



ISSUE BRIEF:

General Fund Expenditure and Revenue Growth in FY 2004-05

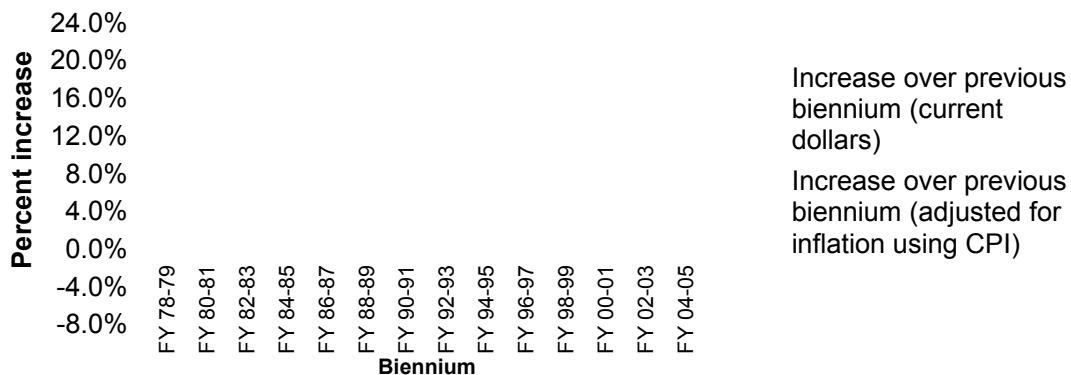
February 2003

According to the November 2002 forecast, general fund expenditures in FY 2004-05 biennium are projected to exceed FY 2002-03 expenditures by 14.3 percent.¹ Revenues are forecast to rise by only 6.6 percent. This issue brief begins by providing some historical perspective, comparing the projected expenditure growth rate to biennial growth rates since the late 1970's. After commenting on the policy implications of the gap between projected growth in revenues and expenditures, the issue brief estimates how much of the 2004-05 projected growth in expenditures and revenues is due to the 2001 property tax reforms and other one-time budget changes.

Historical Perspective: General Fund Expenditure Increases

Figures 1 and 2 compare the projected 14.3 percent growth in general fund expenditures to biennial growth rates over the past 26 years. Growth rates are shown both for *current dollar* expenditures and for expenditures *adjusted for inflation*.²

**Figure 1.
Biennium-to-Biennium Increases
in General Fund Expenditures
FY 1978-79 to FY 2004-05**



¹ Due to "unallotment," total FY 2002-03 expenditures will be lower than shown in the November forecast (and revenues a bit higher). This issue brief does not adjust for these changes.

² Inflation adjustment uses the Consumer Price Index for July of even-numbered years, at the mid-point of each biennium.

Given the much higher rates of inflation in the late 1970's and early 1980's, it is best to focus on the inflation-adjusted growth rates.³ The two-year expenditure growth of 14.3 percent is 9.1 percent higher than inflation. This 9.1 percent inflation-adjusted growth rate for 2004-05 expenditures exceeds that in all but four of the previous thirteen biennia – all except 1978-79 (9.5 percent), 1984-85 (11.5 percent), 1994-95 (9.3 percent), and 1998-99 (9.4 percent). The 2004-05 inflation-adjusted growth rate also exceeds the average growth rate during the last six biennia (1992-2003).

As shown in Figure 1, inflation-adjusted growth was negative during each of the previous two recessions (1980-83 and 1992-93). Unlike the two previous recessions, the November forecast – prior to legislative action this session -- shows no biennium with negative growth.⁴

Figure 2.
Growth Rate for FY 2004-05 Expenditures
Compared to Average for Last Six and Thirteen Biennia

	1978-2003	1992-2003	2004-05
Biennial increase (2-year growth)			
Current dollars	14.0%	13.3%	14.3%
Adjusted for inflation	3.7%	7.8%	9.1%
Annual increase (1 year growth)			
Current dollars	6.8%	6.5%	6.9%
Adjusted for inflation	1.8%	3.8%	4.5%
Biennial growth above 2004-05 average			
Current dollars	6 of 13	1 of 6	
Adjusted for inflation	4 of 13	2 of 6	
Largest 2-year increase			
Current dollars	26.0% (78-79)	15.5% (94-95)	
Adjusted for inflation	11.5% (84-85)	9.4% (98-99)	
Smallest 2-year increase			
Current dollars	4.9% (86-87)	6.3% (92-93)	
Adjusted for inflation	-8.2% (80-81)	-1.3% (92-93)	

Sources: General fund budget (unadjusted) from Department of Finance on website at

www.budget.state.mn.us/budget/summary/2000/2000historicalspending.pdf .

