Budget Decisions in the 2002 Legislative Session

State's Budget Balanced in the Short Term, but Large Deficit Remains for Next Biennium

The primary task for the 2002 Legislature was to bring the state's budget back into balance. When the 2002 Legislature convened, they faced projected state revenues for the 2002-03 biennium that were 7.6% lower than predicted at the end of the 2001 session. This meant a $1.953 billion deficit for 2002-03 and a $2.535 billion shortfall for 2004-05.[1]

With a deficit of this magnitude, the Legislature faced very difficult choices. In January, the Minnesota Council of Nonprofits released a set of principles to guide the budget-balancing decisions of the 2002 Legislature. These principles argued that:

1. 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.
2. The state should use a combination of the three primary budget-balancing tools available: raising revenue, using reserves, and cutting spending.
3. 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.
4. 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.[2]

This document describes the major budget decisions of the 2002 Legislative session, and measures them against these principles for fiscal decisions.[3]

How Was the 2002-03 Budget Balanced?

In February, the Legislature passed the "Phase One" budget reconciliation agreement (HF 351), which addressed the 2002-03 budget deficit and made a dent in the deficit for 2004-05, primarily through use of reserves and one-time balances, but also through a significant level of spending reductions and by removing discretionary inflation growth from the deficit equation.

After the Phase One plan was agreed upon, a new financial forecast showed that the projected deficit had grown. Not only did the Legislature need to fill an additional $439 million shortfall for 2002-03, but also wanted to find the resources for some new spending, including anti-terrorism efforts and the debt service for the bonding bill.[4] Phase Two (HF 3270) involved additional use of reserves, shifts in payments to school districts and counties, and a small amount of additional spending. In both phases, the Legislature had to override a veto by Governor Ventura for their decisions to become law.

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[1] Minnesota Department of Finance, *November 2001 Economic Forecast*, www.finance.state.mn.us/ffeu/forecasts/2001nov/2001nov.pdf. The state uses a two-year budget cycle, called a biennium. The 2002-03 biennium covers the 2002 and 2003 fiscal years. A fiscal year runs from July 1 to June 30; for example, the 2002 fiscal year runs from July 1, 2001 to June 30, 2002, and is abbreviated FY 2002 or FY02.

[2] See Minnesota Council of Nonprofits, *Principles for State Fiscal Decisions*, www.mncn.org/bp/fiscalp.pdf.

[3] Much of the data in this report comes from House Fiscal Analysis spreadsheets and their *Summary of the Fiscal Actions of the 2002 Legislature*, www.house.leg.state.mn.us/fiscal/files/02budsum.pdf.

[4] The capital investment bill — commonly called the bonding bill — includes projects that are mainly funded through bonds. The interest that the state pays on these bonds is called the debt service.

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By the end of the 2002 session, $2.605 billion in adjustments had been made to the 2002-03 budget and $1.766 billion to 2004-05. The budget-balancing solution passed by the 2002 Legislature is far from ideal, given its heavy reliance on timing shifts and one-time resources, the lack of a long-term solution, and the absence of any revenue increases. However, it does address the short-term deficit with less of a negative impact on vulnerable Minnesotans than other budget-balancing proposals made during the session. Another positive note is that policy-makers took action so that the federal economic stimulus plan did not create additional budget problems for Minnesota. However, a considerable shortfall remains for the next biennium, and balancing the 2004-05 budget will be more difficult, as the state has spent down most of its reserve accounts.

The budget decisions of the 2002 session are outlined in the following table, and described in more detail and measured against our fiscal principles below.

