



# Budget Reforms in the 2007 Legislative Session: Progress Lost to a Veto

In the 2007 Legislative Session, the primary task of the Legislature was to pass the state's budget for the next two years, formally called the FY 2008-09 biennium. Elected officials not only debated the perennial funding choices such as education and health care spending, but also broader budget reform issues, including the appropriate size of the state's budget reserve, how the state does its budget forecasting, how to handle volatility in future revenues and whether to set targets for the total size of government.

A good budget process promotes responsible decision-making and encourages public understanding and participation. In 2007, the Minnesota Budget Project launched a Campaign for a Better Budget Process, and described several characteristics of a positive budget process:

- Responsible fiscal management.
- Clear lines of accountability.
- Flexibility to respond to short-term challenges and plan for a long-term vision.
- Good financial information.
- Stability in the decision-making process.<sup>1</sup>

As part of this campaign, the Minnesota Budget Project recommended two policy changes in the 2007 Legislative Session: **build the state's budget reserve to a responsible level** so that policymakers can respond deliberatively to an economic downturn or unforeseen event and **ensure the state's economic forecasts take inflation into account** so that budget decisions are made with complete financial information. This analysis summarizes the decisions made in the 2007 Legislative Session on these and other proposed budget reforms.<sup>2</sup>

The forecasting issue became one of the most prominent fiscal issues of the legislative session. Ultimately, the Legislature put into their omnibus tax bill (HF 2268) provisions to boost the budget reserve, smooth out future revenue fluctuations and restore the impact of inflation to the state's forecasting process. The Governor, citing his opposition to the forecasting provision, vetoed the omnibus tax bill. This meant that none of the budget reforms in that bill became law.

## ***Governor Vetoes Tax Bill, Citing Opposition to Restoring Inflation to the Economic Forecast***

The Minnesota Department of Finance prepares an economic forecast in November and February each year. The forecast takes a reading of the state's fiscal health and the health of the economy. The Legislature is required to balance its budget, and the forecast helps them do that by giving them a prediction of how much income to expect by the end of the year, and how much of that income will be spent, based on current law. However, due to a provision passed in 2002, state law prohibits the Department of Finance from factoring in the impact of inflation on most areas of future spending.

Each year, the cost of providing a service generally rises as the cost of materials, rent and personnel rises. If the level of funding remains constant, over time inflation erodes the state's ability to provide the same level of service. When the impact of inflation on future spending is not included in the forecast, the public and policymakers are given a mistaken impression of the state's ability to meet its commitments.

It is important to understand what restoring inflation to the forecast does *not* do. Factoring inflation into the state's economic forecast does not mean that any state program or service is automatically granted an inflationary increase. Actual levels of spending are still determined by the Legislature. Rather, the

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<sup>1</sup> For more information, see the Minnesota Budget Project's Campaign for a Better Budget Process website, [www.mncn.org/bp/betterbudgetcampaign.htm](http://www.mncn.org/bp/betterbudgetcampaign.htm).

<sup>2</sup> The data in this analysis comes from spreadsheets, analysis and budget documents prepared by the Minnesota Department of Finance, Minnesota Department of Revenue and legislative research and fiscal analysis staff. The opinions expressed are those of the authors.

elimination of inflation from the estimate of general fund spending hampers the Department of Finance's ability to give the Legislature the most accurate reading of the state's fiscal health. For example, if the impact of inflation on spending were taken into account, the projected \$2.2 billion surplus for FY 2008-09 measured by the February 2007 forecast would be cut in half. This figure more accurately captures whether revenues are sufficient to maintain services in the future.

In its omnibus tax bill, the Legislature reinstated the inclusion of inflation in the forecast, with a slight change from the way it was calculated in the past.<sup>3</sup> On May 30, 2007, the Governor vetoed the omnibus tax bill, publicly citing the forecasting provision as a reason for the veto. The Governor's veto decision means the state lost an important opportunity this year to improve the budget process.

### ***Consensus on Need to Increase Budget Reserve; Progress Lost to Tax Bill Veto***

When facing a budget deficit, adequate budget reserves allow policymakers time to respond in a thoughtful and deliberative way, instead of making quick and drastic choices to balance the budget. In addition, adequacy of reserves is one factor that rating agencies use to determine the state's credit rating, which in turn influences how much interest the state will pay when borrowing.

