

2006 Budget Decisions Leave Much on the Table for 2007

In each legislative session, Minnesotans have the chance to articulate their hopes for the state's future and take the steps necessary to realize that vision. Each legislative session is an opportunity to address short-term needs, consider solutions to ongoing challenges, and invest in the structures essential to the long-term health and prosperity of the state. In the 2006 Legislative Session, policymakers focused on addressing immediate needs, missing the opportunity to offer comprehensive plans for moving the state towards a more positive future.

Limited financial resources and a lack of agreement on the need to raise additional resources meant that the 2006 supplemental budget agreement failed to make progress on rising citizen concerns about priorities including affordable health care, accessible educational options, and safe and adequate transportation choices. The 2006 Legislature also did not adequately respond to federal changes that will weaken human services funding and policies in the state. On a positive note, the Legislature did undo some of the budget gimmicks used to solve past state deficits.

Although finances were relatively tight, the 2006 Legislature was not facing the deficits that characterized recent years. Policymakers primarily resolved recent budget shortfalls by cutting a broad range of services, such as health care and child care programs for Minnesota's low- and moderate-income families.¹ Some argued that the state's serious fiscal condition justified the significant pain caused by these cuts. But when the fiscal picture brightened in 2006, those who felt the greatest impact from past budget cuts were still largely left behind.

2006 Session Had Limited Agenda, Limited Resources

The 2006 Legislative Session was not a budgeting year; the state's two-year budget for the FY 2006-07 biennium was set during the 2005 Session. Even-numbered sessions typically focus on approving capital investments in the state's infrastructure, called the "bonding bill." However, depending on what resources are available and what other issues have emerged, lawmakers usually do make adjustments to the budget during even-numbered sessions.

Under the state's current system of raising revenues, the 2006 Legislature had only a few resources available to them. The state's February forecast identified \$405 million in general fund dollars available for the two-year budget cycle — equivalent to just over 1% of the state's general fund budget for the FY 2006-07 biennium.

But for much of the session, there was a threat that these funds would disappear. In 2005, as part of a deal that ended a budget stalemate and a partial state government shutdown, legislators and the Governor agreed to a 75¢ increase in the cigarette tax, calling it a "Health Impact Fee." Tobacco companies challenged the tax increase, and for much of the 2006 Legislative Session lawmakers waited to hear how the Minnesota Supreme Court would rule. On May 16, less than one week before the end of session, the Court ruled in favor of the State, averting a \$368 million loss of revenue that would have wiped away most of the surplus.

¹ For more information on the budget decisions made during previous legislative sessions, see the following Minnesota Budget Project publications: *Impact of the Final FY 2004-05 Budget*, *The FY 2006-07 Budget: Impact on Working Families and Individuals*, *The FY 2006-07 Budget: Impact on Children & Youth*, *The FY 2006-07 Budget: Impact on Populations with Unique Needs*, all available at www.mncn.org/bp/mnbudget.htm.

With limited general fund resources available, policymakers sought to bring additional dollars to the table. Both the Governor and House put forth proposals to use funds from the state's Health Care Access Fund. The Health Care Access Fund was created in 1992 to provide affordable health care for working Minnesotans, and therefore proposals to use these funds for other purposes are controversial. The Governor and House also proposed using a portion of the state's federal welfare-to-work dollars, formally called Temporary Assistance to Needy Families or TANF, for initiatives not specifically designed to help low-income families reach self-sufficiency. In contrast, the Senate passed several tax provisions that would have raised general fund revenues. These proposals were unpalatable to House leaders and Governor Pawlenty, who had vowed not to raise state taxes. Ultimately, no additional revenues were made available in 2006, whether by drawing on dedicated funds or raising revenues.

On the spending side of the budget, the Governor, House, and Senate each identified a number of urgent budget deficiencies, priority areas for additional resources, and new initiatives that were fairly limited in scope. But with very different ideas about priorities for funding and whether and how to raise additional revenues, finding common ground between the three divergent budget proposals proved to be a challenge.

The Work Left Undone

With limited resources, no agreement to raise additional funds, and plenty of areas in need of attention, it is not surprising that there were some significant disappointments in the 2006 Legislative Session. Minnesota will have another opportunity to address these issues in 2007. Those opportunities include:

Health Care. The Senate Health and Human Services Committee proposed legislation to improve health care coverage for low-income children and adults, roll back copayment and premium increases in MinnesotaCare, reinstate health care outreach grants, and offer MinnesotaCare as an option for small employers. The full legislature never had the chance to consider these health care improvements because other contentious issues kept the bill from coming up for a vote on the floor of the Senate. Likewise, a Governor's initiative to improve access to mental health treatment never made it out of committee in either body.

