Fiscal Analysis Department
Minnesota House of Representatives

ISSUE BRIEF

PLANNING ESTIMATE INFLATION IN THE STATE BUDGET

January 2007

In the 2002 session, language in law requiring the Commissioner of Finance to include an adjustment for inflation in budget estimates of future bienniums prepared in a budget forecast was removed from law. Since 2002, there has been discussion about re-instating that law. The following discussion is designed to respond to some of the questions raised about the inflation issue.

Why is inflation included in revenue but not spending?

The argument is made that inflation is counted on the revenue side but not on the expenditures side. This is for the most part true but the manner in which tax policy and appropriations policy is set in law tends to be different. The major taxes (income and sales in particular) are set in law as percentages of income or sales. To the extent income changes or eligible sales change (typically the effect of inflation would be to increase incomes or sales) because of inflation, that change is built into the projected revenue.

Most appropriations are set in law in terms of total dollars. The general education formula is a dollar amount per pupil unit. (The forecast does take into account projected changes in enrollment.) Aid to cities and counties is set in law as a dollar amount. For future years, these formulas do not change until the Legislature takes action. Inflationary pressures will certainly exist in these areas but the Legislature has to weigh inflation pressures and others in making appropriations for the next biennium.

Which inflation measure should be used?

Most discussion and past practice has been to use the consumer price index (CPI). There is an alternative that some argue is more appropriate for state government appropriations – that is the index of government purchased goods and services (PGSL). The chart below shows those indicators for FY 2008 – 2011 from November 2006.

	FY 2008	FY 2009	FY 2010	FY 2011
CPI	2.1%	1.8%	1.8%	1.7%
PGSL	2.7%	2.3%	2.4%	2.4%

All the cost projection numbers regarding inflation in this paper use the CPI numbers. When the previous requirement was in law to calculate inflation in the forecast, the Department of Finance used the CPI numbers. In most cases, using the PGSL would result in higher inflation numbers than using CPI.

What is the difference from how inflation is now reported?

The Department of Finance currently reports in forecast documents the effect on the budget if an inflation amount equal to the consumer price index was applied to projected spending in the fiscal years of the next beinniums. (See attached page 8 of the November 2006 forecast for the inflation discussion.) For example, in the November 2006 forecast for FY 2008 estimated inflation is shown as $340 million. The difference between projected revenues and expenditures is $344 million so a balance, if inflation was subtracted, would be $4 million.

Under the practice in effect prior to the 2002 changes in statute dealing with inflation, the inflation numbers would be subtracted from any balance reported in the fund balance statements at the end of the forecast. The November 2006 forecast reported that "Forecast revenues now exceed projected spending by $1.132 billion in FY 2008-09." Instead of that statement, the statement might be "Forecast revenues now exceed projected spending, including estimated inflation, by $142 million in FY 2008-09." The definition of projected spending would now include an estimate for inflation. (See attached page 57 from the February 2002 Forecast. Estimated Inflation is about 10 lines up from the bottom of the page – added in as an expenditure.)

What would the effect on budgeting be in the 2007 session?

The 2007 Legislature will be budgeting for FY 2008 and FY 2009. The Legislature will need to determine actual appropriations for those fiscal years. In making those appropriations, the Legislature will consider the Governor's recommendations and many other sources of input including to what extent the effect of inflation on program budgets should be funded. Inflation calculations will no longer be relevant in FY 2008 and FY 2009 once appropriations are being made for those years. As far as budgeting projections, the inflation consideration for the 2007 session will apply to FY 2010 and FY 2011.

If inflation is calculated for FY 2010 and 2011 assuming the base level of spending for FY 2008 and 2009 (the amount projected in the November 2006 forecast), inflation for FY 2010 and 2011 would "cost" about $900 million.

If inflation is calculated for FY 2010 and 2011 assuming the base level of spending for FY 2008 and 2009 will be increased by $1 billion above the amount projected in the November 2006 forecast (using $1 billion of the available $2 billion) inflation for FY 2010 and 2011 would "cost" about $940 million.

If inflation is calculated for FY 2010 and 2011 assuming the base level of spending for FY 2008 and 2009 will be increased by $2 billion above the amount projected in the November 2006 forecast (using $2 billion of the available $2 billion) inflation for FY 2010 and 2011 would "cost" about $975 million.

If inflation is applied to the budget proposal presented on January 22 by the Governor, inflation at the CPI rate would cost $319 million in FY 2010 and $638 million in FY 2011 (a total of $957 million for the biennium). As a note, according to Department of Finance figures, the Governor's FY 2008-09 recommendations include $671 million of "one-time" spending and revenue items. While the Governor's budget recommendations do not specifically recognize inflation in FY 2010 and 2011, those recommendations do leave a large enough balance in FY 2010 and 2011 to cover the projected inflation.

