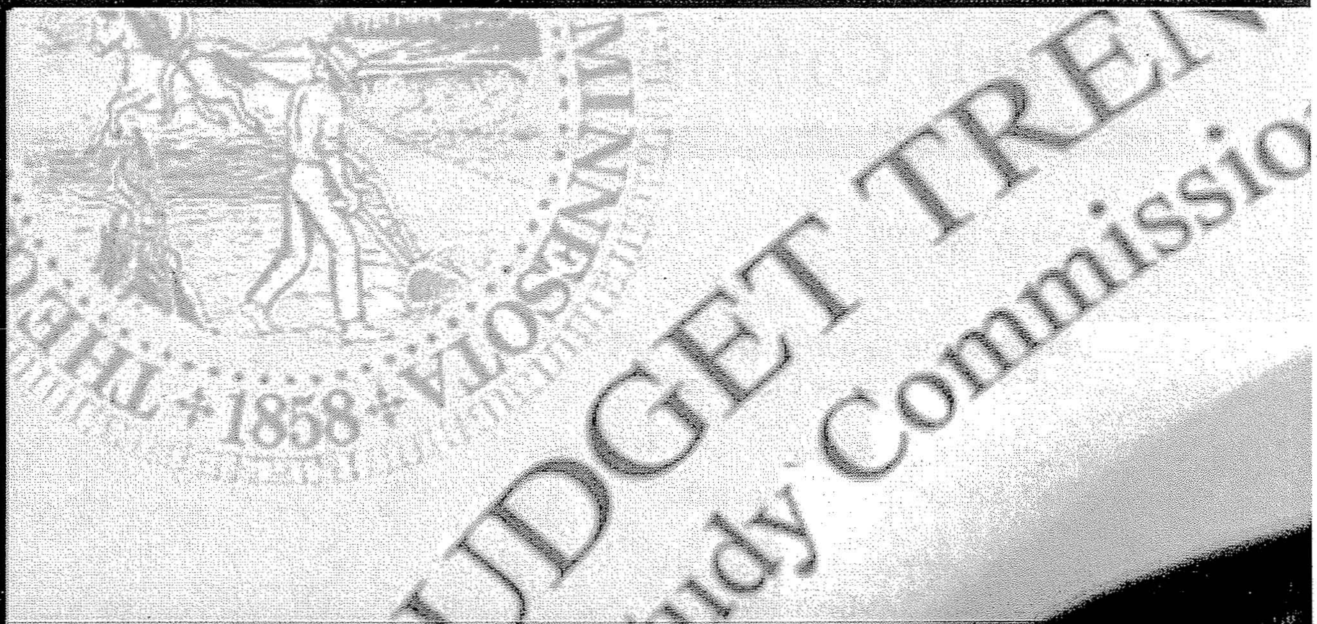
State of MINNESOTA



Budget Trends Study Commission

Commission Report to the Legislature

January 12, 2009

Budget Trends Study Commission

January 12, 2008

Representative Lyndon Carlson
Chair, House Finance Committee

Senator Richard Cohen
Chair, Senate Finance Committee

Representative Ann Lenczewski
Chair, House Tax Committee

Senator Tom Bakk
Chair, Senate Tax Committee

We are pleased to transmit the final report of the State Budget Trends Study Commission. The Commission was authorized by the Laws of Minnesota 2007, Chapter 148, Article 2 and was comprised of fifteen members including five members appointed by the governor; five by the senate and five by the house.

The Commission began meeting in the fall of 2007 and held fourteen meetings. The Commission reviewed financial recommendations from various studies completed over a 30 year period and heard presentations from numerous state officials with backgrounds in demography, education, health care, finance, and economics. We want to acknowledge the fine work of those individuals and the tremendous support that we received from the Minnesota Management and Budget staff.

The final report identifies fourteen primary findings on demographic and fiscal trends that include:

- Minnesota is currently experiencing a major, long-range demographic shift.
- Despite continuing to rank high among many key social and economic indicators, Minnesota's economy has underperformed recently relative to the nation.
- Minnesota has a long-term structural budget problem, with long term expenditure growth likely to outpace revenue growth.
- Health care growth will become the most important factor in controlling rising state expenditures
- Adjusting the mix of state taxes, while leaving tax base and revenue growth rate neutral, cannot significantly reduce revenue volatility without a radical change in tax rates and a dramatic reweighting of tax revenue sources to the system.
- Minnesota's statutory budget reserve ceiling has not grown to an appropriate level to adequately manage the underlying risks in Minnesota's tax system over time.

I. Introduction

For a cold place at the end of the road, Minnesota's economic performance over the past half-century has been very successful. Prudent and adequate investments in education, infrastructure, and technology have fueled enhanced productivity, innovation, and global competitiveness. Overall, Minnesota's economic growth rate has outpaced the national average and the state has led in many social and economic indicators.

Past performance, however, does not ensure future success. Despite continuing to rank high in many key areas, Minnesota's population and employment growth, for example, have slowed considerably since 2002 relative to the experience of the 1990s. These, along with growth in per capita personal income and per capita GDP, have more recently begun to lag national growth for the first time in over a decade.

Minnesota is experiencing a period of rapid and critical change. Some of the recent economic underperformance can be attributed to short-term fluctuation in the business cycle, such as the slump in new housing construction. Likewise, Minnesota has not benefitted from strong growth in national defense spending or energy production and has suffered from challenging times in the airline industry. Looking longer term, however, it is now critically important to consider how these current economic concerns will influence Minnesota's growing challenges coupled with an aging population, a changing workforce, rising health care costs, and slowing taxable consumption.

Today, as the first of Minnesota's 1.4 million baby-boomers begin to reach retirement age, the state has reached an inflection point - a moment of profound change that produces an immediate shift from recent trend. This milestone requires a complete reassessment of the way the state's economy is perceived. No longer can Minnesota sit by and watch as the crest of this giant aging wave grows larger. As Minnesota's population begins to transform, new, long ranging factors will begin to weigh more and more heavily on the state's tax base, spending needs, and overall economic progress. The wave is beginning to break and policymakers have not adequately prepared for the overwhelming implications this will have on state government finances.

The 1995 *Within Our Means* report issued by Minnesota Planning made the following prescient appeal:

> "If there is a time to solve the state's fiscal problems, it is now. The economy has been strong. The percentage of Minnesotans of working age is still growing and will reach an all-time high in 2010, before beginning a long-term decline. Over the next 15 years, the combined proportion of children and elderly — the age groups most dependent on support from others — will be less than at any time since 1950. From now to the year 2010, the state will have a maximum percentage of people in their peak earning years. After 2010, solutions will be more difficult, as the percentage of Minnesotans of working age begins to decline."
>
> - Within Our Means, 1995

Unfortunately, as a consequence of the relative strength of Minnesota's economy throughout the late 1990s, this call for action was fundamentally ignored. Today, the economy is weaker and the state's fiscal problems have grown more apparent. Despite this, however, the plea for meaningful attention is now more critical than ever. Whether designed with intention or not, the policies established today will form long-range expectations that will be very difficult to modify in the future. If Minnesota wishes to have the prosperity it had in past decades, the solutions will need to be robust, effective, and immediate.

II. Charge of the Budget Trends Study Commission

The Budget Trends Study Commission was established by the 2007 Minnesota State Legislature. The Commission is charged with studying the impact Minnesota's changing demographic trends will have on the long-term stability of state budget conditions, including examining revenue volatility and trend growth rates, current spending pressures, long term revenue forecasts, and projected expenditure obligations. The Commission was informed by past commission reports and consulted with various state agencies, including the Minnesota departments of Revenue and Education, the State Demographic Center, the Office of Higher Education, and Minnesota Management & Budget (MMB), on current demographic data and analysis, long-term projections of revenues and expenditures, and analysis of tax base volatility.

This report contains the Commission's findings and recommended actions. Additional information, including the full content of presentations made to the Commission, can be found on MMB's web site. It is the Commission's hope that this report will assist the Governor and State Legislature in proactively addressing long term budget stability.

III. Background: Past Commission Reports

The Budget Trends Study Commission builds on the valuable work of previous Minnesota commissions and work groups that have convened over the last 25 years to address state government finances. Many of the issues the state is currently facing have been discussed for decades and remain relevant today. The Commission has mindfully incorporated their insights into this report.

Past reports have focused on some combination of three topics: improving tax policy; promoting economic growth; or adjusting budget processes. The most common focus has addressed revenue system changes and policies directed toward achieving enhanced revenue stability. A recommendation often encouraged is a broadening of the sales tax base to increase revenue predictability and fairness in the tax system. Other revenue themes included the need to maintain simplicity in the tax system by decreasing the number of tax credits, deductions, and exemptions allowed. Others suggested improving predictability by minimizing annual changes in the tax law. (Appendix A includes a summary of the past reports and their key findings.)

Past reports also address the need to use better financial management tools and spending controls in order to improve budget stability. Many of these recommendations form the basis for the state's current practices. Maintaining an adequate budget reserve, defining revenue and spending targets, and using more comprehensive long-range planning tools have all been recommended in the past. Previous commissions have recommended establishing spending controls, such as setting fixed spending targets for major expenditure areas that do not fluctuate based on forecast or entitlement changes. Establishing formal contingency plans in the event of insufficient revenues has also been suggested.

The Budget Trends Study Commission has built on an extensive body of work provided by previous commissions. As much as these past reports provided a base for this commission to work from, topics such as the impact of demographics on revenues and spending, the size of the budget reserve, and the issue of budget volatility were not directly addressed. It is our intention that the Budget Trends Study

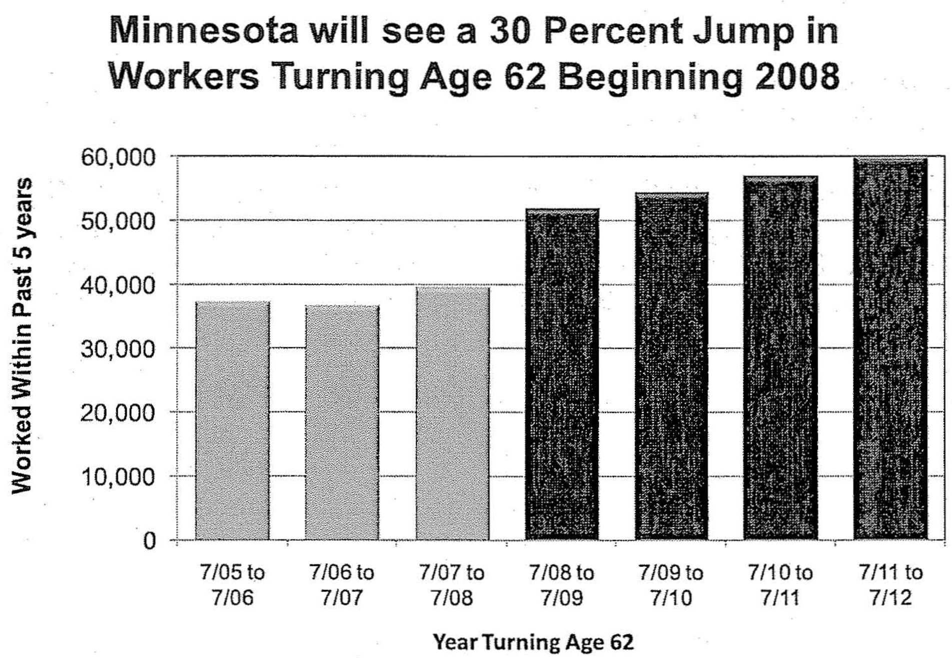
Commission's recommendations be added to this body of knowledge so that it might help to frame current and future budget discussions.