At the beginning of the session, the state had \$653 million in its budget reserve, as well as \$350 million in its cash flow account. Together, this adds up to just over \$1 billion, equal to 3.1% of the state's FY 2008-09 general fund spending.<sup>4</sup> The state's Council of Economic Advisors, a group of economists appointed to advise the state on economic trends, has long recommended that the state strive for budget reserves equal to 5% of biennial general fund spending.

There was bipartisan support for bolstering reserves this session. The House recommended a \$30 million increase in the budget reserve. The Governor proposed an increase of \$147 million. His proposal also would have dedicated a portion of future surpluses to the budget reserve until it reached 5.0% of annual spending – over halfway towards the Council of Economic Advisors' recommendation. The Senate proposed an ambitious \$629 million increase to the budget reserve.<sup>5</sup> Under the Senate's proposal, the budget reserve would have reached \$1.6 billion, or 5.1% of FY 2008-09 biennial spending. This would have realized the Council of Economic Advisors' recommended budget reserve level.

Ultimately, the final budget reserve proposal by the Legislature was remarkably similar to the Governor's request. It would have boosted the budget reserve by \$150 million, which would have brought total reserves to 3.6% of FY 2008-09 general fund spending.

However, the bipartisan consensus on increasing the budget reserve was lost when the entire omnibus tax bill was vetoed. As a result, the budget reserve will remain at its current level.

### ***Legislature Passes Provision Addressing Future Revenue Fluctuations***

Responsible fiscal management dictates that policymakers should be careful to distinguish between revenues available on a one-time basis and sustainable, ongoing revenue sources. This follows the common sense that tells a person who receives a \$5,000 bonus one year not to count on receiving a similar bonus when planning next year's budget. In this vein, the House tax committee adopted a proposal to address a predicted one-time spike in tax revenues of \$327 million in FY 2011.

The anticipated revenue increase would occur as a result of a lower federal tax rate on capital gains that is set to expire, or "sunset", in 2010. The Department of Finance predicts that investors will sell off more stocks and bonds in the year before the lower tax rate expires, resulting in a temporary jump in capital gains tax revenues in FY 2011. However, it also predicts that there will be a corresponding drop in capital gains taxes in the following years.

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<sup>3</sup> The inflation adjustment would not be applied where the forecast already includes a "statutory growth factor."

<sup>4</sup> All calculations of reserves as a percentage of general fund spending are based on the level of projected FY 2008-09 spending in the *February 2007 Economic Forecast*.

<sup>5</sup> The proposal would have also dedicated all interest on the \$629 million to the budget reserve.

Under the House omnibus tax bill, the additional revenues in FY 2011 would be set aside in a “tax volatility reduction account.”<sup>6</sup> These revenues would then be distributed back to the general fund over several years, thus minimizing the distorting effects of the spike in revenues to the state budget. This proposal was included in the omnibus tax bill, which was vetoed by the Governor.

### ***Price of Government Target is Eliminated***

The Price of Government is a useful statistic that informs the perennial policy debate over the appropriate amount of spending on public services.<sup>7</sup> The Price of Government measures the total amount of state and local revenues — including taxes, fees and tuition at state colleges and universities — as a percentage of personal income in the state. For example, the Price of Government in 2007 is 16.2%. This means that for every dollar of personal income, 16.2 cents pays for the total cost of public services from the state and all units of local government, including school districts, townships, cities and counties.

In each odd-numbered year, each body of the Legislature proposes a Price of Government target as part of the biennial budget process. A Price of Government can be calculated for the Governor’s proposed budget as well. For example, for the FY 2008-09 biennium, the Price of Government for the Governor’s budget was 16.1%. Proposed targets do not become law, but rather set budgeting parameters.

The state government omnibus bill (SF 1997), which was signed by the Governor, eliminated the requirement that the Governor, House and Senate set Price of Government targets. The requirement that the Department of Finance regularly calculate the Price of Government remains unchanged.

### ***Next Steps***

A detail of the budget process — inflation in the forecast — became one of the hottest issues of the 2007 Legislative Session. Unfortunately, the Governor opposed this critical component of a better budgeting process. Other important budget reforms, such as increasing the state’s budget reserve, garnered bipartisan support, but were lost when the omnibus tax bill was vetoed. The Governor’s veto meant that no progress on reforms was made in the 2007 session, but the increased level of support and public interest indicates that the debate will continue.

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<sup>6</sup> The funds would only be set aside in the tax volatility account if the state is projecting a surplus.

<sup>7</sup> Information on the Price of Government can be found at the Minnesota Department of Finance’s website. See [www.budget.state.mn.us/budget/index.shtml](http://www.budget.state.mn.us/budget/index.shtml).