

Experts say financial crisis looms over Minnesota Legislature

*By Charley Shaw and Betsy Sundquist, Staff Writers
Saint Paul Legal Ledger Capitol Report, August 11, 2008*

Remember all those happy faces at the end of May, when Minnesota's DFL-controlled Legislature and Republican Gov. Tim Pawlenty finally reached a budget agreement?

Remember the news conference at which legislative leaders and Pawlenty praised themselves and each other for the bipartisan cooperation it took to produce a budget they all said was the best for Minnesota?

In fact, observers say, all that was just election-year happy talk — and no one will be smiling next year.

That's because the shortfall officially projected right now for the 2010-11 biennium budget is close to \$1 billion, and it will almost certainly be higher next spring. Many believe the deficit will be double the current projection — and a few are suggesting that it could rival the \$4.5 billion deficit that loomed over the state in 2003, and precipitated budget fixes that still reverberate in Minnesota today.

As a result, budget analysts and state agency heads are making increasingly dire predictions about what will happen during the 2009 legislative session, when legislators will be forced to craft a budget out of lower-than-expected revenues, higher expenditures and ever-shrinking reserve funds.

Some observers say the looming deficit is starting to assume the proportions of some daunting mythological beast, and that slaying the dragon may require a combination of finger-crossing and luck.

“It's going to be very difficult,” says Rep. Kathy Tingelstad, R-Andover, one of more than a dozen House members retiring this year who won't have to deal with state budget woes. “Everything is going to be looked at (and) entire programs cut — not just cut, but taken out of the state budget. Some programs will live or die based on nonprofit funding rather than state funding.”

Aaron Twait, the Minnesota Taxpayers Association's research director, sums up the prospects for the 2009 session: “It will make this year look like a pillow fight.”

2008 'solutions' raided reserve funds

“The victory lap that the legislators went on — we questioned that,” says Mark Haveman, executive director of the Minnesota Taxpayers Association. “It seemed like they just took care of the needs for the current session and went home.

“If the numbers take a turn south ... I think it’s going to get worse, not better. Everybody is sort of crossing their fingers that the deficit won’t take off.”

During 2008, lawmakers corrected a \$935 million general fund budget deficit that will keep the state operating through the current two-year budget cycle, which ends next June 30. And they did it primarily by raiding what Haveman calls “the state’s couch cushions:” the budget reserve, which was tapped in the last session to the tune of \$500 million.

That left only \$153 million in the budget reserve, plus \$353 million in the cash-flow account.

About two-thirds of the money that lawmakers used to balance the budget in the last session was one-time money, which will compound the difficulty of correcting a deficit in 2009, according to Aaron Twait, the Minnesota Taxpayers Association’s research director.

The 2009 Legislature faces the herculean task of not only fixing a shortfall that could be huge, but also trying to predict revenues and handle unexpected expenditures — such as the \$38 million that was earmarked this year for the victims of the August 2007 Interstate 35W bridge collapse that killed 13 and injured more than 140.

That special fund was part of \$142 million in new spending approved by the 2008 Legislature, despite the deficit.

The Legislature has found itself in this position before. In 2003, lawmakers plugged the \$4.5 billion general fund deficit in part by taking \$1 billion from the tobacco endowment fund. In 2009, however, legislators will not be able to fall back on as many special-fund balances. And the tobacco endowment is now drained.

The situation is akin to a Minnesota family juggling its bills, paying what must be paid to keep the lights on, the family fed and the cars running, and putting off those bills whose non-payment won’t have immediate consequences — or even taking money intended for the doctor bill and using it to buy gasoline.

One example of a one-time fund shift this year that isn’t possible again in 2009 was the redirection of \$80 million of federal Temporary Assistance to Needy Families (TANF) money to the general fund. That money, which came from a reserve fund, was intended to be used for programs such as the Minnesota Family Investment Program (NFIP). Lawmakers also redirected federal child-care dollars and workforce development money to help bring the 2008 budget into balance.

“I think a lot of these accounting maneuvers — whether they’re shifts or transfers — really depend on how desperate [lawmakers] get,” Twait says. “Just because you have money sitting there, it doesn’t mean you can necessarily use it.”

Deficit projections keep rising

Minnesota’s dire budget outlook has been creeping further into the red for more than a year, and the numbers have been there for anyone to see.

The February 2007 forecast showed a small positive balance for the 2010-2011 biennium, but one that had weakened by \$418 million from the previous November’s forecast. The reason for the \$418 million dip was that corporate income taxes and sales tax receipts had slipped, according to the state Finance Department.

By November 2007, a \$211 million structural shortfall was projected for 2010 and 2011. Those projections did not include anticipated inflation of state expenditures.

In February of this year, the anticipated deficit had grown to \$1.86 billion. An update last month from the state Department of Finance indicated that revenues were higher than predicted in the February forecast. But the state’s economic-forecasting firm, Global Insight Inc., expects the economy to continue weakening. State lawmakers are concerned that declining economic growth will make the state’s budget hole even deeper.

