

HIGHLIGHTS

\$935 Million Deficit Forecast for 2008-09 Biennium

A forecast for further weakening of the U.S. economy has increased the expected state budget deficit. State general fund revenues for the 2008-09 biennium are now forecast to total \$32.542 billion, \$530 million less than projected in November and \$1.270 billion less than end-of-session estimates. Expenditures are now expected to exceed November's projections by \$64 million and end-of-session estimates by \$130 million. When combined with a \$33 million reduction in dedicated reserves, this leaves a projected \$935 million deficit for the current biennium, \$562 million more than forecast in November. The deficit is 2.7 percent of total general fund spending.

Recession Expected for U.S. Economy in First Half of 2008

Global Insight's February baseline scenario includes two quarters of declining real GDP. The forecast decline in real GDP is small, averaging just 0.2 percent on an annual basis for the first half of 2008. But, this short, mild recession eliminates about one year of economic growth and one year of state revenue growth. The federal stimulus package helps limit the recession's length, but the rebates come too late to prevent U.S. output from declining in the first half of 2008.

Individual and Corporate Income Tax Revenues Show Largest Declines

Individual income tax receipts in the 2008-09 biennium fall by \$313 million (2.0 percent) from November's estimate. A reduction in non-wage income, primarily capital gains income, accounts for more than 75 percent of that decline in revenues. Corporate tax receipts were reduced by \$139 million (7.3 percent) from November's estimate and are now \$456 million (21 percent) below end-of-session estimates.

Projected Shortfall for 2010-11 Biennium Has Grown

Budget planning estimates for FY 2010-11 now show a shortfall of \$1.086 billion. In November the projected shortfall was \$211 million. Projected spending for FY 2010-11 does not include general inflation. Adjusting for inflation adds an additional \$1.040 billion to spending estimates for the next biennium.

BUDGET UPDATE AND OUTLOOK

Projected Budget Deficit Grows to \$935 Million

The outlook for the U.S. economy has been downgraded since November and forecasts for 2008 have been cut back. Global Insight's February's baseline scenario includes both a projected recession during the first half of 2008 and the recently approved federal stimulus package. The projected short and mild economic slowdown will affect Minnesota. State revenues are now expected to fall short of November's estimates by \$530 million or 1.6 percent. General fund expenditures are expected to increase by \$64 million, with \$33 million of that increase funded from the targeted case management reserve.

FY 2008-09 Forecast

(\$ in millions)

	<u>November Forecast</u>	<u>February Forecast</u>	<u>\$ Change</u>
Beginning Balance	\$2,245	\$2,245	–
Revenues	33,072	32,542	(530)
Expenditures	34,654	34,718	64
Reserves	<u>1,036</u>	<u>1,003</u>	<u>(33)</u>
Balance	\$(373)	\$(935)	\$(562)

The combined revenue, expenditure, and reserve changes leave a projected state deficit of \$935 million for the 2008-09 biennium, \$562 million more than forecast in November. Compared to end-of-session estimates, general fund revenues have fallen by \$1.270 billion (3.8 percent), while expenditures have grown by \$130 million (0.4 percent).

FY 2008-09 Forecast Compared to End-of-Session

(\$ in millions)

