A bill for an act

relating to finance; requiring reports and recommendations to bring the state budget into compliance with generally accepted governmental accounting principles; requiring disclosure of the impact of inflation on state expenditures; amending Minnesota Statutes 2004, sections 16A.055, subdivision 1; 16A.103, subdivisions 1a, 1b; 16A.11, subdivision 2.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

Section 1. Minnesota Statutes 2004, section 16A.055, subdivision 1, is amended to read:

Subdivision 1. [LIST.] (a) The commissioner shall:

(1) receive and record all money paid into the state treasury and safely keep it until lawfully paid out;

(2) manage the state's financial affairs;

(3) keep the state's general account books according to generally accepted government accounting principles;

(4) keep expenditure and revenue accounts according to generally accepted government accounting principles;

(5) develop, provide instructions for, prescribe, and manage a state uniform accounting system;

(6) provide to the state the expertise to ensure that all state funds are accounted for under generally accepted government accounting principles; and

(7) coordinate the development of, and maintain standards for, internal auditing in state agencies and, in cooperation with the commissioner of administration, report to the legislature and the governor by January 31 of odd-numbered years, on progress made.

(b) As part of the comprehensive annual financial report, the commissioner shall list any laws that require the state's general fund budget not to be reported in accordance with generally accepted government accounting principles.

Sec. 2. Minnesota Statutes 2004, section 16A.103, subdivision 1a, is amended to read:

Subd. 1a. [FORECAST PARAMETERS.] The forecast must assume the continuation of current laws and reasonable estimates of projected growth in the national and state economies and affected populations. Revenue must be estimated for all sources provided for in current law. Expenditures must be estimated for all obligations imposed by law and those projected to occur as a result of <u>deflation, inflation, and other</u> variables outside the control of the legislature. ~~Expenditure-estimates-must-not include-an-allowance-for-inflation.~~

Sec. 3. Minnesota Statutes 2004, section 16A.103, subdivision 1b, is amended to read:

Subd. 1b. [FORECAST VARIABLE.] In determining <u>the rate of deflation or inflation, the application of deflation or inflation,</u> the amount of state bonding as it affects debt service, the calculation of investment income, and the other variables to be included in the expenditure part of the forecast, the commissioner must consult with the chairs and lead minority members of the senate ~~State-Government~~ Finance Committee and the house Ways and Means Committee, and legislative fiscal staff. This consultation must occur at least three weeks before the forecast is to be released. No later than two weeks prior to the release of the forecast, the commissioner must inform the chairs and lead minority members of the senate ~~State-Government~~ Finance Committee and the house Ways and Means Committee, and legislative fiscal staff of any changes in these variables from the previous forecast.

Sec. 4. Minnesota Statutes 2004, section 16A.11, subdivision 2, is amended to read:

Subd. 2. [PART ONE: MESSAGE.] Part one of the budget, the governor's message, shall include the governor's recommendations on the financial policy of the state for the coming biennium, describing the important features of the budget plan, embracing a general budget summary setting forth the aggregate figures of the budget so as to show the balanced relation between the total proposed expenditures and the total anticipated income, with the basis and factors on which the estimates are made, the amount to be borrowed, and other means of financing the budget for the coming biennium, compared with the corresponding figures for at least the last two completed fiscal years and the current year. <u>The budget plan must include recommendations on how to bring the</u>

budget into compliance with generally accepted governmental accounting principles. The budget plan shall be supported by explanatory schedules or statements, classifying its expenditures by agencies and funds, and the income by agencies, sources, funds, and the proposed amount of new borrowing, as well as proposed new tax or revenue sources. The budget plan shall be submitted for all special and dedicated funds, as well as the general fund, and shall include the estimated amounts of federal aids, for whatever purpose provided, together with estimated expenditures from them.

Sec. 5. [EFFECTIVE DATE.]

This act is effective the day following final enactment.

Senate Counsel & Research

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Jo Anne Zoff Sellner
Director

Senate
State of Minnesota

S.F. No. 2 - Inflation in State Budgets

Author: Senator Richard J. Cohen

Prepared by: Peter S. Wattson, Senate Counsel (651/296-3812) PSW

Date: January 6, 2005

S.F. No. 2 restores inflation to state budget expenditure forecasts, which had been required until inflation was taken out of forecasts by Laws 2002, ch. 220, art. 13, §§ 1-2. It also requires the Commissioner of Finance to identify laws that require the state's general fund budget not to be reported in accordance with generally accepted governmental accounting principles and requires the Governor to recommend how to bring the budget into compliance with generally accepted governmental accounting principles.

Section 1 requires the Commissioner of Finance to identify, as part of the state's comprehensive annual financial report, laws that require the state's general fund budget not to be reported in accordance with generally accepted governmental accounting principles.

Section 2 requires that each forecast of general fund expenditures include the effects of inflation.

Section 3 includes inflation among the forecast variables on which the Commissioner of Finance must consult with legislative leaders before issuing a new forecast of state revenues and expenditures. It also updates a reference to the Senate Finance Committee.

