

November 2009

HIGHLIGHTS

Weaker than Projected Economy Leaves \$1.203 Billion Budget Deficit

General fund revenues are now forecast to fall \$1.156 billion (3.7 percent) below earlier estimates for the 2010-11 biennium. After adjusting for actions taken by the Governor following the legislative session, general fund expenditures are \$44 million lower. When combined with a \$91 million reduction in the ending balance from FY 2008-09, a budget deficit of \$1.203 billion is now projected for FY 2010-11. About 70 percent of the projected deficit is due to a reduction in expected income tax receipts.

Forecast for U.S. GDP on Track, But Labor Markets Weaker than Projected

Real GDP growth turned positive in the third quarter of 2009 and most forecasters believe that signaled the end of the Great Recession. But, that good economic news has yet to be reflected in labor markets.

The unemployment rate, already above the highs projected early in 2009, is expected to trend even higher over the next six months. Payroll employment reports already show greater job losses than were anticipated last February, and most forecasters believe job losses will edge still higher since employers are not expected to start adding new jobs until spring. The additional labor market slack has produced much weaker than expected wage growth. In February, U.S. wages were expected to fall by 0.4 percent in 2009. Global Insight's November baseline projects a decline of 4.5 percent. Non-farm proprietor's income, a measure of small business income, is now expected to show a similar percentage decline.

Structural Shortfall for 2012-13 grows to \$5.4 billion

Planning estimates continue to show a significant budget gap in FY 2012-13. Based on updated economic assumptions and current law spending assumptions, on-going expenditures will exceed on-going revenues by an additional \$995 million, leaving a total shortfall of \$5.426 billion without adjustment for inflation.

BUDGET UPDATE AND OUTLOOK

\$1.2 Billion Deficit Projected for the 2010-11 Biennium

Extended weakness in the U.S. economy has caused a further reduction in Minnesota's budget outlook. An economic recovery is taking place, but the recession's impact on employment and wages was worse than anticipated. Current forecasts do not expect U.S. employment to return to pre-recession highs until early 2013. Total U.S. wages are now expected to remain below previous highs until mid 2011, over one year later than anticipated in February. The result is a lower ending balance for FY 2009 and additional annual shortfalls throughout the forecast horizon.

Revenues for the 2010-11 biennium are now expected to total \$29.986 billion, down \$1.156 billion (3.7 percent) from end-of-session estimates that include the Governor's unallotment and executive actions. This change in expected revenues, when combined with a small, \$44 million decrease in projected general fund expenditures and a \$91 million reduction in the balance from the 2008-09 biennium, produces a \$1.203 billion budget deficit for the current biennium.

FY 2010-11 Budget

(\$ in millions)

	<u>End of Session</u>	<u>November Forecast</u>	<u>Change</u>
Balance from FY 2009	\$538	\$447	(\$91)
Revenues	31,142	29,986	(1,156)
Expenditures	31,330	31,286	(44)
Budget Reserve	0	0	0
Cash Flow Account	<u>350</u>	<u>350</u>	<u>0</u>
Balance	\$0	(\$1,203)	(\$1,203)

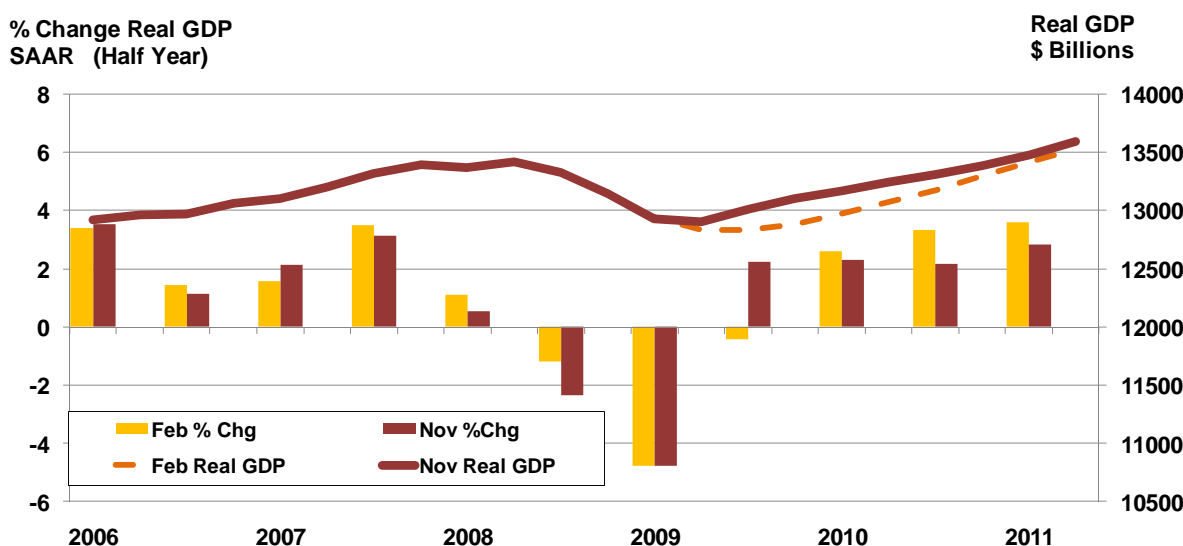
The end-of-session estimates include both the 2009 legislatively enacted budget and the impact of the Governor's unallotment and executive actions. Minnesota continues to have a cash flow account of \$350 million. The state's budget reserve is zero.