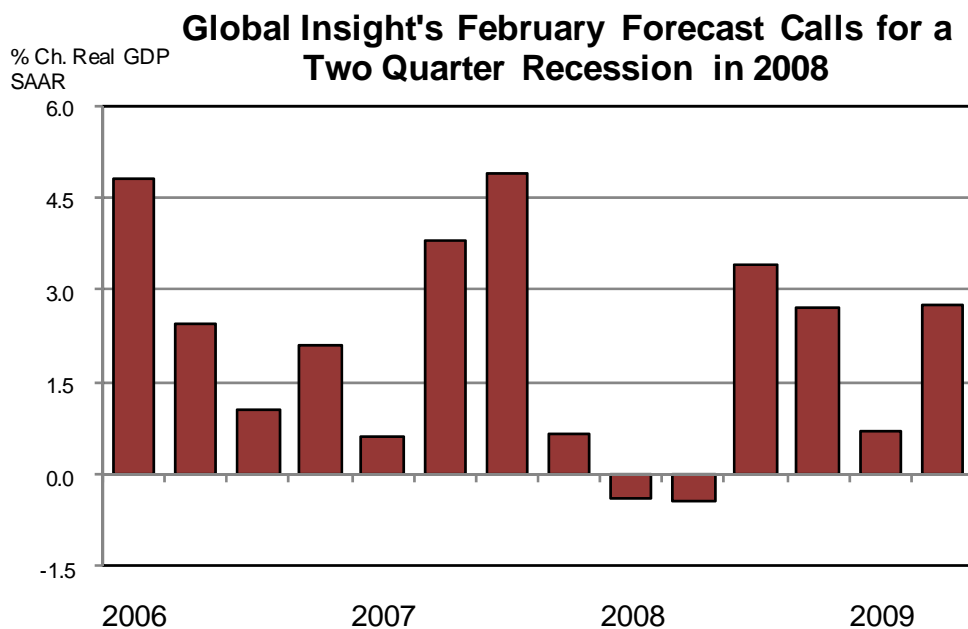
	<u>End-of- Session</u>	<u>February Forecast</u>	<u>Total Change</u>	
Beginning Balance	\$2,106	\$2,245	\$139	
Revenues	33,812	32,542	(1,270)	(3.8%)
Expenditures	34,588	34,718	130	0.4%
Reserves	<u>1,036</u>	<u>1,003</u>	<u>(33)</u>	
Balance	\$294	\$(935)	\$(1,228)	

A Short, Mild Recession Is Expected in 2008

Last fall most economists expected slow economic growth, but no recession, during 2008. Everyone agreed that the risk of recession had increased, but most believed central bankers' efforts to restore liquidity to the global financial system would be successful and that the availability of credit would not be an ongoing problem. The economic weakness caused by the housing slump and higher energy prices was seen as a serious, but manageable problem, as long as credit flowed normally.

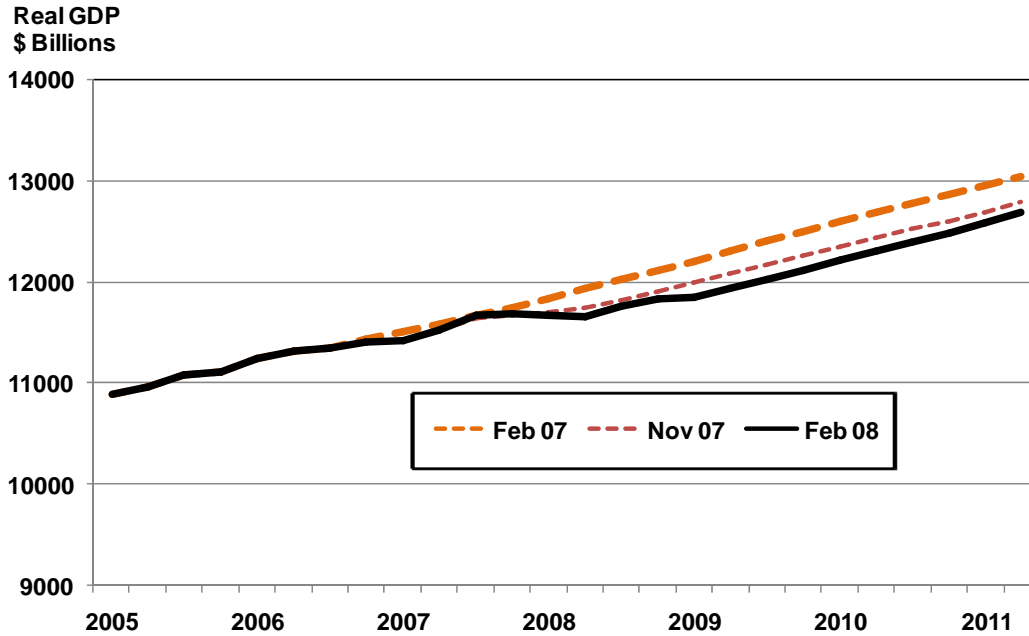
Since the beginning of 2008 though, the bad economic news has outweighed the good. January payroll employment declined by 17,000 jobs, December retail sales were weaker than expected, consumer confidence plunged, and the ISM non-manufacturing index plummeted. Any one of these items could be dismissed as a one-month anomaly. But when taken together, and coupled with signs that global financial markets still were struggling to deal with the fallout from mispriced sub-prime mortgages and other credit instruments, there was a clear sign that the economy was weaker than previously suspected. During January most forecasts for 2008 were reduced. And, since most of those original forecasts had previously called for only very slight growth, the markdowns produced declines in real GDP for the first half of 2008.