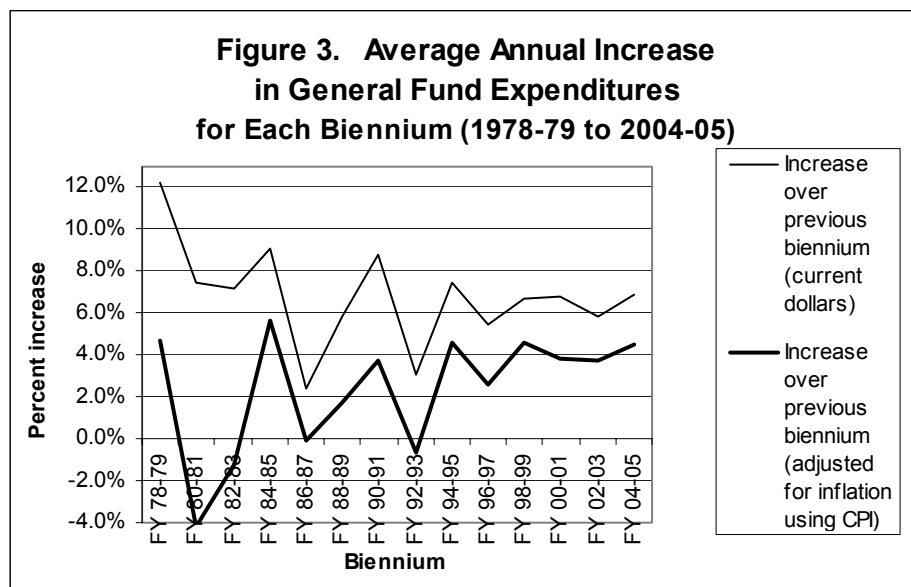
Consumer price index from U.S. Department of Labor at www.bls.gov/cpi/home.htm . For future years, inflation rates are based on the November 2002 forecast (2.3% in 2003 and 2.4% in 2004).

³ For example, the 15.5 percent biennial growth in expenditures in the 1980-81 biennium was much less than inflation, which exceeded 25 percent (over two years). After adjusting for inflation, *real* expenditures in 1980-81 *fell* by 8.2 percent compared to the previous biennium.

⁴ If the 2004-05 budget is balanced entirely by expenditure cuts, *actual* expenditure growth is likely to be negative in FY 2004-05. The 14.3 percent projected growth in expenditures (growth totaling \$3.9 billion) is smaller than the projected \$4.2 billion deficit. If expenditures were cut by \$4.2 billion, the change in expenditures compared to FY 2002-03 would be *negative* 1.2 percent in current dollars and *negative* 5.7 percent after adjusting for inflation.

Annual versus two-year growth rates: Biennium-to-biennium growth occurs over *two* years, which can be a source of confusion. Most people are more accustomed to comparing *annual* growth rates, so Figure 3 shows historical growth rates on an annual basis instead.

Expenditure growth of 14.3 percent in *two* years reflects *average annual* growth of 6.9 percent per year, which exceeds forecast inflation by 4.5 percent per year.