General Fund Changes	**Phase One**		**Phase Two**		**Total**	
($ in millions) Parentheses indicate an *increase* in general fund spending.	**2002-03**	**2004-05**	**2002-03**	**2004-05**	**2002-03**	**2004-05**
Reserves, Transfers, and Shifts	**1,345.0**	**0.0**	**765.0**	**5.0**	**2,110.0**	**5.0**
Budget Reserve	653.0				653.0	
Cash Flow Account	195.0		155.0		350.0	
Tax Relief Account	158.1				158.1	
Local Government Aid (LGA) Reform Account	14.0				14.0	
Assigned Risk Plan	94.9		14.0		108.9	
Workers Compensation Special Fund	230.0		20.0		250.0	
K-12 Aid Payment Timing Shift			437.5	5.4	437.5	5.4
K-12 Special Ed Excess Cost Aid Shift			26.5	(0.4)	26.5	(0.4)
County Social Services Payment Shift			36.9		36.9	
Bond for Cash Capital Projects			75.0		75.0	
Spending Reductions	**505.4**	**1,840.7**	**(34.3)**	**(44.2)**	**471.1**	**1,796.5**
K-12 Education	15.0	24.1	(19.7)	(2.9)	(4.7)	21.3
Family & Early Childhood Education	4.0	8.0			4.0	8.0
Higher Education	50.0	100.0	(5.0)		45.0	100.0
Health & Human Services	96.0	186.4	10.3	(1.7)	106.2	184.6
Environment & Natural Resources	14.3	28.6	9.0	0.1	23.3	28.7
Agriculture	2.7	5.4			2.7	5.4
Transportation/Public Safety (including St. Paul busway)	44.1	8.2	(0.2)	(0.4)	43.9	7.9
Judiciary (including anti-terrorism)	26.3	52.6	(13.0)	(0.1)	13.3	52.5
Economic Development	7.1	16.2	(0.1)	(2.1)	7.1	14.1
State Government	41.9	57.8	6.8	19.7	48.7	77.5
Local Government (TIF Grants)	129.0	76.0			129.0	76.0
Hiring Freeze	40.0	80.0	(10.3)		29.7	80.0
Professional & Technical Contracts Moratorium	35.0	70.0	(6.7)	(13.4)	28.3	56.6
Debt Service & Capital Projects			(5.4)	(43.4)	(5.4)	(43.4)
Eliminate Planning Estimate Inflation		1,127.3				1,127.3
Tax Changes	**0.0**	**0.0**	**24.2**	**(35.7)**	**24.2**	**(35.7)**
June Accelerated Sales Tax Delay			25.5	(25.5)	25.5	(25.5)
Other Tax Changes			(1.3)	(10.2)	(1.3)	(10.2)
TOTAL:	**1,850.5**	**1,840.7**	**754.9**	**(74.9)**	**2,605.4**	**1,765.8**
Balance					**+315.7**	**-1,447.6**

Source: Author's analysis of House Fiscal Analysis data

Use of Reserves, Transfers, and Shifts

The largest component of the budget-balancing plan for 2002-03 is the use of one-time budget adjustments including reserves, transfers from other funds, and timing shifts. While these mechanisms make up for revenue shortfalls in the short-term, they are not a permanent solution. In all, $2.110 billion in adjustments were made in this category for 2002-03, but only $5.0 million in 2004-05, reflecting the one-time nature of this budget-balancing tool.

Reserves and Transfers

The entire $653.0 million Budget Reserve, or "rainy day account," which had been set aside to deal with budgetary shortfalls, was used in Phase One. However, there was a great deal of discussion about the need for some reserves in order to protect the state's credit rating. In Phase Two, additional resources were found so that an estimated $315.7 million will be transferred to the Budget Reserve at the end of the 2002-03 biennium.

The entire $350.0 million Cash Flow Account, which is used to address cash flow problems during the year, was transferred to the General Fund. Under this agreement, the state has access to the approximately $1.183 billion in Tobacco Endowments for short-term cash needs. Endowment funds used for cash flow must be paid back with interest by the end of the biennium. Currently, the interest earned on these endowments are dedicated to programs including medical education and tobacco use prevention. If endowment funds are needed for cash flow, the appropriations from the fund must be held harmless to the extent possible.