Global Insight Inc. (GII) is among those whose February baseline forecasts contains a recession in 2008. They now expect real GDP to decline at a 0.4 percent annual rate in the first quarter of 2008 and by 0.5 percent in the second quarter. The economy, buoyed by the stimulus package, then bounces back strongly, growing at a 3.4 percent annual rate in the third quarter, and at a 2.7 percent rate in the fourth quarter. In early 2009, though economic growth again slows considerably as the stimulus provided by the rebates fades.



February’s GII baseline puts the U.S. economy on a path where real GDP is more than 2 percent below the levels projected in February 2007. Future economic growth rates in the current forecast never exceed the long term trend growth rate assumed a year ago. The gap between the level of real output currently projected and that forecast last February does not narrow appreciably through calendar 2011.

The Recession Eliminates about One Year of U.S. Economic Growth



The outlook for real GDP growth in both calendar 2008 and 2009 has been cut back. In November GII expected growth of 1.9 percent in 2008 and 2.9 percent in 2009. The February baseline calls for growth rates of 1.4 percent and 2.2 percent. In February 2007, growth rates of 3.0 percent and 3.2 percent were forecast.

GII believes inflation will remain under control, leaving the Fed free to concentrate on restoring economic growth. While CPI growth of 2.5 percent is now projected for 2008 a decline in oil prices allows inflation to slow to 1.6 percent in 2009. GII expects oil prices to fall below \$80 per barrel in the second quarter and remain at that level beyond 2011. Global Insight assigns a probability of 50 percent to their February baseline forecast. A “double dip” recession is assigned a probability of 25 percent as is a scenario in which the economy barely avoids a recession.

FY 2008-09 Revenue Forecast Now \$1.27 Billion Below End-of-Session Estimates

General fund revenues for the 2008-09 biennium are now forecast to total \$32.542 billion, \$530 million less than projected in November and \$1.270 billion less than end-of-session estimates. While forecast receipts from each major tax – other than the statewide levy – fell between November and February, forecast declines in the income tax and the corporate income tax explain almost all of the additional decline in revenues.

Projected individual income tax receipts fell by \$313 million from November's estimates. The decline in the personal income tax is due to slower growth in wages and declines in non-wage income. The forecast includes a small decrease in capital gains realizations in 2008. Declines in portfolio income, which includes interest and dividends as well as capital gains, explain about 75 percent of the decline in projected individual income tax receipts since the November forecast.

Forecast Revenue FY 2008-09, Change from November

(\$ in millions)

	<u>February Forecast</u>	<u>\$ Change from Nov</u>	<u>% Change</u>
Individual Income	\$15,345	\$(313)	(2.0)
Sales	9,145	(13)	(0.1)
Corporate	1,760	(139)	(7.3)
Motor Vehicle Sales	293	(20)	(6.4)
Statewide Levy	1,442	4	0.3
Other	<u>4,556</u>	<u>(49)</u>	<u>(1.1)</u>
Total Revenues	\$32,542	\$(530)	(1.6)

Forecast receipts from all sources are now forecast to be \$1.270 billion (3.8 percent) below end-of-session estimates. Projected corporate receipts fell by the largest dollar amount and the largest percentage, down \$456 million or 20.6 percent from end-of-session estimates. Receipts from the individual income tax and the sales tax are now projected to be \$282 million (1.8 percent) and \$322 million (3.4 percent) less than forecast at the time the budget was passed.

Forecast Revenue FY 2008-09, Change from End-of-Session

(\$ in millions)

	<u>End-of- Session</u>	<u>February Forecast</u>	<u>Change from End-of-Session</u>	<u>% Change</u>
Individual Income	\$15,628	\$15,345	\$(282)	(1.8)
Sales	9,467	9,145	(322)	(3.4)
Corporate	2,216	1,760	(456)	(20.6)
Motor Vehicle Sales	317	293	(23)	(7.4)
Statewide Levy	1,402	1,442	40	2.9
Other	<u>4,782</u>	<u>4,556</u>	<u>(226)</u>	<u>(4.7)</u>
Total Revenues	\$33,812	\$32,542	\$(1,270)	(3.8)

The large decline in corporate receipts since last February's forecast comes from three sources. First, corporate estimated tax payments through November were substantially below levels forecast in February 2007 reducing the base level for future growth. Second, as is typical in economic downturns, the outlook for corporate profits, particularly in the financial sector, has declined. Finally, corporate tax refund payments for tax year 2006 have been well above previously expected levels, further reducing net receipts to the state from this tax. The forecast for net corporate tax receipts for the 2008-09 biennium is now less than 80 percent of the amount received in the 2006-07 biennium.

