Minnesota
Department of Finance

November 2002

November 2002 Economic Forecast

Highlights

2004-05 Budget Deficit Grows to $4.560 Billion - $356 Million Deficit in 2002-03

The weak stock market, a slow-to-rebound economy, and higher than projected human services expenditures have increased the projected 2004-05 biennial deficit to $4.560 billion, $2.910 billion more than end-of-session estimates. That deficit includes a $356 million deficit now forecast for the 2002-03 biennium. Since Minnesota's Constitution forbids borrowing for operating purposes beyond the end of a biennium, the FY 2003 deficit will need to be remedied before June 30, 2003. Excluding the 2002-03 deficit, a $4.204 billion problem remains for 2004-05.

Revenues Lower and Expenditures Higher than End-of-session Estimates

A 2004-05 budget gap of $1.650 billion was projected at the close of the 2002 legislative session. Biennial revenues are now expected to be $26.857 billion, $1.634 billion (5.7 percent) less than previously estimated. Expenditures are projected to be $30.975 billion, $926 million (3.1 percent) more than end-of–session estimates. Lower capital gains income is the source of more than half of the revenue shortfall. Higher health care costs dominate the spending increases.

Economic Outlook Remains Strong But Forecast Makes No Provision for Possible War with Iraq

The large projected deficit for 2004-05 is not due to a weak economic outlook. The Global Insight (formerly DRI) baseline forecast now calls for real GDP growth of 2.6 percent in 2003, followed by growth of 4.1 percent in 2004 and 3.8 percent in 2005. That forecast is slightly more optimistic than the Blue Chip Consensus forecast through 2005. There is substantial downside risk, however. Global Insight has indicated their baseline forecast would be lowered should war break out with Iraq.

Current Budget Deficits Extend through 2006-07

Even with the strong economic growth assumed through 2007 a large budget gap remains in future years. Managing the deficit will require significant, ongoing changes in the state budget.

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Budget Summary

Budget Shortfall of $356 Million Projected for End of 2002-03 Biennium

The weak stock market, a slowly rebounding economy, and higher than projected human services expenditures combined to produce a projected shortfall of $356 million for June 30, 2003. General fund revenues are now expected to be $668 million less than end-of–session estimates, while transfers and other resources are $94 million higher. Forecast spending exceeds prior estimates by $76 million causing a total shortfall of $650 million for the current biennium. A $318 million projected unspent balance left by the 2002 Legislature offsets $294 million of this forecast shortfall leaving a forecast deficit of $356 million with $24 million in expected budget reserves at year-end.

FY 2002-03 Forecast

($ in Millions)

	End of Session	November Forecast	$ Change
Beginning Balance	**$1,574**	**$1,574**	**$0**
Revenues	25,317	24,649	(668)
Other Resources	451	545	94
Total Resources	**27,342**	**26,768**	**(574)**
Expenditures	**27,024**	**27,100**	**76**
Budget Reserve	318	24	(294)
Available Balance (Deficit)	**$0**	**$(356)**	**$(356)**

Action Will be Required to Balance FY 2003

Because Minnesota's Constitution prohibits borrowing beyond the end of the biennium for operating purposes, action will be required to bring revenues and expenditures into balance before June 30, 2003.

The $318 million budget reserve shown in end-of-session estimates conformed to current law requiring that any FY 2003 balance be allocated to the budget reserve. The state's reserve was entirely depleted by the "phase one" budget solution last spring. The $24 million in reserves now shown reflects two separate actions. In April 2003 a transfer of $20 million from the excess surplus in the assigned risk plan is anticipated. On June 30, 2003, a $3.9 million appropriation is made to the reserve.

State Revenues Down $574 Million from February Forecast

Minnesota general fund revenues are now expected to total $25.194 billion through the end of the current biennium, $574 million (2.2 percent) below end-of-session estimates. Receipts for fiscal 2002 were $76 million less than forecast, and state receipts for the current year are projected to fall short of prior estimates by $498 million.

FY 2002-03 General Fund Revenues

($ in Millions)

	End of Session	November Forecast	$ Change	% Change
Revenues				
Income Tax	$11,783	$11,014	($769)	(6.5)
Sales Tax	7,614	7,676	62	0.8
Corporate Income Tax	1,158	1,071	(87)	(7.5)
Motor Vehicle Sales Tax	692	701	9	1.3
Subtotal	**21,247**	**20,462**	**(785)**	**(3.7)**
Statewide Property Tax	891	894	3	0.3
Tobacco Settlement	301	314	13	4.3
All Other Non-dedicated	2,878	2,979	101	3.5
Total Revenues	**25,317**	**24,649**	**(668)**	**(2.6)**
Transfers, Other Revenue	451	545	94	20.8
Total Resources	**$25,768**	**$25,194**	**$(574)**	**(2.2)**

Most of the shortfall for the current biennium comes from the individual income tax. The extremely weak performance of the stock market in recent years caused portfolio income to drop dramatically. Capital gains realizations are now believed to have fallen by 55 percent in tax year 2001, and they are projected to fall by an additional 16 percent in the 2002 tax year. Growth rates for pension income, dividends, and IRA distributions have also been significantly reduced. Wage growth is also slightly weaker than was projected in February's forecast consistent with current withholding tax collection experience and diminished expectations for 2002 bonuses. The forecast for corporate income tax receipts was also reduced, while outlooks for the sales tax, the motor vehicle sales tax, and other revenues improved.

Gains in other tax and non-tax revenues also offset some of the decline in income and corporate tax receipts. Forecasts for the deed, mortgage, and estate taxes were all increased consistent with current collection experience. The increase in transfers and other revenue was primarily due to an increase in prior year adjustments.

Net Expenditures Increase $76 Million in Current Biennium

Forecast spending for FY 2002-03 has been increased by $76 million (0.3 percent), from end-of-session estimates. Spending for health care increased by $107 million. This increase was caused by higher caseloads in General Assistance Medical Care (GAMC) and increasing cost of services resulting from changes in both the acuity of care and case mix. The heath care increase was partially offset by a $33 million reduction in debt service costs due to unanticipated repayment of a maximum effort school loan, and higher than expected premiums received on recent bond sales. Other spending areas show modest changes from previous estimates, while education finance estimates are almost unchanged.

FY 2002-03 General Fund Spending

($ in Millions)

	End of Session	November Forecast	$ Change	% Change
Education Finance	$10,661	$10,660	$(1)	0.0
Higher Education	2,808	2,807	(1)	0.0
Intergovernmental Aids	2,762	2,758	(4)	(0.1)
Health Care	4,708	4,815	107	2.3
Health & Human Services	2,002	1,951	(51)	(2.5)
Debt Service	614	581	(33)	(5.4)
All Other	3,469	3,528	59	1.7
Total Spending	**$27,024**	**$27,100**	**$76**	**0.3**

Six major functional areas account for 87 percent of general fund spending. They are the programs most likely to be affected by forecast changes in enrollments, caseload, and current law formulae. With few exceptions, "all other" spending -- including environmental resources, economic and workforce development, public safety and corrections, transportation, and general government -- is limited to specific amounts set in law for the biennium.

Changes in the "all other" spending category are limited to authorized transfers between agencies, cancellations of excess funding at year-end, and authorized carry forward of unspent appropriations between years or biennia. Of the $59 million increase, $17 million is an increase in penalties and interest for recent court decisions on tax issues and $20 million is from hiring freeze and contract moratorium savings distributed to other areas. Changes to dedicated revenue spending and adjustments to end-of-session estimates account for the remaining $22 million.

First Forecast of 2004-05 Budget Outlook Shows Projected Deficit of $4.560 Billion

This is the first actual forecast of revenues and expenditures for the 2004-05 biennium. Prior estimates of the budget situation for the next biennium have been based on revenue and expenditure planning estimates derived using long-term trends in economic growth, not a specific short-term forecast. Planning estimates are used to highlight situations where potential discrepancies between future revenues and future expenditures might create fiscal problems for the state budget. This forecast specifically establishes the current law context for budget development for the 2004-05 biennium.

Since no budget is currently in place, expenditure projections assume the extension of current programs, adjusted only for projected changes in caseload and enrollment. As required by law inflation is no longer included in the expenditure projections. Expenditure differences between the end-of-session estimates and this forecast are largely due to changes in enrollment, caseload and other formula or program changes currently in law. If inflation were to be included for all programs at an annual rate of 2.5 percent, the budget shortfall would grow by more than an additional billion dollars.

Change in FY 2003 Outlook Adds to 2004-05 Budget Problems

Projections at the end of 2002 legislative session showed a projected budget shortfall for the 2004-05 biennium of $1.650 billion with $411 million in projected reserves. With this forecast, the expected deficit increases to $4.560 billion and reserves fall to $110 million. Revenues for the 2004-05 biennium are now projected to be $1.634 billion (5.7 percent) below end-of-session planning estimates, while the expenditure forecast exceeds prior projections by $926 million.

FY 2004-05 Revenue and Expenditure Forecast

($ in millions)

	End of Session	November Forecast	$ Change	% Change
Beginning Balance	**$318**	**$(332)**	**$(650)**	
Total Revenues	28,491	26,857	(1,634)	(5.7)
Expenditures	30,049	30,975	926	3.1
Budget Reserve	375	79	(296)	
Education Reserve	36	31	(5)	
Available Balance (Deficit)	**$(1,650)**	**$(4,560)**	**$(2,910)**	

Balancing the budget for the current biennium will eliminate $356 million of the $4.560 billion budget deficit projected for the next biennium, leaving a prospective deficit of $4.2 billion with $110 million of reserves under current law.

Fiscal 2004-05 Revenue Growth Reduced to 6.6 Percent

Total current resources for the 2004-05 biennium are now expected to be $26.857 billion, an increase of 6.6 percent from projected receipts in the 2002-03 biennium. General fund receipts for the motor vehicle sales tax fall due to the dedication of 32 percent of collections to the Highway Users Tax Distribution Fund, 20.5 percent to the Metropolitan Area Transit Fund, and 1.25 percent to the Greater Minnesota Transit Fund. The growth rate for the sales tax is also artificially low due to elimination of the June accelerated payment in 2004. The extremely high growth rate for corporate income tax receipts reflects recovery from the very depressed level of corporate profits in 2002 and 2003. Other resources are projected to fall to more normal levels in the 2004-05 biennium after being boosted by one-time transfers that were part of the 2002 budget solution.

FY 2004-05 General Fund Revenues

($ in Millions)

	FY 2002-03	FY 2004-05	$ Change	% Change
Revenues				
Income Tax	$11,014	$12,173	$1,159	10.5
Sales Tax	7,676	8,188	512	6.7
Corporate Income	1,071	1,348	277	25.8
Motor Vehicle Sales	701	536	(165)	(23.5)
Subtotal	**20,462**	**22,245**	**1,783**	**8.7**
Statewide Property Tax	894	1,207	313	35.1
Tobacco Settlement	314	392	78	24.7
All Other Non-Dedicated	2,979	2,718	(261)	(8.8)
Total Revenues	**24,649**	**26,562**	**1,913**	**7.8**
Transfers, Other	545	295	(250)	(45.9)
Total Resources	**$25,194**	**$26,857**	**$1,663**	**6.6**

Individual Income Tax Forecast Down $1.333 Billion From 2004-05 Planning Estimates

Forecast revenues for the 2004-05 biennium are down $1.634 billion (5.7 percent), from the end-of-session revenue planning estimates. Although the forecast for each of the major revenue sources was less than previously projected, individual income tax revenues account for more than 80 percent of the total reduction.

FY 2004-05 General Fund Revenues

($ in Millions)

	End of Session	November Forecast	$ Change	% Change
Revenues				
Income Tax	$13,506	$12,173	$(1,333)	(9.9)
Sales Tax	8,324	8,188	(136)	(1.6)
Corporate Income	1,405	1,348	(57)	(4.1)
Motor Vehicle Sales	570	536	(34)	(6.0)
Major Taxes	**23,805**	**22,245**	**(1,560)**	**(6.6)**
Statewide Property Tax	1,226	1,207	(19)	(1.5)
Tobacco Settlement	379	392	13	3.4
All Other Non-Dedicated	2,826	2,718	(108)	(3.8)
Total Revenues	**28,236**	**26,562**	**(1,674)**	**(5.9)**
Transfers, Other Revenues	255	295	40	15.7
Total Resources	**$28,491**	**$26,857**	**$(1,634)**	**(5.7)**

As in fiscal 2003, more than half of the change in the income tax forecast came from a reduction in non-wage, portfolio income from investments and pensions. In 2004 those sources of taxable income grow at a slower rate than was projected in the planning estimates and that growth comes from a lower base. Although the gap between the end-of-session income tax planning estimate and the current forecast narrows slightly in 2005 when growth rates for investment income begin to pick up, the improvement is slight. Reductions in projected revenues from the other major tax sources were small and consistent with a slightly less optimistic economic outlook than was used in February.

FY 2004-05 Projected Spending to Grow by $3.875 Billion

Projected current law spending for the FY 2004-05 biennium is expected to reach $30.975 billion, an increase of $3.875 billion (14.3 percent), over projections for FY2002-03. When compared to end-of-session estimates, projected spending increases by $926 million.

Comparisons to the current biennium can be misleading since there have been several material changes in the state's expenditure structure. Property tax reform and relief was in place for only part of the 2002-03 biennium. That change accounts for approximately $1.0 billion of the increase shown for education finance in the next biennium. The FY 2003 payment shift in education aids payments also produced a one-time $454 million cut that "bumps-back" in FY 2004. If these changes are excluded, the growth in education finance shrinks to approximately $670 million. While pupil estimates are expected to decline slightly, the remaining growth is largely attributed to the biennial cost of the per student formula increase from FY 2002 to FY 2003.

Spending for health care programs continues to be one of the largest and fastest growing areas of the budget. More than one-third of the biennial expenditure growth occurs in health care and human services spending. Significant increases in projected health care spending in FY 2004-05 are primarily the result of growing costs of medical assistance health care services and higher General Assistance Medical Care (GAMC) caseloads.

FY 2004-05 Expenditure Estimates

($ in Millions)

	FY 2002-03	FY 2004-05	$ Change	% Change
Education Finance	$10,660	$12,772	$2,112	19.8
Higher Education	2,807	2,911	104	3.7
Intergovernmental Aids	2,758	3,090	332	12.0
Health Care	4,815	5,934	1,119	23.2
Health & Human Services	1,951	2,185	234	12.0
Debt Service	581	695	114	19.6
All Other	3,528	3,388	(140)	(4.0)
Total Spending	**$27,100**	**$30,975**	**$3,875**	**14.3**

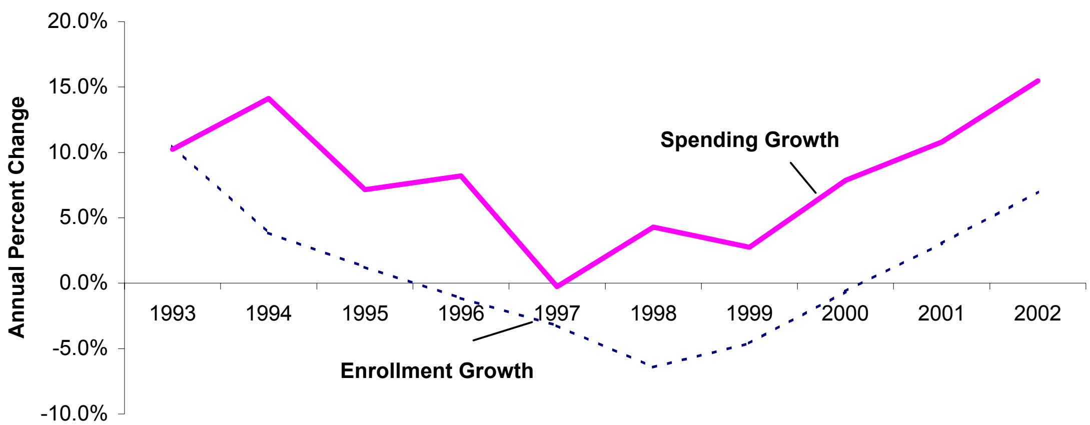
Spending in the "all other" category is forecast to decline from the current biennium due to significant one-time spending in FY 2002-03 for general capital projects and transportation projects that will not continue.

Health Care Projected to Grow 23 Percent in 2004-05

Health care spending increases are driven by several factors: increased program enrollment, medical inflation, and changing utilization of health care services. The changes in this forecast reflect the combined impact of a weaker economy, leading to higher enrollment, and persistent medical inflation, resulting in higher service costs.

Most increases in health care spending can be traced to the state's Medicaid program, known as Medical Assistance (MA). This federal entitlement program for low-income families, persons with physical and developmental disabilities, and the frail elderly accounts for more than 90 percent of state health care spending. The program serves roughly 450,000 people by covering costs for health care services, such as hospital and physician visits, nursing home services, home care, and other medical and long-term care services. The state and federal government split the costs for MA equally. The remaining health care programs such as General Assistance Medical Care (GAMC) and Chemical Dependency Entitlements, are fully funded by the state.

MA Enrollment & Spending Growth



As the chart indicates, Medical Assistance spending grew relatively slowly from 1997 to 1999, due in part to a substantial drop in the number of familes receiving basic care. A strong economy and welfare reform led to a decline in enrollment. Slower economic growth is beginning to reverse this trend.

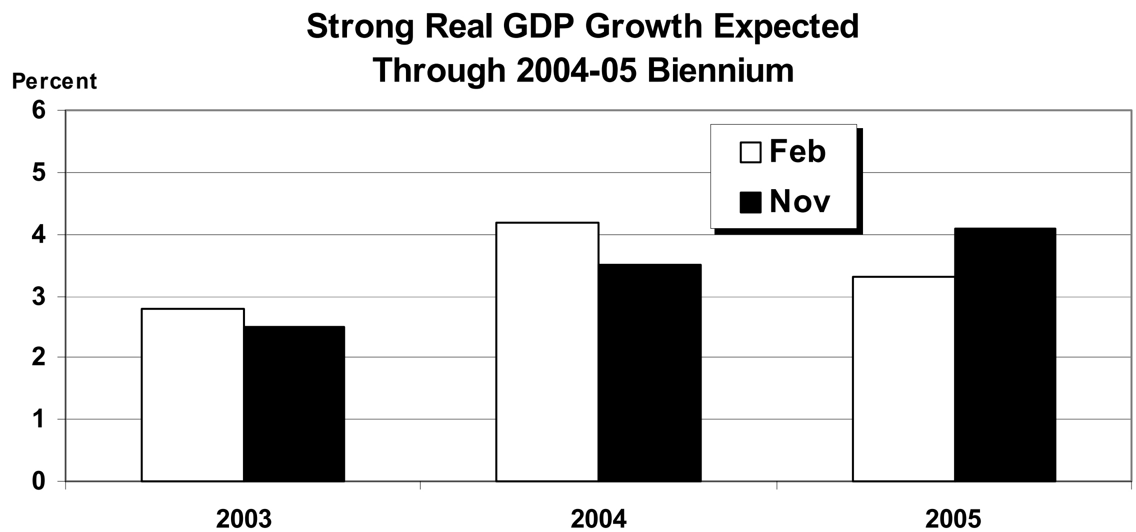
Even during periods of declining enrollment (i.e., 1997-2000), overall spending in the Medical Assistance program grew. This is because in addition to enrollment, many other factors may have the effect of contributing to health care spending growth, including:

- a greater proportion of higher cost caseloads (e.g., the elderly and persons with disabilities);
- increasing service utilization among recipients;
- medical price inflation;
- the availability of more expensive technology; and
- the effectiveness of purchasing arrangements.

Between 1997 and 2002, the per-person amount the state paid for Medical Assistance services grew 52 percent, or 8.7 percent per year.

Steady National Economic Growth Expected Through Entire Forecast Horizon

The large revenue shortfall for the current biennium and the coming biennium should not be attributed to a deteriorating economic outlook. The November Global Insight Incorporated (GII) baseline forecast contains strong growth with no recession through 2007. The projected real GDP growth rates are below those observed in the supercharged years of the late 1990's, but they exceed those observed in the late 1980's or the mid 1990's. GII currently assumes real GDP growth rates of 2.6 percent in 2003, 4.1 percent in 2004, and 3.8 percent in 2005. The Consensus Forecast from the Blue Chip panel is for 2.8 percent growth in 2003, 3.4 percent growth in 2004, and 3.3 percent in 2005. GII sees little inflationary pressure through the entire forecast horizon. They now project CPI growth of 2.3 percent in 2003, 2.4 percent in 2004, and 2.3 percent in 2005.



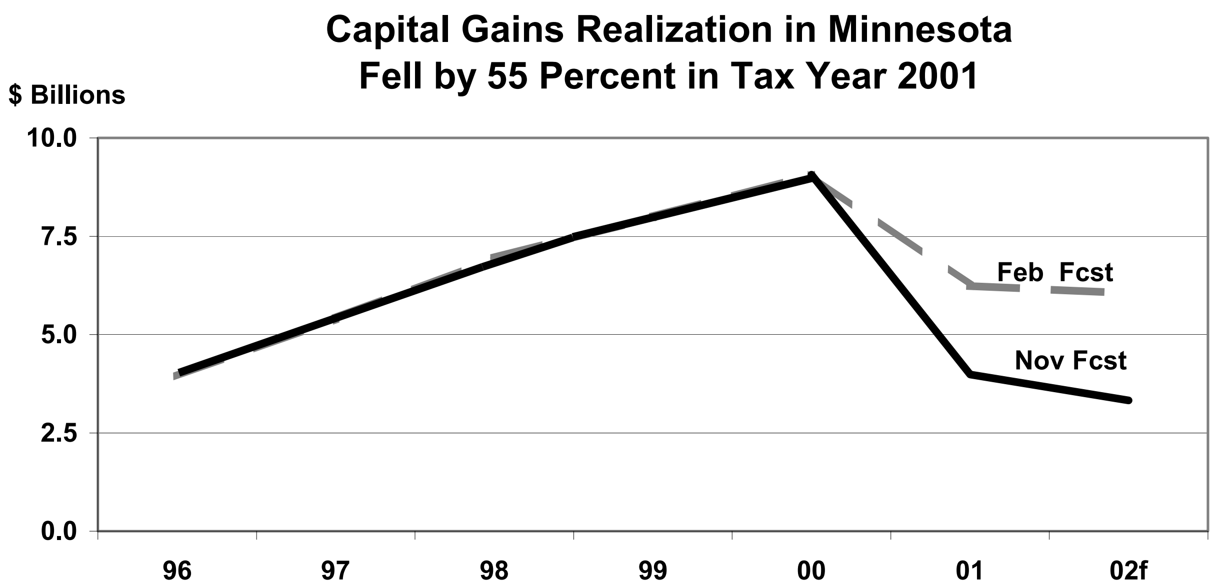
Global Insight assigns a probability of 55 percent to their current baseline forecast. A more pessimistic forecast which includes a double dip recession is assigned a 30 percent probability and a slightly more optimistic forecast, a 15 percent probability. Minnesota's Council of Economic Advisors agreed that while the GII baseline forecast is consistent with the consensus, it is more likely to be too optimistic than too pessimistic.

Potential War With Iraq Adds to Forecast Uncertainty

The possible U.S. invasion of Iraq creates a major challenge for all economic forecasts. Since both the probability of hostilities breaking out and the duration of any war--should one occur--are unknown, forecasters have generally chosen not to include this geo-political shock into their baseline scenarios. GII's baseline scenario follows that approach, and assumes that war with Iraq will be avoided. Should war break out, GII will lower their national economic forecast. The amount of that reduction will depend on the expected length of the war. GII's decision to make no provision for war in their baseline scenario, while consistent with the practice of most other forecasters, adds further downside risk to the 2004-05 revenue forecast.

