Staying Within Our Means

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Despite the $2.3 billion state government surplus forecast for the close of the 1998-99 biennium, Minnesota Planning's two-year-old warning that the state faces a long-term deficit remains largely unchanged. In January 1995, Minnesota Planning published *Within Our Means*, which

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projected that combined state and local government revenues will fall short of expenditures by an average of $625 million in each of the three bienniums starting in July 1999. As a result of revenue and spending changes over the last two years, Minnesota Planning now expects a slight surplus in the 2000-01 biennium, but deficits are anticipated after that.

The Minnesota Planning projections are based on planning scenarios that build on official Department of Finance forecasts. Different from Finance forecasts, the planning scenarios usually round revenues and expenditures to the nearest $100 million because of the imprecision of long-range projections. The planning scenarios include both state and local government revenues and expenditures, while the Department of Finance focuses on state-level information. Also, the planning scenarios go beyond the Finance Department's 1999 forecasts to 2005.

The shortfall between revenues and expenditures is not a cyclical problem. It is structural because it is based on the way the state gathers revenues and makes spending decisions. It also is spurred by demographic changes that affect revenues and demand for public services.

Within Our Means explained how changing demographics, program eligibility standards, regulations and mandates, costs of labor and materials and mounting infrastructure needs would drive spending up faster than revenues.

In response to the pending structural deficit, the Legislature and the Governor have made concerted efforts to gain control of fast-growing spending areas. Limits were placed on corrections spending and more effective use of prison space has forestalled the need to build more prisons. Innovative steps have been taken to move people off welfare more quickly. Savings were realized by greater use of managed health care.

The dramatic, short-term improvement in state government's fiscal outlook has made it tempting for some people to dismiss the warning of two years ago to live within our means. The Legislature is facing strong pressures to use the surplus for major spending increases or tax cuts. Such decisions must be made with a long-term perspective. "Staying Within Our Means" demonstrates that the current fiscal position is the result of unexpectedly strong growth in personal income. It does not change the less optimistic, longer-term outlook presented in *Within Our Means.*

Two uncertainties underscore a continuing need for fiscal responsibility. First, a slightly lower-than-expected economic growth would cause dramatic dips in revenues. Personal income is now expected to grow close to 5 percent annually through 2005. If growth slowed only to 4 percent, revenues would be about $225 million less in 2000 and as much as $1.7 billion less in 2005. Such a minor change in income growth could transform projected deficits from small to large. Second, uncertainty plagues expenditure outlooks in many areas. Chief among these is health care, where expected changes in federal policy could dramatically influence demands for state and local funds.

A decision to spend most of the surplus could cause long-term fiscal problems. The surplus presents opportunities to reduce taxes or finance new or expanded programs. The kinds of tax cuts and spending are as important as the amount. One-time tax cuts or spending may be affordable. However, permanent reductions in the tax rate or changes in the types of income or sales to which the rates are applied would reduce revenues for years to come. Similarly, using a surplus to make more people eligible for services or increase a program's budgetary base creates long-term spending commitments.

In the long run, growth in Minnesota's tax income will be diminished because the percentage of Minnesotans of working age will begin to decline after 2010. Spending decisions over the next decade should position Minnesota to deal with the growing dependent population after 2010.

Deficits remain in the forecast for 2002 through 2005

Revised planning scenarios prepared for "Staying Within Our Means" indicate that combined state and local revenues are still likely to fall short of expenditure needs between 2001 and 2005.

Putting the Surplus in Perspective

- The existing budget reserve of $260 million is only 1.4 percent of projected biennial revenues; the Council of Economic Advisers recommends a long-term goal of a 5 percent reserve.
- Minnesota businesses may find expansion more difficult in the future because of labor shortages or costs.
- The long-term economic outlook is still optimistic, but even slight unexpected downturns can cause large declines in revenues and increases in family support and health costs.
- Use of the surplus for large, permanent spending increases or tax cuts would have ripple effects into future bienniums and increase the size of expected deficits after 2001.

Two years ago, Minnesota Planning projected that combined state-local government revenues would fall $500 million or more short of spending demands each biennium between 1999 and 2005. The revised planning scenarios show a small surplus in the 2000-01 biennium, but deficits are predicted for the following four years. Revenues are expected to fall $400 million short of expenditures in the 2004-05 biennium.

The revised planning scenarios are only slightly different from those in *Within Our Means*. In most years, the revised scenarios project between $50 million and $200 million less spending – not a large difference compared to the $25 billion to $30 billion per year in combined state and local expenditures.