Forecast Spending \$64 Million Higher; Reserves Lower by \$33 Million

General fund spending for the biennium is forecast to be \$34.718 billion, up \$64 million (0.2 percent), from November's estimate. Modest increases in K-12 education and health and human services account for this change, with slight reductions in debt service, property tax aids and credits, and dedicated spending partially offsetting those increases.

Much of the change in K-12 education is a revision to pupil estimates. Almost half of the health and human services increase is money previously held as a reserve.

Forecast Spending, FY 2008-09

(\$ in millions)

	November Forecast	February Forecast	\$ Change	% Change
K-12 Education	\$13,788	\$13,805	\$17	0.1
Property Tax Aids & Credits	3,154	3,152	(3)	(0.1)
Health & Human Services	9,630	9,703	74	0.8
Debt Service	876	869	(7)	(0.9)
All Other	<u>7,207</u>	<u>7,190</u>	<u>(17)</u>	<u>0.0</u>
Total Spending	\$34,655	\$34,718	\$64	0.2
Reserves				
Budget Reserve	\$653	\$653	\$0	
Cash Flow Account	350	350	0	
Targeted Case Management Reserve	<u>33</u>	<u>0</u>	<u>(33)</u>	
Total Reserves	\$1,036	\$1,003	\$(33)	

The reduction in budget reserves is due to use of the targeted case management reserve account. This account had held \$33 million for counties for medical assistance case management services in anticipation of federal funding reductions. After the November forecast, federal rules were issued that triggered statutory provisions directing this money to be spent. As a result, reserves are \$33 million lower compared to November, and \$33 million of the health and human services increase is attributable to this change.

FY 2010-11 Planning Estimates Show Bigger Shortfall

The longer-term outlook for the state's budget has changed significantly. When the FY 2008-09 budget was enacted, the planning estimates showed a structural balance of \$1.137 billion. They now show a structural shortfall of \$1.086 billion.

Change in FY 2010-11 Planning Estimates

(\$ in millions)

	<u>End-of-Session</u>	<u>Nov Change</u>	<u>Feb Change</u>	<u>Feb Forecast</u>
Projected Revenues	\$36,843	\$(1,130)	\$(669)	\$35,044
Projected Spending	<u>35,707</u>	<u>218</u>	<u>206</u>	<u>36,130</u>
Difference	\$1,137	\$(1,348)	\$(875)	\$(1,086)

Projected revenue planning estimates for FY 2010-11 are now \$669 million below November estimates, and \$1.799 billion below end-of-session estimates. Projected expenditures are \$206 million higher than in November and \$424 million more than at the end of the special legislative session.

FY 2010-11 Revenue-Expenditure Balance

(\$ in millions)

	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2010-11</u>
Projected Revenues	\$16,998	\$18,046	\$35,044
Projected Spending	<u>17,848</u>	<u>18,282</u>	<u>36,130</u>
Difference	(850)	(236)	(1,086)
Estimated Inflation (CPI)	339	701	1,040

As specified in current law, expenditure projections for the next biennium do not include any adjustment for inflation. Estimated inflation at 1.9 percent per year would add \$339 million and \$701 million for FY 2010 and FY 2011 respectively, a total of \$1.040 billion.

Projected spending and revenue in FY 2010-11 will be affected by actions taken to balance the budget in the current biennium.

After the forecast was completed, the Legislature overrode the Governor's veto of the omnibus transportation finance bill. Due to timing issues, the general fund impacts of this law change are *not* included in this forecast. This legislation contains \$2.8 million of additional spending in FY 2008-09, and reduces general fund revenues by an estimated \$77 million in FY 2010-11.

A complete version of this forecast can be found at the Department of Finance's World Wide Web site at www.finance.state.mn.us. This document is available in alternate format.