Policy Perspective: Revenue Growth, Expenditure Growth, and the \$4.2 Billion Deficit forecast for FY 2004-05

The gap between the biennium-to-biennium growth rates for revenues (6.6 percent) and expenditures (14.3 percent) makes the 2004-05 budget deficit larger than it otherwise would be, but it accounts for only part of the budget problem. If expenditure growth were reduced to match revenue growth (at 6.6 percent), the deficit would fall be cut in half. The other half of the deficit reflects the gap between revenues and expenditures *in 2002-03*. In the November forecast, 2002-03 expenditures exceed 2002-03 revenues by \$1.9 billion. That gap in 2002-03 has been bridged by (a) depleting \$1.6 billion in reserves built up in past years and (b) unallotting a total of \$0.3 billion. Because expenditures exceed revenues in 2002-03, equalizing the 2004-05 expenditure and revenue growth rates would solve only half of the budget problem.⁵

Explaining the 2004-05 Growth in Expenditures and Revenues

Four observations are useful in addressing the reasons for the relatively high growth rate in general fund expenditures.

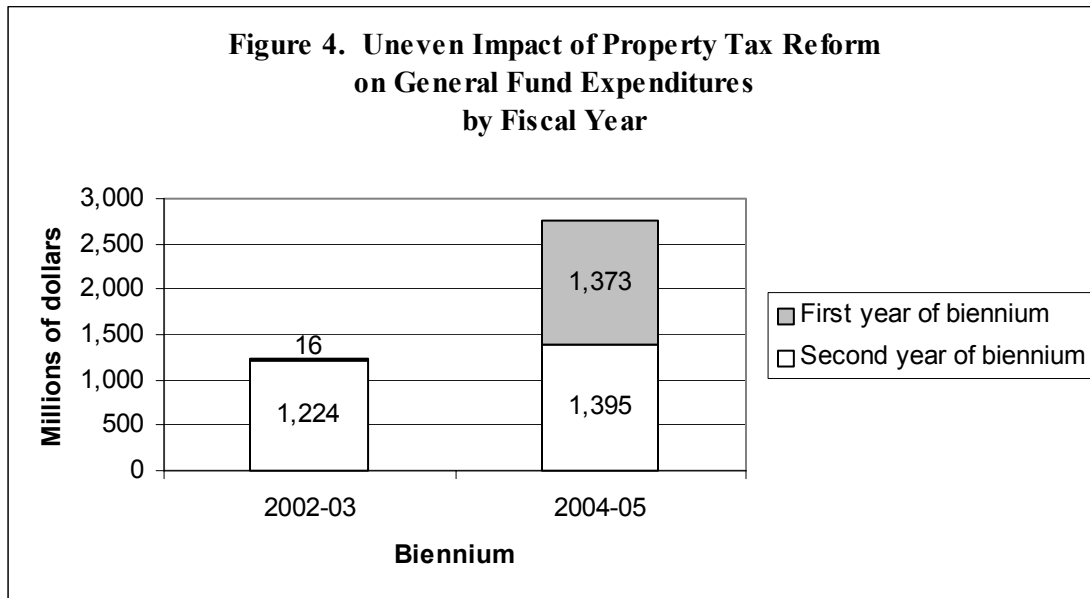
- State spending is only part of state, local, and school district spending. State takeover of services previously funded by local government or school districts will increase state spending. (It may increase *state* spending even if total *state and local* spending remains unchanged.)
- General fund spending is only part of total state spending. Shifting funds from the general fund to other funds (or from other funds to the general fund) can significantly affect the reported rates of growth in general fund spending and revenues.
- Any permanent expenditures starting in the middle (or end) of a biennium will result in a large reported biennium-over-biennium expenditure increases in the next biennium. For example, if spending increases by \$100 every year starting in FY 2003, that totals only \$100 in FY 2002-03 but \$200 in FY 2004-05.

⁵ See footnote 4 for further discussion.

Expenditure Growth in 2004-05: Impact of Property Tax Reform and Change in the Payments Schedule for Education Aids

Property Tax Reform: Of the 14.3 percent two-year growth in general fund spending, 5.7 percent can be traced to the property tax reforms enacted in 2001.

The pattern of expenditure increases due to property tax reform is shown in Figure 4. The takeover of the K-12 general education levy began in FY 2003, halfway through the biennium, and the full cost of some of the other property tax reform provisions was also partially delayed. As a result, property tax reform increased FY 2002-03 costs by \$1.24 billion and FY 2004-05 costs by 2.78 billion. The difference between these two numbers – over \$1.5 billion – represents a 5.7 percent increase in spending in the 2004-05 biennium.



