REPORT TO GOVERNOR-ELECT ARNE CARLSON ON THE BUDGET CRISIS

The Budget Crisis Management Task Force is pleased to submit this final report on policy recommendations for managing the budget crisis faced by the State of Minnesota both in the remainder of FY '91 and the 1992-93 biennium.

FY 1991 Spending Reductions

- Our principal and strongest recommendation is that your administration's first order of business should be elimination of the FY1991 shortfall through expenditure reductions. While both one-time and on-going reductions should be considered, an emphasis should be placed on long-term base savings to take advantage of the compounding effect; one dollar reduced now equals three dollars in savings by the end of the 1992-93 biennium.

- The existing budget reserve should not be used to address FY '91 shortfalls. It is prudent to save the budget reserve for use in managing the 1992-93 problem since economic prospects remain uncertain.

The primary reason for recommending 1991 spending reductions is that it starts to address the larger 1992-93 problem. We come to this recommendation after exploration of the November fiscal forecast and an examination of the available options. The fiscal forecast does indeed show that Minnesota has a budget problem of significant proportions. The problem is $197 million for this fiscal year and $1.2 billion for FY1992-93, not counting inflationary adjustments. This shortfall picture is predicated on the economy performing according to what is called the "control" scenario as estimated by Data Resources Inc. (DRI). If the economy worsens or gets better, the amount of the problem will vary accordingly. The sense at this juncture is that much of what could happen with the economy is predicated upon foreign policy events and decisions. Accordingly, we believe it is prudent to save the existing budget reserve for use in managing the 1992-93 problem.

War will cause the economy to worsen, and in what is called the "high oil" scenario, $650-$750 million would be added to the budget shortfall. While we cannot make a guess as to the likelihood of war anymore accurately than others, we can urge fiscal caution until the Middle East crisis starts toward resolution and the direction of the nations's economy is clearer. It should be emphasized that recovery from the current recession will not be solely predicated on resolution of the Mideast Crisis. While the threat of war might have accelerated the economic downturn, additional complex weaknesses in the nation's economy will also slow economic recovery during the coming year. This high degree of economic uncertainty argues strongly for the use of expenditure reductions in the remainder of FY1991 rather than using the budget reserve.

Some one time items could be considered for covering the $197 million shortfall because that would still protect the reserve, but baseline reductions should be made to the greatest extent possible. The principal reason to start downsizing now is the positive compounding effect reductions taken today will have by the end of FY1993. Every one dollar taken out of the base now is the equivalent of $3 in savings by the end of FY1993.

We do not make this recommendation for reductions in FY1991 in a vacuum. We have reviewed a number of options and believe our recommendation can be accomplished. The reductions should consider all programs and constituencies of the budget. They should represent the Governor's priorities and address issues such as dedicated funds so that all funds and all components of government share in the solution. We examined several scenarios that we concluded are feasible and have reviewed these with the appropriate commissioners. We do not specify them here because you and the commissioners need to select those which represent your objectives and priorities.

We believe that the Governor should make it a first priority to address the FY1991 shortfall and have a deficit reduction package on the desk of each legislator early in January, so that the new legislature can make the deficit reduction bill the first order of business. Given this, we agree that it is prudent to delay the FY1992-93 budget message in order to give additional time for preparation, and to allow the Legislature time to first deal with the FY1991 problem.

Balance Revenues and Expenditures

o It is essential that biennial revenues and expenditures be brought into balance. A balanced budget in FY1992-93 should be presented, along with baseline projections for a balanced FY1994-95 biennial budget. Spending shifts should not be used. In order to meet constitutional requirements, the FY1990-91 budget was "balanced" by spending a one-time revenue surplus, which shifted permanent expenditure liabilities into future biennia. Although the current recession has compounded the shortfall, this structural imbalance must be corrected so that the state is spending no more than it is taking in during any biennium.

The budget must be balanced in both the FY1992-93 and FY 1994-95 biennia. On its face, this recommendation seems simplistic, since a balanced budget is required by the Minnesota Constitution. However, this recommendation goes beyond technical compliance and attempts to broaden the meaning of the word "balanced" to a concept which means "don't spend more than is taken in during the two year period, and don't push expenditures into the following biennia."

For example, in the current biennium (FY1990-91), the November Forecast indicates that the state will spend about $600 million more than the revenue it will take in. Because one-time funds were used to pay for on-going commitments, the future spending base is larger than the revenue stream can support; this is one of the structural causes of the FY1992-93 problem. The downturn in the economy has made the budgetary gap more severe, but a significant budget problem would still have existed in FY1992-93, even without the recession. Thus, in solving the FY1992-93 shortfall, care should be taken to not put undue pressure on the following biennium.