FY 2008-09 General Fund Forecast Change
February 2008 vs November 2007
(\$ in thousands)

	11-07 Fcst FY 2008-09	2-08 Fcst FY 2008-09	\$ Difference
<u>Actual & Estimated Resources</u>			
Balance Forward From Prior Year	2,244,935	2,244,935	0
Current Resources:			
Tax Revenues	30,694,562	30,207,568	(486,994)
Non-Tax Revenues	1,537,268	1,522,056	(15,212)
Subtotal - Non-Dedicated Revenue	32,231,830	31,729,624	(502,206)
Dedicated Revenue	156,998	139,298	(17,700)
Transfers In	633,476	623,026	(10,450)
Prior Year Adjustments	50,000	50,000	0
Subtotal - Other Revenue	840,474	812,324	(28,150)
Subtotal-Current Resources	33,072,304	32,541,948	(530,356)
Total Resources Available	35,317,239	34,786,883	(530,356)
<u>Actual & Estimated Spending</u>			
K-12 Education	13,791,476	13,808,385	16,909
K-12 Shift Buyback	(3,810)	(3,810)	0
Subtotal K-12 Education	13,787,666	13,804,575	16,909
Higher Education	3,155,162	3,155,162	0
Property Tax Aids & Credits	3,154,482	3,151,836	(2,646)
Health & Human Services	9,629,584	9,703,199	73,615
Public Safety	1,886,633	1,886,633	0
Transportation	249,641	249,641	0
Environment, Energy & Natural Resources	450,037	450,582	545
Agriculture & Veterans	275,647	275,647	0
Economic Development	396,853	396,853	0
State Government	664,277	664,452	175
Debt Service	875,761	868,821	(6,940)
Capital Projects	20,500	20,500	0
Estimated Cancellations	(21,164)	(21,164)	0
Subtotal Expenditures & Transfers	34,525,079	34,606,737	81,658
Dedicated Expenditures	129,410	111,710	(17,700)
Total Expenditures & Transfers	34,654,489	34,718,447	63,958
Balance Before Reserves	662,750	68,436	(594,314)
Cash Flow Account	350,000	350,000	0
Budget Reserve	685,667	653,000	(32,667)
Budgetary Balance	(372,917)	(934,564)	(561,647)

FY 2010-11 General Fund Planning Estimates Change
February 2008 vs November 2007
(\$ in thousands)

	11-07 Plng Est FY 2010-11	2-08 Plng Est FY 2010-11	\$ Difference
<u>Actual & Estimated Resources</u>			
Balance Forward From Prior Year	662,750	68,436	(594,314)
Current Resources:			
Tax Revenues	33,392,891	32,787,831	(605,060)
Non-Tax Revenues	1,520,981	1,491,476	(29,505)
Subtotal - Non-Dedicated Revenue	34,913,872	34,279,307	(634,565)
Dedicated Revenue	136,026	117,626	(18,400)
Transfers In	613,319	597,324	(15,995)
Prior Year Adjustments	50,000	50,000	0
Subtotal - Other Revenue	799,345	764,950	(34,395)
Subtotal-Current Resources	35,713,217	35,044,257	(668,960)
Total Resources Available	36,375,967	35,112,693	(1,263,274)
<u>Actual & Estimated Spending</u>			
K-12 Education	13,805,385	13,876,426	71,041
Higher Education	3,191,030	3,191,030	0
Property Tax Aids & Credits	3,203,756	3,209,303	5,547
Health & Human Services	10,987,782	11,128,920	141,138
Public Safety	1,906,244	1,906,244	0
Transportation	212,054	212,054	0
Environment, Energy & Natural Resources	376,155	378,373	2,218
Agriculture & Veterans	250,096	250,096	0
Economic Development	281,318	281,318	0
State Government	621,429	621,622	193
Debt Service	987,305	991,148	3,843
Capital Projects	20,500	20,500	0
Estimated Cancellations	(20,000)	(20,000)	0
Subtotal Expenditures & Transfers	35,823,054	36,047,034	223,980
Dedicated Expenditures	101,226	82,826	(18,400)
Total Expenditures & Transfers	35,924,280	36,129,860	205,580
Balance Before Reserves	451,687	(1,017,167)	(1,468,854)
Cash Flow Account	350,000	350,000	0
Budget Reserve	653,000	653,000	0
Budgetary Balance	(551,313)	(2,020,167)	(1,468,854)
Structural Balance	(211,063)	(1,085,603)	(874,540)