The cost of inflation in each of these scenarios reduces the $3.2 billion balance projected for the FY 2010-11 beinnium.

What is the net effect of adding inflation to the budget calculations?

In the 2007 session the legislature will make appropriations for FY 2008 and 2009 and will need to determine to what extent those appropriations will reflect any amounts for inflation. The inflation calculation will apply to budget calculations for FY 2010 and 2011 (the "tails" years). Adding inflation will set aside $940 to $975 million of the projected balance in FY 2010-11 for inflation purposes. That $940 to $975 million would not be available to fund other programs. This would increase the amount of spending increases or revenue reductions in FY 2008-09 that need to be one-time so that the FY 2010-11 projected budget remains balanced.

What happens if inflation rates change?

Current inflation rates of about two percent as measured by the consumer price index are relatively low compared to previous decades. In the early 1990s, inflation rates were about 3.5 percent as determined by the consumer price index. In the 1980s inflation rates were considerably higher. An inflation rate of four percent would "cost" twice as much as an inflation rate of two percent.

What are the options for acknowledging the inflation impact on expenditures in future budgets?

1. Inflation is counted only if it is built into current law for specific programs. A current law provision provides for an adjustment in a funding formula for future years by some measure of inflation. An example of this would be the current funding formula for the payment in lieu of taxes (PILT) program (see M.S. 477A.145).

2. Information is provided in state budget forecasts on the impact of inflation in future budgets using some measure of inflation. This inflation information is general in the sense that it measures the cost of inflation against all state appropriations and states that information in terms of "if inflation was applied to all state appropriations, it would cost an additional $___". This is the current situation and the attached page 8 from the November 2006 forecast illustrates how inflation is currently presented.

3. An amount representing inflation is added to expenditure for future years. While the amount is not allocated to any particular program, it is set aside as a spending item in the forecasted budget for future years. The amount is determined by applying an inflation measure to all or most expenditures in each fiscal year of the next biennium. This is the situation prior to the 2002 change in law and is illustrated on the attached page 57 from the February 2002 Forecast

4. Calculate inflation on a program by program basis for and add those amounts to each program when expenditure numbers are presented for future years. Rather than an inflation amount added into future year expenditures as a total number, it would be built into each appropriation item as appropriate. This practice was used in the late 1990s – see attached page 57 from the February 1998 Forecast.

5. Amend existing statutes to build inflationary measures into those programs and appropriations that should automatically receive inflationary increases in future years. This would make all programs and programs that are determined should receive an inflation adjustment to automatically receive that adjustment in law. The adjustment would operate like it does for the PILT program described in option number 1. Forecasts would reflect the increases.

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Planning Estimates Provide Guidelines for Future Budget Outlook

This report provides the first revenue and expenditure planning estimates for the 2010-11 biennium. These planning estimates offer a framework for determining the sustainability of FY 2008-09 budget decisions into the future.

Projected revenues for FY 2010-11 reflect the trend of continued growth forecast for the 2008-09 biennium. FY 2011 also includes $327 million of one-time capital gains revenue attributable to the scheduled increase of the federal capital gains tax rate to 20 percent. Current law spending estimates are adjusted only to reflect enrollment and caseload growth in entitlement programs and areas where specific statutory formulae exist. The FY 2010-11 planning estimates provide a benchmark to determine if ongoing spending exceeds revenues in succeeding FY 2011 budget periods.

Budget Planning Estimates

($ in millions)

	FY 2008	FY 2009	FY 2010	FY 2011
Forecast Revenues	**$16,427**	**$17,091**	**$17,939**	**$19,054**
Projected Spending	16,083	16,413	16,719	17,057
Difference	**$344**	**$678**	**$1,220**	**$1,997**
Estimated Inflation (CPI)	*$340*	*$650*	*$970*	*$1,300*

The table shows annual revenues and expenditures excluding beginning balances and reserves. The difference can be thought of as a "structural" balance. That is, how much more is being collected than spent before any tax or spending decisions are made. Since the expenditure projections do not include a general adjustment for inflation, future increases in state spending may be significantly greater than those shown.

Projected inflation based on the consumer price index is now expected to be 2.1 and 1.8 percent for FY 2008 and FY 2009, and 1.8 and 1.7 percent for FY 2010 and FY 2011. At these levels, a general adjustment for inflation would add nearly $340 million per year to spending – compounding to nearly $1.3 billion per year by FY 2011. An alternative inflation measure recommended by the Council of Economic Advisors, the index of government purchased goods and services, is more than one-half percent per year higher. At that level, simple inflation would add nearly $430 million per year, or $1.7 billion by FY 2011.

A complete version of the November 2006 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.

