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OPINION EXCHANGE

State budget surplus sounds too good to be true — and it is

The numbers are distorted by how inflation gets factored in.

By William C. Melton | MARCH 18, 2015 — 6:18PM

Last year at this time, I highlighted the major role of the inflation bias in distorting the official Minnesota budget forecasts. Minnesota has one of the strongest economies in the nation, and its budget position is enviable. However, the official budget numbers distort the picture — and the distortion is growing by leaps and bounds.

This is not the fault of the highly professional staff at Minnesota Management and Budget (MMB). They do a fine job of drawing out budget implications from a bewildering variety of information about the economy and the state's finances. Instead, the responsibility rests with the governor and the Legislature. By law, the official budget projections must include inflation in estimates of revenues, but inflation must be excluded from estimates of expenditures.

It was not always this way. Before 2002, Minnesota's budget forecasts took a common-sense approach; inflation was incorporated consistently in all parts of the budget. Every year since the law was changed in 2002, the Minnesota Council of Economic Advisers (CEA), a private-sector advisory group for MMB, has criticized the current practice as misleading. (Full disclosure: I've been a member of the CEA for many years.)

As far as I can tell, practically everyone in the state is getting a false impression of the true budget position.

After the release of the new budget numbers at the end of February, I checked a variety of news sources to see whether reports of the official \$1.869 billion surplus forecast for the next biennium (July 1, 2015 through June 30, 2017) would include the crucial information that \$0.893 billion of that surplus was an illusion created by the inflation bias. Unfortunately, none of the news accounts I saw included this essential corrective.

The public discussion has taken off from the official number, with no questions asked. Spending proposals and tax-cut proposals have proliferated. Many of these initiatives have considerable merit, but they should be evaluated against the background of consistent budget data — and that means a surplus of about \$1 billion for the 2015-17 biennium, not the higher, distorted number.

If this is not done, Minnesota will start to lay the foundation for serious budget problems in a year or two. The state endured serial budget crises for years and only recently emerged into a solid financial condition. If anyone wants to return to serial budget crises, they should explain why.



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It gets worse.

The February forecast included projections for the 2018-19 biennium. As far as I can tell, these projections have been ignored in all news accounts. They shouldn't have been. The official projections anticipate that revenues in the 2018-19 biennium will exceed expenditures by a mind-boggling \$3.184 billion!

Here is the not-so-good news: \$3.279 billion of this — over 100 percent! — is accounted for by inflation bias. In other words, the legally mandated bias transformed a nearly balanced revenue and expenditure position in 2018-19 into a colossal surplus.

It's going to get still worse.

As I noted a year ago, these very large distortions have been produced in an environment of historically low inflation. Most inflation measures have been tracking in the 1-2 percent range during recent years. Most economists expect that as the U.S. economy continues to expand, inflation will accelerate at least modestly. If and when it does, the inflation bias will produce multibillion-dollar distortions in the budget forecasts.

Budgeting is hard. However, it's crazy-hard when the official forecasts have been distorted massively. Minnesotans deserve accurate information, not budget numbers that are too good to be true. It's way past time for the governor and the Legislature to fix this problem.

William C. Melton formerly was chief economist of American Express Financial Services. The views expressed here are his own and should not be attributed to the Minnesota Council of Economic Advisors or to any other organization.