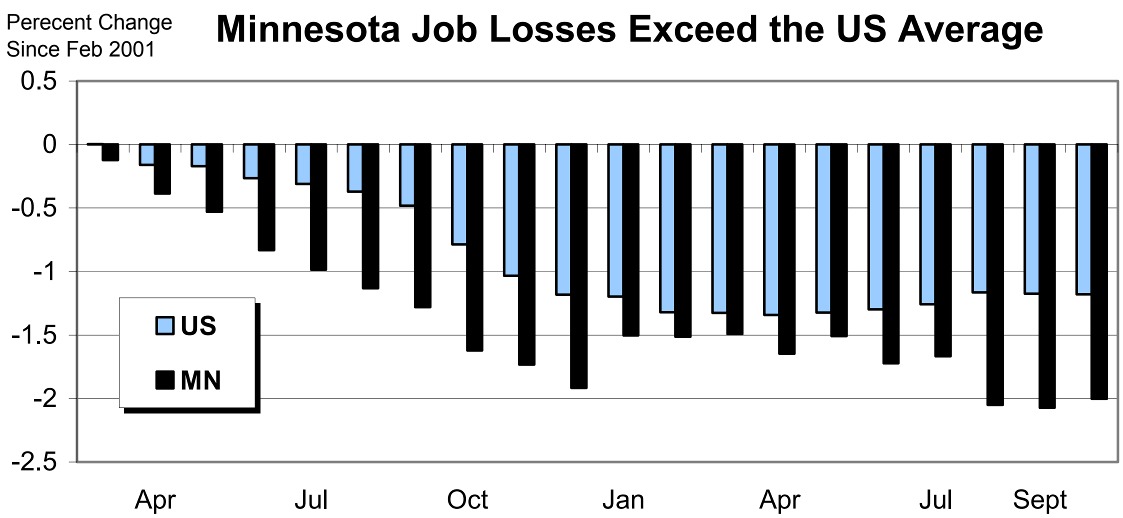
Lower Than Anticipated Capital Gains Income Reduces Income Tax Forecast

More than one half of the reduction in expected individual income tax receipts in this forecast is attributable to lower net capital gains realizations. Much of that reduction has already occurred. Tax year 2001 Minnesota filings are consistent with a decline of 55 percent in net capital gains realizations between tax year 2000 and tax year 2001. February's revenue forecast assumed a decline of 33 percent. The continuing weak stock market and the existence of loss carry-forwards from tax year 2001 make it likely that net realizations will decline again in 2002, and net realizations are forecast to be 16 percent lower in 2002 than in 2001. Capital gains begin to increase again in 2003, but from a substantially lower base. Continuing stock market losses are expected to leave net capital gains realizations for 2002 at a level roughly equivalent to that observed in 1994, well before the stock market boom of the late 1990s.



Minnesota's Economy Hit Harder than the National Economy in 2001 Recession

Payroll employment losses in Minnesota were greater on a percentage basis than they were nationally during the recent recession, and Minnesota continues to struggle to recover. Through October, employment on a seasonally adjusted basis remains more than 2.0 percent below February 2001's peak. Nationally employment has fallen by just 1.2 percent over that same time period.



Manufacturing employment in Minnesota has suffered the most noticeable losses, falling by more than 38,000 jobs in less than 2 ½ years. That drop wiped out more than 80 percent of Minnesota's manufacturing job gains of the 90's. Still though, the manufacturing job loss in Minnesota was smaller on a percentage basis than the national average.

The Minnesota economic forecast calls for manufacturing employment to stabilize by mid 2003 and then begin to grow slowly. By the end of fiscal 2005 manufacturing employment has increased by more than 8,000 in Minnesota. Growth in U.S. manufacturing, while also positive, is even more subdued than in Minnesota. Minnesota is projected to add more than 108,000 jobs before the end of the 2004-05 biennium.

Planning Estimates Provide Outlook Through FY 2007

Almost all states are currently experiencing sizeable fiscal problems. Many national observers of state finances are now suggesting that states are unlikely to see improvements in their fiscal positions for four to five years. Historically, state revenues and fiscal stability lag economic recovery. For this reason, a longer term outlook is a useful measure when formulating state budget plans.

This report provides the first revenue and expenditure planning estimates for the 2006-07 biennium. The planning estimates provide a necessary framework against which the potential impact of FY 2004-05 budget decisions can be judged. Projected revenues for FY 2006-07 reflect the trend of continued growth forecast for the 2002-03 and 2004-05 biennia. The revenue estimates also include prospective inflation.

The planning estimates do not include any tax or spending changes beyond those in current law. Current law spending estimates have been adjusted only to reflect enrollment and caseload growth in entitlement programs and areas where specific statutory formulae exist. Expenditure estimates are not adjusted for inflation. Since the impact of inflation is not included in the expenditure projections, it is important to recognize that, given inflationary pressures and historical growth trends in state spending, increases in state spending may be significantly greater than those shown.

FY 2006-07 Planning Estimates
($ in Millions)

	FY 2005	FY 2006	FY 2007
Forecast Revenues	**$13,896**	**$14,658**	**$15,329**
Projected Spending	15,647	15,964	16,289
Difference	**$(1,751)**	**(1,306)**	**$(960)**

The expenditure and revenue planning estimates make no assumptions about actions in the 2003 legislative session to balance the FY 2003 deficit, or to resolve the FY 2004-05 budget gap. The FY 2006-07 planning estimates represent a benchmark to determine if ongoing spending exceeds revenues in succeeding budget periods. Economic changes, as well as the nature and timing of budget changes, will materially affect both revenue and expenditure projections for the FY 2006-07 biennium.

A complete version of the November 2002 forecast can be found at the Department of Finance's World Wide Web site at -- www.finance.state.mn.us. This document is available in alternate format.

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Forecast Fundamentals:
About the Revenue and Expenditure Forecast

The November forecast establishes the starting point for FY 2004-05 budget considerations. It contains revised revenue and expenditure estimates for the current biennium based on the most recent information about the national and state economic outlook, caseload, enrollments, and cost projections. Additionally this forecast provides closing balances for FY 2002 and compares how actual revenue collections and expenditures in that year compare to end-of session estimates.

The revised forecast for the current FY2002-03 biennium is followed by the first complete forecast for the next budget period, FY 2004-05, and by revenue and expenditure planning estimates for FY 2006-07. Planning estimates should not be interpreted as explicit forecasts, but rather as a guide to indicate whether proposed actions will create financial problems in future years.

Revenue estimates for the current year and the next biennium are based on econometric models that forecast the Minnesota economy. Those models are driven by a national economic forecast provided by Global Insight Incorporated (GII), the firm that purchased Minnesota's long-time consultant on the national economy Data Resources Incorporated, (DRI). Use of the Global Insight forecast does not indicate a change in the national forecasting service used in the forecast; it simply reflects a change in the name of the forecasting service.

The GII baseline forecast is then reviewed by Minnesota's Council of Economic Advisors. Their comments are found in the "Economic Summary." The "Economic Outlook" which follows provides a more comprehensive overview of the current outlook for the U.S. and Minnesota economies. Revenue planning estimates for FY 2006-07 come from slightly less complex models and are driven entirely by the longer term national economic outlook provided by GII. No Minnesota specific forecast is used.

Expenditure estimates in most areas are shown at the level of the appropriations made during the 2002 legislative sessions, plus any authorized future spending increases. Entitlement programs –such as K-12 education, intergovernmental aids, health care, and family support are forecast based on expected changes in eligibility, enrollment, and average cost. No adjustments for inflation were made in future spending except those for in statute.

The difference between the forecast and the budget process is clearly defined, but often confused. The forecast does not reflect the Governor's budget recommendations or potential legislative action, only current law. Presentation of the current law forecast for various areas will likely be accompanied by a discussion of possible future legislative changes. The forecast presents only a current law framework for those discussions. A forecast increase in spending for any area in the current biennium or the next biennium does not preclude the governor or the legislature from proposing budget changes that would lead to significantly different spending levels than are shown in this forecast.

Economic Summary

The recession is over, the economic outlook for at least the next 18 months is favorable, and the U.S. economy has been growing for more than a year. Only the most pessimistic forecasts project a return to recession in the absence of major international or financial industry shocks. And, the Federal Reserve took out additional insurance against that risk in early November by cutting interest rates 50 basis points. But, even with this good economic news, corporate decision makers and consumers have grown nervous about this recovery's pace.

It is true that current growth rates do not match those we grew accustomed to during the late 1990s. It is also true that the economy has not shown the super-normal growth typically observed during the first few quarters of a recovery. But, that should not be cause for great concern. Those great years of the late 1990's were the best economy in our generation, and the period following the 1990-91 recession, which led up to the "best economy in a generation" was characterized as a "jobless recovery."

The current uncertainty leaves a potential problem though. As one member of Minnesota's Council of Economic Advisors noted, widespread perception of weakness could generate conditions that could further delay the recovery. Industrial production has declined for 3 consecutive months, setting the stage for an extremely weak 4th quarter of 2002. That, coupled with almost non-existent job growth, weak non-auto consumer spending, and the failure of business investment to accelerate has led most forecasters to cut back their forecasts for economic growth in 2003.

Economists, recognizing that 3 percent real GDP growth is not anemic growth, and that a 5.7 percent unemployment rate is not the sign of a faltering economy, believe that much of the current concern is misplaced. Everyone expects business investment spending to pick up by mid 2003, but until that occurs the economic outlook will remain clouded.

Last February most forecasts expected business investment would be accelerating by now, putting the economy in position to settle in to a steady state growth level of nearly 4 percent. Now, the consensus is that business investment will not begin to grow significantly for at least six more months, postponing the recovery until at least the summer of 2003.

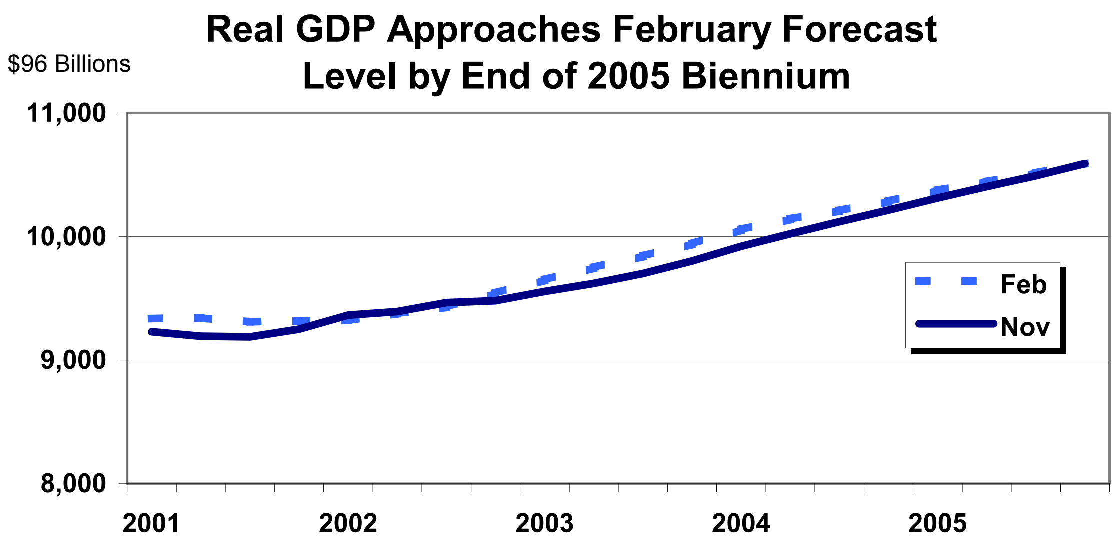
Global Insight, Inc (GII)[*], Minnesota's national economic consultant now expects 2.6 percent real growth in calendar 2003, also down from September's forecast of 3.2 percent. Their February baseline forecast anticipated real GDP growth of 4.0 percent in 2003, followed by growth of 3.9 percent and 3.0 percent in 2004 and 2005. GII's November baseline forecast anticipates real growth rates of 4.1 percent for 2004 and 3.8

[*] DRI-WEFA changed its name to Global Insight (GII) in October, 2002, completing a transition that began in May 2001 when Global Insight acquired both Data Resources and WEFA and consolidated the forecasting activities of the two firms. In this document both the current forecast and the February forecast will be referred to as GII forecasts.

percent for 2005. The November Blue Chip Consensus outlook calls for real GDP to grow at an annual rate of 2.8 percent in 2003. In September their consensus outlook was for 3.2 percent growth.

Inflation is not expected to be a problem through the forecast horizon. GII now projects CPI growth of just 2.3 percent in 2003, 2.4 percent in 2004, and 2.3 percent in 2005. February's baseline forecast was similar, projecting CPI growth of 2.4 percent in 2003, and 2.5 percent in both 2004 and 2005.

GII assigns a probability of 55 percent to their baseline forecast. A scenario with a return to recession in the first two quarters of 2003 is assigned a 30 percent probability, while a slightly more optimistic scenario is assigned a 15 percent probability. Conversations with GII staff confirm that they believe that the risks surrounding this forecast are significantly weighted to the downside.



Members of Minnesota's Council of Economic Advisors and Finance Department economists agreed that the November GII baseline forecast reflects the consensus short-term outlook. While some Council members noted that their personal forecasts were less optimistic and others believed the economy likely to do better than GII's projections, differences between their forecasts and the baseline over the short term were smaller than has been typical in the past. Council members also believe that if the GII Baseline forecast is wrong, it is much more likely to be too optimistic than too pessimistic.

Uncertainty about the economic effects of a potential conflict with Iraq is a major source of downside risk for this forecast. Unfortunately, because possible outcomes are so diverse, most economists have decided against trying to factor the impact of possible hostilities into their forecast scenario. Instead, preferring not to take on the impossible task of forecasting of geo-political actions, forecasters are currently basing their economic projections on the assumption that the United States will not be forced to take direct action against Iraq. GII's November baseline follows this approach, making no exogenous adjustments to reflect the likely economic impact of the outbreak of hostilities with Iraq.

Both the Council and the Finance Department believe this approach is reasonable given the uncertainty surrounding any U.S. action. They note, however, that the outbreak of war with Iraq would almost certainly cause the U.S. economy to under-perform this forecast and create a revenue shortfall. Finance Department conversations with GII staff confirmed that a U.S. invasion of Iraq would cause the 2003 U.S. economic forecast to be lowered.

Council members agreed with the Finance Department's decision to use the GII baseline forecast for 2006 and 2007 as the basis for constructing revenue planning estimates for the 2006-07 biennium. The nominal GDP growth rates assumed, 5.5 percent in 2006 and 5.0 percent for 2007, are consistent with the long-term growth assumptions used by the Congressional Budget Office, as are the long term CPI inflation assumptions of 2.2 and 2.1 percent.

Finance Department economists observed that revenue growth rates have become much more volatile than nominal GDP growth in recent years. The growth in the late 1990's in the proportion of taxable income derived from capital gains and the increased reliance on bonuses and stock options in compensation packages has made the link between economic growth and growth in tax receipts much less direct. Revised estimates of growth rates for these sources of income as well as other portions of non-wage income are likely to materially reduce the revenue forecast.

Finance Department economists also noted that this recession appears to be hitting Minnesota harder than the U.S. average. Through October payroll employment was more than 2 percent below its February 2001 high point. During that same period, U.S. employment fell only by 1.2 percent. Minnesota manufacturing employment has fallen by 7.8 percent over that same period, giving back virtually all the state's manufacturing job growth of the 1990's.

Council members again cautioned state policy makers against assuming that future economic news will be better than that implied in the November baseline scenario. Noting the preponderance of downside risk associated with this forecast, the Council urged that any budget solution include a plan for re-establishing the budget reserve to provide a cushion against any unexpected economic weakness over the next biennium.

Economic Outlook

Dr. Greenspan says the economy is in a soft patch, meaning some momentum has been lost. The cause appears to be psychological. For months, the news has been dominated by corporate scandals, a volatile stock market, layoffs, talk of war, and terroristic acts. Quite understandably, consumer and business sentiment sagged under that cloud of uncertainty. In response, individuals are shopping more carefully and firms are reluctant to hire new workers or rebuild depleted inventories. Global Insight (GII) and other forecasters have adapted by lowering their outlook. However, they believe the recovery will proceed.

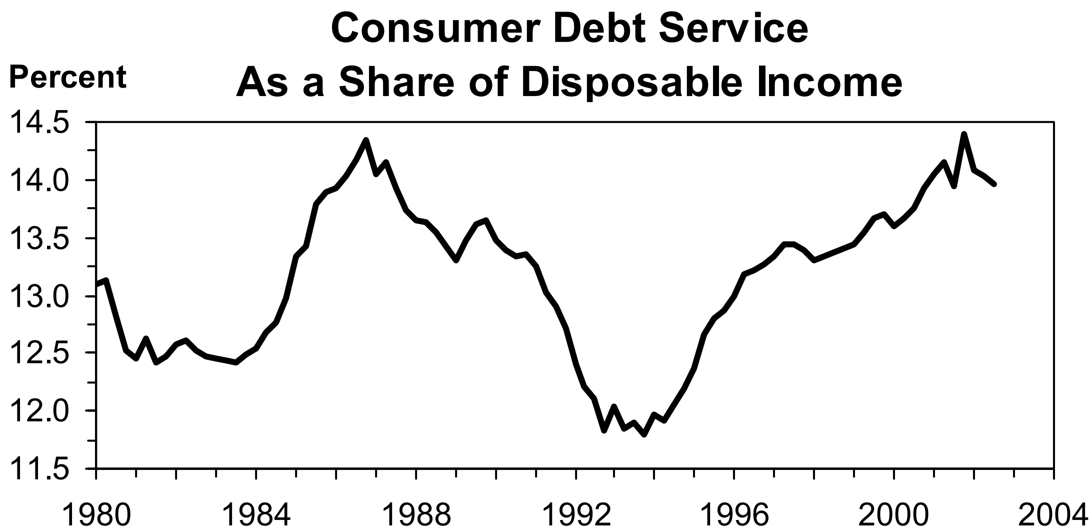
A double-dip recession is possible, but unlikely for several reasons. It appears the Federal Reserve's recent 50 basis point interest rate cut helped dispel some of the financial markets' gloom. There is strong federal fiscal stimulus from increased defense and domestic security spending, while tax collections have declined sharply. And, low interest rates and rising incomes are supporting consumer outlays. Though retailers report consumers are spending more cautiously, autos and homes continue to sell well, just not at last summer's pace. Economists believe those sources of strength are enough to keep the economy moving slowly ahead.

A stronger recovery will have to wait for increased business outlays for offices and factories. That will only come with improved profits as idle capacity is reduced, a process which will take at least several months. Accordingly, most forecasters including GII have pushed their prediction for a commercial construction rebound out to late 2003.

For the next 8 to 10 months, the November Baseline scenario has the economy struggling along heavily dependent on federal fiscal stimulus and, especially, on the consumer. The risk is that an unfavorable shock will lead to a consumer retrenchment. But, once past this soft patch, the outlook improves because the underlying fundamentals are favorable except for a record trade deficit.

A Cloud of Uncertainty

A cloud of uncertainty has swept over the country. What began as reports of questionable accounting at a single firm grew into tales involving many firms in accounting irregularities and huge executive payouts. Then came indictments for corporate fraud and Securities and Exchange Commission fines for misleading research by investment firms. Meanwhile, there were unprecedented public preparations for war with Iraq and discussions of its potential casualties. As concern over business practices and war intensified, investors bailed out of stocks, accelerating a two-year slide. And there was no help from the labor market. Analysts started talking about a jobless recovery as preliminary estimates of monthly employment gains were revised downward and layoffs regularly made the news. Little attention was paid to positive news that mass layoffs have declined to a 2-year low.



For the next several months the economy will be heavily dependent on the consumer. An unfavorable shock could lead to retrenchment. Consumers may be especially sensitive to an adverse shock because their debt service payments are near a record high relative to personal income.

So, it is no surprise that consumer sentiment sank to its lowest level in nearly 10 years before rebounding slightly in recent weeks, and that business executives continue to say they are very pessimistic about the near-term outlook. But, economists know that a glum outlook is not always reflected in how people act. Despite their cautious behavior, consumers have continued buying and firms apparently have begun accumulating inventories.

A Soft Patch

For the next several months, the recovery is expected to be weak and uneven across industries and regions. No doubt the soft patch reflects the hard-to-measure impact of uncertainty which is making both consumers and firms hesitant. *Business Week* reports the uncertainty may now be fading. That leaves the economy still dominated by the legacy of the 1990's, primarily excess capacity created by speculation fueled with readily available bank loans and the late 1990's soaring stock market. Until idle capacity is absorbed, low utilization rates will hold down profits and business investment will languish, leaving the economy to struggle along.

Sometime next summer or fall, economists believe the economy's underlying strength will begin to show. Productivity is the reason most often cited. Chairman Greenspan and many others believe the economy retains the potential for the robust productivity gains which surfaced in the late 1990's. If true, then the most likely long-term scenario is much stronger wages and profits growth in a relatively benign inflationary environment. Finance Department economists caution, though, that no one, not even Dr. Greenspan, has a rigorous way to forecast productivity improvements. Predictive theories of productivity are, at best, in their infancy. What economists can do is make inferences after accounting for productivity increases with the benefit of hindsight.

Consumption

Retail sales results indicate consumers are putting off some discretionary purchases. Economists are disappointed at recent small gains over depressed post-September 11 figures, though not greatly surprised given all the uncertainty. The spending data suggest a shift in behavior has occurred with little chance of a rebound soon. A *Wall Street Journal* article notes that once consumers become more cautious, they remain so for a while even if conditions improve.

Consequently, most analysts now expect weaker holiday retail sales than they were predicting a few months ago. GII has lowered its estimate for fourth quarter real consumer spending growth to a negative 1.4 percent annual rate. Much of that decline reflects auto sales borrowed from the future as consumers rushed to take advantage of zero percent financing last summer. But the outlook holds little if any good news for many retailers as the Christmas season approaches.

Though up slightly in the last few weeks, both the University of Michigan and Conference Board indexes of consumer sentiment are close to their lowest levels in several years. While consumers are more cautious, there is virtually no evidence they are retrenching. In the absence of unfavorable shocks, economists believe low interest rates, current income growth, and cash taken out of mortgage refinancings will be enough to keep consumers spending.

An outright retrenchment is a rare event that might be triggered under current conditions. Consumers may be unusually sensitive to an adverse shock because they have suffered enormous wealth losses in the stock market, their debt service payments are near a record high relative to disposable income, and the job market is weak. War with Iraq accompanied by a run up in oil prices is also a source of concern, though war's impact could be mitigated by relatively high crude inventories and the fact that hostilities are widely expected. Most analysts agree that a war is much less a potential problem than one which goes badly. Another shock analysts think about often is a sharp decline in housing prices which have grown faster than incomes in many markets

Investment

Housing has been a critical source of strength in the economy. Contrary to the fears of some observers, no general decline in prices is currently underway. But, the real estate market has softened despite record low mortgage rates. Mortgage applications are gradually slipping and most analysts expect starts and sales to follow. GII reports that lenders are treating both builders and mortgage applicants more cautiously. As they become increasingly concerned about delinquencies and overpriced homes, lenders are beginning to view mortgages as a more risky investment.

GII's November Baseline forecast assumes firms will start rebuilding their inventories in the current quarter. Inventories are now extremely lean, with *Business Week* reporting that the ratio of stockpiles to sales is at or near a record low. Inventory accumulation has not contributed regularly to real GDP growth for about two years.

Even with a steady boost from inventories, the economy will not grow fast enough to absorb normal increases in the labor force, so the unemployment rate will rise. Faster growth is waiting on a rebound in business investment spending which could prove to be elusive. Just when investment will accelerate is unclear. The uncertain relationship between capacity utilization, orders, production, profits, and capital spending decisions is a longstanding, unresolved problem in business cycle analysis.

GII and other forecasters expect capital spending will improve in 2003 because of higher capacity utilization, improved cash flow from a slight upturn in profits, and the new depreciation allowances enacted last March. As a result, some 90 percent of non-financial firms' capital outlays could be covered by internally generated funds. That is fortunate since, in the current environment of low stock prices and uncertainty over corporate accounting, some other sources of financing have dried up.

Evidence for a revival in equipment spending is mixed. *Business Week* reports that non-aircraft capital goods orders and shipments began to improve last summer and third quarter GDP data suggest that, except for aircraft, an upswing in business outlays for equipment and software is underway. But, recent reports of weakening factory orders suggest business investment may have since taken a turn for the worse. That would be a major disappointment. Also, the National Association of Business Economists reports its survey of members indicates the number who plan to boost capital spending within the next year has declined.