IV. Commission Findings

Over the last year of deliberations, the Budget Trends Study Commission carefully considered numerous presentations on current demographic analyses, policy area overviews, and original economic research and analysis. These presentations provided the source for **14** principal findings, which are listed below.

Finding #1: Minnesota is currently experiencing a major, long range demographic shift.

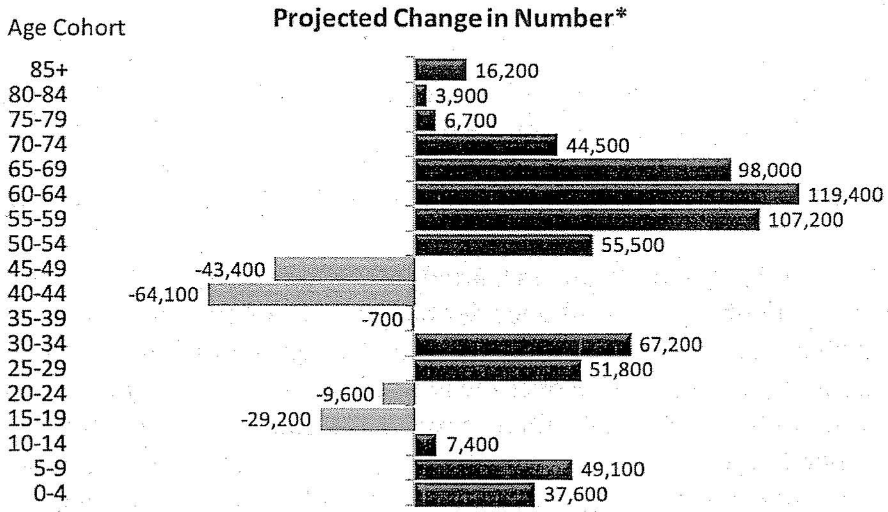
The first of Minnesota's 1.4 million baby boomers started to reach traditional retirement age in recent years and are now becoming eligible for Social Security benefits. Beginning in 2008, the state will see a 30 percent increase in the number of workers turning age 62. The aging of Minnesota's largest generational cohort will continue to accelerate over the next 12 to 13 years and their pending retirement will put an incredible strain on the state's labor force, private and public sector employers, tax revenues, and priorities for public spending moving forward. Although little has been done to prepare for this demographic shift, it will have extraordinary implications for the state's economic and workforce development priorities, health care, economic assistance, social service, and education programs.



Source: Minnesota State Demographic Center & American Community Survey (2005)

Interpreting the impact of this demographic trend was a significant element of the Brandl-Weber report entitled *An Agenda for Reform.* Written in 1995, it argued that current spending trends are unsustainable given the demographics of the state and the nation. The report recommended changes to the spending and budgeting processes. These were ultimately obscured, however, by a short-lived increase in revenues beginning in the late 1990s.

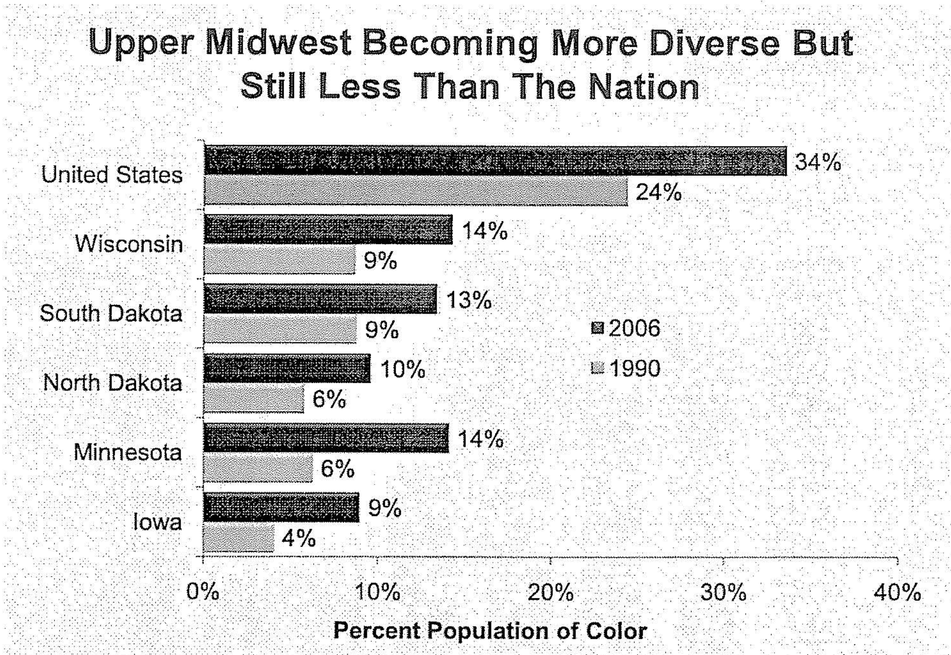
From 2005 to 2015, the Fastest Growth in Minnesota will be from Ages 55 to 69



Source: Minnesota State Demographic Center
*Numbers are rounded

Finding #2: Minnesota has become more diverse in recent years and this will continue to increase as economic growth depends on attracting new workers to the state.

Net migration, both domestic and international, continues to increase the diversity of Minnesota's population. Most migrants are younger, thus migration has slowed the societal aging process and is adding workers to the labor force. Younger migrants also increase Minnesota's fertility rates. Without migration, the population of Minnesota and the United States would currently be older and have fewer births.



Note: Population except white alone, not Hispanic, 2006 Census Bureau estimate
Source: Minnesota Demographic Center

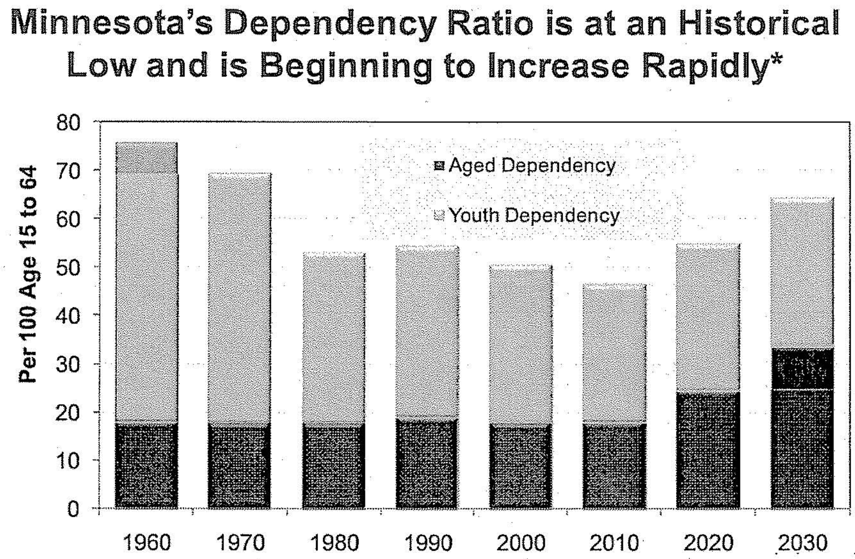
While net migration has diffused the aging process, it has not reversed. For the next two decades, while most of the growth in the state and national population will be from people in their 60s and 70s, much of Minnesota's workforce growth will be migrants from other states and countries. The demand for new workers to replace the retiring workforce drives both international and domestic migration and will be increasingly necessary as Minnesota faces a reduction in the working age population. Minnesota's economic performance will be increasingly tied to the ability to attract new workers.

Finding #3: Public spending priorities will need to shift as Minnesota's economically dependent population grows larger and relies more heavily on fewer workers.

Since the 1980s, Minnesota's economy has benefited from having a peak level of workers in their peak years of productivity and earnings. This has fueled extraordinary economic growth and productivity gains. As the boomer generation begins to exit the labor force, however, a very large cohort in their late 40s to early 60s will be followed by a much smaller, younger, and less experienced generation currently in their 20s and 30s. As a result, the labor force will begin to grow at a much slower pace than encountered in the recent past and it will be necessary that new workforce entrants are adequately prepared to be productive contributors to the Minnesota economy.

The dependency ratio, which is a measure of the population that is traditionally active in the labor force versus those who are not, is currently at a record low. As baby boomers reach retirement age and Minnesota's labor force growth rates start to decline, the dependency ratio will begin to rise. This will mean that the earnings of the working age population will need to be stretched further to support the state's economically dependent population.

A rising dependency ratio will have profound implications on virtually all aspects of state and local government. For instance, a larger dependent population will put upward pressure on government expenditures. Dependent populations rely more heavily on health care, education, economic assistance, and social service programs. For example, when individuals in their late 40s and early 50s move into their late 50s and early 60s, annual health care costs double, thus the aging of the baby boomers will have large effects on state human services, health care, and related expenditures.



*The dependency ratio is calculated by comparing the number of people between the ages 0-14 and 65 and over to the number of people between the ages of 15-64.

As the demand for services targeted toward seniors increases there will not be a corresponding decrease in the demand for other essential state services, such as K-12 education. Current trends signify that by 2020 the number of seniors in the state of Minnesota will exceed the number of school age children for the first time. However, this change is due to the unprecedented number of individuals reaching age 65, not to a drop in the school age population. Over the next twenty years, the number of school age children in Minnesota will actually be increasing.

Historically Minnesota has had a very well educated population, with a high percentage of the population having a high school diploma. High school graduation rates, however, are declining in Minnesota and throughout the United States. This decline will threaten our ability to compete in the global economy. One particular concern is the drastic difference in graduation rates between white and minority students. High school graduation rates for black students, for example, are currently 27% lower than graduation rates for white students in Minnesota. There is an even wider gap reported in some publications that use a different methodology for measurement.[1]

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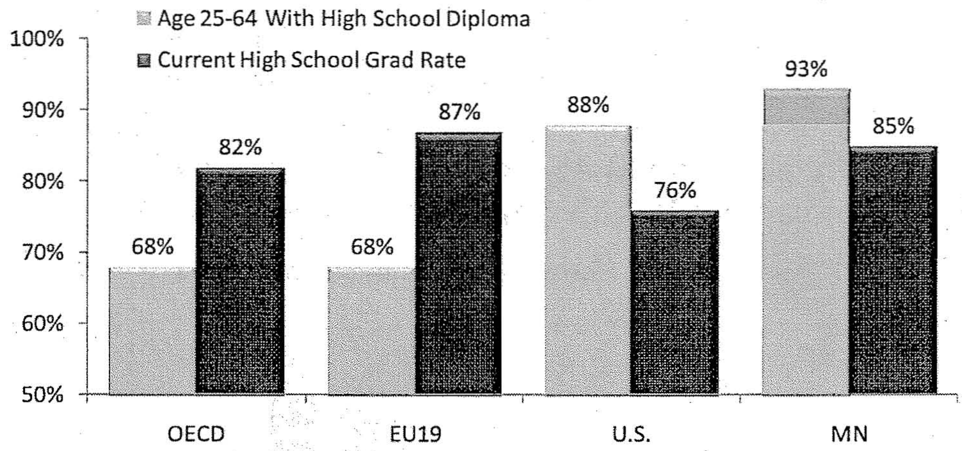
[1]The graduation rates cited are provided by the Office of the State Demographer. There is currently not a clear consensus on the methodology for measuring graduation rates. The federal government is working on rules to standardize the methodology. The Minnesota Department of Education is moving toward the use of the National Governors Association Graduation Rate. The NGA rate is a four-year, on-time graduation rate agreed to by all 50 states. This methodology results in lower graduation rates than those provided above. More information can be found on the MDE website at www.education.state.mn.us

