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Report to the
State Legislature on

**The 1982
Statewide Audit:
An Analysis of
Financial Problems
and Opportunities**

March 1983

**Prepared by the
Financial Audit Division
Office of the Legislative Auditor
State of Minnesota**

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FINANCIAL AUDIT DIVISION

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The Financial Audit Division of the Office of The Legislative Auditor has recently completed its fourth annual Statewide Audit. This audit focuses on the major state programs which generate approximately 90-95 percent of the state's revenues and expenditures. The products of this audit have historically been threefold:

- (1) An audit opinion for inclusion in the Annual Financial Report prepared by the Department of Finance. The opinion discusses the accuracy of the information in this report and enhances its credibility.
- (2) Management letters to the agency heads of the twenty-four state agencies included in the audit scope. These letters discuss in detail the accounting and financial management problems disclosed by the audit.
- (3) A summary report to the state Legislature.

We have significantly expanded our summary report to the Legislature this year. We feel our experiences with the major state programs can be helpful to the Legislature as they address the many fiscal issues which face the state. Accordingly, this report discusses the fiscal problems of the General Fund and certain other state funds, and the opportunities for improving the state's financial management.

Gerald W. Christenson

Gerald W. Christenson
Legislative Auditor

PREFACE

The Legislature is too often confronted with detailed data on a particular program or area of state finances. Unfortunately, legislators are often without an appropriate context from which to evaluate individual programs or issues. We felt that our annual Statewide Audit would provide an ideal forum from which to develop a comprehensive look at state finances--to identify the financial management problems and opportunities.

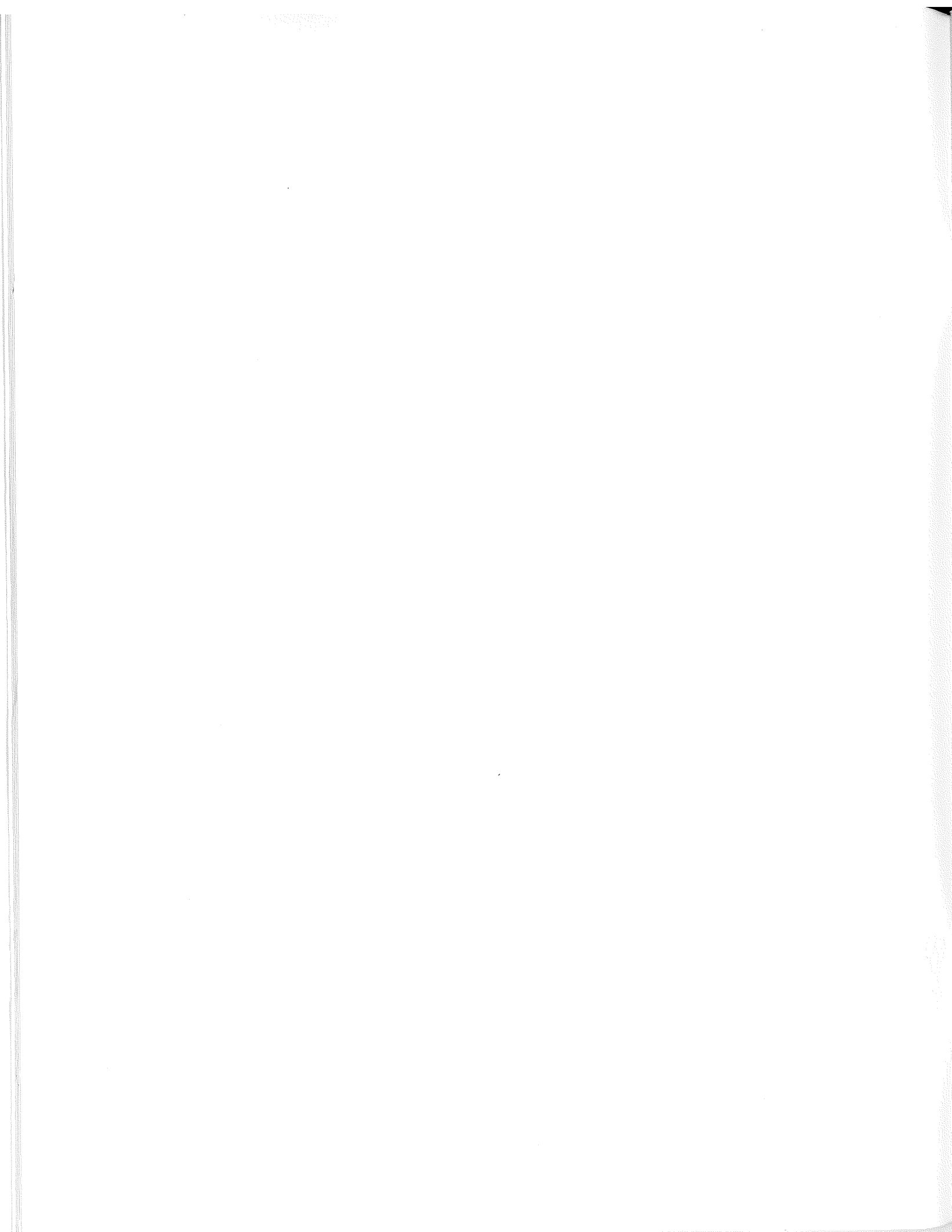
This report represents our attempt to provide such a broad-based analysis of state finances. Perhaps the most comprehensive source of information on the state's finances is the Annual Financial Report prepared by the Department of Finance. Unfortunately, it is often a difficult source for nontechnical audiences to analyze and interpret. Therefore, we have attempted to translate that technical information so that it is more readily understandable. We believe our report will be helpful as the Legislature attempts to weigh the importance of various issues. Also, it provides a framework for understanding and evaluating the state's financial management systems.

We have provided the affected state departments the opportunity to respond in writing to our findings and recommendations. Basically, they have agreed with our analysis. It must be remembered that our purpose in this report is to provide a comprehensive analysis of state finances, cite major financial trends, and identify issues of importance. We have attempted to provide only a basic discussion of many important financial issues. We suggest that the state agencies which are responsible for a particular issue should be contacted for more detailed information or explanations as these problems are addressed.

The entire Financial Audit Division staff is involved with the Statewide Audit for approximately six months each year. This report represents one product of those efforts. Specific questions on this report or any other aspects of the Statewide Audit should be directed to either John Asmussen, Deputy Legislative Auditor, (296-1727) or Claudia Gudvangen, Audit Manager, (296-4718).

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REPORT HIGHLIGHTS

STATE FUNDS EXPERIENCING FINANCIAL PROBLEMS

General Fund

- The General Fund has expended \$900 million more than it has collected over the last three fiscal years, resulting in a fund deficit of \$624 million as of June 30, 1982. (pp.1-7)

- Revenue shortfalls have continually plagued the fund. Although revenues increased by 14.2 percent from fiscal year 1980 to 1982, an estimated 11.1 percent of the increase could be traced to legislative changes to tax laws. (pp.8-12)

- Despite several budget cuts, expenditures increased by 19.1 percent from 1980 to 1982. Changes in specific expenditure programs varied widely (Note: All percentages are based on the two year period from 1980 to 1982 and should not be confused with annual increases.):
 - Direct Property Tax Relief Programs increased by 40.1 percent because of an expanded state commitment. (pp.25-26)

 - Expenditures for welfare benefits have increased by 44.6 percent. An estimated 7.9 percent of this increase was due to the state assuming a higher share of the state/county financing ratio for certain programs. Much of the remaining increase resulted from the 52.5 percent increase in the Medical Assistance Program. (pp.27-29)

 - Debt Service expenditures increased by 53.5 percent. Much of this increase was caused by the addition of \$32 million in short-term interest costs. (pp.29-31)

 - State institutions' expenditures increased by 21.4 percent. They increased only 16.9 percent on a net cost basis (when considering the revenues which are generated). (pp.20-22)

 - State departments' (other than institutions) expenditures increased by an average of 7.2 percent. (pp.17-20)

-- Intergovernmental Transfer Payments (other than Direct Property Tax Relief Programs) increased by an average of 10.6 percent. (pp.22-25)

- Severe cash flow problems have introduced the need for extensive short-term borrowing. Short-term borrowing was unnecessary in fiscal year 1980. However, as of June 30, 1982, \$760 million of short-term certificates of indebtedness were outstanding. (pp.33-36)
- A significant amount of revenues must be used to finance obligations incurred in prior fiscal years. An estimated 30 percent of fiscal year 1983 revenues will have to be used for obligations incurred in 1982 and prior fiscal years. (pp.36-39)

Unemployment Compensation Fund (pp.45-51)

- The fund has depended on borrowing from the Federal Unemployment Account to meet benefit payment obligations (\$78 million was borrowed from the account during the first half of fiscal year 1983).
- The deficit fund balance has grown from \$114 million during fiscal year 1981 to \$210 million by June 30, 1982, and is projected to reach \$400 million by April 30, 1983.
- Interest costs to be paid on federal loans made after March 31, 1982 will have to come from sources other than the UC Fund (possibly the General Fund).

Workers' Compensation Special Compensation Fund (pp.51-54)

- The revenues generated for the Workers' Compensation Special Compensation Fund have not been sufficient to pay the benefit claims submitted. At June 30, 1982, estimated unpaid claims totaled over \$36 million.
- The state is at least a year behind in paying most claims (primarily to insurance companies).

Teachers Retirement Fund (pp.54-58)

- The funding ratio has not significantly improved since 1973, and the fund appears unable to be fully funded by the target date of June 30, 2009.
- The funding ratio, which has ranged from 50 to 56 percent, is significantly below that of other major state pension plans which are approaching an 80 percent funding level.
- The actuaries' reports for the past few years have indicated that even with the additional support rate currently being contributed by the state, the funding rate of the Teachers Retirement Fund is inadequate.

Maximum Effort School Loan Fund (pp.58-59)

- Various changes to the maximum effort school aid law in recent years have allowed school districts to defer repayment of principal and interest on both debt service and capital loans.
- It is uncertain that the capital loans totaling \$41.8 million at June 30, 1982 will be collected. As a result, the ability of the Maximum Effort School Loan Fund to meet its future debt service requirements remains questionable, and additional General Fund appropriations may be necessary to pay off the general obligation bonds used to finance the program.

OPPORTUNITIES FOR IMPROVED FINANCIAL MANAGEMENT

Strengthening Financial Controls (pp.61-67)

- The 1982 Statewide Audit has produced 205 recommendations to state agencies. These recommendations are intended to strengthen the financial controls over the affected state programs. This will ensure that the state is maximizing the collection of revenues to which it is entitled, expending only the proper dollar amount for authorized programs, and properly safeguarding its assets.

Verifying Data Provided By Local Governments (pp.67-69)

- Many state aids are calculated based on data provided by local governments. The reliability of such data could be enhanced through a technique such as a unified audit. This would effectively establish an audit network between the state and its local governments.

EDP File Matching Techniques (pp.69-70)

- EDP file matching techniques would enable the state to better utilize the information it maintains and improve efforts to identify ineligible benefit recipients or maximize revenue collections. There are several legal (primarily data privacy laws), technical, and policy questions which must be addressed before many of these techniques may be utilized.

SECTION I

GENERAL FUND FINANCES

The recent financial problems of Minnesota's General Fund have been widely publicized. The Legislature has been called into special session several times and other measures have been instituted in an attempt to improve General Fund finances. Those actions have resolved the problems for the current biennium and attention has been turned to future governmental finances in Minnesota. However, it is useful to look back over the past few fiscal years. The financial trends of those years reveal the magnitude of the problems experienced and how they will affect future finances. A closer look indicates that the changes in specific revenue sources and expenditure programs have varied widely. Finally, it is important to focus on certain financial issues that may impact the General Fund's future fiscal condition.

I.A. RECENT FINANCIAL TRENDS -- FOCUSING ON FUND BALANCE¹

The 1980-81 and 1982-83 biennial budgets as originally enacted into law were assumed to be in balance. Revenues were estimated and expenditures were authorized on commensurate patterns. Unfortunately, numerous problems developed which caused actual revenues to fall significantly below estimates. Accordingly, expenditures were then at a level significantly above revenues and the budget was out of balance. The state continually experienced this problem over the last few years and frequent corrective actions were required.²

We have prepared a series of exhibits which illustrate the relationship between General Fund revenues and expenditures³ over the last few years. Table 1 shows historical revenue and expenditure data for fiscal years 1980 to 1982.

¹We use the term "fund balance" to mean General Fund equity, whether it is positive (surplus) or negative (deficit).

²See Appendix I which reviews the budgetary shortfalls and resulting corrective actions which have occurred during fiscal years 1981, 1982, and 1983.

³In this analysis, we are including transfers from/to other funds as a component of revenues and expenditures.

TABLE 1
GENERAL FUND
SUMMARY OF ANNUAL FINANCES
FISCAL YEARS 1980 TO 1982
(000's Omitted)

	Fiscal Year		
	1980	1981	1982
Revenues	\$ 3,228,934	\$ 3,320,587	\$ 3,687,965
Expenditures	(3,401,030)	(3,690,495)	(4,051,036)
Net Annual Decrease to Fund Balance	<u>(\$ 172,096)</u>	<u>(\$ 369,908)</u>	<u>(\$ 363,071)</u>

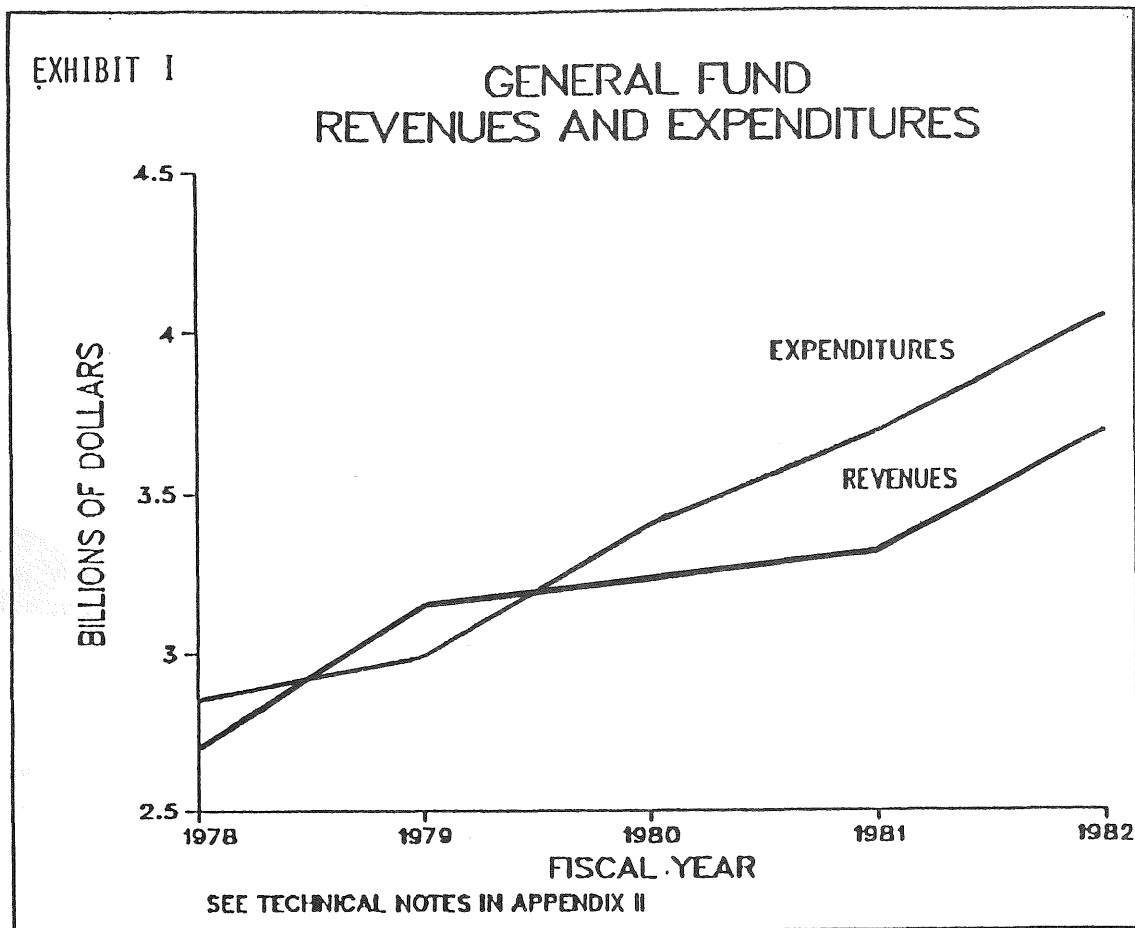
See Technical Notes in Appendix II.

General Fund finances have resulted in reductions to fund balance of over \$900 million during this three year period. This is indicative of the severity of the General Fund's problems and has resulted in a fund deficit of approximately \$624 million as of June 30, 1982.⁴

Exhibit I graphs historical revenues and expenditures since 1978. We have added data for fiscal years 1978 and 1979 (again, see Technical Notes in Appendix II)) to demonstrate how the system has fallen out of balance in the last three years. The graph plots annual revenues and expenditures at the end of each fiscal year. The difference between revenues and expenditures in any given year represents the annual change to fund balance. Thus, if one wants to calculate year-end fund balance, this annual change must be added to beginning fund balance (see Exhibit III).

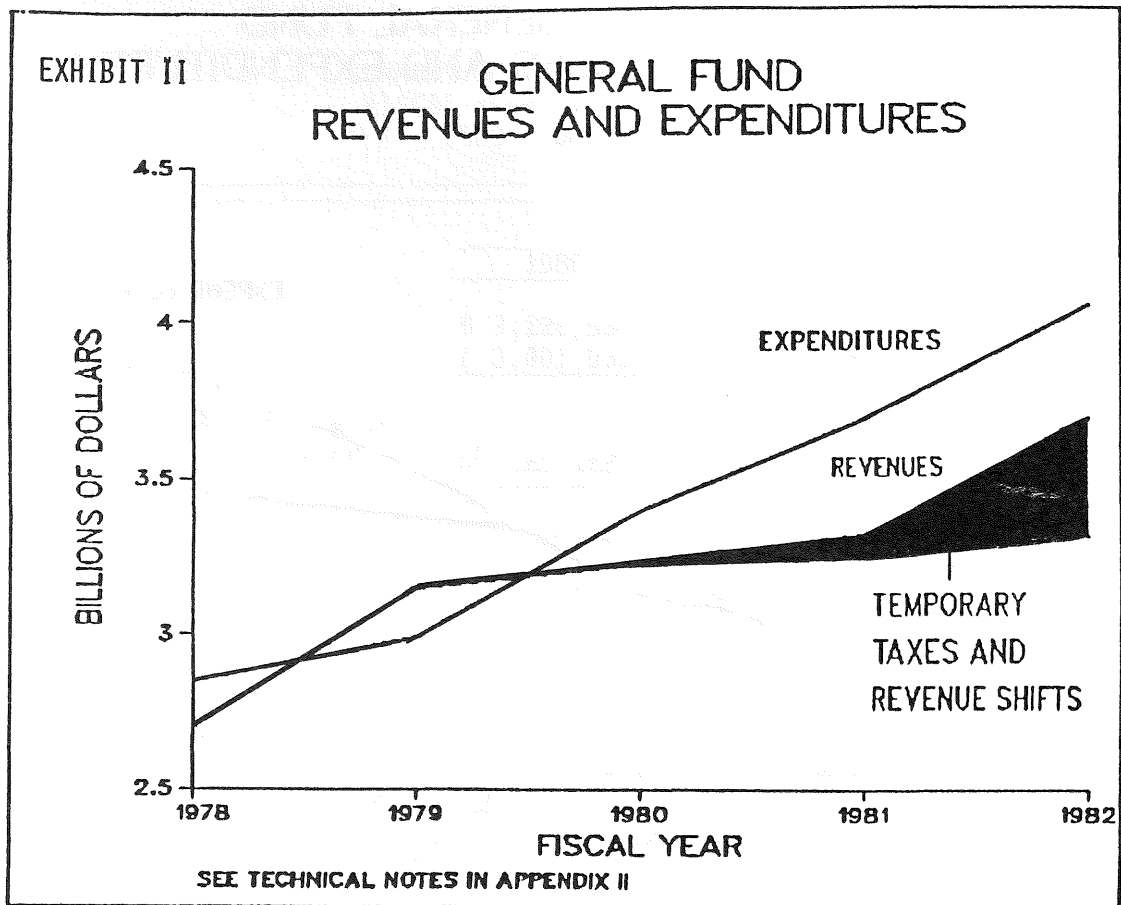
The crossing pattern illustrated in fiscal years 1978 to 1980 is perhaps the normal pattern to expect for a healthy General Fund. This reflects the uncertainty associated with revenue estimates and the need to continually adjust fund balance so it is retained at an acceptable level. However, as can be seen, revenues did not recover to the level of expenditures in either fiscal year 1981 or 1982. Whereas a reduction in fund balance was affordable in 1980 (because of a beginning fund balance), continued reductions in 1981 and 1982 have resulted in the sizable fund deficit at the end of 1982.

⁴Note that fiscal year 1982 ends in the middle of a biennium and that constitutional and statutory provisions only preclude deficits at the end of a biennium.



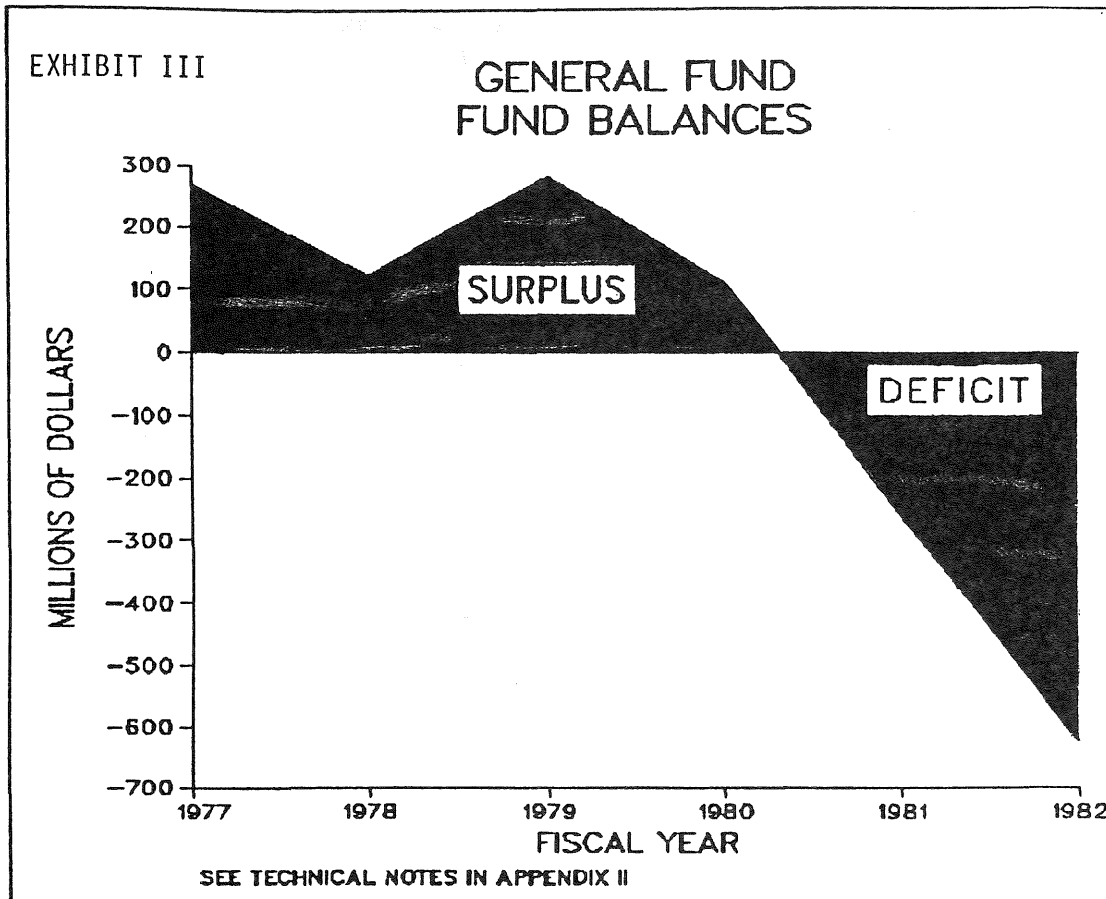
Much of the problem with the General Fund finances can certainly be attributed to depressed economic conditions which have resulted in revenue shortfalls. However, later analyses will indicate that the state has committed itself to a level of expenditures which is difficult to adjust. Thus, expenditures are difficult to manipulate in the short term if they are to be reduced commensurate with revenues. This requires that revenues be increased or that revenue/expenditure "shifts" be initiated. Unfortunately, "shifts" or temporary revenue increases do not supply long-term relief in periods of economic downturn. When problems with the economy persist, as they have for the last few years, remedies to the state's fiscal problems must continually be sought and instituted.