Sen. Tom Bakk, DFL-Cook, and chairman of the Senate Taxes Committee, is one legislator who expects the state budget problem to get worse before it gets better.

Bakk points out that in addition to using \$500 million from budget reserves last session, the Legislature also made more than \$250 million in cuts.

“We all found out that making cuts was hard, and a deal had to be made in the end,” he says. “Going forward next biennium, the problem is much larger.”

Budget cuts were indeed widespread in the last session. Legislators ended up slicing \$267 million out of the general fund — although certain items continued to be considered off-limits on both sides of the aisle. One example: The final budget deal included a \$51-per-pupil increase in the state’s formula for K-12 education, for a one-time increase of \$43.8 million. K-12 education general fund spending in the 2008-09 budget was \$13.8 billion, or about 40 percent of a roughly \$35 billion budget, which left only about 60 percent of the general fund available for cuts.

The biggest share of cuts this year came from health and human services: \$172 million, which was put into the general fund. And that doesn’t count \$50 million from the Health Care Access Fund (made up of a 2 percent tax on medical care in the state).

Health and human services “tends to be a target, and that’s because it is a part of the budget that’s increasing at the most rapid rate,” says Rep. Julie Bunn, DFL-Lake Elmo,

who serves on the House health policy and finance committees. Welfare programs are among the most vulnerable whenever the state has a deficit, she says.

Bakk currently puts the expected deficit for the next biennium at about \$1.9 billion, and he would like to see lawmakers also pay back the reserve funds that they used this year.

“You have, with inflation, a \$2 billion problem,” he says. “You have to add the \$500 million to backfill the reserve, which creates a \$2.5 billion problem.”

Compounding the problem: slightly lower-than-expected sales tax collections, a direct result of higher fuel prices, which shows no signs of abating.

Global Insight in February forecast that by the end of 2008, a barrel of crude oil would be down to \$80. That prediction will likely prove to be wildly optimistic: After a high of \$145 a barrel, the price has dropped to about \$118, a figure that’s still forced Minnesotans to cut back on driving. Global Insight in July revised its oil outlook and anticipates oil will peak at \$160 a barrel at the end of 2008. The result: weakened economic growth and a serious reduction in discretionary spending among Minnesota households, resulting in lower tax revenue.

Part of the self-congratulatory proclamations that went on in May at the end of the session included claims by DFLers that the final budget deal didn’t include a net tax increase.

Don’t repeat that within earshot of Phil Krinkie, though.

Krinkie, a former Republican state representative from Shoreview and currently president of the Taxpayers League of Minnesota, points out that some businesses in the state will pay more corporate income taxes, because the 2008 Legislature raised \$109 million by tightening up laws allowing Minnesota corporations to receive tax deductions on foreign income by setting up foreign operating corporations.

Lawmakers also raised \$37 million in one-time revenue with a timing shift that increased the percentage of sales taxes paid in June.

Nan Madden, director of the Minnesota Budget Project, says the 2008 Legislature squandered future deficit-cutting opportunities.

“I think one of the things that’s disappointing to us is [that] there were opportunities to close that [future budget] gap, and those opportunities were not taken,” she says, pointing to tax proposals that were abandoned at the end of the session and additional tax breaks that lessened revenue. The lost opportunities included a property tax hike on business and vacation properties that would have raised \$82 million in revenue. Pawlenty objected to the business property tax changes, and they were dropped from the final tax bill.

Lawmakers also added \$30 million in tax benefits to current military personnel, and spent \$64 million on property tax aid to cities and counties. When spending cuts and spending increases during the 2008 session are put together, according to the Department of Finance, the net change in the 2010-11 budget outlook is \$3 million more in spending.

So what can be done? Or is the situation going to get progressively worse?

Krinkie, for one, believes that the budget might run into the red even before the end of the current biennium. He predicts that if revenues decline before the end of this fiscal year, lawmakers might have to pass a deficiency bill next winter before they take up the thorny issue of the 2010-11 budget.

“The chances are that the revenues just won’t be there,” Krinkie says.

At least two commissions are studying budget and tax trends with the intention of recommending that state lawmakers change the way they budget. Those suggestions could include new formulas for amassing reserves and limiting spending surpluses to one-time-only expenditures on tax rebates.

Legislators and tax experts are also taking a hard look at Minnesota’s sales tax base, which currently leaves out purchases of clothing and legal services. Bills introduced in the 2008 session proposed to simultaneously expand the sales tax base and lower the sales tax rate. But the bills drew criticism from retailers and didn’t pass.

Bakk anticipates that lawmakers will place close scrutiny on all sales tax exemptions in the 2009 session.

“We’ll probably spend some time taking a look at those and having those constituencies come in and argue why (these special exemptions were) put into law,” he says.

(Reprinted with permission of Finance and Commerce Media Group)