Balances were also transferred into the state's General Fund from the following additional special accounts:

- All of the Tax Relief Account, which contained $158.1 million left from the 2000-01 biennium.
- The $14.0 million LGA (Local Government Aid) Reform Account, which was established by the 2001 omnibus tax bill for use in future reform to the LGA formula.
- $108.9 million from the Assigned Risk Plan and $250.0 million from the Workers' Compensation Special Fund.[5]

Shifts

The Legislature makes additional revenues available in 2002-03 by delaying when payments are made to local units of government. Currently, most state aid to school districts is distributed over two years, with school districts receiving 90% of the appropriation in the current fiscal year and the rest in the following fiscal year. Starting in FY 2003, 83% will be paid in the current fiscal year and 17% in the next. The deficit for FY 2003 is reduced because payment of $437.5 million to school districts is delayed until FY 2004. $17.5 million is appropriated to help school districts with cash flow issues that may arise from the new distribution schedule.

Changes are also made to the way in which counties receive community social services funding. One-fourth of these payments is shifted from one fiscal year into the next, which reduces the deficit in FY 2003 by $36.9 million.[6]

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[5] The Assigned Risk Plan provides workers' compensation coverage to employers who are unable to purchase coverage in the private market. At the end of 1999, there was a $553 million surplus in this fund, primarily due to returns on investments. In the 2000 session, $450 million was transferred out of the Assigned Risk Plan and into the following: $325 million to the new Workers Compensation Special Fund to settle long-term claims, $110 million to the state's General Fund, and $15 million to the Minnesota Compensation Health Association. House Fiscal Analysis, *Assigned Risk Plan Surplus Grows by $73 million*, www.house.leg.state.mn.us/fiscal/files/ibasgrsk.pdf.

[6] The affected payments include: community social services grants, family preservation grants, developmental disability semi-independent living services, developmental disability family support, adult mental health grants, and children's mental health grants.

An additional $75 million is made available by taking cash appropriated in past years for certain capital expenditure projects to address the 2002-03 deficit. The projects themselves will still be funded, but by state bonds instead of direct appropriations.

Expenditure Changes

The net effect of expenditure changes made in the 2002 session is a $471.1 million reduction in 2002-03 and a $1.797 billion reduction in 2004-05. In 2002-03, the reductions come from specified cuts affecting nearly every major spending category, as well as a state hiring freeze and contracts moratorium. Of the $1.797 billion in cuts for 2004-05, $669.2 million comes from targeted reductions, the hiring freeze, and contracts moratorium, and $1.127 billion from eliminating discretionary inflation.

In Phase Two, the Legislature offset a few of the consequences of Phase One, including providing funds to reopen the Governor's Residence and to restore tax compliance activities in the Department of Revenue. New appropriations were limited, and include anti-terrorism activities and making up for a shortfall in state financial aid grants.

As is true for the budget as a whole, budget adjustments in each spending category can include expenditure cuts, transfers from dedicated accounts, and shifting funding responsibility to other levels of government. For example, the $2.7 million reduction in Agriculture in 2002-03 is reached by making $1.7 million in expenditure reductions and by transferring $1 million in special revenues relating to agriculture into the General Fund. In some cases, transferring special revenues simply draws down an account balance that would not otherwise be used. In others, it means that fewer funds are available for the specified purpose of the account.

The table below measures the budget adjustments as a percentage of each spending category's General Fund expenditures in the 2002-03 budget. In general, the percentage cut for 2004-05 is roughly twice that for 2002-03, since the cuts for 2002-03 mainly occur in 2003 only, whereas cuts occur in both years of the 2004-05 biennium. This table includes specified adjustments only; it does not include the hiring freeze, contracts moratorium, elimination of inflationary growth, or the impact of timing shifts.