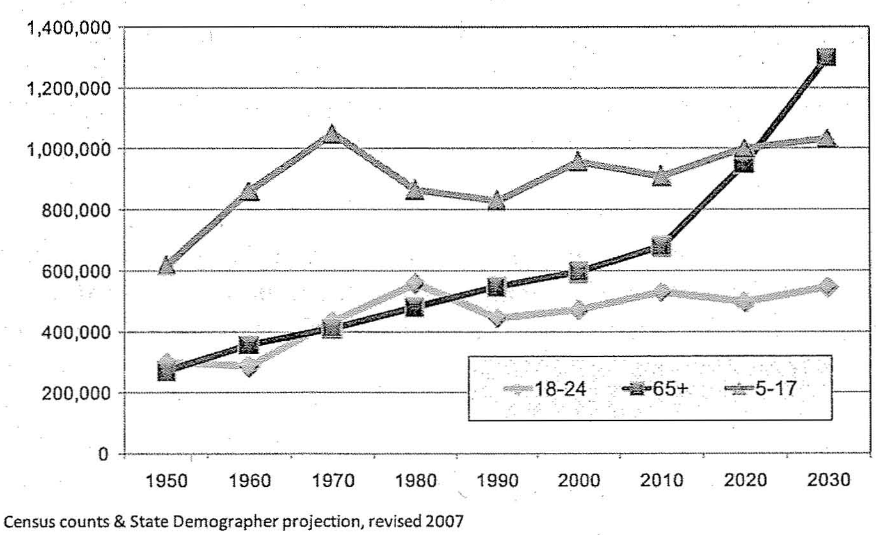
High School Graduation Is Declining In The US & MN While Increasing In Our Competitor Countries



Source: OECD Education At A Glance, 2005

The demographic shift will also impact the state's budget by placing downward pressure on revenues. A large percentage of the income seniors report on their tax returns is tax exempt. According to a recent study by the Minnesota Department of Revenue, two-thirds of Social Security, one-quarter of pension and IRA income, and 28% of the total income of the average Minnesota senior is tax exempt. The study also found that once an individual turns 60 years old the amount of income tax they pay declines much faster than their total income declines. For example, in Minnesota total income for individuals aged 65 to 69 is approximately 18 percent less than for those aged 55 to 59, while average income tax paid is approximately 40 percent less.

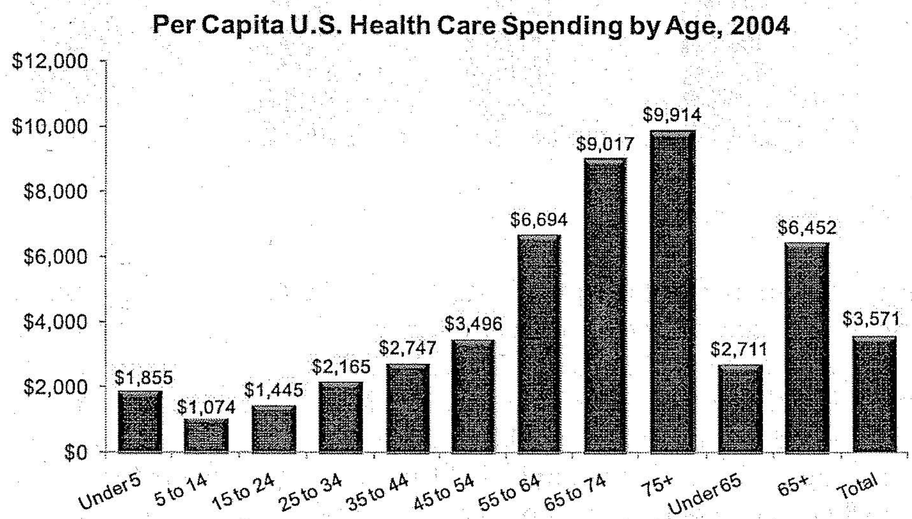
Critical Age Shifts of School Age and Senior Populations Beginning in 2008-2011 will Result in Changing Spending Priorities



Census counts & State Demographer projection, revised 2007

Seniors also pay less sales tax than non-seniors. Based on a 2004 study of consumption differences by age, Paul Menchik of Michigan State University suggested that aging alone would reduce sales tax revenue by 5 percent in the typical state between 2000 and 2030. In contrast, a more recent analysis by Peter Fisher of the University of Iowa suggests that aging by itself will increase sales tax revenues by 0.3% between 2005 and 2030. For Minnesota, Fisher estimates a small reduction in sales tax revenue of 0.2% due to aging. Overall, there are other reasons to worry about the future of sales tax revenues. For example, the general growth in the largely untaxed services sector and the inability to collect tax on many internet and catalog sales is more concerning than the aging of the population.

Individuals ages 45-54 Spend Nearly Half the Amount on Health Care as those ages 55-64



Source: Agency for Health Care Research and Quality, Medical Expenditure Panel Survey, data for per capita spending by age group in the Midwest. Excludes spending for long-term care institutions.

Finally, another likely impact of a rising dependency ratio will be an increase in the importance of information technology (IT) and its role in delivering state services. At a minimum, increasing IT capacity will be necessary to boost productivity of the remaining workforce. It will also be needed to support complex government programs and keep pace with the demands of the citizenry regarding customer service, access to information, and system integrity. Government currently depends on a loosely coordinated network of county and state workers to navigate a complex array of regulations and program objectives. This strategy will certainly not work for the future without support for information systems that provide necessary controls over funds, convenience for customers, and provide policy makers better and timelier information.

Finding #4: Despite continuing to rank high among many key social and economic indicators, Minnesota's economy has underperformed recently relative to the nation. Accordingly, the Governor and Legislature should be conscious of assumptions regarding future economic growth when proposing budgetary changes.

Minnesota's economic performance has outpaced the national average over the past half-century. In 1960, for example, Minnesota ranked 25th in the nation in personal income per capita. By 2006, the state ranking was 14th.

Past performance, however, does not ensure future success. The vibrant "dot-com boom" economy of the late 1990s left Minnesota with strong momentum moving into the 2001 recession. This arguably helped dampen the severity of the downturn. During the subsequent recovery, however, Minnesota's population and employment growth slowed significantly relative to the experience of the 1990s. Despite continuing to rank high in many key areas, by 2004, both indicators had begun to significantly lag national growth for the first time in at least a decade.

While there are additional factors that could weigh more heavily on the state's economy than on its national counterpart, some of the recent economic underperformance can be attributed to short-term fluctuation in the business cycle, such as the slump in new housing construction, abnormal financial market conditions, or the sharp decline in spending for automobiles and household durables. Likewise, Minnesota has not benefitted from strong growth in national defense spending or energy production and has suffered from challenging times in the airline industry. A satisfactory explanation for this phenomenon, or whether Minnesota's recent economic underperformance will continue, will not likely be available until well into the recovery.

Finding #5: Demographic and economic factors will lead to lower growth of state tax revenues over the next 25 years.

Minnesota's economy will grow over the next 25 years, but both state and national real (inflation adjusted) growth rates are expected to be well below those experienced during the late 1990s. Between 1996 and 2000 real GDP grew at an average annual rate of 4.1 percent. Between 2026 and 2030, Global Insight's trend growth forecast shows real GDP growth rates averaging just 2.4 percent. That slowdown in national economic growth rates is expected to produce slower general fund revenue growth in Minnesota.

As Minnesota's population ages over the next 25 years, retirees become an increasingly larger proportion of the tax payer base. Between 2005 and 2030 the number of Minnesotans age 65 to 69 will increase by 120 percent; the number between age 70 and 74 by 140 percent. Both the slowdown in projected real economic growth rates and the increased percentage of the taxpayer base over age 65 will affect the long-term state revenue outlook[2,3].

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[2] Long Term Revenue Forecast Assumptions: Projected state tax revenue growth rates for the next 25 years were prepared for the Commission's use by Minnesota Management and Budget's economic analysis division using economic assumptions taken from the Global Insight, Minnesota's national economic consultant, trendlong scenario prepared in February, 2008. The long-term projections assume the economy suffers no major mishaps between spring 2008 and the end of the 25 year forecast horizon. In that scenario actual output is assumed to be equal to potential output and no recessions are included in that projection.

Estimates of the changes in the age distribution of Minnesota taxpayers were made based on projections provided by the State Demographic Center. The models used in the long-term revenue forecast exercise were the same as those used in the twice yearly biennial revenue forecast with one important exception. The income tax model was adjusted so that the filer base in 2033 reflected not only the income growth that occurred over the 25 year forecast horizon, but also the change in the age distribution and the accompanying changes in the composition of income that would occur given the changes in age distribution. Finally, an analysis of the impact of individuals moving from no-filer to filer status conducted by Minnesota Department of Revenue staff showed no material effect on projected revenue growth rates.

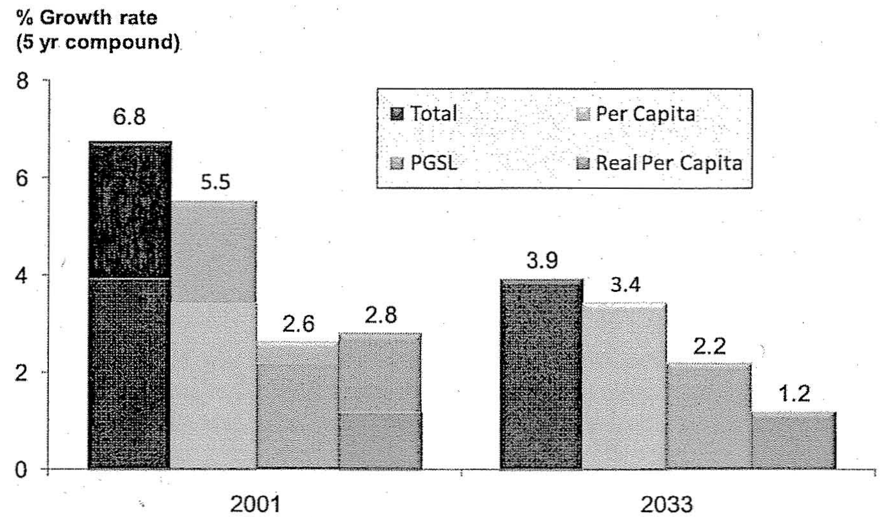
Labor force growth rates used in Minnesota were below the national average between 2020 and 2030 of the forecast horizon. The slower work force growth used in the long-term projections was not due to a declining labor force participation rates among those 16 to 64. The projected growth rate for that group, 81.1 percent, was still well above the projected national average of 75 percent. Nor was it due to lower than average participation rates for those over age 65. Minnesota remained above the projected national average participation rate for that age cohort as well. The reason labor force growth is expected to be below the national average is that the number of Minnesotans over the age of 65 is growing faster than the national average and the number of Minnesotans 16 to 64 is not expected to grow as fast as the US average.

The long-term revenue projections indicate that state policymakers should expect significantly slower revenue growth over the next 25 years than occurred during the late 1990s. Between 1996 and 2001 state revenues grew at a compound annual rate of 6.8 percent. Looking to the future, expected revenue growth between 2028 and 2033 is 3.9 percent. After adjusting for population growth and inflation, real per capita revenue grew at a compound rate of 2.8 percent between 1996 and 2001. Between 2028 and 2033 real per capita revenues are expected to grow by 1.2 percent.