Section 4 requires the Governor to recommend, as part of the biennial budget message, how to bring the budget into compliance with generally accepted governmental accounting principles.

PSW:ph

Note 20 – Budgetary Basis vs GAAP

Actual revenues, transfers-in, expenditures, encumbrances, and transfers-out on the budgetary basis do not equal those on the GAAP basis in the Governmental Funds Statement of Revenues, Expenditures and Changes in Fund Balances for the General Fund. This inequality results primarily from the differences in the recognition of accruals, reimbursements, deferred revenue, intrafund and loan transactions, and from the budgetary basis of accounting for encumbrances. On the budgetary basis, encumbrances are recognized as expenditures in the year encumbered. The modified accrual basis of accounting recognizes expenditures when the goods or services are received, regardless of the year funds are encumbered. A reconciliation of the fund balances under the two bases of accounting for the General Fund is provided in the following table.

Reconciliation of GAAP Basis Fund Balance
to Budgetary Fund Balance
As of June 30, 2004
(In Thousands)

	General Fund
GAAP Basis Fund Balance:	$ (327,959)
Less: Reserved Fund Balance	120,506
Undesignated Fund Balance	$ (448,465)
Basis of Accounting Differences:	
Revenue Accruals/Adjustments:	
Taxes Receivable	$ (376,153)
Tax Refunds Payable	532,704
Human Services Receivable	(33,228)
Deferred Revenue	(7,709)
Other Receivables	(18,304)
Investments at Market	(1,183)
Expenditure Accruals/Adjustments:	
Medical Assistance	284,060
Human Services Grants Payable	44,302
Education Aids	1,224,718
Police and Fire Aid	73,269
Permanent School Fund Reimbursement	(6,568)
Other Payables	13,394
Fund Structure Differences:	
Terminally Funded Pension Plans	8,286
Designated for Appropriation Carryover and Budgetary Reserve	(597,599)
Budgetary Basis:	
Undesignated Fund Balance	$ 691,524

GOVERNMENTAL FUNDS
BALANCE SHEET
JUNE 30, 2004
(IN THOUSANDS)

	GENERAL	FEDERAL	NONMAJOR FUNDS	TOTAL
ASSETS				
Cash and Cash Equivalents	$ 1,465,328	$ 168	$ 2,199,443	$ 3,664,939
Investments	46,830	-	905,503	952,333
Accounts Receivable	1,521,821	227,143	330,378	2,079,342
Interfund Receivables	193,655	4,516	137,725	335,896
Due from Component Units	-	-	122,347	122,347
Accrued Investment/Interest Income	6,742	-	8,713	15,455
Federal Aid Receivable	-	610,566	87,530	698,096
Inventories	-	49	15,202	15,251
Loans and Notes Receivable	51,997	117	276,123	328,237
Advances to Other Funds	4,700	-	-	4,700
Securities Lending Collateral	333,364	-	292,916	626,280
Investment in Land	-	-	15,441	15,441
Total Assets	$ 3,624,437	$ 842,559	$ 4,391,321	$ 8,858,317
LIABILITIES AND FUND BALANCES				
Liabilities:				
Accounts Payable	$ 2,334,115	$ 657,643	$ 428,241	$ 3,419,999
Interfund Payables	36,204	142,523	143,106	321,833
Due to Component Units	101,083	2,591	38,324	141,998
Deferred Revenue	1,147,630	32,709	172,213	1,352,552
Securities Lending Collateral	333,364	-	292,916	626,280
Total Liabilities	$ 3,952,396	$ 835,466	$ 1,074,800	$ 5,862,662
Fund Balances:				
Reserved Fund Balances:				
Reserved for Encumbrances	$ 65,242	$ -	$ 259,365	$ 324,607
Reserved for Local Governments	-	-	441,027	441,027
Reserved for Trust Principal	-	-	918,428	918,428
Other Reserved Fund Balances	55,264	7,093	917,293	979,650
Total Reserved Fund Balances	$ 120,506	$ 7,093	$ 2,536,113	$ 2,663,712
Unreserved Fund Balances:				
Designated for:				
Special Revenue Funds	$ -	$ -	$ 580,118	$ 580,118
Undesignated, reported in:				
General Fund	(448,465)	-	-	(448,465)
Capital Project Funds	-	-	(62,340)	(62,340)
Special Revenue Funds	-	-	262,630	262,630
Total Unreserved Fund Balance	$ (448,465)	$ -	$ 780,408	$ 331,943
Total Fund Balances	$ (327,959)	$ 7,093	$ 3,316,521	$ 2,995,655
Total Liabilities and Fund Balances	$ 3,624,437	$ 842,559	$ 4,391,321	$ 8,858,317

The notes are an integral part of the financial statements.

