

## The November 2007 Forecast: Stormy Weather Ahead

The state's November economic forecast release on November 30, 2007, predicts a weak economy and on-going state budget deficits. Previously, a \$294 million surplus had been predicted for the current two-year budget cycle (the FY 2008-09 biennium). Slower economic growth has reduced expected revenues for FY 2008-09 by \$739 million. The result is a general fund deficit of \$373 million. This deficit is equal to 1% of total biennial general fund spending.<sup>1</sup>

The predictions of a weak economy have even greater implications for the upcoming FY 2010-11 biennium. Projected revenues are down \$1.1 billion from previous estimates. The result is a \$1.2 billion deficit in FY 2010-11 when the impact of inflation is included — equal to 3.5% of the general fund budget. Without inflation, the FY 2010-11 deficit is estimated at \$211 million.

### **The Forecast Numbers at a Glance**

- \$373 million deficit in FY 2008-09
- \$211 million deficit in FY 2010-11; Deficit is \$1.2 billion when the impact of inflation is included.

The state constitution requires that the budget be balanced by the end of the FY 2008-09 biennium on June 30, 2009. However, it is likely that policymakers will act in the 2008 Legislative Session to bring the budget back into balance, as the sooner they start to address the deficit, the more options are available to them.

The forecast is the official measure of the state's fiscal health, and serves as the benchmark against which budget and tax proposals are measured. Prepared by the Minnesota Department of Finance each November and February, forecasts predict revenues and expenditures based on current laws and a model of how the economy is expected to perform. The forecast does not reflect any policy proposals by the Governor or Legislature.

### **Future Deficit Problem Understated**

The budget challenges ahead are more significant than indicated by the official "bottom line" shown in the November forecast. Although the forecast adjusts the revenue numbers to account for the impact of inflation, due to a provision passed in 2002, state law prohibits the

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Department of Finance from considering the impact of inflation on most areas of state spending when determining the size of the state's general fund balance. As noted above, adding inflation makes a significant difference: the FY 2010-11 deficit is \$1.2 billion when inflation is taken into account, instead of \$211 million.

Minnesotans are familiar with inflationary cost increases in their daily lives, and similarly the state faces added expenses as the cost of rent, supplies and personnel rises over time. It is standard practice in most private businesses and city governments to account for inflation in their planning. In the past, the state recognized the reality of inflation in its forecasts as well,

<sup>1</sup> The data in this analysis comes from the Minnesota Department of Finance, *November 2007 Economic Forecast*, [www.finance.state.mn.us/ffeu/index.html](http://www.finance.state.mn.us/ffeu/index.html). The opinions expressed in this analysis are those of the authors.

and used estimates of inflationary pressures to determine whether budget decisions were sustainable over a four-year planning horizon.

The state's Council of Economic Advisors notes that, "projecting future expenditures without making allowance for inflation except where required under current law understates the severity of any financial problems the state may face in future biennia." Many prominent state finance experts have 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.<sup>2</sup> 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 keep current commitments into the future.

### **Forecast Contains High Levels of Risk**

The November forecast predicts weak economic growth in the next six to nine months, but no actual recession (a recession is defined by negative economic growth over an extended period of time). It predicts that economic growth will pick up in the second half of 2008, although growth will remain lower than previously predicted.

Unfortunately, it is more likely that the actual performance of the economy will be worse than projected, rather than better. Global Insight, the national economic consultants that construct the economic model used to prepare the forecast, notes there are several areas of concern in the national economy, including the housing market, credit market and energy prices. If any of these areas performs worse than expected, the forecast's predictions will have proven too optimistic. Global Insight gives a 55% probability that their economic forecast is correct, and a 35% chance to a more pessimistic economic scenario including a recession. Weaker economic performance is likely to increase the size of the state's budget deficits, because revenues will be lower than expected and more Minnesotans will qualify for services targeted to those facing financial hardship.

Minnesota must also now contend with a new and troubling dynamic – the state's economy is now in a weaker position than the national economy. Several times this year, the state's monthly unemployment rate has risen above the national figures – the first time this has happened in the 30 years that such records have been kept.

### **A Little Bit of Budget History**

In addition to the current economic conditions described in the November forecast, it is also helpful to understand the budget decisions that have been made in the last ten years, and what they mean for today's budget situation.