Unlike the mixed signals on equipment spending, construction data clearly show that investment in structures is still declining. Firms have virtually no need for additional space because of idle factory capacity, rising office vacancy rates, very slow hiring, and the slump in business travel. *Business Week* indicates that since early 2001, spending for offices, factories, and warehouses has dropped almost 30 percent with more to come. Construction of new college and religious buildings has also slipped, apparently because the bearish stock market has led to cuts in charitable giving and lowered the value of endowments. One bright spot is state and local building which is largely bond financed. But, that is about the only exception. The decline in commercial construction activity is playing a significant role in keeping the recovery weak. In the November Baseline forecast, a turnaround does not occur until late next year.

Government

In the current quarter, with consumer spending shrinking, state and local outlays flat, and the trade deficit growing, federal spending is the only significant positive contributor to real final demand. The economy has been getting a boost from rising federal spending and declining tax collections for some time. GII estimates that federal outlays rose 10 percent in the fiscal year ending last September 30. Only once in the last 20 years, in 1985, did nominal spending rise more that 10 percent. And while spending rose, tax collections declined 10 percent. As a result, the federal deficit swung from a nominal $100 billion surplus to a $160 billion deficit this year.

Not all of the current deficit is the result of last year's tax cut or more recent increases in defense and homeland security spending. *The Economist* reports that the federal fiscal system's automatic stabilizers are effectively assisting the recovery. When the economy falters, tax revenues grow more slowly or fall, and unemployment compensation and other expenditures rise without new legislation. This stimulates the economy as the federal government drains less purchasing power and pumps more money in. During this business cycle, the automatic stabilizers have contributed to an increasing federal deficit, but GII expects that will shrink to zero by about 2008 as the economy recovers. The U.S. fiscal stabilizers are often considered to be among the more successful fiscal policies currently pursued in industrial countries.

Some economists believe there is an urgent need for more federal fiscal stimulus. Their concern is that cuts in state and local spending will offset a significant part of federal stimulus, raising the risk that the current slowdown will worsen. Others, however, are concerned that additional federal tax cuts or spending increases will inflate future deficits to the point that interest rates rise as the U.S. Treasury competes with the private sector for borrowed funds. Should that happen, Standard and Poors economists believe higher rates could become a drag on long-term growth.

International

A global economic slowdown is underway and it seems to be deepening. Recently, the Organization For European Economic Cooperation and Development lowered its projection for world GDP growth in 2003. The European Union economies are struggling. So are Japan and parts of Latin America including Argentina and Brazil. That has reduced overseas demand for U.S. made goods, widening the trade deficit. Despite some decline in the value of the dollar, trade continues to be a drag on the economy as the deficit remains at record levels.

With the exception of Canada, few if any industrial economies are doing better than the U.S. For one reason, analysts point to overseas policy failures. Many countries do not have effective fiscal stabilizers. The European Union has a fiscal stability pact which limits government deficits to 3 percent of GDP and outstanding total public debt to 60 percent of GDP, greatly limiting tax and spending policy as a counter-cyclical tool. The alternative is monetary policy, but that is an option which the EU has hesitated to use out of fear of reigniting inflation. In Japan, fiscal policy efforts have been largely confined to public infrastructure projects while monetary policy has driven short term interest rates to near-zero, all with little if any success. In Latin America, Argentina plunged into a currency crisis, severe recession, and deflation because of difficulty repaying foreign hard currency loans. Brazil also has difficulty with loan repayments, and is experiencing very slow growth, but not a recession. According to some analysts, the problems

Argentina and Brazil face are largely the result of trade deficits attributable to excessively expansionary fiscal policies and flawed monetary policies.

Monetary Policy

Between last January and November, the Federal Reserve Open Market Committee declined to lower the nominal federal funds rate below 1.75 percent, a 40-year low. Though recognizing in its public statements that the risks in the economy were on the side of greater weakness, the Fed was clear that it was reluctant to reduce the funds rate as called for by some observers.

Finally, on November 6, the rate was lowered to 1.25 percent, but the Fed's statement that the upside and downside risks were balanced was interpreted to mean that there will be no more reductions. In the view of most economists, the cut will have little real impact because there seem to be few constraints on consumer lending except possibly for mortgages, and lower rates will not significantly accelerate absorption of excess capacity. Most forecasters agree that at most the lower rate could help dispel the gloom.

Inflation

Forecasters have a relatively benign outlook for prices. Only modest acceleration in inflation is expected over the course of the next year. In the GII November Baseline, after rising an estimated 1.6 percent in 2002, the Consumer Price Index rises 2.3 percent in 2003. Similarly, the GDP deflator increases 1.2 percent in 2002 and 2.1 percent in 2003. Detailed examination of these composites reveals that prices of services are rising faster than average, finished goods prices are almost flat, and industrial commodity prices are falling.

Near-zero inflation in many product categories, and declining prices in others have raised concerns that the U.S. could go the way of Japan where policy failures led to deflation, a broad decline in the general price level. The U.S. last experienced deflation in the 1930's, also, it is generally believed, a result of mistaken policy.

General deflation imposes hardships currently experienced by relatively few living outside Japan and Argentina. Falling prices increase the real burden of debt, forcing borrowers to cut spending and sell assets in order to make payments. Consumers tend to cut spending in favor of hoarding cash because its purchasing power is growing. Usually, a downward spiral in assets, incomes, consumer demand, and capital outlays develops which is difficult to control because central banks operate primarily by lowering nominal interest rates below inflation, creating stimulative negative real rates.

Nominal rates cannot follow falling prices because there is no such thing as a negative nominal rate. For that reason some observers think the federal funds rate is perilously close to zero at 1.25 percent. At zero, the central bank's remaining option is to somehow pump cash into the economy. Recently, Dr. Greenspan tried to be reassuring by indicating that the Fed could buy U.S. Treasury bonds, forcing down long term rates.

Buying short-term treasuries is what the Fed normally does anyway to lower positive short-term nominal interest rates. But if short-term rates are already at zero and prices are falling it is unclear how effective Dr. Greenspan's proposed policy would be.

Articles in *Business Week* and *The Economist* indicate that a few economists, notably those at Morgan Stanley and Goldman Sachs, now think U.S. deflation is a serious risk. Others, including those at Smith Barney and the Federal Reserve are doubtful though they concede there is a possibility. Recently, The *Wall Street Journal* reported that the Fed has been studying the Japanese experience closely. Economists who doubt that deflation will appear usually cite the fact that the economy is still growing and services prices are rising, with double digit increases in health care and insurance.

Minnesota Outlook

Last February, Finance Department economists noted that optimistic signs were more numerous in the national economy than in Minnesota's. Now, many of the nationwide signs have faded, and the state economy is weaker than expected in February's forecast.

Both comprehensive data and anecdotes indicate a soft state economy. The most current data is labor market information from the Minnesota Department of Economic Security. Though less alarming than it could be because the situation appears to have stabilized in the past few months, seasonally adjusted employment has declined about 13,000 since May. That has left the monthly job count down about 10,000 compared to a year ago. It was a broad decline, with decreases occurring in construction, manufacturing, trade, transportation, communication, and public utilities, and government. Significant job losses have also been experienced in the business services sector.

Job seekers are having a difficult time. Economic Security's Job Vacancy Survey shows the number of openings has declined. In addition, each week some 1,100 unemployed are exhausting their 26 weeks of benefits, up from about 725 a year ago. While initial unemployment claims are down from a year ago, they are still well above the level of two years earlier. Economic Security indicates that an undercurrent of relatively small layoffs is keeping claims for unemployment compensation at relatively high levels.

Press articles reflecting a stalled-out job market have been appearing for months. There are many announcements of layoffs, and virtually no news of expansions. For example, last summer saw the closing of a major catalog and internet retailer with loss of some 4700 jobs. Smaller, but still large layoffs came when a paper mill shut down and a major interstate trucker declared bankruptcy. In more recent news, there have been layoffs in finance, insurance, retailing, software, manufacturing, and the airlines.

A New Model of the Minnesota Economy

November's Minnesota outlook was prepared using a reformulated version of the Finance Department model of the state's economy. In the past, the model has combined Department of Economic Security job count data and U.S. Department of Commerce estimates of wages paid in the state. However, using the Commerce data precludes distinguishing between regular wages and performance based compensation, largely bonuses paid and stock options exercised. That distinction is made in the new model which is based on wages paid data gathered by Economic Security from employers' quarterly reports to the unemployment insurance system.

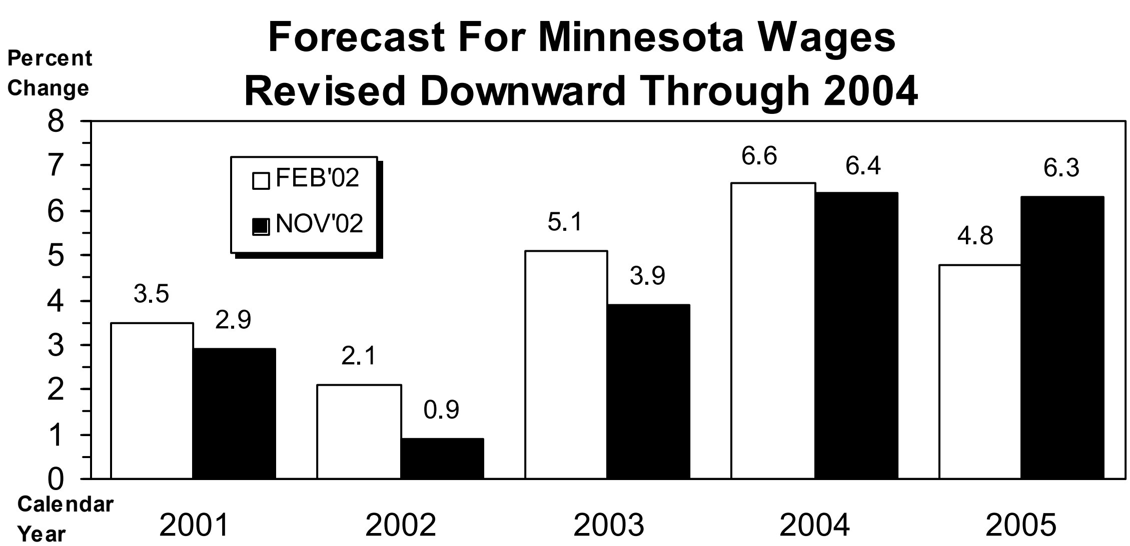
In their reports, employers lump regular wages together with bonuses and options. Last summer, Finance Department economists developed statistical techniques which allow them to make inferences about the bonuses and options. Consequently, regular wages are now analyzed and forecast separately from performance based compensation. For the first quarter of 2002, Finance Department Economists estimate that bonuses and options accounted for about 6% of all Minnesota wages, down substantially from a year earlier.

In the new model, regular pay in the separate sectors is determined as always by employment, inflation, productivity, and other variables. Performance pay is driven by the stock market which determines when options become exercisable. Ideally, industry profits should also have a role in determining performance pay, but existing industry profits data is of questionable accuracy, and is available only after considerable delay. That data is not forecast by GII.

Finance Department economists view the reformulated model as an improvement, but caution that no one has much experience forecasting performance compensation. No one knows when bonuses lost during the recession will be restored, or how many new stock options will be granted. There is no reliable information indicating how large the existing backlog of unexercised stock options is, and when they might be exercised and reported as wages. Some analysts think unexercised options could amount to 10-20 percent of outstanding stock in many industries. Though those options may be out of the money now because of declines in the stock market, no one knows what prices are needed to make them exercisable.

Minnesota's Outlook Revised Down

Preliminary data and estimates for 2002 indicate Minnesota's economy is trailing last February's forecast. While Minnesota employment in 2002 could slightly exceed the February forecast, income estimates have been revised downward. For 2003, both employment and income estimates have been revised downward. The Minnesota economy is not expected to outperform its U.S. counterpart under most measures until 2005.



The November outlook for Minnesota wages was generated using a revised Finance Department model of the Minnesota economy which forecasts regular wages and performance compensation separately.

There are two principal reasons for the revised outlook. One is the U.S. economy's unexpected loss of momentum in the current quarter which led GII to lower its forecast. The other reason is relatively weak performance expected from Minnesota's construction, transportation, communication, and public utilities, and state and local government sectors.

Commercial construction in the state is winding down, probably more so than nationwide since United Properties reports that there are no new multitenant office buildings in the pipeline for 2003 delivery. Vacant office space is abundant. A recent article in *Minnesota Business* indicates office vacancy rates are at their highest level in a decade. Demand for industrial space is soft and there is little new development activity. Population driven retail development continues, but opinions differ as to its strength.

Current conditions are expected to persist in the construction industry for the next few years. Industry sources do not foresee a quick rebound like the one that followed the real estate slump of the early 1990's because this time there seems to be no potential big users of space waiting in the wings for the economy to improve. In the November forecast, employment growth in Minnesota's construction sector lags behind its national counterpart.

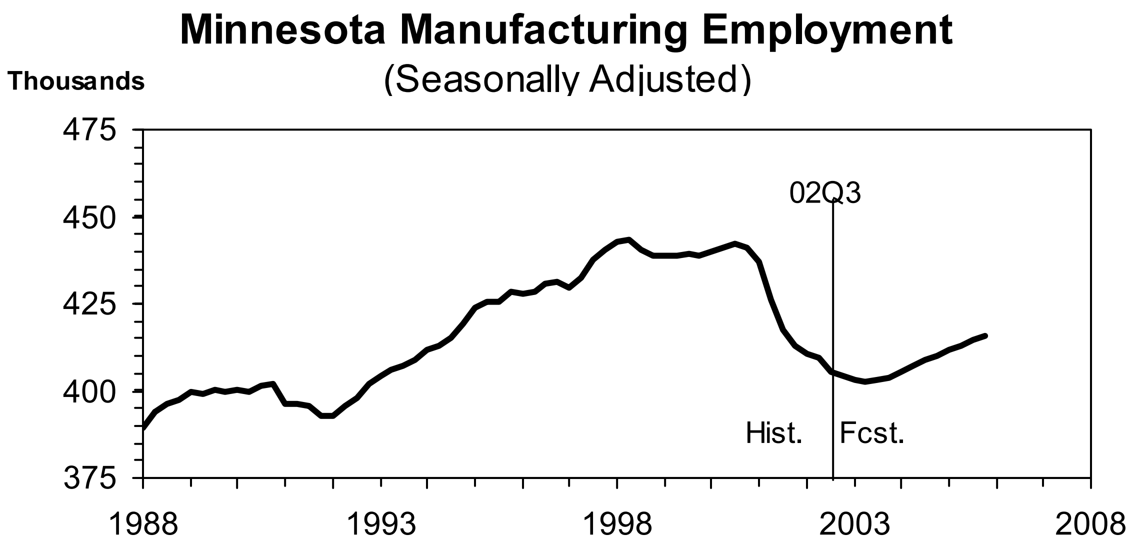
Minnesota's transportation, communication, and public utilities sectors are struggling. A few months ago, the bankruptcy of a major interstate carrier caused a large layoff in the trucking industry. Depressed conditions in the travel industry persist, and more of the same is expected. Airline layoffs continue and negotiations are underway for delays in new aircraft deliveries scheduled for 2003 and 2004. Elsewhere, there have been reports of continued distress in telecommunications and financial difficulties at two major public utilities.

GII’s November Baseline forecast for nationwide state and local government employment assumes only a small decline in early 2003 with steady growth after that. Press reports lead Finance Department economists to doubt that is likely in Minnesota. Widely reported pressures on public sector budgets are reflected in a forecast for a slow decline in public sector employment ending in late 2003. It is not possible to predict where the job losses will occur. That will depend on how state and local agencies and schools manage through the forecast horizon. By the end of 2005, it is assumed that public sector jobs return to current levels.

Manufacturing

After having lost most of the jobs gained since 1990 to the recent recession, the manufacturing sector is forecast to begin a rebound in 2003’s third quarter. This is an optimistic outlook for Minnesota's manufacturing sector, which has outperformed its national counterpart for years. That is expected to continue in the future, despite rising defense expenditures for military equipment produced in other states.

Measured by employment gains, some parts of the manufacturing sector are forecast to perform better than others. Among the best performers are instruments and medical devices, industrial machinery except computers, food processing, and lumber and wood products. The worst performers include computers, paper products and electronic and electrical equipment.



Minnesota's manufacturing sector has lost most of the jobs gained since 1990 to the recent recession and it probably is still contracting. In the November Outlook for the state economy, much depends on a timely rebound in 2003's third quarter.

Agriculture

The state's agricultural outlook has brightened somewhat. Good growing conditions in Minnesota produced record corn and soybean harvests in 2002 even though adverse weather elsewhere reduced total U.S. corn and soybean production 5 percent and 7 percent, respectively. The resulting national supply pinch has driven farm commodity prices higher, leaving Minnesota growers in a favorable marketing position with cash prices for both corn and soybeans more than 25 percent above last year's level. Current estimates are that Minnesota growers are likely to receive as much as $150 million more than last year for those two commodities. Livestock prices remain weak, but the additional crop income will boost Minnesota farm income in both 2002 and 2003. Higher federal program payments will also lift farm income in 2003.

Not a Pessimistic Forecast

Despite the downward revision, November's Minnesota outlook should not be considered pessimistic for the long-term future. Much of the softness can be attributed to special circumstances in certain sectors which will fade over time. If the national recovery proceeds as in GII's November Baseline, then Minnesota employment should have bottomed out in 2002's third quarter. Services and trade will rebound very soon. At first, growth will be slow in 2003 and then begin to accelerate as manufacturing turns around.

In 2004, further acceleration will occur as the construction, transportation, communications, and public utilities and government sectors gradually resume contributing to the state's economic expansion.

Finance Department economists note the forecast for increases in real wages per job for both the U.S. and Minnesota. GII assumes that the marketplace will translate productivity growth into wage increases which are not eroded by inflation. If that happens, then the state's labor force advantages in education and in previous work experience gained through relatively high participation rates should lead Minnesota real wages per job to slightly outperform the national average beginning in 2003.

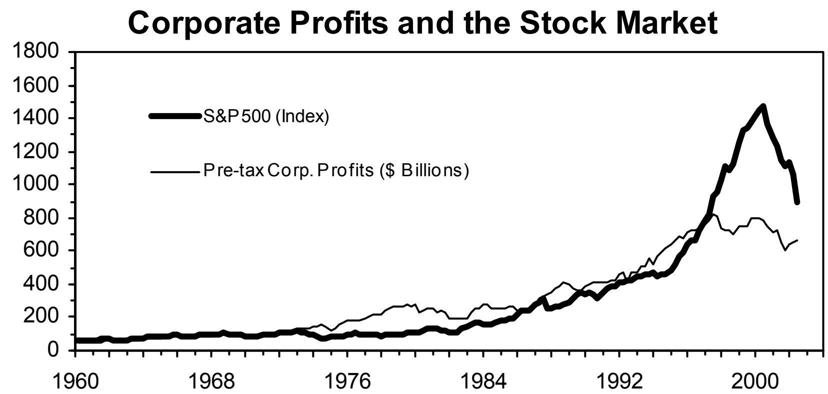
In the view of Finance Department economists, there is risk attached to GII's assumption that productivity gains will be translated into higher wages. If that happens nationally, there is no reason to think it will not happen here since Minnesota is not an island. And, normally the marketplace can be counted on to work as GII assumes. However, while the U.S. economy appears well on its way to a nearly 5.0 percent increase in output per hour in 2002, Finance Department economists observe that very little of that gain has appeared thus far in wages, profits, or the state's tax collections.

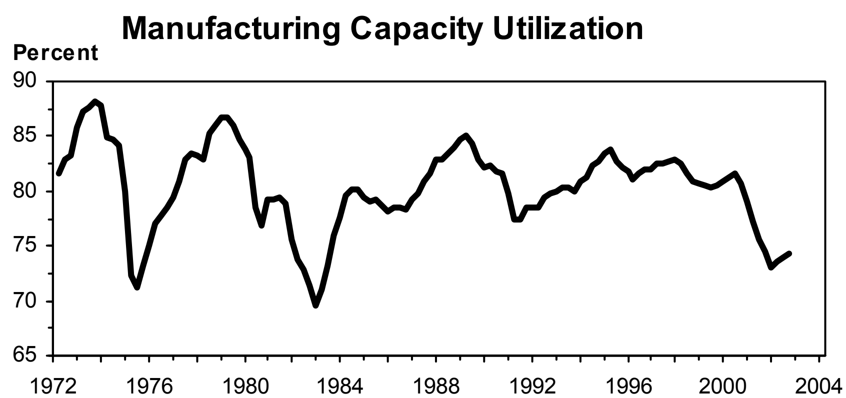
MINNESOTA OUTLOOK COMPARED TO THE U.S.