The Impact of Changing State Law

The impact of changing state law with respect to the tax treatment of social security and pension income was also examined. Exempting social security was estimated to reduce the compound growth rate of state revenues by 0.14 percentage points, while exempting all pensions would reduce state revenue growth by 0.26 percentage points. If both pensions and social security were exempted from taxation state revenues would grow at a 3.4 percent compound annual rate for the 25 year study period, 0.37 percentage points less than baseline growth. In the latter instance state revenues in 2033 would be about 8.5 percent less than under current law, income tax revenues would be 14.4% less.

5 Year Compound Growth Rates of Minnesota State Revenues: 2001 & 2033



Source: Analysis from Minnesota Management & Budget (MMB)
* PGSL is the price deflator for State and Local Government purchases of public goods and services.

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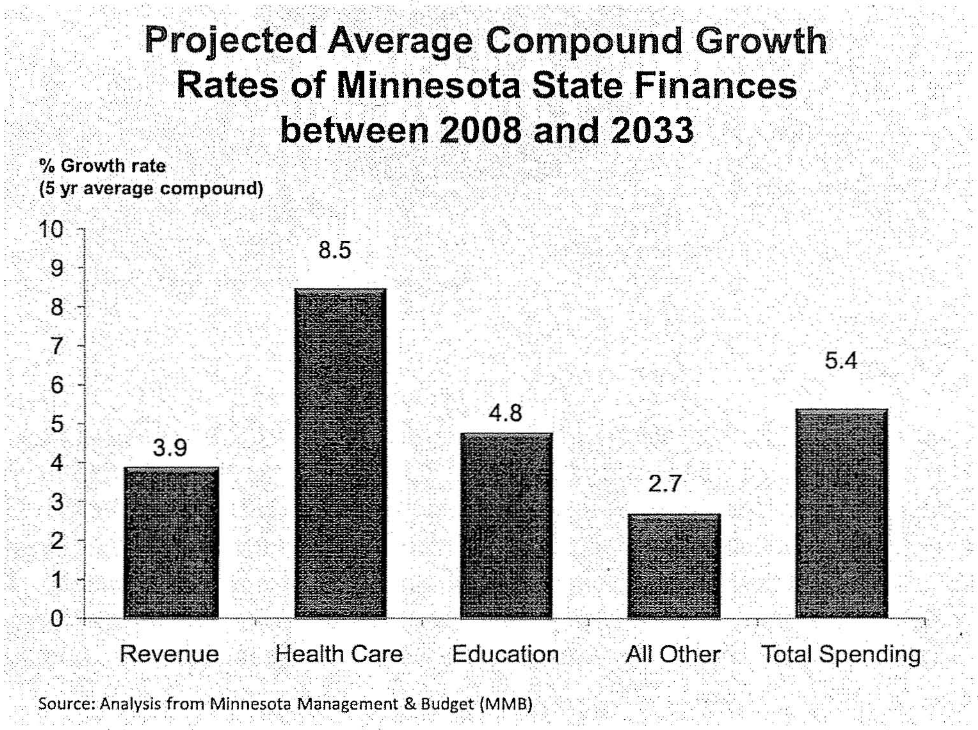
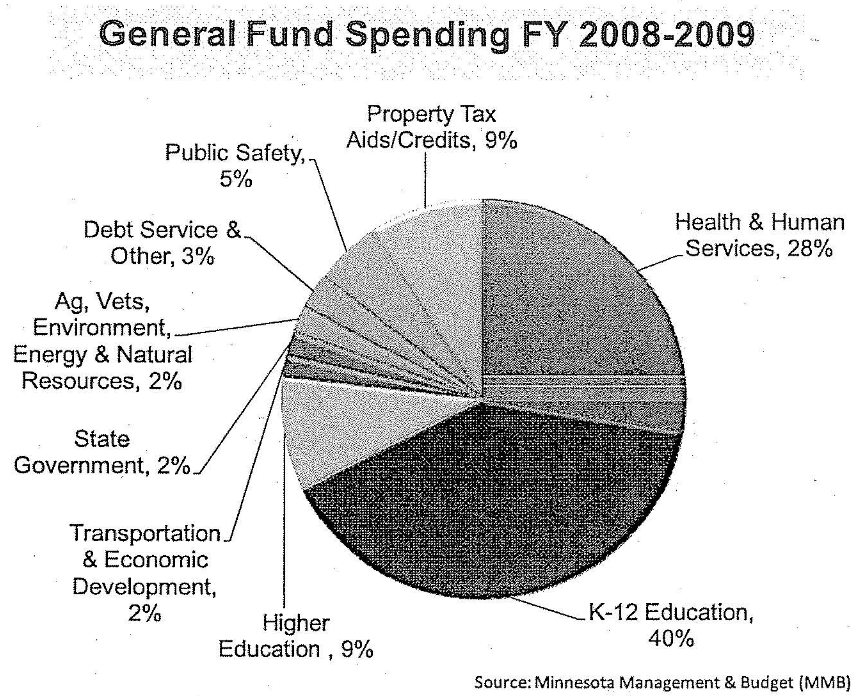
[3] Long-term Revenue Forecast Sensitivity: To examine the sensitivity of the long-term growth rate as a result of shocks to the economy, a series forecasts were made using less optimistic assumptions. In general, results were relatively robust with compound growth rates between 2008 and 2033 changing only modestly. Using long-term growth rates for wages and consumer spending taken from Global Insight's cycle scenario reduced the long-term growth rate from 3.8 percent to 3.4 percent. Using the cycle's projected growth rates for nominal wages and consumer spending and reducing the forecast growth rate for non-wage portfolio income by 2 percentage points from that used in the trend forecast produced a compound growth rate of 3.0 percent between 2008 and 2033.

Finding #6: Minnesota has a long-term structural budget problem, with long-term expenditure growth likely to outpace revenue growth.

To analyze state spending growth, general fund spending was divided into the following three major categories: health care, K-12 education and all other spending. The projected growth rates shown below are largely based on historical growth rates in these spending areas from FY 1997-2007. This look at projected growth rates in both revenues and expenditures reveals that over the next 25 years Minnesota will not generate sufficient revenues to sustain current rates of spending growth. As shown below, total spending projections reveal a growth rate of 5.4 percent per year and the projected compound growth rate for revenues over the next 25 years is only 3.9 percent.



The disparate growth rates for the three expenditure categories are significant because, as the pie chart below illustrates, health care and K-12 education expenditures currently make up a majority of state general fund spending. Since these areas are projected to grow faster than total revenues, options for any other spending become extremely limited. A more extended review of the growth assumptions can be found below.



Health Care Expenditures

Growing at an average annual rate of 8.5 percent[4], state payments for direct health care services are the fastest growing segment of the state's budget and consume a greater share of available resources each year. State health care programs face many of the same cost pressures that exist in the private health care market, including medical inflation and increased utilization of services spurred in large part by the development of new medical technologies, services, and pharmaceuticals to treat illnesses. In addition, because eligibility criteria for state health care programs are specified in statute, the state accommodates higher enrollment whenever the number of persons eligible for care increase (for example, when the economy weakens).

K-12 Expenditures

K-12 education expenditures represent the largest portion of state general fund spending. The projected growth rate for K-12 education is based on a measure of historical growth in education spending combined with projected growth in the K-12 population. Much of the anticipated growth in K-12 spending is based on the assumption that Minnesota will continue to invest in K-12 in a manner consistent with past growth. Past growth in K-12 spending is due primarily to legislative action and not automatic formula growth or demographic changes. The growth rate incorporates the assumption that growth through legislative action will continue.

The historical growth rate was calculated on a per pupil basis and incorporates growth in both state aid and local levies from 1997-2007. Historic growth in both state aid and local levies was used in the calculation because these two sources of funding often have an inverse relationship with each other.[5]

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[4] Average annual growth in general fund spending on Medical Assistance, General Assistance Medical Care, and chemical dependency entitlement grants between 1997 - 2007

[5] In the period from 1997-2007, state aid grew at 7.4 percent annually, but the total growth rate combining aid and levy was only 4.4 percent annually. This is because in that time period the state took over a large portion of education funding from

When one source increases significantly, the other may decrease or grow at a slower pace or vice versa. Looking at overall growth from both sources provides a clearer picture of what overall cost pressures are in the area of K-12 education. This per pupil growth rate was then combined with the demographic projections of growth in the school age population to arrive at the total projected growth rate of 4.8 percent. Over the past decade the school age population has been declining. This trend is projected to reverse in fiscal year 2010, with continued growth in the school age population through 2025.[6]

This 4.8 percent growth rate represents observed growth in education funding on a per pupil basis combined with projected demographic growth in the school age population. There are additional pressures on the education system that may push the cost pressures even higher in the future. It is not simply that the number of school age children is growing, but the composition of the school age population is changing in ways that have an impact on cost as well. In recent years there has been growing concentration of poverty in Minnesota schools, which drives additional funding. There has also been an increase in the number of students that come to school without adequate English skills and therefore generate limited English proficiency funding from the state. Additionally, special education costs have increased with more students generating special education funding and services for special education students becoming more expensive. This growth in special populations served by Minnesota's public schools may result in cost pressures beyond the level of observed growth in recent years.

<u>All Other Spending</u>

The all other spending category includes general fund spending outside of health care and K-12 education expenditures. The majority of the general fund spending in this category are expenditures on higher education, aids to local governments, the non-health care portion of health and human services, and general state government.[7]

From FY 1997-2007, the compound average annual growth rate for all other spending was 2.7 percent. This percentage was deemed to be a reasonable growth rate to assume into the future. It falls between the annual compound growth rate from 2008 to 2033 forecasted for the consumer price index (CPI) and the one projected for the implicit price deflator for state and local governments (PGSL) that takes compensation costs into account.

There are demographic trends that will likely affect the all other spending area. For example, the decline in the 18-24 year old population expected next decade will likely result in diminished pressure on higher education enrollment. The effect of this demographic shift on expenditures is unclear. At the same time that the 18-24 year old population is declining, baby boomers will continue to retire and the growth of the labor force will slow. This will increase the demand for higher education institutions to increase the number of graduates in engineering, education, health care, and skilled trades, as well as increase the demand for training existing workers. The aging of the baby boomers will also impact

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the local level in the form of the general education levy, as a result the growth rate for local levies was negative. In the years since the takeover of the general education levy, state spending has been growing at 2.7 percent annually, whereas local levies have grown at 11.9 percent on a per pupil basis.

[6] The Minnesota State Demographer is projecting continuing increases in birth rates in Minnesota, which will result in an increase in the school age population. Birth rates have been increasing since 2001.

[7] The all other spending category includes general fund spending on higher education, intergovernmental aids, the non-health care portion of health and human services, general government, public safety and corrections, debt service, economic and workforce development, and transportation.

corrections expenditures. The number of prisoners age 55 and older is increasing rapidly. This will lead to higher health care and other costs related to an aging prison population.

Finding #7: Health care growth will become the most important factor in controlling rising state expenditures.