Change in the Payments Schedule for Education Aids: In recent years, 90 percent of all education aid payments have been paid during the current fiscal year, while the final 10 percent was delayed, included in a settle-up payment in the following fiscal year. In 2002, the law was changed to reduce the current-biennium payments to 83 percent of the total, raising the deferred payment to 17 percent of the total aid payment. This law change helped balance the FY 2002-03 budget by reducing FY 2003 expenditures by \$446 million. The net savings in the next biennium is negligible. By cutting 2002-03 biennium expenditures by \$446 million, this one-time shift raised general fund expenditure growth for the 2004-05 biennium by 1.6 percent.

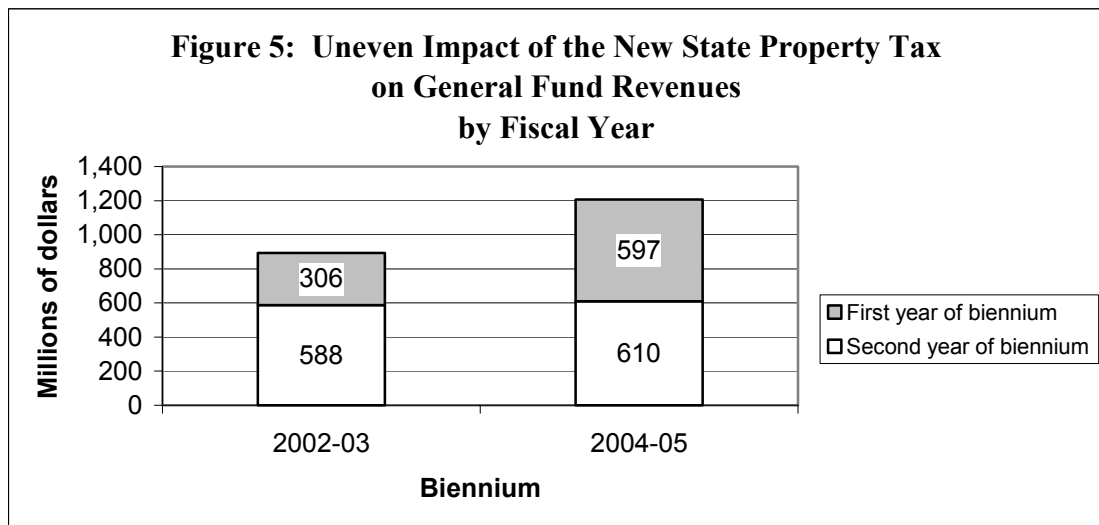
Summary: Of the 14.3 percent growth in spending, 7.3 percent is the result of either property tax reform or the change in the payments schedule for education aids. The remaining 7.0 percent biennial growth exceeds growth rates for only two of the past 13 biennial budgets. Adjusted for inflation – at 2.2 percent growth over two years (1.1% above inflation each year) – it exceeds the expenditure growth rate for only the recession years (1980-83 and 1991-92) and 1985-86.

Revenue Growth in 2004-05: Impact of Property Tax Reform and One-Time Legislative Provisions

Property tax reform also had an impact on the reported growth in revenue. If expenditures are adjusted for property tax reform, a similar adjustment should be made for revenue growth. Of the 6.6 percent growth in general fund revenues, 0.7 percent was due to property tax reform. Two other one-time provisions helped reduce the growth rate by 1.7 percent.

Property Tax Reform: Two tax provisions were integral parts of property tax reform:

- A state property tax was enacted, taxing business property and cabins. This is a state tax, and its revenues are deposited in the general fund. Because the tax was introduced halfway through fiscal year 2002, its 2004-05 revenue impact exceeds its 2002-03 impact by \$300 million. This represents 1.2 percent of FY 2002-03 total revenues.



- Property tax reform also included the state takeover of transit operating costs, which were previously funded by local property taxes. Starting in FY 2003, that local property tax funding was replaced by a portion of the state’s motor vehicle sales tax revenue. That sales tax revenue – no longer deposited in the general fund – is now dedicated to special funds for metro and rural transit. This dedication affected only one year of sales tax in the 2002-03 biennium but two years in the following biennium. As a result, it cut general fund revenues by \$130 million more in 2004-05 than it did in the previous biennium – equivalent to 0.5 percent of FY 2002-03 revenue.