Budget adjustments as a percentage of General Fund expenditures	**2002-03**	**2004-05**
K-12 Education	0%	-0.2%
Family & Early Childhood Education	-0.8%	-1.6%
Transportation/Public Safety[7]	-0.8%	-4.1%
Judiciary/Crime Prevention	-1.0%	-3.7%
Higher Education	-1.6%	-3.4%
Health & Human Services	-1.6%	-2.5%
Agriculture	-1.8%	-4.3%
Economic Development	-1.8%	-3.8%
Environment & Natural Resources	-5.9%	-6.9%
State Government	-6.2%	-10.4%

Source: Author's analysis of House Fiscal Analysis data. Base budget is as measured in the February 2002 forecast.

[7] While the $40 million cancellation for the St. Paul Busway is included in transportation in the table on page 2, it is not included in transportation here, as that project was a capital expenditure and not part of the transportation base budget.

The Legislature sought to focus cuts more on administration and less on program cuts, and therefore the largest percentage cuts are seen in State Government. However, this plan will lead to lay-offs of state workers, and it is unclear how the reductions will impact the provision of services.

The Legislature did not make cuts to general aid formulas to local units of government in this budget agreement. They did eliminate $129.0 million in 2002-03 and $76.0 million in 2004-05 for TIF grants. The TIF grant program was created as part of last year's tax bill to help local governments who may encounter problems with their Tax Increment Financing (TIF) districts due to property tax reform.

Hiring Freeze and Contracts Moratorium

While the majority of cuts in 2002-03 are specified in the targets for each spending area, an additional $58.0 million reduction will come through a hiring freeze and a reduction in contract expenditures, with an additional $137.0 million in savings from these sources in 2004-05. These reductions are *in addition to* the targeted cuts outlined in the various spending areas. The hiring freeze means that executive and legislative branch employers cannot hire any employees before July 1, 2003.[8] If it appears that the hiring freeze will not achieve the full $29.7 million in savings during the 2002-03 biennium, the Governor must make proportional reductions in executive agency operating budgets in order to reach $29.7 million.[9] The $28.3 million saved through professional and technical service contracts would be achieved through reducing contracts and from a moratorium on entering into new contracts before July 1, 2003.[10]

Phase One called for larger reductions in these areas — $40.0 million from the hiring freeze and $35.0 million from the contracts moratorium. In Phase Two, the amounts were reduced to reflect a number of exemptions. Only as these provisions are implemented over time will we know the impact on individual agencies and programs.

Expenditure Reductions in 2004-05

The size of the expenditure reductions jumps from $471.1 million in 2002-03 to $1.796 billion in 2004-05. The $1.796 billion comes in two ways. First, the deficit is reduced by $669.2 million from cuts in the budget from specified reductions, the hiring freeze, and contracts moratorium. The deficit is reduced by an additional $1.127 billion by eliminating estimated inflation from the Forecast.

Since November 1991, the state's Economic Forecasts have provided an estimated inflation figure for the next biennium to approximate the amount needed for existing programs to respond to price increases caused by inflation.[11] The estimated inflation amount is not automatically added to the state's budget, but rather is only expended when appropriated by the legislature for a specific purpose.

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[8] Exemptions are made for Minnesota State Colleges and Universities (MnSCU), employees of state correctional facilities, employees of the Department of Corrections who provide direct service to offenders, employees of state operated services within the Department of Human Services, student workers, employees paid entirely with federal or special revenue funds or by non-state entities, and employees who perform essential services.

[9] If proportional reductions become necessary, portions of the Department of Corrections and Department of Human Services budgets would not be reduced.

[10] MnSCU and the Higher Education Services Office (HESO) were exempted from the contracts moratorium, as are contracts paid entirely by non-state sources; contracts relating to threats to public health, welfare, or safety; contracts necessary to avoid a disruption of essential state functions, that reduce state costs, or avoid a legal liability; and contracts authorized by the 1999 through 2002 bonding laws.