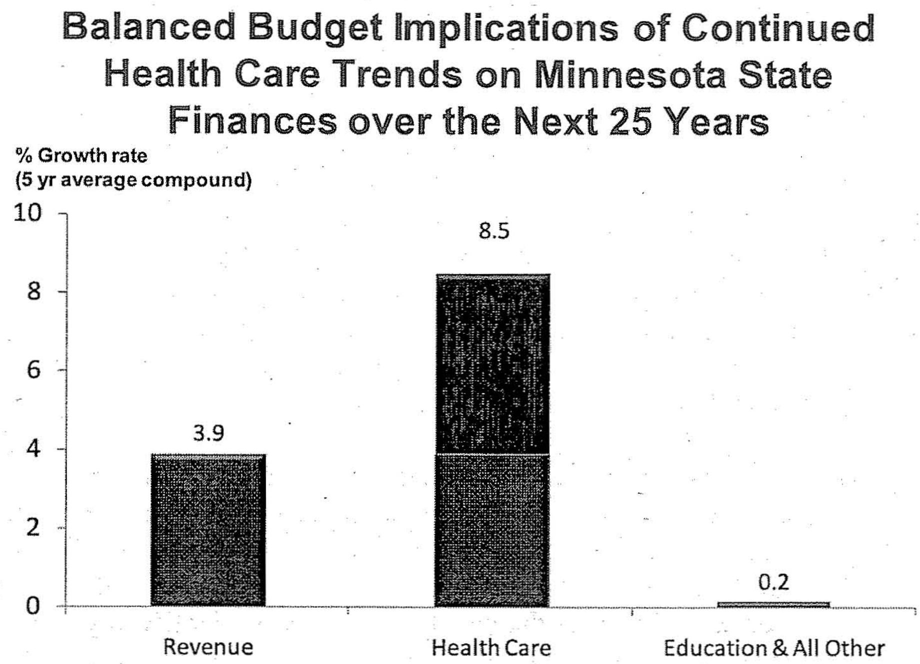
In FY 2007, about one out of every five state general fund dollars were spent on public health care programs—including Medical Assistance (the state's Medicaid program), General Assistance Medical Care, and chemical dependency treatment entitlement grants.[8] If current growth rates continue unchecked over the next 25 years, two out of every three state general fund dollars will go toward health care. Although there are considerable uncertainties in forecasting expenditures over such a long time period, it is clear that health care's current growth trajectory will produce significant budget challenges in the near-term and prove to be unsustainable over the long-run.

To illustrate the crux of the problem the state will face over the next 25 years, consider a scenario in which revenue grows 3.9 percent per year (as described above) and health care continues to grow at a rate of 8.5 percent per year. In order to achieve balanced budgets over the 25 year time horizon, expenditures on all other segments of the budget, including K-12 education, would have to remain essentially flat, as shown in the graph below.[9] If instead, we make the assumption that health care continues to grow at 8.5 percent and spending on K-12 education grows by 2 percent per year (CPI inflation) for the next 25 years, all other segments of the budget beyond health care and K-12 will have to be reduced by 3.9 percent each year to avoid budget deficits.[10] This would nearly eliminate all other areas of spending by 2035.

[8] State payments for direct health care services in FY 2007 include those for: Medical Assistance ($2.9B); General Assistance Medical Care ($281M); MinnesotaCare ($267M); and chemical dependency treatment entitlement grants ($78M). MinnesotaCare is funded out of the Health Care Access Fund through provider and premium tax revenues and is therefore not included in general fund projections. It should be noted, however, that this program has also grown significantly over the years and represents additional state health care obligations, compounding the challenges discussed above.

[9] Growth on all segments of the budget outside of health care would have to be limited to 0.2percent per year.

[10] 2 percent is the average Consumer Price Index (CPI) projected over the 25 year time horizon.



Source: Analysis from Minnesota Management & Budget (MMB)

These scenarios illustrate that state health care spending cannot continue on its current course. Yet in the decades to come demographics are not favorable. For the state, the aging of the population means that a larger share of the population will become eligible for and begin using expensive long-term care services under the Medical Assistance program. Furthermore, because health care costs for an individual generally increase with age, and a higher proportion of individuals covered by state programs will be older, it stands to reason that the state's average cost of care will increase. In a nutshell, even as historical growth trends are unsustainable, demographic changes beginning in this decade will put even more upward pressure on spending.

In reality, changes to the health care system to moderate cost growth, whether in the private market or within state and federal programs, will have to take place. The Congressional Budget Office (CBO) in a recent long-term outlook for national spending on Medicare, Medicaid, and all other health care services provides a baseline assumption that changes will take place in the health care system over the next 75 years such that Americans' consumption of goods and services other than health care does not decline in real terms.

Many of the options that seem to hold merit - increasing access to information on the efficacy of treatments, changing provider payment incentives to encourage quality and value, promoting disease management and care coordination - have been widely debated in Minnesota and included in whole or in part in recent health reform legislation. But significant questions remain as to how these changes will be implemented and what the outcomes for the system as a whole and for state public programs will be.

Finding #8: State revenue volatility will make long-term budget instability more difficult to manage.

Ever-changing budget situations tend to obscure the long-term demographic trends of the state. This volatility, with boom times evaporating into bust periods, adds to the work of the Governor and the Legislature in a way that makes other policy debates less likely. More volatile tax systems create an environment of larger surpluses and greater deficits. It can also pose greater challenges to fiscal policymakers by focusing discussion on cost rather than effectiveness and on immediate needs and solutions rather than future infrastructure and economic growth.

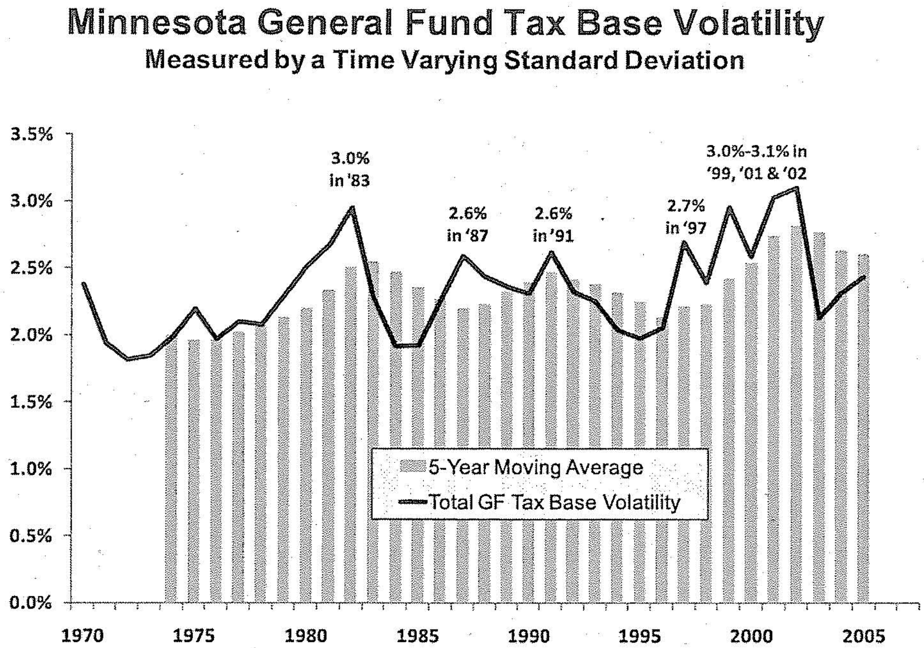
Though it has not always been a central theme, budget volatility has played a role in the results of several earlier commissions. The stability of the sales tax base was considered by multiple commissions, with many of them recommending broadening the sales tax base as a way to help increase revenue predictability and fairness in the tax system. Other common recommendations related to revenue volatility included minimizing yearly changes to tax law and diversifying revenues by maintaining an equal mix of income, sales, and property tax revenue. On the spending side, formal contingency plans, where appropriations are adjusted accordingly if expected revenues are not realized, have been recommended in the past. The maintenance of a budget reserve has also been suggested more than once as a way to help ensure budget stability.

In creating this commission, the Legislature specifically charged the State Budget Trends Study Commission with examining the stability of the state budget over time. The boom-bust revenue cycle seems to be growing in recent budget years and has produced concerns over the volatility of Minnesota's general fund revenues. Using analysis from MMB, the Commission examined detailed components of Minnesota's general fund revenue volatility over the past half-century to identify key sources of volatility in the state's existing tax base. The study provided the foundation for a methodical examination of the implications volatility has on Minnesota's biennial budget reserve, allowing the Commission to consider options to reduce the impact of volatility on the tax system.

Finding #9: Minnesota's general fund tax base has grown more volatile in the past decade.

In new research, the State Economist and MMB staff analyzed the volatility of the state's current law general fund tax base. This research nets out any impact of state tax law changes over time and provides a realistic assessment of the uncertainty and risk inherent within the current tax system.

While short-term cyclical volatility in Minnesota's general fund tax base appears to increase during periods of economic downturn and typically parallels a significant disturbance or shock, long-term trend volatility in the tax base is roughly 30 percent greater today than it was during the 1970s. Most of this increase has noticeably occurred since the late 1990s.



Source: Analysis from Minnesota Management & Budget (MMB)

Minnesota's corporate franchise tax base, which constitutes 7 percent of general fund tax revenue and boasts the highest trend growth rate, is the most volatile of the three major revenue sources, extremely sensitive to economic cycles and thus subject to substantial uncertainty. In fact, the volatility of Minnesota's corporate franchise tax base is almost four times greater than the volatility of the individual income tax base and nearly six times greater than the volatility of the general sales tax base.

Minnesota's individual income tax base, comprising roughly 48 percent of the state's general fund tax revenue, is the second most volatile tax system. While still relatively low compared to the corporate franchise tax base, Minnesota's individual income tax base volatility has grown to be slightly more volatile since the late 1990s. Examination of the detailed components of the individual income tax base concludes that wages and salaries, comprising roughly 72 percent of Federal Gross Income (FGI), are the least volatile and that net capital gains, 7 percent of FGI, are the most volatile element. Despite exhibiting the least uncertainty, the volatility of wages and salaries has been steadily increasing since the late 1990s. This is presumably the result of a growing trend toward stock options and bonus remuneration. Likewise, the volatility in capital gains has also exhibited noticeable increases since the mid-1990s. The study attributes this to factors such as changes in asset values, investor decisions, or shifting economic trends. According to the Congressional Budget Office, because capital realizations "depend on both household decisions about the amount of assets to sell in a given year and the underlying accrual of capital gains in those assets," capital gains are inherently volatile.

The general sales tax base, comprising roughly 31 percent of Minnesota's general fund tax revenue grows at approximately the same trend growth rate as the individual income tax base and is the least volatile of the state's major general fund revenue sources. For this reason, as was mentioned earlier, declining taxable consumption and general growth in the largely untaxed services sector remains a growing concern among state budget officials.