Revised revenue scenarios are now higher in 1999 and 2000, but $100 million to $140 million lower each year from 2001-05 than previously projected.

The net result is that the projected balances improve in each of the three bienniums – from a $500 million deficit to a $300 million surplus in 2000-01 and from deficits of $600 million and $800 million to shortfalls of $200 million and $400 million in 2002-03 and 2004-05, respectively. Surpluses or deficits of these magnitudes represent less than 1 percent of total state and local expenditures.

The planning scenarios presented here do not take into account unexpected events, such as recessions, natural disasters or judicial rulings, that could cause revenues to fall or expenditures to rise.

Projected revenues and spending also can easily alter with slight changes in income and the economy. The anticipated deficits after the turn of the century could easily be better or worse than projected.

Revenues will grow a bit less than thought two years ago

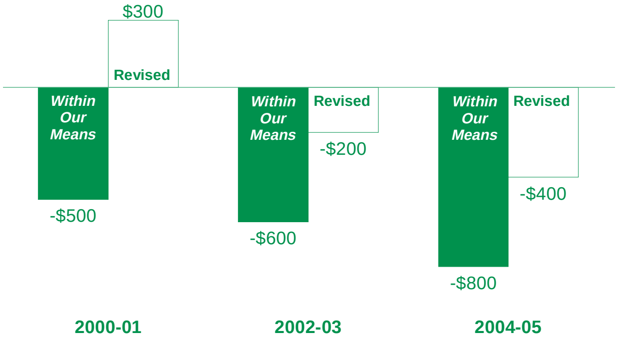
Combined state and local government revenues are now expected to be about $100 million to $140 million less each fiscal year from 2001 through 2005 than calculated two years ago. This change is minor in the long-term outlook. The revised projections are less than half a percent lower than those in *Within Our Means*.

Annual personal income from 2001 through 2005 is now predicted to be about 3.6 percent higher than previously expected. Because revenues are sensitive to growth in personal income, such growth would likely cause state and local revenues to rise.

However, the Governor and the Legislature have decided to hold revenues to a lower percentage of personal income than two years ago, causing projected revenues to be slightly less than previously expected. Minnesota law requires the Governor and the Legislature to set targets for the "price of government." This price is the total of all state and local government revenues expressed as a percentage of personal income. In 1995, the Governor and the Legislature agreed on a target of 18.4 percent. Since 1995, they have agreed that the 18.4 percent target is too high.

Within Our Means assumed that revenues would continue to be 18.4 percent of personal income. The revised planning scenarios assume revenues will be only 18 percent of revenue in 1999, 17.8 percent in 2000 and 17.7 percent from 2001 through 2005. These are the Governor's recommended targets for 1999, 2000 and 2001.

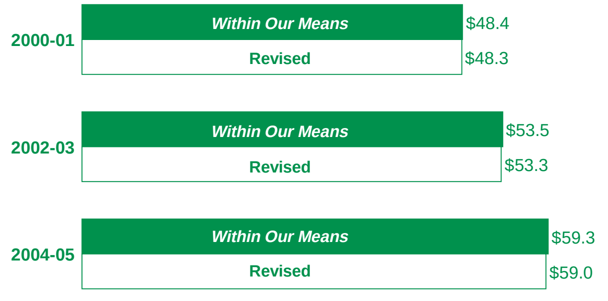
Long-Term Deficits Are Smaller Than Projected in 1995
(in millions)



Note: State and local revenues are combined in these estimates covering three bienniums. Numbers might not match differences between revenues and spending expressed in other graphics due to rounding.

Source: Minnesota Planning

Revenue Estimates Are Slightly Lower Than Projected in 1995
(in billions)



Note: State and local revenues are combined in these estimates covering three bienniums.

Source: Minnesota Planning

Keeping revenues at 18.4 percent would produce $31.5 billion in 2005 — some $1.2 billion more than projected with the 17.7 percent figure. Using this lower assumption in the "Staying Within Our Means" planning scenarios causes revenues to be slightly lower than previously projected, despite the anticipated increases in personal income.