The Great Recession Is History, Here Comes the “Not So Great” Recovery

The worst recession in more than 60 years has ended. But, those expecting a quick leap to a golden age of growth will be disappointed. Most forecasters believe the longest and deepest recession since World War II will be followed by one of the slowest recoveries on record.

Given the extreme uncertainty at the time early 2009 forecasts first were made most have provided reasonable guides to the path GDP has taken through some very difficult economic times. The consensus believed we would see the recession deepen in early 2009, followed by a modest recovery in late summer, and that pattern has (thus far) been correct. While February’s baseline forecast from IHS-Global Insight, the state’s macroeconomic consultant was slightly more pessimistic than most at that time, its projection of a 2.7 percent decline in real GDP in 2009 is extremely close to the 2.5 percent decline that most observers now expect for this year. Global Insight currently projects real GDP growth of 2.2 percent in 2010 and 2.9 in 2011. February’s baseline forecast was very similar with expected 2010 and 2011 growth rates of 2.0 percent and 3.1 percent respectively.

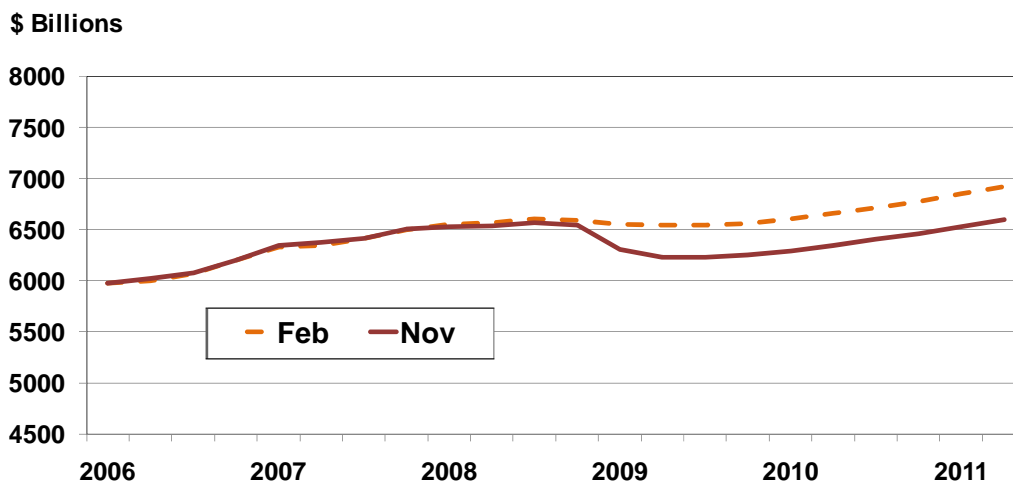
Little Change in Global Insight’s Forecast for Real GDP



Unfortunately, forecasts of employment and income have been much less successful. The U.S. unemployment rate is already well above the high predicted in February, and job losses currently exceed February’s projected peak by more than 20 percent. And, February’s expectations for the change in total U.S. wages, a decline of slightly less than 1 percent over three quarters, looks quite cheery compared to what has happened to date. Global Insight now expects five quarters of wage declines on a year over year basis, weakness well beyond anything observed in the post World War II period. In the November baseline U.S. wages do not exceed their previous highs until mid 2011. The

labor market lethargy is worrisome since in the absence of a significant pick-up in incomes it will be difficult for the economy to generate the additional spending needed for a sustained recovery. Weak wage growth also has a direct impact on state tax receipts since wages are the largest source of state income tax revenue.