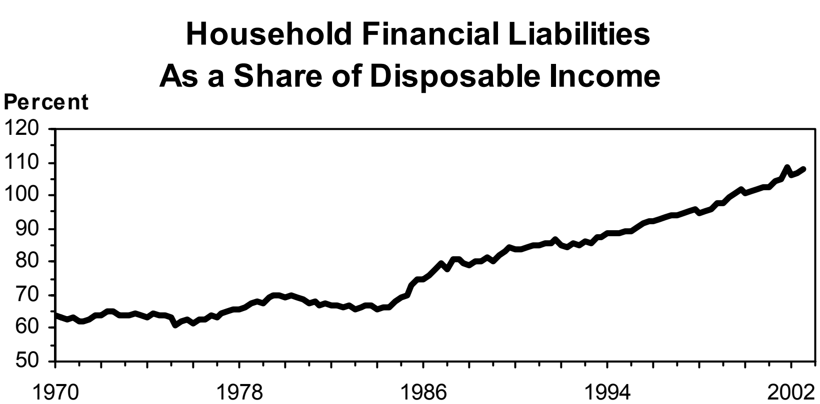
(Calendar Year Percent Changes)

	2001	2002	2003	2004	2005
Establishment Employment					
Minnesota					
November 2002	-0.1	-0.7	0.5	1.9	1.8
February 2002	0.3	-0.8	1.2	1.7	1.6
United States					
November 2002	0.2	-0.8	0.9	2.5	1.7
February 2002	0.4	-0.4	1.6	2.1	1.6
Real Wages Paid Per Job					
Minnesota					
November 2002	0.9	0.3	1.2	2.1	2.3
February 2002	1.3	1.9	1.6	2.5	0.9
United States					
November 2002	0.2	0.8	1.1	1.8	2.1
February 2002	3.1	2.1	1.3	1.3	0.9

Selected National Economic Indicators







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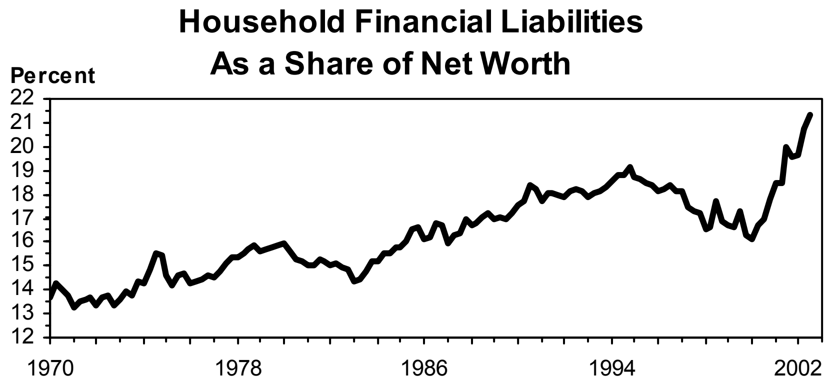
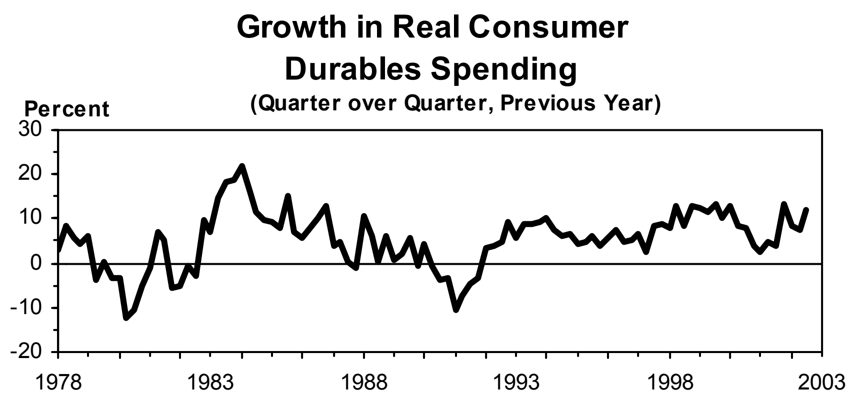
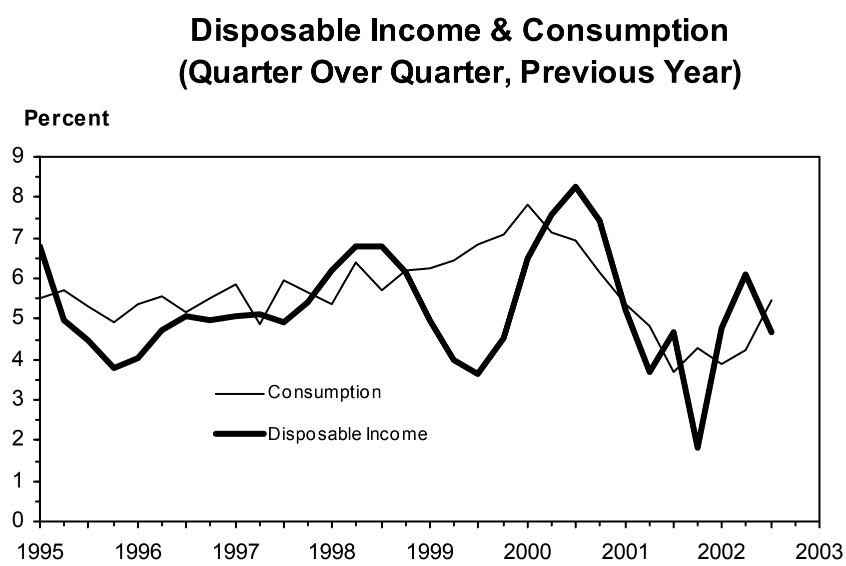
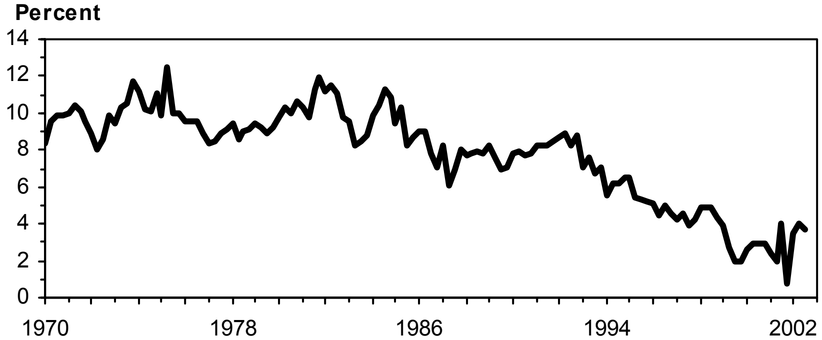




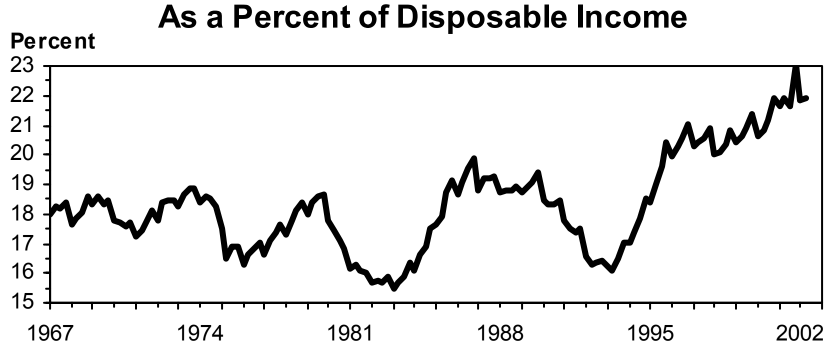


Selected National Economic Indicators

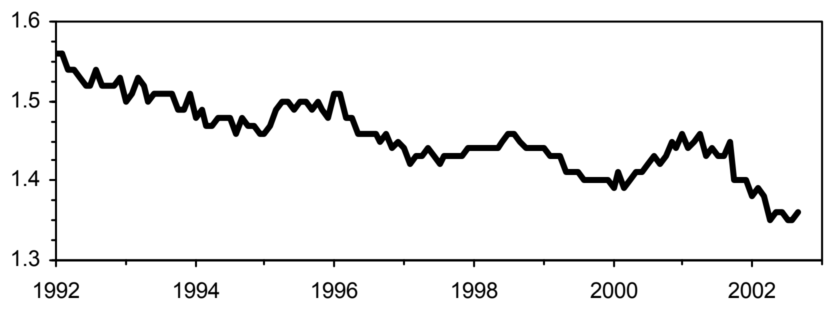
Saving as a Fraction of Disposable Income



Installment Credit Outstanding As a Percent of Disposable Income

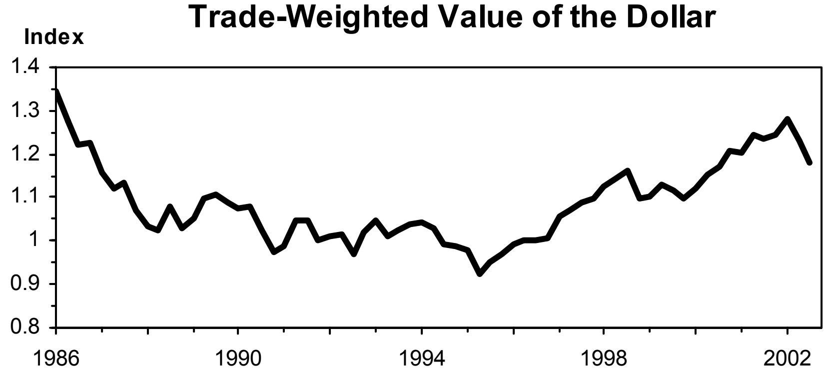


Manufacturing and Trade Inventory to Sales Ratio

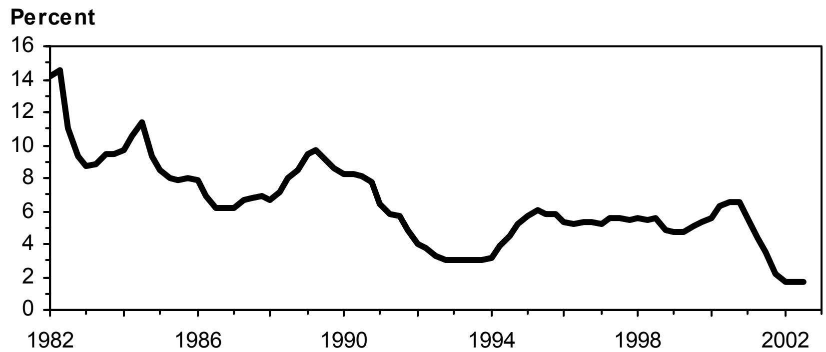


Selected National Economic Indicators

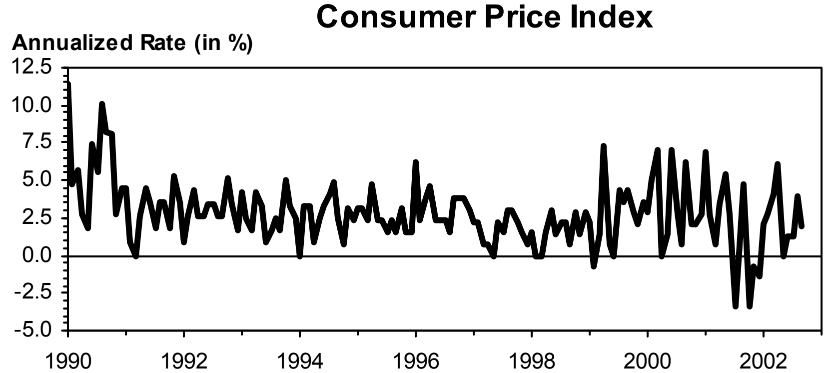
Trade-Weighted Value of the Dollar



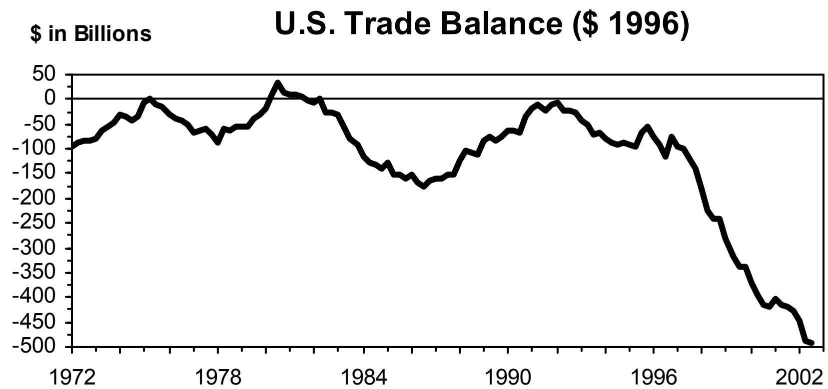
Federal Funds Rate

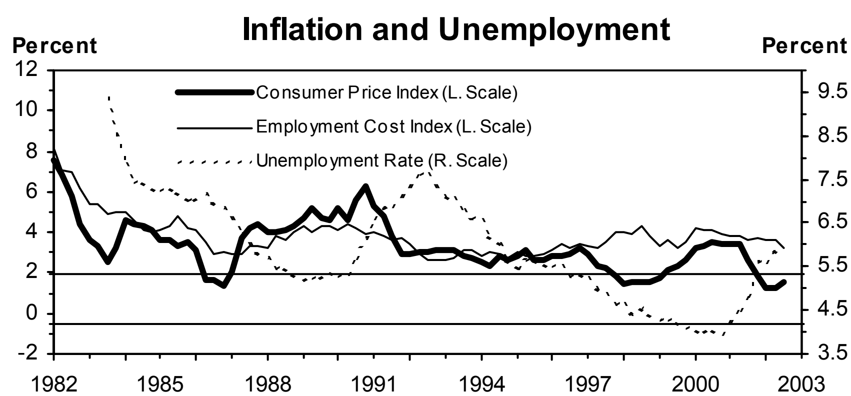


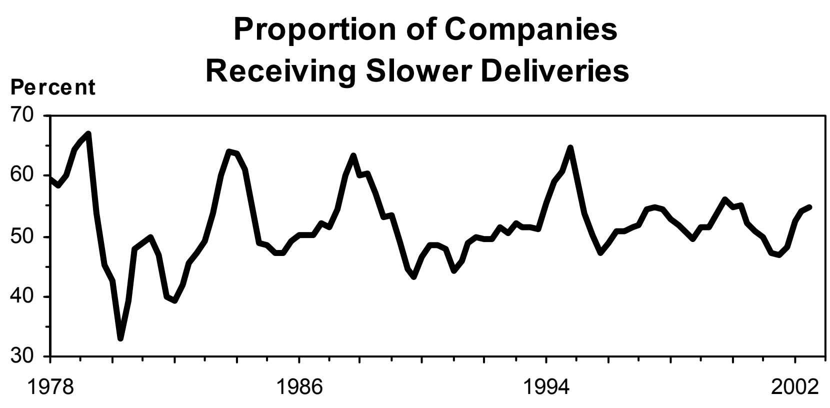
Consumer Price Index



Selected National Economic Indicators

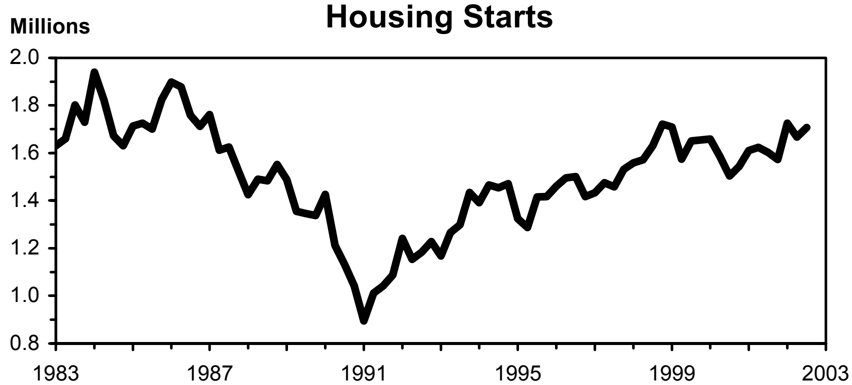




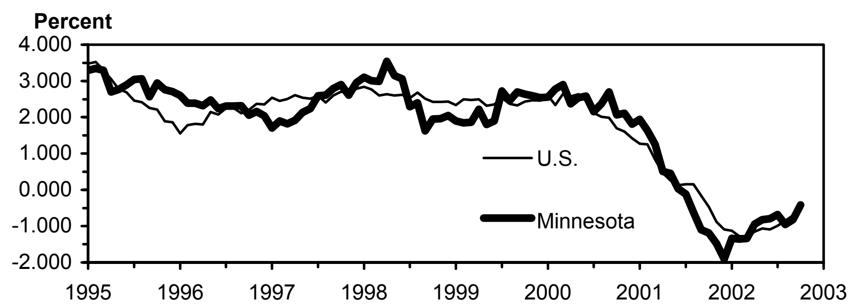


Selected National Economic Indicator

Housing Starts



Minnesota and U.S. Jobs (Month Over Month, Previous Year)



FY 2002-03 Budget Status

The 2002 Legislature took action to eliminate the $2.289 billion general fund shortfall forecast in February 2002. The budget changes enacted left a projected $318 million budget balance at the end of fiscal 2003. That balance was to be transferred to the budget reserve account at June 30, 2003.

The November forecast shows a significant change in the state's financial position with only seven months left in the biennium. Revenues, transfers and other resources for the current biennium are now expected to be $25.194 billion, a decrease of $574 million (2.2 percent) from the end-of-session estimates. State general fund expenditures and transfers for FY 2002-03 are now expected to be $27.100 billion, a net increase of $76 million (0.3 percent) from prior estimates.

While the forecast changes result in a net $650 million reduction, $294 million of the amount expected in the budget reserve is automatically drawn down by the forecast. The result is a $356 million deficit forecast for June 30, 2003.

The $356 million projected deficit is about 2.5 percent of revised total spending for fiscal year 2003. However, with only seven months remaining in the fiscal year, the actual percentage impact will likely be more than double that if measured against actual, remaining unspent funds.

FY 2002-03 Forecast
($ in Millions)

	End of Session	November Forecast	$ Change
Beginning Balance	**$1,574**	**$1,574**	**$0**
Revenues	25,317	24,649	(668)
Other Resources	451	545	94
Total Resources	**27,342**	**26,768**	**(574)**
Expenditures	**27,024**	**27,100**	**76**
Budget Reserve	318	24	(294)
Available Balance (Deficit)	**$0**	**$(356)**	**$(356)**

Impact of November Forecast

Two major pieces account for most of the forecast revision. The first is a $769 million reduction in forecast income tax revenues for the biennium. The second, a forecast increase of $107 million in heath care spending. All other adjustments associated with the November forecast account for a net $226 million gain in other revenue and expenditure estimates.

$24 Million Remains in Budget Reserve and Is Available to Offset Part of the Deficit

The budget reserve was entirely depleted by "phase one" of the legislative budget solution in the 2002 session. In "phase two" the legislature directed that any balance on June 30, 2003 be allocated to partially restoring the reserve. At the end of the 2002 First Special Session, a total of $318 million was projected for the budget reserve. Of this amount, $294 million is automatically drawn down by the forecast. However, under current law, $24 million will still remain in the budget reserve. The $24 million residual shown in the current forecast is two separately timed deposits. The first is $20 million anticipated in April 2003 from the excess surplus in the assigned risk plan. Current law annually transfers excess surpluses in the plan to the budget reserve beginning in January 2003. The second is a $3.9 million appropriation in the 2002 session to be deposited in the reserve on June 30, 2003. Legislative action is required to make these funds available to offset the projected FY 2003 deficit.

Action will be Required before June 30, 2003 to Re-balance the FY 2003 Budget

Both the Minnesota State Constitution (Article XI, section 6) and state statutes (M.S. 16A.152) require that the budget be balanced for the biennium. While short-term borrowing is permitted for cash flow or other purposes, the state constitution prohibits the state from borrowing money for operating purposes that it cannot repay by the end of the two-year budget period. Similarly, state statutes governing the use of the budget reserve and executive branch unallotment authority are specific in providing the necessary authorities to balance state revenues and expenditures to deal with a projected deficit.
The relevant provisions are included in the appendix.

Revenue Forecast
FY 2002-03

Current general fund resources for the 2002-03 biennium are now forecast to total $25.194 billion, $575 million (2.2 percent) less than end-of-session estimates. The forecast for net non-dedicated revenues fell by $668 million, or 2.6 percent, to $24.649 billion. A little more than 30 percent of the shortfall in non-dedicated revenues occurred in fiscal 2002. The remainder will occur during the current fiscal year. Much of the projected shortfall will be seen in lower final payments and higher than previously anticipated refunds on tax year 2002 individual income tax filings due April 15, 2003.

Revenues from the five major taxes are expected to fall short of end-of-session estimates by $781 million or 3.5 percent. Almost the entire shortfall occurs in individual income tax receipts where the current forecast is $769 million (6.5 percent) less than earlier estimates. A much larger than anticipated decline in capital gains realizations in tax year 2001, carried forward to tax year 2002, explains more than one half the decline in individual income tax revenue. Slower than expected wage growth explains another 30 percent of the drop in revenue. The sales tax, the motor vehicle sales tax, and the statewide property tax levy all show small increases over end-of-session estimates. Expected corporate income tax receipts, however, are $87 million less than previously projected. Other tax and non-tax revenues are now projected to be $114 million above forecast.

Revenues FY 2002-03
($ in millions)

	FY2000-01	FY2002	FY2003	FY2002-03
Individual Income	11,472	5,443	5,570	11,014
Sales	6,135	3,785	3,891	7,676
Corporate	1,529	529	542	1,071
Motor Vehicle Sales	1,089	425	277	701
Statewide Property Tax	- -	306	588	894
Five Major Taxes	20,223	10,488	10,868	21,356
Other Revenue	2,483	1,533	1,446	2,979
Tobacco Settlement	235	157	158	314
Net Non-dedicated	22,941	12,177	12,472	24,649
Other Resources	892	133	412	545
Current Resources	**23,833**	**12,310**	**12,884**	**25,194**

Individual Income Tax

Individual income tax receipts are forecast to total $11.014 billion in the 2002-03 biennium, down $769 million from end-of-session estimates. Fiscal 2002 closed with net income tax receipts $289 million below forecast. Through October, fiscal 2003 withholding tax payments were $29 million below levels forecast in February and individual estimated tax payments $21 million less than anticipated. Net fiscal 2003 individual income tax receipts were a total of $63 million below forecast.

A downward revision to the forecast for net capital gains realizations explains more than one-half of the change in this biennium's income tax forecast. In February, Minnesota capital gains realizations were projected to decline by more than 30 percent in tax year 2001, and drop an additional 3 percent in tax year 2002. Based on a preliminary estimate of Minnesota individual income tax liability for tax year 2001, conversations with other states, and reports of partial information from federal tax returns, net capital gains in Minnesota are now estimated to have fallen by 55 percent in tax year 2001. Following re-estimation of the model the Finance Department uses to estimate capital gains realizations, and using current data, a further reduction of 16 percent in tax year 2002 is now forecast. This unprecedented drop in capital gains realizations lowers the base level of realizations through the entire forecast horizon, reducing revenues substantially in the 2004-05 biennium as well.

Changes in the forecast for wage growth account for about 30 percent of the change in individual income tax receipts in this forecast. Wages are now forecast to grow 0.9 percent in 2002; in February wage growth of 2.1 percent was anticipated. Slower wage growth was forecast to be consistent with observed withholding receipts to date. From February through October withholding payments were $58 million below forecast.

Growth rates for other types of portfolio and investment income were also reduced, consistent with the lower assumed capital gains realizations and with partial tax year 2001 data. Interest income was reduced to reflect the historically low interest rate environment expected to remain through mid 2003. The estimate of income taxes paid by fiduciaries was reduced by $18 million for tax year 2002 and beyond due to the stock market's weak performance. Farm income was increased by a total of more than $200 million for tax years 2002 and 2003 reflecting stronger prices and the good growing conditions observed in Minnesota in 2002. The growth rate for rental income was lowered, adjusting the forecast for the weaker rental market for commercial property.

This is the first use of the current House Income Tax Simulation (H.I.T.S) model and the first use of a sample of tax year 2000 filers. The model change and the sample changes had no material impact on the forecast. The H.I.T.S. model was calibrated to match a preliminary estimate of final tax year 2001 Minnesota liability. Since final tax year 2001 liability is not available until the end of the calendar year, an estimate was made based on collections received and the number of returns filed to date, then adjusting for the number remaining to be processed and the expected average liability of those remaining to be processed. The H.I.T.S. model will be re-calibrated in February after final tax year 2001 liability is known.

Typically about 25,000 current year returns are processed in November and December. This year we estimate that 75,000 returns will be processed. If that estimate is correct, there will have been no growth in the number of returns filed between tax year 2000 and tax year 2001, something that has not happened since the early 1980s. If fewer returns are processed, or if the average liability is below that assumed in preparing the estimate, liability for tax year 2001 will be reduced. Other things equal, a lower liability for tax year 2001 reduces the income tax forecast for tax year 2002 and beyond.

Sales Tax

Net sales tax collections for the 2002-03 biennium are now expected to reach $7.675 billion, $62 million (0.7 percent) more than end of session estimates. The forecast for gross sales tax receipts increased by $28 million, while sales tax refunds are now projected to be $30 million less than February's estimate. Lower than anticipated payout on the 2001 sales tax rebate added an additional $4 million to net sales tax receipts. Net sales tax receipts in FY 2002 exceeded the forecast by $36 million of which $26 million came from lower refunds. Through October, fiscal year 2003 net receipts were $11 million above forecast. FY 2003's entire positive variance can be attributed to lower than anticipated refunds.

Consumer durable spending grew more rapidly than expected in fiscal 2002, offsetting weaker than forecast purchases of business capital equipment and construction materials. In fiscal 2003 purchases of both consumer durables and business capital equipment are expected to grow more rapidly than was forecast in February.

The receipts elasticity used to convert the simulated sales tax base to gross revenues was set at .975, as in recent forecasts to adjust for the current sales tax model's history of over estimating in recent quarters. In addition, an explicit adjustment was made for revenue lost due to e-commerce sales. The forecast for the remainder of fiscal 2003 was reduced by $7 million to reflect revenue lost due to growth in e-commerce sales beyond that already reflected in the reduced base. In fiscal 2004 and 2005 the estimated losses grow to $16.2 million and $23.9 million.

Corporate Franchise Tax

Net corporate tax receipts for the 2002-03 biennium are now estimated to total $1.071 billion, $87 million (7.5 percent), less than end-of-session estimates. Net corporate tax receipts finished the 2002 fiscal year almost precisely on target. Thus far in fiscal 2003, however, they are $36 million below forecast, and the forecast was reduced to be consistent with current receipts. In addition settlement of a court case produced a one-time increase in refunds for fiscal 2003. GII now expects corporate profit growth to be stronger in 2003 than they expected last February, but that growth does not lift the forecast sufficiently to prevent a reduction in corporate tax receipts in fiscal 2003.

Motor Vehicle Sales Tax

The sales tax on motor vehicles is now projected to add $701 million to the general fund during the 2002-03 biennium, $9 million, (1.3 percent) more than end-of-session estimates. Fiscal year 2002 closed with a positive variance of $6 million. Fiscal 2003 year-to-date collections through October are $14 million above forecast, due to the extremely heavy sales last August. Since then sales have fallen, and the GII forecast is for slightly weaker light vehicle sales for the remainder of the biennium.