From 1997 to 2007, the state saw five years of surpluses (in the 1997 to 2001 Legislative Sessions), followed by four years of deficits (2002 to 2005). In the 2006 and 2007 Legislative Sessions, the state's budget was relatively balanced. And now once again the state finds itself in a deficit situation.

The budget choices made over the last ten years, combined with economic trends, have contributed to a current budget situation that is very different from ten years ago.

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<sup>2</sup> See *Minnesota's Experts Call on Policymakers to Fix the State's Financial Forecasts*, [www.mncn.org/bp/forecaststatement.htm](http://www.mncn.org/bp/forecaststatement.htm), and other information about this issue at Minnesota Budget Project, Campaign for a Better Budget Process, [www.mncn.org/bp/betterbudgetcampaign.htm](http://www.mncn.org/bp/betterbudgetcampaign.htm).

- State and local government is a smaller share of the economy than in the previous decade. The price of government, a measure of all state and local revenues as a share of personal income, is 7% smaller today than ten years ago.
- Minnesota's tax system has seen two major changes. First, total state and local taxes are lower today than in 1996, measured as a share of income; however, average taxes have been on the rise since 2002. Second, Minnesota's tax system is becoming less fair, in part due to a greater reliance on local property taxes.<sup>3</sup>

### **Tough Choices Ahead in the 2008 Legislative Session**

The Minnesota Legislature and Governor are likely to act in the 2008 Legislative Session to balance the FY 2008-09 budget. Any state facing a deficit has three major budget-balancing tools available: raising revenues, cutting spending and using one-time actions, such as drawing on reserve funds.

Raising revenues is a reasonable response to a budget deficit, and even offers an opportunity to restore some balance to the state's tax system. Economic experts, including Peter Orszag, director of the Congressional Budget Office, and Joseph Stiglitz, recipient of the 2001 Nobel Prize in Economics, have argued that a well-crafted tax increase may have less impact on the economy than reducing government spending.<sup>4</sup>

Budget-balancing decisions should not make the impact of the economic downturn worse for those Minnesotans least able to weather the weakening economy, including low-income families, laid-off workers and other vulnerable populations. Policymakers should make sure services that are in greater demand in hard times — such as unemployment insurance and medical assistance — are robust and adequately funding.

One-time actions, such as drawing down budget reserves, are insufficient to address the state's structural deficit. As mentioned above, deficits are projected to continue into the next biennium, and there is a significant possibility that the problem may be worse than currently projected. If this is the case, using budget reserves to cover the shortfall would leave Minnesota even more vulnerable if the economic situation worsens. It is also an option which would use one-time resources to address an ongoing problem. And while the state does have reserves just over \$1 billion, this is well below the recommendation of the Minnesota Council of Economic Advisors. The Council has long recommended reserves of 5% of the state's biennial general fund budget. Current reserves are about 2.9% of the state's biennial budget.<sup>5</sup>

### **What's Next**

Policymakers and the public will have updated budget information when the next forecast is released in February. Shortly afterwards, the Governor will release his proposal for addressing the deficit in his Supplemental Budget, and the legislative budget process will get underway in earnest.

After six years of either cuts or relatively small increases in state investments in services, there is increasing public pressure to make progress on priorities ranging from education to transportation to health care.

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<sup>3</sup> For more information on the tax system in Minnesota, see Minnesota Budget Project, *Tax Fairness is Declining in Minnesota*, [www.mncn.org/bp/incido7.htm](http://www.mncn.org/bp/incido7.htm).

<sup>4</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?*, [www.cbpp.org/10-30-01sfp.htm](http://www.cbpp.org/10-30-01sfp.htm).

<sup>5</sup> See Minnesota Budget Project, *Build the State's Budget Reserves to a Responsible Level*, [www.mncn.org/bp/BuildReserves.htm](http://www.mncn.org/bp/BuildReserves.htm).

Tough choices are ahead, but they can be smart choices. Policymakers have the opportunity to make budget decisions in the 2008 Legislative Session that could put the state on a much stronger footing. It is possible to balance the budget in ways that:

- Rebalance the state's revenue system to restore fairness and ensure adequate revenues.
- Make the investments that Minnesotans expect for our economic well-being and quality of life.
- Reform the state's budget process to ensure a fully-informed debate and sustainable budget choices.