Startribune
Commentary
Jan 4th, 05

Time for state to stop all the fiscal charades

By John Gunyou, Jay Kiedrowski and Pamela Wheelock

It's official. Minnesota is now facing its fourth straight year of budget deficits. This time the gap is $1.4 billion. It is not $700 million, as our governor and some legislators have suggested, because this lower amount ignores the real cost of funding the state's program commitments.

Minnesota should not be facing yet another budget deficit. The economic recovery is well behind us, and other states have already returned to making investments in their future. We're still saddled with a budget deficit because the problems that began in fiscal year 2003 were never resolved.

The shortfalls of 2003, 2004 and 2005 were mostly deferred, rather than permanently fixed. For three years in a row, the governor and Legislature have relied on one-time patches to put off the day of reckoning. One-time fixes should only be used during a recession to phase in the necessary permanent revenue and spending changes — reforms yet to be made in Minnesota.

Rather than craft a permanent resolution to the shortfalls, the governor and Legislature used one-time reserves and accounting tricks to paper over the problem. Although our leaders claimed they balanced the budget when the crisis first hit, in truth, the 2003 budget was nearly $1 billion out of balance on an accrual basis. That meant they didn't fix the problem by balancing

Minnesota should

2006-07 and 2008-09 with no more gimmicks.

➤ Second, the governor and Legislature must work together on a bipartisan basis. From our years of experience, we know that real bipartisan efforts will be needed to craft an honest and lasting budget solution. For the governor and his legislative allies, that means putting taxes back on the table. Despite all their high-tax claims, Minnesota is no longer among the most expensive states in the country. The Minnesota Taxpayers Association recently reported that our total state and local spending now ranks 22nd among states — right down there in the middle of the pack.

For starters, we should seriously consider raising the gas tax to provide a stable source of funding for Minnesota's transportation needs. It hasn't been increased in 16 years, and a higher gas tax is widely supported by business and government groups throughout the state.

The cigarette tax is another strong candidate — it would raise revenue and reduce health care costs by cutting back smoking, especially among young people. Minnesota's current tax is 35th among states, which ranks us down with the tobacco-producing Southern states.

Compromise also means putting favorite projects and programs on the table, even though past budget actions have already reduced spending on many state programs in the last several years. We would hope that the Legislature looks first at programs that are not clearly linked to state priorities or where there is insufficient evidence that the programs are effective in delivering results.

Minnesota should not be facing yet another budget deficit. Our leaders must honestly balance the budget, and stop shifting fiscal problems into the future.

ongoing revenue with ongoing spending.

As three former Minnesota finance commissioners who have served Republican, DFL and Independent governors, we believe it's time for a permanent solution to these chronic budget crises. We think it's time for our leaders to set aside their partisan finger-pointing and political posturing, and do the right thing for Minnesota.

The governor and Legislature must restore fiscal stability by adopting a budget that carefully balances both taxing and spending decisions. How they do that is open to policy debate — some leaders want to hold the line on taxes, while others want to invest more resources in priority programs. Regardless of their choices, the solution must be balanced and sustainable in the long run.

Here are three steps to achieving fiscal stability:

➤ First and foremost, our leaders must absolutely forgo the use of any more gimmicks — no more shifts, transfers, reserves, revenue accelerations or other "smoke and mirror" tricks. Ongoing revenue must be balanced with ongoing spending to permanently resolve the budget problem.

Our leaders must honestly balance the budget, and stop shifting fiscal problems into the future. For example, they must not claim they avoided a gas tax increase by borrowing against future federal transportation allotments. That has the short-term political benefit of building road projects today, but forcing a future burden onto taxpayers — either by reducing construction or by increasing taxes.

There is no free lunch. The governor must set the standard with his January budget proposal to the Legislature by structurally balancing both fective in delivering results.

However, that doesn't mean just cutting budgets — it means spending smarter. For example, it's going to take real leadership to achieve the reforms necessary to bring health care spending into line, which is one of the most significant parts of the state budget — specifically long-term care for the elderly and disabled. This is a time for hard work, collaboration and creativity — not political posturing and sound bites.

➤ Finally, the House and Senate should commit to pass a concurrent revenue resolution by March 15, as required by state law. The brinkmanship that led to a legislative stalemate last year must end. Have the debate as to how much revenue Minnesota should raise for the 2006-07 budget, and then set that amount by March 15. This will allow ample time for the finance and appropriation committees to craft the details of the program expenditures for the next budget during their open hearings.

We would suggest starting at the current price of government — how many cents of every dollar earned goes to pay for government programs. That current share is about 16 percent of personal income. It's fallen from 17 percent a decade earlier, and is scheduled to drop to 15 percent over the next five years.

There's no need to drive it lower. If we simply freeze the share of income that state and local governments are already taking from taxpayers, there should be adequate resources to pay for real growth and inflationary costs of priority programs as our economy continues to grow.

That's it — three steps to fiscal stability. True leaders have the courage to make the tough choices. They don't avoid dealing with the real issues by using accounting gimmicks and symbolic gestures. It's time for the governor and the Legislature to lead. It's time to stop all the fiscal charades and honestly balance the budget.