The Decline in U.S. Wages Has Been Much Greater than Forecast in February



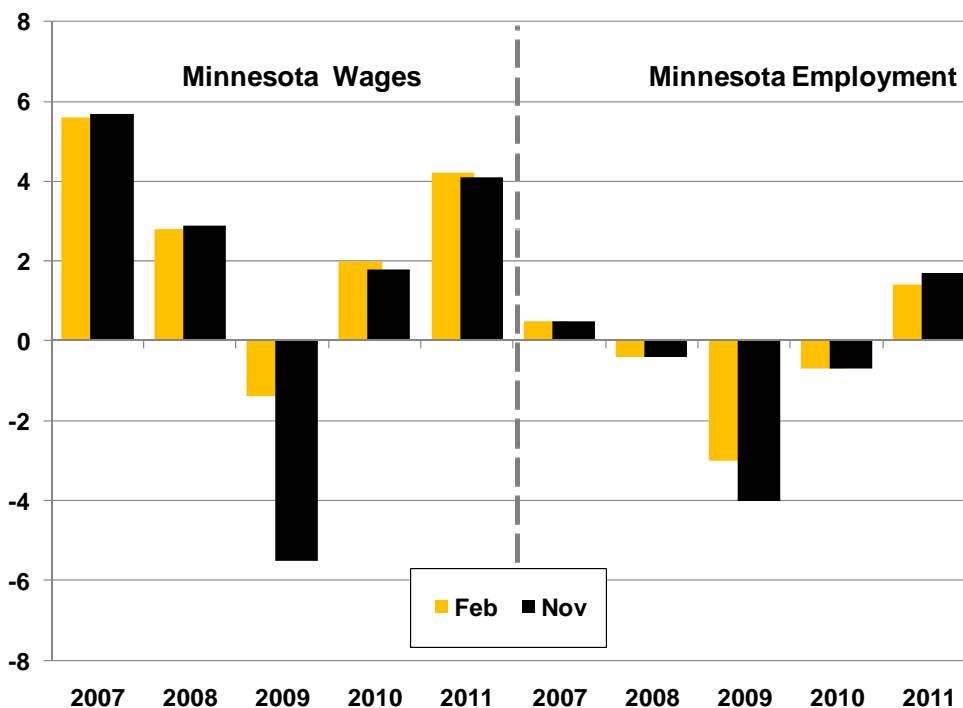
Historically, jobs have not recovered as quickly as GDP and economists have factored that into their forecasts. Payroll employment, down more than 7.3 million from its December 2007 peak is not expected to reach its pre-recession high until 2013 and the U.S. unemployment rate, currently 10.2 percent, is expected to move even higher in the next six months. But, even once the unemployment rate begins to decline, progress will be slow. By 2013 unemployment still is expected to exceed 8 percent. That extended weakness in labor markets is mirrored in household incomes. Total wages received by U.S. workers currently are 5 percent below their summer 2008 high and they are not expected to regain that earlier level again until mid 2011. Proprietors' income are down 4.5 percent in 2009 to the lowest level since 2004. They are projected to remain below 2008 levels until 2011.

Global Insight assigns a probability of 60 percent to their baseline forecast and probabilities of 20 percent each to a more optimistic forecast in which the recovery in GDP follows a V shape and a forecast containing an extended recession. However, even in the more optimistic forecast, it takes until mid 2011 for the unemployment rate to drop below 8 percent and until early 2012 for employment to reach pre-recession levels.

The Great Recession Hit Minnesota Employment and Wages Hard

Minnesota’s October unemployment rate was well below the national average, but that does not mean the state’s economy has avoided the worst of this recession. Through October, payroll employment in the state has fallen by 131,000 jobs from its previous high and further declines are expected until early spring. Non-farm employment in Minnesota is on track to fall by 4 percent in 2009, the worst single year performance in this state in the post World War II era. The projected decline is a full 1 percentage point more than was forecast in February. Employment in Minnesota is now expected to fall by more than 150,000 jobs between the first quarter of 2008 and the first quarter of 2010, 30,000 more than projected last February. If this forecast holds true, more than a decade of job creation will be lost. The combination of substantial current and expected job losses and what is expected to be a slow recovery, leaves Minnesota employment below its pre-recession level through 2013.

2009 Declines in Minnesota Wages and Employment Exceeded Forecast



Minnesota’s job losses have been accompanied by record declines in total wages paid to state residents. Minnesota wages and salaries had not declined on an annual basis since state wage data was first reported in 1970. Through mid November 2009 wages are on pace to decline by 5.5 percent. In February wages were projected to decline by 1.4 percent. While total wages paid in the state are expected to resume growing in 2010 and continue to grow in 2011, total Minnesota wages and salaries do not reach their previous highs until after the close of the current biennium.

