would raise it by 16¢ per pack, for a total of 64¢ per pack. Raising the cigarette tax to 77¢ per pack, as in Wisconsin, and raising related tobacco taxes by a similar amount, would raise \$98 million in FY 2003.<sup>12</sup>

Updating the gas tax for inflation would mean an increase of 12¢ per gallon, for a total of 32¢ per gallon. Recent proposals have suggested an increase of 5¢ per gallon, which would raise \$160 million in FY 2003, and then index the gas tax for inflation, which would raise an additional \$16

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<sup>10</sup> *Tax Expenditure Budget 2000-2003*.

<sup>11</sup> A more detailed list of items that would be taxed under Options 2 and 3 is provided in Appendix 1.

<sup>12</sup> Governor Jesse Ventura, *2002-03 Supplemental Budget Recommendations*.

million in FY 2004.<sup>13</sup> The gas tax is different from the other revenue sources discussed in this document because gas tax revenues are dedicated to transportation. Therefore, an increase in the gas tax does not directly ease the general fund budget deficit. However, a gas tax increase would allow policy-makers to dedicate a smaller portion of other taxes to transportation, such as motor vehicle sales taxes, and thereby make more of these other taxes available to the general fund.

Excise taxes, and tobacco taxes in particular, are more regressive than the general sales tax. Proponents of increased excise taxes argue that the positive social impacts of increasing excise taxes, such as a reduction of youth smoking, outweigh the impact on tax fairness, or that in the case of the gas tax, that they serve as a “user fee” by which those who use a service are the ones who pay for it. Nonetheless, policy-makers should be careful not to become overly reliant on these regressive taxes as a revenue source.

### ***Revenue Increases Should Not Hit Low-Income Families the Hardest***

Whatever revenue increases may be implemented, attention must be paid to the effect on tax fairness. The combination of tax increases during the recession of the early 1990s and the tax cuts enacted in the better economic times that followed have led to tax systems in most states that are more regressive.<sup>14</sup> Many of the options discussed above would hit low-income taxpayers the hardest. Fortunately, there are several strategies that can be used in combination with the options listed above to ensure that budget balancing decisions are not overly burdensome on the state’s low-income taxpayers:

- Expand existing refundable income tax credits for low-income families, such as the Working Family Credit or Property Tax Refund.
- Reduce the sales tax rate. Some base broadening options bring in a large amount of revenue at the current 6.5% rate, and therefore the rate could be lowered while still having a net increase in sales taxes.<sup>15</sup>
- Provide a sales tax credit to low- and/or moderate-income taxpayers to offset sales tax base broadening. One possible mechanism would be an automatic sales tax credit, similar to the sales tax rebate, but targeted to specific income groups.

### ***Federal Revenue Sharing***

In past recessions, the federal government provided financial assistance to states through revenue sharing. Revenue sharing can be provided quickly and with little administrative burden by channeling additional revenue to the states through existing programs. For example, one proposal under discussion is for the federal government to temporarily pay for a larger share of Medicaid, which is jointly funded by states and the federal government and provides health care for low-income families, seniors, and disabled persons. State policy-makers should encourage implementation of federal revenue sharing.

### **State and Local Expenditures**

The third budget balancing tool available to the state is reducing expenditures. In thinking about expenditures, policy-makers must consider the state’s budget shortfall, but also must respond to the recession. We suggest the following to guide decisions if policy-makers determine that spending cuts are necessary to balance the budget:

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<sup>13</sup> *Supplemental Budget Recommendations.*

<sup>14</sup> For more on this issue, see the Center on Budget and Policy Priorities’ *The Rising Regressivity of State Taxes.*

<sup>15</sup> If this approach is used, the revenue estimates of the base expansions above should be reduced to take into account the lower rate.