FY 2004-05 GENERAL FUND PLANNING ESTIMATES
FY 2004, FY 2005, Biennial Total
($ in thousands)

	FY 2004	FY 2005	Biennial Total
Actual & Estimated Resources			
Balance Forward From Prior Year	(1,114,507)	(2,787,299)	(1,114,507)
Current Resources:			
Net Non-Dedicated Revenue			
Individual Income Tax	6,542,600	6,953,000	13,495,600
Sales Tax	3,997,200	4,346,800	8,344,000
Corporate Income Tax	690,300	703,500	1,393,800
Motor Vehicle Sales Tax	284,218	285,767	569,985
Statewide Property Tax	604,960	621,030	1,225,990
Tobacco Settlements	188,723	190,822	379,545
Other Non-Dedicated Revenue	1,365,026	1,404,047	2,769,073
Subtotal Net Non-Dedicated Revenue	13,673,027	14,504,966	28,177,993
Dedicated Revenue	57,401	57,589	114,990
Transfers In	31,088	31,118	62,206
Prior Year Adjustments	10,100	10,100	20,200
Subtotal Current Resources	13,771,616	14,603,773	28,375,389
Total Resources Available	**12,657,109**	**11,816,474**	**27,260,882**
Actual & Estimated Spending by Function			
Education Finance	6,338,803	6,374,023	12,712,826
Higher Education	1,477,496	1,477,496	2,954,992
Intergovernmental Aids	1,531,258	1,566,932	3,098,190
Health Care	2,628,523	2,809,474	5,437,997
Health & Human Services	1,082,381	1,095,298	2,177,679
Environmental Resources	271,049	269,130	540,179
Economic & Workforce Development	181,411	181,281	362,692
Public Safety & Corrections	492,320	507,720	1,000,040
Transportation	84,134	84,134	168,268
General Government	621,557	639,033	1,260,590
Debt Service	310,352	327,696	638,048
Transportation Projects/Tabs	5,000	10,000	15,000
Estimated Cancellations	(5,000)	(15,000)	(20,000)
Estimated Inflation	367,723	759,604	1,127,327
Subtotal - Major Spending Categories	15,387,007	16,086,821	31,473,828
Dedicated Expenditures	57,401	57,589	114,990
Total Expenditures & Transfers	**15,444,408**	**16,144,410**	**31,588,818**
Balance Before Reserves	**(2,787,299)**	**(4,327,936)**	**(4,327,936)**
Cash Flow Account	350,000	350,000	350,000
Budget Reserve	684,000	684,000	684,000
Tax Relief Account	158,148	158,148	158,148
Dedicated Reserves	38,459	79,347	79,347
Budgetary Balance	**(4,017,906)**	**(5,599,431)**	**(5,599,431)**

Appendix

F.Y. 2000-01 Base, Inflation, Planning Estimates
February 1998 Forecast
($ in Thousands)

	Base F.Y. 2000-01	Inflation F.Y. 2000-01	Total Planning Est
Actual & Estimated Resources:			
Balance Forward From Prior Year	2,886,208	0	2,886,208
Current Resources:			
Net Non-Dedicated Revenue			
Individual Income Tax	11,060,600	0	11,060,600
Sales Tax	7,191,900	0	7,191,900
Corporate Income Tax	1,602,000	0	1,602,000
Motor Vehicle Excise	824,700	0	824,700
Other Non-Dedicated Revenue	1,811,659	0	1,811,659
Subtotal Net Non-Ded. Rev.	22,490,859	0	22,490,859
Dedicated Revenue	278,510	0	278,510
Transfers In	458,989	0	458,989
Prior Year Adjustments	20,200	0	20,200
Subtotal-Current Resources	23,248,558	0	23,248,558
Total Resources Available	**26,134,766**	**0**	**26,134,766**
Actual & Estimated Spending by Function:			
Education /Children & Families	7,133,707	269,768	7,403,475
Post-Secondary Education	2,315,461	87,553	2,403,014
Property Tax Aids & Credits	2,788,644	106,601	2,895,245
Other Major Local Assistance	1,011,355	38,298	1,049,653
Health Care	3,788,952	144,305	3,933,257
Family Support	543,456	20,601	564,057
State Operated Institutions	919,680	34,856	954,536
Legisl., Judicial, Const. Officers	503,793	19,050	522,843
State Agencies' Operations & Grants	1,557,194	57,598	1,614,792
Debt Service	587,286	0	587,286
Estimated Cancellations	(20,000)	0	(20,000)
Subtotal-Major Spending Categories	21,129,528	778,631	21,908,159
Dedicated Expenditures	278,510	0	278,510
Total Expenditures & Transfers	**21,408,038**	**778,631**	**22,186,669**
Balance Before Reserves	**4,726,728**	**(778,631)**	**3,948,097**
Cash Flow Account	350,000	0	350,000
Budget Reserve	522,000	0	522,000
Property Tax Account	872,000	0	872,000
Dedicated Reserves	67,460	0	67,460
Budgetary Balance	**2,915,268**	**(778,631)**	**2,136,637**