Other Revenues

Other tax and non-tax revenues are expected to total $3.293 billion during the current biennium, up $144 million (3.4 percent) from end-of-session estimates. Mortgage tax collections are forecast to exceed prior estimates by $74 million, reflecting the surge in refinancing of home mortgages brought on by historically low interest rates. Estate tax revenues are now projected to exceed the forecast for the biennium by $60 million. The current boom in housing sales boosted expected deed tax revenues $22 million above end-of session estimates. Tobacco settlement payments are forecast to exceed prior estimates by $13 million. Investment income was reduced by $8 million because of projected lower cash balances.

Expenditure Forecast
FY 2002-03 Biennium

Forecast expenditures for the FY 2002-03 biennium now total $27.100 billion, $76 million more than comparable estimates at the end of the 2002 regular session and special legislative session on flood relief. This change in total estimated spending reflects a 0.3 percent increase over previous estimates.

FY 2002-03 Expenditures
($ in millions)

	End of Session	November Forecast	Difference
Education Finance	$10,661	10,660	$(1)
Higher Education	2,808	2,807	(1)
Intergovernmental Aids	2,762	2,758	(4)
Health Care	4,708	4,815	107
Health & Human Services	2,002	1,951	(51)
Environmental Resources	496	486	(10)
Economic & Workforce Development	402	400	(2)
Public Safety & Corrections	958	947	(11)
Transportation	424	430	6
General Government	1,123	1,180	57
Debt Service	614	581	(33)
Capital Projects	2	2	0
Estimated Cancellations	(28)	(15)	13
Subtotal	**26,932**	**27,002**	**70**
Dedicated Expenditures	92	98	6
Total Expenditures	**$27,024**	**$27,100**	**$76**

Projected growth in the cost of health care programs increase expected spending by $107 million. All other net spending is $31 million less than previously forecast. Accounting for almost all of the net decrease in other spending areas is a $33 million reduction in estimated debt service payments for FY 2002-03. The debt service reduction is the product of an unanticipated repayment of a maximum effort school loan as well as higher than expected premiums received from recent bond sales.

While changes in estimates are shown for other functional categories of the budget, none of these represent significant adjustments to the forecast. Typically, end-of-session estimates are based on appropriations. With the November forecast in the second year of the biennium, actual spending is included for FY 2002 and authorized appropriations may be carried forward into FY 2003. Additionally there are differences shown that reflect adjustments between categories, transfers of funds between agencies, and changes in dedicated revenue estimates and related dedicated spending. In a limited number of areas, end-of-session estimates have been restated to reduce changes caused by alignment issues. However, these changes have no material impact on total estimated spending or the ending balance.

Education Finance Estimates for FY 2002-03 Virtually Unchanged

Education Finance, the largest category of state general fund spending, consists of K-12 education aids, family and early childhood education programs, and intergovernmental aids to schools. For the biennium, Education Finance spending is now expected to total $10.7 billion.

Projected expenditures are $864,000 less than at the end of the 2002 legislative session. This modest change reflects a number of small reductions in FY 2002 spending, offset by increases projected for FY 2003, particularly in General Education.

Most K-12 Education funding is driven by the number and characteristics of students receiving educational services. This forecast reflects slightly lower projections for pupil counts in the current biennium than was assumed at the end of the 2002 legislative session. In the current school year (FY 2003), K-12 enrollment is projected to be 852,203 students.

K-12 Aids can be divided into 2 major funding streams: 1) General Education, the primary source of basic operating funds for schools, and 2) “categorical” aid tied to specific activities or “categories” of funding.

Over three-quarters of K-12 aid ($8.1 billion for FY 2002-03) is distributed to schools through the General Education program, and most of the forecast change (a $19 million increase) is also in this program. Lower pupil estimates are offset by rapidly rising projections for compensatory aid (up $10.3 million). Compensatory funding is a part of the General Education program that provides additional revenue to schools with concentrations of students from low-income families. It is based on the number of pupils eligible for free and reduced price lunches. As the state’s economy has softened, these figures have climbed higher. Projections for compensatory funding are based on caseload estimates for the Minnesota Family Investment Program (MFIP, the state’s cash assistance program for families with children).

Two other factors contribute significantly to the increases in General Education since end-of-session: a $9 million increase in Training and Experience (T & E) revenue and a $1.8 million increase in Post Secondary Enrollment Options (PSEO). T & E provides funding to districts with relatively large proportions of experienced, more highly paid teachers. The forecast change in T & E is due to lower than anticipated attrition of more experienced teachers coupled with layoffs of less experienced teachers.

In PSEO, the amount of spending per credit at higher education institutions jumped significantly because past estimates had not reflected the effect of General Education roll-ins from the 2001 session, and do not reflect any significant changes in the number of students, or number of credits being taken. These increases are offset by smaller changes in other components of General Education, the largest of which is a $5.7 million decrease in Limited English Proficiency (LEP) revenue due to lower estimates of the number of immigrant students.

Intergovernmental Aids Change Little, Down $4 Million

Intergovernmental aids represent slightly over 10 percent of projected general fund spending. Estimates for the biennium now total $2.758 billion, down $4 million (0.15 percent) from end-of-session estimates. The net decrease in estimates is a combination of a number of factors.

Forecast spending is higher in two areas. Property tax refunds are expected to be $3.7 million higher largely due to higher than expected local levy certifications, while $1 million of the increase is due to increasing property insurance premiums that act to increase police and fire aids.

Offsetting these increases are a $1.6 million reduction in Market Value Homestead credit estimates due to higher growth in assessed value and a $2.8 million reduction in Police and Fire amortization aids. A $5 million reduction that is shown merely represents moving FY 2002 Metropolitan Council Transition aid from tax/intergovernmental aids, to the transportation functional category.

Health Care Forecast for FY 2002-03 Increases $107 Million

Health care spending represents nearly 18 percent of total general fund spending. The current forecast for health care programs is expected to be $4.8 billion for the FY 2002-03 biennium, an increase of $107.3 million from end-of-session estimates. While spending recorded at the close of FY 2002 was $9.8 million below forecast, FY 2003 spending estimates are $117.1 million higher than end-of-session estimates. The most significant forecast increases occur in MA long-term care waiver programs and in General Assistance Medical Care (GAMC).

Higher-than-expected average cost growth in MA long-term care waiver programs is driving an overall forecast increase of $46.3 million for the biennium. Changes in the MA Waiver for Persons with Mental Retardation and Related Conditions (MR/RC Waiver) account for roughly three-quarters of this increase. MR/RC Waiver increases are largely due to an unexpected rise in service costs for the group of recipients already receiving waiver services prior to FY 2001. With a significant number of lower-cost recipients entering the program during an open enrollment period in the closing months of FY 2001, counties had additional flexibility under their spending caps to increase the amount of services available to individuals already enrolled in the program.

The GAMC forecast is also $36.6 million higher than projected in the end-of-session estimates. A rapidly rising caseload and a more pessimistic economic scenario lead to a 16 percent increase in projected caseloads in FY 2003. This caseload effect accounts for nearly all of the increase in the GAMC forecast for the current biennium. It is expected that this trend will continue with a 36 percent increase in projected caseloads, on average, for the next biennium.

Less significant forecast cost increases for the current biennium include: MA basic care for the elderly and disabled, and MA long term care facilities. Higher average costs for persons with disabilities account for most of the increase in the MA basic care for the elderly and disabled activity for the current biennium ($7.5 million). In recent years, pharmacy costs have been one of the main contributors to cost increases for this group. MA long-term care facility spending increases for the current biennium (net $6.3 million after alternative care cancellations) are largely due to higher patient loads in regional treatment center–mental illness/chemical dependency programs.

Health & Human Services Reduced $51 Million for FY 2002-03

Since the end of the 2002 legislative sessions, the forecast for Health and Human Services programs has declined by $50.6 million (2.5%) for the current biennium.

The net reduction for the current biennium can largely be explained by three factors:

- a decrease in the state's share for the Minnesota Family Investment Program (MFIP), due to federal maintenance of effort (MOE) requirements and current law distribution of TANF funds;
- a decline in the Group Residential Housing (GRH) forecast, due primarily to lower caseload projections; and
- lower administrative spending within the Departments of Human Services and Health than shown at the end of session, as undesignated administrative reductions from the 2002 legislative session were not allocated and were arrayed in another functional category.

Despite what appears to be downward forecast movement for the current biennium, the persistently sluggish economy has resulted in further caseload increases within the state's economic support programs.

Consequently, MFIP caseloads are projected to be 6% higher for FY 2003. Higher General Assistance caseload projections for both basic and emergency needs have the effect of increasing the forecast for the FY 2002-03 by $3.0 million.

Child Care Assistance expenditures—in part a function of the number of MFIP cash assistance cases—are forecast to increase by $6.5 million in FY 2003 over end of session estimates. The change in FY 2003 is primarily driven by an estimated increase in the average annual cost per family.

Debt Service Costs for the Current Biennium are $33 Million Lower

The total estimated debt service for the 2002-03 biennium is now $581 million, $33 million less than end-of-session estimates. Total receipts in the debt service fund are $21.8 million greater than previously forecast which reduces the required general fund transfer. Most of the increase in receipts is the result of a school district repaying a $18.4 million Maximum Effort School loan. This repayment was not anticipated in the end-of-session forecast.

Further reducing the general fund transfer is the fact that winning bidders on the state's general obligation bonds continue to pay large premiums to the state. Premiums paid on the June and November 2002 bond sales totaled $34 million, which was $11 million over the amount of premiums incorporated in the previous forecast.

All Other Spending Areas Show only Marginal Changes

The remaining spending areas account for a net $59 million increase from previous estimates. Several items account for the majority of this change.

Of the $57 million increase shown for General Government, $47 million is attributed to treatment of across-the-board reductions related to 2002 legislative action on the hiring freeze and professional-technical contract moratorium that extends through June 30, 2003. Enacted law specified total required dollar savings to be realized but did not specify individual agency reductions. The total saving of $58 million was a single amount in the general government category in end-of-session estimates.

Subsequently, the reduction was allocated proportionately to individual executive branch agencies. The general government portion is $10.6 million. The remaining $47 million is now distributed to other functional categories and contributes to the net changes shown for other categories. The allocation of these cut by functional area is highlighted below:

- Education Finance – $3.1 million
- Higher education - 0.8 million
- Health and Human Services $15.6 million
- Environmental Resources – $11.1 million
- Economic and Workforce Development - $4.2 million
- Public Safety and Corrections - $9.8 million
- Transportation - $2.7 million
- General Government – $10.6 million

Of the remaining increase in spending estimates, $17 million is the result of a change in the estimates for penalties and interest paid by the Department of Revenue. FY 2002-03 projected payments from this open appropriation have increased from $40 million to $57 million largely due to a single recent unfavorable decision on tax litigation.

Finally, forecast dedicated revenue spending has increased $6 million from previous estimates. This increase is related primarily to various dedicated receipt sources for state programs. The increase in dedicated spending is directly offset by a corresponding increase in estimated receipts, and does not affect the ending general fund balance.

FY 2004-07 Budget Outlook

This forecast for the 2004-05 biennium describes the budget outlook if current laws and policies remain unchanged. The revenue forecast is based on the GII November 2002 baseline forecast for the U.S. economy. It establishes the resources available under current law to fund state programs. Expenditure estimates are based on current law adjusted only for enrollment, caseload changes, and specific formula requirements. No adjustment is included for estimated inflation. If expenditures were uniformly adjusted for estimated inflation, it would add approximately $1.1 million in spending and increase the forecast deficit by a like amount. The projected deficit is the difference between current law expenditures and current law revenues.

Unlike the FY 2003 deficit of $356 million, the additional $4.2 billion projected shortfall for FY 2004-05 does not represent an enacted budget. Instead, the November revenue forecast, when matched against "base level" current law expenditures, provides the framework for developing a budget for the next two years.

FY 2004-05 Biennial Budget Forecast

($ in millions)

	FY 2002-03	FY 2004-05	$ Change	% Change
Beginning Balance	**$1,574**	**$(332)**	**$(1,906)**	**(121.1)**
Revenues	24,649	26,562	1,913	7.8
Other Resources	545	295	(250)	(45.9)
Current Resources	**25,194**	**26,857**	**1,663**	**(6.6)**
Expenditures	**27,100**	**30,975**	**3,875**	**14.3**
Budget Reserve	24	79	55	
Education Reserve	na	31	31	
Available Balance (Deficit)	**$(356)**	**$(4,560)**	**$(4,204)**	

The Forecast Expenditure "Base" Is the Starting Point for Budget Development

Within the forecast, "base" spending levels include the cost of current statutory commitments. No additional funding for general inflation or the cost of future labor contracts has been included in the calculation of base level estimates for the next biennium. While current resources (i.e. revenues, transfers expected within the biennium) are projected to increase by $1.663 billion for FY 2004-05 over the current biennium, projected expenditures increase by $3.875 billion. Significant growth over the current biennium is forecast in education finance ($2.112 billion), intergovernmental aids

($332 million), health care programs ($1.119 billion), and health and human services spending ($234 million).

Budget Reserves Increase $86 Million in FY 2004-05, Available to Offset Deficit

Even as the forecast projects a deficit for the coming biennium, there remain in law provisions that set aside additional money in reserves for FY 2004-05. The remaining $24 million budget reserve for FY 2003 is increased by several specific requirements in law for FY 2004-05. First, an additional $31 million was appropriated in the 2001 session to increase the budget reserve in FY 2004. The 2002 legislature appropriated an additional $12 million per year.

Also, an education reserve account was created. Beginning in FY 2004 this set-aside account is funded at an amount equal to the yearly growth in the statewide property tax. By FY 2005 the education reserve account is forecast to be $31 million. Legislative action is required to use either of these projected balances to offset forecast shortfalls.

Initial Set of FY 2006-07 Planning Estimates

The planning estimates for FY 2006-07 are materially different from the short-term forecasts for the current and FY 2004-05 biennia. Projection methods are different and the longer-term projections carry a higher degree of uncertainty and an inherently larger potential range of error. This is the first set of planning estimates for the FY 2006-07 biennium.

Planning estimates for FY 2006-07 are presented to help identify longer-term state finance issues. Revenue projections are based on the projected growth rate for 2006 and 2007 in GII's November baseline forecast. Expenditure projections assume current laws and policies continue unchanged, adjusting only for caseload and enrollment changes as well as specific formula-driven items.

As with the estimates for FY 2004-05, projected current law expenditures for FY 2006-07 do not include the cost of estimated inflation. Estimated inflation for FY 2006-07 compounded over four years would more than double the $1.1 billion estimate that would represent a simple inflationary adjustment to FY 2004-05. By FY 2006-07, the inflationary costs would add over $2 billion to the spending shown in the planning estimates.

The FY 2006-07 planning estimates shown below display projected "current resources" compared to projected spending. The term "current resources" refers to revenues and transfers received *within* a fiscal year or biennium. Balances or deficits from prior years, as well as any reserves are excluded. When compared with projected spending, the difference highlights the "structural" balance or gap – how much more is being spent than collected.

FY 2006-07 Long Term Planning Estimates
($ in millions)

	FY 2004-05	FY 2006-07	Change	%
Current Resources				
Revenues	26,562	29,690	3,128	11.8
Transfers, other	295	298	3	1.0
Total	**26,857**	**29,988**	**3,131**	**11.7**
Projected Spending				
Current Law	30,975	32,259	1,274	4.1
Difference	**(4,118)**	**(2,266)**		

Long Term Planning Estimates Highlight Likely Future Budget Problems

For FY 2006-07 current resources are projected to reach $29.988 billion, an increase of $3.131 billion (11.7 percent) over the forecast for FY 2004-05. Projected current law expenditures are projected to be $32.254 billion, a biennial increase of $1.279 billion (4.1 percent) over forecast spending levels for FY 2004-05.

At nominal values, revenue growth exceeds expenditure growth in the planning estimates, beginning to reduce projected budget gaps. This happens largely because the spending estimates assume that no increases in spending will occur over the four-year period FY 2004-07 beyond those incorporated into major forecast areas for enrollment, caseload, and current formula-driven aids.

To provide perspective, it is useful to recognize that over the last decade general fund spending has grown more than 5 percent *per year*. Contrasting this with the 4.1 percent *biennial* growth shown for FY 2006-07 highlights that significant budget changes would be required to achieve the future spending levels assumed in the planning estimates.

The budget planning estimates are not intended to predict a balanced or unbalanced budget in the future. Their purpose is to assist in determining how well ongoing expenditures will match revenues based on trend projections of Minnesota's economy and what it will cost to maintain the same programs. The FY 2006-07 planning estimates provide a baseline against which the longer-term impacts of FY 2004-05 budget proposals and decisions can be measured.

Revenue Forecast
FY 2004-05

Total current resources for the 2004-05 biennium are forecast to be $26.911 billion, $1.967 billion (8.0 percent) more than revenues for the 2002-03 biennium. That forecast is down $1.580 billion (5.6 percent) from February's revenue planning estimates adjusted for actions by the 2002 legislature. General fund receipts from the five major taxes are now projected to grow by 9.9 percent over levels forecast for the 2002-03 biennium.

Revenues FY 2004-05

($ in millions)

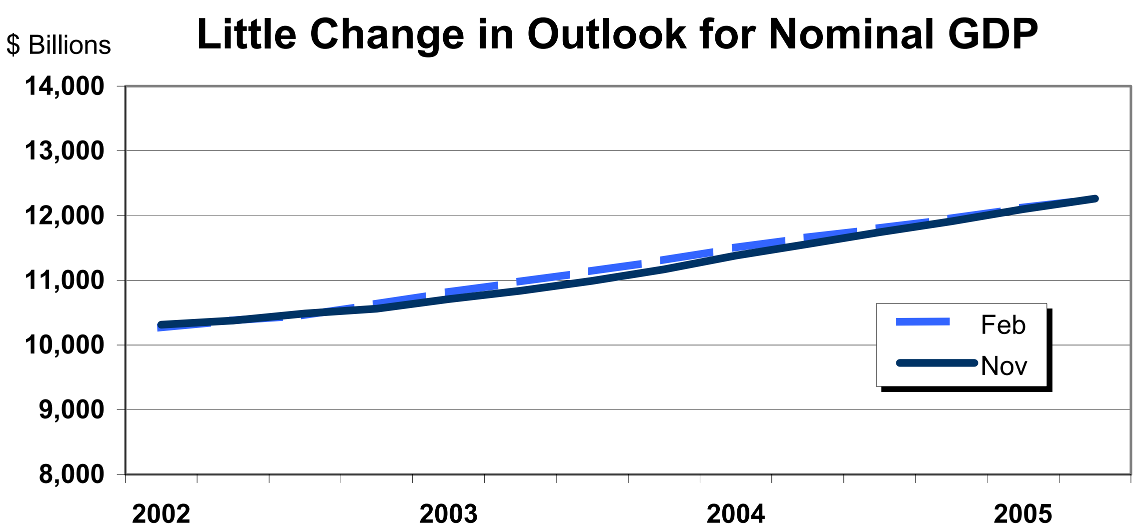
	FY2002-03	FY2004	FY2005	FY2004-05
Individual Income	11,014	5,875	6,298	12,173
Sales	7,676	3,890	4,298	8,188
Corporate	1,071	640	708	1,348
Motor Vehicle Sales	701	272	264	536
Statewide Property Tax	894	597	610	1,207
Five Major Taxes	21,356	11,274	12,178	23,452
Other Revenue	2,979	1,345	1,373	2,718
Tobacco Settlement	314	195	197	392
Net Non-dedicated	24,649	12,814	13,748	26,562
Other Resources	545	147	148	295
Current Resources	**25,194**	**12,961**	**13,896**	**26,857**

Individual income tax revenues grew the most between the 2002-03 biennium and the 2004-05 biennium, increasing $1.159 billion (10.9 percent). Sales tax revenues grow by $512 million or 6.7 percent. Corporate income tax receipts showed the largest percentage change, increasing nearly 26 percent, or $276 million, from their depressed fiscal 2002-03 base. Both the sales tax and motor vehicle sales tax biennial growth comparisons are distorted due to tax law changes. The general sales tax's growth rate is artificially depressed by the elimination of the June accelerated sales tax payment in 2004. In the absence of that change in payment requirements, the sales tax would have grown by 8.7 percent. Growth in the motor vehicle sales tax collections is understated because the full extent of the allocation of a portion of that tax to the highway user fund is not reflected until 2004. Actual motor vehicle sales tax collections, before transfers to the Highway Users Distribution Fund, the Metropolitan Area Transit Fund, and the Greater Minnesota Transit Fund are forecast to be the same in the 2004-05 biennium as in the current biennium.

This is the first detailed forecast of revenues for the 2004-05 biennium. Previous revenue estimates for the biennium were simple extrapolations of projected 2003 revenue using long-term trend growth. Large changes between end-of-session planning estimates and the first detailed forecast for a biennium often occur. Because planning estimates cover revenues which will not begin to be received for 17 months, minor changes in the revenue outlook for 2002-03 biennium, or in the outlook for economic growth in 2004 or 2005 can compound into large changes in the revenue projections by the end of the 2004-05 biennium.

Changes in Economic Assumptions

The economic outlook used in this first detailed forecast of revenues for the 2004-05 biennium is slightly less optimistic than that used as the basis for February's revenue planning estimates. The current GII baseline forecast shows real GDP at a slightly lower level at the start of the biennium than was assumed in February. Real growth also proceeds at a slightly slower pace in fiscal 2004, but then accelerates almost reaching the level assumed in February by the close of the biennium. The outlook for nominal (current dollar) growth is similar.



Income Tax

Individual income tax revenues in the 2002-03 biennium are forecast to total $12.173 billion, $1.159 billion (10.9 percent) more than is expected for the 2002-03 biennium, but $1.332 billion (9.7 percent) less than end-of-session revenue planning estimates. A much larger than anticipated decline in net capital gains realizations in tax year 2001, and accompanying declines in other investment income and pension income account for the majority of the difference in projected revenues between prior estimates and this forecast. Lower investment income levels also reduce the proportion of social security income subject to tax.

Capital gains realizations in tax years 2004 and 2005 are projected to grow by 18 percent per year. But, because that growth comes from a substantially lower base than previously assumed, the additional revenues generated only slightly exceed those generated by the much slower growth rates assumed in the planning estimates. Nominal wage growth rates of 6.4 percent in 2004 and 6.3 percent in 2005 assume acceleration in income from bonuses and stock options, as well as growth in base wages.

Sales Tax

Net sales tax receipts for the 2004-05 biennium are projected to reach $8.188 billion, up 6.7 percent from levels currently anticipated for FY 2002-03. The change in the timing of receipts associated with elimination of the June accelerated payment created a one-time shift of $164 million from the biennium. That shift, artificially depresses the projected sales tax growth rate in 2004. The forecast for 2004-05 was $136 million, (1.6 percent) below the end-of-session planning estimate.

Minnesotans' purchases of consumer durables in fiscal 2004-05 are projected to increase by 10.2 percent over the prior biennium's level, consistent with Global Insight's forecast for an improved economy. In the current biennium growth now appears to have been just 7.3 percent. For business equipment spending the improvement is even more dramatic with 11.1 percent growth projected for the next biennium following a 7.9 percent decline in fiscal 2003-03. Sales of construction materials, the third major component of Minnesota's sales tax base, are now forecast to grow by 7.3 percent in 2004-05, following 6.3 percent growth during 2002-03.

Explicit adjustments for sales tax revenue lost to e-commerce were also made. Sales tax revenues lost to e-commerce were estimated to grow by $16 million in fiscal 2004 and $24 million in fiscal 2005. The-end-of-session planning estimates included no adjustment for the additional revenue lost to the expansion of e-commerce. Sales tax refunds are projected to total $487 during the biennium, $35 more than in 2002-03, and $14 more than end-of-session planning estimates.

Corporate Franchise Tax

Corporate tax revenues for the 2004-05 biennium are forecast to total $1.348 billion, 25.8 percent more than is now expected to be received during the 2002-03 biennium, but $57 million (4.0 percent) less than was projected in end-of-session planning estimates. Global Insight believes that a recovery in corporate profits is underway, and that by early in the 2004 fiscal year corporate profits will be above the nominal levels observed in 2000. Corporate profits share of GDP remains below its historical level throughout the forecast horizon. The corporate income tax remains the most volatile of Minnesota's major taxes.