Exhibit II dispels any notion that revenues began recovering in fiscal year 1982. The exhibit shows that most of the revenue increases in fiscal years 1981 and 1982 are caused by temporary taxes and revenue shifts. Again, those measures do not provide a long-term remedy to the depressed revenue base. Several measures, primarily the accelerated collection of revenues, provide only a one-time increase to revenues. Thus, in ensuing years, revenues would revert to their previous level, unless economic recovery was experienced. Other measures, primarily temporary taxes, would continue to sustain the revenue base as long as they were in effect.



Two additional observations can be drawn from Exhibit II. First, even with the budget-balancing efforts, the fund balance has continued to decline. Such losses were stabilized in 1982, but continued to be very significant. Secondly, it is obvious that the budget-balancing efforts continually anticipated an ensuing economic recovery. Since that recovery has not yet been realized, the fiscal problems have continued.

Exhibit III then translates the data into year-end fund balances. Again, we can see that the crossing pattern of revenues and expenditures from 1978 to 1980 simply results in a fluctuating positive fund balance, or surplus. When revenues did not recover sufficiently in 1981 and 1982, the fund balance became negative and resulted in the deficits.



Finally, Exhibits IV and V show two projections for the remainder of fiscal year 1983 and the 1984-85 biennium. Both exhibits illustrate the drastic measures which are needed to balance the budget as of June 30, 1983. Essentially, the constitution and statutes preclude a fund deficit on June 30, 1983, since it is the end of a biennium. Therefore, given the \$624 million deficit at the end of 1982, a \$624 million increase to fund balance is required in 1983. Coupled with the fact that fund balance declined by \$363 million in 1982, a turnaround of nearly \$1 billion must be achieved in General Fund finances from 1982 to 1983. This is a phenomenal task. It becomes possible only when extensive "shifts" of expenditures are made from 1983 to 1984. Thus, the Legislature has essentially been committed to a significant amount of expenditures in 1984, even before passage of the 1984-85 budget. This further adds to the difficulty in adjusting the level of expenditures and diminishes policy alternatives. The impact of these shifts is discussed further in Section I.E.

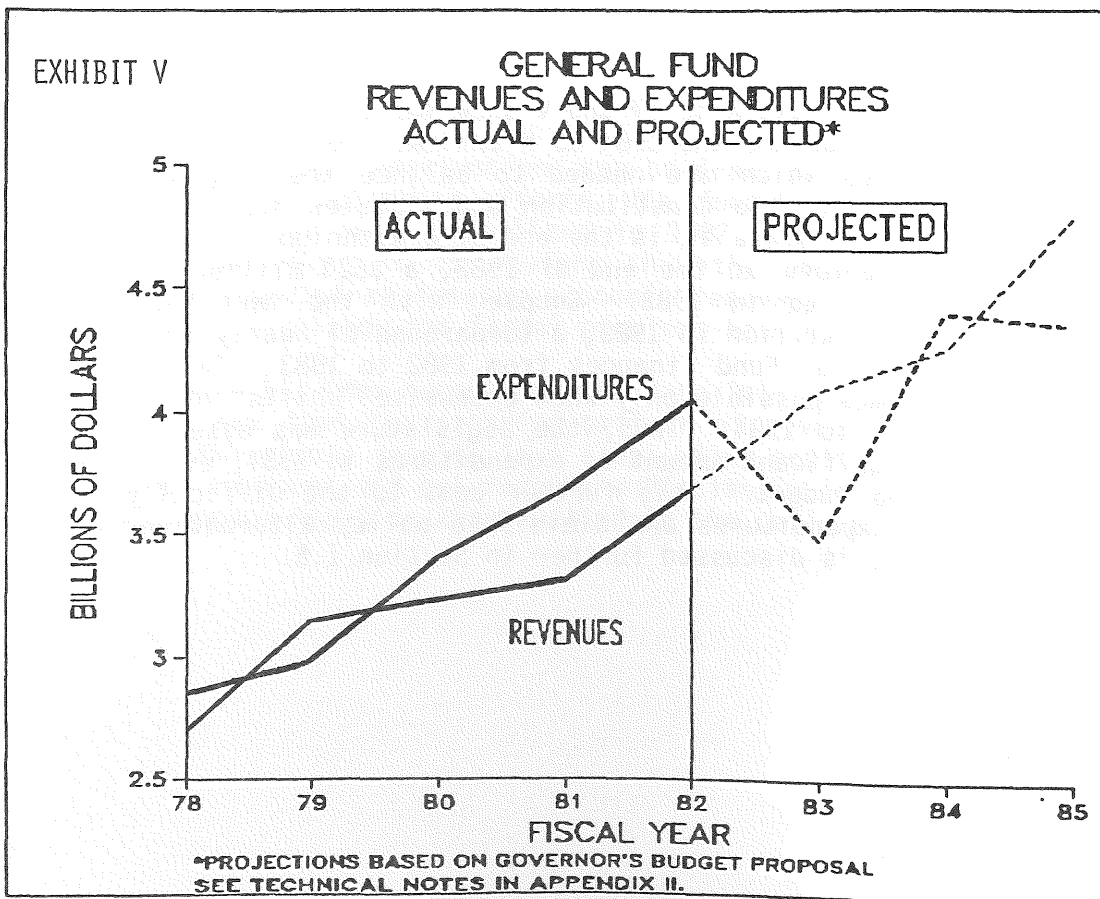
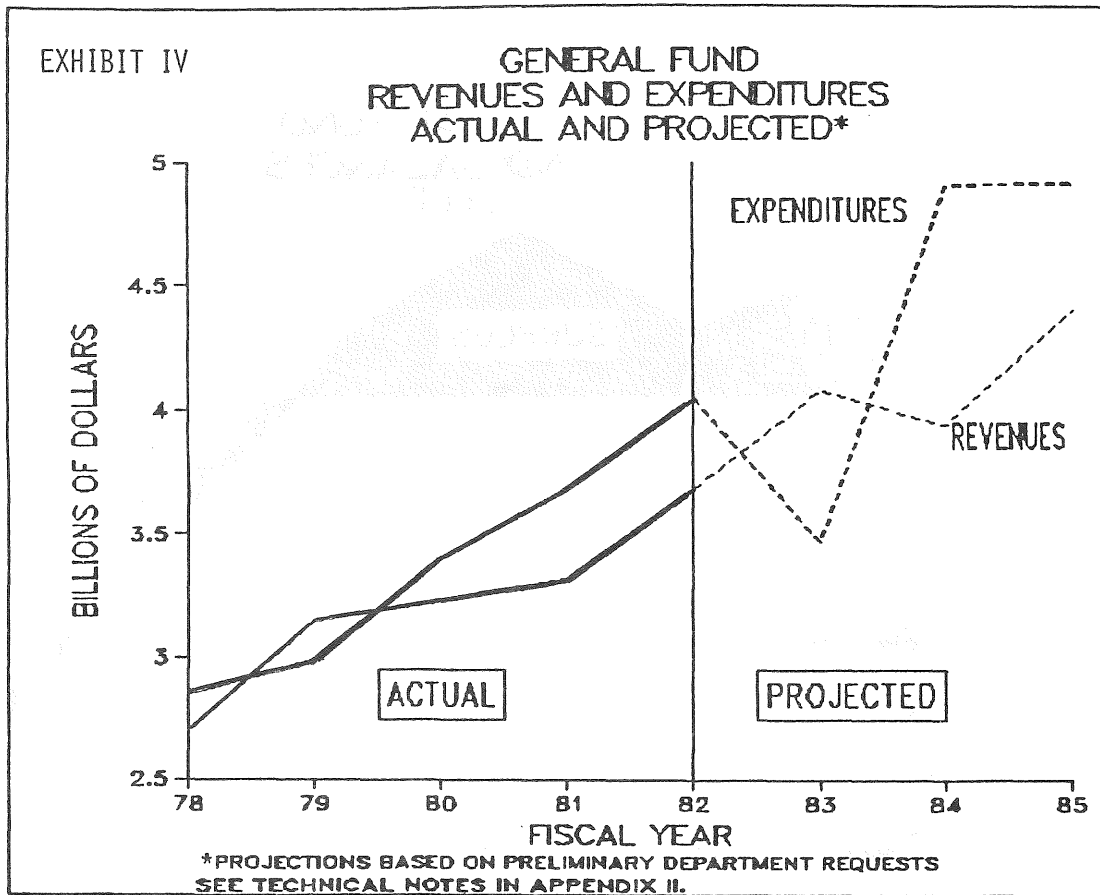


Exhibit IV utilizes preliminary department requests for 1984 and 1985 projections. It is based on the January 19, 1983 Department of Finance Fund Balance Analysis Report. This projection assumes that all temporary taxes will lapse as of June 30, 1983. Obviously, this scenario cannot become a legally adopted budget. It would result in a projected fund deficit which would exceed \$1 billion.

Exhibit V utilizes the Governor's budget proposal for 1984 and 1985 projections. It is based on the February 15, 1983 Department of Finance Fund Balance Analysis Report. Incorporating the Governor's proposed budget would result in a projected fund deficit of approximately \$150 million in the middle of the biennium. This deficit is projected to be recovered during fiscal year 1985 and an additional \$250 million reserve fund would be established. Hence, the Governor's budget proposal anticipates that General Fund 1985 finances would improve by an estimated \$400 million relative to 1984.

Obviously, whatever budget is finally enacted for the 1984-85 biennium will have to be balanced. Perhaps that biennial budget will perform according to original projections and special budget-balancing efforts will be avoided. Even if this is achieved, several fiscal problems will continue into the future as a result of difficulties experienced in fiscal years 1981 and 1982. These include:

- cash flow problems which will require extensive short-term borrowing,
- the degree to which future bienniums will be expected to finance obligations or commitments incurred in the current biennium, and
- the lowered credit ratings which have been imposed on the state's general obligation bonds and certificates of indebtedness.

These and other issues of importance to the General Fund are discussed in Sections I.D-F. However, first we will investigate the changes which have occurred in individual revenues (Section I.B.) and expenditure programs (Section I.C.).

I.B. ANALYSIS OF REVENUE SOURCES

Most observers of state government would agree that depressed revenue growth has been a primary cause of the General Fund's recent budgetary problems. This is reinforced by reviewing Appendix I. Despite the economic problems which depressed revenues, Table 2 indicates that General Fund revenues increased by 14.2 percent from 1980 to 1982. However, our analysis of this revenue growth reveals that most of that increase resulted from tax law changes and other structural changes in revenues. If the revenue structure which existed in 1980 had continued into 1982 without substantive change, we estimate that revenues would have grown by only 5 percent over this two year period. Also, it is interesting to note from Table 2 that individual revenue sources have reacted very differently during this time period.

TABLE 2

GENERAL FUND

REVENUES BY SOURCE
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Revenue Source	Fiscal Year 1980 Revenues	Percent Change in Rev- enues 1980-81	Fiscal Year 1981 Revenues	Percent Change in Rev- enues 1981-82	Fiscal Year 1982 Revenues	Percent Change in Rev- enues 1980-82
<u>Taxes:</u>						
Individual Income	\$1,749,828		\$1,892,685		\$1,992,357	
Less: Refunds	(352,265)		(333,866)		(293,162)	
Net	<u>\$1,397,563</u>	+11.5%	<u>\$1,558,819</u>	+ 9.0%	<u>\$1,699,195</u>	+21.6%
Corporate Income	\$ 376,095		\$ 352,462		\$ 358,300	
Less: Refunds	(30,386)		(63,382)		(56,151)	
Net	<u>\$ 345,709</u>	-16.4%	<u>\$ 289,080</u>	+ 4.5%	<u>\$ 302,149</u>	-12.6%
Sales (Net)	<u>\$ 650,902</u>	+ 5.8%	<u>\$ 688,895</u>	+27.2%	<u>\$ 876,078</u>	+34.6%
<u>Other Taxes (Net) -</u>						
Gross Earnings	\$ 131,082	+ 4.6%	\$ 137,070	- 0.7%	\$ 136,102	+ 3.8%
Mining	114,752	-10.5	102,699	+10.9	113,910	- 0.7
Motor Vehicle Excise	89,660	- 1.7	88,095	+18.3	104,219	+16.2
Cigarette/Tobacco	86,929	+ 2.0	88,638	+ 0.4	88,958	+ 2.3
Liquor	54,408	+ 2.6	55,805	- 0.6	55,469	+ 2.0
Bank Excise	36,115	- 1.3	35,640	-16.7	29,687	-17.8
Gift & Inheritance	40,813	-43.5	23,042	+16.4	26,821	-34.3
Others	25,567		20,880		23,449	
Net Other Taxes	<u>\$ 579,326</u>	- 4.7%	<u>\$ 551,869</u>	+ 4.8%	<u>\$ 578,615</u>	- 0.1%
Net Taxes	<u>\$2,973,500</u>	+ 3.9%	<u>\$3,088,663</u>	+11.9%	<u>\$3,456,037</u>	+16.2%
<u>Non-Tax Revenues:</u>						
Cost of Care Fees	\$ 57,454	+ 9.6%	\$ 62,986	+27.3%	\$ 80,186	+39.6%
Tuition & College Fees	38,398	+18.7	45,550	+13.2	51,575	+34.3
Investment Income	43,358	-33.2	28,957	-20.5	23,026	-46.9
Misc. Fees & Charges	42,225	+ 7.3	45,320	- 4.7	43,169	+ 2.2
Other Revenues	<u>18,703</u>		<u>29,360</u>		<u>31,874</u>	
Net Non-Tax Revenues	<u>\$ 200,138</u>	+ 6.0%	<u>\$ 212,173</u>	+ 8.3%	<u>\$ 229,830</u>	+14.8%
<u>Transfers From</u>						
<u>Other Funds:</u>						
Federal Revenue- Sharing	\$ 45,477		\$ 11,389		--	
Others	9,819		8,362		2,089	
Net Transfers	<u>\$ 55,296</u>	-64.3%	<u>\$ 19,751</u>	-89.4%	<u>\$ 2,089</u>	-96.2%
TOTAL REVENUES	<u>\$3,228,934</u>	+ 2.8%	<u>\$3,320,587</u>	+11.1%	<u>\$3,687,956</u>	+14.2%

See Technical Notes in Appendix II.

For purposes of our analysis, we have classified changes in revenues into two categories:

- (A) Structural Changes - This primarily includes changes to tax laws and federal government policies or responsibilities.
- (B) Economic Growth - This assumes that 1980 revenue policies would remain unchanged and monitors what changes would have occurred in revenues by 1982.

The complexity of General Fund revenue policies precludes an exact categorization of all changes to revenues from 1980 to 1982. However, we have attempted to incorporate the effects of major policy changes into our analysis and believe that it fairly represents the changes over this two year time period.

Table 3 indicates how we have segregated revenue changes between those that are structural and those that represent economic growth.

TABLE 3
GENERAL FUND
REVENUE CHANGES -- BY TYPE
FISCAL YEARS 1980 TO 1982
(In million \$)

<u>Type of Change</u>	<u>Dollar Change 1980-81</u>	<u>Percent Change 1980-81</u>	<u>Dollar Change 1981-82</u>	<u>Percent Change 1981-82</u>	<u>Dollar Change 1980-82</u>	<u>Percent Change 1980-82</u>
Structural changes by State Legislature	\$42	+1.3%	\$316	+ 9.6%	\$358	+11.1%
Other structural changes ⁽¹⁾	(48)	-1.5	(11)	- 0.4	(59)	- 1.9
Net Structural Changes	(\$ 6)	-0.2%	\$305	+ 9.2%	\$299	+ 9.2%
Economic Growth	98	+3.0	62	+ 1.9	160	+ 5.0
TOTAL CHANGE	<u>\$92</u>	<u>+2.8%</u>	<u>\$367</u>	<u>+11.1%</u>	<u>\$459</u>	<u>+14.2%</u>

(1) Other structural changes include federal law changes and reduced investment income.

This analysis shows that revenues have grown only 5 percent on their own. Further, revenues would only have increased 3.1 percent if the state Legislature had taken no action to revise revenue policies. To achieve the overall 14.2 percent increase, revenue policies had to be modified by the state Legislature so that an additional 11.1 percent was realized. This was slightly offset by a 1.9 percent decline attributed to other structural changes in revenue policies.

Table 4 further analyzes the structural changes which have occurred with revenues from 1980 to 1982.

TABLE 4

GENERAL FUND

STRUCTURAL REVENUE CHANGES
FISCAL YEARS 1980 TO 1982
(In Million \$)

Type of Change	Dollar Change 1980-81	Dollar Change 1981-82	Dollar Change 1980-82
Minnesota Law Changes:			
Individual Income Tax			
Accelerated Withholding	\$60		\$ 60
Accrual of Federal Income Tax Deductibility		\$ 52	52
7% Surcharge		63	63
Total Individual Income Tax	<u>\$60</u>	<u>\$115</u>	<u>\$175</u>
Sales Tax			
Accelerated Collections		\$ 28	\$ 28
Increase from 4% to 5%		159	159
Total Sales Tax	<u>---</u>	<u>\$187</u>	<u>\$187</u>
Motor Vehicle Excise (from 4% to 5%)		\$ 16	\$ 16
Reduced Inheritance Tax	(18)		(18)
Extending County Share of Medicaid to Mentally Retarded Residents of State Hospitals		3	3
Converting Agriculture Grain Inspection Fees to a Dedicated Account	<u>---</u>	<u>(5)</u>	<u>(5)</u>
Net - Minnesota Law Changes	<u>\$42</u>	<u>\$316</u>	<u>\$358</u>
Federal Changes:			
Elimination of Revenue Sharing	(\$34)	(\$ 11)	(\$ 45)
Retroactive Adjustment to Cost of Care Fees	<u>---</u>	<u>6</u>	<u>6</u>
Net - Federal Changes	<u>(\$34)</u>	<u>(\$ 5)</u>	<u>(\$ 39)</u>
Other Changes:			
Reduced Investment Income (Unavailability of Excess Cash)	<u>(\$ 14)</u>	<u>(\$ 6)</u>	<u>(\$ 20)</u>
NET STRUCTURAL CHANGES	<u>(\$ 6)</u>	<u>\$305</u>	<u>\$299</u>

Most of the structural changes initiated by the Legislature were in reaction to the projected budgetary shortfalls (again, see Appendix I). This is not the case for all the legislative changes, however. For example, the inheritance tax was reduced as a matter of modified tax policy. Also, the grain inspection fees which were moved to a dedicated account in 1982 were offset by the related reduction in expenditures which would now be charged to the dedicated account.

The federal government's decision to eliminate revenue sharing to the states served to phase out the \$45 million that Minnesota had received from this program in 1980. This created a modest structural reduction to revenues, because revenue sharing provided slightly over 1 percent of 1980 General Fund revenues.

The state's cash flow problems and elimination of the fund balance diminished the availability of excess cash balances and the opportunity to generate investment income for the General Fund. We have termed this \$20 million reduction in investment earnings as a structural change. The decision in the 1979 legislative session to reduce the fund balance or "surplus" supports categorizing the reduction as structural. However, the reduction is also inextricably related to various other factors and certainly may be partially attributable to the economic problems.

When the effects of structural changes are removed from revenues, presumably only the effects of economic growth patterns remain. Table 5 attempts to estimate the effects of economic growth on major revenue sources. The table is stated on a percentage basis which is useful in comparing the changes between individual revenue sources.

Table 5 indicates that tax revenues from corporations were particularly depressed because of economic problems. This is certainly understandable because corporations are ordinarily taxed based on their profits or production. This makes corporate tax sources particularly sensitive to the economy. Corporate income taxes fell by 12.6 percent from 1980 to 1982. Other similar types of taxes also fell, such as bank excise taxes (-17.8 percent) and mining taxes (-0.7 percent).

Other tax sources showed a modest percentage increase for the two year period. However, none of the increases can be considered significant, particularly since originally much larger increases were anticipated so that authorized expenditure increases could be financed. Appendix I further illustrates the extent to which these revenue shortfalls were experienced.

Finally, the major fee areas, cost of care and tuition, exhibited the most significant increase in revenues. However, it must be remembered that these fees are basically reactionary to the costs incurred by the state hospitals, nursing homes, universities, and community colleges. Therefore, the reasonableness of these fee increases can best be evaluated when compared to the expenditures of the respective state institutions. Table 11 in Section I.C. compares the changes in state institutions' expenditures to their respective revenues. That analysis shows that these fee revenues have generally outpaced the growth in expenditures, but only by a modest amount. Further, Section I.C. indicates that the growth in the net cost of state institutions is comparably higher than that of most other state departments.

TABLE 5

GENERAL FUND

REVENUES BY SOURCE

ANALYSIS OF PERCENT CHANGES FROM FISCAL YEAR 1980 TO 1982

Major Revenue Sources	Percent Change 1980-82		Total
	Due to Economic Growth	Due to Structural Change	
Taxes:			
Individual Income	+ 9.0%	+12.6%	+21.6%
Corporate Income	-12.6		-12.6
Sales	+ 5.8	+28.8	+34.6
Gross Earnings	+ 3.8		+ 3.8
Mining	- 0.7		- 0.7
Motor Vehicle Excise		+16.2	+16.2
Cigarette/Tobacco	+ 2.3		+ 2.3
Liquor	+ 2.0		+ 2.0
Bank Excise	-17.8		-17.8
Gift & Inheritance		-34.3	-34.3
Net Taxes	<u>+ 4.1%</u>	<u>+12.1%</u>	<u>16.2%</u>
Non-Tax Revenues:			
Cost of Care Fees	+24.1%	+15.5%	+39.6%
Tuition and College Fees	+34.3		+34.3
Investment Income		-46.9	-46.9
Misc. Fees and Charges	+ 5.8	- 3.6	+ 2.2
Net Non-Tax Revenues	<u>+23.0%</u>	<u>- 8.2%</u>	<u>+14.8%</u>
Transfers	<u>-14.5%</u>	<u>-81.7%</u>	<u>-96.2%</u>
TOTAL REVENUES	<u>+ 5.0%</u>	<u>+ 9.2%</u>	<u>+14.2%</u>

In summary, it is obvious that General Fund revenues have been depressed for the last few years. We estimate that total revenues would have increased by only 3.1 percent from 1980 to 1982 if the Legislature had not acted to institute certain structural changes to revenue policies (see Table 3). Undoubtedly, revenues will have to be monitored closely in the ensuing biennium. Economic recovery will have to be experienced if further structural changes in revenue policy are to be avoided as a source of increased revenues.

I.C. ANALYSIS OF EXPENDITURE PROGRAMS

The General Fund expenditures totaled over \$4 billion in fiscal year 1982. Approximately 80 percent of this amount was either returned to local governments to finance their programs, spent on property tax relief, or paid out as subsidies to individuals. Thus, the state spent only 20 percent of this amount for state government administrative functions. Table 6 displays this breakdown of General Fund expenditures.