No Short-term Borrowing

o Short-term borrowing should not be used. Borrowing for operations only exacerbates the problem, creating an immediate interest expense and long-term credit cost due to reduced ratings.

This recommendation is straight-forward. Borrowing for operations makes a difficult situation worse by forestalling any resolution of the underlying fiscal problem. Interest costs go up, credit ratings go down and nothing is done to address the root cause of the budget gap.

Maintenance of Budget Reserve

- The budget reserve fund concept should be maintained, and a goal established to restore the fund to 5% of General Fund expenditures (approximately $750 million) by the end of FY1995. The budget reserve is Minnesota's principal weapon to manage unanticipated shocks to the revenue system caused by cyclical volatility, and should not be used to perpetuate any imbalance in the on-going revenue/expenditure relationship. Use of the reserve is similar to internal short-term borrowing, which shifts the problem to the next biennium once the "savings account" is gone.

The budget reserve is more than a "rainy day" fund. A principal function of the fund is to balance cash flow during the year so that short-term borrowing can be avoided. The Finance Department estimates that a reserve of about $400 million is needed for this purpose alone. In addition, the fund allows the state to address unanticipated expenditures of a non-recurring nature, and represents a major factor in the high state bond credit rating.

While the budget reserve fund is an important tool which can be used to manage short-term cash shortfalls, balances should not be used for on-going operating expenditures, unless plans have been established to address future operating budget shortfalls. Unless this principle is followed, use of the budget reserve merely shifts the imbalance into the next biennium, and perpetuates the problem.

It is expected that the fiscal problems of the FY1992-93 biennium will require some use of the budget reserve fund, but at no point should the reserve be exhausted. Minimal use is acceptable to absorb the shock of extensive expenditure reallocations, so long as there is a mechanism to replenish the reserve in time to meet the next economic downturn. A goal should be established so that the reserve is restored to 5% of General Fund resources (approximately $750 million) by the end of the FY1995.

Baseline Budget System

- **The current baseline budget approach should be continued for the next biennium. This system allows policy officials to plan for and track the impact of all changes in current law, rather than automatically building increased spending into base budgets.**

- Spending commitments should not be made for future biennia. Funding increases for both state agencies and transfer payment programs should be subject to the baseline biennial budget process, rather than automatically receive formula increases. This approach ensures that <u>all</u> state spending programs must compete equally for policy approval.

The baseline budget concept as embodied in the current budget instructions should be retained. It is important that discipline be injected into the State's budgeting process. Budgets have historically been constructed from a base that is assumed to incorporate automatic inflators. Policy discussion then focused on "change" requests, so that budgets were adopted as additions to or cuts in the inflated base, rather than from an examination of the whole program.

Policy debates should instead address the continued usefulness of the priorities reflected in the base spending discussions, rather than automatically assuming inflation of the program. The spending dynamic changes immensely when it is required that base program spending be re-examined to allow for inflationary pressures and salaries. If something is no longer needed, it will be identified so that newer ideas can be funded.

This approach will also facilitate financial management when the recession ends. The restructuring of the expenditure base will allow for enhanced expenditures in the future. However, this money should not automatically go toward inflationary pressures, but should be used to enhance the budgets of agencies and transfer programs that have done a respectable job in reviewing their base so that new priorities and ideas can be considered.

It is important that <u>all</u> state spending be subject to this baseline budget process. Both state agency programs and transfer payments should be required to compete for continued funding. For example, the Legislature is to be complemented for not including automatic educational aid formula increases in current law, but rather requiring that these programs be subject to the same policy trade-off discussions as all other state activities.

State-Local Fiscal Relationship

- Minnesota has an extremely complex system of mandated expenses and local revenues, composed of state and local taxes and transfer payments. The entire system should be reexamined and changed to provide more accountability in both taxing and spending decisions.

Three-fourths of the taxes and revenues collected by the state and passed through the general fund are returned to towns, cities, counties, schools, and other taxing jurisdictions. Because of the "grandparent" clauses in many of the current funding laws, it is not clear on what basis state revenues are being redistributed to local governments. This causes intense competition among local units of government to gain greater amounts of state revenues.

While local governments complain that the state mandates programs without paying the cost, state lawmakers believe the current systems encourage spending by masking the true costs of local decisions. This intricate system of mandates and transfer payments must be examined and restructured to accomplish legitimate statewide priorities, while making taxing authorities accountable to the Minnesota citizens who pay the taxes.