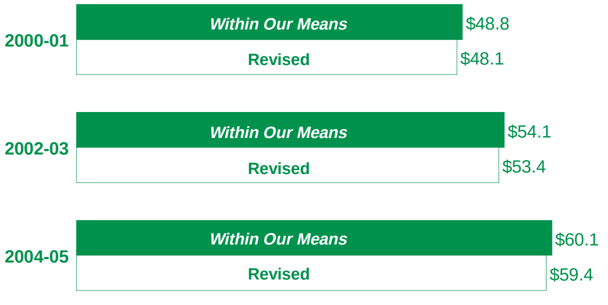
The difference between the 1995 and revised scenarios illustrates how sensitive revenue projections are to changes in personal income. At a 17.7 percent price of government, a 1 percent change in personal income corresponds to about $300 million in revenue in 2005. If personal income is held constant and the price of government is changed up or down by a tenth of 1 percent, revenue changes by about $170 million.

Actual revenues can become higher or lower than the targeted price of government because some parts of the state's tax system are very sensitive to growth in personal income, producing revenue growth faster than income. By the same token, slowdowns in personal income growth can cause revenues to slow disproportionately.

Expenditures will grow a bit more slowly than expected

Slightly lower expenditure levels are now anticipated than were projected in *Within Our Means*. The revised planning scenarios begin with slightly lower state and local spending — $22.3 billion in 1999, about $200 million less than the 1999 estimates in *Within Our Means*. The revised scenarios also assume slower spending growth for 1999-2005 than previously expected.

Spending Estimates Are Lower Than Projected in 1995
(in billions)



Note: State and local expenditures are combined in these estimates covering three bienniums.

Source: Minnesota Planning

The greatest improvements in the spending outlook are in the areas of health care, family support programs and criminal justice. Spending growth has slowed in each area since 1995, and anticipated growth rates are now somewhat less than contemplated two years ago.

Criminal justice. Corrections spending is now expected to grow less rapidly than thought in 1995. Projections of prison populations have been reduced by about 300 inmates. In addition, the Department of Corrections has re-evaluated prison capacity and determined that by using space more efficiently, it has at least 200 more beds available than previously estimated. The department now believes that, with construction of the new prison at Rush City, another new prison is not needed until 2004. The original *Within Our Means* projected spending needs for three new prisons between 1995 and 2005. In an attempt to hold down growth in corrections spending, the Legislature limited corrections appropriations to $614 million for the 1996-97 biennium.

Family support. Welfare caseloads have declined dramatically since 1994. The average number of people receiving Aid to Families with Dependent Children benefits peaked at 192,000 in 1994 and fell to 174,000 in 1996. New federal welfare reform has resulted in a larger-than-ever grant to Minnesota for 1997 and 1998. However, this grant is a fixed amount each year, and the state must absorb any spending above that amount. In addition, the new program will put more burden on the child care and job training services needed to move Minnesota families off welfare. The 1997 Minnesota Legislature must make decisions on these and other welfare program issues.

Health care. Since 1995, health care costs have not grown as quickly as expected. *Within Our Means* assumed annual increases in health care spending of 13 percent. The revised planning scenarios are based on 7.5 percent annual increases. The slowed growth rate is in part due to savings from greater use of managed care and a lower medical care inflation rate. Also, a strong economy has left fewer people in need of government-supported health care, resulting in Medicaid case load reductions.

Minnesota will receive $1.8 billion in federal Medicaid grants in 1997 to help pay for the state's Medical Assistance program. Pressure continues to mount in Washington to control federal health care costs. Changes in the way the federal government pays for health care could dramatically affect the spending outlook for Minnesota.

The state's current fiscal position is strong

The $2.3 billion surplus forecast for the state's upcoming 1998-99 biennium builds from stronger-than-expected revenue growth during the current two-year period.

The Finance Department's February 1997 forecast for the two-year budget period ending June 30 predicts a $1.4 billion surplus. The increase reflects stronger-than-expected revenue growth. The November 1994 forecast anticipated revenues of $17.7 billion for the biennium. The new forecast projects revenues of $19.3 billion. Sales and income tax revenues are now expected to be about $1.3 billion higher than forecast two years ago.

Since *Within Our Means* was published in 1995, strong individual income tax receipts pushed up revenues, while expenditures for state agencies, state-operated institutions, health care and postsecondary education were less than expected. State government revenue collections have been higher than expected since 1995 because a minor slowdown in economic growth did not materialize. Strong employment and wage growth, recovery of the farm sector from the 1993 floods and higher-than-expected levels of capital gains income contributed to higher income tax revenues.

The latest forecast for the upcoming 1998-99 biennium also shows a healthier balance than earlier predictions. In November 1994, the Finance Department issued an estimate showing a $383 million deficit in June 1999. Now the February 1997 forecast contains a $2.3 billion surplus. If a $261 million budget reserve is included in the current forecast, the balance climbs to $2.5 billion.