In summary, the net impact of property tax reform on revenue growth in 2004-05 – the increased property tax revenue partially offset by the loss of dedicated motor vehicle sales tax – accounts for 0.7 percent of the 6.6 percent growth in revenue. The remaining 5.9 percent growth over two years was due to other factors.

Impact of Two Other Special Provisions: Two other one-time legislative provisions significantly reduced the biennium-over-biennium growth in 2004-05 revenues.

- In FY 2003, a total of \$259 million was transferred to the general fund from other funds (the Workers Compensation Fund and the Assigned Risk Plan). By increasing total revenue in FY 2002-03 by \$259 million, this large one-time transfer (to help balance the budget) reduced the growth in revenue in 2004-05 over 2002-03 by the same amount. If this transfer were ignored, FY 2004-05 revenues would have grown by an additional 1.0 percent (a total of 7.6 percent rather than 6.6 percent).⁶
- Legislation enacted in 2001 repealed the June accelerated sales tax payments, but with a delayed effective date. This had no impact on revenues in the 2002-03 biennium, but it reduced 2004-05 revenues by \$164 million. This provision's one-time revenue loss cut the 2004-05 revenue growth rate by 0.7 percent.

In the absence of these two one-time provisions, revenues would have grown by 8.3 percent in FY 2004-05, rather than 6.6 percent.⁷

Summary

The 14.3 percent projected growth in general fund expenditures is high by historical standards. After adjusting for inflation, the 9.1 percent growth (over 2 years) would exceed that in all but four of the last thirteen biennial budgets. Each of the last two recessions resulted in negative or near zero growth for at least one biennium (in both 1980-88 and 1991-92). If the 2004-05 budget is balanced by cutting expenditures, the biennial growth in inflation-adjusted expenditures will also be reduced to below zero.

The mismatch of an expenditure growth rate of 14.3 percent and a revenue growth of 6.6 percent accounts for approximately half of the \$4.2 billion budget deficit forecast for the 2004-05 biennium. The other half of the deficit results from the \$1.9 billion gap between total expenditures and total revenues in FY 2002-03. That gap was bridged using \$1.6 billion of budget reserves built up in earlier years (plus unallotments totaling \$0.3 billion).

Over half of the 14.3 percent forecast growth in 2004-05 general fund expenditures is due to property tax reforms (enacted in 2001) and the change in the payment schedule for education aids (2002). Because the costs of reform started mid-biennium, they increased expenditures by much more in 2004-05 than in 2002-03. The combined expenditure increase – above the cost impact in 2002-03 – totals over \$2 billion. This accounts for

⁶ The November forecast projected *tax revenues* to grow by 8.9 percent in the 2004-05 biennium, but *non-tax revenue* was projected to fall by 22.3 percent. This drop in non-tax revenue pulled total revenue growth down to 6.6 percent. Most of the drop in non-tax revenue was due to the two one-time transfers (discussed in the text) totaling \$259 million. The rest of the decline in non-tax revenue reflected a drop in interest earnings – due to lower interest rates as well as the drop in reserves. In the absence of property tax reform and repeal of the June accelerated sales tax payments, tax revenues would have grown by 8.8 percent.

⁷ If property tax reform were netted out as well, the 2-year growth would have been 7.6 percent.

7.3 percent of the 14.3 percent growth in spending. The increase due to other causes – 7.0 percent in current dollars and 2.2 percent in inflation-adjusted dollars – would be lower than the actual growth rate in any biennium except during the two previous recessions and FY 1985-86.

General fund revenue growth for FY 2004-05 – at 6.6 percent – also results partly from property tax reform. Of the 6.6 percent growth, 0.7 percent is due to property tax reform provisions (increased state property tax collections net of the loss in motor vehicle sales taxes dedicated to transit). Two other one-time provisions significantly *reduced* revenue growth rates for the 2004-05 biennium. One-time transfers in 2003 reduced 2004-05 revenue growth by 1.2 percentage points, and the repeal of June accelerated sales tax payments reduced 2004-05 revenue growth by 0.7 percentage points.