John Gunyou is Minnetonka's city manager, Jay Kiedrowski is a senior fellow at the University of Minnesota's Humphrey Institute, and Pamela Wheelock is executive vice president and chief finance officer of Minnesota Sports and Entertainment.

Senator Cohen from the Committee on Finance, to which was referred

S.F. No. 350: A bill for an act relating to state government; providing deficiency funding for certain state agencies; appropriating money.

Reports the same back with the recommendation that the bill be amended as follows:

Page 1, delete lines 17 to 19 and insert:

"General $ 30,874,000"

Page 1, line 25, delete "230,000" and insert "199,000"

Page 2, line 34, delete "4,370,000" and insert "3,870,000"

Page 2, line 41, delete "and 3" and insert "to 4"

Page 2, line 42, delete "4,180,000" and insert "3,350,000"

Page 2, after line 43, insert:

"Subd. 4. Community Services 330,000"

Page 3, delete sections 9 and 10

Page 3, line 35, delete "<u>10</u>" and insert "<u>8</u>"

Renumber the sections in sequence

And when so amended the bill do pass. Amendments adopted. Report adopted.

....
(Committee Chair)

January 20, 2005...............
(Date of Committee recommendation)

Senator Cohen introduced--

S.F. No. 350: Referred to the Committee on Finance.

A bill for an act

relating to state government; providing deficiency funding for certain state agencies; appropriating money.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

DEFICIENCY APPROPRIATIONS

Section 1. [APPROPRIATIONS.]

The sums shown in the columns marked "APPROPRIATIONS" are appropriated from the general fund, or another named fund, to the agencies and for the purposes specified in this act, to be available for the fiscal year indicated for each purpose, and are added to appropriations in Laws 2003, First Special Session chapters 1, 2, and 14. The figure "2005," where used in this act, means that the appropriation or appropriations listed under it are available for the year ending June 30, 2005.

SUMMARY BY FUND

	2005	TOTAL
General	$ 31,405,000	$ 31,405,000
TOTAL	$ 31,405,000	$ 31,405,000

APPROPRIATIONS
Available for the Year
Ending June 30
2005

Sec. 2. BOARD ON JUDICIAL STANDARDS 230,000

This appropriation is added to appropriations in Laws 2003, First Special Session chapter 2, article 1, section 7.

Sec. 3. BOARD OF PUBLIC DEFENSE 7,681,000

This appropriation is added to appropriations in Laws 2003, First Special Session chapter 2, article 1, section 8.

Sec. 4. PUBLIC SAFETY

Subdivision 1. Total Appropriation

General Fund 986,000

This appropriation is added to appropriations in Laws 2003, First Special Session chapter 2, article 1, section 9. The amounts that may be spent from this appropriation for each program are specified in subdivisions 2 and 3.

Subd. 2. Emergency Management 710,000

[FEMA MATCHING FUNDS.] This appropriation is to provide matching funds for FEMA funds received for natural disaster assistance payments. This appropriation is available until June 30, 2007.

Subd. 3. Law Enforcement and Community Grants 276,000

[GANG STRIKE FORCE.] This appropriation is for grants to the Criminal Gang Strike Force under Minnesota Statutes, chapter 299A.

Sec. 5. CORRECTIONS

Subdivision 1. Total Appropriation

General Fund 4,370,000

This appropriation is added to appropriations in Laws 2003, First Special Session chapter 2, article 1, section 13. The amounts that may be spent from this appropriation for each program are specified in subdivisions 2 and 3.

Subd. 2. Correctional Institutions 4,180,000

Subd. 3. Operations Support 190,000

Sec. 6. HUMAN SERVICES

Subdivision 1. Total Appropriation 13,394,000

This appropriation is added to appropriations in Laws 2003, First Special Session chapter 14, article 13C, section 2, subdivision 8. The amounts that may be spent from this appropriation for each program is specified in subdivision 2.

Subd. 2. State-Operated Services	13,394,000
This appropriation is for the forensic treatment programs operated by state-operated services.	
Sec. 7. VETERANS AFFAIRS	39,000
This appropriation is added to appropriations in Laws 2003, First Special Session chapter 1, article 1, section 17.	
Sec. 8. ADMINISTRATION	4,705,000
This appropriation is to the Department of Administration for relocation costs for the Departments of Health and Agriculture and is available until June 30, 2006. Notwithstanding any law to the contrary, proceeds from the sale or disposition of the Department of Health land and building at 717 Delaware Street in Minneapolis, after paying all expenses incurred in selling or disposing of it, estimated to be approximately $4,853,000, must be deposited in the general fund.	

Sec. 9. [SUNSET OF UNCODIFIED LANGUAGE.]

<u>All uncodified language in this act expires June 30, 2005, unless another date is specified.</u>

Sec. 10. [FORECAST ALLOCATION.]