- Spending cuts should be done cautiously and deliberatively, taking into account the state’s needs.
- Counter-cyclical programs, such as unemployment insurance, welfare, and medical assistance, must be allowed to work. These programs are intended to act as automatic stabilizers that expand in times of economic crisis, and offset other budget balancing actions the state must take but that are a drag on the economy. They should not be cut.
- In order to not make the recession worse for those Minnesotans least able to weather the downturn, programs that mainly benefit vulnerable populations should not be cut.
- Budget balancing decisions should be informed by the economic or stimulus effect of the decision.
- Decision-makers should recognize that the impact of cuts may be larger than the lost state funding, because state spending often leverages additional public or private funds and volunteer activities.

These principles apply to local government as well. While local government aids appear as a separate expenditure category in the state budget, local governments fund many of the same services that the state does. The two largest budget items for counties are human services and public safety, which make up 41% and 18% of county expenditures respectively. For cities with populations over 2,500, public safety makes up the largest portion of the budget at 35%, followed by streets and highways at 16%.<sup>16</sup> State aid is an important part of funding these local services. In 1999, state aid made up 30% of county revenues and 28% of revenues for cities over 2,500. Significant cuts to local government aid would mean considerable pressure to cut crucial services at the local level.

Another one of our principles is that budget balancing should be informed by past budget decisions, including how surpluses were divided between tax cuts and new spending, and how certain programs were underfunded even in times of surplus. Of the surpluses allocated in the 1997 through 2001 legislative sessions, twice as much was dedicated to tax cuts and rebates as was allocated to new spending.

Policy-makers should also acknowledge how new spending was distributed in the 2002-03 budget. For example, as the table shows, any cuts to Family & Early Childhood Education or Economic Development will be out of a 2002-03 general fund budget that did not even keep up with inflationary growth.<sup>17</sup>

<b>2002-03 General Fund Spending as passed in the 2001 session (change from existing law)</b>	
Transportation & Public Safety/Courts	21.5%
Higher Education	6.6%
Education Finance*	4.7%
Health & Human Services/Corrections	3.1%
Environment & Agriculture	3.0%
State Government	0.8%
Family & Early Childhood Education	0%
Economic Development	-0.4%
* Does not include state takeover of the general education levy	

## **Conclusion**

There is no question that difficult choices are ahead for Minnesota’s decision-makers. 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 increasing the recession’s burden on those who are hurting most.

<sup>16</sup> Office of the State Auditor, *1999 Budget Data For Minnesota Counties Together With 1998 Revised Budgets and 1999 Budget Data Together With 1998 Revised Budget Data*. 1999 is the most current year for which audited information is available.

<sup>17</sup> Data in this paragraph and accompanying table are author’s calculations based on House Fiscal Analysis data. See Minnesota Budget Project, *Unbalanced Priorities: Dividing Up the Surplus in the 2001 Legislative Session*.

## **Appendix 1: Sales Tax Base Broadening Options**

### **Option 2: Eliminate exemptions on products and services purchased by consumers and businesses: \$1.27 billion for FY 2003**

Publications, textbooks, computers for school use, residential heating fuels, residential water services, sewer services, used manufactured homes	\$203 million
Personal services: beauty/barber, shoe repair, tax prep, misc.	\$38 million
Business services: advertising, direct mail advertising, consumer credit reporting & collections, secretarial, computer & data processing, other	\$394 million
Other services: legal, engineering, accounting, research & testing, management & PR, scientific consulting, auto repair, misc. repair	\$622 million
Television commercials, advertising materials	\$9 million
<b>TOTAL (FY 2003):</b>	<b>\$1.266 billion</b>

### **Option 3: Eliminate exemptions on products and services purchased by mainly by consumers: \$413 million**

Publications, textbooks, computers for school use, residential heating fuels, residential water services, sewer services, used manufactured homes	\$203 million
Personal services: beauty/barber, shoe repair, tax prep, misc.	\$38 million
Other services: auto repair, misc. repair	\$172 million
<b>TOTAL (FY 2003):</b>	<b>\$413 million</b>