Figure 6 summarizes these results. Detailed calculations are shown in the appendix.

**Figure 6.
Explaining Forecast Expenditure and Revenue Growth
FY 2004-05 Over FY 2002-03**

	2-year growth	
	<i>Current dollars</i>	<i>Inflation adjusted dollars</i>
Expenditure Growth		
November 2002 forecast	14.3%	9.1%
Impact of property tax reform	5.7%	
Impact of education aids payments shift	1.6%	
Growth from other sources	7.0%	2.2%
Revenue Growth		
November 2002 forecast	6.6%	1.8%
Impact of property tax reform	0.7%	
Impact of one-time transfers in 2003	-1.0%	
Impact of repealing accelerated sales tax	-0.7%	
Growth from other sources	7.6%	2.7%

If the fiscal impacts of property tax reform and other one-time changes were removed, 2004-05 revenues and expenditures would both be expected to exceed 2002-03 levels by roughly 7 percent. If expenditure and revenue growth were the same – at seven percent – this would cut the forecast deficit by about half. In the current biennium (2002-03), even after the unallotments announced earlier this month, expenditures will exceed revenues by \$1.6 billion. This 2002-03 gap was bridged by depleting \$1.6 billion in reserves. If 2004-05 revenues and expenditures (after unallotment) both grow by seven percent (after adjusting for the unallotments), that \$1.6 billion gap would also grow by seven percent, to about \$1.7 billion. Equal growth rates for expenditures and revenues would reduce the deficit, but that would not be sufficient to solve the budget problem.

This issue brief is available on the House Fiscal Analysis Department website at
www.house.leg.state.mn.us/fiscal/files/ibgferg03.pdf.

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Appendix A: Biennial Growth Rates for Expenditures
 FY2004-05 growth over FY2002-03

November 2002 forecast

(\$1000s)

General Fund Expenditures	Source	FY02	FY03	FY02-03 Biennium	FY04	FY05	FY 04-05 Biennium	2-Year Growth		Average Annual Percent Growth
								(\$1000s)	Percent	
Total expenditures (November 2002 forecast)	2	12,753,956	14,345,632	27,099,588	15,327,869	15,647,310	30,975,179	3,875,591	14.3%	6.9%
Property tax reform*										
General education levy appropriation	1	0	1,198,087	1,198,087	1,331,000	1,331,232	2,662,232			
Conversion of \$415 referendum revenue	1	0	179,219	179,219	199,132	199,132	398,264			
Referendum equalization aid	1	0	24,423	24,423	28,358	29,775	58,133			
Referendum tax base replacement aid	1	0	7,850	7,850	8,722	8,722	17,444			
Debt service equalization aid	1	0	12,955	12,955	13,020	11,413	24,433			
Dedication of state tax growth to education	1	0	0	0	14,985	30,345	45,330			
Market value homestead credit to schools	2	0	57,652	57,652	70,888	72,906	143,794			
Market value homestead credit (non-school)	2	0	257,935	257,935	250,973	243,256	494,229			
Market value homestead cr agric land to schools	2	0	3,198	3,198	5,499	5,836	11,335			
Market value homestead cr agric land (non-school)	2	0	14,335	14,335	18,396	18,396	36,792			
Eliminate education homestead credit	1,2	0	-359,847	-359,847	-405,779	-410,366	-816,145			
Eliminate agricultural education credit	1	0	-50,135	-50,135	-56,335	-56,405	-112,740			
Reduce disparity aids/credit (school)	1	0	-2,295	-2,295	-2,550	-2,550	-5,100			
Reduce disparity aids/credit (non-school)	1	0	-4,350	-4,350	-4,350	-4,350	-8,700			
Rental tax base replacement aid	1	0	0	0	14,100	20,753	34,853			
Eliminate TIF aid penalties	1	0	5,400	5,400	5,400	5,400	10,800			
Homeowner property tax refund changes	1	0	7,106	7,106	5,770	7,477	13,247			
Homeowner property tax refund -- targeting payments	1	0	-2,200	-2,200	-3,300	-1,400	-4,700			
Increase city LGA	1	0	140,000	140,000	143,500	147,088	290,588			
Eliminate town LGA	1	0	-3,869	-3,869	-3,966	-4,065	-8,031			
Eliminate school HACA	1	0	-7,972	-7,972	-5,973	-3,944	-9,917			
Eliminate HACA for city,town,spec dist,mobile home	1	0	-263,159	-263,159	-263,546	-263,551	-527,097			
Taconite production tax and tax relief programs	1	10,900	11,700	22,600	11,500	11,600	23,100			
<u>Transit takeover (expenditures only)</u>	1	<u>5,000</u>	<u>-2,101</u>	<u>2,899</u>	<u>-2,101</u>	<u>-2,101</u>	<u>-4,202</u>			
Total property tax reforms		15,900	1,223,933	1,239,833	1,373,343	1,394,599	2,767,942	1,528,110	5.6%	2.8%
Change payment schedule for education aids (83%/17%)	2	0	-445,725	-445,725	-2,608	-2,608	-5,216	440,509	1.6%	0.8%
Growth in expenditures for other reasons		12,738,056	13,567,425	26,305,481	13,957,134	14,255,319	28,212,453	1,906,973	7.0%	3.5%