Welfare-to-Work. Earlier in 2006, Congress approved significant changes that will impact Minnesota's welfare-to-work program, the Minnesota Family Investment Program (MFIP). The Minnesota Senate recommended reforms to help the state meet the new federal requirements. However, the session ended with only very minor changes to the program. As a result, Minnesota may find it more difficult to meet the new federal requirements, and faces penalties in terms of lost federal TANF funds and required increases in state TANF-related spending, which would have a \$24 million general fund impact in FY 2008-09.

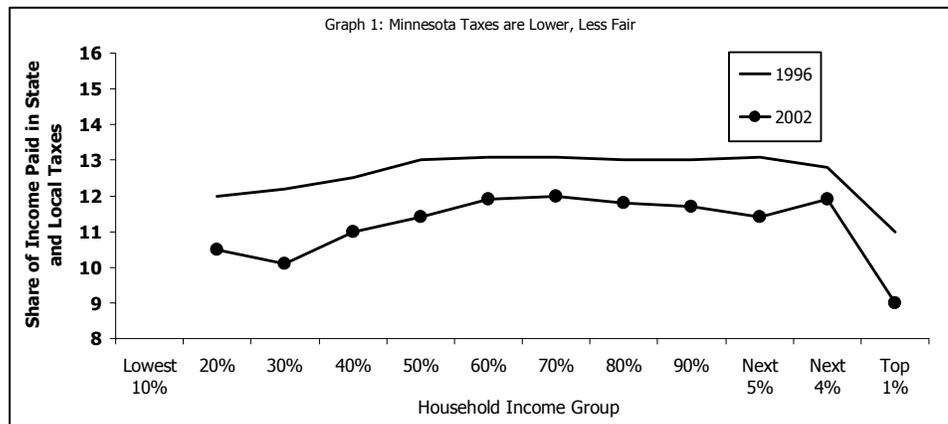
County Social Services. In February 2006, Congress passed legislation that cut federal spending in a range of areas by \$40 billion over a five year period. One provision changed the types of county social services eligible for federal Medicaid reimbursement. This set of services, called "targeted case management", includes coordinating services for at-risk children and adults with disabilities so that they receive early and effective treatment and reduce expenses in the long run. Noting the severe impact this federal change would have (forcing counties to cut services or ultimately raise property taxes to make up for the lost federal dollars) the Senate tax bill included a provision to temporarily help counties make up for the lost dollars. In the end, however, the Legislature did not provide any assistance to counties.

Affordable Housing. In response to declining state funding for Minnesota’s urgent affordable housing needs, the Senate advanced the Housing Solutions Act, which would assess a surcharge on deed transfers and raise approximately \$69 million in one year. This dedicated revenue stream would fund low-income rental assistance, workforce housing, and a local incentive fund to meet community housing needs around the state. The proposal, however, was removed from the Senate tax bill late in the session.

Tax Fairness and Adequacy. Since the mid-1990s, two significant changes have occurred in Minnesota’s tax system. One is that taxes are lower for Minnesotans. The other is that tax fairness is eroding.² Both of these trends are shown in Graph 1. The 2006 Legislature failed to make progress in ensuring that the state’s revenue system raises sufficient revenues to fund the state’s priorities, and that those revenues are raised fairly.

In the 1997 to 2001 Legislative Sessions, Minnesota’s taxes were cut significantly. One-time rebates totaling \$3.7 billion were enacted, and ongoing reductions were made to property taxes, income taxes, and motor vehicle registration taxes (“tabs”). Not surprisingly, from 1994 to 2002, the percentage of income that Minnesotans pay in total state and local taxes fell by more than 12%. (2002 is the most recent year for which data is available).³ Recent state budget deficits and the ongoing inability of the Legislature to respond to pressing needs suggest that the state’s current system of raising revenues is inadequate to fund the state’s priorities.

Minnesota’s tax system is also becoming less fair. While Minnesotans paid an average of 11.3% of their incomes in state and local taxes in 2002, the 1% of Minnesotans with the highest incomes (those with household incomes over \$323,340) paid only 9.0%. And this data does not reflect more recent increases in tobacco taxes and property taxes, both of which further shift responsibility for funding public services to low- and middle-income Minnesotans.



The Senate Tax Committee heard several proposals to address both fairness and adequacy concerns, including:

- Creating a new top income tax bracket on the highest-income Minnesotans, raising \$111 million in FY 2008-09,
- Changing tax rules on corporations operating overseas (so-called “Foreign Operating Corporations”), raising \$246 million in FY 2008-09, and

² See Minnesota Budget Project, *Minnesota’s Taxes: Who Pays and How Much?*, www.mncn.org/bp/incido5.pdf, for an analysis of Minnesota’s tax system based on the Minnesota Department of Revenue’s *Tax Incidence Study*.