Fiscal Volatility

- Volatility in Minnesota's tax structure causes a feast or famine cycle depending on changes in the economy. Any consideration of tax changes should work toward dampening this volatility.

- There is also volatility in the Minnesota expenditure structure. When revenues drop off during recessions, it is difficult to readily adjust to cover commitments and entitlement programs established during healthier fiscal times. Long-term program commitments should not be based on short-term prosperity, and funding formulas must recognize the implications of economic cycles.

- No new dedicated funds should be created, and efforts should be made to reduce the number of existing funds in which spending is restricted to specific programs. Revenue dedication reduces policy flexibility to deal with shifting priority needs, and does not subject these program areas to competitive trade-off discussions.

The Budget Stability Report produced by the Minnesota Tax Commission in 1983 notes the volatility of the Minnesota revenue system. While improvements to the income tax structure were made in 1987, considerable volatility still exits. It should be emphasized that the volatility of the Minnesota system effects not only state agencies, but also those local units of government which are dependent on transfer payments.

There is no doubt that all of Minnesota is ill-served by the "feast or famine" nature of its expenditures. When the economy is good and revenues are very strong, appetites for service grow accordingly, and when revenues are down the cuts in services are more of a shock to the system that need be, had the State not spent excessively during the good times.

Minnesota would be better served by having a smoother path. in both expenditures and revenues. If revenues are considered as part of a solution to the crisis, volatility should be one of the criteria in choosing which tax increases to enact. In addition, program entitlements and funding formulas should be reviewed to recognize that short-term prosperity and past experiences with program participation are not sound bases for the construction of future commitments.

The dedication of funding sources to specific program priorities is seductive since it helps ensure an on-going source of program support. However, such a practice severely hampers policy flexibility in dealing with crisis situations, and does not allow for changes in program priorities over time. More importantly, "off-budget" funds are not subject to competitive trade-off discussions during the budgeting process, thereby weakening policy flexibility and control.

<u>Budget Process Reform</u>

o While the general forecasting process is sound, certain reforms should be considered to maintain the integrity of and improve the accuracy of the revenue and expenditure forecasts which provide a basis for budgeting decisions. The Finance Department should be responsible for <u>all</u> forecasts, and improved monitoring should be considered for early warnings of potential budget shortfalls.

o Greater fiscal discipline is necessary in the budgeting process. The Legislature should publicly adopt a budget resolution in early April after the session forecast to provide direction to Legislative committees. Both tax and spending issues must be considered, and targets established before the closing hours of the session. Minnesota should first decide what it can afford, before deciding how to spend it.

o Reform in the timing of budget preparation during the transition to a new administration should also be considered. Although constitutional change would be necessary, adequate time does not exist to prepare a biennial budget which accurately reflects the priorities of a new Governor.

Budget process reform is essential to managing spending growth in the state of Minnesota. We can no longer afford the historical practices of deciding which programs to fund, total up all the bills and raise revenue to meet the total. We must first decide how much Minnesota can afford, and decide within that total framework what the priorities of Minnesota ought to be. Although the suggestion that a tax bill be adopted prior to a spending bill has merit, another approach which considers both tax and spending policy would be to adopt a budget resolution in early April after the session forecast. This approach would also meet the objective of properly balancing spending needs within the capacity of the State's resources.

Revisions in the forecasting process are also suggested. One of the principal causes of the current FY1991 shortfall was the inaccuracy in forecasting health and human services and educational program expenditures. It is recommended that the Finance Department be responsible for all expenditure forecasting, as well as revenue estimates. By lodging responsibility in one agency, the integrity of the forecasting process is reinforced. In addition, it is suggested that improved monitoring of expenditures in those areas with more volatility be improved to provide an early warning system.

An additional process reform which has merit is changing the nature of the timing for when the biennial budget is presented. When reviewing the budget crisis, it was apparent that even if all the agency time-lines had been met, there was not significant time for a new administration to prepare a budget. Some constitutional change should be considered that would allow additional time for budget preparation, such as moving when the biennial budget cycle takes place forward a year. While we don't have any specific recommendations at this time, the problem is very evident that when a new governor faces a significant budget gap, there is not sufficient time to prepare a solution and incorporate the new governor's priorities and policies.

The Budget Crisis Management Task Force wishes you well in working with the Legislature to solve the significant fiscal crisis facing Minnesota. We are hopeful that these recommendations will be implemented in your efforts to improve Minnesota's financial condition.