Sources: 1. House Fiscal Analysis Department, Summary of Fiscal Actions of the 2001 Legislature. 2. Department of Finance, Consolidated Funds Report, November 2001 forecast.

*Excludes TIF grant fund, where the 2001 appropriation was fully repealed in 2002. Excludes completion of courts takeover. Ignores small net impact of out-of-home placement takeover.

**State appropriation net of HACA reductions and estimated revenue from fines. Out-of-home placement provisions assumed to have costs that net out to zero.

Appendix B: Biennial Growth Rates for Revenues
 FY2004-05 growth over FY2002-03

November 2002 forecast

(\$1000s)

General Fund Revenues	Source	FY02	FY03	FY02-03 Biennium	FY04	FY05	FY 04-05 Biennium	2-Year Growth		Average Annual Percent Growth
								(\$1000s)	Percent	
Tax Revenues	2	11,421,412	11,909,401	23,330,813	12,248,322	13,159,899	25,408,221	2,077,408	8.9%	4.4%
All other revenue*	2	<u>888,613</u>	<u>974,322</u>	<u>1,862,935</u>	<u>712,208</u>	<u>736,196</u>	<u>1,448,404</u>	-414,531	-22.3%	
Total current resources		12,310,025	12,883,723	25,193,748	12,960,530	13,896,095	26,856,625	1,662,877	6.6%	3.2%
Change due to property tax reform (2001)										
State-wide property tax	2	305,573	588,264	893,837	596,771	610,376	1,207,147	313,310	1.2%	
Dedicate motor vehicle sales tax to metro transit	2	0	-122,652	-122,652	-126,301	-122,242	-248,543	-125,891	-0.5%	
Dedicate motor vehicle sales tax to rural transit	2	<u>0</u>	<u>-7,479</u>	<u>-7,479</u>	<u>-7,701</u>	<u>-7,454</u>	<u>-15,155</u>	-7,676	0.0%	
Total increase due to property tax reform (2001)		305,573	458,133	763,706	462,769	480,680	943,449	179,743	0.7%	
All except property tax reform		12,004,452	12,425,590	24,430,042	12,497,761	13,415,415	25,913,176	1,483,134	5.9%	2.9%
Repeal of June accelerated payments	3	0	0	0	-155,000	-9,300	-164,300	-164,300	-0.7%	
One-time transfers from workers compensation fund and assigned risk plan	2	0	258,900	258,900	0	0	0	-258,900	-1.0%	
Growth in revenue for other reasons		12,004,452	12,166,690	24,171,142	12,652,761	13,424,715	26,077,476	1,906,334	7.6%	3.7%

Sources: 1. House Fiscal Analysis Department, Summary of Fiscal Actions of the 2001 Legislature.
 2. Department of Finance, Consolidated Funds Report, November 2001 forecast.
 3. Department of Finance (by email).

*Includes both non-tax revenues and transfers.