<u>The commissioner of finance shall reduce the amount allocated on the basis of the November 2004 general fund forecast for the purpose of Minnesota Statutes, section 16A.152, subdivision 2, paragraph (a), clause (3), by $25,100,000.</u>

Sec. 11. [EFFECTIVE DATE.]

<u>Sections 1 to 10 are effective the day following final enactment.</u>

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Jo Anne Zoff Sellner
Director

Senate
State of Minnesota

S.F. No. 350 - Relating to 2005 Deficiency Appropriations

Author: Senator Richard J. Cohen

Prepared by: Chris Turner, Senate Research (651/296-4350) CT

Date: January 19, 2005

Section 1 is the appropriation summary.

Section 2 appropriates $230,000 to the Board on Judicial Standards to pay for the costs of a contested case related to the removal of a judge from the bench. The board has recently reduced the request to $199,000.

Section 3 appropriates $7,681,000 to the Board of Public Defense to replace dedicated funding that was lost when the public defender co-pay legislation passed during the 2003 session was found to be unconstitutional.

Section 4 appropriates $986,000 to the Department of Public Safety.

> $710,000 is to match federal disaster assistance money (FEMA) for flooding that occurred late in the summer of 2004 in southeastern Minnesota.
>
> $276,000 is to continue operation of the Criminal Gang Strike Force.

Section 5 appropriates $4,370,000 to the Department of Corrections.

> $2,850,000 is for renting prison beds to accommodate a higher inmate population than was projected at the time of the original appropriation.

$1,000,000 is for increased costs in the Department of Corrections health system due to higher inmate populations and higher than projected inflation costs for staff, supplies, and equipment.

$520,000 ($330,000 in community services and $190,000 in operations services) is for the restructure of the civil commitment review process and increased staffing to manage sex offender revocation hearings.

Section 6 appropriates $13,394,000 to the Department of Human Services. This appropriation is to accommodate higher numbers of patients in DHS forensic treatment programs (sex offenders who have been civilly committed and persons committed as mentally ill and dangerous) at the St. Peter state hospital. The $13.4 million appropriation is offset by a 10 percent county share of $1.6 million, for a net cost to the general fund of $11.9 million.

The caseload need of the department is actually $16 million (which produces the $1.6 million county share figure). State-operated services is using $2.7 million in carryforward funds to mitigate a portion of the increased cost, hence the lower deficiency appropriation.

Section 7 appropriates $39,000 to the Department of Veterans Affairs for increased rent.

Section 8 appropriates $4,705,000 to the Department of Administration to fund the lab and office space relocation costs of the Departments of Health and Agriculture. The cost is offset by the anticipated sale proceeds of $4.8 million from the existing Department of Health lab building in Minneapolis.

Section 9. Sunsets uncodified language June 30, 2005.

Section 10. Funds $25.1 million of the deficiency costs with a partial rollback of the November forecast allocation to the school payment shift from $118 million to $93 million. This changes the current year aid payment percentage from 81.9 percent to 81.5 percent.

Section 11 provides an immediate effective date.

CT:vs

Senator ..... moves to amend S.F. No. 350 as follows:

Page 1, delete lines 17 to 19, and insert:

"General $ 30,874,000"

Page 1, line 25, delete "230,000" and insert "199,000"

Page 2, line 34, delete "4,370,000" and insert "3,870,000"

Page 2, line 41, delete "and 3" and insert "to 4"

Page 2, line 42, delete "4,180,000" and insert "3,350,000"

Page 2, after line 43, insert:

"Subd. 4. Community Services 330,000"

Senator ..... moves to amend S.F. No. 350 as follows:

Page 3, delete sections 9 and 10

Renumber the sections in sequence and correct the internal references

Amend the title accordingly

MINNESOTA · REVENUE

Expanded Tax Compliance Initiatives

FY 2004 – 2005

Report to the Minnesota Legislature

January 2005

Laws of Minnesota 2003, First Special Session,
Chapter 1, Article 1, Section 15, Subdivision 2.

Minnesota Department of Revenue
600 North Robert Street
St. Paul, Minnesota 55146
651-556-4044
www.taxes.state.mn.us

Table of Contents

Summary of Findings

The Minnesota Legislature appropriated $12.8 million to the Department of Revenue for the 2004-05 biennium to collect $59.8 million through expanded tax compliance activities (Laws of Minnesota 2003, First Special Session, Chapter 1, article 1, section15, and subdivision 2). This report summarizes the results the department has achieved through the end of November 2004, and is the second of two reports for the biennium. During this period — with 71 percent of the biennium completed — the department has:

- Collected and deposited in the general fund $63.9 million, or 107 percent, of the anticipated $59.8 million sought through the tax compliance initiatives.

- Resolved a total of 14,028 noncompliant individual income tax cases.

- Identified a total of 590 noncompliant sales and use tax payers and 732 noncompliant corporate tax payers.

- Expended $6.6 million and hired 109 full-time equivalents (FTEs).