TABLE 6
GENERAL FUND
EXPENDITURES BY MAJOR CATEGORIES
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Expenditure Category	Percent Change in		Percent Change in		Percent Change in	
	F.Y. 1980 Expenditures	1980-81	F.Y. 1981 Expenditures	1981-82	F.Y. 1982 Expenditures	1980-82
State Government Operations (Salaries, Supplies, and Expense)	\$ 562,152	+ 7.8%	\$ 605,731	+ 6.0%	\$ 641,869	+14.2%
Intergovernmental Transfer Payments	1,750,182	+ 4.4	1,826,773	+ 6.0	1,936,298	+10.6 ⁽¹⁾
Direct Property Tax Relief Programs	510,135	+22.0	622,387	+14.8	714,676	+40.1
Subsidies to Individuals	391,651	+26.7	496,141	+11.9	554,959	+41.7
Debt Service	88,173	+ 6.6	93,996	+43.9	135,302	+53.5
Other Transfers	<u>98,737</u>	<u>-54.0</u>	<u>45,467</u>	<u>+49.4</u>	<u>67,932</u>	<u>-31.2</u>
TOTAL EXPENDITURES	<u>\$3,401,030</u>	<u>+ 8.5%</u>	<u>\$3,690,495</u>	<u>+ 9.8%</u>	<u>\$4,051,036</u>	<u>+19.1%</u>

(1) In substance, Intergovernmental Transfer Payments increased by 14.5 Percent. A shift of \$67.4 million in Local Government Aids reduces this to the apparent level of 10.6 Percent.

See Technical Notes in Appendix II.

A review of expenditures from 1980 to 1982 reveals how spending patterns have changed over the last few years as the General Fund experienced financial difficulties. The analysis in Table 6 indicates that total expenditures have increased 8.5 percent and 9.8 percent in fiscal years 1981 and 1982, respectively, resulting in a 19.1 percent increase for the two year period. However, it must be remembered that these are average increases and the change in individual programs departs significantly from that average. For the purposes of our analysis, we have classified expenditures into the following six categories:

- (A) State Government Operations - This category includes salary cost, administrative expenditures, supplies, and equipment purchases for all state institutions and other state departments.
- (B) Intergovernmental Transfer Payments - This category includes all school aids, aids to the University of Minnesota, Local Government Aids, and a variety of other aids paid to local governments.
- (C) Direct Property Tax Relief Programs - This category includes property tax relief paid to local governments on behalf of property owners, e.g., the Homestead Credit, and refund amounts paid directly to taxpayers, e.g., the Circuit Breaker.
- (D) Subsidies Paid to Individuals - This category is dominated by welfare benefits and includes other programs such as scholarship and grant programs for college students.
- (E) Debt Service Payments - This category includes the repayment of general obligation bond principal and interest, plus interest on short-term certificates of indebtedness.
- (F) Other Transfers - This category consists of monies paid to other state funds for expenditure. Primary amounts include the distribution of certain taconite taxes to the Iron Range Resources and Rehabilitation Board and amounts distributed to the Minnesota Housing Finance Agency for housing programs.

We will further investigate the change in spending patterns for each of these categories. However, there is a general observation which can be made for all categories. The analysis in Section I.A. indicated that expenditure growth has not been significantly affected by the financial problems experienced by the state. This occurs because, for all practical purposes, major expenditure areas cannot be controlled in the short-term. State policies have established a variety of commitments which are difficult to renege on in the short-term. For example, Direct Property Tax Relief programs were greatly expanded in the 1979 and 1980 legislative sessions and affected local government budget decisions in 1981 and 1982. Since local governments had levied property taxes assuming that the state would deliver these property tax relief payments and the many Intergovernmental Transfer Payments, the state was unable to significantly reduce these commitments without devastating local government finances. There are also certain contracted expenditures which are difficult to control in the short-term. These include most salary costs, debt service expenditures, and certain administrative expenditures, such as communications and utilities.

On the other hand, there are expenditure programs which can be controlled with short-term notice. These include items which are discretionary and can be reduced or delayed in the short-term, such as travel, consultant contracts, and certain grant programs. Unfortunately, these programs constitute a minor amount of the state's budget. Our analysis reveals that most of these controllable expenditures have been reduced in 1982 below what they were in 1980.

In summary, the pattern which emerges with expenditures is that they are difficult to control in the short-term. State policies and contractual agreements seem to establish expenditure levels which are difficult to adjust. If there is a desire to reduce state spending or make it more flexible, substantial changes in state finances will be necessary.

I.C.1. State Government Operations

We have classified salaries, administrative expenditures, supplies, and capital expenditures as comprising State Government Operations. Two analyses of this category are included: (1) by expenditure type, and (2) by department/institution. These analyses reveal how and where recent budget cuts have affected state government finances.

Table 7 illustrates State Government Operation expenditures by type. The table demonstrates how dominant salaries are as a component of operating expenditures. Salaries comprised approximately 80 percent of all operating expenditures during this period. Although the size of the state's work force has been on the decline for the last few years (see the February 1983 Report by the Department of Employee Relations), salary costs rose 9.4 percent and 7.1 percent in fiscal years 1981 and 1982, respectively. Certainly, some reduction in the work force is attributable to layoffs. However, the costs of severance pay and unemployment compensation ordinarily obviate any significant short-term savings for the state. Furthermore, when negotiated and discretionary salary increases are also considered, salary costs become an area where annual increases must be expected.

Government operation expenditure types, other than salaries, have generally averaged comparably lower growth. This seems to indicate that most departments have opted to direct budget cuts to these categories when short-term savings are needed. Indeed, many of these expenditure types allow a certain amount of discretion by agency heads and can be controlled in the short-term. Table 8 indicates the percentage change in those expenditure types which allow some discretion.

TABLE 7
GENERAL FUND
STATE GOVERNMENT OPERATIONS BY EXPENDITURE TYPE
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Expenditure Type	F.Y. 1980 Expenditures	Percent Change in Expen- ditures 1980-81	F.Y. 1981 Expenditures	Percent Change in Expen- ditures 1981-82	F.Y. 1982 Expenditures	Percent Change in Expen- ditures 1980-82
Salaries	\$444,278	+ 9.4%	\$486,145	+ 7.1%	\$520,542	+17.2%
Administrative Expenditures:						
Communications	12,632	+ 7.4	13,566	+ 6.1	14,388	+13.9
Computer Services	12,520	+ 5.6	13,226	- 7.0	12,295	- 1.8
Professional Tech Services	11,533	- 0.3	11,496	- 1.1	11,364	- 1.5
Utilities	7,998	+13.2	9,053	+ 5.8	9,575	+19.7
Travel	8,960	- 8.6	8,192	+ 6.0	8,686	- 3.1
Rent	8,298	- 3.1	8,039	+ 4.4	8,394	+ 1.2
Printing	6,881	- 0.6	6,838	+ 0.6	6,877	- 0.1
Other Purchased Services	4,279	+23.7	5,292	+ 0.2	5,301	+23.9
Repairs	3,069	+ 5.9	3,249	+14.4	3,718	+21.1
Consultants	1,841	+ 0.9	1,858	-62.1	705	-61.7
Advertising	1,259	- 1.4	1,242	-21.0	981	-22.1
Other	1,963		1,928		1,957	
Total	<u>\$ 81,233</u>	<u>+ 3.4%</u>	<u>\$ 83,979</u>	<u>+ 0.3%</u>	<u>\$ 84,241</u>	<u>+ 3.7%</u>
Supplies	34,955	- 7.1	32,479	+11.3	36,153	+ 3.4
Capital Expenditures	12,715	+ 4.6	13,295	-16.6	11,082	-12.8
Other (Including Miscellaneous Adjustments)	4,724		12,019		9,503	
Less: Reimbursements From Others	(15,753)		(22,186)		(19,652)	
TOTAL STATE GOVERNMENT OPERATIONS	<u>\$562,152</u>	<u>+ 7.8%</u>	<u>\$605,731</u>	<u>+ 6.0%</u>	<u>\$641,869</u>	<u>+14.2%</u>

TABLE 8

GENERAL FUND

STATE GOVERNMENT OPERATIONS
DISCRETIONARY EXPENDITURE TYPES
PERCENT CHANGE 1980 TO 1982

<u>Expenditure Type</u>	<u>Percent Change</u>
Consultants	-61.7%
Advertising	-22.1
Capital Expenditures	-12.8
Travel	- 3.1
Computer Services	- 1.8
Professional Technical Services	- 1.5
Printing	- 0.1
Rent	+ 1.2
Supplies	+ 3.4

Aside from salaries and the discretionary expenditures listed in Table 8, the remaining expenditure types have shown sizable increases. This is caused because either they are unavoidable and influenced by market forces or they reflect trade-offs from other expenditure types that have been depressed. For example, utilities rose by 19.7 percent and communications by 13.9 percent for the two year period. These are needed services which must be acquired at the market price. Repairs increased by 21.1 percent for the two years. This is most likely attributable to reduced expenditures for new equipment and is the trade-off experienced from that decision.

Table 9 is a more traditional look at State Government Operations--by department and institution. The difference between this and other analyses of the General Fund is that all grant and benefit expenditures have been excluded from state department's budgets. Thus, we are focusing only on salaries, administrative expenditures, supplies, and capital items which are purchased by state departments. As the state experienced its budget problems, all departments or institutions were not affected the same. The average increase in operating expenditures for the two years was 14.2 percent. However, state institutions, which were shielded from some budget cuts, had an average increase of 21.4 percent while all other state departments averaged a 7.2 percent increase. Further, even within those two categories there was a wide disparity between individual departments or institutions.

TABLE 9

GENERAL FUND

STATE GOVERNMENT OPERATIONS BY DEPARTMENT/INSTITUTION (1)
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Department/ Institution	F.Y. 1980 Expenditures	Percent Change in Expen- ditures 1980-81	F.Y. 1981 Expenditures	Percent Change in Expen- ditures 1981-82	F.Y. 1982 Expenditures	Percent Change in Expen- ditures 1980-82
Constitutional Officers:						
Attorney General	\$ 8,357	+12.6%	\$ 9,411	+ 7.7%	\$ 10,136	+21.3%
Governor/Lt. Governor	1,513	- 9.4	1,371	+ 4.3	1,430	- 5.5
Secretary of State	678	+34.8	914	+ 3.7	948	+39.8
State Treasurer	812	+ 8.1	878	+ 2.1	896	+10.3
State Auditor	241	+ 2.5	247	+ 8.9	269	+11.6
Subtotal	<u>11,601</u>	<u>+10.5</u>	<u>12,821</u>	<u>+ 6.7</u>	<u>13,679</u>	<u>+17.9</u>
Judiciary:						
District Court Judges	10,948	+ 7.5	11,766	- 0.2	11,748	+ 7.3
Supreme Court	3,044	+21.5	3,697	+12.8	4,171	+37.0
Subtotal	<u>13,992</u>	<u>+10.5</u>	<u>15,463</u>	<u>+ 2.9</u>	<u>15,919</u>	<u>+13.8</u>
Legislative:						
House of Representa- tives	9,305	+14.6	10,664	+ 1.5	10,824	+16.3
Senate	5,941	+22.4	7,270	- 5.2	6,895	+16.1
Legislative Auditor	1,837	+13.2	2,079	+ 4.4	2,170	+18.1
Revisor of Statutes	1,199	+31.2	1,573	+25.7	1,978	+65.0
Other Legislative Commissions	<u>1,313</u>		<u>1,956</u>		<u>1,323</u>	
Subtotal	<u>19,595</u>	<u>+20.1</u>	<u>23,542</u>	<u>- 1.5</u>	<u>23,190</u>	<u>+18.3</u>
Central Financial and Administrative:						
Revenue	23,978	+ 3.9	24,862	+12.8	28,054	+17.0
Administration	14,464	+ 3.0	14,893	+ 2.0	15,187	+ 5.0
Finance	4,975	+ 1.5	5,050	+ 2.2	5,160	+ 3.7
Employee Relations	2,845	+ 4.7	2,979	+ 3.6	3,087	+ 8.5
Investment Board	938	+14.2	1,071	+13.3	1,213	+29.3
Subtotal	<u>47,200</u>	<u>+ 3.5</u>	<u>48,855</u>	<u>+ 7.9</u>	<u>52,701</u>	<u>+11.7</u>
Direct Service Departments:						
Natural Resources	35,782	+13.1	40,463	- 1.5	39,838	+11.3
Public Welfare	19,599	+ 3.8	20,334	+ .3	20,403	+ 4.1
Education	14,392	+ 1.9	14,659	+ 7.2	15,718	+ 9.2
Public Safety	11,912	+ 0.6	11,987	+ 8.7	13,028	+ 9.4
Corrections	9,382	+ 0.3	9,408	+ 0.4	9,449	+ .7
Health	8,531	+ 5.1	8,962	+ 0.7	9,025	+ 5.8
Energy, Planning, and Development	9,198	+ 6.1	9,761	-10.4	8,745	- 5.0
Commerce	5,540	+ 4.3	5,778	+20.3	6,953	+25.5
Agriculture--Excluding Grain Inspection	5,592	+ 7.8	6,028	+ 6.2	6,399	+14.4
Agriculture--Grain Inspection ⁽²⁾	7,099		8,398		--	
Pollution Control	4,708	+ 3.1	4,853	+16.6	5,660	+20.2
Zoological Gardens	5,005	+ 1.1	5,059	- 2.8	4,919	- 1.7
Labor and Industry ⁽³⁾	5,623	+ 3.2	5,805	+12.1	6,506	+15.7
Military Affairs	3,721	+ 6.9	3,979	+ 7.4	4,274	+14.9
Public Service/ Utilities	3,586	+ 2.7	3,682	+ 3.2	3,798	+ 5.9
State University Board	2,988	+ 0.5	3,004	+18.9	3,571	+19.5
MECC	3,339	+ 1.8	3,400	- 4.5	3,247	- 2.8
Community College Board	2,397	+ 4.1	2,496	+22.7	3,062	+27.7
HECB	1,473	+ 7.3	1,580	- 4.2	1,514	+ 2.8
Animal Health Board	1,034	+ 3.5	1,070	+15.8	1,239	+19.8

TABLE 9
(Con't)

GENERAL FUND

STATE GOVERNMENT OPERATIONS BY DEPARTMENT/INSTITUTION (1)
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Department/ Institution	F.Y. 1980 Expenditures	Percent Change in Expen- ditures 1980-81	F.Y. 1981 Expenditures	Percent Change in Expen- ditures 1981-82	F.Y. 1982 Expenditures	Percent Change in Expen- ditures 1980-82
Direct Service						
Departments: (cop't) ⁽⁴⁾						
Economic Security	2,987	+45.7	4,351	-71.6	1,236	-59.6
Human Rights	922	+ 4.6	964	+14.2	1,101	+19.4
Mediation Services	816	+14.2	932	+ 8.0	1,007	+23.4
Other Departments	8,459		9,279		9,514	
Subtotal	<u>174,085</u>	<u>+ 7.0</u>	<u>186,232</u>	<u>- 3.2</u>	<u>180,206</u>	<u>+ 3.5</u>
TOTAL NON-INSTITUTIONS	<u>\$266,473</u>	<u>+ 7.7%</u>	<u>\$286,913</u>	<u>- 0.4%</u>	<u>\$285,695</u>	<u>+ 7.2%</u>
State Institutions:						
State Universities	\$ 96,439	+ 5.0%	\$101,245	+19.7%	\$121,169	+25.6%
Community Colleges ⁽⁵⁾	46,111	+ 7.6	49,598	+21.1	60,079	+30.3
Welfare Institutions	122,479	+ 9.3	133,911	+ 4.9	140,409	+14.6
Correctional Facilities	32,234	+ 4.5	35,051	+13.0	38,074	+18.1
Veterans Homes	4,081	+25.7	5,129	+20.8	6,194	+51.8
TOTAL INSTITUTIONS	<u>\$301,344</u>	<u>+ 7.8%</u>	<u>\$324,934</u>	<u>+12.6%</u>	<u>\$365,925</u>	<u>+21.4%</u>
Unallocated Expenditures	10,088		16,070		9,901	
Less: Reimbursements From Others	(15,753)		(22,186)		(19,652)	
TOTAL - STATE GOVERNMENT OPERATIONS	<u>\$562,152</u>	<u>+ 7.8%</u>	<u>\$605,731</u>	<u>+ 6.0%</u>	<u>\$641,869</u>	<u>+14.2%</u>

NOTES:

- (1) Only major departments are listed.
- (2) The Grain Inspection Program and the fees which it generates were moved to a dedicated account in 1982.
- (3) 1982 Labor and Industry expenditures include the Workers' Compensation Court of Appeals (\$367,000) and the Hearing Examiners (\$1,368,000). These two programs had been part of Labor and Industry in 1980 and 1981. Although they separated from Labor and Industry in 1982, we have included their expenditures so that all data is comparable.
- (4) These drastic changes are caused by a structural tradeoff between certain counselor salaries and vocational rehabilitation benefits. Salaries dropped significantly in the General Fund as they are now paid with federal monies. Vocational rehabilitation benefits rose significantly (see Table 16) because they were formerly paid from federal monies and are now paid from the General Fund. These changes were designed to offset each other and negate any significant impact on the General Fund.
- (5) The phasing out of Rochester State Hospital has reduced its expenditures. All hospitals, other than Rochester, have averaged a two year increase in expenditures of 18.7 percent.

Looking at state departments, other than institutions, one can see an extremely wide range in the expenditure changes. Table 10 indicates the distribution of departmental expenditure changes from 1980 to 1982.

TABLE 10
GENERAL FUND
STATE DEPARTMENTS (EXCLUDING INSTITUTIONS)
DISTRIBUTION OF EXPENDITURE CHANGES 1980 TO 1982

<u>Percent Expenditure Change 1980 to 1982</u>	<u>Number of Departments</u>
Decreased	5
Increased 0 - 5%	4
Increased 5 - 10%	7
Increased 10 - 15%	5
Increased 15 - 20%	8
Increased 20 - 25%	3
Increased over 25%	6

Many of these changes may be attributed to structural changes in a department's organization or to a change in responsibilities. However, just by scanning this distribution, one can conclude that expenditures have changed in a disparate manner for various departments.

At first look one can conclude that institutions account for one-half of all state government operating expenditures. However, state institutions do generate revenues for the General Fund (except for correctional facilities). Colleges and universities collect tuition revenues from students; and the welfare institutions and the veterans homes are partially financed by federal and county monies through the Medical Assistance program, and to a lesser degree, by residents' resources. Table 11 considers the impact of revenues generated by the institutions and reduces their expenditures to a net cost figure. On a net cost basis, we can see that institutions comprise less than one-half of state government operating expenditures. Also, the average net cost percentage increase has been reduced to 16.9 percent. This reduced growth in net cost is realized in the colleges/universities and welfare institutions. Tuition revenues have grown at a higher percentage than college/university expenditures. This difference in growth is not large, however, and occurred primarily between fiscal years 1980 and 1981. In fact, tuition revenue increases in 1982 were outpaced by increases in expenditures.

TABLE 11
GENERAL FUND

STATE GOVERNMENT OPERATIONS
NET COST OF INSTITUTIONS
FISCAL YEARS 1980 TO 1982
(000's Omitted)

<u>Institutions</u>	<u>F.Y. 1980</u>	<u>Percent Change From 1980-81</u>	<u>F.Y. 1981</u>	<u>Percent Change From 1981-82</u>	<u>F.Y. 1982</u>	<u>Percent Change From 1980-82</u>
State						
Universities:						
Expenditures	\$ 96,439	+ 5.0%	\$101,245	+19.7%	\$121,169	+25.6%
Revenues	(24,070)	+18.3	(28,464)	+11.4	31,722	+31.8
Net Cost	<u>\$ 72,369</u>	<u>+ 0.6</u>	<u>\$ 72,781</u>	<u>+22.9</u>	<u>\$ 89,447</u>	<u>+23.6</u>
Community						
Colleges:						
Expenditures	\$ 46,111	+ 7.6%	\$ 49,598	+21.1%	\$ 60,079	+30.3%
Revenues	(14,328)	+19.2	(17,086)	+16.2	(19,853)	+38.6
Net Cost	<u>\$ 31,783</u>	<u>+ 2.3%</u>	<u>\$ 32,512</u>	<u>+23.7%</u>	<u>\$ 40,226</u>	<u>+26.6%</u>
Welfare						
Institutions:						
Expenditures	\$122,479	+ 9.3%	\$133,911	+ 4.9%	\$140,409	+14.6%
Revenues (1)(3)	(57,454)	+ 9.6	(62,986)	+18.3	(74,500)	+29.7
Net Cost	<u>\$ 65,025</u>	<u>+ 9.1%</u>	<u>\$ 70,925</u>	<u>- 7.1%</u>	<u>\$ 65,909</u>	<u>+ 1.4%</u>
Veterans Homes:						
Expenditures	\$ 4,081	+25.7%	\$ 5,129	+20.8%	\$ 6,194	+51.8%
Revenues	(3,027)	- 0.1	(3,023)	+ 8.1	(3,269)	+ 8.0
Net Cost	<u>\$ 1,054</u>	<u>+99.8%</u>	<u>\$ 2,106</u>	<u>+38.9%</u>	<u>\$ 2,925</u>	<u>+177.5%</u>
Correctional						
Facilities:						
Net Cost (2)	<u>\$ 32,234</u>	<u>+ 4.5%</u>	<u>\$ 35,051</u>	<u>+13.0%</u>	<u>\$ 38,074</u>	<u>+18.1%</u>
TOTAL NET COST -						
STATE						
INSTITUTIONS	<u>\$202,465</u>	<u>+ 5.4%</u>	<u>\$213,375</u>	<u>+10.9%</u>	<u>\$236,581</u>	<u>+16.9%</u>

(1) Retroactive adjustments of \$5,686,000 are excluded from revenues as they could distort the trend analysis.

(2) Correctional facilities do not generate significant General Fund revenues.

(3) The state's share of Medical Assistance has been excluded from these revenues, because in substance the General Fund is simply paying itself.

The net cost of welfare institutions increased by only 1.4 percent from 1980 to 1982. This does not necessarily indicate any particular cost-containment trend, however. Revenues increased by approximately \$3.2 million in 1982 because of a law change which allowed counties to be billed for mentally retarded residents through the Medical Assistance program. Also, the closing of Rochester State Hospital has served to slow expenditure increases in 1982. The trend in recent years toward placing more residents in community facilities, rather than state welfare institutions, may contribute to this minimal increase.

The Veterans Homes present an entirely different picture. Net costs to the General Fund have more than doubled since 1980. However, since they only comprise approximately 1 percent of all institution costs, their impact is minimal.

In summary, the state's budget problems have affected state departments and institutions differently. There is not a clear pattern of across-the-board reductions; rather, reductions have varied significantly. Further, the analyses indicate that departments have generally opted to reduce certain discretionary expenditures, other than salaries, to achieve short-term budget savings.

I.C.2. Intergovernmental Transfer Payments

Intergovernmental Transfer Payments⁵ comprise approximately one-half of the General Fund's budget. The programs we have classified into this category are shown in Table 12. For purposes of our analysis, we have categorized Direct Property Tax Relief Payments and Subsidies Paid to Individuals separately. These additional two categories are also largely remitted to local governments for expenditure and do serve to benefit local government finances. However, they are also either designed to provide direct benefits to individuals or are not necessarily viewed as local responsibilities which simply receive state financing, such as are the Intergovernmental Transfer Payments.