Motor Vehicle Sales Tax

The sales tax on motor vehicles is now projected to yield $536 million, $33 million (5.9 percent), less than end of session planning estimates. Global Insight has reduced their baseline forecast for consumer spending on motor vehicles and parts since their February forecast. Light vehicle sales are now expected to be strong in much of 2004 and 2005, but as consumers pause after the extremely strong sales recorded in the 2002 model year, sales are expected to be well below year earlier levels through the first half of fiscal 2004.

Other Revenues

Other tax and non tax revenues, including the statewide property tax levy are expected to total $4.317 billion, 3.1 percent more than is projected for the 2002-03 biennium. The statewide property tax grows by $313 million, much of that growth occurs because fiscal 2002 receipts do not reflect a full year of collections. The end of the home mortgage refinancing boom causes mortgage tax receipts to be $67 million less in the 2004-05 biennium than is forecast for 2002-03. Mortgage tax receipts, however, are still expected to be $35 million greater than projected in the end-of-session planning estimates. Deed tax receipts, while changing little from the prior biennium are up $24 million from the previous estimate. The Insurance Gross Premiums tax, up $60 million from projected receipts for the 2002-03 biennium, is $47 million less than was projected in the planning estimates reflecting lower than expected collections over the past 12 months.

Non-tax revenues, including tobacco settlement revenues are now expected to reach $1.154 billion in the 2004-05 biennium, down $164 million or 11.6 percent from the level currently expected for the 2002-03 biennium. When compared to end of session planning estimates non-tax revenues are off $93 million, or 7.5 percent. A lower investment income forecast, attributable to greatly reduced cash balances was the source of more than one half of the reduction in non-tax revenues from the planning estimates. Tobacco settlement revenue is now projected to be $392 million in the 2004-05 biennium, $12 million more than previously anticipated.

Revenue Planning Estimates
FY 2006-07

The first planning estimates for the 2006-07 biennium call for general fund current resources to total $29.988 billion, an increase of $3.131 billion or 11.7 percent over the current forecast for the 2004-05 biennium. Net non-dedicated revenues reach $29.690 billion, $3.128 billion more than is forecast for 2004-05. Receipts from the five major taxes grow by 12.6 percent. Individual income tax receipts grow by 14.3 percent from levels forecast for the 2004-05 biennium; the sales tax grows by 13.2 percent.

FY 2006-07 Revenue Planning Estimates
($ in millions)

	FY2004-05	FY2006	FY2007	FY2006-07
Individual Income	12,173	6,751	7,163	13,914
Sales	8,188	4,531	4,737	9,268
Corporate	1,348	696	685	1,381
Motor Vehicle Sales	536	280	286	566
Statewide Property Tax	1,207	628	647	1,275
Five Major Taxes	23,452	12,886	13,518	26,404
Other Revenue	2,718	1,425	1,460	2,885
Tobacco Settlement	392	199	202	401
Net Non-dedicated	26,562	14,510	15,180	29,690
Other Resources	295	148	149	298
Current Resources	**26,857**	**14,658**	**15,329**	**29,988**

No one can forecast the path of the economy five years into the future. These baseline revenue planning estimates are not explicit forecasts, they are extrapolations based on projected trends in the economy. Even small deviations from the assumed trend over five years will compound and produce sizeable changes in revenues. In addition, because of the way the estimates are constructed, any change in the base level of revenues for fiscal 2005 will be reflected in the revenue planning estimates for 2006 and 2007. Other things equal, stronger than anticipated revenue growth through fiscal 2005 will carry forward and add significantly to revenues in the 2006-07 biennium. But, should the economy grow more slowly than forecast during the next three years, or should some item of portfolio income such as capital gains fall well below forecast - as it did in tax year 2001 -- the revenue outlook for the 2006-07 biennium will deteriorate.

The revenue planning estimates are only a guide to the level of future revenues. They are not a guarantee. If the economy remains as strong as GII projects through 2007, the revenue planning estimates are likely to slightly understate actual receipts unless capital gains drop dramatically. But, the GII baseline forecast includes strong growth with no recession for at least the next five years, and that scenario could be overly optimistic. If economic conditions are not as projected actual revenues could exceed or fall short of the planning estimates by $2 billion or more depending on the economy's performance over the next 4 years.

As is customary when the first planning estimates are prepared for a new biennium, Finance Department economists evaluated the methodology used to establish the economic growth assumptions used in preparing the revenue planning estimates. For a number of years the Finance Department was concerned about the positive bias created by use of the growth rates provided in DRI's Trendlong scenario. The Trendlong scenario, which DRI identified as the envelope of the maximum sustainable growth rates over time, failed to take into account the possibility that the economy might not perform at peak level for one or more years during the forecast horizon. Finance Department economists also noted that typically there was a sudden surge in the assumed real growth rate at the point the 3-year short-term forecast was spliced to the long-term outlook. That higher economic growth rate appeared to add a positive bias to the forecast for the years covered in Minnesota's revenue planning estimates.

Since 1994 the Finance Department has used a series of alternative, hybrid forecasts to overcome that apparent positive bias in the Trendlong estimates. It has also been Finance Department practice to replace the first year of the hybrid estimate with values from the Control forecast in November of odd numbered years. This practice limited the use of hybrid projections to forecasts for calendar years beginning more than 3 years into the future, consistent with the length of the forecast made by DRI's short-term macro-economic model. For example, last February's 2004-05 planning estimates were based on the calendar year 2004 Control values. The hybrid estimates were used only for the final six months of fiscal 2005.

Global Insight's purchase of DRI and WEFA necessitated some reworking of the firm's U.S. macro model. Improvements appear to include a smoother growth path for years four and five of the forecast and a less abrupt transition to the long term growth path. After examining the GII projections for 2006 and 2007, Finance Department economists and the Council of Economic Advisors agreed to use the GII baseline growth rates for 2006 and 2007 in preparing the revenue planning estimates. The real growth rates assumed, 3.5 percent and 3.1 percent are consistent with those assumed by the CBO and those of the Blue Chip Consensus. The inflation rates, a CPI rate of 2.2 percent and 2.1 percent, while slightly below both the Blue Chip Consensus and CBO, are well within normal limits. Finance Department economists caution, however, that because this forecast calls for strong economic growth lasting for at least 5 years, the economic projections in this forecast are more likely to prove to be too optimistic than too pessimistic.

The individual income tax estimates were prepared using the House Income Tax Simulation Model. Assumed filer growth in Minnesota was consistent with average national employment growth for the years in question. All elements of income and all individual itemized deductions were assumed to grow at the growth rate of taxable personal income - the combination of wages and salaries, proprietors' incomes, dividend, interest and rents - projected by GII in their baseline forecast. Calendar year income tax liabilities were converted into fiscal year revenues using the same proportions as forecast for 2005.

Use of the GII baseline scenario for 2006 and 2007 allowed the use of the complete sales tax model to estimate sales tax revenue planning estimates. In prior years sales tax planning estimates had been made based on a model using 14 broad categories of items in Minnesota's sales tax base. Corporate tax receipts in Minnesota were estimated to grow at the same rate as GII's forecast of national before tax corporate profits. Minnesota's motor vehicle sales tax collections are expected to grow at the GII baseline growth rate for national consumption of motor vehicles and parts. The deed and mortgage tax was forecast based on the projected growth in the value of new and existing home sales. Planning estimates for other tax and non-tax revenues were prepared by extrapolating existing trends.

Expenditure Estimates
FY 2004-07

FY 2004-05 Biennial Budget Expenditure Estimates

Projected state general fund expenditures for FY 2004-05 total $30.975 billion, up 14.3 percent from spending estimates for the current biennium. The November 2002 expenditure forecast for the FY 2004-05 biennium totals $30.975 billion, a $926 million increase from the comparable estimates at the end of the 2002 legislative sessions. Increased health care and human service spending accounts for nearly two-thirds of the change from end-of-session estimates.

FY 2004-05 Expenditures Estimates
($ in millions)

	FY2002-03	FY2004-05	$ Difference	% Change
Education Finance	$10,660	$12,772	$2,112	19.8
Higher Education	2,807	2,911	104	3.7
Intergovernmental Aids	2,758	3,090	332	12.0
Health Care	4,815	5,935	1,120	23.3
Health & Human Services	1,951	2,185	234	12.0
Environmental Resources	486	514	28	5.8
Economic & Workforce Development	400	359	(41)	(10.3)
Public Safety & Corrections	947	979	32	3.4
Transportation	430	162	(268)	(62.3)
General Government	1,180	1,210	30	2.5
Debt Service	581	695	114	19.6
Capital Projects	2	0	(2)	nm
Estimated Cancellations	(15)	(20)	(5)	33.3
Subtotal-Major Spending Categories	**27,002**	**30,792**	**3,790**	**14.0**
Dedicated Expenditures	98	183	85	86.7
Total Expenditures	**$27,100**	**$30,975**	**$3,875**	**14.3**

Major growth areas in state spending for FY 2004-05 over the current biennium continue to be health care, heath and human services, intergovernmental aids, and education finance. Net spending in all other categories is actually projected to decrease due to a significant amount of one-time appropriations in FY 2002-03. General Fund appropriations for transportation are an example.

FY 2004-05 Expenditures Forecast Changes
($ in millions)

	End of Session	November Forecast	Difference
Education Finance	$12,686	$12,772	$86
Higher Education	2,855	2,911	56
Intergovernmental Aids	3,044	3,090	46
Health Care	5,393	5,935	542
Health & Human Services	2,110	2,185	75
Environmental Resources	508	514	6
Economic & Workforce Development	351	359	8
Public Safety & Corrections	949	979	30
Transportation	162	162	0
General Government	1,209	1,210	1
Debt Service	687	695	8
Estimated Cancellations	(20)	(20)	0
Subtotal-Major Spending Categories	**29,934**	**30,792**	**858**
Dedicated Expenditures	115	183	68
Total Expenditures	**$30,049**	**$30,975**	**$926**

FY 2004-05 Base Expenditures are Starting Point for Budget Planning

FY 2004-05 "base" expenditure estimates are the starting point for decisions on the next budget. The expenditure estimates represent the cost of current law for major forecast items extended into the next biennium adjusted only for enrollment, caseload, or cost increases in current law or formula. For individual agency operating budgets or grants, FY 2003 appropriations are carried forward and adjusted for one-time items, specific increases in law, and a limited number of technical items.

This forecast differs from recent forecasts in one important respect. The estimated impact of inflation on salaries and benefits, goods, or services is *not* included in the baseline forecast for programs. This change in forecast practice was made in accordance with 2002 session legislative changes incorporated into the statute governing forecast preparation.

Spending Growth is distorted by Recent Budget Actions

Even without considering inflation some level of current law growth from one biennium to the next is common. This occurs normally as increases from the first to the second year in the current biennium carry forward into the following two years. Secondly, there are "fiscal tails" – costs reflected for only a single year or part of the current biennium that are fully reflected in each of the next two years.

However, the 14 percent current law expenditure increase shown for FY 2004-05 is unusually large. The size of the increase is driven primarily by the impact of 2001 property tax reform and relief that is incorporated into education finance as well as FY 2003 payment shifts or one-time cuts enacted as part of the 2002 legislative budget solution.

Of the total $2.1 billion increase shown for Education Finance, approximately $1.0 billion represents the cost of property tax reform to Education Finance. It represents the cost of the state assumption of the general education property tax levy and the school portion of intergovernmental aids reduction, accounts for nearly one-half of the growth shown for Education Finance in FY 2004-05. The education payment shift to an 83-17 payment schedule, which was enacted in 2002, had a similar impact. It was a one-time $454 million reduction in FY 2003 spending that bumps back up in FY2004 and FY 2005.

These two items account for over $1.4 billion of the FY 2004-05 increase. If these "distortions" were factored out, biennial growth for education finance would be approximately $670 million or about 6.3 percent.

Of the remaining areas and growth in spending, health care growth is the single largest factor driving increases in forecast spending for the next biennium. Driven by rising health care costs and growing caseloads spending will grow by $1.120 billion, up $542 million from end-of-session estimates.

Increases projected for other forecast areas are more modest. Enrollments and caseload growth are the primary factors affecting higher education and corrections forecast spending, while increases for intergovernmental aid programs are largely driven by a formula that includes an inflation factor for Local Government Aid and by projected growth in property tax refund programs.

FY 2006-07 Expenditure Projections are Relatively Flat

The growth shown for FY 2006-07 expenditures is lower than that for shown for FY 2004-05. Total spending can be expected to increase $1.279 billion, 4.1 percent over FY 2004-05 levels. Absent the one-time distortions, spending growth flattens. For all the major forecast areas, from education finance to heath care and intergovernmental aids, the growth trend remains the same as described for FY 2004 and FY2005 -- with the health care and human services forecast accounting for the largest portion of the growth.

FY 2006-07 Expenditure Planning Estimates Grow by 4.1 Percent

The 2006-07 planning estimates project expenditures beyond the upcoming budget biennium. These out-year estimates provide a baseline from which to measure the longer-term affordability of policy choices that might be considered in the 2003 legislative session.

FY 2006-07 Planning Estimates
($ in millions)

	FY 2004-05	FY 2006-07	$ Difference	% Change
Education Finance	$12,772	$12,854	$82	0.6
Higher Education	2,911	2,900	(11)	(0.4)
Intergovernmental Aids	3,090	3,194	104	3.4
Health Care	5,935	6,859	924	15.6
Health & Human Services	2,185	2,208	23	1.1
Environmental Resources	514	500	(14)	(2.7)
Economic & Workforce Development	359	358	(1)	(0.3)
Public Safety & Corrections	979	1,018	39	4.0
Transportation	162	162	0	0.0
General Government	1,210	1,273	63	5.2
Debt Service	695	760	65	9.4
Estimated Cancellations	(20)	(20)	0	0.0
Subtotal-Major Spending Categories	**30,792**	**32,066**	**1,274**	**4.1**
Dedicated Expenditures	183	188	5	2.7
Total Expenditures	**$30,975**	**$32,254**	**$1,279**	**4.1**

All FY 2006-07 expenditure projections begin with the forecast level of spending for FY 2005. Like the estimates for FY 2004-05, these projections are based on current law, only incorporating forecast caseload, enrollment changes, and formulae in current law. The planning estimates are not adjusted for the potential impact of inflation.

Education Finance Grows to $12.8 Billion in FY 2004-05

Education Finance will grow to $12.8 billion in the next biennium, up $2.1 billion from FY 2002-03, primarily reflecting the annualized effect of two significant decisions of the 82nd Legislature. The largest changes are a $1.4 billion increase to K-12 aids and a $432 million reduction in school intergovernmental aids, both due to the state assumption of the cost of the General Education levy as part of the property tax reforms of the 2001 legislative session. An additional $454 million of this biennial increase is due to a delay, or "shift," in the timing of school aid payments that reduced expected spending in the

2002-03 biennium by this amount. Neither change reflects new revenue to school districts, but simply reflects a change in timing and composition of the funds they receive.

General Education

Within General Education, the economic assumptions of the forecast again drive compensatory estimates up for FY 04-05, with compensatory spending expected to be $120 million higher than in the 2002-03 biennium.

Referendum revenue will also grow by $101 million (aid + levy) in the next biennium, with an increasing proportion of funding coming from levy proceeds and a declining portion from state sources. These figures are higher than previous projections due to a passage rate of 74.4% in the November elections, compared to the 50% rate used in previous estimates.

Categorical Aids

Charter school lease aid is projected to grow by $14.8 million over current levels, reflecting the combination of rising numbers of students in charter schools as well as higher per pupil lease costs. Debt service equalization is estimated to grow by $17.1 million, primarily due to anticipated new debt and capital loan refunding. In addition, community education is estimated to decline by $11.6 million, primarily as result of a projected increase of 11 percent in local adjusted net tax capacity.

Special education aid and special education excess cost aid both grow significantly in the 2004-05 biennium, though most of this growth is due to the change in payment timing described above. However, both also have statutory annual inflation factors, of 4.6% in special education and 2.0% in excess cost aid. Adult basic education (ABE) is projected to grow by $13.3 million. This also reflects the change in payment timing as well as a statutory growth factor of 8.0% per year.

Education Finance Will Grow $82 Million in FY 2006-07 Biennium

Higher spending projections for FY 2006-07 are mainly due to growth in a few categorical programs that are offset by a decrease in General Education.

General Education

General Education is projected to decline by $84 million, largely related to lower projections for compensatory education. Estimates for pupil counts are essentially flat, resulting in few changes in the basic component of General Education.

Categorical Aids

Growth is forecast in special education and special education excess cost aid, primarily driven by statutory inflation factors. The programs are projected to grow by $111.6 million over FY 2004-05.

Spending for charter school programs is also expected to rise by almost $20 million in 2006-07, largely attributable to charter school lease aid and rising numbers of students in charter schools.

Programs in the Family & Early Childhood Education area are forecast to grow $12.8 million above 2004-05 levels. This is primarily attributable to growth in the adult basic education program.

Spending on School Intergovernmental Aids will also be slightly higher in FY 2006-07, totaling $187 million, an increase of $9.2 million over 2004-05.

Post-Secondary Education Spending Increases by $104 Million in FY 2004-05

FY 2004-05 spending for post-secondary education is projected to increase by $104 million over FY 2002-03. The increase is primarily related to two factors: the biennial cost of increases to the University and MnSCU that occurred from FY 2002 to FY 2003 ($50 million), and the effect of growing enrollment ($54 million).

Of the first category, the largest component reflects the full two-year cost of FY 2003 appropriation increases extended into FY 2004-05, $16 million in MnSCU and $13 million for the University of Minnesota. One-time reductions to MnSCU in FY 2002-03 bump back up adding $27 million to the biennial comparison, in part offset by a $3.6 million legislatively mandated decrease in their FY 2004-05 base appropriation. The University of Minnesota also received a base reduction of $4 million in the FY 2004-05 biennium. A base increase to the College Savings Program and carry forward in Higher Education Services Office programs, offset by one-time reductions, result in a $2 million increase over the current biennium.

The $54 million related to enrollment reflect the funding formula that triggers charges to higher education funding when a two-percent change in full-year equivalent enrollment occurs at the institutions. Such changes are made based on 65 percent of the instructional services base. MnSCU changes include some estimates for forecasted enrollment, while the University of Minnesota requests adjustments based on actual enrollment. The $54 million in forecasted enrollment adjustments includes $40 million for MnSCU, of which $13 million is a one-time adjustment for FY 2001-02 to revise prior estimates for actual enrollment. The University of Minnesota's actual enrollment adjustments total $15 million, net of a decrease of $3 million for enrollments that did not materialize in prior years.

The increase shown for higher education spending is $56 million over end-of-session estimates. Most of this increase, $54 million, is due to the inclusion of enrollment adjustments in the November forecast estimates. The remaining change reflects funds that were carried forward from FY2002-03 in the Higher Education Services Office's MnLink, and Learn & Earn programs.

Intergovernmental Aids Will Increase $332 Million in FY 2004-05

Non-School Intergovernmental Aid expenditures for FY 2004-05 are expected to be $3.09 billion, an increase of $332 million (12.0 percent) over current biennium. The 2001 property tax reform added approximately $265 million in net non-school intergovernmental aids (excluding TIF grants) in FY 2003. Simply extending this to two full years in FY 2004-05, accounts for the majority of the projected growth. Major increases include:

- $432.7 million because the new Market Value Homestead Credit, the Market Value Ag Land Credit, and the large FY 2003 increase in LGA are carried for two full years.
- $141.6 million in homeowner, renter and targeted property tax refunds caused by higher local levies and lower household income than previously expected.
- $61.5 million for new aid programs including Out of Home Placement aid and the ForestLand Credit program.
- $47.1 million from inflationary growth in LGA, Criminal Justice and Family Preservation Aid as provided by formula in statute.
- $19.4 million in Police and Fire pension aids due to rapid escalation in premiums for personal property insurance that is the funding source for this aid.

These increases from the current biennium to FY 2004-05 are offset, in part, by other reductions that occur including:

- $340.5 million in HACA as FY 2003 reductions become permanent and new reductions offset court takeover costs and new out-of-home placement aid.
- $3.6 million caused by eliminating one-time programs such as Flood Abatement Aid and the Washburn-Crosby project.
- $23.8 million reflects an "artificial" reduction – in FY 2004-05 DNR (environmental resources) budgets funding for payment in lieu of taxes (PILT) payments, while the Department of Revenue (intergovernmental aid) historically pays out the funds to local units.

Intergovernmental Aid Growth Slows in FY 2006-07

Non-School Intergovernmental Aid expenditures for FY 2006-07 are expected to be $3.19 billion, an increase of $104.4 million (3.3 percent) over FY 2004-05 forecast levels. The trends for FY 2004-05 continue into succeeding years, but the significant changes between FY 2003 and FY 2004-05 from property tax reform are fully incorporated. As a result the percent growth is less. Major increases include:

- $70.5 million from inflationary growth in LGA, Criminal Justice and Family Preservation Aid mandated by statute.
- $62.5 million in homeowner and renter property tax refunds increases continuing the recent growth trend in assessed value and levies.
- $53.3 million because the Out of Home Placement Aid program will be in effect for two full years.
- $21.0 million in Police and Fire pension aids due to rapid escalation in premiums for personal property insurance (funding source).

The biennial growth is partially offset by reductions in the following items:

- $79.0 million in HACA to offset additional court takeover.
- $31.2 million in Market Value Homestead Credits due to continued assessed value growth (lowers total credit) and larger proportional share going to schools.

Health Care

"Health Care" includes state payments for direct health care services, such as hospital and physician visits, nursing home services, home care, and other medical and long-term care services. Most of the spending in this area occurs in the state's Medical Assistance (MA) program, a federal entitlement program for low-income families, persons with physical and developmental disabilities, and the frail elderly. The state and federal government split the costs for MA, while the General Assistance Medical Care (GAMC) program is funded fully by the state.

Health Care Expected to Grow $1.1 Billion in 2004-05, and $924 Million in 2006-07

All health care programs—with the exception of MA long-term care facilities grants—are expected to grow significantly over the next two biennia. Health care is one of the most rapidly growing segments of the state budget, increasing 23% in the FY 2004-05 biennium, and 16% in the FY 2006-07 biennium.

Health Care, FY 2002-2007

($ in thousands)

	FY 2002-03	FY 2004-05	FY 2006-07
MA MFIP & Families Basic Care	923,136	1,237,011	1,431,083
MA Elderly & Disabled Basic Care	1,123,199	1,456,772	1,795,583
GAMC	446,643	667,610	748,241
MA Long Term Care Waivers	1,114,398	1,405,047	1,704,329
MA Long Term Care Facilities	1,119,592	1,067,511	1,068,964
Chemical Dependency Entitlements	87,993	100,521	110,342
Total	**4,814,961**	**5,934,472**	**6,858,542**
$ Change	1,212,899	1,119,511	924,070
% Change	34%	23%	16%

Many factors contribute to the growth in the amount the state is projected to pay for health care services, including:

- increasing enrollment;
- higher cost caseloads;
- increasing service utilization among recipients;
- increases in the prices of certain services, such as inpatient hospital and prescription drugs;
- the availability of new and more expensive technology; and
- the effectiveness of purchasing arrangements and/or utilization review procedures.

Spending trends in some program areas are also driven by changes in service delivery systems, such as the transition of individuals from institutional long-term care to community-based services.

The table below shows projected annual growth in spending, enrollment, and cost per enrollee by major health care program between FY 2002 and 2007. GAMC is expected to be the fastest growing spending area (16%/yr), followed by MA basic care for families, the elderly, and disabled (13%/yr), MA long-term care waivers (12%/yr), and MA long-term care facilities (-1%/yr).

	Projected Annual Growth[1] in:		
	State Share of Spending	Monthly Avg. Enrollment	Monthly Avg. Payments
MA MFIP & Families Basic Care	13%	4%	9%
MA Elderly & Disabled Basic Care	13%	3%	9%
GAMC	16%	5%	11%
MA Long Term Care Waivers	12%	7%	5%
MA Long Term Care Facilities	(1%)	(3%)	2%
Overall	10%	4%	6%
1/ Average annual growth, FY 2002-07			

Declining projected spending in the MA long term care facilities segment reflects Minnesota's effort to move people with continuing care needs out of institutional settings and into community-based settings. The substantial enrollment growth projected for MA Long Term Care Waivers (7% per year) can be attributed, at least in part, to this trend. Costs per enrollee are anticipated to increase 11% per year in the GAMC program; 9% per year in MA basic health care; and 5% and 2% per year for MA long term care waivers and facilities, respectively.