Projected Revenues for 2010-11 Biennium Fall by \$1.156 Billion

General fund revenues are now forecast to total \$29.986 billion during the 2010-11 biennium, \$1.156 billion (3.7 percent) less than expected after the legislative session and executive actions. An \$827 million reduction in expected individual tax receipts accounted for nearly three-quarters of the forecast decline. Almost all of the reduction in income taxes was due to reductions in the forecasts for wages and proprietors income. Projected portfolio income changed little in aggregate as reductions to forecasts of some types of income were offset by increases in others.

Forecast Revenue FY 2010-11

(\$ in millions)

	<u>End-of- Session</u>	<u>November Forecast</u>	<u>\$ Change</u>	<u>% Change</u>
Individual Income	\$14,927	\$14,099	(\$827)	(5.5)
Sales	8,548	8,516	(32)	(0.4)
Corporate	1,219	1,273	54	4.4
Motor Vehicle Sales	92	99	7	7.7
Statewide-Levy	<u>1,552</u>	<u>1,525</u>	<u>(27)</u>	<u>(1.7)</u>
Subtotal	26,337	25,512	(825)	(3.1)
Other Taxes	2,409	2,250	(159)	(6.6)
Non-Tax Revenues	1,572	1,530	(42)	(2.7)
Dedicated/Transfers	<u>824</u>	<u>694</u>	<u>(130)</u>	<u>(15.8)</u>
Total Revenues	\$31,142	\$29,986	(\$1,156)	(3.7)

Changes in the forecast for the other major tax types were small and offsetting. The forecasts for corporate taxes and the motor vehicle sales tax were increased by \$54 million and \$7 million, respectively. The forecast for sales tax receipts and the state wide property tax levy were reduced by \$32 million and \$27 million. Other tax and non tax revenues including dedicated revenues and transfers fell by a total of \$331 million. Some of that revenue decline, however, is due to changes in the accounting treatment of particular revenue items and thus overstates losses in other revenues. For example, a portion of previously projected income tax reciprocity revenue is now included as part of withholding tax collections in the individual income tax.

Final receipts for FY 2009 also were below forecast. General fund revenues closed the last fiscal year \$147 million below earlier projections. Individual income tax receipts were \$220 million below February's forecast. Final payments and refunds for tax year 2008 returns were very close to forecast. Almost the entire income tax variance came from lower than projected withholding receipts and estimated payments.

Forecast Spending Slightly Lower

General fund spending for the current biennium is forecast to be \$31.286 billion, down \$44 million (0.1 percent) from end-of-session estimates.

The largest increase, \$109 million, occurs in health and human services. A general fund transfer to the health care access fund in FY 2011 is now forecast to meet MinnesotaCare expenditures that exceed available resources in that fund. Additional MinnesotaCare spending is forecast due to the transition of General Assistance Medical Care (GAMC) enrollees into the program as well as underlying growth in enrollment and managed care rates. Higher than anticipated property tax refunds account for the \$36 million change in the property tax aids and credits area.

Offsetting these increases are a \$123 million reduction in debt service costs and a \$52 million reduction in all other spending. Debt service costs are now lower because of the refinancing of outstanding bonds in 2009, which reduced debt service costs, and lower interest rates assumed for future bond sales. All other spending is down because of an accounting change that transfers dedicated revenues and expenditures from the general fund to other funds, primarily the special revenue fund.

Forecast Spending, FY 2010-11
(\$ in millions)

	<u>End of Session</u>	<u>November Forecast</u>	<u>\$ Change</u>	<u>% Change</u>
K-12 Education	\$13,393	\$13,337	(\$56)	(0.4)
K-12 Payment Deferrals	(1,760)	(1,717)	43	
Property Tax Aids & Credits	3,063	3,098	36	1.1
Health & Human Services	9,057	9,166	109	1.2
Debt Service	1,078	955	(123)	(11.4)
All Other	<u>6,499</u>	<u>6,447</u>	<u>(52)</u>	<u>(0.8)</u>
Total Spending	\$31,330	\$31,286	(\$44)	(0.1)

FY 2012-13 Planning Outlook Worsens

The deterioration in the longer term revenue forecast now results in a \$5.426 billion shortfall projected for the next biennium. This compares with a \$4.431 billion gap projected at the end of session. Planning estimates for FY 2012-13 now show general fund revenues of \$33.218 billion and projected spending of \$38.644 billion. The gap between ongoing revenues and spending has increased by \$995 million from end-of-session estimates.