A review of Table 12 indicates the wide range of programs which are designed to provide state financing to local governments. Minnesota governments in many respects maintain a shared tax system. State government has taken much of the responsibility for collecting taxes through the statewide tax sources, such as income and sales taxes, and then has redistributed these proceeds to its local governments. This serves to reduce local governments' reliance on their limited taxing sources, primarily the property tax. The state provides Intergovernmental Transfer Payments to its local governments in basically two forms: (1) for general government purposes (or general aids), and (2) for specific programs (or categorical aids). Table 13 divides Intergovernmental Transfer Payments between these two forms.

⁵For purposes of explanation, we consider the University of Minnesota to be a local unit of government. Because of its autonomy from the state, it exhibits the characteristics more of a local government than a state department.

TABLE 12

GENERAL FUND
INTERGOVERNMENTAL TRANSFER PAYMENTS BY PROGRAM
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Program	F.Y. 1980 Expenditures	Percent Change in Expen- ditures 1980-81	F.Y. 1981 Expenditures	Percent Change in Expen- ditures 1981-82	F.Y. 1982 Expenditures	Percent Change in Expen- ditures 1980-82
School Aids:						
Foundation Aids	\$ 644,413	+ 1.5%	\$ 653,818	+14.7%	\$ 749,871	+16.4%
Categorical Aids:						
Transportation Aids	\$ 88,435	+20.0%	\$ 106,088	+15.3%	\$ 122,372	+38.4%
Vocational Ed. Aids	108,528	+13.8	123,546	+ 6.7	131,867	+21.5
Special Ed. Aids	87,353	+ 5.5	92,189	+14.6	105,669	+21.0
Others	30,336		33,829		41,029	
Subtotal - Categorical Aids	\$ 314,652	+13.0%	\$ 355,652	+12.7%	\$ 400,937	+27.4%
Contributions to Teachers Pension Plans						
	\$ 137,833	+ 9.4%	\$ 150,773	+ 5.6%	\$ 159,178	+15.5%
Total	\$1,096,898	+ 5.8%	\$1,160,243	+12.9%	\$1,309,986	+19.4%
Aids to University of Minnesota:						
Maintenance & Operations	\$ 174,320	- 1.6%	\$ 171,479	+20.4%	\$ 206,493	+18.5%
Categorical Aids	47,823	- 3.3	46,231	- 2.8	44,939	- 6.0
Total	\$ 222,143	- 2.0%	\$ 217,710	+15.5%	\$ 251,432	+13.2%
Aids to Other Local Governments:						
Levy Coordinated Aids:						
Local Gov't Aid	\$ 230,182	+ 0.4%	\$ 231,005	-12.2%	\$ 202,889	-11.9%
Taconite Aids	40,740	+ 0.8	41,049	+12.7	46,279	+13.6
Attached Mach. Credit	11,440	+ 0.4	11,491	- 2.2	11,238	- 1.8
DNR Payments in Lieu of Property Taxes	4,901	- 4.0	4,703	- 8.0	4,328	-11.7
Subtotal - Levy Coordinated Aids	\$ 287,263	+ 0.3%	\$ 288,248	- 8.2%	\$ 264,734	- 7.8%
Program Aids:						
Public Transit Aids	\$ 26,562	-11.1%	\$ 23,619	-31.4%	\$ 16,201	-39.0%
Police & Fire Aids	19,219	+ 8.4	20,837	+ 5.1	21,899	+13.9
Corrections Aids	10,323	+11.1	11,467	+ 9.1	12,513	+21.2
Community Health Services Aids	10,193	+20.2	12,255	- 7.0	11,401	+11.9
Welfare Admin. Aids	9,741	-39.5	5,894	+17.9	6,950	-28.7
Shade Tree Disease Control Grants	9,623	-12.6	8,415	-67.9	2,699	-72.0
Planning & Rec. Aids	3,262	+45.6	4,751	-22.5	3,682	+12.8
Inheritance Tax Apportionment	3,965					
Contributions to Local Pension Plans	1,763	+260.3	6,352	+69.3	10,754	+510.0 ⁽¹⁾
Subtotal - Program Aids	\$ 94,651	- 1.1%	\$ 93,590	- 8.0%	\$ 86,099	- 9.0%
Total	\$ 381,914	--	\$ 381,838	- 8.1%	\$ 350,833	- 8.1%
Other Programs (Includes Misc. Adjustments)						
	\$ 49,227		\$ 66,982		\$ 24,047	
TOTAL - INTERGOVERNMENTAL TRANSFER PAYMENTS	\$1,750,182	+ 4.4%	\$1,826,773	+ 6.0%	\$1,936,298	+10.6%

(1) The increase in contributions to local pension plans is due primarily to the state providing aid to amortize the unfunded liability of local police and fire relief associations and of the Minneapolis Employees Retirement Fund.

TABLE 13

GENERAL FUND

INTERGOVERNMENTAL TRANSFER PAYMENTS
 GENERAL AIDS VS. CATEGORICAL AIDS
 FISCAL YEARS 1980 TO 1982
 (000's Omitted)

	F.Y. 1980 Expenditures	F.Y. 1981 Expenditures	F.Y. 1982 Expenditures	Percent Change Expen- ditures 1980-82
General Aids:				
School Foundation Aids	\$ 644,413	\$ 653,818	\$ 749,871	+16.4%
University of Minn. - Maintenance & Operations	174,320	171,479	206,493	+18.5
Aids to Other Local Governments - Levy Coordinated	287,263	288,248	264,734	- 7.8 ⁽¹⁾
Subtotal	<u>\$1,105,996</u>	<u>\$1,113,545</u>	<u>\$1,221,098</u>	<u>+10.4%</u>
Categorical Aids:				
To Schools	\$ 452,485	\$ 506,425	\$ 560,115	23.8%
To University of Minn.	47,823	46,231	44,939	- 6.0
To Other Local Governments	94,651	93,590	86,099	- 9.0
Other	49,227	66,982	24,047	
Subtotal	<u>\$ 644,186</u>	<u>\$ 713,228</u>	<u>\$ 715,200</u>	<u>+11.0%</u>
TOTAL - INTERGOVERNMENTAL TRANSFER PAYMENTS	<u>\$1,750,182</u>	<u>\$1,826,773</u>	<u>\$1,936,298</u>	<u>+10.6%</u>

(1) The apparent reduction of aids to other local governments by 7.8 percent is misleading, because \$67.4 million dollars of Local Government Aid payments were rescheduled or "shifted" from fiscal year 1982 to 1983. Adjusting for the effect of this shift reveals that these aids instead increased by 15.6 percent for substantive purposes. Accordingly, general aids have averaged a two year increase of 15-20 percent for all local units of government.

The increase in general aids was somewhat reduced by a decline in categorical aids to all local governments, except schools. Aids targeted to specific programs showed a two year decline of 6.0 percent to the University of Minnesota and 9.0 percent to other local governments (aside from schools). For example, the Shade Tree Disease Prevention Program was phased out during these two years. It had partially reimbursed local governments for their costs incurred in combatting Dutch Elm disease. On the other hand, categorical aids to schools showed a relatively high two year increase of 23.8 percent (including payments to teachers' pension plans). This outpaced the growth in foundation aids to schools and would serve to target state aids to particular school programs.

The net result of all Intergovernmental Transfer Payments produces the following two year results:

- school aids increased 19.4 percent,
- aids to the University of Minnesota increased 13.2 percent, and
- aids to all other local governments increased 9.5 percent (after removing the effects of the \$67.4 million shift in Local Government Aids).

State budget cuts were passed on to local governments in certain instances and have held down the growth in these aid programs. However, it shall also be remembered that General Fund revenues increased by only 14.2 percent from 1980 to 1982. Further, local governments benefit from the Direct Property Tax Relief Programs discussed in the next section. Also, the state has assumed a higher share of welfare costs, as discussed in Section I.C.4., which directly reduces county welfare costs and effectively serves as another form of state aid.

I.C.3. Direct Property Tax Relief Programs

Direct Property Tax Relief Programs were significantly increased in the 1979 and 1980 legislative sessions. Payments from these programs are shown on Table 14. These programs are difficult to reduce when budgetary shortfalls are discovered. The state's commitment is established well in advance during the property tax assessment and billing process. Thus, minimal budget cuts were achieved with these programs. For example, the Renter's Credit payments were reduced by 8 percent in fiscal year 1982 (the 8 percent reduction to homeowners will appear in fiscal year 1983, because they are paid in August of the ensuing fiscal year). This reduction could not be incorporated on the claim forms, but rather could occur only after a Department of Revenue recalculation. Accordingly, Direct Property Tax Relief Programs have shown an extremely high growth rate of 40.1 percent during this two year period when the state was experiencing severe budgetary problems.

Our office has recently issued two reports on Direct Property Tax Relief Programs. Because of that, we will discuss only one additional point here. That is the inverse relationship between the cost of the Homestead Credit and the Property Tax Refund Program (Homeowners Circuit Breaker). Homestead Credit payments increased by \$190 million from 1980 to 1982. The property tax refund payments in turn decreased by \$41 million from 1980 to 1982. This occurs because the Homestead Credit reduces the property tax amount which may be claimed under the refund program. It should be noted, however, that this phenomenon does not extend to the Renter's Credit Program. Rental property is not eligible for the Homestead Credit, thus payments to renters increased by 19.8 percent.

TABLE 14

GENERAL FUND

DIRECT PROPERTY TAX RELIEF PAYMENTS BY PROGRAM
 FISCAL YEARS 1980 TO 1982
 (000's Omitted)

Program	F.Y. 1980 Expenditures	Percent Change in Expen- ditures 1980-81	F.Y. 1981 Expenditures	Percent Change in Expen- ditures 1981-82	F.Y. 1982 Expenditures	Percent Change in Expen- ditures 1980-82
Payments to Local Governments:						
Homestead Credit	\$246,058	+47.3%	\$362,530	+20.5%	\$436,800	+77.5%
Taconite Homestead Credit	16,301	+ 7.6	17,542	+10.5	19,388	+18.9
Agricultural Credit	37,304	+30.5	48,671	+40.5	68,377	+83.3
Reduced Assessment Credit					10,000	
Wetlands Credit					3,123	
Native Prairie Credit					100	
Total - To Local Governments	<u>\$299,393</u>	<u>+43.2%</u>	<u>\$428,743</u>	<u>+25.4%</u>	<u>\$537,788</u>	<u>+79.6%</u>
Property Tax Refunds to Individuals:						
Renters (Excluding Seniors & Disabled)	\$ 75,799	+ 9.5%	\$ 83,000	+ 9.4%	\$ 90,783	+19.8%
Homeowners (Excluding Seniors & Disabled)	67,265	-23.5	51,444	-49.6	25,945	-61.4
Senior Citizens & Disabled	67,678	-12.5	59,200	- 3.0	57,411	-15.2
Targeted Relief					2,749	
Total - To Individuals	<u>\$210,742</u>	<u>- 8.1%</u>	<u>\$193,644</u>	<u>- 8.7%</u>	<u>\$176,888</u>	<u>-16.1%</u>
TOTAL DIRECT PROPERTY TAX RELIEF PAYMENTS	<u><u>\$510,135</u></u>	<u><u>+22.0%</u></u>	<u><u>\$622,387</u></u>	<u><u>+14.8%</u></u>	<u><u>\$714,676</u></u>	<u><u>+40.1%</u></u>

I.C.4. Subsidies to Individuals

Table 15 indicates that the predominant component of subsidies paid to individuals is for welfare programs.⁶ State paid welfare benefit expenditures have increased by 44.6 percent from 1980 to 1982. However, this increase is not all due to growth in the basic cost of welfare benefits. Most welfare programs are financed jointly by state, federal, and county governments. Minnesota laws have been revised in the last several years to increase the state's share for welfare benefits while correspondingly reducing the counties' share. This serves as yet another method by which the state provides financial aid to its local units of government. For example, the Minnesota Supplemental Aid Program is financed exclusively by the state and counties. In fiscal year 1980, the state paid 60 percent of the cost of this program and counties paid 40 percent. State law changed this ratio for fiscal year 1982 to 85 percent state paid and 15 percent county paid. Thus, by looking only at the state's expenditures for this program, we see a 72.6 percent two year increase. However, we estimate that 50.8 percent of this increase is due to the state assuming a larger share of this program's cost and only 21.8 percent is due to an increased cost in program benefits. Table 16 further analyzes the expenditure increases for the three welfare programs for which the state/county financing ratio changed between fiscal year 1980 and 1982.

The analysis in Table 16 shows that welfare benefits actually grew in cost by an estimated 36.7 percent, while the decision to increase the state's share of financing these programs cost an additional 7.9 percent.

This substantial increase in the cost of welfare benefits is primarily attributable to the 52.5 percent two year increase in the Medical Assistance Programs.⁷ Eligibility requirements were tightened for other programs such as AFDC and General Assistance and the Catastrophic Health Expense Protection Program was phased out. This served to moderate or even eliminate the cost for those programs. However, the answer has not yet been found to contain the rapidly rising cost of the Medical Assistance Program.

⁶With the exception of Medical Assistance, General Assistance Medical Care (GAMC), and Catastrophic Health Expense Protection Program (CHEPP), state welfare monies are remitted to the counties who are responsible for paying individuals. However, we do not believe such programs are viewed as local programs because of the many federal and state mandates which govern them. Hence, the state's share of financing is treated as subsidy payments to individuals, rather than Intergovernmental Transfer Payments.

⁷The expenditures for Medical Assistance represent the net cost to the state for this program. Gross expenditures have been reduced by counties' reimbursement for their share, amounts recovered from insurers and others, and amounts paid to state hospitals (because this in turn is deposited into the General Fund). Thus, these numbers differ significantly from those presented in budget reports.

TABLE 15

GENERAL FUND

SUBSIDIES TO INDIVIDUALS BY PROGRAM
FISCAL YEARS 1980 TO 1982
(000's Omitted)

Program	F.Y. 1980 Expenditures	Percent Change in Expen- ditures 1980-81	F.Y. 1981 Expenditures	Percent Change in Expen- ditures 1981-82	F.Y. 1982 Expenditures	Percent Change in Expen- ditures 1980-82
Welfare Benefits:						
Medical Assistance	\$184,965	+19.6%	\$221,274	+27.5%	\$282,151	+52.5%
GAMC	36,970	+26.9	46,908	-19.5	37,767	+ 2.2
AFDC	49,770	+43.9	71,633	+13.3	81,172	+63.1
General Assistance	8,835	+102.4	17,882	-23.9	13,609	+54.0
Mn Supplemental Aid	6,006	+41.7	8,508	+21.8	10,366	+72.6
Catastrophic Health Expense Program	3,808		11,914			
Other Programs	49,203		55,803		65,939	
Total - Welfare Benefits	<u>\$339,557</u>	<u>+27.8%</u>	<u>\$433,922</u>	<u>+13.2%</u>	<u>\$491,004</u>	<u>+44.6%</u>
Higher Education						
Student Aids:						
Scholarships & Grants	\$ 16,942	+47.5%	\$ 24,981	- 1.0%	\$ 24,733	+46.0%
AVTI Tuition Subsidy	1,735	-23.4	1,329	-18.4	1,085	-37.5
Student Work-Study	2,502	+38.9	3,476	-25.4	2,594	+ 3.7
Private College Aid	4,630	+ 0.9	4,670	-26.8	3,417	-26.2
Interstate Tuition Reciprocity	10,189	-51.0	4,992	+35.1	6,746	-33.8
Total - Student Aids	<u>\$ 35,998</u>	<u>+ 9.6%</u>	<u>\$ 39,448</u>	<u>- 2.2%</u>	<u>\$ 38,575</u>	<u>+ 7.2%</u>
Other Benefit Programs:						
Weatherization & Emer- gency Heating	\$ 3,952	+164.5%	\$ 10,452	- 7.0%	\$ 9,720	+146.0%
Long-Term Sheltered Workshops	4,891	+18.6	5,802	+ 9.5	6,355	+29.9
State Youth Program	4,499	-44.4	2,503	+16.2	2,909	-35.3
Economic Opportunity Program	1,037	+16.8	1,211	- 2.5	1,181	+13.9
Vocational Rehabilita- tion Program ⁽¹⁾	412	+270.4	1,526	+152.1	3,847	+833.7
Mayo Medical School	1,305	- 2.1	1,277	+ 7.1	1,368	+ 4.8
Total - Other Benefits	<u>\$ 16,096</u>	<u>+41.5%</u>	<u>\$ 22,771</u>	<u>+11.5%</u>	<u>\$ 25,380</u>	<u>+57.7%</u>
TOTAL SUBSIDIES TO INDIVIDUALS	<u><u>\$391,651</u></u>	<u><u>+26.7%</u></u>	<u><u>\$496,141</u></u>	<u><u>+11.9%</u></u>	<u><u>\$554,959</u></u>	<u><u>+41.7%</u></u>

(1) See Note 4 to Table 9 for an explanation of this increase.

TABLE 16

GENERAL FUND

WELFARE PROGRAMS FOR WHICH STATE/COUNTY FINANCING RATIOS CHANGED
FROM FISCAL YEAR 1980 TO 1982

Program	Estimated Increase Due to Higher State Financing Ratio		Estimated Increase Due to Growth In Program Costs		Total Increase to State Expenditures 1980-1982	
AFDC	+\$20,264	+40.7%	+\$ 11,138	+22.4%	+\$ 31,402	+63.1%
General Assistance	+ 3,629	+41.0	+ 1,145	+13.0	+ 4,774	+54.0
MN Supplemental Aid	+ 3,049	+50.8	+ 1,311	+21.8	+ 4,360	+72.6
Subtotal - Programs with Higher State Financing Ratios	+\$26,942	+41.7%	+\$ 13,594	+21.0%	+\$40,536	+62.7%
All Other Programs			+ 110,911	+40.3	+ 110,911	+40.3
TOTAL WELFARE PROGRAMS	+\$26,942	+ 7.9%	+\$124,505	+36.7%	+\$151,447	+44.6%

I.C.5. Debt Service

Table 17 shows Debt Service Payments for fiscal years 1980 to 1982. Although total payments increased by 53.5 percent for these two years, much of that increase is attributable to the need for short-term borrowing which was unnecessary during fiscal year 1980. By June 30, 1982, however, the state had \$760 million of short-term certificates of indebtedness outstanding. The need for short-term borrowing was introduced when the General Fund's fund balance was eliminated. Even with a zero fund balance on June 30, the General Fund would still ordinarily require short-term borrowing during the fiscal year, because June 30 is normally the state's best cash position. This phenomenon has been caused by the use of budgetary shifts dating back to the late 1960s. Most budgetary shifts have transferred payment dates from the end of one fiscal year to the beginning of the ensuing year. This results in a dramatic improvement in cash position at the end of one fiscal year, followed by an equally devastating deterioration of cash flow at the start of the next fiscal year. Cash flow is discussed further in Section I.D.

The required General Fund transfers to the Debt Service Fund for general obligation bond debt service costs have shown a 17.7 percent increase from 1980 to 1982. There was not a dramatic increase in outstanding bonds which must be repaid from the General Fund during this time. These amounts outstanding at the end of fiscal years 1980, 1981, and 1982 were

\$754 million, \$784 million, and \$841 million, respectively, representing a 11.5 percent increase in outstanding debt over the two year period. This, coupled with the timing of bond sales and debt repayment schedules, has resulted in the increase of \$13 million, or 23 percent, in transfers for principal repayments.

TABLE 17
GENERAL FUND
DEBT SERVICE
FISCAL YEARS 1980 TO 1982
(000's Omitted)

<u>Type of Debt Service</u>	<u>F.Y. 1980 Expenditures</u>	<u>F.Y. 1981 Expenditures</u>	<u>F.Y. 1982 Expenditures</u>
General - Obligation Bond Repayments: (1)			
Principal	\$54,938	\$61,493	\$ 67,652
Interest	35,835	42,451	55,687
Less: Amount Accumulated in Debt Service Fund	(2,600)	(15,879)	(19,596)
Total	<u>\$88,173</u>	<u>\$88,065</u>	<u>\$103,743</u>
Short-Term Interest: (2)	<u>-0-</u>	<u>5,931</u>	<u>31,559</u>
TOTAL - DEBT SERVICE	<u><u>\$88,173</u></u>	<u><u>\$93,996</u></u>	<u><u>\$135,302</u></u>

(1) Technically, these amounts are transferred to the Debt Service Fund for repayment.

(2) Only short-term interest is accounted for as an expenditure. The certificates are not treated as either revenues or expenditures, because they must be repaid in the same biennium.

Transfers for interest costs have shown a much more dramatic increase, rising from \$36 million to \$56 million, or by 55 percent, from 1980 to 1982. Certainly much of this increase is due to the higher market interest rates associated with new bond sales. Interest rates on recent bond sales have exceeded 10 percent. These bonds effectively are replacing older issues which carry much lower interest rates and have been repaid. Aside from the rise in market interest rates, some of the increase could be associated with the decline in the state's bond rating. Although we cannot assign an estimated cost to the reduced credit ratings because of the many factors which influence investors' decisions, most studies do indicate that reduced credit ratings introduce some additional cost. Bond rating firms have cited the state's recent budgetary problems and the extensive reliance on short-term borrowing as the primary causes of the reduced credit ratings.

Finally, it must be remembered that constitutional provisions require the General Fund to transfer the ensuing fiscal year's debt service amounts into the Debt Service Fund on the preceding November 1. This was first implemented by the Department of Finance midway through fiscal year 1980. Establishing this debt service reserve account may not be a popular requirement with all legislators; however, it has introduced certain advantages. First, it is a very conservative financing policy and was cited by the bond rating firms as the primary reason why the state maintained its high credit rating early in the period of budgetary problems. Because of the severity of the problems, the credit rating was eventually lowered; however, we anticipate the debt service financing policy will prove beneficial in restoring the state's credit rating. Secondly, these advance deposits allow the Debt Service Fund to earn additional investment income. Table 17 shows that these amounts accumulated in the Debt Service Fund have increased significantly from 1980 to 1982. This in turn reduces the amount which must be transferred in future fiscal years.

In summary, the state's budgetary and cash flow problems have introduced the need for short-term borrowing. This cost the General Fund an additional \$32 million in 1982. Associated with these problems was the diminished availability of excess cash to generate investment income contributing to the decline in these revenues as discussed in Section I.B. Finally, short-term borrowing also has meant a decline in the state's long-term credit rating. This is costing the state higher interest rates. To curtail the growth in debt service costs, the state will have to remedy its cash flow problems, reduce or eliminate short-term borrowing needs, and restore its high credit rating.

I.C.6. Other Transfers

In addition to the long-term debt amounts discussed in the previous section, the General Fund is required by law to transfer various amounts to other state funds for expenditure. The major interfund transfers are identified in Table 18.

Total interfund transfers show some drastic year-to-year changes, decreasing 54.0 percent from 1980 to 1981 and then increasing 49.4 percent from 1981 to 1982. These changes were caused primarily by the methods for distributing monies to the Housing Finance Agency and the Post Retirement Investment Fund. The amounts paid to these two recipients in 1980 were for the entire 1980-81 biennium. Thus, they received little additional funding in fiscal year 1981. The \$1.6 million paid to the Housing Finance Agency resulted from a Legislative Advisory Commission appropriation. This method of funding was changed in the 1982-83 biennium. Thus, payments for 1982 are only for that fiscal year and additional amounts were then paid in fiscal year 1983.

Other transfers show a more stable year-to-year change. Payments to the Iron Range Resources and Rehabilitation Board and Northeast Minnesota Economic Protection Fund are based on taconite tax collections. The Historical Society is treated similarly to the University of Minnesota in the appropriation process.