To collect the $63.9 million to date, the department spent $6.6 million, or approximately $1 for every $8 collected. In the remaining months of the FY 2004-05 biennium, the department expects to further exceed the $59.8 million legislated goal.

Expanded Tax Compliance Initiatives Report 2004

This report was prepared by the Minnesota Department of Revenue (the department) and developed for the legislature in response to a legislative directive (Laws of Minnesota 2003, First Special Session, Chapter 1, article 1, section15, subdivision 2). Copies of this report are available on the Department of Revenue website at www.taxes.state.mn.us.

Cost of report preparation: $25 x 20 hours = $500.
Report printing cost: $100.
Total estimated cost of this report: $600.

Purpose of this Report

This is the second of two reports by the department for the FY 2004-05 biennium. It provides performance results in accordance with the 2003 session mandate.

For the FY 2004-05 biennium, the department was appropriated $12.8 million from the general fund to identify and collect tax liabilities from individuals and businesses that currently do not pay taxes owed. This initiative is expected to result in new general fund revenues of $59.8 million by the end of the biennium.

The 2003 session mandate directs the department to report performance results for the following:

- The number of non-compliant corporate taxpayers each year and the percentage and dollar amount of valid tax liabilities collected;
- The number of non-compliant sales and use taxpayers each year and the percentage and dollar amount of the valid tax liabilities collected;
- The number of non-compliant individual income tax cases resolved each year and the percentage and dollar amount of valid tax liabilities collected; and
- Base level expenditures and staff positions provided at the budget activity level related to compliance and audit activities, including baseline information as of January 1, 2002.

The department's progress as shown by these performance indicators was first reported in detail in March 2004. The first report provided background and a description of how the expanded tax compliance initiative was implemented within the department. As a follow-up to the first report, the focus of this report is to provide a status update of the mandated performance indicators for the FY 2004-2005 biennium. Biennium-to-date results referenced in this report reflect the time period of July 2003 to November 2004.

This report is organized into four sections:

I. FY 2003 Compliance and Enforcement Base Performance
II. FY 2004-05 Expanded Tax Compliance Initiative Performance
  - Year-to-Date Expenditures/Full-Time Equivalents (FTEs) Hired
  - Year-to-Date Revenues
III. Observations and Trends
IV. Appendix - Methodology

I. FY 2003 Compliance and Enforcement Base Performance

A key element of the department's strategic plan is to ensure that *everyone pays the right amount, no more, no less*. To make this vision operational, the department is focusing on methods for measuring compliance with Minnesota's tax system.

Recently, the department conducted two landmark studies to measure the tax gap—the difference between the amount of taxes actually paid and the amount of taxes that should have been paid. The first of the two studies, conducted in 2002, revealed a *sales tax gap* of about $500 million; that is expected to grow to $700 million by 2007. Similarly, in 2004, the agency, in consultation with the State Demographer's Office and the Minnesota Department of Finance, conducted a study of the *individual income tax* utilizing the 2000 Census information. This study revealed an annual gap of about $604 million.

To eliminate or minimize this gap, the department is conducting the following activities in order to pursue noncompliant taxpayers including, but not limited to: (1) auditing of taxpayer filings to correct errors and detect abuse; (2) identifying taxpayers who should file, but did not ("nonfilers"); (3) identifying unreported taxable activity; (4) providing taxpayer outreach and education programs; and (5) pursuing collection activities on delinquent accounts. In Table 1.0, the department provides an estimate of dollars expended and revenues generated as a result of audit and compliance activities conducted in FY 2003 from the major tax types administered in the department.

For the tax types listed in table 1.0, assessments are made from audits. The taxpayer generally has 60 days to appeal any assessment before the case is sent to the Collection division for collection. Appendix A shows the methodology for Table 1.0.

Table 1.0
FY 2003 Estimated Direct Compliance and Enforcement Activity Base Revenue

Tax Type/Function	FTE	Estimated Compliance Revenues	Estimated Expenditures	Ratio (rev:exp)
Collection	160	$171,812,750	$ 9,727,883	17.7
Individual Income Tax	105	$ 9,788,237	$ 6,053,459	1.6
Withholding	7	$ 414,224	$ 361,049	1.2
Sales and Use/Corp Taxes	167	$ 74,992,995	$11,116,474	6.7
Special Taxes	36	$ 4,100,155	$ 2,115,699	1.9
Tax Operations	26	$ 14,470,883	$ 1,321,015	11.0
TOTAL	*501*	*$275,579,244*	*$30,695,579*	*8.9*

The base revenues generated from all audit and compliance activities is a function of multiple variables such as the retention of experienced revenue tax specialists (RTS), as well as the number of analytical software applications tools deployed by the department for audit selection. The ratio of revenues to expenditures continues to remain high, despite recruitment and retention issues that are described in detail in section III.

II. Performance of the FY 2004-05 Expanded Tax Compliance Initiative

Expenditures and Full-time Equivalents

As of November 30, 2004, the department has spent approximately $6.6 million for this initiative for the FY 2004-2005 biennium. Payroll is the largest expenditure category accounting for 84 percent of total expenditures. Table 2.0 shows these expenditures in detail.