Revised Health Care Forecast is $541 Million above End-of-Session Estimates

Forecast spending for health care programs is now expected to be $5.9 billion for the FY 2004-05 biennium, an increase of 10%, or $541 million, over end-of-session estimates. The most significant increases for the next biennium are in GAMC, MA long-term care waiver programs, and MA MFIP and families basic care.

The GAMC forecast is $210.1 million higher for the FY 2004-05 than projected at the end of session. As was noted for the FY 2002-03 biennium, an increase in projected caseloads due to a more pessimistic economic outlook accounts for the majority of the increase for the upcoming biennium. The remainder of the forecast variance for FY 2004-05 is due to a 25% increase in HMO rates for the GAMC program effective January 2003. The Department of Human services anticipates increases of this magnitude to bring GAMC capitation rates in line with the health plans' actual costs for the GAMC population.

An increase in the MA MFIP and families basic care segment of $116 million for the upcoming biennium can be attributed to: (1) an 8.6% increase in MFIP caseloads due to a slower than anticipated economic recovery; and (2) a higher than projected cost for the "Cover All Kids" legislation passed in the 2001 session. The projected cost of "Cover All Kids" has gone up because HMO rates for the affected age groups of children are higher than anticipated, and because the proportion of parents in the expansion group is greater than originally projected, also resulting in higher HMO rates for the expansion population.

Higher-than-expected average cost growth in MA long-term care waiver programs is also driving an overall forecast increase of $118.2 million. About 40% of this change can be attributed to the higher average cost assumptions in the MR/RC Waiver program discussed earlier for the current biennium. Higher caseloads and average costs for personal care and private duty nursing services (PCA/PDN), the MA Elderly Waiver (EW), and the MA Disabled Waiver (CADI) account for most of the remaining increase.

Other forecast changes in FY 2004-05 estimates include: MA basic care for the elderly and disabled ($67.5M increase), and MA long term care facilities ($20.5M increase). Again, higher average costs for the elderly and persons with disabilities account for most of the increase in the first activity. MA long-term care facility increases for the upcoming biennium are largely due to increases in the nursing home caseload forecast. Increased caseload projections—due to the fact that the state has not realized the bed closures anticipated from long term care reform legislation passed in the 2001 session—result in an increase of $34.2 million for the FY 2004-05 biennium. These nursing home increases are partially offset by reductions in expected Intermediate Care Facility for the Mentally Retarded (ICF/MR) and Day Training & Habilitation (DT&H) spending.

Health & Human Services

"Health and Human Services" is a broad set of state programs that pay for everything from direct cash welfare benefits to grants to local governments for public health infrastructure. Among the activities funded by Health and Human Services are:

- Cash welfare and food stamp benefits (Minnesota Family Investment Program)
- Child care assistance
- Prescription drug benefits
- Assisted living supports
- Child welfare grants to counties
- Adoption grants
- Operating funds for state residential treatment centers
- Operating funds for Veteran's Nursing Homes, and
- Public health grants to cities and counties.

Much of the funding in this area of the state's budget is relatively stable and consists of discretionary grants to local units of government for the provision of public health activities and social services. In addition to state funding, there are significant levels of federal funding that provide many of these services. The remaining narrative focuses on a few programs whose funding fluctuates based on estimates of demand—principally economic supports for low-income families.

Welfare reform has dramatically affected the budget for Health & Human Services. Major reform at the federal level in 1996 changed the nature of the state-federal funding arrangement for cash welfare benefits. The federal government created block grants to states to pay for their share of welfare and childcare benefits. The Temporary Assistance for Needy Families (TANF) block grant has served as a major funding source for many self-sufficiency activities in this state since the late 1990s. Minnesota, like many other states, has utilized unused TANF funding to broaden the scope of its self-sufficiency spending to go beyond the traditional cash welfare system.

Health & Human Services Spending Expected to Grow $234 Million in FY2004-05, and $23 Million in FY 2006-07

By early in the FY 2004-05 biennium, the economy is expected to show signs of improvement. As such, the baseline MFIP caseload forecast is projected to begin to slowly drop during this timeframe. Even with this improvement, spending on Health & Human Services is estimated to be $2.2 billion for the FY 2004-05 biennium, an increase of $233.5 million (11%) over the current biennium.

Biennial changes projected for entitlement programs include: (1) increases in Child Care Assistance expenditures of $40.1 million; (2) increases in GRH of $36.9 million; and (3) increases in MFIP, GA, and Minnesota Supplemental Aid (MSA), together totaling $16.4 million.

Also contributing to the change for the biennium are projected spending increases in the Prescription Drug Program ($26.6M). Although not historically recognized as a forecast program due to the program's financial management requirements in current law, the 2002 legislature directed the Department of Finance to recognize end of 2002 session estimates totaling $40.2 million for the FY 2004-05 biennium in the fund balance. Current estimates from the Department of Human Services suggest the projected program need to be lower, or $34.2 million for the same time period.

Remaining increases in the FY 2004-05 biennium can largely be explained by one-time, or time-limited, reductions to non-entitlement grants and administrative spending within the Departments of Human Services and Health that occurred in the FY 2002-03 biennium as result of 2002 legislative session actions.

Reductions in MFIP spending are apparent by the FY 2006-07 biennium, as caseload projections continue to decline with expectations of a much-improved economy. Offsetting these reductions, growth in Child Care Assistance, GRH, MSA, and Prescription Drug programs drive a smaller overall increase in spending over the previous biennium of $22.8 million in FY 2006-07.

Revised Health & Human Services Spending is $75 Million Above End-of-session Estimates

Since the end of the 2002 legislative session, the forecast for Health and Human Services programs in FY 2004-05 has increased by $74.7 million (3.5%).

Despite what appears to be downward forecast movement for the current biennium, the persistently sluggish economy has resulted in further caseload increases within the state's economic support programs.

Consequently, MFIP caseloads are projected to be 12% higher for the FY 2004-05 biennium. Together with an increase in the projected average cash grant, these caseload effects result in a forecast increase of $31.8 million for the upcoming biennium. Higher General Assistance caseload projections for both basic and emergency needs have the effect of increasing the forecast for the FY 2004-05 biennium by $9.8 million.

Child Care Assistance expenditures—in part a function of the number of MFIP cash assistance cases—are forecast to increase by $42.1 million in FY 2004-05 when compared to end of session. This change is attributable to estimated increases in both the number of families receiving childcare and the average annual cost per family.

Fiscal Year 2004-07 Debt Service Costs Based on Higher Capital Budget Assumptions

The debt service estimate for the 2004-05 biennium is $695 million, which is $8 million more than forecast at the end of session. The increase is a result of the change in the assumption on the size of future capital budgets and a decrease in investment earnings on cash balances in the debt service fund because of lower forecast interest rates.

Most of this difference results from a change in assumptions about the size of future capital budgets. Since February 1999, forecasts of debt service costs have assumed a $400 million capital budget in even-numbered years and $50 million capital budgets in odd-numbered years. Considerable discussion has occurred over the years regarding how to best forecast the size of future capital budgets and debt service costs. The November 2002 forecast changes the methodology in forecasting debt service costs by adopting a rolling, multi-year average for estimating capital budgets in even and odd-numbered years. Debt service costs will now be based on Minnesota's 10-year historical average of general obligation bonding for major capital budgets of $530 million in even-numbered years and emergency bonding bills of $87 million in odd-numbered years. This new approach reflects a reasonable probability that significantly sized capital budgets will be adopted in the future and budget forecasts will reflect increased pressure on debt service costs.

The forecast debt service for the 2006-07 biennium is $760 million. This is an increase of $65 million over the amount estimated for the 2004-05 biennium.

All Other FY 2004-05 Spending will decline from the Current Levels

The majority of state agencies and programs, outside the major forecast areas, will show little change from the FY 2002-03 biennium to projected spending for FY 2004-05. The reason for this is twofold. Generally, FY 2003 appropriations are carried forward as the base for FY 2004-05 spending. However, one-time appropriations do not continue and are reduced in the base spending levels for the next biennium. Some of the unique factors, however are highlighted below:

Environmental Resources

The $28 million increase in FY 2004-05 general fund spending in the environment is the net result of two factors:

An artificial distortion accounts for $27 million. DNR has an open appropriation for payment in lieu of tax (PILT) payments. However, DNR transfers the money to Revenue, who makes the payment. Consequently, history shows "$0" while FY 2004-05 shows the estimated amount required for the next two years.

The remainder is primarily the effect of one-time reductions in general fund appropriations in PCA and OEA in FY 2003. Solid waste funds were used one-time to supplement general fund supported programs in FY 2003. In FY 2004-05, the general funds portion returns.

Economic and Workforce Development

The $41 million (10.3 percent) decline from the current biennium to FY 2004-05 is the result of one-time appropriations not continuing into the next budget period. The largest of these changes were $24 million for the affordable rental investment and $13.2 million for the dislocated worker program.

Public Safety and Corrections

The cost of correctional services, including adult institutions, community services and juvenile services, will increase $60 million in FY 2004-05. This includes $55 million for increasing numbers of inmates the state must house, a legislatively mandated reduction of $13 million in FY 04-05 and other miscellaneous increases of $18 million. Current year prison populations are nearly 300 more than forecast one year ago. The department of corrections projects total inmates at 7,288 by the end of FY 2003 and 8,172 by the end of FY 2005.

Further, the cost of correctional services, including adult institutions, community services and juvenile services, is estimated to increase an additional $35 million in FY 2006-07 planning estimates. Virtually all of this change is for additional inmates projected in that biennium, estimated to total 8,753 by the end of FY 2007.

Transportation

Transportation expenditures for 2004-05 are lower than spending for 2002-03 by $268 million. This difference is due largely to two factors. The first is the one-time funds appropriated for road construction in 2000 that were carried forward into 2002-03 ($264 million less $10.1 million refinanced to bonds, and $2.7 million due to professional-technical contract reductions). The second is the combination of a reduction in direct appropriations for Metropolitan Council Transit from 2002-03 to 2004-05 ($7.7 million) and a $5 million one-time appropriation in 2002 to Metropolitan Council Transit for transition costs related to the change from property tax to MVET funding.

General Government

The cost of the state's trial courts is estimated to increase $120 million in FY 2004-05. Of this increase, $99 million is for continuation of the state takeover of locally funded court costs. Nearly 80% of those costs are offset by fine revenues redirected to the state and decreases in HACA to counties no longer responsible for those costs. The remainder of the difference is primarily for salary and benefit increases and other costs of a growing court caseload.

The cost of the state's trial courts is estimated to grow an additional $67 million in FY 2006-07 planning estimates. Most of this increase is projected for the completion of the state takeover of locally funded costs in that biennium. A majority of those cost increases will likely be offset by fine revenues redirected to the state and decreases in HACA to counties no longer responsible for those costs.

Selected Constitutional And Statutory Provisions

Minnesota State Constitution Article XI- Appropriations and Finances

Section 6 – Certificates of Indebtedness

As authorized by law certificates of indebtedness may be issued during a biennium, commencing on July 1 in each odd-numbered year and ending on and including June 30 in the next odd-numbered year, in anticipation of the collection of taxes levied for and other revenues appropriated to any fund of the state for expenditure during that biennium.

No certificates shall be issued in an amount which with interest thereon to maturity, added to the then outstanding certificates against a fund and interest thereon to maturity, will exceed the then unexpended balance of all money which will be credited to that fund during the biennium under existing laws. The maturities of certificates may be extended by refunding to a date not later than December l of the first full calendar year following the biennium in which the certificates were issued. If money on hand in any fund is not sufficient to pay all non-refunding certificates of indebtedness issued on a fund during any biennium and all certificates refunding the same, plus interest thereon, which are outstanding on December 1 immediately following the close of the biennium, the state auditor shall levy upon all taxable property in the state a tax collectible in the ensuing year sufficient to pay the same on or before December 1 of the ensuing year with interest to the date or dates of payment. Selected Statutory Provisions (revised)

Minnesota Statutes 16A.152 Budget reserve and cash flow account.

Subdivision 1. Cash flow account established.

(a) A cash flow account is created in the general fund in the state treasury. Beginning July 1, 2003, the commissioner of finance shall restrict part or all of the balance before reserves in the general fund as may be necessary to fund the cash flow account, up to $350,000,000.

(b) The amounts restricted are transferred to the cash flow account and shall remain in the account until drawn down and used to meet cash flow deficiencies resulting from uneven distribution of revenue collections and required expenditures during a fiscal year.

Subd. 1a. Budget reserve. A budget reserve account is created in the general fund in the state treasury. The commissioner of finance shall transfer to the budget reserve account on July 1 of each odd-numbered year any amounts specifically appropriated by law to the budget reserve.

Subd. 1b. Budget reserve increase. On June 30, 2003, the commissioner of finance shall transfer $3,900,000 to the budget reserve account in the general fund. On June 30, 2004, the commissioner of finance shall transfer $12,300,000 to the budget reserve account in the general fund. On June 30, 2005, the commissioner of finance shall transfer $12,000,000 to the budget reserve account in the general fund. The amounts necessary for this purpose are appropriated from the general fund.

Subd. 2. Additional revenues; priority. If on the basis of a forecast of general fund revenues and expenditures, the commissioner of finance determines that there will be a positive unrestricted budgetary general fund balance at the close of the biennium, the commissioner of finance must allocate money to the budget reserve until the total amount in the account equals $653,000,000.

The amounts necessary to meet the requirements of this section are appropriated from the general fund within two weeks after the forecast is released.

Subd. 3. Use. The use of the budget reserve should be governed by principles based on the full economic cycle rather than the budget cycle. The budget reserve may be used when a negative budgetary balance is projected and when objective measures, such as reduced growth in total wages, retail sales, or employment, reflect downturns in the state's economy.

Subd. 4. Reduction.
(a) If the commissioner determines that probable receipts for the general fund will be less than anticipated, and that the amount available for the remainder of the biennium will be less than needed, the commissioner shall, with the approval of the governor, and after consulting the legislative advisory commission, reduce the amount in the budget reserve account as needed to balance expenditures with revenue.

(b) An additional deficit shall, with the approval of the governor, and after consulting the legislative advisory commission, be made up by reducing unexpended allotments of any prior appropriation or transfer. Notwithstanding any other law to the contrary, the commissioner is empowered to defer or suspend prior statutorily created obligations, which would prevent effecting such reductions.

(c) If the commissioner determines that probable receipts for any other fund, appropriation, or item will be less than anticipated, and that the amount available for the remainder of the term of the appropriation or for any allotment period will be less than needed, the commissioner shall notify the agency concerned and then reduce the amount allotted or to be allotted so as to prevent a deficit.

(d) In reducing allotments, the commissioner may consider other sources of revenue available to recipients of state appropriations and may apply allotment reductions based on all sources of revenue available.

(e) In like manner, the commissioner shall reduce allotments to an agency by the amount of any saving that can be made over previous spending plans through a reduction in prices or other cause.

Subd. 5. Restoration. The restoration of the budget reserve should be governed by principles based on the full economic cycle rather than the budget cycle. Restoration of the budget reserve should occur when objective measures, such as increased growth in total wages, retail sales, or employment, reflect upturns in the state's economy. The budget reserve should be restored before new or increased spending commitments are made.

Subd. 6. Notice to committees. The commissioner shall notify the committees on finance and taxes and tax laws of the senate and the committees on ways and means and taxes of the house of representatives of a reduction in an allotment under this section. The notice must be in writing and delivered within 15 days of the commissioner's act. The notice must specify:
(1) the amount of the reduction in the allotment;
(2) the agency and programs affected;

(3) the amount of any payment withheld; and
(4) any additional information the commissioner determines is appropriate.

Subd. 7. Delay; reduction. The commissioner may delay paying up to 15 percent of an appropriation to a special taxing district or a system of higher education in that entity's fiscal year for up to 60 days after the start of its next fiscal year. The delayed amount is subject to allotment reduction under subdivision 4.

HIST: 1973 c 492 § 23; 1978 c 793 § 47; 1981 c 1 § 2; 1 Sp1981 c 5 § 1; 2Sp1981 c 1 § 3; 3Sp1981 c 1 art 1 § 1; 3Sp1981 c 2 art 2 § 3; 1983 c 342 art 18 § 1-3; 1984 c 502 art 1 § 1; 1984 c 628 art 2 § 1; 1Sp1985 c 14 art 18 § 1,2,4; 1 Sp1986 c 1 art 5 s 1-3; 1987 c 268 art 18 § 1-3; 1988 c 690 art 2 § 1; 1988 c 719 art 13 § 1,2; 1989 c 329 art 1 § 1; 1Sp1989 c 1 art 15 § 1,2; 1990 c 604 art 10 § 4; 1991 c 291 art 21 § 2; 1992 c 511 art 9 § 1; 1993 c 192 § 58-63,111; 1993 c 375 art 17 § 1,2; 1994 c 632 art 5 § 1; 1994 c 647 art 1 § 1; 1995 c 264 art 6 § 1; 1Sp1995 c 3 art 14 § 1-3; 1996 c 461 § 1; 1996 c 471 art 10 § 1; 1997 c 231 art 9 § 1; 1998 c 389 art 9 § 1; 1Sp2001 c 5 art 20 § 2,3; 1 Sp2001 c 10 art 2 § 24; 2002 c 220 art 13 § 3-5; 2002 c 377 art 12 § 1

Alternative Forecast Comparison

Real GDP (Annual Rates)

	02 III	02V	03I	03II	03III	03IV	02A	03A	04A
DRI Control (11-02)	3.1	0.7	3.1	2.8	3.4	4.2	2.3	2.6	4.1
Blue Chip (11-02)	3.1	1.6	2.7	3.3	3.6	3.7	2.3	2.8	NA
Economy.Com (11-02)	3.1	1.4	2.4	NA	NA	NA	2.3	2.5	NA
American Express (11-02)	3.1	2.4	3.1	3.0	4.1	4.0	3.0*	3.5*	NA
UBS Warburg/Paine Webber (11-02)	3.1	1.8	2.5	4.5	3.5	3.5	2.5	3.0	3.1

Consumer Price Index (Annual Rates)

	02 III	02V	03I	03II	03III	03IV	02A	03A	04A
DRI Control (11-02)	1.9	2.5	2.1	2.1	2.6	2.4	1.6	2.3	2.4
Blue Chip (11-02)	1.9	2.3	2.2	2.0	2.2	2.3	1.6	2.2	NA
Economy.Com (11-02)	1.9	1.9	1.9	NA	NA	NA	1.6	2.0	NA
American Express (11-02)	1.9	2.4	2.5	2.0	3.0	3.2	1.9*	2.3*	2.7
UBS Warburg/Paine Webber (11-02)	1.9	2.9	2.3	2.1	2.3	2.6	1.6	2.4	2.3

* 4Q/4Q

Forecast Comparisons

Real Economic Growth
(Annual Percent Change in Real GDP)

	2002	2003	2004	2005	2006	2007
Nov 98 DRI Control	1.7[1]	1.7[1]				
Feb 99 DRI Control	1.7[1]	1.7[1]				
Nov 99 DRI Control	2.0[2]	2.0[2]				
Feb 00 DRI Control	3.4	2.0[2]				
Nov 00 DRI Control	4.3	4.8	3.2[3]	3.2[3]		
Feb 01 DRI Control	4.0	4.8	3.2[3]	3.2[3]		
Nov 01 DRI Control	0.4	4.4	3.8	3.2[3]		
Feb 02 DRI Control	1.0	4.0	3.9	3.2[3]		
Nov 02 GII Baseline	2.3	2.6	4.1	3.8	3.5	3.1

Inflation
(Annual Percent Change in CPI-U)

Nov 98 DRI Control	2.8	2.9				
Feb 99 DRI Control	2.4	2.5				
Nov 99 DRI Control	2.6	2.8				
Feb 00 DRI Control	2.5	2.6				
Nov 00 DRI Control	1.7	1.9	2.4[3]	2.7[3]		
Feb 01 DRI Control	1.8	1.6	2.4[3]	2.7[3]		
Nov 01 DRI Control	1.9	2.4	2.6	2.7[3]		
Feb 02 DRI Control	1.4	2.4	2.5	2.7[3]		
Nov 02 GII Baseline	1.6	2.3	2.4	2.3	2.2	2.1

(1) Long-term trend from DRI Cyclelong, Summer 1998
(2) Long-term trend from DRI Cyclelong, Summer 1999
(3) 10 year trend from DRI Early Recession (Pessim), November, 2000

Minnesota - U.S. Comparison Report

November 2002 Control

(Annual Percent Changes)

	1999	2000	2001	2002	2003	2004	2005
Wage and Salary Income							
United States	6.6	8.2	2.4	1.4	4.1	6.7	6.0
Minnesota	6.6	8.5	2.9	0.9	3.9	6.4	6.3
Implied Annual Wage							
United States	4.1	5.9	2.2	2.2	3.2	4.2	4.3
Minnesota	4.2	6.0	2.9	1.7	3.3	4.4	4.5
Non-Farm Employment							
United States	2.4	2.2	0.2	-0.8	0.9	2.5	1.7
Minnesota	2.3	2.4	-0.1	-0.7	0.5	1.9	1.8
Personal Income							
United States	4.9	8.0	3.3	3.0	4.2	5.9	5.9
Minnesota	4.7	7.6	2.9	2.5	4.1	6.0	6.0

Comparison of Actual and Estimated Non-Restricted Revenues
Fiscal Year-To-Date Through October 2002
($ in Thousands)

	Forecast Revenues	Actual Revenues	Variance Act-Fcst
Individual Income Tax			
Withholding	1,602,633	1,573,977	(28,656)
Declarations	232,563	211,382	(21,181)
Miscellaneous	63,636	66,139	2,503
Gross	1,898,832	1,851,498	(47,334)
Refund	41,999	57,768	15,769
Net	1,856,833	1,793,730	(63,103)
Corporate & Bank Excise			
Declarations	191,784	164,420	(27,363)
Miscellaneous	43,815	50,971	7,157
Gross	235,598	215,391	(20,207)
Refund	19,000	34,971	15,971
Net	216,598	180,420	(36,178)
Sales Tax			
Gross	1,284,582	1,285,100	518
Refunds	71,000	60,335	(10,665)
Net	1,213,582	1,224,765	11,183
2001 Sales Tax Rebates	0	-965	(965)
Motor Vehicle Sales	90,095	103,751	13,656
Other Revenues			
Inherit/Gift/Estate	19,000	78,394	59,394
Liquor/Wine/Beer	19,995	21,368	1,373
Cigarette/Tobacco/Cont Sub	59,116	63,407	4,291
Deed and Mortgage	61,056	84,627	23,571
Insurance Gross Earnings	53,000	49,556	(3,444)
Lawful Gambling	16,099	15,741	(358)
Health Care Surcharge	45,056	46,305	1,249
Other Taxes	659	914	255
Statewide Property Tax	0	1,047	1,047
DHS RTC Collections	16,580	19,471	2,891
Income Tax Reciprocity	0	0	0
Investment Income	10,000	9,672	(328)
Tobacco Settlement	0	0	0
Departmental Earnings	60,682	60,435	(247)
Lottery Revenues	9,628	7,167	(2,461)
Revenues yet to be allocated	0	2,015	2,015
Residual revenues	16,280	21,467	5,187
Other Subtotal	**387,151**	**480,621**	**93,470**
Other Refunds	**3,393**	**9,321**	**5,928**
Other Net	**383,758**	**471,300**	**87,543**
Total Gross	**3,896,258**	**3,936,361**	**40,103**
Total Refunds	**135,392**	**162,395**	**27,002**
Total Net	**3,760,866**	**3,773,967**	**13,101**

Factors Affecting the Individual Income Tax

($ in billions)