TABLE 18

GENERAL FUND

INTERFUND TRANSFERS
FOR FISCAL YEARS 1980 TO 1982
(000's Omitted)

Transfer Recipient	Amounts Transferred		
	F.Y. 1980	F.Y. 1981	F.Y. 1982
Housing Finance Agency	\$45,010	\$ 1,640	\$19,087
Iron Range Resources and Rehabilitation Board	20,843	19,424	22,936
Northeast Minnesota Economic Protection Fund	8,964	9,358	8,846
Historical Society	6,749	7,279	6,715
Post Retirement Investment Fund	11,241	-0-	5,494
Other Funds	<u>5,930</u>	<u>7,766</u>	<u>4,854</u>
TOTAL TRANSFERS	<u>\$98,737</u>	<u>\$45,467</u>	<u>\$67,932</u>

CONCLUSIONS

In summary, expenditures have increased by 19.1 percent from 1980 to 1982. It must also be remembered that revenue increased by only 14.2 percent during this period. Individual expenditure programs have varied significantly from the average growth rate. Several programs' expenditures rose dramatically because of changes in policy or decisions to expand the state's responsibilities. For example, Direct Property Tax Relief Programs rose by over 40 percent because of an expanded state commitment and certain welfare programs increased by at least 40 percent because the state was assuming a higher share of the state/county financing ratio. Short-term borrowing introduced additional interest costs of \$32 million in 1982 and contributed heavily to a 53.5 percent increase in debt service costs. Other programs increased significantly because they were not amenable to cost containment or budget cuts. The primary example is Medical Assistance costs which rose by 52.5 percent.

On the other hand, certain other areas were limited in growth significantly below the average of 19.1 percent. Most notable are state departments (other than state institutions) which averaged a two year increase of 7.2 percent. Further, certain smaller grant programs, such as the Catastrophic Health Expense Protection Program and the Shade Tree Disease Control Program, were phased out during this period. However, this slowed growth and reduction of certain state programs occurred in minor components of the state budget. For example, the Medical Assistance Program alone, which rose by 52.5 percent, cost approximately the same in 1982 as all state departments (excluding state institutions) which rose by only 7.2 percent. This emphasizes that the 19.1 percent increase in expenditures from 1980 to 1982 was merely an average for all programs.

I.D. CASH FLOW

As we have discussed for the last three years in our Statewide Audit Reports, the General Fund has experienced serious cash flow problems because of the uneven timing of revenue collections and expenditure payments during the year. The problems have been intensified because of the continuing budget problems which the state has encountered and which have resulted in less than anticipated revenue collections.

The Department of Finance has dealt with the cash flow problems by delaying payments and initiating short-term borrowing through the issuance of certificates of indebtedness in accordance with the Minnesota Constitution, Article XI, Section 6 and Minn. Stat. Section 16A.671. Laws of 1981, Special Session III, Chapter 2, enacted in January 1982, revised the procedures for issuance of certificates of indebtedness and eliminated the previously established maximum of \$360 million. During fiscal years 1982 and 1983, the following activity relating to certificates of indebtedness sales took place:

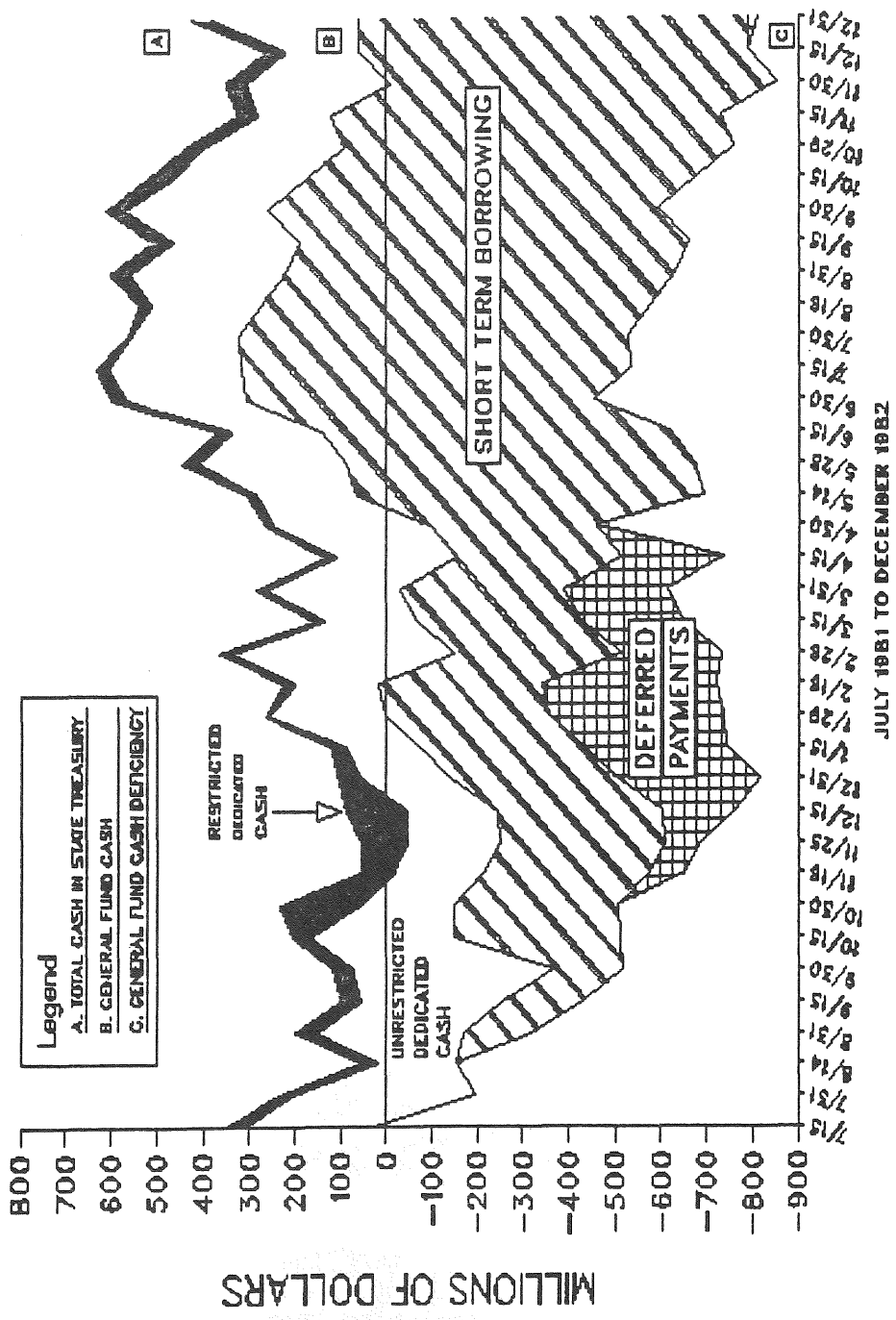
August 21, 1981	-	\$150 million in certificates due October 1, 1981 were sold
October 1, 1981	-	\$150 million repaid and \$360 million in new certificates due July 1, 1982 were issued
May 4, 1982	-	\$400 million in certificates due June 1, 1983 were sold
July 1, 1982	-	\$360 million repaid and \$450 million in new certificates issued

As of December 31, 1982, the amount of certificates of indebtedness outstanding totaled \$850 million. During fiscal year 1982, interest and fiscal agent fees paid on the certificates totaled \$31.6 million.

The primary use of deferred payments occurred between November 15, 1981 and April 20, 1982. Local Government Aid of \$78 million and \$80 million was withheld in November and December 1981, respectively. The total of \$158 million was released in February 1982. School aid payments of \$154 million and \$67 million were withheld in December 1981 and January 1982, respectively. The total of \$221 million was released in April 1982. In addition to these deferred payments, the budget balancing bill passed in December 1982 allowed for a delay in the payment of school aids based on the cash flow requirements of the individual school districts. Payments totaling approximately \$17 million were deferred on December 30, 1982.

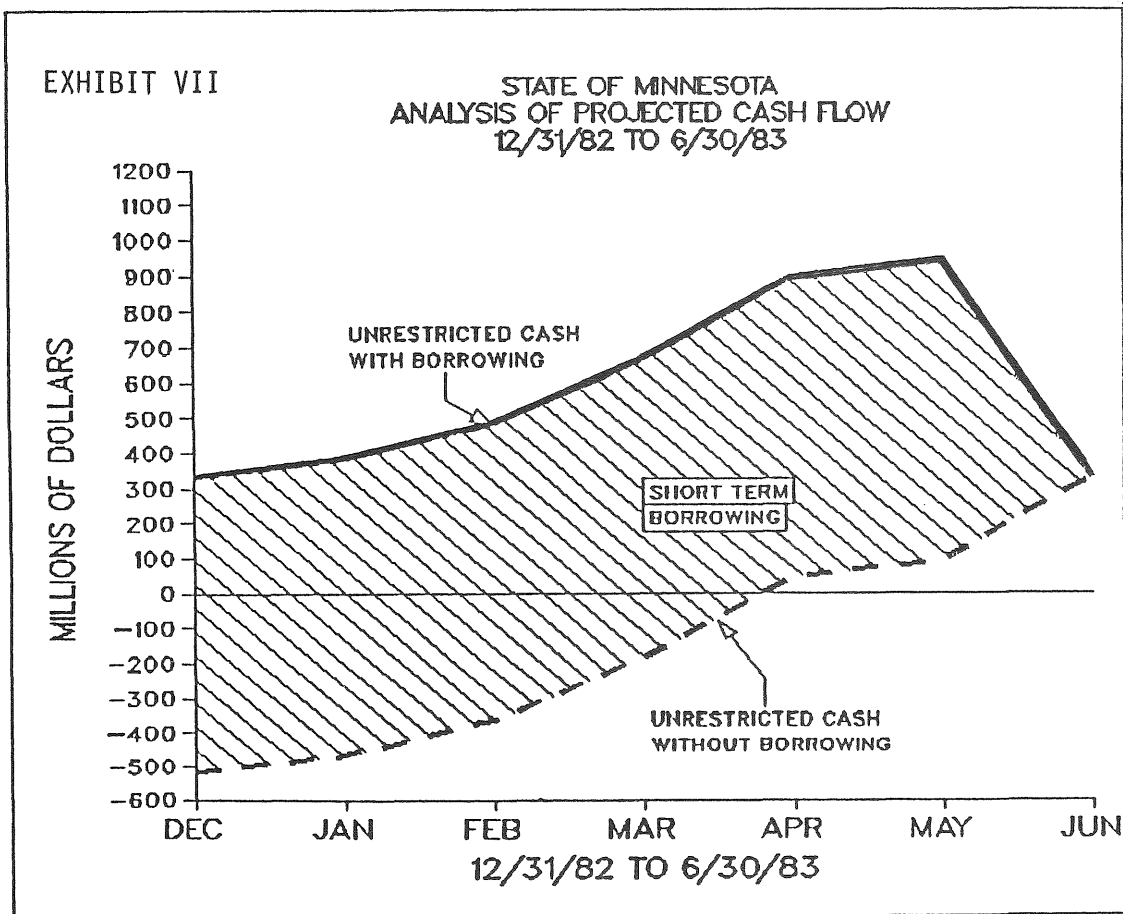
Exhibit VI shows graphically the cash flow problems encountered by the state during the eighteen months ended December 31, 1982. Line A represents the total cash in the State Treasury measured at the middle and end of each month. The total includes both the pooled cash of certain dedicated funds which is available for General Fund use to cover cash deficiencies in accordance with Minn. Stat. Section 16A.671, Subd. 2(c) and the remaining cash, as identified by the shaded area, which is restricted and unavailable for General Fund use. The General Fund was forced to borrow from the restricted funds in November and December 1981 because of

EXHIBIT VI
 STATE OF MINNESOTA
 ANALYSIS OF CASH FLOW
 JULY 1981 TO DECEMBER 1982



the severity of the cash flow problems. The need for such borrowing from restricted funds was eliminated when the maximum limitation for the issuance of certificates of indebtedness was repealed. Line B shows the actual cash balance in the General Fund during the time period. Line C shows what the General Fund cash deficiency would have been if the state had not delayed payments, issued certificates of indebtedness, or borrowed from the pooled cash of dedicated funds. As can be seen, in December 1981 and November 1982 the negative cash position of the General Fund exceeded \$800 million. An example may clarify Exhibit VI. On December 15, 1981, the General Fund cash position was brought up to zero by deferring payments totaling \$158 million, issuing certificates of indebtedness totaling \$360 million, borrowing \$201 million from available dedicated funds, and borrowing \$44 million from restricted dedicated funds.

Exhibit VII shows the Department of Finance's estimate of how the state will recover from its cash flow problems during the last six months of fiscal year 1983. The solid line shows the projected total unrestricted cash in the State Treasury estimated as of the end of each month. The broken line shows what the unrestricted cash position would have been if the state had not borrowed \$850 million through the issuance of certificates of indebtedness. As can be seen from the graph, the cash position of the state significantly improves during the last half of the fiscal year when receipts exceed disbursements. It should be noted that Exhibit VII shows only the month-end balances, which are not necessarily the cash low points for the various months. The drop in total cash in June occurs as the certificates of indebtedness are paid off, \$400 million on June 1, 1983 and \$450 million on June 30, 1983.



Another policy which will have an effect on the General Fund cash flow problems is the decision to use payment shifts to solve the current budget problems. Delaying payments from the end of one fiscal year to the beginning of the next puts additional strain on the General Fund's cash resources. As can be seen from Exhibit VI, the General Fund normally experiences its severest cash flow problems during the first six months of the fiscal year when required expenditures exceed the revenues collected. Incurring additional expenditures during this time period without generating additional revenue places greater burdens on the state's cash position. In the future, the Legislature must consider the overall effect of budgetary decisions on the General Fund's cash position. If the need for short-term borrowing is to be eliminated, significant changes in the timing of revenue collections and expenditure payments will be necessary.

I.E. COMMITMENTS AND POTENTIAL LIABILITIES: THE DEMANDS ON FUTURE RESOURCES

In attempting to plan for the use of future resources, the Legislature must first consider known commitments, as well as certain additional potential liabilities, which must be funded from these resources. Because Minnesota statutes in effect require that the budget be balanced at the end of a biennium, the state must use revenues earned in fiscal year 1983 to eliminate the fiscal year 1982 General Fund deficit. This will reduce the amount of resources available to fund fiscal year 1983 programs. As previously discussed in Section I.A., Exhibits IV and V show the Department of Finance's projections of fiscal year 1983 revenues and expenditures which would eliminate the fiscal year 1982 deficit and result in a balanced budget at the end of the biennium.

In addition to the budgetary deficit, there were certain obligations or commitments which existed at June 30, 1982 but were to be funded from future resources. These resulted in part from normal long-term commitments funded over several years, such as repayments on general obligation bonds, as well as payment shifts and other budgetary decisions, which use future resources to pay prior obligations. Table 19 shows an estimate of the known commitments or obligations for major programs as of June 30, 1982 which are payable from fiscal year 1983 revenues.

Based on estimated fiscal year 1983 revenue of approximately \$4 billion, it can be seen from Table 19 that at least 30 percent of these resources were committed as of June 30, 1982. There are also additional payment shifts from fiscal year 1983 to 1984, including renter's credit, senior citizens and disabled credits, and increased school aids, which will place greater strain on the next fiscal year's resources. This method of financing diminishes the legislative flexibility in making policy decisions regarding funding of programs. For example, if a program were to be eliminated or the funding level changed, it may take two years to realize the effect of the change because current year resources are being used to pay prior year commitments. In addition, when and if the state were to attempt to eliminate the use of payment shifts in the budget process, it would be necessary to pay for a portion of two year's costs from one year's resources.

TABLE 19
GENERAL FUND
PRIOR OBLIGATIONS PAYABLE FROM FISCAL YEAR 1983 RESOURCES
(In Million \$)

Fiscal Year 1982 Fund Deficit	\$ 624
Transfer to Debt Service Fund for general obligation bonds	115
Education aids and tuition reciprocity final payments for fiscal year 1982 services	104
One-half of calendar year 1982 Local Government Aid (estimated) ⁽¹⁾	118
One-half of calendar year 1982 Homestead Credit (estimated) ⁽¹⁾	187
One-half of calendar year 1982 Agricultural Credit (estimated) ⁽¹⁾	38
Refunds payable resulting from litigation (estimated)	<u>30</u>
Total	<u>\$1,216</u>

(1) These programs are intended to provide financing to local governments on a calendar year basis. However, no payments are made until after the start of the new state fiscal year on July 1. Thus, we estimate that one-half of these payments are associated with obligations from the first half of the calendar year which is during the preceding state fiscal year.

In addition to the known commitments, there are various contingent liabilities, which may place a potential drain on future General Fund resources. One of the most significant of these relates to possible losses from litigation. The State of Minnesota, its officers and employees are currently defendants in several lawsuits that, if settled adversely to the state, could have a significant impact on its financial position. Three of the lawsuits concern mining taxes and, if lost, could result in significant budget problems at the end of the current, or beginning of the next, biennium:

- The taconite mining companies have initiated actions seeking a refund of state mining occupation taxes paid for 1971 and subsequent years. A test case in the Minnesota Tax Court was decided in favor of the companies. The state has appealed that case to the

Minnesota Supreme Court, and a decision is expected in early 1983. The total claimed amount for the various cases is approximately \$70 million. Of this amount, the state has determined that even if they win the various lawsuits, they have incurred a \$30 million liability for refunds relating to currently uncontested issues. The \$30 million has been recorded as a liability at June 30, 1982 in the General Long-Term Debt Account Group. Procedures have been implemented to offset the liability against future occupation tax and sales tax owed by the mining companies. It is estimated that \$2.5 million will be credited against sales tax in fiscal year 1983.

- Two mining companies have contested the theory upon which the taconite production tax is calculated. The Tax Court recently ruled in favor of one of the mining companies and awarded them a \$3.9 million tax credit. Although the total effect of the ruling on the other mining companies has not been determined, the Department of Revenue in the past has estimated that the state's liability could vary between \$18.6 and \$26.9 million. The state has decided to appeal the decision to the Minnesota Supreme Court.
- Other cases seek elimination of the taconite production tax and a refund of taxes paid for 1975 and subsequent years. These cases raise issues related to the cases discussed previously and will not be heard by the Tax Court until the occupation tax cases are settled. The total production taxes collected for tax years 1971 through 1981 was \$557 million. Approximately 99 percent of these taxes have been redistributed to local units of government either directly or through grants from the Iron Range Resources and Rehabilitation Board (IRRRB). As a result, if the state should lose the lawsuit, future revenue losses would most directly affect these local units. Liability for repayment of prior year tax collections would rest primarily with the state, however. A decision would have to be made by the state whether to impose this liability upon the local units of governments to whom the monies were distributed. Another factor affecting any potential liability would be whether the court would allow another means of taxation to replace the production tax.

There are several other large lawsuits pending against the state. These are discussed in the notes to the state's financial statements. Included are the following:

- Seven railroad companies are challenging the constitutionality of the gross earnings tax as applied to railroads. The companies seek elimination of the tax and a refund of payments made for the years 1971 through 1977. Total collections for this time period were \$84.5 million.
- A newspaper company is challenging the constitutionality of the use tax imposed on ink and paper products utilized in producing a newspaper. It has been estimated that approximately \$10 million in refunds will have to be made if the state receives an adverse decision. The state lost in District Court but received a favorable verdict from the Minnesota Supreme Court. The company is appealing to the United States Supreme Court.

- A class action suit alleges sex discrimination by St. Cloud State University in setting salaries for female faculty members. The state won in District Court but the case has been appealed to the United States Court of Appeals.

We make no inference here about the state's possibility of winning or losing these lawsuits nor are we suggesting that refunds will have to be made for certain of the amounts discussed. We believe it is important that the lawsuits be carefully monitored, so that the current and long-term financial impact of any adverse decisions may be estimated. The state must consider the potential impact of possible losses from the major lawsuits and develop contingency plans for dealing with such losses now rather than having to react to them in the future.

I.F. BUDGET VS. GAAP: A QUESTION OF MEASUREMENT

Minn. Stat. Section 16A.10 requires the Commissioner of Finance to prepare a biennial budget for all state departments and agencies, subject to the approval of the Governor. The Governor submits the budget to the Legislature in January of each odd-numbered year. The budget document includes actual receipts and expenditures for the preceding two fiscal years and estimates for the current and succeeding two fiscal years. In addition to the biennial budget, for accounting and control purposes, annual budgets, including income and spending plans, are prepared by each agency. The Department of Finance, within certain legislative guidelines, establishes the procedures and forms for preparation of both the annual and biennial budgets.

Generally accepted accounting principles (GAAP) for governmental entities are established by the National Council on Governmental Accounting (NCGA)'s Statement 1, Governmental Accounting and Financial Reporting Principles. Statement 1 provides that the financial statements for governmental fund types, such as the state's General and Special Revenue Funds, should be prepared using the modified accrual basis of accounting, which requires that revenues be recognized in the accounting period in which they become available and measurable and expenditures be recognized in the accounting period in which the fund, or current, liability is incurred, if measurable. The cash basis of accounting, where revenue is recognized when the actual cash is received and expenditures are recognized when the actual cash disbursements are made, is basically not in conformity with generally accepted accounting principles, because financial statements are subject to manipulation through timing of the processing of receipt and disbursement transactions. The financial statements for the state's funds included in the annual financial report issued by the Department of Finance are prepared using the modified accrual basis of accounting for governmental funds.

There are no specific requirements as to the accounting basis to be used in the preparation of annual or biennial budgets. Statement 1 recommends that operating budgets, whenever possible, be prepared in conformity with generally accepted accounting principles in order to avoid duplicative recordkeeping and inconsistent reporting which may prove confusing to the users of financial statements. However, individual state laws often require or allow budgetary reporting using other accounting bases than those required by generally accepted accounting principles.

Minnesota statutes do not require a specific accounting basis to be used in the preparation of the biennial budget. In addition, there is no requirement that revenues and expenditures be measured consistently for all programs. As a result, budgeting for the various programs in the General Fund has been handled inconsistently. In some cases, expenditures are budgeted on a cash basis, while for other programs they are budgeted on a modified accrual basis. Similarly, some revenues are accrued while others are reported on a cash basis. As a result, the General Fund revenues, expenditures and available fund balance reported in the basic financial statements differ from the amounts shown in the budgetary statements. We believe the inconsistent measurement basis in the budgetary system distorts the budgetary fund balance.

One prime example of a program which is treated differently for budgetary and financial reporting purposes is the Medical Assistance subsystem payments made by the Department of Public Welfare. For the budget system, the program is reported basically on a cash basis. All disbursements made through June 30 of a given fiscal year are recorded as expenditures of that fiscal year. All payments made after June 30 are recorded as expenditures of the next fiscal year irrespective of the time period during which the services were provided. We believe this method of recording expenditures does not give a true picture of the obligations incurred for the program and is subject to manipulation in that invoices may be held at the end of the fiscal year and not paid until after June 30 so as to reduce the current year expenditures and inflate the available fund balance. Even without manipulation, it is simply not feasible to receive and process all claims by June 30. For financial reporting purposes, this program is reported on a modified accrual basis with expenditures charged to the fiscal year during which the services were rendered. As a result, fiscal year 1982 expenditures included an additional \$34 million in accrued Medical Assistance liabilities, for claims which had not been received or processed as of June 30.

Other programs are also reported on a modified accrual basis for financial reporting purposes and on a cash basis for budgetary purposes. Table 20 shows a reconciliation of the June 30, 1982 undesignated fund balance for the General Fund as reported for budgetary and financial reporting purposes.

There does not appear to be any logical or systematic methodology used to determine the accounting basis for certain areas of the budgetary process. This is particularly true in dealing with grant and aid expenditure programs. As shown in Table 20, approximately \$60 million in grant and aid liabilities for services rendered through June 30, 1982 were not reflected in the budgetary fund balance. However, expenditures for other large programs, such as Teachers Retirement contributions and Social Security contributions, are reported on the modified accrual basis for budgetary purposes.