Results of Minnesota's 2005-2007 General Fund Revenue Volatility Study

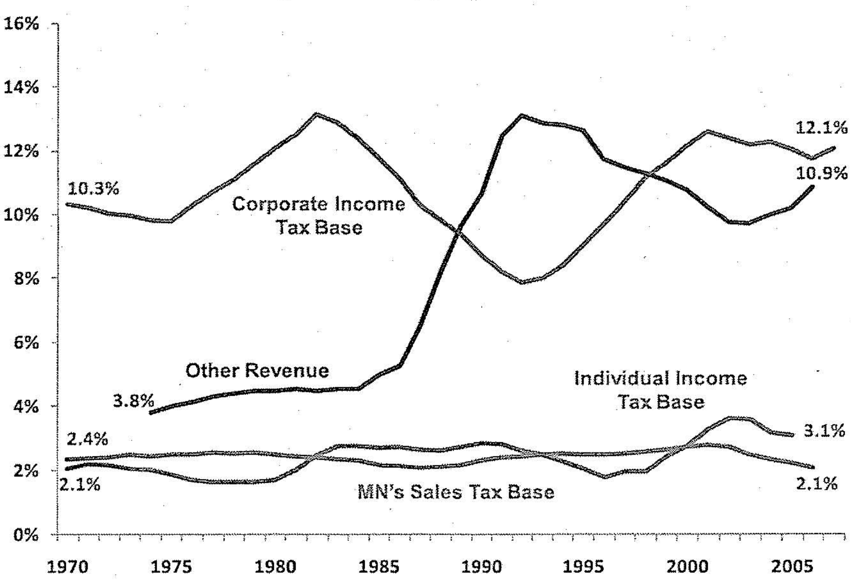
	Trend Growth Rate	Tax Base Volatility (Measured by a Time-Varying Standard Deviation)	Proportion of Total GF Revenues
Individual Income Tax Base	5.4%	3.1%	48.1%
Corporate Income Tax Base	14.9%	12.1%	7.4%
MN Sales Tax Base	5.2%	2.1%	31.2%
Other Revenue	11.0%	10.9%	13.3%
Total Portfolio	**6.5%**	**2.6%**	**100%**
Inflation	*2.6%*	*0.6%*	*N/A*

Source: Analysis from Minnesota Management & Budget

Under the current dedicated motor vehicle sales tax (MVST) structure, "all other" general fund tax revenues, or 13 percent of general fund tax revenue, have experienced relatively high levels of volatility compared to the individual income and general sales tax bases since the late 1980s. This category is highly influenced by the volatile structure of the insurance gross premiums, deed and mortgage, and estate taxes.

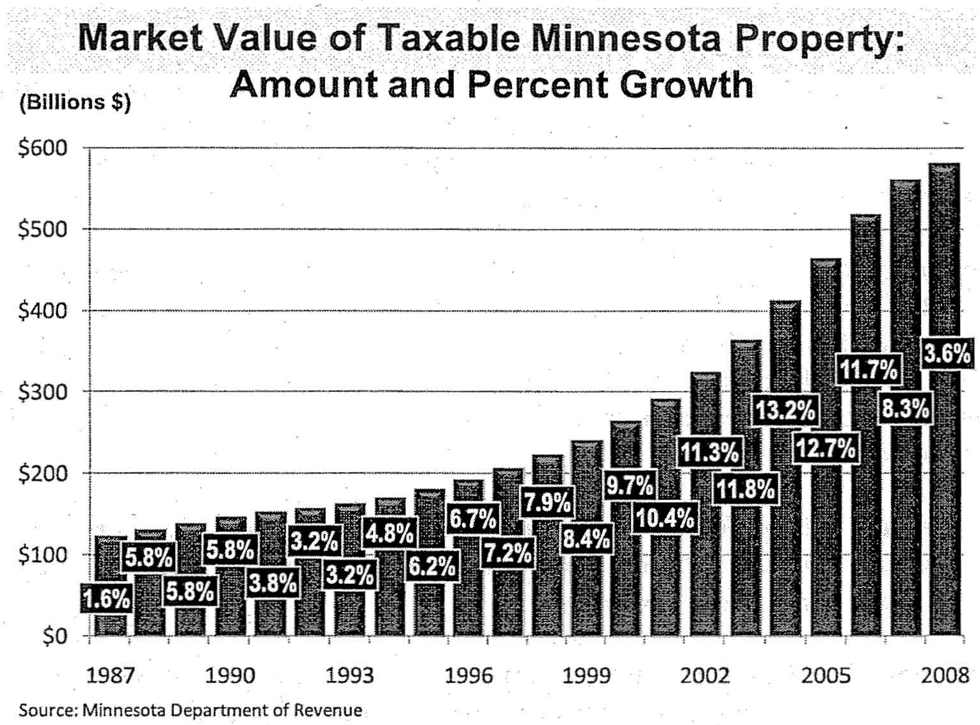
The statewide property tax base, also included in "all other" general fund tax revenues for this analysis, is defined as the net capacity of commercial-industrial, public utility, railroad, mineral, and seasonal recreation property. The statewide property tax is inherently stable compared to other major revenue sources because the state has the option of setting the mandated levy. In 2001, Minnesota instituted a statewide property tax as part of a major overhaul of the property tax system. The current levy was set at $592 million in 2002 and for subsequent years is increased by the rate of increase in the implicit price deflator for state and local government consumption expenditures and gross investment. The initial levy has grown to nearly $700 million in 2007.

MN's General Fund Tax Base Volatility by Major Source:
Measured by a Time Varying Standard Deviation



Source: Analysis from Minnesota Management & Budget (MMB)

Property taxes are important because they are the primary source of funding for local government. While state property tax revenues compromise just 4.5 percent of general fund dollars, they account for the second largest tax source, or 20 percent, of Minnesota's state and local government revenues. To the extent that the state attempts to equalize property taxes, as in school aid distribution, or offset increases, as in local government aids (LGA) and property tax credits and refunds, property tax levels are a state concern. Minnesota has periodically used property tax levy limits to slow the increase of local property taxes and to reduce the requirement for state support. Property taxes need to remain a significant funding source for state and local government to help support local government and stabilize the state dollars going to local government for equalization and reduction.



Finding #10: Replacing highly volatile tax base components with less volatile sources could reduce the volatility of the overall general fund tax system. However, such changes would also affect revenue growth rates and the distribution of the tax burden among taxpayers.

Each component of a tax base may be independently more or less volatile than the tax base itself. For instance, consumer expenditures on food, clothing, and prescription and nonprescription drugs are each less volatile than the current general sales tax base. Likewise, each of the components of the individual income tax base, except for wages and salaries, is more volatile than the income tax base as a whole. In addition, the bases of different state taxes may be more or less volatile than the overall general fund tax system.

When components are added to or subtracted from a tax base, those components carry with them their own degrees of volatility, as well as interactions with the other components of the base. Those interactions may serve to dampen or exacerbate the volatility of the base as whole. Therefore, the volatility of a tax base is not simply the sum of the volatility of each of the components.

As an illustration, note that an unintended consequence of the full dedication of MVST receipts outside of the general fund was to increase the volatility of the state's general fund tax base by roughly 10 percent. This happened because the performance of the MVST helped by further diversifying the overall performance of the general fund.

Because tax base components also grow at different rates, changing the base of a tax will affect the overall revenue growth rate. And, since different taxes fall on different taxpayers, changing tax bases will also affect the distribution of the tax burden among taxpayers. This is why careful analysis is required to understand the full impact of an introduction or removal of specific revenue sources into or out of the tax system.

Nevertheless, we can say that reducing the state's reliance on highly volatile revenue sources, such as capital gains and corporate franchise tax receipts, for less volatile revenue sources such as food, clothing, services, or prescription and nonprescription drugs could reduce the volatility of the overall general fund tax system. But, this reduction would come at the expense of the high growth rates exhibited for capital gains and corporate franchise tax receipts and the overall progressivity of the state tax system. At this time we do not have estimates of any of these effects.

Expanding the sales tax base by including currently untaxed items (and reducing the sales tax rate to raise the same amount of revenue) can affect both the growth rate and volatility of the sales tax revenue stream, but the magnitude of those effects is likely to be small for most individual items. For example, taxing clothing would have little impact on either the growth rate or the volatility of the sales tax base. Taxing personal services would increase the growth rate by a noticeable amount, but would have little effect on sales tax base volatility.

Finding #11: Adjusting the mix of the current tax base, while remaining revenue growth rate neutral, cannot significantly reduce revenue volatility without a dramatic reweighting of tax revenue sources and a radical change in tax rates to the system.

It is important to first note that volatility is not the only criterion that should be used in determining a state revenue system. Equity, efficiency, simplicity, growth, sustainability, and administrative convenience are all factors that need to be balanced within an effective state tax system. The MMB study, however, is a measure of tax-mix efficiency derived exclusively from volatility.

The MMB analysis concludes that creating a more efficient tax-mix level, which minimizes annual revenue volatility while maintaining the current trend growth rate of general fund tax receipts, would yield a modest 5 percent reduction in Minnesota's tax system volatility. This modest reduction would, however, require a dramatic reweighting of tax revenue sources and a radical change in tax rates to the system.

The results indicate that in order to keep the tax base and biennial revenue growth neutral and decrease the volatility of the tax system by nearly the 5 percent necessary to achieve the efficient tax-mix portfolio level, the general sales tax collections would need to almost double. This would effectively require doubling the current sales tax rate and would shift its proportion of general fund revenues from 31 percent to 60 percent of the total. An efficient tax mix would also require that individual income tax collections make up just 9 percent of the total general fund revenues, down from 48 percent of the receipts under the current structure. This would require a dramatic 1/5 reduction of today's individual income tax rate. The sales tax base and the individual income tax base are almost perfectly correlated, i.e. as one source of revenue moves either up or down, the other will generally move in lockstep. Since the annual revenue volatility of the individual income tax base is about 50 percent greater than the sales tax base and both have similar growth rates, under an efficient tax-mix scenario the sales tax base is preferable.

Finally, despite their level of volatility, the efficient tax mix derived exclusively from volatility suggests increasing the proportion of the total general fund revenues resulting from corporate franchise tax collections from 7 percent to 13 percent of the total and increasing the proportion from "all other" tax revenue collections from 13 percent to 17 percent of the total. These increases occur because the performance of the corporate franchise tax and others such as the property tax, the insurance premiums tax, and the deed and mortgage tax function as neutralizers in a diversified system to other dominant tax revenue streams such as the general sales and income taxes. In other words, their correlation with the general sales tax base is near zero meaning their movements are theoretically random.

The efficient tax mix scenario described above minimizes annual revenue volatility while maintaining the current trend growth rate of general fund tax receipts. Analysis is also possible to understand the impact of a reweighting of the tax mix to minimize annual volatility under different growth rate scenarios. For a full understanding of various scenarios, further examination would be required.

Finding 12: Shifting consumption patterns have reduced Minnesota's sales tax base.

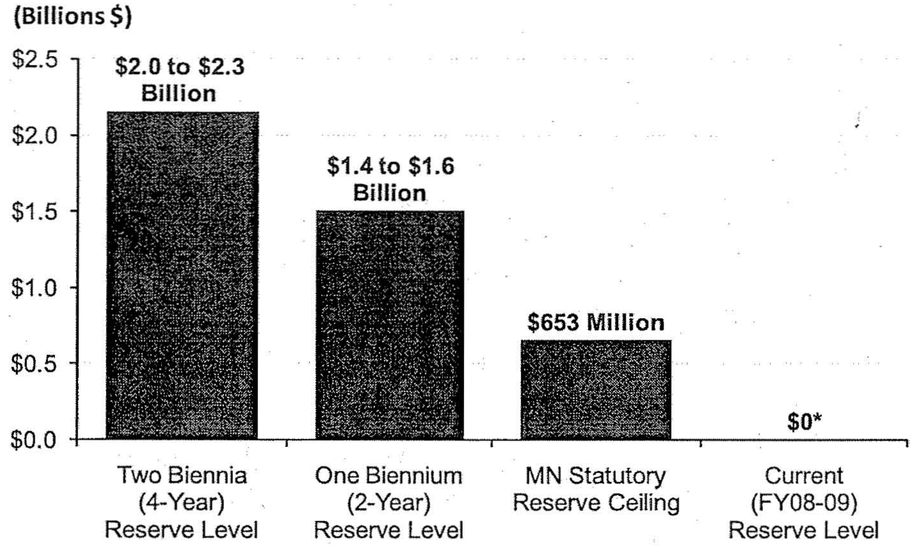
Declining taxable consumption for automobiles and household durables, growth in the largely untaxed services sector, the careful spending lifestyle of an aging population, and legal barriers to collecting tax on most internet and catalog sales challenge the sustainability of Minnesota's sales tax base. As a result of changing consumption patterns, the share of personal consumption expenditures subject to tax fell from 33.3% in 1970 to only 28.5% in 2006. This means that the shifting consumption patterns have cut the sales tax base (holding law constant) by more than one-seventh. As noted in finding #10, however, an expansion of the sales tax base to address this challenge may significantly change the distribution of the tax burden among taxpayers.