	Calendar Year					
	2000	2001	2002	2003	2004	2005
Minnesota Non-Farm Tax Base						
November 1998 Control	123.620	128.830				
February 1999 Control	125.150	130.330				
November 1999 Control	126.630	133.200				
February 2000 Control	127.870	134.090				
November 2000 Control	138.670	146.530	155.040	165.080		
February 2001 Control	139.420	145.300	152.840	162.610		
November 2001 Control	139.610	144.440	146.880	155.990		
February 2002 Control	139.610	143.910	145.890	153.470		
November 2002 Control	139.930	144.070	147.215	152.808	162.343	172.910
Minnesota Wage and Salary Income						
November 1998 Control	91.370	95.761				
February 1999 Control	91.969	96.329				
November 1999 Control	95.060	100.590				
February 2000 Control	95.600	100.500				
November 2000 Control	96.555	102.910	109.420	116.870		
February 2001 Control	97.350	102.290	108.100	115.190		
November 2001 Control	96.490	100.340	102.920	109.210		
February 2002 Control	96.490	99.840	101.910	107.140		
November 2002 Control	96.488	99.765	101.843	105.830	112.573	119.653
Minnesota Property Income						
November 1998 Control	23.438	23.891				
February 1999 Control	24.317	24.821				
November 1999 Control	22.523	23.243				
February 2000 Control	22.984	23.956				
November 2000 Control	32.711	33.690	35.015	36.754		
February 2001 Control	32.670	33.216	34.163	36.102		
November 2001 Control	33.339	33.868	33.184	35.201		
February 2002 Control	33.339	33.851	33.466	35.074		
November 2002 Control	33.062	33.763	34.297	35.244	37.289	40.070
Minnesota Proprietors' Income						
November 1998 Control	8.808	9.182				
February 1999 Control	8.867	9.181				
November 1999 Control	9.045	9.365				
February 2000 Control	9.288	9.636				
November 2000 Control	9.405	9.938	10.607	11.455		
February 2001 Control	9.407	9.800	10.570	11.323		
November 2001 Control	9.778	10.232	10.779	11.586		
February 2002 Control	9.778	10.216	10.515	11.256		
November 2002 Control	10.280	10.543	11.077	11.732	12.478	13.188

Factors Affecting Sales Tax, Corporate Income Tax, and Sales Tax on Motor Vehicles

($ in billions)

	Fiscal Year					
	2000	2001	2002	2003	2004	2005
SALES TAX						
Minnesota's Proxy Share of U.S. Consumer Durable Spending (Excluding Autos)						
November 1998 Control	10.207	10.662				
February 1999 Control	10.456	10.828				
November 1999 Control	10.442	11.041				
February 2000 Control*	9.648	10.100				
November 2000 Control	9.875	10.512	11.124	11.978		
February 2001 Control**	10.307	10.783	11.180	12.043		
November 2001 Control*	10.193	10.725	10.477	10.784		
February 2002 Control	10.193	10.723	10.740	10.843		
November 2002 Baseline*	10.052	10.404	10.806	11.146	11.733	12.451
Minnesota's Proxy Share of U.S. Capital Equipment Spending						
February 1998 Control						
November 1998 Control	10.743	11.224				
February 1999 Control	11.103	11.461				
November 1999 Control	11.519	12.189				
February 2000 Control*	11.362	12.161				
November 2000 Control	11.243	12.887	13.717	14.577		
February 2001 Control	11.267	12.272	12.850	13.868		
November 2001 Control*	10.913	11.475	9.671	9.812		
February 2002 Control	10.913	11.474	9.683	9.850		
November 2002 Baseline	10.309	10.535	11.032	11.377	12.105	12.792
November 2002 Baseline*	10.768	10.998	9.799	10.252	10.693	11.579
Minnesota's Proxy Share of U.S. Construction Spending						
November 1998 Control	6.620	6.927				
February 1999 Control	6.872	7.081				
November 1999 Control	7.278	7.671				
February 2000 Control*	7.404	7.540				
November 2000 Control	7.595	7.677	7.985	8.507		
February 2001 Control	7.595	7.818	7.955	8.386		
November 2001 Control*	7.545	8.152	8.438	8.545		
February 2002 Control	7.545	8.152	8.345	8.420		
November 2002 Baseline*	7.582	8.227	8.467	8.337	8.612	9.424

* Reflects data revision.

** Reflects change in data definition

Factors Affecting Sales, Corporate Income And Sales Tax on Motor Vehicles

($ in billions)

	Fiscal Year					
	2000	2001	2002	2003	2004	2005
SALES TAX (Cont.)						
Minnesota's Non-Farm Personal Income						
November 1998 Control	141.19	147.71				
February 1999 Control	142.42	148.03				
November 1999 Control*	141.35	147.91				
February 2000 Control	142.37	149.75				
November 2000 Control	152.34	161.70	170.86	181.54		
February 2001 Control	152.78	161.59	169.03	179.41		
November 2001 Control	151.24	161.58	163.61	174.93		
February 2002 Control	157.17	162.38	165.28	173.63		
November 2002 Control	151.51	162.41	166.54	173.04	181.57	192.47
SALES TAX ON MOTOR VEHICLES						
Minnesota's Proxy Share of U.S. Consumption of Motor Vehicle and Parts						
November 1998 Control	5.718	5.900				
February 1999 Control	5.803	6.039				
November 1999 Control*	6.425	6.519				
February 2000 Control	6.574	6.517				
November 2000 Control	6.646	6.671	6.764	7.452		
February 2001 Control	6.630	6.444	6.566	7.080		
November 2001 Control	6.780	7.097	7.007	7.484		
February 2002 Control	6.894	7.163	7.403	7.506		
November 2002 Control	6.737	6.939	7.493	7.353	7.568	7.361
CORPORATE FRANCHISE TAX		Calendar Year				
U.S. Corporate Profits						
November 1998 Control	697.4	710.9	697.4	710.9		
February 1999 Control	678.9	688.4	678.9	688.4		
November 1999 Control*	883.8	894.2	883.8	894.2		
February 2000 Control	849.7	823.4	849.7	823.4		
November 2000 Control	940.7	910.0	993.5	1,089.0		
February 2001 Control	929.5	892.2	1,006.3	1,066.2		
November 2001 Control	845.4	663.6**	685.7	761.2		
February 2002 Control	845.4	631.9**	722.1	786.0		
November 2002 Control	782.3	670.2	662.2	771.1	873.5	871.0

* Data Revision.

** Finance Dept Estimate

Current Biennium Forecast Comparison
November 2002 vs End of Session
($ in thousands)

	9-02 Enacted FY 2002-03	11-02 Fcst FY 2002-03	$ Difference
Actual & Estimated Resources			
Balance Forward From Prior Year	1,574,200	1,574,200	0
Current Resources:			
Net Non-Dedicated Revenue			
Individual Income Tax	11,782,600	11,013,542	(769,058)
Sales Tax	7,613,602	7,675,548	61,946
Corporate Income Tax	1,157,790	1,071,158	(86,632)
Motor Vehicle Sales Tax	692,629	701,425	8,796
Statewide Property Tax	890,851	893,837	2,986
Tobacco Settlements	301,206	314,295	13,089
Other Non-Dedicated Revenue	2,878,424	2,979,321	100,897
Subtotal Net Non-Dedicated Revenue	25,317,102	24,649,126	(667,976)
Dedicated Revenue	92,861	102,968	10,107
Transfers In	369,171	375,393	6,222
Prior Year Adjustments	(10,826)	66,261	77,087
Subtotal Current Resources	25,768,308	25,193,748	(574,560)
Total Resources Available	**27,342,508**	**26,767,948**	**(574,560)**
Actual & Estimated Spending by Function			
Education Finance	10,660,574	10,659,710	(864)
Higher Education	2,807,841	2,806,480	(1,361)
Intergovernmental Aids	2,762,569	2,758,324	(4,245)
Health Care	4,707,704	4,814,961	107,257
Health & Human Services	2,001,728	1,951,175	(50,553)
Environmental Resources	495,756	486,037	(9,719)
Economic & Workforce Development	402,339	400,208	(2,131)
Public Safety & Corrections	957,702	946,522	(11,180)
Transportation	424,016	430,124	6,108
General Government	1,122,675	1,179,690	57,015
Debt Service	613,970	581,047	(32,923)
Capital Projects	2,146	2,146	0
Estimated Cancellations	(27,800)	(15,000)	12,800
Subtotal - Major Spending Categories	26,931,220	27,001,424	70,204
Dedicated Expenditures	92,861	98,164	5,303
Total Expenditures & Transfers	**27,024,081**	**27,099,588**	**75,507**
Balance Before Reserves	**318,427**	**(331,640)**	**(650,067)**
Budget Reserve	318,427	23,900	(294,527)
Budgetary Balance	**0**	**(355,540)**	**(355,540)**

November 2002 General Fund Forecast
Current Biennium
($ in thousands)

	Actual FY2002	11-02 Fcst FY 2003	11-02 Fcst FY 2002-03
Actual & Estimated Resources			
Balance Forward From Prior Year	1,574,200	1,130,269	1,574,200
Current Resources:			
Net Non-Dedicated Revenue			
Individual Income Tax	5,443,342	5,570,200	11,013,542
Sales Tax	3,784,523	3,891,025	7,675,548
Corporate Income Tax	529,458	541,700	1,071,158
Motor Vehicle Sales Tax	424,711	276,714	701,425
Statewide Property Tax	305,573	588,264	893,837
Tobacco Settlements	156,646	157,649	314,295
Other Non-Dedicated Revenue	1,533,097	1,446,224	2,979,321
Subtotal Net Non-Dedicated Revenue	12,177,350	12,471,776	24,649,126
Dedicated Revenue	34,599	68,369	102,968
Transfers In	67,585	307,808	375,393
Prior Year Adjustments	30,491	35,770	66,261
Subtotal Current Resources	12,310,025	12,883,723	25,193,748
Total Resources Available	**13,884,225**	**14,013,992**	**26,767,948**
Actual & Estimated Spending by Function			
Education Finance	4,930,945	5,728,765	10,659,710
Higher Education	1,394,932	1,411,548	2,806,480
Intergovernmental Aids	1,286,040	1,472,284	2,758,324
Health Care	2,212,259	2,602,702	4,814,961
Health & Human Services	947,540	1,003,635	1,951,175
Environmental Resources	238,630	247,407	486,037
Economic & Workforce Development	204,953	195,255	400,208
Public Safety & Corrections	447,583	498,939	946,522
Transportation	199,898	230,226	430,124
General Government	573,682	606,008	1,179,690
Debt Service	285,553	295,494	581,047
Capital Projects	2,146	0	2,146
Estimated Cancellations	0	(15,000)	(15,000)
Subtotal - Major Spending Categories	12,724,161	14,277,263	27,001,424
Dedicated Expenditures	29,795	68,369	98,164
Total Expenditures & Transfers	**12,753,956**	**14,345,632**	**27,099,588**
Balance Before Reserves	**1,130,269**	**(331,640)**	**(331,640)**
Budget Reserve	0	23,900	23,900
Tax Relief Account	158,148	0	0
Appropriations Carried Forward	316,393	0	0
Budgetary Balance	**655,728**	**(355,540)**	**(355,540)**

Fiscal Year Comparison
Percent Change
($ in thousands)

	11-02 Fcst FY 2003	11-02 Fcst FY 2004	% Change	11-02 Fcst FY 2005	% Change
Actual & Estimated Resources					
Balance Forward From Prior Year	1,130,269	(331,640)		(2,698,979)	
Current Resources:					
Net Non-Dedicated Revenue					
Individual Income Tax	5,570,200	5,875,100	5.5%	6,297,800	7.2%
Sales Tax	3,891,025	3,889,700	0.0%	4,297,800	10.5%
Corporate Income Tax	541,700	639,800	18.1%	708,200	10.7%
Motor Vehicle Sales Tax	276,714	272,624	-1.5%	263,863	-3.2%
Statewide Property Tax	588,264	596,771	1.4%	610,376	2.3%
Tobacco Settlements	157,649	194,944	23.7%	197,011	1.1%
Other Non-Dedicated Revenue	1,446,224	1,345,457	-7.0%	1,372,733	2.0%
Subtotal Net Non-Dedicated Revenue	12,471,776	12,814,396	2.7%	13,747,783	7.3%
Dedicated Revenue	68,369	90,128	31.8%	93,357	3.6%
Transfers In	307,808	45,906	-85.1%	44,855	-2.3%
Prior Year Adjustments	35,770	10,100	-71.8%	10,100	0.0%
Subtotal Current Resources	12,883,723	12,960,530	0.6%	13,896,095	7.2%
Total Resources Available	**14,013,992**	**12,628,890**	**-9.9%**	**11,197,116**	**-11.3%**
Actual & Estimated Spending by Function					
Education Finance	5,728,765	6,365,618	11.1%	6,406,488	0.6%
Higher Education	1,411,548	1,460,804	3.5%	1,450,144	-0.7%
Intergovernmental Aids	1,472,284	1,528,994	3.9%	1,561,083	2.1%
Health Care	2,602,702	2,864,657	10.1%	3,069,815	7.2%
Health & Human Services	1,003,635	1,092,253	8.8%	1,092,395	0.0%
Environmental Resources	247,407	258,952	4.7%	255,347	-1.4%
Economic & Workforce Development	195,255	179,851	-7.9%	179,035	-0.5%
Public Safety & Corrections	498,939	482,405	-3.3%	497,082	3.0%
Transportation	230,226	80,909	-64.9%	80,909	0.0%
General Government	606,008	594,463	-1.9%	615,518	3.5%
Debt Service	295,494	333,835	13.0%	361,137	8.2%
Estimated Cancellations	(15,000)	(5,000)	-66.7%	(15,000)	nm
Subtotal - Major Spending Categories	14,277,263	15,237,741	6.7%	15,553,953	2.1%
Dedicated Expenditures	68,369	90,128	31.8%	93,357	3.6%
Total Expenditures & Transfers	**14,345,632**	**15,327,869**	**6.8%**	**15,647,310**	**2.1%**
Balance Before Reserves	**(331,640)**	**(2,698,979)**		**(4,450,194)**	
Budget Reserve	23,900	67,200		79,200	
Dedicated Reserves	0	8,507		30,619	
Budgetary Balance	**(355,540)**	**(2,774,686)**		**(4,560,013)**	

Biennial Comparison
FY 2004-05 vs FY 2002-03
($ in thousands)

	11-02 Fcst FY 2002-03	11-02 Fcst FY 2004-05	$ Difference	% Change
Actual & Estimated Resources				
Balance Forward From Prior Year	1,574,200	(331,640)	(1,905,840)	-121.1%
Current Resources:				
Net Non-Dedicated Revenue				
Individual Income Tax	11,013,542	12,172,900	1,159,358	10.5%
Sales Tax	7,675,548	8,187,500	511,952	6.7%
Corporate Income Tax	1,071,158	1,348,000	276,842	25.8%
Motor Vehicle Sales Tax	701,425	536,487	(164,938)	-23.5%
Statewide Property Tax	893,837	1,207,147	313,310	35.1%
Tobacco Settlements	314,295	391,955	77,660	24.7%
Other Non-Dedicated Revenue	2,979,321	2,718,190	(261,131)	-8.8%
Subtotal Net Non-Dedicated Revenue	24,649,126	26,562,179	1,913,053	7.8%
Dedicated Revenue	102,968	183,485	80,517	78.2%
Transfers In	375,393	90,761	(284,632)	-75.8%
Prior Year Adjustments	66,261	20,200	(46,061)	-69.5%
Subtotal Current Resources	25,193,748	26,856,625	1,662,877	6.6%
Total Resources Available	**26,767,948**	**26,524,985**	**(242,963)**	**-0.9%**
Actual & Estimated Spending by Function				
Education Finance	10,659,710	12,772,106	2,112,396	19.8%
Higher Education	2,806,480	2,910,948	104,468	3.7%
Intergovernmental Aids	2,758,324	3,090,077	331,753	12.0%
Health Care	4,814,961	5,934,472	1,119,511	23.3%
Health & Human Services	1,951,175	2,184,648	233,473	12.0%
Environmental Resources	486,037	514,299	28,262	5.8%
Economic & Workforce Development	400,208	358,886	(41,322)	-10.3%
Public Safety & Corrections	946,522	979,487	32,965	3.5%
Transportation	430,124	161,818	(268,306)	-62.4%
General Government	1,179,690	1,209,981	30,291	2.6%
Debt Service	581,047	694,972	113,925	19.6%
Capital Projects	2,146	0	(2,146)	nm
Estimated Cancellations	(15,000)	(20,000)	(5,000)	33.3%
Subtotal - Major Spending Categories	27,001,424	30,791,694	3,790,270	14.0%
Dedicated Expenditures	98,164	183,485	85,321	86.9%
Total Expenditures & Transfers	**27,099,588**	**30,975,179**	**3,875,591**	**14.3%**
Balance Before Reserves	**(331,640)**	**(4,450,194)**	**(4,118,554)**	
Budget Reserve	23,900	79,200	55,300	
Dedicated Reserves	0	30,619	30,619	
Budgetary Balance	**(355,540)**	**(4,560,013)**	**(4,204,473)**	

FY 2004-05 Biennial Comparison
November 2002 vs End of Session
($ in thousands)

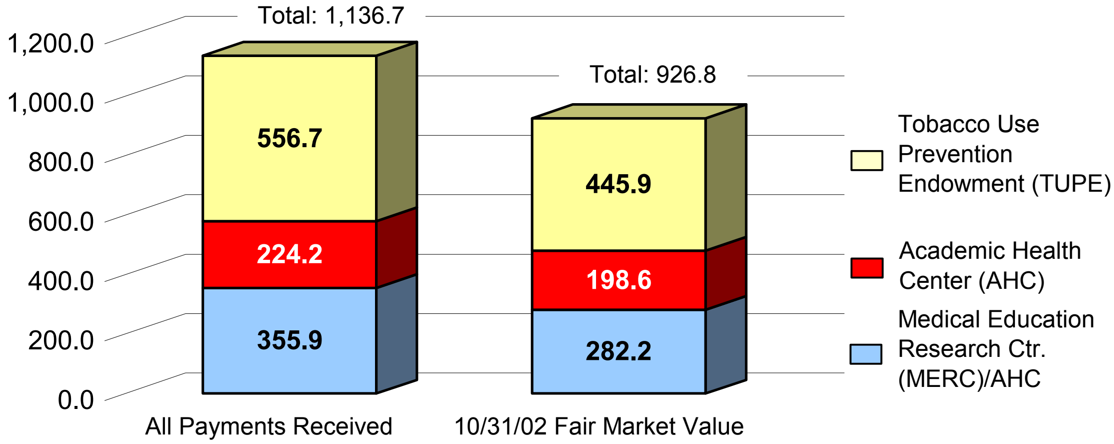
	9-02 Enacted FY 2004-05	11-02 Fcst FY 2004-05	$ Difference
Actual & Estimated Resources			
Balance Forward From Prior Year	318,427	(331,640)	(650,067)
Current Resources:			
Net Non-Dedicated Revenue			
Individual Income Tax	13,505,643	12,172,900	(1,332,743)
Sales Tax	8,323,865	8,187,500	(136,365)
Corporate Income Tax	1,404,737	1,348,000	(56,737)
Motor Vehicle Sales Tax	569,985	536,487	(33,498)
Statewide Property Tax	1,225,990	1,207,147	(18,843)
Tobacco Settlements	379,545	391,955	12,410
Other Non-Dedicated Revenue	2,825,871	2,718,190	(107,681)
Subtotal Net Non-Dedicated Revenue	28,235,636	26,562,179	(1,673,457)
Dedicated Revenue	114,608	183,485	68,877
Transfers In	120,738	90,761	(29,977)
Prior Year Adjustments	20,200	20,200	0
Subtotal Current Resources	28,491,182	26,856,625	(1,634,557)
Total Resources Available	**28,809,609**	**26,524,985**	**(2,284,624)**
Actual & Estimated Spending by Function			
Education Finance	12,685,668	12,772,106	86,438
Higher Education	2,854,992	2,910,948	55,956
Intergovernmental Aids	3,043,635	3,090,077	46,442
Health Care	5,393,396	5,934,472	541,076
Health & Human Services	2,109,985	2,184,648	74,663
Environmental Resources	508,370	514,299	5,929
Economic & Workforce Development	351,383	358,886	7,503
Public Safety & Corrections	949,360	979,487	30,127
Transportation	161,818	161,818	0
General Government	1,209,317	1,209,981	664
Debt Service	686,775	694,972	8,197
Estimated Cancellations	(20,000)	(20,000)	0
Subtotal - Major Spending Categories	29,934,699	30,791,694	856,995
Dedicated Expenditures	114,608	183,485	68,877
Total Expenditures & Transfers	**30,049,307**	**30,975,179**	**925,872**
Balance Before Reserves	**(1,239,698)**	**(4,450,194)**	**(3,210,496)**
Budget Reserve	374,405	79,200	(295,205)
Dedicated Reserves	36,288	30,619	(5,669)
Budgetary Balance	**(1,650,391)**	**(4,560,013)**	**(2,909,622)**

FY 2002-07 Planning Horizon
November 2002 General Fund Forecast
($ in thousands)

	11-02 Fcst FY 2002-03	11-02 Fcst FY 2004-05	11-02 Plng FY 2006-07
Actual & Estimated Resources			
Balance Forward From Prior Year	1,574,200	(331,640)	(4,450,194)
Current Resources:			
Net Non-Dedicated Revenue			
Individual Income Tax	11,013,542	12,172,900	13,914,300
Sales Tax	7,675,548	8,187,500	9,267,800
Corporate Income Tax	1,071,158	1,348,000	1,380,500
Motor Vehicle Sales Tax	701,425	536,487	566,356
Statewide Property Tax	893,837	1,207,147	1,274,563
Tobacco Settlements	314,295	391,955	401,444
Other Non-Dedicated Revenue	2,979,321	2,718,190	2,884,989
Subtotal Net Non-Dedicated Revenue	24,649,126	26,562,179	29,689,952
Dedicated Revenue	102,968	183,485	188,238
Transfers In	375,393	90,761	89,323
Prior Year Adjustments	66,261	20,200	20,200
Subtotal Current Resources	25,193,748	26,856,625	29,987,713
Total Resources Available	**26,767,948**	**26,524,985**	**25,537,519**
Actual & Estimated Spending by Function			
Education Finance	10,659,710	12,772,106	12,853,937
Higher Education	2,806,480	2,910,948	2,900,288
Intergovernmental Aids	2,758,324	3,090,077	3,194,434
Health Care	4,814,961	5,934,472	6,858,542
Health & Human Services	1,951,175	2,184,648	2,207,442
Environmental Resources	486,037	514,299	500,302
Economic & Workforce Development	400,208	358,886	358,218
Public Safety & Corrections	946,522	979,487	1,017,796
Transportation	430,124	161,818	161,818
General Government	1,179,690	1,209,981	1,272,926
Debt Service	581,047	694,972	759,641
Capital Projects	2,146	0	0
Estimated Cancellations	(15,000)	(20,000)	(20,000)
Subtotal - Major Spending Categories	27,001,424	30,791,694	32,065,344
Dedicated Expenditures	98,164	183,485	188,238
Total Expenditures & Transfers	**27,099,588**	**30,975,179**	**32,253,582**
Balance Before Reserves	**(331,640)**	**(4,450,194)**	**(6,716,063)**
Budget Reserve	23,900	79,200	79,200
Dedicated Reserves	0	30,619	176,287
Budgetary Balance	**(355,540)**	**(4,560,013)**	**(6,971,550)**

Tobacco Endowments Decline in Value

One remaining payment of $117 Million due in January 2003



Actual and Estimated Appropriation Amounts

November 2002 Forecast

($ in millions)

FY	MERC/AHC	AHC	TUPE
2003	14.58	12.80	26.96
2004	15.35	15.72	24.31
2005	14.71	16.44	22.55

Tobacco Settlement Payments

($ in millions)

	2002	2003	2004	2005
Annual Payments				
November 2002	156.6	157.6	194.9	197.0
February 2002	149.6	151.6	188.7	190.8
Change	7.0	6.0	6.2	6.2
Settlement Payments				
November 2002	221.3	117.5	N/A	N/A
February 2002	218.9	111.2	N/A	N/A
Change	2.4	6.3		