Minnesota Needs to Prepare for Future: Inside the November 2017 Economic Forecast

MINNESOTA BUDGET PROJECT
An initiative of the Minnesota Council of Nonprofits

The *November 2017 Economic Forecast* brought some concerning news. Minnesota is in shaky budget territory, with a $188 million negative balance projected for the current two-year budget cycle, FY 2018-19.[1] Minnesota also has a projected $586 million deficit for the upcoming FY 2020-21 biennium.

Forecast Numbers at a Glance

- Minnesota has a projected $188 million negative balance for FY 2018-19, the current biennium.
- Minnesota has a projected $586 million deficit for FY 2020-21, which does not include the $1.3 billion impact of inflation on expenditures.

This November forecast marks the first comprehensive look at Minnesota's budget landscape that incorporates the budget passed in the 2017 Legislative Session. Notably, state policymakers used almost all of last year's projected surplus on a budget that included large and growing tax cuts. Meanwhile, federal policymakers have put forth proposals that could significantly cut federal funding to the state while also shifting additional responsibilities to it.

More recent information suggests the state budget numbers are likely to improve when the next state budget forecast is released in February. But nonetheless, the November forecast underlines that last year's budget left the state in a vulnerable position. This session, it will be imperative for Minnesota policymakers to position our state to continue to meet the needs of Minnesotans in a time of significant uncertainty.

Minnesota Forecast to Have Negative Balances for this Biennium and Next

The forecast projects a $188 million negative balance for FY 2018-19 and also projects a deficit for the next budget cycle. In FY 2020-21, the state has a $586 million projected deficit, and this does not include the $1.3 billion estimated cost for current funding levels in many areas of the budget to keep up with inflation.

The projected deficit is due to a number of factors, including lower projected revenues and increased projected spending compared to the end of the last legislative session. In the current FY 2018-19 biennium, tax revenues are expected to come in slightly lower than previously expected, primarily due to lower income and corporate taxes. At the same time, the forecast anticipates higher special education spending, a result of more children receiving the services they need with smaller student to staff ratios.

The FY 2020-21 estimate shows a more significant deficit, even while assuming that spending for most services will continue at FY 2018 levels, with only limited funding adjustments in response to changes in school enrollment and health care caseloads, as required by law.

The state's economic forecasts are critical tools that policymakers and the public use to measure the state's fiscal health and form the baseline against which spending and tax proposals are assessed. Minnesota Management and Budget prepares forecasts each November and February. State, national, and global economic trends are used to estimate Minnesota's future revenues and expenditures under current laws on taxes and spending.

For more than a decade, the official forecast figures have left out the impact of inflation on most areas of future spending. Failing to include the impact of inflation can lead policymakers to make tax and budget

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decisions that are not sustainable. The state's Council of Economic Advisors recommends that Minnesota include inflation in its planning estimates so that they provide a more useful guide to policymaking.

Slow Economic Growth Expected Nationally, But There's Considerable Uncertainty

The forecast shows that Minnesota's economy is still doing fairly well. Minnesota's economic growth was faster than the nation's in 2016. Low unemployment combined with a high demand for workers mean the state continues to have a tight labor market, which has supported wage and income growth. It's not all roses at the state level though; the forecast notes that Minnesota's housing market is tight, which could mean more Minnesotans with unaffordable housing costs.

The national economy is expected to grow at a slower rate than previously projected in the February 2017 forecast. The economy is expected to grow by 2.2 percent in 2017 and between 2.0 and 2.5 percent yearly from 2018 through 2021.

Like any prediction of the future, this economic forecast is subject to risk. IHS Markit, the state's macroeconomic consultant, assigns a 65 percent probability to their baseline economic forecast. They assign a 20 percent probability to their more pessimistic scenario in which there is a recession in 2018. The forecasters also assign a 15 percent probability to a more optimistic scenario.

However, with large-scale policy changes proposed at the federal level, there was increased uncertainty around this forecast. Soon after the November forecast came out, federal policymakers passed a tax bill that introduces sweeping changes to our nation's tax and health care systems, while increasing the national deficit by at least $1 trillion. These changes will have far reaching impacts, which may not be fully captured even in the next budget and economic forecast. The state's January Economic Update suggests modest positive economic impact from the federal tax bill. However, federal policymakers are still discussing potential deep funding cuts, which would also create big budget challenges at the state level.

The forecast also projects continued economic growth throughout 2021, which would amount to over 10 years of economic growth since the last recession. Such sustained economic growth would be fairly unprecedented, and would be well beyond the average length of economic expansions in the United States.[2] In the past 50 years, the U.S. has experienced a recession every five or six years on average. Recessions of course don't happen on a timer, but the longer the economic growth, the less likely it is that we will continue to avoid a recession.

Policymakers Should Prepare for Uncertain Future

The November forecast is our first glance at the state's budget and economic picture in advance of the upcoming legislative session. The forecast that policymakers will use to inform their decisions in the 2018 Legislative Session will come in February.

As required by law, the November forecast's budgetary projections are based on current state and federal laws – the forecast doesn't anticipate likely federal changes. The February forecast will include the impact of the federal tax bill, and the state's budget picture will improve since federal policymakers finally reauthorized funding for the Children's Health Insurance Program (CHIP). But at the same time, there are serious threats to both the state's budget and Minnesotans through federal proposals that would fundamentally weaken federal commitments to the safety net. These would result in a large loss of funding to the state and to essential federal services that Minnesotans count on.

In addition to potential federal changes, the economy itself is another area of uncertainty. Forecasters give a one in five chance that there will be a short recession this year. During a recession, the needs of Minnesotans grow – just at the time that the resources our state relies on to meet those needs shrink.

State policymakers are not able to control the decisions that come out of Washington or the course of the national economy. But their priority should be to put the state in a strong position to respond to federal changes and to support Minnesotans in an economic slowdown. Getting ready for what's ahead is more important than ever to make Minnesota a state where everyone can thrive.

Strengthening the state's budget reserve is one important way to better position the state to respond to an uncertain future. The budget reserve is critical to ensuring Minnesota can adequately respond to the next economic downturn. In the same way a family might save to be able to make it through a long illness or job loss, Minnesota keeps this reserve so when a recession hits, the state can avoid drastic cuts in essential services and continue to serve Minnesotans' needs. During the last recession, deficits were much larger than the budget reserve, and Minnesota policymakers made painful service cuts. A healthy level of reserves makes it possible to maintain essential services when Minnesotans fall on tough times, and afford state policymakers the time they need to make responsible and thoughtful budget choices instead of having to make hasty decisions to balance the state's budget.

The November forecast brought our state some concerning news. The picture is likely to improve in February, but it won't change the fact that Minnesota is not as well prepared as it should be to meet the challenges ahead. In the upcoming legislative session, policymakers should make strategic choices that strengthen the state's economic future, while also strengthening the state's ability to respond to uncertainty, whatever the source.

By Clark Goldenrod

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[1] Data in this analysis come from Minnesota Management and Budget, November 2017 Budget and Economic Forecast, December 2017.
[2] Minnesota Budget Project analysis of National Bureau of Economic Research data.