TABLE 20
GENERAL FUND
RECONCILIATION OF FUND BALANCE
JUNE 30, 1982

Undesignated Fund Balance - Budgetary Basis	(\$652,581,561)
Revenue and Transfer-in Adjustments:	
Taxes receivable	8,740,262
Welfare receivable	11,734,741
Deferred revenue	(11,354,311)
Other accruals	2,135,873
Expenditure and Transfer-out Adjustments:	
Medical assistance liability	(34,131,188)
Police and fire aid	(21,898,509)
Grants in lieu of taxes	(4,327,984)
Workers and unemployment compensation	(3,039,632)
Other accruals	<u>(545,790)</u>
Undesignated Fund Balance - Modified Accrual Basis	<u>(\$705,268,099)</u>

The Department of Finance has certain discretion in establishing the budgetary basis to be used. The department has used their authority to change the accounting basis for certain programs. For fiscal year 1980, various accruals were not made for budgetary purposes because the Department of Finance historically had simply used data as posted to the state-wide accounting system, and in some cases, programs had been recorded on a cash basis. In fiscal year 1981, the department took steps to revise the accounting procedures and convert certain revenue and expenditure programs from the cash to the modified accrual basis. For example, tax refunds previously were reported on the cash basis for budgetary purposes. However, in fiscal year 1981, the Department of Finance directed the Department of Revenue to change to the modified accrual basis for recording the tax refunds. Basically, this requires that refunds applicable to all tax returns on hand on June 30 of a given fiscal year be reported as a reduction of revenue for that fiscal year. The department did not consistently follow the decision to accrue tax refunds for fiscal year 1981, however. Because of an error in recording refunds in the accounting system, approximately \$8.6 million in refunds relating to fiscal year 1981 were reported as reductions of revenue for fiscal year 1982 for budgetary purposes even though the Department of Finance was aware of the necessary adjustment.

Similarly, regarding expenditures, employer contributions for teachers retirement were reported on a cash basis prior to 1981 when they were changed to the modified accrual basis for budgetary purposes. There are other programs, such as Medical Assistance, where it appears that the

Department of Finance would have the authority to establish a different accounting basis than currently is in use. The Medical Assistance program is somewhat unique and more sensitive in that there have been problems in measuring the projected liabilities and deficiency appropriations have consistently been necessary to fund the program. The Department of Finance did not complete the change to the modified accrual basis in 1981 for certain programs such as Medical Assistance, in part because of the fiscal problems which the General Fund was encountering. The department did not want to further reduce the available fund balance by accruing additional liabilities, which would have amounted to approximately \$30 million for Medical Assistance in fiscal year 1981.

For certain other programs, such as the liability for Police and Fire Aid, the Legislature has established in statute fairly definite procedures for determining the budgetary basis for the measurement of program costs. Legislative action would be required to make the budgetary accounting basis consistent with that required by generally accepted accounting principles for these programs.

Another facet of the budgetary question which is more significant is the issue of payment shifts. Because of the projected General Fund deficiency in fiscal year 1981, the Legislature authorized the cancellation of \$242 million in school aid appropriations and the restoration of these amounts as fiscal year 1982 appropriations. In accordance with generally accepted accounting principles, these amounts were still fiscal year 1981 obligations, although they were reported in fiscal year 1982 for budgetary purposes. Table 21 shows the school aid expenditures on a budgetary basis for the last three fiscal years.

TABLE 21
GENERAL FUND
EDUCATION AIDS - BUDGETARY BASIS
FISCAL YEARS 1980 TO 1982
(000's Omitted)

	1980	1981	1982
Foundation Aids	\$644,413	\$458,785	\$ 944,903
Vocational-Technical Education Aids	108,528	103,893	151,519
Special Education Aids	87,353	86,890	110,968
Transportation Aids	88,435	99,285	129,175
Agriculture Credit Aids	37,034	38,831	78,233
Other	30,336	29,279	45,645
Total	<u>\$996,099</u>	<u>\$816,963</u>	<u>\$1,460,443</u>

As can be seen, the shifting between fiscal years presents a distorted view of the actual obligations incurred for school aids during those years.

In order to provide meaningful information and to allow for valid comparisons among programs and between fiscal years, we believe a consistent basis for measuring revenues and expenditures should be used for budgetary reporting. The modified accrual basis required by generally accepted accounting principles would satisfy this need and would prevent distortions and manipulation of accounting data based on the timing of cash flow. However, there are certain disadvantages to unilaterally adopting generally accepted accounting principles as the basis for budgetary accounting. Potentially, it could diminish the legislative prerogative to determine which resources will be used to fund program costs. There may be cases where the Legislature will make a conscious decision that certain costs should be funded from future rather than current resources. Such departures should be carefully considered and enacted in a manner which clearly indicates the intended impact on fund balance. In addition, the General Fund fund balance computed in accordance with generally accepted accounting principles has consistently been lower than the budgetary fund balance. For fiscal year 1982, if the modified accrual basis had been used for budgetary reporting, the available fund balance at June 30 would have been decreased by approximately \$50 million. Adopting principles which would further decrease the fund balance in a time of severe budget balancing problems probably would not be a popular decision. If the state were to convert to generally accepted accounting principles for budgetary accounting, it would most likely have to be done at the beginning of a new biennium. The State of New York is adopting generally accepted accounting principles for budgetary reporting, but is phasing the conversion in over five to seven years.

In summary, we believe that the inconsistencies in the current budgetary measurement procedures provide incomplete information on the state's financial condition. There is need for a well defined and uniform policy for measuring revenues and expenditures. We believe that the Legislature should consider revising the budget process for future years so that the budget is prepared following a consistent measurement basis such as generally accepted accounting principles. Such a transition may require several years so that current financial problems are not aggravated. Also, such a change should be completed so that the Legislature retains control over key funding decisions.



SECTION II

FISCAL PROBLEMS OF OTHER STATE FUNDS

The General Fund is one of the sixty state funds which are presented in the state's Annual Financial Report. The Statewide Audit reviews the finances of all these funds. In addition to the General Fund, four other funds have experienced significant financial problems. Although the General Fund is the most visible of the state's funds and has attracted the most concerns, it is also important that other state funds be maintained on a sound financial basis. In this section, we analyze the financial problems of these other four funds.

II.A. UNEMPLOYMENT COMPENSATION FUND

Minnesota's Unemployment Compensation Fund, (UC Fund) is experiencing serious financial problems, which include:

- an increased dependence on borrowing from the Federal Unemployment Account to meet benefit payment obligations (\$78 million was borrowed from the account during the first half of fiscal year 1983),
- an increasing deficit fund balance, which grew from \$114 million during fiscal year 1981 to \$210 million by June 30, 1982, and is projected to reach \$400 million by April 30, 1983, and
- interest costs to be paid on federal loans made after March 31, 1982, that will have to come from sources other than the UC Fund (possibly the General Fund).

Minnesota has relied heavily on borrowing from the Federal Unemployment Account for help in financing its unemployment insurance program. Despite the obvious repercussions to this type of financing, the fund is not capable of sustaining itself under the current set of economic circumstances. The blend of increased dependence on borrowing, the unresponsive tax structure, unfavorable economic conditions, and recent changes in federal law have all contributed to the erosion of the UC Fund.

Table 22 summarizes the fund's cash flow of revenues (including reimbursable accounts) and expenditures by quarter for fiscal years 1981 and 1982. Total revenues increased from \$235,671,035 in fiscal year 1981 to \$237,344,795 in fiscal year 1982 or 0.7 percent. During the same period total expenditures increased from \$329,754,039 to \$370,398,038 or 12.3 percent. It should be noted that the first quarter taxes (January 1 - March 31) which are due and collected during the second quarter (April 1 - June 30), represent the highest amount of collections during the year with each successive quarter collections declining from those of the previous quarter. This quarterly reduction in tax revenues is a result of the limits of the taxable wage base component of the state tax (discussed later). An employer is not liable for the unemployment state tax on wages paid to employees in excess of the taxable wage base amount.

TABLE 22

UNEMPLOYMENT COMPENSATION FUND

REVENUES AND EXPENDITURES
FISCAL YEARS 1981 AND 1982

<u>Quarter Ended</u>	<u>Revenues</u>	<u>Loans</u>	<u>Expenditures</u>
September 30, 1980	\$ 66,357,417	\$ -0-	\$ 72,927,128
December 31, 1980	48,664,532	26,300,000	79,100,242
March 31, 1981	35,176,274	71,600,000	106,804,947
June 30, 1981	<u>85,472,812</u>	<u>14,200,000</u>	<u>70,921,722</u>
TOTALS, FY 1981	<u>\$235,671,035</u>	<u>\$112,100,000</u>	<u>\$329,754,039</u>
September 30, 1981	\$ 64,098,091	\$ -0-	\$ 50,437,196
December 31, 1981	40,173,932	-0-	64,147,442
March 31, 1982	28,930,582	77,900,000	128,298,884
June 30, 1982	<u>104,142,190</u>	<u>17,942,117</u>	<u>127,514,516</u>
TOTALS, FY 1982	<u>\$237,344,795</u>	<u>\$ 95,842,117</u>	<u>\$370,398,038</u>

There are many complex variables that affect the stability of the fund, ranging from the unemployment rate to the financing structure of the fund. While it may be extremely difficult to identify the specific impact of any single variable, it is obvious that the fund is headed in the wrong direction. We are not attempting to identify or propose specific solutions, but are stating that legislative action is necessary to assure future fund solvency.

Minnesota's unemployment insurance program is a coordinated federal/state program designed to provide economic security to workers during temporary periods of unemployment. The state's employers have financed the program since its inception through the payment of both federal and state unemployment taxes or "contributions." The Department of Economic Security collects and deposits the state tax directly to the UC Fund.

The components of the state tax consist of (1) a contribution (tax) rate and (2) a taxable wage base.

(1) The contribution is comprised of:

- a minimum rate which is based on the UC Fund's cash balance on June 30 and effective for the following calendar year, and
- an experience ratio which is calculated by dividing 125 percent of total benefits charged to an employer's account during the previous 36 months ended June 30, by the employee's total taxable payroll for the same period. (For calendar years after 1983, the calculation is based on the previous 48 months and 60 months, respectively.)

The department calculates or assigns an annual contribution rate for all employers for the coming calendar year based on information through the previous June 30. As such, current and future benefits are paid with taxes collected using tax rates calculated on unemployment activity six months to three and one-half years earlier.

The minimum rate treats all employers equally without regard to an employer's experience with unemployment. The minimum rate is graduated based on the fund's cash balance on June 30. It has been 1.0 percent since 1977, because the fund balance has been below \$80 million. The current minimum rate schedule is shown in Table 23.

TABLE 23
UNEMPLOYMENT COMPENSATION FUND
SCHEDULE OF MINIMUM RATES
FISCAL YEARS 1977 TO 1982

<u>Fund Balance</u>	<u>Minimum Rate</u>
Below \$80 million	1.0%
Between \$80 and \$90 million	0.9%
Between \$90 and \$110 million	0.8%
Between \$110 and \$130 million	0.7%
Between \$130 and \$150 million	0.6%
Between \$150 and \$170 million	0.5%
Between \$170 and \$200 million	0.3%
Above \$200 million	0.1%

The graduation is structured for tax reductions as the fund's cash balance increases, but does not provide additional support when the fund falls below \$80 million or is depleted.

The experience ratio by nature is designed to place greater responsibility for the cost of unemployment with those employers having higher unemployment rates. The ratio is dependent on benefits paid and chargeable to an employer over a period of time compared to the employer's total taxable payroll for the same time period. Prior to calendar year 1983, state law limited the increase in the experience ratio to no more than 1.5 percent per year. For calendar years subsequent to 1982, the law provides a yearly increase or decrease in the experience ratio to no more than 2.5 percent per year for employers having an annual payroll greater than \$250,000. Employers having an annual payroll of less than \$250,000 can apply for a limitation of the increase or decrease in the experience ratio to no more than 1.5 percent per year.

The maximum contribution rate (minimum rate plus the experience ratio) is legislatively set at 7.5 percent which means the maximum experience ratio for any employer cannot exceed 6.5 percent. As a result, the limit forces the fund to absorb those benefits paid but not chargeable to an employer. The minimum and maximum state contribution rates in effect since 1972 are shown in Table 24.

TABLE 24
UNEMPLOYMENT COMPENSATION FUND
MINIMUM AND MAXIMUM STATE CONTRIBUTION RATES
CALENDAR YEARS 1972 TO 1982

<u>Year</u>	<u>Minimum Rate</u>	<u>Maximum Contribution Rate</u>
1972-73	.7%	4.5%
1974-75	.9%	5.0%
1976	.9%	6.0%
1977-82	1.0%	7.5%

(2) The taxable wage base is that portion of each employee's total wage subject to the contribution rate. The taxable wage basis in effect since 1972 is shown in Table 25.

TABLE 25
UNEMPLOYMENT COMPENSATION FUND
STATE TAXABLE WAGE BASE
CALENDAR YEARS 1972 TO 1982

<u>Year</u>	<u>State Taxable Wage Base</u>
1972-75	\$4,800
1976	6,200
1977	7,000
1978	7,500
1979-81	8,000
1982	8,300

The Legislature controls and sets both components of the state tax. Since 1977, the minimum rate and the maximum contribution rate have remained unchanged, while the taxable wage base has increased 18.5 percent (from \$7,000 to \$8,300). For calendar year 1982 and years thereafter, the taxable wage base will be computed by the department at 60 percent of the average annual wage.

Theoretically, tax revenues should be sufficient to cover benefit payments and to build and maintain the integrity of the fund's reserve. The reserve concept as it relates to an unemployment insurance program is a cash reserve or balance amount identified and maintained as a cushion against future periods of high unemployment. It should not be used as a basis for increasing benefits or reducing taxes, but should serve as a hedge against rising unemployment and borrowing. Generally, as unemployment rises, tax revenue declines, benefit payments increase, and borrowing becomes necessary as reserves are depleted.

Through Title XII of the Social Security Act, Minnesota's Unemployment Compensation Fund (when its reserves were depleted) was allowed to obtain interest free loans from the Federal Unemployment Account. The fund first utilized Title XII in the mid-1970s, and obtained interest free loans totaling \$47 million in 1975, \$76 million in 1976, and \$49 million in 1977. It repaid the outstanding loans totaling \$172 million in 1979. The fund borrowed \$28.8 million during 1980, \$85.8 million in 1981 and \$174 million in 1982.

During 1981, amendments to Title XII Section 1202 eliminated the interest free status of loans made to states on or after April 1, 1982, and also prohibited the payment of interest (directly or indirectly) by a state from amounts in the Unemployment Compensation Fund. Of the \$174,047,117 borrowed during 1982, \$96,147,117 is costing Minnesota 10 percent per annum in interest. At December 31, 1982, interest owed was \$2,346,434. This should be of particular concern to legislators since the interest will potentially be paid from the General Fund. The 1982 First Special Session Laws, Chapter 2, Section 41, allowed the payment of interest from the contingent account; however, this source is simply not sufficient to pay interest on the outstanding loans.

Minnesota employers also pay a federal unemployment tax which is used to finance the administration of Minnesota's unemployment insurance law. The FUTA (Federal Unemployment Tax Act) tax structure is somewhat different than the state tax in that the FUTA tax rate and taxable wage base are less. The FUTA tax rates and taxable wage basis in effect since 1977 are shown in Table 26. Federal legislation effective January 1, 1983, has increased both the FUTA tax rate from 3.4 percent to 3.5 percent, and the taxable wage base from \$6,000 to \$7,000.

Employers are allowed a credit against the federal tax for taxes paid into Minnesota's fund. The total credit allowable may not exceed 2.7 percent of taxable FUTA wages. Because of this credit, the effective FUTA tax rate on employers was 0.7 percent.

TABLE 26

UNEMPLOYMENT COMPENSATION FUND

FUTA TAX RATES AND TAXABLE WAGE BASE
CALENDAR YEARS 1977 TO 1982

<u>Year</u>	<u>FUTA Tax Rate</u>	<u>FUTA Taxable Wage Base</u>
1977	3.4%	\$4,200
1978-82	3.4%	6,000

Effective January 1, 1980 provisions of Title XII outlined a loan repayment schedule for states whose unemployment compensation funds failed to repay outstanding loans by a certain date. This schedule increased the FUTA tax rate each year until the loans are repaid. For Minnesota, the loan repayment schedule under Title XII for loans received during 1980, 1981 and 1982 is outlined in Table 27.

TABLE 27

UNEMPLOYMENT COMPENSATION FUND

TITLE XII LOAN REPAYMENT SCHEDULE
CALENDAR YEARS 1980 TO 1982

<u>Calendar Year</u>	<u>Annual Loan Amounts</u>	<u>Repayment Due</u>	<u>Additional FUTA Tax Rate</u>			
			<u>.3%</u>	<u>.6%</u>	<u>.9%</u>	<u>1.2%</u>
1980	\$ 28,800,000	11/10/82	1982	1983	1984	1985
1981	85,200,000	11/10/83	1983	1984	1985	1986
1982	174,047,117	11/10/84	1984	1985	1986	1987

Since the fund did not repay the \$28.8 million by November 10, 1982, Minnesota employers pay an additional three-tenths of one percent FUTA tax for calendar 1982. This increase is assessed on the 1982 Employer's Annual Federal Unemployment (FUTA) Tax Return and was due by January 31, 1983. It increases the employers effective FUTA tax rate from 0.7 percent to 1.0 percent for 1982. In 1983, the effective FUTA tax rate will be 1.3 percent. The additional amounts collected as a result of this increase are applied against the unpaid loans. For each additional year the loans remain outstanding, the FUTA tax is increased by three tenths of one percent, plus the difference between 2.7 percent and the average contribution rate in the preceding tax year. Unlike the prior loan repayment made in 1979 by the fund, Minnesota employers are being directly assessed to repay the current loans.

All benefits (regular and extended) are paid out of the UC Fund to eligible individuals as determined by the department. The number of weeks that regular benefits are paid and the weekly benefit amount are based on the number of credit weeks earned and wages paid to a claimant. A claimant can draw regular benefits for a minimum of 11 weeks to a maximum of 26 weeks, and can receive a weekly benefit up to a maximum of \$184. The 1982 Legislature suspended the annual automatic formula for determining the maximum weekly benefit amount and set the maximums of \$191 and \$198 for 1983 and 1984, respectively.

Extended benefits are paid to eligible claimants after regular benefits have been exhausted. The maximum extended benefit period (number of weeks) is 50 percent of the regular benefit period. The claimant's weekly extended benefit amount is equal to the weekly regular benefit amount.

Regular benefits paid to a claimant are charged against the appropriate employer's account. Under the Federal-State Extended Unemployment Compensation Act, the federal share of extended benefits paid is 50 percent. Prior to March 5, 1982, the fund absorbed the remaining extended benefits paid. The 1982 Legislature provided that the state share of extended benefits paid will now be charged to the appropriate employer's account to the same extent as regular benefits are charged.

The effect of the 1982 legislative changes will not be immediately felt in terms of reducing either the fund's dependence on borrowing or the deficit. Since employers pay the cost, the impact of any financing decisions will affect them almost immediately. Financing decisions made by the Legislature should be continually evaluated in terms of fund responsiveness to current economic conditions. The efforts toward fund solvency and the building of future fund reserves will be both long and costly for Minnesota employers. The Legislature will be required to identify sound and equitable short-term and long-range plans and goals. In addition, the Legislature needs to identify non-fund sources for financing the loans obtained after April 1, 1982. The decisions that have to be made from the existing alternatives will be difficult and sensitive. Until such decisions are made, the fund will continue to experience financial dependence and deficit spending.

II.B. WORKERS' COMPENSATION SPECIAL COMPENSATION FUND

The Workers' Compensation Special Compensation Fund was established to provide reimbursement to insurers and self-insurers for money advanced to pay supplementary benefits that augment the claimants workers' compensation benefits, and second injury claims for physically impaired individuals who are properly registered under the second injury law and suffer a subsequent injury attributable, at least in part, to the pre-registered impairments. The fund also makes direct payments for wage loss compensation and medical expenses for persons whose employers failed or

refused to provide workers' compensation coverage; and it advances benefits to injured workers or dependents when rights to benefits are assured but there is a temporary dispute between two or more employers or insurers regarding legal liability in the case.

The fund operates on receipts generated primarily from assessments charged insurers and self-insurers on the total amount of benefits paid under Minn. Stat. Section 176.101 or 176.111. Minn. Stat. Section 176.131, Subd. 10, authorizes the commissioner to set the annual assessment rate in accordance with an adjustment schedule based on the balance in the fund on September 30 each year and an estimate of expenditures during the next calendar year. Setting the assessment rate is a complex and sensitive issue. The department wants to avoid accumulating a large surplus in the fund, while at the same time ensuring that the assessment rate is sufficient to provide the financing necessary for the fund to meet its obligations. The department must consider the overall controversial climate relating to workers' compensation costs in the state. In the past, department staff estimated that a one percent increase in the assessment rate would result in a 1.5 percent increase in workers' compensation insurance premiums.

In our management letters to the Department of Labor and Industry in the last several years, we have commented on the serious financial problems which the fund has had; and we previously issued an adverse audit opinion on the fund's financial statements, because of the inability to determine the accrued liabilities at a given point in time. The basic problem the fund has encountered is that the receipts collected through the annual assessments have not kept pace with the amount of benefit claims submitted. For the majority of benefits, our testing during 1982 indicated that the department was at least a year behind in paying claims.

Table 28 highlights the financial problems the fund has experienced in the last four fiscal years. Disbursements of the fund significantly exceeded receipts during the first three years shown. Also, although an increased assessment rate during fiscal year 1982 has produced additional receipts, the amount of estimated unpaid claims at June 30, 1982 has doubled from the preceding year. The assessment rate for calendar year 1982 was increased to 15 percent. The effect of this was first seen in August 1982, when the assessments for January through June 1982 were due and collections exceeded \$16 million. Assessments for the second half of calendar year 1982 are due in March 1983. If the collections in March 1983 are equal to August 1982, it appears that the fiscal year 1983 receipts will be sufficient to pay only the claims on hand at June 30, 1982. Subsequent to our review, the department set the assessment rate for calendar year 1983 at 17 percent. The effect of this increase will not be seen until August 1983.

TABLE 28

WORKERS' COMPENSATION SPECIAL COMPENSATION FUND

SUMMARY OF ACTIVITY
FISCAL YEARS 1979 TO 1982

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Assessment Rate ⁽¹⁾	13%	8%	6%	8%
Receipts:				
Collections	\$14,956,000	\$11,326,000	\$13,344,000	\$16,971,000
Investment Income		400,000	203,000	89,000
Total	<u>\$14,956,000</u>	<u>\$11,726,000</u>	<u>\$13,547,000</u>	<u>\$17,060,000</u>
Disbursements:				
Claims Paid	\$19,356,000	\$18,412,000	\$16,066,000	\$16,927,000
Administration				98,000
Total	<u>\$19,356,000</u>	<u>\$18,412,000</u>	<u>\$16,066,000</u>	<u>\$17,025,000</u>
Cash and Investments at June 30	\$ 9,727,000	\$ 3,041,000	\$ 522,000	\$ 557,000
Estimated Unpaid Claims at June 30	Not Available	Not Available	<u>\$18,053,000</u>	<u>\$36,423,000</u>
Amount to be Financed from Future Collections	N/A	N/A	<u>\$17,531,000</u>	<u>\$35,866,000</u>

(1) The assessment rate is set on a calendar year basis. The rates shown on the foregoing schedule are the rates to which the fiscal year receipts relate. In effect, the receipts during a given fiscal year are for assessments for the preceding calendar year.

During our fiscal year 1982 audit, we limited our review of procedures for processing and paying special compensation claims because the department had contracted with a certified public accounting firm to conduct a special study to assess the financial status and operation of the fund. The final report from the study, issued in December 1982, included an estimation of the long-term liabilities of the fund, a review of the fund administration and accounting procedures and controls, and recommendations for management reporting and staffing. Department personnel have stated that they intend to pursue changes to deal with the critical financial position of the fund during the 1983 legislative session. In addition, the department intends to implement certain of the recommendations included in the special study in an attempt to improve the procedures for administration of the fund.