Table 2.0.
FY 2004-05 Expanded Tax Compliance Expenditures through 11/30/04

	Expenditures	% of Total
Payroll	$5,631,749	84%
Contractual	$ 12,014	0%
Equipment	$ 460,797	7%
Supplies	$ 82,540	1%
Technology	$ 237,500	4%
Other	$ 243,601	4%
Total	*$6,668,201*	*100%*

On average, it takes the department approximately one to two months to fill positions for this initiative. Table 2.1 shows the number of staff hired to date. Since July 2003, approximately 109 FTEs have been hired in the Revenue Tax Specialist (RTS) or Revenue Collection Officer (RCO) classifications.

Table 2.1
Expanded Tax Compliance Initiative FTE

	FY 2004 Actual	FY 2005 YTD Actual	FY 2004-2005 planned
Initiative FTEs	66	109	133

Revenues

As described in the first report, to improve compliance overall, noncompliant taxpayers must be identified and noncompliant cases must be resolved. Table 2.2 shows, as mandated, the number of individual income tax noncompliant cases resolved and the number of taxpayers that are not in compliance with the sales and use and corporate tax laws.

For individual income tax, the number of noncompliant taxpayer cases resolved as a result of the tax compliance initiative is 14,028. An individual income taxpayer case is resolved if the following occurs:

- The auditor files a return for a nonfiling taxpayer; or
- The auditor is able to get the nonfiling taxpayer to file a return;
- The auditor completes an audit report. This audit report may indicate a balance due, a refund or no change to the return.

The “noncompliant” criteria are slightly different for businesses and corporations. Businesses are identified as noncompliant with the tax laws if the audit or other compliance actions result in a change in taxpayer liability.

Additional revenue is generated from the compliance actions listed in Table 2.2. The expanded tax compliance initiative provides funding to increase audit and collection activity. The department has selected these tax types to be the focus of the expanded direct compliance efforts: income tax, sales and use tax, corporate tax, insurance tax, gambling tax and withholding tax.

Table 2.2
FY 2004-05 Year-To-Date Non-Compliance with the Tax System

	Non Compliant Cases "Identified" FY 2004-05 to Date	Non Compliant Cases "Resolved" FY 2004-05 to Date
Individual Income Tax System	--------	14,028
Sales and Use Tax System	590	-------
Corporate Tax System	732	-------
TOTAL[1]	***1,322***	***14,028***

Through the end of November 2004 (with 71 percent of the biennium completed), the total revenue collected from the tax compliance initiative and deposited into the general fund is $63.9 million. Table 2.3 provides detailed data related to the total revenues collected for each tax type/function from this initiative. By the end of FY 2005, the department expects to further exceed the legislated goal.

Table 2.3
Biennium Year-To-Date Compliance Initiative Revenue Results

Tax Type/Function	Actual Compliance Collections	Biennium Target	% of Target Achieved
Collection	$34,192,648	$32,887,000	104%
Individual Income Tax	$8,307,758	$6,371,000	130%
Withholding	$1,777,142	$2,295,000	77%
Sales and Use/Corp Taxes	$13,295,378	$16,282,000	82%
Special Taxes	$3,501,412	$1,001,000	350%
Tax Operations Early Audit[2]	$2,900,170	$1,002,000	289%
TOTAL	***$63,974,508***	***$59,838,000***	***107%***

[1] This total excludes taxpayers noncompliant with the withholding tax system. The Withholding Tax Division has identified 1,917 taxpayers as noncompliant with the withholding tax system as result of the tax compliance initiative. The criteria for a taxpayer being identified as noncompliant with the withholding tax system is as follows:

a. Withholding income tax but not remitting it;
b. Withholding income tax but not depositing it in a timely manner; or
c. Not withholding income tax when they should have.

[2] In Table 2.3, for Tax Operations Early Audit, January 2004 is the first month that initiative collections were reported. The amount in this table for Tax Operations Early Audit includes collections from refund reductions only. Collections for payments received from accounts receivable and refund offsets are not included in this table because this data was not available when the report was compiled. This data will be included in the final report for the expanded tax initiatives of the FY 2004-05 biennium.

III. Observations and Trends

Although expanded tax compliance activities are generating substantial revenue, improving tax compliance with the tax system remains a challenging task. Staff retention is a growing concern. Since July 2001, the department has received additional funding to fill staff positions for the tax compliance initiatives. The revenue production from direct compliance activities is related to the actual number of positions in the RTS and RCO classifications working in the field. Turnover from these position classifications has a direct impact on revenues generated as a result of direct compliance activities. From FY 2002 to FY 2004, the turnover rate (the ratio of new hires to the number of resignations) has increased in the combined RTS classification from 11 percent to 24 percent. This turnover rate is twice the national average. Within the RTS specialist classification, another trend involves the rate of resignations for this classification within one year of service. In FY 2003, 50 percent of RTS specialists who resigned had served one year or less. In FY 2004, 79 percent of the RTS specialists who resigned served one year or less. In response to this trend, the department has initiated focus groups to help identify strategies to retain employees in this classification.