Finding #13: Minnesota's statutory budget reserve ceiling has not grown to an appropriate level to adequately manage the underlying risks in Minnesota's tax system over time.

Just like there is no "right" level of insurance, there is no "right" level of budget reserves if you are willing to accept the risk. Since there are negative side-effects for taking that risk, however, the state has established a budget reserve. Currently the statutory budget reserve ceiling is capped in law at $653 million, which is roughly 1.9% of the biennial budget.

At current levels of volatility, the MMB study concludes that given a structural balance between revenues and expenditures at the beginning of budget considerations, a biennial (two-year) budget reserve of 4.1 percent to 4.6 percent ($1.4 to $1.6 billion in FY08-09) of biennial resources is required to adequately manage the underlying risks in Minnesota's tax system over any consecutive two year period. This conclusion assumes that a reserve should be sufficient to handle a biennial deficit in all but 1 of every 20 periods.

Appropriate Size for MN's Rainy Day Fund
(Example for FY08-09 and FY10-11)



Source: Analysis from Minnesota Management & Budget (MMB)
* Current Reserve Level as of December 16, 2008

If further insurance against volatility were sought, the analysis concludes that a two-biennial (or four-year) budget reserve of 2.9 percent to 3.3 percent ($2.0-$2.3 Billion in FY08-09 and FY10-11) of two consecutive biennium's resources would be suitable to manage the fundamental revenue risks in Minnesota's tax system looking out at a four-year period. Again, this conclusion assumes that a reserve should be sufficient to handle a biennial deficit in all but 1 of every 20 periods.

The current deficit of $4.8 billion that the state is facing for FY 2010-11 exceeds the two biennia reserve amount specified above. There are a few reasons worth mentioning regarding why the above reserve amount would not be sufficient to completely protect against the current situation. First, the current deficit includes a $946 million shortfall for FY 2010-11 that was left unsolved at the end of the 2009 legislative session. The model used to determine the appropriate size of the budget reserve assumes that there is not an existing unsolved shortfall going into a biennial period. Second, $580 million of the current deficit is due to anticipated growth in spending. The above model is intended to manage the risk on the revenue side of the budget, so it does not incorporate volatility on the spending side. This is particularly important to note, because many state expenditures are counter cyclical. As the economy weakens, for instance, the demand for state assistance increases. Lastly, the two biennia reserve amount is sufficient to handle a biennial deficit in all but 1 in 20 periods. The current economic situation appears to be similar in magnitude to the recession experienced in the early 1980's and may be the worst in the post-World War II period. The current situation likely meets the criterion of a 1 in 20 outlier.

Finding #14: Minnesota needs a cash flow reserve account of sufficient size so that the state can avoid short-term external borrowing during a biennium.

In addition to balancing its budget, the state must be sure to have sufficient cash to pay its bills on time. The cash flow account, capped at $350 million, was set in the 1990s and calculated based on the maximum anticipated borrowing at the time. Though fiscal circumstances have changed since then, this number has not been adjusted.

Based on current payment schedules, the state needs access to $2 billion during a normal fiscal year for cash flow purposes. This is because, for example, taxes that are not paid until April are needed to support payments made in the prior December. The state does not, however, need to maintain a $2 billion cash flow account because there is existing authority to borrow between other funds that have existing cash balances. The statutory general fund for cash purposes includes the special revenue fund, the health care access fund, the MnSCU fund and the health impact fund. The state regularly borrows from these funds to meet cash needs beyond the $350 million cash flow account.

The current practice of inter-fund borrowing depends on adequate balances in these funds. To date, this inter-fund borrowing has been sufficient to prevent the need for external short-term borrowing to cover cash flow needs. External short-term borrowing for cash flow purposes is undesirable because it negatively impacts the state bond rating. In addition, the recent turmoil in the financial markets highlights the precarious situation states can find themselves when external short-term borrowing is needed. If surpluses in these funds were depleted, the state would need a significantly larger cash flow account.

V. Recommendations

As the Commission's findings suggest, the state of Minnesota faces many long-term fiscal challenges. While future Legislatures and Governors will be responsible for molding public policies to address these challenges, the Budget Trends Study Commission has some ideas that may be considered immediately (We note where our recommendations are similar to those of earlier study reports.).

In general, we believe that three basic strategies will help Minnesotans in this coming public policy debate. First, we need to ensure that decision-makers and citizens have access to the information necessary to make informed budget and policy decisions. We have significant resources and if used wisely, the state can continue to be a place of relative prosperity for future generations.

Second, as the findings indicate, Minnesota is on an unsustainable course in terms of revenue and expenditure growth. It will be important for the Governor and Legislature to focus on achieving long-term balance of state revenues and expenditures, both through good financial management and policy changes that address the underlying growth in revenues and expenditures.

Finally, we expect that policy-makers will do what they can to incrementally dampen state budget volatility. While Minnesota is better positioned than some states, current elected officials still have far too few tools to deal with economic uncertainty. This shortage of tools has lessened the state's ability to focus on key issues such as the impact of economic and demographic changes, growing health care and education costs, or reviewing the effectiveness of current policies.

Provide decision-makers and citizens with the necessary information to make informed budget and policy decisions.

The Commission has tried to preview the future, knowing that broad demographic changes are occurring right now. We are sure that we will have missed some key changes, however. Will baby boomers retire earlier than expected or remain in the workforce well past age 62? Will the productivity of the workforce improve or falter into the future? These and other questions must be monitored and factored into public decisions. We believe that future decision-makers and the citizens who elect them, need to have high quality, timely information in these times of change. As a result, the commission recommends the following:

- **Create a permanent long-range planning function in state government [Carlson Report, 1992].** Currently, planning activities are scattered in various agencies or not addressed at all. We should systematically create better information necessary for public and elected officials to manage for the long-term, including a statewide system of performance measurement.

- **Release a demographic forecast at the start of each biennium.** This demographic forecast should be released with the economic forecast every second year in order to remind policy makers about the changing population of this state and clarify the impacts.

- **Financial forecasts should be based on current law and inflation (or deflation) of both revenues and expenditures to provide an accurate planning perspective [Department of**

Finance Report, 1986; Carlson Report, 1992].[11] However, budgets should not automatically fund inflation allowances. Base spending should be scrutinized.

Achieve long-term balance of state revenues and expenditures

The findings of this report indicate that our state's current spending and revenue trends are simply unsustainable. Until there are significant changes in public expectations, state officials will repeatedly scramble to balance the budget but will not have the time or resources to address the state's competitive position and seek opportunities for future prosperity.

Achieving long-term balance of state revenues and expenditures will require reductions in spending growth or increases in revenues. Regardless of any revenue increases, specific programmatic changes will be necessary in expenditure areas with high, unsustainable growth rates, such as public health care spending. An alternative is to raise significant additional revenue in the form of new taxes or expanding existing taxes. But even this new revenue would only be a short-term fix – the state's revenues grow more slowly than its fastest growing spending areas.

Better financial management tools are also necessary to ensure that we maintain our focus on long-term balance. The recommendations address both facets of this approach to achieving long-term balance.

The findings reveal that state tax revenues are projected to grow at a much slower pace of the next 25 years. Other states have adopted tax and spending policies which will be very expensive in the coming years. Even when included in a "balanced" proposal, there is no way to reflect the substantial future costs that some ideas will incur simply because our population is changing so quickly. Minnesota is blessed with relatively few unpaid debts such as retiree health care and we urge lawmakers to keep it that way.

- **Minimize tax exemptions, deductions and credits (e.g. continue to tax pension income), unless necessary for federal conformity. [Department of Revenue Report, 1992]** In the end, retirees can already expect a lower tax burden and policies should not extend additional benefits.

The State needs to manage toward a long-term balance of state revenues and expenditures. This will be much more difficult than it sounds. Although structural balance has been a tenet of state financial management for many years, the trend revenue and spending numbers will make the task much more challenging. The findings indicate that projected expenditure growth is anticipated to outpace revenue growth in the coming years. We urge policymakers to start making the adjustments necessary to bring our underlying revenues and spending into long-term balance.

Achieving long-term balance of state revenues and expenditures will require reductions in spending growth or increases in revenue growth, and possibly both. Specific programmatic changes will be necessary in expenditure areas with high, unsustainable growth rates, such as health care. An alternative is to repeatedly raise significant additional revenue in the form of new taxes or expanding existing tax bases.

[11] Not all members of the Commission agree with this recommendation. Opponents of this recommendation believe the official forecasted surplus or deficit should continue to be based entirely on current law (though they agree the impact of inflation should continue to be noted), and that automatically including inflation adds confusion to the policymaking process and tends to promote spending.

- **To help the Governor and Legislature manage long-term obligations, the State should begin by spending no more in the current biennial budget than can be supported by ongoing revenues.** While this recommendation seems obvious given the state's balanced budget requirement, the Governor and Legislature should only use ongoing revenue, not one time balances, shifts, or temporary taxes, to balance the budget. Likewise, the Governor and Legislature should not authorize spending on items that have unsustainable "tails" (items that cost substantially more in future budgets than in the current budget).

- **Any additional one-time revenues should be used strictly for building reserves, paying off shifts, capital projects, or other one-time purposes.** Any additional on-going spending or revenues must be offset by a similar reduction in spending elsewhere or an increase in revenues.

- **Expenditure forecasts should include information about rates of growth by expenditure area.** This will highlight the fastest growing elements and provide a basis which is more easily understood.

- **The Governor and Legislature should create a structurally balanced budget for the current and following biennium.** The discipline of four year budget horizons could serve the state well and should be required. Before the Legislature and Governor complete their tax and spending decisions to balance the budget, they should ensure that the following biennial revenues and expenditures are balanced.

- **When making budgetary decisions to achieve a balance of expenditures and revenues the Governor and Legislature should consider the impact of shifting the expenditure burden to the private sector or local units of government.** Similar to the principles used to evaluate tax policy, the Governor and Legislature should use the criterion of equity, efficiency, sustainability and simplicity when evaluating expenditure options and changes.

As stated in the findings, health care growth will become the most important factor in rising state expenditures. Controlling health care costs is not a problem unique to Minnesota. And any solution will not be owned alone by the state. We will need to work with our partners, including the private sector, other states, and the federal government, in order to come to a new and more sustainable system.

The Commission respects that this problem will not be dealt with easily and that it does not have adequate time or expertise to make useful and specific recommendations. But the state does have a tradition of coming together to solve its problems and it is in this context that it makes one recommendation.

- **Create a long-term public-private group with the responsibility to annually recommend policy changes for controlling the total cost of public healthcare and medical assistance services.** The group, to be selected by the Governor and Legislature, should be charged with sustaining progress in health care reform and integrating our basic and continuing care systems so that incentives are for better care, not higher costs.

The findings detailed how the retiring baby boomers will be replaced by smaller generational cohorts. It will be necessary for these next generations to have high levels of productivity and participation in the workforce in order to sustain the Minnesota economy and state revenues, especially in the face of a rising dependency ratio.