II.C. TEACHERS RETIREMENT FUND

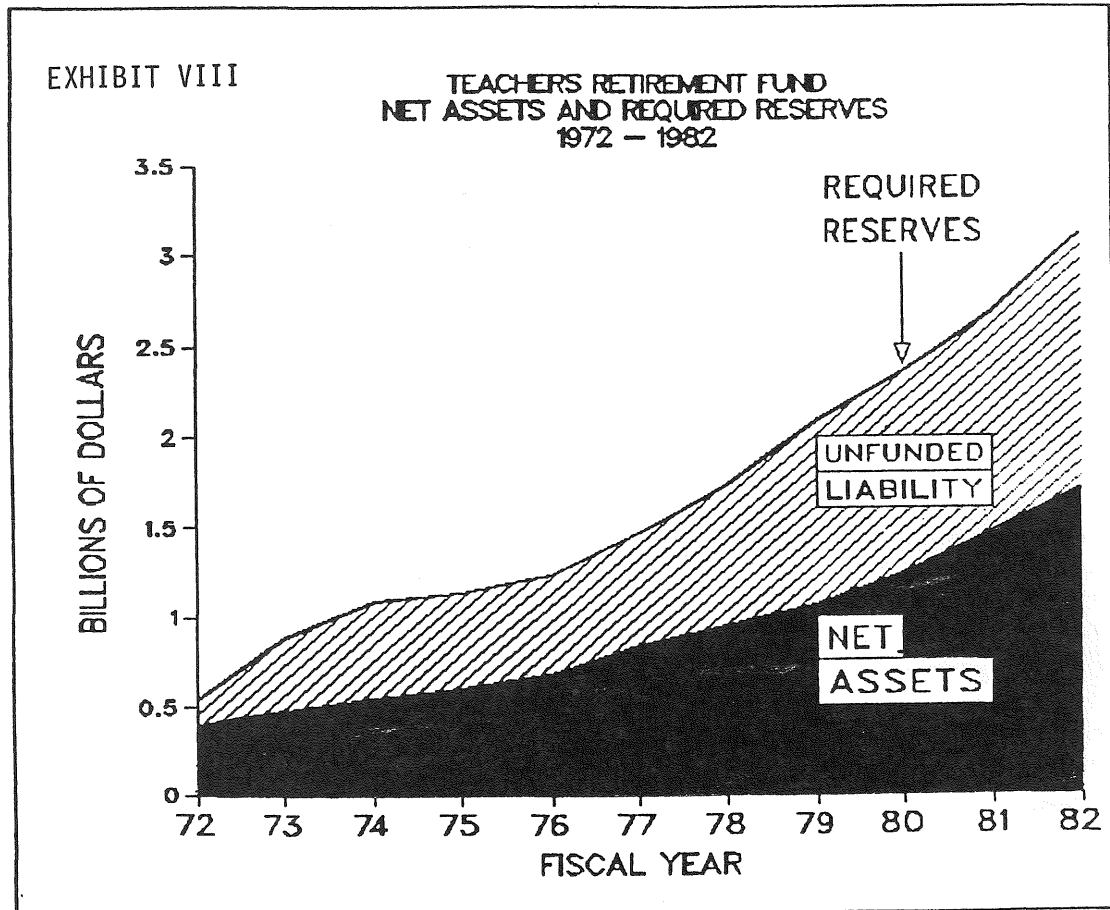
The funding ratio of the Teachers Retirement Fund has not significantly improved since 1973 and the fund appears unable to be fully funded by the target date of June 30, 2009. Table 29 shows, for the past 10 years the funding ratio has remained stable, ranging from 50 to 56 percent. This funding ratio is significantly below that of other major state pension plans which are approaching an 80 percent funding level. The actuaries' reports for the past few years have included the statement that it is apparent that even with the additional support rate currently being contributed by the state, the funding rate of the Teachers Retirement Fund is inadequate.

TABLE 29
TEACHERS RETIREMENT FUND
SUMMARY OF NET ASSETS, UNFUNDED LIABILITIES,
REQUIRED RESERVES, AND FUNDING RATIOS
JUNE 30, 1972 TO 1982

June 30	Net Assets	Unfunded Liabilities	Required Reserves	Funding Ratio
1972	389,406,363	154,289,274	543,695,637	71.6%
1973	468,337,531	409,397,553	877,735,084	53.4% ⁽¹⁾
1974	538,893,416	539,626,284	1,078,633,461	50.0%
1975	586,870,721	545,075,979	1,131,946,700	51.8%
1976	665,810,655	598,123,281	1,293,764,171	51.5%
1977	822,410,185	640,572,428	1,462,982,613	56.2%
1978	940,345,339	792,431,347	1,732,776,686	54.3%
1979	1,064,237,842	1,015,936,134	2,080,173,976	51.2%
1980	1,232,115,128	1,129,006,116	2,361,121,244	52.2%
1981	1,462,538,605	1,228,407,275	2,690,945,880	54.4%
1982	1,710,750,595	1,397,335,069	3,108,085,664	55.0%

(1) The introduction into the Teachers Retirement Association (TRA) laws of the High 5 Formula program created a significant increase in the amount of the required reserves. This resulted in a decrease of the funding ratio from 71.6% to 53.4%.

The two components of the funding ratio are net assets and required reserves (the amount required to fund plan benefits). The actuarial calculations of required reserves are made in accordance with the requirements of Minn. Stat. Section 356.215. The statute provides a number of assumptions that are used by the actuaries when calculating required reserves, including an assumed 5 percent rate of return for investments of the fund and an assumed annual growth rate of 3.5 percent for members' salaries. The unfunded liability (unfundedness) of \$1.397 billion as of June 30, 1982 is the amount by which required reserves exceed net assets of the fund. Exhibit VIII shows the relationship between net assets and required reserves for the past 11 years.



The unfundedness has occurred because pension benefits which have been earned in the past were not fully financed. Also, unfundedness can be affected significantly when pension benefits undergo major amendments. For example, pension benefits were significantly increased in 1973 when the state began basing annuities on the high five year average salary for each retiree. Because of this major change in pension benefits, TRA's funding ratio dropped from 71.6 percent in 1972 to 53.4 percent in 1973.

Funding of the Teachers Retirement Fund is accomplished three ways:

1. Employees contribute 4.5 percent of their salary. (Note that certain older employees belong to the "Basic" plan which is not coordinated with the social security system. These employees contribute 8.5 percent of their salary. New employees cannot join this old plan.)
2. The state, on behalf of the schools, matches the employees' contributions and contributes an additional 3.05 percent of their salary (this additional contribution is intended to finance the unfundedness).
3. Net assets are invested and investment earnings are deposited with the fund.

The unfunded liability at June 30, 1982 of \$1.397 billion increased by \$169 million during fiscal year 1982. Although the total dollar unfundedness increased, the fund did show a slight increase in its funding ratio, from 54.35 percent to 55.04 percent. This occurred because net assets grew at a higher percentage than required reserves. However, this increase in the funding ratio was still not sufficient for the fund to meet its scheduled funding date of 2009.

The unfunded liability increased by \$169 million during fiscal year 1982, due primarily to a net actuarial loss for the year. The loss occurred primarily because the fund experienced a growth in salary rates and investment income which significantly deviated from the statutory assumptions which the actuary was required to use. As mentioned previously, the contribution rates are based in part on the assumption that members will achieve salary increases each year equal to 3.5 percent of their present salaries. During fiscal year 1982, teachers' salaries actually increased by over 15 percent (over 12 percent in fiscal year 1981), thus resulting in an actuarial loss of over \$223 million. When contribution rates are based on salary assumptions that are too low, the amounts being contributed are insufficient to finance future benefits because benefits grow each year in proportion to actual salaries.

The other material item that affects the annual change in the unfunded liability is an actuarial gain that is realized when investment earnings are greater than expected or assumed. During fiscal year 1982, earnings on investments were assumed to be 5 percent, as discussed previously, but actual earnings during the year were greater than 5 percent, resulting in an actuarial gain of over \$47 million. This actuarial gain partially offsets the large actuarial loss described above, but not sufficiently enough to decrease the total unfunded liability. The fund also

experienced a net actuarial gain of \$7 million from a variety of other actuarial assumptions. The net effect resulted in the \$169 million net actuarial loss for the year.

It should also be noted that the statutory assumptions utilized for actuarial estimations do affect the calculation of required reserves. The net actuarial loss, which was previously discussed, reflects only the differences between actual 1982 experience and these statutory assumptions. These assumptions further impact total required reserves. Thus, future net actuarial losses could continue to be realized if these assumptions are maintained and actual experience follows the 1982 pattern.

The appropriate funding level for pension plans is a basic policy decision. Normally, governments as well as private industry, attempt to fully fund their pension plans over many years. There are extreme cases when full funding is not attempted, such as our social security system. With the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the federal government has taken the initiative to impose controls and requirements for full funding on private pension funds. The federal government has been considering extending these requirements to pension plans of state and local units of government. Furthermore, there are many advantages for a pension plan to become fully funded as soon as possible. Minimum contribution payments are lower in earlier years because interest income has a longer period to accrue and can contribute more towards reducing the unfunded liability balance. As the required deadline for full funding approaches (2009), there is less time to accrue interest on investments which will force contribution rates to increase if the unfunded liability is to be eliminated. Also, by achieving and maintaining a full funding level, the pension plan ensures that the benefits of future recipients are well protected. In the event the plan terminates or is significantly changed, full funding would enable paying the vested benefits of future retirees without requiring the collection of additional contributions. For example, if the Teachers Retirement Fund was currently fully funded, the additional contribution of 3.05 percent of salary would no longer have to be paid by the state on behalf of the school districts.

Finally, full funding eliminates the problems that demographic changes may introduce for pension plans. An example of this problem is evidenced by the social security system. By making current employees and employers fund the benefits of current retirees, the burden fluctuates widely as the ratio of retired to active employees changes. This fluctuation would not occur if the social security system were fully funded from its inception. It is important to remember that pension plans are designed to set aside sufficient monies to finance future pension benefits. A fully funded plan assures employees that they will receive their pension benefits upon retirement and avoids such financing problems as are now being faced by the social security system and, to a lesser degree, by the Teachers Retirement Fund.

Because the actuarial assumptions play such a key role in funding decisions, they deserve close scrutiny. The Department of Finance has commissioned Winklevoss & Associates, Inc. to review the status of all state retirement funds and to take a critical look at the assumptions being used. Hopefully, this study will provide useful information for the Legislature and the state's pension fund managers as they seek solutions to

TRA's funding problem. Ideally, a solution will be identified and implemented in the near future. A solution will become more difficult in the future because there will be fewer years over which it can be financed. Obviously, TRA management is aware of the problem surrounding the funding issue. They should continue to work with the Legislature in seeking a solution to the problem.

II.D. MAXIMUM EFFORT SCHOOL LOAN FUND

The maximum effort school aid law (Minn. Stat. Section 124.36 to 124.47) provides debt service or capital loans to school districts which have such low property valuations that the levies required for debt service are excessive. Currently, a district qualifies for assistance if a levy of 16 mills on the Equalization Aid Review Committee (EARC) valuation is not sufficient to meet its debt service needs. At June 30, 1982, loans outstanding in the Maximum Effort School Loan Fund totaled approximately \$44.9 million.

Minn. Stat. Section 124.41, Subd. 1 provides that the Commissioner of Education shall receive and consider applications for and grant or deny loans. Subd. 2 provides, in part, that upon the request of the Commissioner of Education, the Commissioner of Finance shall from time to time as needed issue and sell general obligation bonds and shall credit the net proceeds of their sale to the Maximum Effort School Loan Fund after deducting a portion required to be transferred to the Debt Service Fund for interest on the bonds.

Principal and interest payments by the school districts on debt service and capital loans are deposited to the loan repayment account within the Maximum Effort School Loan Fund. Minn. Stat. Section 124.46, Subd. 3 provides that on November 1 each year there shall be transferred to the Debt Service Fund from the loan repayment account, a sum of money which, when added to the balance in the Debt Service Fund, will be sufficient to pay principal and interest on the school loan bonds coming due within the next ensuing year and to and including July 1 of the second ensuing year. The department was unable to transfer the required amount to the Debt Service Fund on November 1, 1980 because of insufficient monies in the loan repayment account. An amount of \$2,111,761 was loaned from the General Fund to complete the required transfer to the Debt Service Fund. The loan was subsequently repaid. Laws of 1981, Chapter 358, Article IX, Section 14, provided General Fund appropriations to be used for the fiscal year 1982 and 1983 Debt Service Fund transfers if sufficient funds were not available in the loan repayment account. The purpose of these appropriations was to prevent a statewide property tax levy which would otherwise be required pursuant to Minn. Stat. Section 124.46, Subd. 3. General Fund appropriation amounts of \$3,398,664 and \$4,386,609 were needed for the November 1, 1981 and 1982 Debt Service Fund transfers, respectively. There was no provision in the appropriation law for repayment of the General Fund contribution.

The financial problems of the Maximum Effort School Loan Fund have resulted in part because the maximum effort school aid law has been amended in recent years to allow school districts to defer principal and interest on both debt service and capital loans. It is uncertain that the

capital loans totaling \$41.8 million will be collected because of the following factors affecting the ability of the districts to repay the outstanding amounts:

- The Legislature has changed the mill rate used in calculating the maximum effort debt service levy, which inversely affects the loan repayments required from the school districts. A 1980 statutory amendment decreased the mill rate from 20 to 15 which deferred, and possibly discharged, the repayment of loans for several school districts. Our review indicated that loan repayments due December 15, 1982 were \$1.3 million less than they would have been without the change. A 1981 amendment increased the levy to 16 mills for loans approved after August 1, 1981. In theory, the increase should require more frequent repayments on new loans.
- Laws of 1982, Chapter 548, Article 6 changed the calculation of the maximum effort debt service levy for certain loans. The change allowed one school district, which had approximately 10 percent of the outstanding capital loans at June 30, 1982, to reduce its levy and extend its remaining repayment schedule to 13 rather than three years. The district's payment due December 15, 1982 was \$630,000 less than it would have been without the statutory change.
- Minn. Stat. Section 124.43, Subd. 4 provides that in the event any capital loan is not repaid within 30 years after it is granted, the liability of the school district shall be satisfied and discharged and interest thereon shall cease. School districts may issue local bonds during the first 20 years after the loan is granted, causing a higher required debt service levy and less ability to liquidate the maximum effort loan.
- The amount of the maximum effort debt service levy is dependent upon future economic conditions within the local school districts which affect the adjusted assessed valuation upon which the levy is based.

Because of the uncertainty as to future collectibility of the capital loans and because we were unable to apply adequate alternative audit procedures, we were unable to express an opinion on the financial statements for the Maximum Effort School Loan Fund for fiscal year 1982. Because of the various statutory changes made in the maximum effort school aid laws, the ability of the fund to meet its future debt service requirements remains questionable. As a result, additional General Fund appropriations may be necessary to pay off the general obligation bonds.

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SECTION III

OPPORTUNITIES TO IMPROVE FINANCIAL MANAGEMENT

The Financial Audit Division works continuously to improve the financial management of state government. The Statewide Audit produces numerous recommendations each year that are designed to improve the financial controls maintained over major state programs. These recommendations are discussed in Section III.A. We will be working with state departments to implement our recommendations.

We are also currently working on two additional projects that we believe will be very useful in improving the state's financial management. The first involves the potential for implementing a unified audit approach and establishing a network for verifying financial information provided to the state by its local governments. This is discussed in Section III.B. The other is a research project to analyze the potential for using EDP file matching techniques. Such techniques could better utilize the information currently maintained by the state and assist in assuring that only eligible recipients participate in certain benefit programs and that the state is collecting the revenues to which it is entitled. The status of this project is discussed in Section III.C.

III.A. AN ANALYSIS OF CONTROLS MAINTAINED OVER MAJOR STATE PROGRAMS

During our 1982 Statewide Audit, we reviewed the systems in many departments which process the major revenue and expenditures of the state. We developed various findings and recommendations which were reported to the departments and the Legislative Audit Commission in management letters. As explained later in this section, most of the recommendations can be implemented by the staff in the appropriate departments, and we will determine the status of implementation during our 1983 Statewide Audit. Some of the recommendations require legislative action to change a requirement or policy, and these also will be summarized more fully.

Many of the findings involved internal control deficiencies in the state's overall financial management structure. Internal control has been defined by the American Institute of Certified Public Accountants as:

the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

⁸Statements on Auditing Standards, paragraph AU §320.09, American Institute of Certified Public Accountants.

The controls are characterized as either:

- Accounting controls that are concerned mainly with the safeguarding of assets and the reliability of financial records.
- Administrative controls that are concerned mainly with operational efficiency and adherence to managerial policies.

This section is intended to make the Legislature aware of the necessity for strong internal controls and the findings we have developed when applying the characteristics to the systems currently in effect in the various departments. Because our main objective was to give an audit opinion on the state's financial statements, we were primarily concerned with accounting controls. Verifying the reliability of the state financial records, reducing the vulnerability to fraud or undetected errors, and determining that the state's assets are safeguarded are essential aspects of our audit. Effective systems of controls, especially accounting controls, are the first step toward deterring fraud in government and providing reasonable assurance that public funds and property are properly safeguarded.

During the Statewide Audit, we cited several deficiencies in department systems and identified many opportunities to improve financial management. In 24 department management letters, we made 205 recommendations to address various problem areas as identified in Table 30.

TABLE 30
RECOMMENDATIONS IN DEPARTMENT MANAGEMENT LETTERS
FISCAL YEAR 1982

	<u>Number of Recommendations</u>
Problem areas identified:	
● Safeguarding assets	21
● Verifying the reliability of state financial records	36
-- Controlling revenue losses	70
-- Controlling expenditure overpayments or excesses	34
● Improving operational efficiency and strengthening managerial policies	<u>44</u>
Total Recommendations	<u>205</u>

TABLE 30
(Con't)

Most recommendations can be implemented by the departments as follows:

• Recommendations will require statutory change or some other involvement from the Legislature	8 ⁽¹⁾
• Recommendations can be implemented by the staff of the appropriate departments	<u>197</u>
Total Recommendations	<u>205</u>

(1) Six recommendations have been included in departments' house-keeping bills; one required legislative approval which was sought; and one is being reviewed by the affected department's legal staff.

Safeguarding Assets

Controls to safeguard the assets of the state were reviewed in some departments, and we made several recommendations in the Departments of Transportation, Corrections and Revenue.

In the Department of Transportation (MN/DOT), we found that effective management and control over consumable inventory had not been experienced. MN/DOT maintains an inventory of fuels, lubricants, paints, road chemicals, motor vehicle parts, and other consumable items at various locations throughout the state. The amount of consumable inventory reported on the balance sheet of the Trunk Highway Fund at June 30, 1982, totalled \$13.8 million and comprised 10.3 percent of total assets. Because we could not verify the unit prices of the consumable inventory and our audit tests at the two largest inventory centers, Golden Valley and Oakdale, indicated errors in the quantities reported in the perpetual inventory records, we qualified our audit opinion on the fiscal year 1982 Trunk Highway Fund financial statements. Two factors contributed significantly to the consumable inventory valuation problem. First, MN/DOT officials have not devised an organization plan and complete consumable inventory policies and procedures with the basic characteristics of good internal control. More importantly, they also have not authorized the testing by an independent party to verify that the system of internal control is properly maintained at all locations.

We recommended that policies and procedures include six significant control points and that the custodial, recordkeeping, and accounting functions be separated.

In the Department of Corrections at Minnesota Correctional Industries-Stillwater (MCI-STW), we found that the fixed asset records had not been updated as a result of a physical inventory in twenty years. Assets of the Minnesota Correctional Industries Fund are valued at \$1,241,070, excluding buildings, of which over 50 percent are held at

MCI-STW. We recommended that a priority be placed on updating the fixed asset records of MCI-STW and that policies and procedures outlined by the Inventory Management Division (including a system to spot-check all areas of fixed assets at least annually) be implemented. The Commissioner responded that they would implement our recommendations.

Controls over unclaimed refund warrants in the Department of Revenue were found not to be sufficient to ensure that these warrants are not lost or stolen. We recommended more secure procedures for handling the warrants and that refund amounts remaining unclaimed after five years should be transferred to the State Treasurer in accordance with the abandoned property law of the state.

Verifying the Reliability of Financial Records

Much of the work in our statewide audit was directed toward giving our audit opinion on the state's financial statements. This opinion primarily informs statement readers of any major departures from generally accepted accounting principles. In order to render the appropriate opinions, we assessed the controls in the major revenue and expenditure data processing systems of the state funds, and developed recommendations to reduce revenue losses and expenditure overpayments or excesses. Verifying documentation and written procedures played a significant part in developing these recommendations.

Many recommendations involved segregation of functions in processing both revenue and expenditures, so that the same person is not in a position to perpetuate and to conceal irregularities in the normal course of his duties. Another important control for the processing of revenue and expenditures is that transactions are approved by someone independent of the processing duties, and we made recommendations to obtain the necessary approvals.

We made several recommendations in the Departments of Revenue and Natural Resources to help in assuring that proper controls over state revenue collection systems existed. The recommendations to the Department of Education were examples of those made to ensure that expenditures, such as aid payments, were paid under an adequate data processing system. We will discuss the recommendations more fully in the following two sections.

Controlling Revenue Losses

The major portion of the state's revenue is from taxes. In the Department of Revenue, we found that documentation of the individual income tax computer system and of the processing functions performed on the Revenue Accounting Division's mini-computer system was insufficient to ensure the existence of proper accounting controls over the individual income tax processing system and other tax processing systems within the Department of Revenue. We recommended various developments to improve the documentation to a point where it can be relied upon in terms of meeting management's objectives and from an auditing perspective. In response, the Department of Revenue has indicated a lack of resources precludes the implementation of these recommendations.

We also noted that corporate income tax returns are not processed on a computerized system, which would provide more accurate processing of the returns and a faster assignment of the correct corporate tax liability while companies are still active. We recommended that the department formalize the plans to implement a computerized corporate income tax processing system and obtain approval from the chairmen of the House Appropriations and Senate Finance Committees so that funding for the project can be obtained.

Processing revenue after it is received by the state requires prompt depositing, and in the Department of Natural Resources (DNR) we found a need to account for receipts in a timely and proper manner. Testing revealed that amounts totaling over \$400,000 would remain at the DNR License Center until finally being deposited into a clearing account up to 11 days after being received. The License Center also failed to adequately monitor the collection of these receipts. DNR requires that the counties remit the receipts from the local sales of licenses in one month by the fifteenth of the following month. However, we noted that receipts from license sales totaling \$76,000 in May 1982 were not deposited until the middle of July, approximately 30 days late. Failure to collect these receipts on a timely basis results in a loss of interest income to the state. We recommended a number of improvements in the 1981 and 1982 State-wide Audit management letters, but many of them were not implemented.

Also at DNR, we pointed out that federal grant procedures needed strengthening in the area of indirect cost reimbursement, because indirect costs for some divisions are either not included on reimbursement requests or are mixed with direct costs. It was estimated that the General Fund did not receive \$250,475 in reimbursement of indirect costs for the two largest forestry programs. The forestry division also does not file reimbursement requests for federal grants on a timely, regular basis, because they are submitted only once a year. By not submitting reimbursement requests at least quarterly, the state carries the reimbursable costs up to nine months longer than necessary.

Controlling Expenditure Overpayments or Excesses

The major General Fund expenditure category for the year ended June 30, 1982 was grants and subsidies. Many of the aids were paid in the Department of Education. We found that component foundation aid and transportation aid calculations were processed and paid using incorrect Equalization Aid Review Committee (EARC) adjusted assessed valuations of property in the school districts. We recommended that the department adjust any inaccurate aid distributions and develop proper procedures to uniformly apply new EARC valuations to all applicable aid distributions.