[11] For more on this topic, see House Fiscal Analysis, *Planning Estimate Inflation in State Budget Forecasts*, www.house.leg.state.mn.us/fiscal/files/ibinflate.pdf.

It is unfortunate that the Legislature chose to change Forecast methodology. The state will face inflationary pressures whether or not they are specified in the Forecast document. Unless additional revenues are found to provide inflationary adjustments, after program and state agency budgets are reduced in 2004-05 through specified cuts, the hiring freeze, and contracts moratorium, their budgets will be further eroded by a projected 2.5% each year by inflation.

Tax Changes

The tax decisions made in the 2002 legislature have little net impact on the state's fiscal picture, and are mainly adjustments to existing law.[12] Tax changes raise $24.2 million in revenue in 2002-03 and reduce revenues by $35.7 million in 2004-05.

Perhaps the most significant part of the bill is in the area of federal conformity. Minnesota largely follows federal law definitions related to income and corporate taxes. However, conforming to the federal economic stimulus package enacted in March 2002 would mean a loss of $233.5 million of state revenue for 2002-03 and $145.6 million in 2004-05. In the omnibus tax bill, policy-makers agreed to conform to most of the items in the federal stimulus bill, but not the "bonus depreciation" provision, which accounts for most of the cost. Bonus depreciation allows a business to claim an immediate tax deduction of up to 30% of the cost of new equipment purchases, rather than following the standard accounting approach of depreciating the cost gradually over several years. The decision not to conform to this federal provision strikes a balance between keeping things simple for taxpayers and avoiding a significant loss of revenue.

The tax bill also revisits the issue of the June Accelerated Sales Tax. Currently, merchants must remit a portion of their estimated sales tax collections for June in advance, which moves some sales tax revenues into the prior fiscal year. In the 2001 session, legislators decided that this provision should be repealed, and that in the year prior to the repeal, the advance payment would be only 62% of estimated June sales taxes, rather than 75%.[13] Under the omnibus tax bill, the repeal will still take place in 2004, but the accelerated payment for 2003 will remain at 75%. This shifts $25.5 million of sales tax revenue from the 2004-05 biennium into 2002-03.

The sales tax exemption for construction of low-income housing was scaled back in the omnibus tax bill. This provision, which was passed in the 2001 session, exempted construction materials for low-income housing owned by housing authorities or nonprofits. The 2002 tax bill extends the exemption to low-income housing owned by other types of entities, but limits the exemption only to that portion of a project that is low-income housing, rather than the entire project.

Finally, the stadium bill (HF 2214) allows for a sales tax exemption on construction materials for the project. Assuming a $330 million stadium, this exemption would cost the state $1.6 million in sales tax revenues in 2002-03 and $9.1 million in 2004-05.

Bonding

Normally, the focus of even-year sessions is the capital investment, or bonding, bill, which describes capital projects to be funded during the next six years. The bonding bill passed by the 2002 Legislature totaled $983.6 million. However, this does not mean that the state needed to find $983.6 million immediately to pay for the projects. Rather, the state issues bonds to fund most capital investments, and the short-term cost comes from the debt service on those bonds,

[12] While most of the decisions regarding the tax provisions were made in the budget reconciliation conference committee, the tax provisions were contained in the omnibus tax bill, HF 2498.
[13] Although the intent of the 2001 law was to repeal the June Accelerated Sales Tax in June 2003, due to an error in the bill, the law is now being interpreted so that the repeal takes place in June 2004.

plus any direct appropriations. As originally passed, the bonding bill would have a general fund impact of $17.8 million in 2002-03 and $94.4 million in 2004-05.

Governor Ventura was dissatisfied with the budget decisions made by the Legislature, and argued that since the 2004-05 budget was not balanced, the state could not afford the debt service on a bonding bill of this size. Using his line item veto authority, the Governor eliminated $356.7 million in projects, and put an additional $44 million "on hold." As a result of the Governor's vetoes, the cost of the capital investment bill was lowered to $5.4 million in 2002-03 and $43.4 million in 2004-05.