- **Address education attainment gaps in the current K-12 system.** These are the workers that will be supporting future economic growth and we will need to utilize the talents of all of our younger citizens, no matter their family income, race, or ethnicity.

Manage state budget volatility

As stated in finding #8, state revenue volatility will make long-term budget instability more difficult to manage. The Commission proposes to lessen the impact of over or under estimating revenues on future budget discussions. Unfortunately, one never really knows until the time has passed if the economy would perform under or over expectations. As a result, the commission recommends taking the long view towards budgeting revenues so that temporary spikes in growth are not mistaken for permanent gains.

- **If forecast revenue exceeds trend line growth, trend line revenue growth rates should be the basis for spending decisions.** The Council of Economic Advisers would review the soundness of the trend line forecast. Estimated revenue exceeding trend line growth rates should not be forecast and used for spending. If revenues in excess of the trend line are received during the biennium, those excess revenues should first go to replenishing the budget reserve and buying back shifts (consistent with current law).

- **Permanent tax reductions or expenditure increases should only be undertaken under certain circumstances. [Department of Revenue Report, 1992]** Once the cash flow and budget reserves are at the appropriate levels and all shifts have been bought back, further revenues in excess of the trend line may be used for permanent revenue reductions or expenditure increases as long the following biennial budget is balanced.

The state's tax system would need major revisions to reduce volatility substantially and the Commission does not see an opportunity for fundamental changes. As the findings suggest, adjusting the mix of state taxes cannot significantly reduce volatility without dramatic changes to tax rates or slowing revenue growth. However, members do want to reiterate some of the principles that have served us well in the past. Taxes should be assessed on the broadest base possible with the lowest rates possible, and avoid special exemptions. Whenever sales and other taxes are reviewed, demographic and volatility considerations should be included as factors by policy-makers.

Any recent consideration of "larger" reserves has missed the point that the usefulness of our current reserve levels is diminished. Our state has relatively small reserves when compared to the overall size of the budget and the changes that happen routinely in the economy. As stated in the findings, Minnesota's statutory budget reserve ceiling has not grown to an appropriate level to accurately address the underlying risks in Minnesota's tax system over time. A series of specific changes in the state's budget reserves is recommended.

- **Minnesota Management & Budget (MMB) should determine the size of the budget reserve necessary given the volatility of state revenues. [Department of Finance Report, 1986; Carlson Report, 1992]** MMB should periodically assess the adequacy of the budget reserve based on any changes in the estimated volatility of revenues. Any new estimate of the required budget reserve level should be adjusted in law.

- **Given the current size of the state budget and the current level of revenue volatility, the budget reserve should be increased to $2.1B, the currently calculated level, to provide adequate cushion against economic changes in two consecutive biennia.** This reserve should be maintained to manage cyclical economic volatility, not to cover spending forecast inaccuracies, nor to increase spending above levels specified in the financial plan. The budget reserve should be used to manage through economic downturns.

- **If the budget reserve is depleted in the current biennium, it should be replenished within two biennia.** A budget reserve is a short-term tool, which provides the time necessary to develop long-term solutions to structural budget issues. The budget reserve should be replenished and structural budget issues should be addressed as quickly as possible.

- **A cash flow account should be maintained separate from the budget reserve to avoid short-term external borrowing. [Carlson Report, 1992]** The State of Minnesota must avoid short-term borrowing. The state has not had to borrow short-term since 1983. The ratings agencies lowered the state's credit rating as a result. The cash flow reserve should be set at a level necessary to avoid external short-term borrowing. MMB should periodically calculate state cash flow needs and publish the results in conjunction with the economic forecast. A new estimate of the required cash flow reserve level should be included with the Governor's budget proposal and adjusted in law based on legislative action.

- **To avoid overstating the size of the cash flow reserve, Minnesota Management & Budget's (MMB) authority to borrow between the state's own funds for cash flow needs should be reviewed and expanded.** Under all situations, the state should try to borrow from itself before seeking external sources for borrowing.

Appendix A: Key Findings and Recommendations of Previous Reports

"A tax system that makes sense for Minnesota"
2001 Ventura Tax Reform
May 2000 –June 2001
Minnesota House of Representatives. HF 1 as introduced. 2001 First Special Session.

Property Tax (taxpayers expressed the most frustration with this tax)
- Clarify who is levying the tax and for what purpose
- Simplify the system so that local property taxes are more fairly distributed among types of property and taxpayers
- Ensure that all property is subject to high-quality, annual assessment
- Simplify the property tax system without sacrificing fairness; also make it easier to administer and more efficient
- Taxpayers need to understand how the property tax works and how they can participate in the process to affect spending and taxing decisions.

Sales Tax
- Adopt changes to the sales tax to comply with the national Streamlined Sales Tax Project, allowing Minnesota to participate in a multi-state agreement to provide uniformity to sales tax to reduce burden on multi-state sellers.
- Expand the sales tax to certain goods and services not currently included in the sales tax base. Minnesota has one of higher sales tax rates, with a somewhat narrow base of goods (and very few services) that are taxed.

Income Tax
- The tax system should be at least as progressive as it is now to offset the regressivity of other taxes. However, the progressivity of the income tax contributes to the volatility of the revenue system.
- It should be neutral as to the filing status of taxpayers.
- Tax forms should be simple and easy to understand, eliminating special preferences to certain taxpayers.
- Lower the rates.

An Agenda for Reform
Brandl-Weber
November 1995

The report includes recommendations for restructuring in all major spending areas. The general principles that guide the recommendations are:
- A target should be set for spending and targets should be established for all major expenditure areas (spending should not fluctuate based on entitlements)
- Eligibility for government benefits should be limited to the most needy.
- Funds should go to citizens, not bureaucracies
- Expand choice for government officials
- Enable families and communities to provide some services.

Carlson Commission on Long-Term Financial Management Reform
1992

- A long-term financial plan should be proposed by the Governor in January of each odd-numbered year, and adopted by the Legislature by March 15, prior to debate on specific budget proposals. The plan should be legally required to demonstrate an ongoing structural balance between revenues and expenditures for three biennia.
- Revenue guidelines in the plan should define what percent of Minnesota's personal income should be devoted to public needs, and also the amount and percent of state and local revenues to be derived from income, sales and property taxes.
- Revenue dedication should be avoided, since it reduces budget flexibility. Tax changes should be considered to help dampen volatility.
- Spending guidelines in the three biennia financial plan should specify the growth and proportion of total expenditures to be allocated to broad programs areas.
- Financial forecasts should be based on current law and inflation of both revenues and expenditures to provide an accurate planning perspective. However, budgets should not automatically fund inflation allowances. Base spending should be scrutinized.
- Risk sharing and formal contingency plans should be included in the adopted budget. Specified offsets in lower priority program areas should be identified, with increased management flexibility provided in entitlement programs to allow for possible shortfalls.
- A cash flow account should be maintained separate from the rainy-day budget reserve to avoid short-term borrowing. Cash flow timing changes should be considered.
- A rainy-day budget reserve should be maintained to manage cyclical economic volatility, not to cover spending forecast inaccuracies, nor to increase spending above levels specified in the three-biennia financial plan.
- With the advice of the Legislative Advisory Commission, the Governor should be permitted to unallot funds once the rainy-day budget reserve is depleted.
- To resolve the inherent accountability problem of taxing at the state level and spending at the local level, the state should pay for programs it mandates, and local governments should have greater access to alternative funding, including the removal of artificial property tax limits.

Model Revenue System for Minnesota
July 1992

Overall

- The revenue system should be understandable, fair, competitive, reliable, and efficient. This includes using broad based taxes and minimizing deductions, exclusions, and exemptions.
- The state and local tax structure should not be regressive; each major tax type (income, sales, and property) should make up 20-30 percent of state and local taxes.

Individual Income Tax

- This tax should provide 25-30 percent of total state and local taxes, with total income tax yield larger than the net property tax.
- Federal taxable income should be retained as the starting point for Minnesota taxes.
- Minnesota tax rates should have the following characteristics: 1) be limited to three rates; 2) continuously rise with income; and 3) be competitive with other states; and 4) be sufficiently progressive
- The income tax should be indexed for inflation.

Sales and Use Tax

- The sales tax, not counting excise taxes, should provide 20-25 percent of total state and local taxes.
- The sales tax base should be broadened and the rate reduced. This includes taxing services provided to consumers and reducing product exemptions to major necessities. Products such as clothing, newspapers, and textbooks should be taxed.
- Services that are provided primarily to businesses and items used in production should be exempted from the tax.

Property Tax and Aids

- 25-30 percent of total state and local taxes should be obtained from the property tax.
- Levy limits should be eliminated for general purpose local governments; they should continue for school districts.
- State paid property tax relief should be targeted to taxpayers and not to local governments. The primary objective of state aid to local governments should be to subsidize local government funding for state mandated programs or services.

The Stability of Minnesota's Sales Tax
October 1987

Long-term stability

- Overall, any of the base expansion options would provide relatively long-term stability
- The 1987 sales tax base and personal services generally grew at the same rate as the economy
- Food and clothing purchases grew at a slower rate than the tax base
- Energy-related purchases and medical services grew at a faster rate than the economy; this was partly due to significant price increases over the study period

Short-term stability

- Overall, the 1987 sales tax base was more sensitive to changes in the economy than any of the base expansion options presented
- The tax base was found to be more sensitive to swings in the economy than the expansion options
- Food purchases increased the stability of the sales tax more than any other base expansion option
- Clothing and shoe purchases were the base expansion options with the least effect on the stability of the sales tax

State Budget Stability: The Limits of Forecasting – Creating a Manageable Budget
Department of Finance
November, 1986

Revenue System Changes

- Changing the mix of revenues – reduce reliance upon volatile tax sources, i.e. corporate income tax
- Changing the income tax – Flat rate tax on AGI with large standard deduction
- Establishing a dollar amount of revenue to be raised – similar to local units of government, giving the Commissioner of Finance or Revenue authority to raise or lower tax rates within certain parameters if need be.
- Changing the sales tax base – broaden the base to include less elastic items (this would result in more forecast uncertainty in the first few years the base was broadened)
- Reduce the number of law changes – complicated changes to tax law reduce forecast accuracy

- Budget Reserves – size can be determined based on historical forecast error and revenue volatility
- Trigger Tax and Spending Changes – changes that automatically occur if specified economic or budget events occur.
- Staged Appropriations - 95% of an appropriation is paid and the remaining 5% is held until sufficient tax revenues are confirmed.
- Annual Inflation Adjustments – Annual adjustments reduce uncertainty in the 30-month forecast horizon
- Expenditures linked to Revenues – Volatility risk of a revenue source is shared with the linked expenditure.

Budget Process Changes

- Annual Budgets – potentially retain a longer budget planning horizon, but act on an annual basis on selective portions
- Uniform Budget Cycle – Improve state and local government relationship through a uniform fiscal year

Final Report of the Minnesota Tax Study Commission
(Latimer Commission Report)
December 1984

- Minnesota should rely on a balanced mix of all major tax sources and use taxes that are broadly based
- Reduce the income tax and concentrate the cuts in the lower- to middle-income brackets, while ensuring that all brackets experience declines in their effective rates
- Broaden the sales tax base to personal services and new clothing, while maintaining the current rate (6 percent at the time)
- Simplify the property tax system and fund a property tax credit based on income and property wealth that treats renters and homeowners the same
- Conform Minnesota's individual income tax base to federal taxable income
- Include a budget reserve as a permanent part of the state's fiscal structure

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