

The February 2007 Forecast: Little Change in Near Term, Stormier Outlook for the Future

Before policymakers can make important decisions about the state's budget for the next two years, they need information about the state's fiscal situation. The Minnesota Department of Finance prepares Economic Forecasts twice a year, in November and February. Forecasts are based on an economic scenario and existing state law. The Forecast does not reflect any policy proposals by the Governor or Legislature.

The state's Forecasts take a reading of the state's fiscal health, and are the yardstick against which budget and tax proposals are measured. The February Forecast serves an important dual function: it updates the budget outlook for the current biennium, and gives context for the Legislature's upcoming decisions on the FY 2008-09 biennium.

The February Forecast shows little change from November's estimates for the current two-year budget cycle, the **FY 2006-07 biennium**. There is a \$1.0 billion balance, down \$25 million from November.¹ The change is attributable primarily to a "federal conformity" law passed early in the 2007 Legislative Session that adjusted Minnesota's tax laws based on recent federal tax changes. It is unlikely that much of the FY 2006-07 balance will be spent before the biennium ends on June 30, 2007.

The Forecast Numbers at a Glance

- \$1.0 billion balance in FY 2006-07
- \$2.2 billion balance in FY 2008-09
 - Includes \$1.0 billion brought forward from FY 2006-07
 - \$1.2 billion balance unique to FY 2008-09
 - Inflation costs: \$1.0 - \$1.2 billion

The \$1.0 billion balance for the FY 2006-07 biennium represents 3.15% of total biennial general fund revenues. Because the balance is over 0.5% of total biennial revenues, by law the Governor must develop a tax rebate proposal, and the Legislature must respond by accepting, modifying, or rejecting the Governor's proposal by April 15th. While the Governor has submitted a sales tax rebate proposal, he has clearly expressed his desire that these funds be used for other purposes, and legislative leaders have also been cool to rebate plans.

February's Forecast shows practically no change from November's Forecast for **FY 2008-09**, with a \$2.2 billion balance. About half of the balance is the FY 2006-07 balance brought forward into FY 2008-09, and is available for one-time investments. The remaining \$1.2 billion is available for ongoing commitments, but it should be recognized that covering the estimated cost of inflation to continue current levels of services in FY 2008-09 would cost between \$1.0 and \$1.2 billion.

February's Forecast predicts a stormier outlook for the **FY 2010-11 biennium**. The Forecast's outlook for the FY 2010-11 structural balance — the difference between revenues and spending not including at any balances brought forward — is revised downward by \$418 million, bringing it to \$2.8 billion. The predicted positive balance is roughly equal to the inflationary costs to maintain current levels of services, which is estimated at \$2.5 to \$3.0 billion, depending on which measure of inflation is used. In addition, the \$2.8 billion structural balance is based on

¹ The data in this analysis comes from the Minnesota Department of Finance, *February 2007 Economic Forecast*, www.finance.state.mn.us/ffeu/index.html. The opinions expressed in this analysis are those of the authors.

current law, so it does not include the impact of any budget choices made for the FY 2008-09 biennium.

Inflation Erases Surplus

It is important to note the way inflation is treated in the Forecast. Although the Forecast adjusts the state's revenues to account for the impact of inflation, due to a provision passed in 2002, state law prohibits the Department of Finance from considering the impact of inflation on many areas of state spending when determining the size of the state's general fund balance. If inflation is taken into account, the FY 2008-09 balance is cut in half, and the FY 2010-11 balance disappears.

Our daily experiences tell us that inflation is real. We all know that \$20 today doesn't buy the same amount of gas or milk as it did just a few years ago. Similarly, the cost to the state to provide a service generally rises as the cost of materials, rent, and personnel rises. If the level of funding remains constant, over time inflation will erode the state's ability to provide the same level of service. The Minnesota Budget Project, as well as many prominent state finance experts, has called on the Legislature to repeal the 2002 law that prevents the state's Forecasts from taking to account the impact of inflation on spending.² Repealing that law would not guarantee any area of the budget an automatic inflationary increase, but it would provide policymakers and the public with a more accurate picture of the state's ability to maintain current commitments.

February Forecast May Be Too Optimistic, Especially in the Long-Term

The Forecast offers a look into Minnesota's economic future, and while it is based on the careful analysis of numerous experts, each Forecast still inevitably contains some risk. The economic model used to prepare the February Forecast is a bit more optimistic than the model used in November. It assumes no recession and five years of relatively strong economic growth.

The economic model's revenue and spending predictions must be evaluated from both the short-term and long-term perspective. And in both time frames, there are uncertainties that may lead actual outcomes to be less positive than the predictions.

In the short-term, the primary source of risk resides in Minnesota's housing market. The February Forecast predicts that the housing market downturn will slow and level off in 2007. If the housing market worsens, or if the downturn lasts longer than predicted, personal wealth and consumer spending may also decline – making state revenue projections hard to achieve. The Forecast's job growth predictions may also be hard to meet if the housing market slump is more severe than expected, impacting jobs in the construction, forestry, and related industries.

In the long run, the model assumes no recession and steady economic growth. The Minnesota Department of Finance notes that revenue predictions based on this economic scenario are more likely to be too optimistic than too conservative.

Another possible bump in the revenue road comes because, since the Forecast is based on current law, it assumes that in tax year 2010 the Bush tax cuts will expire as scheduled. This scenario gives the state an extra \$327 million in one-time capital gains revenue in FY 2011, followed by a \$313 million loss in revenue the following year. This would occur as investors sell off their stocks at an accelerated rate in 2010 before the lower capital gains tax rate expires.

² See Minnesota Budget Project, *Campaign for a Better Budget Process*, www.mncn.org/bp/betterbudgetcampaign.htm.

However, there is risk that the tax cuts could be extended, or that investors could behave differently than predicted.

An important tool for managing risk is the state's budget reserves. In Governor Pawlenty's Supplemental Budget, released in response to the February Forecast, the Governor proposes to increase the state's budget reserves by \$100 million, on top of the \$47 million already proposed in his initial budget request. This would bring the reserves to 4.5% of *annual* general fund spending. However, the Minnesota Council of Economic Advisors recommends reserves of 5% of the state's *biennial* general fund budget. (Currently, the state has just over \$1 billion in reserves, or about 3% of the state's biennial budget.)

The Governor's proposal is a good start, and the Minnesota Legislature should take action to ensure stronger budget reserves.³ Minnesota's financial standing (including the state's bond rating) depends on adequate reserves. In addition, a healthy reserve gives policymakers time to make good budget decisions in the face of bad economic times.

What's Next?

With the release of the February Forecast, the Legislature has begun to start crafting their budget proposals. What the Forecast and current budget deliberations have made clear is that, after several years of deficits, the state's budget is tenuously balanced, and the current level of investments are inadequate. Continuing to fall behind in investing in our human capital and infrastructure is a threat to the state's economic future and quality of life. At the same time, our system of raising revenues has become less fair. The Legislature should pass a budget in the 2007 Legislative Session that fairly raises the revenues necessary to invest in the state's priorities.

³ See Minnesota Budget Project, *Campaign for a Better Budget Process*, www.mncn.org/bp/betterbudgetcampaign.htm.