How Does This Plan Measure Up?

The budget-balancing plan passed by the 2002 Legislature is disappointing in several ways, including its reliance on timing shifts and one-time resources and the fact that revenues are not part of the solution. However, the Legislature did address the short-term deficit with a set of choices that are less harmful to vulnerable Minnesotans than some other proposed solutions, and acted to avoid allowing the federal economic stimulus plan to create an even larger state deficit. The budget-balancing decisions of the 2002 Legislature are measured against our principles below.

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 2002 Legislature resolved the short-term deficit while mainly avoiding dramatic reductions in 2002-03 in programs helping low-income families, laid-off workers, and other vulnerable populations. Counter-cyclical programs are being allowed to play their needed role during a downturn — the Legislature provided additional funding for the state dislocated worker program and provided extended unemployment insurance benefits for some workers. However, it is not yet clear what impact the large cuts in state government will have for the provision of services.

Given that the cuts for 2004-05 are larger but even less well-defined, we cannot say at this point whether the goals of not harming low-income and other vulnerable populations will be achieved in the next biennium. The fact that significant cuts to health and emergency assistance programs for low-income persons were proposed during the 2002 session sets an ominous tone for 2003.

The state should use a combination of the three primary budget-balancing tools available: raising revenue, using reserves, and cutting spending.

Only two of the three tools were used by the 2002 Legislature to address the 2002-03 deficit: use of reserves and spending cuts. For 2004-05, only spending reductions were used. Revenue increases were not part of the solution, even though the deficit is the result of revenue shortfalls.

At $1.448 billion, the remaining 2004-05 budget deficit is too large to solve through spending cuts alone, and few reserves are left. Progressive revenue raising must be part of the solution when the 2003 Legislature takes up the 2004-05 budget.

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.

In the past five legislative sessions, over $13 billion in surpluses were allocated. The majority (53%) went for rebates and permanent tax reductions.[14] Given that tax cuts were such a large part of the budget agreements in times of surplus, tax increases should have been part of the agreement to address the deficit.

On the positive side, those spending areas that were unable to even keep up with inflation in the 2002-03 budget as originally passed — Family & Early Childhood Education and Economic Development — were not singled out for disproportionately large cuts in the final agreement.

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.

Conforming to the federal stimulus package would have cost the state $233.5 million in 2002-03. Policy-makers chose to "decouple" from the most costly provision, and in doing so found the appropriate balance between taxpayers' desire for simplicity and the state's revenue needs.

What Lies Ahead?

Although the 2002 legislative session has ended, the impact of its fiscal decisions is not fully known. Only as the provisions are implemented will we know the specific implications of the hiring freeze, contracts moratorium, and general reductions in the operating budgets of state agencies.

A significant challenge remains for 2004-05. Under current estimates, the 2003 legislature will face a $1.448 billion deficit, and the deficit would be $1.127 billion higher if the Forecast recognized inflationary pressures. In addition, the state has already used up most of the reserves that made it possible to balance the 2002-03 budget without raising revenues or slashing government services. While some are holding on to the hope that the economy will turn around and make the deficit go away, the $1.448 billion deficit is based on an economic scenario that already includes an improved economy, and recent reports have shown state revenues are lagging behind the projections.

Policy-makers should return to the principles we have outlined above. After already cutting $1.766 billion from the 2004-05 budget, it's hard to imagine how an additional $1.448 billion could be cut without creating hardship for vulnerable Minnesotans. In this session, only two of the three budget-balancing tools were used. Next session, with reserves nearly depleted, policy-makers must pick up the third tool and acknowledge that the tax cuts of previous sessions went too far, and left the state in a position where it cannot meet its obligations.

[14] Children's Defense Fund-Minnesota and Minnesota Budget Project, *Wasted Opportunities: How We Used Our Surpluses 1997-2001*, www.mncn.org/bp/wasted.htm.