FY 2012-13 Planning Estimates

(\$ in millions)

	<u>FY 2012</u>	<u>FY 2013</u>	<u>FY 2012-13</u>
Resources	\$16,023	\$17,195	\$33,218
Spending	<u>19,680</u>	<u>18,964</u>	<u>38,644</u>
Difference	(\$3,657)	(\$1,769)	(\$5,426)
<i>Inflation</i>	<i>\$413</i>	<i>\$766</i>	<i>\$1,179</i>

Planning estimates assume:

- Complete repayment of the K-12 aid deferral. Delaying repayment would save \$1.167 billion.
- No repayment of the K-12 property tax recognition shift. Repayment would cost \$562 million.
- No continued GAMC spending. Restoring the program would cost \$928 million.

Expenditure projections do not include any adjustment for projected inflation. Inflation, based on the Consumer Price Index (CPI), is expected to be 2.1 percent in FY 2012 and 1.9 percent in FY 2013. At these levels, the cost of inflation would be \$1.179 billion in the next biennium.

The treatment of the Governor's unallotments and executive actions is significant. The planning estimates include complete repayment of K-12 school aids deferred in FY 2010-11 (\$1.167 billion) and no repayment of the K-12 property tax recognition shift (\$562 million). The projections do not include reinstatement of funding for the General Assistance Medical Care (GAMC) program that was line-item vetoed in FY 2011. If the forecast assumed continuation of the program at current levels, an additional \$928 million would be required in the 2012-13 biennium.

The planning estimates make no assumptions about any actions that might be taken in the 2010 legislative session to solve the FY 2010-11 deficit or to reduce the structural shortfall expected for the 2012-13 biennium. The planning estimates are simply a benchmark to determine if ongoing spending will exceed revenues in succeeding budget periods. Economic changes as well as the nature and timing of budget actions will materially affect both revenue and expenditure projections.

A complete version of this forecast can be found at the Minnesota Management & Budget's World Wide Web site at -- www.mmb.state.mn.us . This document is available in alternate format.
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FY 2010-11 Biennium Forecast Comparison

November 2009 vs End-of-Session and Executive Actions

(\$ in thousands)

	7-09 Exec Action FY 2010-11	11-09 Fcst FY 2010-11	\$ Difference	% Change
<u>Actual & Estimated Resources</u>				
Balance Forward From Prior Year	537,920	446,921	(90,999)	-16.9%
Current Resources:				
(C) Tax Revenues	28,745,916	27,762,644	(983,272)	-3.4%
(C) Non-Tax Revenues	1,572,091	1,529,837	(42,254)	-2.7%
Subtotal - Non-Dedicated Revenue	30,318,007	29,292,481	(1,025,526)	-3.4%
(D) Dedicated Revenue	170,690	67,096	(103,594)	-60.7%
(E) Transfers From Other Funds	603,629	560,052	(43,577)	-7.2%
(B) Prior Year Adjustments	50,000	66,837	16,837	33.7%
Subtotal - Other Revenue	824,319	693,985	(130,334)	-15.8%
Subtotal Current Resources	31,142,326	29,986,466	(1,155,860)	-3.7%
Total Resources Available	31,680,246	30,433,387	(1,246,859)	-3.9%
<u>Actual & Estimated Expenditures</u>				
(G) K-12 Education	13,393,157	13,337,420	(55,737)	-0.4%
K-12 Ptx Rec Shift/Aid Payment Shift	(1,759,619)	(1,717,382)	42,237	-2.4%
Subtotal - K-12 Education	11,633,538	11,620,038	(13,500)	-0.1%
(H) Higher Education	2,856,155	2,858,555	2,400	0.1%
(R) Property Tax Aids & Credits	3,062,203	3,098,226	36,023	1.2%
(I) Health & Human Services	9,056,556	9,165,634	109,078	1.2%
(M) Public Safety	1,813,941	1,819,185	5,244	0.3%
(L) Transportation	190,801	192,375	1,574	0.8%
(J) Environment, Energy & Natural Resources	356,444	363,585	7,141	2.0%
(S) Agriculture & Veterans	249,638	252,879	3,241	1.3%
(K) Economic Development	265,182	272,404	7,222	2.7%
(N) State Government	623,461	639,160	15,699	2.5%
(O) Debt Service	1,077,540	954,522	(123,018)	-11.4%
(T) Capital Projects	29,800	29,800	0	0.0%
(X) Cancellation Adjustment	(21,000)	(21,000)	0	0.0%
Subtotal by Appropriation Bill	31,194,259	31,245,363	51,104	0.2%
(D) Dedicated Revenue Expenditures	135,987	40,692	(95,295)	-70.1%
Total Expenditures & Transfers	31,330,246	31,286,055	(44,191)	-0.1%
Balance Before Reserves	350,000	(852,668)	(1,202,668)	
(Y) Cash Flow Account	350,000	350,000	0	
Budgetary Balance	0	(1,202,668)	(1,202,668)	