There also was a need for written procedures for processing data to determine aid payments. The processing of applications, calculating of aid distributions, and payment transaction coding into the statewide accounting system (SWA) for aids to school districts was handled in various divisions of the department. Few divisions had written procedures describing the processing of school district data and the documentation necessary to support aid distributions. Sometimes only one or two people understood the entire process and could locate the documentation necessary to support the aid payments calculated. Documentation of the data processing system for special education aids especially was incomplete. From an

auditing standpoint, documentation is necessary to provide an understanding of the computer system to determine the degree of reliance that can be placed on it to process aid payments accurately, and to determine compliance with statutory requirements. We recommended that written procedures should be developed and consolidated into one user's manual for the processing of data for all aid payments to provide documentation necessary to support the payments. Special emphasis should be placed on documentation for special education aids, so that correct payment to school districts could be verified.

Improving Operational Efficiency and Strengthening Managerial Policies

Many recommendations (44 of 205) were made to increase the efficiency of department operations or to improve the adherence to sound managerial policies. Most recommendations were addressed to efficiently processing transactions within the various departments, but some were made to improve services to other departments or nonstate recipients.

For example, we found that the State Board of Investment (SBI) could improve the reliability of the data from their computerized investment system and provide users with the information necessary to effectively and efficiently use the system.

SBI implemented a new on-line computer investment management system during fiscal year 1982. The system maintains a complete asset inventory, with cost and market valuations, and an income accounting system for all state investments. Various accounting and management reports are prepared for users of the system including SBI, the state-level retirement systems, certain state agencies, and our office.

We used several of the new system reports during our audit of SBI and our testing of all state investment transactions. We encountered some errors in the system reports and information, as did other agencies. We realize that any new computer system may contain some programming errors. However, we also believe that when errors are found, the user agencies should be notified and corrected reports prepared. While it is the user agency's responsibility to reconcile the reports to agency records, the user has the right to expect that the reports are reliable. In addition, user problems with or complaints about the system may be lessened if there is a better understanding of its purposes and capabilities. We made several recommendations to address our concerns, and SBI responded that they are in the process of implementing them.

Implementation of Prior Audit Recommendations

In the last three years we have made many recommendations as a result of our Statewide Audits. The departments to which the recommendations were addressed have been very cooperative in working to improve their controls while evaluating our recommendations. The majority of our recommendations have been either implemented or partially implemented.

As discussed earlier in this report, the General Fund, which supports the activities of most state departments, has experienced severe financial problems during the past year. Because of budget cutbacks, many

state agencies we audited this year encountered problems in completing their work. However, most of those agencies did a commendable job in implementing our recommendations despite the disruptions of the past year. Although we have specifically identified some departments in our discussion, we do not mean to imply that most of these departments have not exerted a concentrated effort to improve the controls over the processing systems. We believe our recommendations have helped management in their efforts to improve their processing systems.

III.B. THE UNIFIED AUDIT

As discussed in Section I, approximately \$3.2 billion of fiscal year 1982 expenditures were paid in grants and subsidies to local governmental units and other recipients. In addition, \$921 million in grants and subsidies were expended from the Federal Fund.

The Department of Education paid over \$1 billion to local educational agencies throughout the state. State aids to schools were made up primarily of Foundation Aids, Vocational-Technical Education Aids, Transportation Aids and Special Education Aids. Federal aids to schools include Programs for the Disadvantaged, Child Nutrition Programs and Programs for the Handicapped. The Department of Public Welfare also paid over \$1 billion to medical providers and local welfare agencies. These aids basically include Medical Assistance, Aid to Families with Dependent Children, General Assistance Medical Care, administrative aids and the social services programs. The Department of Revenue paid approximately \$740 million in property tax credits and Local Government Aids to cities, towns, counties, school districts and special taxing districts.

The Departments of Education and Welfare pay many state and federal grants and subsidies based on the cost of the programs being provided by school districts and local welfare agencies. Generally, costs are accumulated by schools and local welfare agencies and submitted on a periodic basis to the state for reimbursement. The Welfare assistance programs rely upon recipient eligibility data determined at the local welfare agency level. Aid payments are then calculated by Welfare based on the information provided by the local welfare agencies. The basis for Foundation Aids paid by Education, however, is average daily membership of students (ADM). For Transportation Aids, the basis is full-time equivalent pupil units (FTE) in addition to costs incurred by the districts. The basis for Child Nutrition Programs is the amount of milk and the number of breakfasts and lunches served. The schools report program costs, ADM, FTE and number of meals served. Aid payments are then calculated by Education based on the data provided by the school districts. Local Government Aids paid by Revenue are based on formulas prescribed by statute and independent federal census data. Property tax credits are based on information provided by county auditors.

For many of the aid programs in state agencies there is only minimal verification that the data reported to the state accurately reflects the accounts and records of the cities, towns, counties, school districts, and other local agencies. Currently, school districts, counties and certain cities are required to have annual financial audits. However, these audits normally have not included verification of the local data upon

which state and federal aid payments are based. Some state departments have staff who are involved in the verification of data provided by local agencies. However, these staff perform only limited tests to confirm that data reported by local agencies is valid to support state and federal aids administered by state departments. We were told by some department staff that any testing of documentation at the local level was usually limited to meeting the minimum state and federal requirements.

The Department of Education is required in accordance with state statute to conduct at least 25 audits of school district records and files for the purpose of verifying school district pupil unit counts, levy limitations and aid entitlements. For the 1981-1982 school year, the Education audit unit was in the process of examining Foundation and Transportation Aids for 20 districts. The primary objective of these audits is to verify ADM counts for Foundation Aids, and costs and FTE data for Transportation Aids. However, audits of school district data have not been performed by department staff for many other state and federal programs.

In the Department of Public Welfare, we studied the work done by their staff to verify data submitted by local welfare agencies. Our results showed that the work of these staff has not been coordinated to maximize audit coverage and efficiency. Data supporting eligibility, which is determined by the local agencies and tested by the state, is limited to certain programs. Local agency expenditures which are submitted for reimbursement are not verified to supporting documentation at the local level for many programs.

In the Department of Revenue, property tax calculations are independently verified by the department, and the data submitted by county assessors and auditors are compared for reasonableness. However, the department does not determine whether the data submitted is supported by source documentation at the local level.

Without more extensive audits at the local level of the data upon which aid payments are based, the state does not have reasonable assurance that grants and subsidies paid are based on actual costs and for eligible recipients. The most that we could verify during our Statewide Financial Audit was that the payments were calculated accurately by state agencies from the data provided by local agencies.

In the past, we have recommended that state departments increase their efforts to verify the accuracy of the data provided by local agencies upon which aid payments are based. In part, we stated that consideration should be given to increasing the size of the audit staff. However, audit coverage will change in the next years because of certain requirements for federal programs. The Office of Management and Budget (OMB) Circular A-102, Attachment P, "Audit Requirements for Grants-In-Aid to State and Local Governments" provides that the recipient of federal funds (state agencies) are responsible to ensure that audits of subrecipients (local agencies) are completed in accordance with these guidelines. In conjunction with other state and federal agencies, we are working to develop a plan to implement the Attachment P audit on a statewide basis for fiscal year 1983. The Governor has designated the Department of Finance to serve

as the liaison for all state agencies receiving federal funds. Other participants in the planning process are the U.S. Department of Agriculture-Office of Inspector General (designated as lead federal cognizant audit agency by OMB) and the State Auditor.

An area of concern that has not been addressed in state government is the state compliance requirements for cities, towns, counties, school districts and other local agencies. As discussed previously, approximately \$3.2 billion is paid from the General Fund to subrecipients. Although the compliance areas to be tested in accordance with Attachment P requirements relate to only federal funds, the organization-wide audit provides a potential method to also improve the audit coverage for state aid programs. State agencies should consider the feasibility of incorporating state grant and aid compliance provisions in the audit guidelines for subrecipient organization-wide audits to be performed in the future (unified audit approach). If a unified audit of local agencies was conducted, both federal and state compliance features would be evaluated. The unified audit approach would have the advantage of:

- increasing the assurance to the Governor, Legislature, and citizens of the State of Minnesota that expenditures of funds are in compliance with state and federal rules and regulations; and
- coordinating the audit coverage to ensure that the audit will satisfy the needs of all users at all levels of government in the most efficient and cost-effective manner.

Representatives of the Department of Finance will be contacting state agencies in the near future to discuss the implementation of OMB Circular A-102, Attachment P. Agencies will be working with the Department of Finance and in consultation with the State Auditor to establish a plan to implement the state's responsibilities relating to subrecipient funds as provided by these guidelines. Opportunities for a unified audit should also be reviewed by the various agencies.

The future role of agency audit staff should also be coordinated with the audit work performed at the subrecipient level to ensure adequate verification of data upon which aids are based. Statutory changes may be necessary to avoid duplicative audit work and to coordinate the activities of department audit staff performing verification of data provided by local agencies.

III.C. EDP FILE MATCH

During the past months, the Financial Audit Division has been working on a project to identify the potential for computer file matching in the State of Minnesota. As defined in our report, computer file matching is an audit technique whereby common data elements from two or more computer files are cross-matched for the purpose of detecting fraudulent or erroneous information in one or more systems. As part of this project, we have studied the efforts currently being conducted by various other states; including many major successes and a few notable mistakes. We have studied the computer file matching that various departments and agencies of the State of Minnesota have been doing and have identified tremendous potential for expanding this effort.

A major issue which will confront the Legislature concerns data privacy. Because of uncertainty in the interpretation of the Data Privacy Act, file matching has been very limited in this state. We believe that computer file matching can be performed, while at the same time protecting individual privacy. What is necessary is an evaluation and clarification of the data privacy laws to resolve some of the problems we have identified in our report. This report, which will be issued in the near future, discusses more fully these and other issues which we have studied concerning computer file matching.

APPENDICES

GENERAL FUND

APPENDIX I

ANALYSIS OF BUDGETARY SHORTFALLS
FISCAL YEARS 1981, 1982, AND 1983

Date	Fiscal Problem	Action Taken																																												
August 1980	<p>Fiscal year 1981 fund deficit forecast, comprised of:</p> <table border="0"> <tr> <td></td> <td style="text-align: right;"><u>In Millions</u></td> </tr> <tr> <td>Original projected fund balance</td> <td style="text-align: right;">\$ 3.7</td> </tr> <tr> <td>Revenue shortfall</td> <td style="text-align: right;">(171.6)</td> </tr> <tr> <td>Expenditure deficiency</td> <td style="text-align: right;">(27.2)</td> </tr> <tr> <td>Projected Deficit</td> <td style="text-align: right;"><u>(\$195.1)</u></td> </tr> </table>		<u>In Millions</u>	Original projected fund balance	\$ 3.7	Revenue shortfall	(171.6)	Expenditure deficiency	(27.2)	Projected Deficit	<u>(\$195.1)</u>	<p>The Governor cut state expenditures by \$195.1 million including \$89 million in school aids which were subsequently restored by the Legislature, to be paid from fiscal year 1982.</p>																																		
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January - March 1981	<p>Revenue collections were less than estimates and deficiency appropriations were anticipated.</p>	<p>The Legislature in the 1981 Regular Session accelerated income tax withholding payments increasing fiscal year 1981 revenue by an estimated \$60 million. The Governor, in March, issued Executive Order No. 81-2 directing state departments to curtail expenditures during the remainder of fiscal year 1981.</p>																																												
April - June 1981	<p>Revised revenue forecasts in April indicated a fiscal year 1981 fund deficit of \$112.3 million. Revenue estimates were reduced by an additional \$40 million in June.</p> <p>Revised forecast revealed an estimated \$500 million shortfall between revenues and expenditures in the original budget for fiscal years 1982 and 1983.</p>	<p>April, May, and June school aids totalling \$154.6 million were unallotted by the Department of Finance and deferred to fiscal year 1982.</p> <p>The Governor submitted a revised budget for the biennium providing for additional expenditure reductions of \$139.6 million and new revenues of \$460.1 million. The Legislature, in the 1981 Special Session I, enacted legislation to balance the budget through various means, including:</p> <ul style="list-style-type: none"> • increased the sales tax to 5 percent for fiscal years 1982 and 1983 (estimated additional revenue of \$410.8 million); • changed the basis for deductability of federal income taxes (estimated additional revenue of \$51.7 million); • shifted the renter's credit payment from fiscal year 1983 to 1984 (estimated \$100 million); • changed the payment schedule for education aids from 90 percent current year/10 percent following year to 85 percent current year/15 percent following year (estimated \$60 million); and • changed the payment schedule for local government aid (estimated \$67.4 million). 																																												
November 1981	<p>Revised forecast indicated a fiscal year 1983 deficit comprised of:</p> <table border="0"> <tr> <td></td> <td style="text-align: right;"><u>In Millions</u></td> </tr> <tr> <td>Original projected fund balance</td> <td style="text-align: right;">\$ 92.3</td> </tr> <tr> <td>Revenue shortfall</td> <td style="text-align: right;">(606.3)</td> </tr> <tr> <td>Expenditure deficiencies</td> <td style="text-align: right;">(152.3)</td> </tr> <tr> <td>Fiscal year 1981 deficit carried forward</td> <td style="text-align: right;">(22.3)</td> </tr> <tr> <td>Projected Deficit</td> <td style="text-align: right;"><u>(\$688.6)</u></td> </tr> </table>		<u>In Millions</u>	Original projected fund balance	\$ 92.3	Revenue shortfall	(606.3)	Expenditure deficiencies	(152.3)	Fiscal year 1981 deficit carried forward	(22.3)	Projected Deficit	<u>(\$688.6)</u>	<p>The Legislature in 1981 Special Session III enacted legislation to balance the budget through various measures, including:</p> <table border="0"> <tr> <td></td> <td style="text-align: right;"><u>In Millions</u></td> </tr> <tr> <td>Revenues -</td> <td></td> </tr> <tr> <td>7 percent income tax surcharge</td> <td style="text-align: right;">\$199.0</td> </tr> <tr> <td>Sales tax extension and accelerated collections</td> <td style="text-align: right;">64.6</td> </tr> <tr> <td>Corporate income tax revisions</td> <td style="text-align: right;">31.7</td> </tr> <tr> <td>Other income and miscellaneous tax increases</td> <td style="text-align: right;">23.0</td> </tr> <tr> <td>Subtotal</td> <td style="text-align: right;"><u>\$318.3</u></td> </tr> <tr> <td>Expenditures -</td> <td></td> </tr> <tr> <td>School aids -</td> <td></td> </tr> <tr> <td>Budget reduction</td> <td style="text-align: right;">\$125.5</td> </tr> <tr> <td>Optional 2 mill levy increase</td> <td style="text-align: right;">43.0</td> </tr> <tr> <td>Early recognition property tax</td> <td style="text-align: right;">134.0</td> </tr> <tr> <td>Reduced local government aid</td> <td style="text-align: right;">32.0</td> </tr> <tr> <td>Other appropriation reductions (net)</td> <td style="text-align: right;">112.7</td> </tr> <tr> <td>Subtotal</td> <td style="text-align: right;"><u>\$447.2</u></td> </tr> <tr> <td>Total Actions</td> <td style="text-align: right;"><u>\$765.5</u></td> </tr> </table>		<u>In Millions</u>	Revenues -		7 percent income tax surcharge	\$199.0	Sales tax extension and accelerated collections	64.6	Corporate income tax revisions	31.7	Other income and miscellaneous tax increases	23.0	Subtotal	<u>\$318.3</u>	Expenditures -		School aids -		Budget reduction	\$125.5	Optional 2 mill levy increase	43.0	Early recognition property tax	134.0	Reduced local government aid	32.0	Other appropriation reductions (net)	112.7	Subtotal	<u>\$447.2</u>	Total Actions	<u>\$765.5</u>
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ANALYSIS OF BUDGETARY SHORTFALLS
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(1) The March and November 1982 original projected fund balance amounts were reduced by \$50 million for the estimated welfare deficiency which was not dealt with until November.

APPENDIX II

TECHNICAL NOTES ON DATA SOURCES

Historical Data (1978 to 1982) Sources for Sections I.A.-C.

Primary sources for summary historical data (1978 to 1982) were financial reports prepared by the Department of Finance. Detailed historical data on specific revenues and expenditures was derived from the financial reports and Statewide Accounting reports. Both summary and detailed data often had to be adjusted to achieve comparability between fiscal years. Adjustments were basically obtained from Statewide Audit working papers maintained by the Office of The Legislative Auditor. Table II-1 provides a reconciliation between financial reports and amounts utilized in Section I.

Projected Data (1983 to 1985) Sources for Section I.A.

Exhibits IV and V incorporate revenue and expenditure projections for fiscal years 1983 through 1985. Exhibit IV shows the impact of preliminary department budget requests as shown on the January 19, 1983 Department of Finance Fund Balance Analysis Report. Exhibit V shows the impact of the Governor's budget proposal as shown on the February 15, 1983 Department of Finance Fund Balance Analysis Report. The projected amounts from those sources are not comparable to amounts presented in the financial reports because of the many differences between the budgetary basis and the financial reporting basis, generally accepted accounting principles (refer to Section I.F. for an elaboration on these differences). Because of this lack of comparability, we have utilized the year-to-year differences on the revenues and expenditures reported in the Fund Balance Analysis Reports as a basis for calculating the amount by which the 1982 financial report amounts would change in fiscal years 1983 to 1985. Although total revenues and expenditures differ between the budgetary basis and financial reporting basis, we believe that the year-to-year changes under both bases are comparable.

TABLE II-1

GENERAL FUND

REVENUES, EXPENDITURES, AND FUND BALANCES
 RECONCILIATIONS TO FINANCIAL REPORTS
 FISCAL YEARS 1978 TO 1982
 (In Million \$)

	Fiscal Year				
	1978	1979	1980	1981	1982
REVENUES:					
Amounts Presented in Annual Financial Reports:					
Revenues (Net)	\$2,716	\$3,162	\$3,174	\$3,307	\$3,686
Transfers In and Other Sources	76	81	67	20	2
Total Financing Sources	<u>\$2,792</u>	<u>\$3,243</u>	<u>\$3,241</u>	<u>\$3,327</u>	<u>\$3,688</u>
Adjustments:					
Cancellation of Prior Encumbrances ⁽¹⁾	(17)	(21)	(9)		
Estimated Intrafund Transactions ⁽²⁾	(75)	(75)			
Miscellaneous			(3)	(6)	
Revenues Reported in Section I	<u>\$2,700</u>	<u>\$3,147</u>	<u>\$3,229</u>	<u>\$3,321</u>	<u>\$3,688</u>
EXPENDITURES:					
Amounts Presented in Annual Financial Reports:					
Expenditures (Net)	\$2,770	\$2,948	\$3,232	\$3,322	\$4,121
Transfers Out and Other Uses	133	181	171	135	172
Total Financing Uses	<u>\$2,903</u>	<u>\$3,129</u>	<u>\$3,403</u>	<u>\$3,457</u>	<u>\$4,293</u>
Adjustments:					
Current Encumbrances ⁽¹⁾	(77)	(57)			
Prior Encumbrances Expended ⁽¹⁾	97	66			
Estimated Intrafund ⁽²⁾	(75)	(75)			
Prior Adjustment to Debt Service ⁽³⁾		(76)			
School Aids Deferred from '81 to '82				242	(242)
Miscellaneous			(2)	(9)	
Expenditures Reported in Section I	<u>\$2,848</u>	<u>\$2,987</u>	<u>\$3,401</u>	<u>\$3,690</u>	<u>\$4,051</u>
ENDING FUND BALANCE:					
Amounts Presented in Annual Financial Reports:					
	\$ 276	\$ 399	\$ 149	(\$ 20)	(\$ 624)
Adjustments:					
Prior Period Adjustments from Change in Accounting Recognition ⁽⁴⁾					
1979 Changes	(76)				
1980 Changes	(39)	(79)			
1981 Changes	(42)	(42)	(42)		
School Aids Deferred from '81 to '82				(242)	
Miscellaneous	1	3	1		
Ending Fund Balances Reported in Section I	<u>\$ 120</u>	<u>\$ 281</u>	<u>\$ 108</u>	<u>(\$ 262)</u>	<u>(\$ 624)</u>

(1) In the earlier years, encumbrances were considered part of expenditures for financial reporting purposes. Any cancelled encumbrances were then considered to be another financing source in the ensuing years. These earlier amounts have been adjusted in an attempt to be comparable to the later years.

(2) Several activities, such as Medical Assistance reimbursements from counties and rent paid to the Department of Administration, result in the General Fund effectively recognizing offsetting revenues and expenditures (termed intrafund transactions). The effects of these activities have been adjusted out of the later financial reports. However, it was necessary to estimate the effects in 1978 and 1979 so that amounts would be comparable.

(3) Constitutionally required debt service transfers were not properly advanced until 1980. This required that a double payment be recognized in 1979 to "catch-up."

(4) As financial reporting has become more sophisticated, it has been necessary to record several retroactive adjustments to properly recognize many transactions. The need for such adjustments was substantially eliminated by 1981.

Basis for Estimating Certain Structural Changes in Revenues and Expenditures

The analysis of General Fund revenues in Section I.B. estimates the effect of certain law changes on major revenue systems. The largest increases are shown from the 7 percent surcharge for the individual income taxes and the increase from 4¢ to 5¢ in the sales tax. The method of estimating these increases is shown below.

INDIVIDUAL INCOME TAX
ESTIMATED EFFECT OF 7 PERCENT SURCHARGE
FISCAL YEAR 1982
(000's Omitted)

1. Receipts 7/1/81 to 6/30/82 (Source: Statewide Accounting Receipt Reports)	
Withholding	\$1,657,775
Declarations	<u>158,656</u>
Total	<u>\$1,816,431</u>
2. Less: Receipts 7/1/81 to 12/31/81 (Source: December 1981 Department of Finance Monthly Report)	
Withholding	\$ 797,967
Declarations	<u>46,620</u>
Total	<u>\$ 844,587</u>
3. (1-2) Receipts 1/1/82 to 6/30/82 (Time period when surcharge was in effect)	\$ 971,844
4. Less: Estimated Receipts Without Surcharge (3 divided by 1.07)	<u>908,265</u>
5. (3-4) Estimated Receipts From Surcharge	<u>\$ 63,579</u>

SALES TAX
ESTIMATED EFFECT OF INCREASE FROM 4¢ TO 5¢
FISCAL YEAR 1982
(000's Omitted)

1. FY 1982 Net Sales Collections (Source: Statewide Accounting Reports)	\$ 876,078
2. Less: Accelerated Collections June 1982 (Source: Department of Revenue calculations)	(28,233)
July 1981 Receipts - Primarily June 1981 collections which were still at 4¢	(<u>54,688</u>)
3. (1-2) Sales Tax Subject to Increase of 1¢	\$ 793,157
4. Less: Estimated Sales Tax Without 1¢ Increase (3 divided by 1.25)	<u>634,526</u>
5. Estimated Sales Tax Increase Due to Change From 4¢ to 5¢	<u><u>\$ 158,631</u></u>

Finally, Section I.C. in Table 16 contains several estimates of the additional cost associated with the state financing a higher share of certain welfare programs. These estimates were based on the weighted average of the state's financing percentage for each fiscal year. We will not repeat these calculations in their entirety, but the annual weighted averages of the state's share are listed below:

Program	Weighted Average of the State's Financing Share During Fiscal Year		
	1980	1981	1982
AFDC ⁽¹⁾	28.891%	34.379%	38.503%
General Assistance ⁽²⁾	55.0%	67.5%	75.0%
Minnesota Supplemental Aid ⁽²⁾	60.0%	77.5%	85.0%

(1) The federal government assumes approximately 55 percent of the cost of AFDC, with the state and counties dividing the remaining 45 percent as specific by state law.

(2) The counties assume the remaining cost of these two programs.

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