Other trends confronted by the department affecting tax compliance to note:

- An increasing number of citizens believe that cheating on taxes is all right. An IRS survey reveals that 17 percent of the nation's taxpayers think it is all right to cheat on taxes, up from 11 percent just two years earlier.
- More and more, taxpayers are challenging state tax laws. Simultaneously, tax law and accounting firms have become more aggressive in soliciting clients by offering to challenge tax laws and the department's interpretations.
- The tax laws are growing more complex. As the number of tax credits, deductions and special provisions grows, the greater the complexity, length of time, and expense of conducting audits.
- As businesses move from paper to electronic records and transactions, the department's employees need more training to enable them to understand and access various computer systems to ensure the accuracy of the systems, as well as the transactions.
- The department continues to increase the number of accounts receivable dollars collected and cases resolved. The total number of remaining delinquent accounts and dollars available for collection is constant.
- Globalization of commerce increases the number of transactions that cross state and nation borders. As more transactions are made through mail-order firms and the Internet, it is more difficult and expensive for the department to identify them and determine who is responsible for paying the taxes.

IV. Appendix – Methodology

Table 1.0

a. Expenditures:

The base for compliance activity expenditures in FY 2003 was derived by compiling payroll expenditures for the number of full-time equivalents (FTE) engaged in compliance and enforcement activities. These FTEs were identified by management in each tax type/ functional area. Payroll expenditures for FTEs were extracted from the Information Access (IA) warehouse. Employer payroll tax, retirement and insurance were included in the data extraction. The count of FTEs was derived by the total number of hours worked in FY 2003 and divided by 2,088.

b. Revenues:

Collections:
The base consists of total collections as reported in the Lotus Notes database called MCE Performance FY 2003. The total of "tax debt" is the sum of payments collected, minus bad checks.

Sales and Use Tax:
The estimate for base collections is derived from a rolling average of estimated (or actual) collections over a period of four fiscal years, FY 2000 to FY 2003. Included in this estimate are the following compliance activities:

- Actual dollars collected from field and managed audits within 90 days of the order date including claims denied, remaining claims applied, and interest paid on claims allowed that was applied. The estimate does not include the additional claims/credits found during an audit by a revenue tax specialist.
- Dollars from nexus voluntary disclosure. It assumed that 100 percent is collected on liability reported.
- Dollars from nexus investigations. It is assumed that 85 percent is collected from liability reported and assessed.
- Dollars from office audits. It is assumed that 50 percent is collected on assessments.
- Dollars from self-reviews. It is assumed that 100 percent is collected on additional tax reported.
- Dollars from non-filers. It is assumed that 50 percent is collected on assessments.

Corporate Tax:
The estimate for base collections is derived from a rolling average of 3 fiscal years, FY 2001 to FY 2003. Included in this estimate are the following compliance activities:

- Dollars collected from payments paid on proposal as a result of additional tax assessments as recorded in the corporate inventory system.
- Dollars collected from payments received from nexus activities.

- Dollars collected as a result of edit activity on estimated payments. The amounts captured include reduced claimed refunds and reduced claimed overpayments to be carried forward next year.
- Dollars collected from claims denied. If the audit results in additional tax being assessed, only the reduction of the claim to zero is included. For this base estimate in this report, a nine-year average of claims denied is used.
- Over assessments from audits that result in refunding tax as recorded in the corporate inventory system.

Individual Income Tax:
The estimate for base collections is derived from a rolling average of three fiscal years, FY 2001 to FY 2003. Included in this estimate are the following compliance activities:
- Dollars collected from payments received during the proposal period for office audits, field audits and non-filer audits.
- Dollars collected from refunds denied during the early audit phase of processing a tax return.

Withholding Tax:
The estimate for base collections is derived from dollars paid on proposal during the first 90 days of the tax order date, minus dollars transferred out and refunded.

Special Taxes:
The estimate is derived from assessments from direct compliance activities from the following taxes: gambling, insurance, solid waste management, metropolitan landfill contingency action trust fund (MLCAT), dry cleaner, cigarette, tobacco, occupation, liquor, wine, malt beverages, common carrier, mortgage and deed, MinnesotaCare and mining tax. For the taxes listed, except MinnesotaCare, it is assumed that 100 percent is collected from additional tax assessments made. In FY 2003, one MinnesotaCare assessment was excluded from this computation because it has been appealed to the Supreme Court.

Tax Operations:
The estimate is based on calendar year 2003 and includes the following:
- Refund reductions from current and prior year returns including: tax year 1996 and prior years, M-1 returns, M-1X returns PR-X returns, PR returns, and political contribution refund returns;
- Payments received from accounts receivable during 90 days of the tax order date; and
- Refund off-sets which took place during the 90 days of the tax order date.