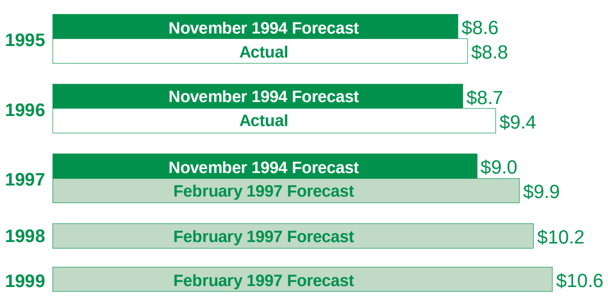
Upward revisions in forecasted personal income will cause revenues to rise in each fiscal year. Fiscal year 1998 revenues are now expected to be $750 million higher than forecast previously and $800 million higher in fiscal year 1999. These are large amounts of money but are still only about 8 percent above what was forecast in November 1994. Had the economy grown more slowly than expected, revenues could have fallen short by similar amounts.

Although the Department of Finance revenue forecasts pertain only to state government funds, they have importance to local governments as well. The state raises about 58 percent of all state and local government revenue in Minnesota. It then allocates about $5.5 billion in state aids, which accounts for about 37 percent of school district and local government revenue.

Expenditures in the 1996-97 biennium were higher than forecast, but the 1998-99 expenditures are lower. Compared to the November 1994 forecasts, the new forecasts for health care is $646 million less. Forecast spending for family support programs, including welfare, is down $205 million, and forecast spending for state-operated institutions, including prisons, is down $119 million.

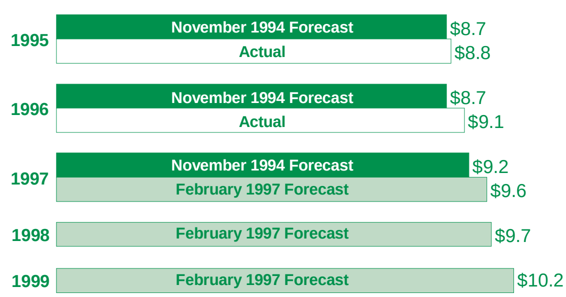
Health care spending remains the big story. At $3.6 billion, health care will account for 18 percent of all state government spending in 1998-99. Health care spending is forecast to grow 39 percent during the 1996-99 period, three times the rate of state revenue growth. If health care spending continues to outpace revenue growth by such a large margin after the turn of the century, and if the projected state-local fiscal deficits materialize, the state will be forced to reallocate spending from other areas to health care.

State Revenues Continue to Exceed Earlier Forecasts
(in billions)



Note: Figures are for fiscal years.
Source: Department of Finance

State Expenditures Have Slightly Exceeded Forecasts
(in billions)



Note: Figures are for fiscal years.
Source: Department of Finance

Caution still needed

Minnesota's current strong fiscal position is not unique. The National Association of State Budget Officers reports that most states are anticipating sizable budget surpluses. Stronger-than-expected economic growth has boosted revenues higher than anticipated across the entire country.

Caution is needed even though the economy has performed better than expected over the past two years. The economy might just as easily slip below any point predicted for the next seven years. Over time, errors in economic forecasts tend to average out.

Minnesota's economy appears to be functioning near capacity. More people have moved to Minnesota, increasing the labor force and stimulating more economic growth than would have otherwise been possible. However, this movement from other states such as California, Illinois and Texas may slow as those states' economies improve. In addition, women are not expected to enter the labor force at the same rates as in the past. Participation of women in the labor force jumped from 63 percent in 1990 to nearly 70 percent in 1995. It is unlikely that these strong growth rates can continue, given the aging and structure of the labor force.

Minnesota's economic growth, adjusted for inflation, is expected to slow over the next several years to below 2 percent. The view of the economy that caused pessimism two years ago has not changed fundamentally. The outlook between 1999 and 2005 is projected to improve mainly because spending will grow more slowly. Cautious spending will be critical to balancing state and local budgets without tax increases.

Line Item is a series of brief publications highlighting and building upon key facts and findings from Minnesota Planning's study, *Within Our Means: Tough Choices for Government Spending.* Published in January 1995, the study examined past local and state government spending and revenues, identified major driving forces and forecast what is expected to happen in the next five to 10 years.

Upon request, *Line Item* will be made available in an alternate format, such as Braille, large print or audio tape. For TDD, contact Minnesota Relay Service at (800) 627-3529 and ask for Minnesota Planning.

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