³ Over time, the *Tax Incidence Study* has been expanded to include more of the total state and local tax system, which means that tax levels for previous years is understated and the actual drop in taxes from 1994 to 2002 is likely to be larger than indicated here.

- Maintaining the tax rate on the statewide property tax paid by businesses and cabins at 2004 levels, raising an additional \$284 million in FY 2008-09. Under current law, the total amount raised by the statewide property tax would grow with inflation.

The revenues raised by these provisions would have been used to cover the cost of tax reductions aimed at middle-income Minnesotans, provide additional aid to local governments to reduce pressures on rising property taxes and to compensate for federal funding cuts, and other priorities. However, none of these provisions passed into law.

The Supplemental Budget Bill

Most of the spending decisions in the 2006 Legislative Session were contained in the supplemental budget bill (HF 4162/SF 3781).⁴ This bill allocated \$193 million in additional general fund spending, primarily to meet funding shortfalls in the state's services for sex offenders as well as those whose mental illness make them dangerous, restore funding in some early childhood programs, and fund a few other small initiatives.

How the Supplemental Budget Bill allocated its general fund resources among various categories of spending is described in more detail below.⁵

Education (additional \$14 million for FY 2006-07)

The supplemental budget bill invested a little more than \$14 million in education, which includes early childhood, K-12, and adult education. This represents a 0.1% increase in funding over the base budget for education.

Funding for **Early Childhood Family Education (ECFE)** was increased but still has not yet returned to the funding levels in place before budget reductions were enacted in 2003. ECFE is a program for all Minnesota families with children between the ages of birth to kindergarten enrollment that works to strengthen families and enhance the ability of parents to provide the best possible environment for the healthy growth and development of their children.

The Legislature also approved additional funding for **Adult Basic Education (ABE) and intensive English instruction** for adult refugees, two areas that have seen cutbacks in recent years. Adult Basic Education offers academic instruction necessary to earn a high school diploma or equivalency certificate, as well as workplace skills enhancement, English as a Second Language (ESL), citizenship, and basic skills education.⁶

Additional funding for **K-12 education** was limited to minor improvements or emergency aid. The supplemental budget bill included funding to institute a Chinese language curriculum in the schools, implement a character development pilot program, expand the Advanced Placement/International Baccalaureate program, and provide one-time heating assistance for schools.

⁴ The other major budget bill passed was the Capital Investment, or bonding, bill. This legislation authorized \$1 billion in projects, but these costs are distributed over the life of the bonds issued to finance these projects. The general fund cost of the 2006 bonding bill is \$8 million in FY 2006-07 and \$68 million in FY 2008-09.

⁵ Data in this section comes from spreadsheets developed by legislative fiscal staff and the Minnesota Department of Finance, and House Fiscal Analysis's *Summary of the Fiscal Actions of the 2006 Legislature*, www.house.mn/fiscal/files/o6budsum.pdf.

⁶ Due to a drafting error, the additional \$1.1 million for ABE was not actually authorized by the legislation. Additional legislation will need to be passed in 2007 in order for the agreed upon increase in ABE to occur. This \$1.1 million is included in the total of \$14 million for Education mentioned above.

Also in this portion of the bill, the Legislature established and provided one-time funding for a **Legislative Commission to End Poverty by 2020**. The Commission will consist of nine Senators, nine Representatives, and two non-voting members appointed by the Governor. Several principles will guide the Commission's work, including that alliances are needed between faith communities, nonprofits, government, business, and others with a commitment to overcoming poverty. The Commission is charged with submitting recommendations on how to end poverty to the Legislature by December 15, 2008.

Higher Education (additional \$5 million for FY 2006-07)

The supplemental budget bill included \$5 million in FY 2007 for new higher education programs at the **University of Minnesota's Rochester branch**.

Health Care (additional \$94 million for FY 2006-07)

The bulk of the supplemental funding in health care, about \$80 million, went to address larger caseloads than had previously been projected in Minnesota's "**state operated services**" for sex offenders as well as those whose mental illness makes them dangerous. An additional \$5 million was appropriated for **avian influenza (bird flu) preparedness** and just over \$6 million to address operating budget shortfalls and improve quality and care standards in **veterans' homes** around the state.

The supplemental budget bill makes changes to the state's **health care programs**, some of which respond to new federal requirements passed in early 2006. These include:

- Making it harder to transfer assets if someone is using Medical Assistance to pay for the costs of long-term care,
- Responding to stricter federal requirements mandating how people applying for some state-funded health care coverage prove their citizenship,
- Eliminating some dental copayments for some low-income adults and children in MinnesotaCare, and
- Providing some additional funding for Critical Access Dental Payments.

Human Services (additional \$7 million for FY 2006-07)

Virtually all of the supplemental funding in human services went to partially restoring cuts made to Minnesota's **child care assistance** programs. Using a combination of general fund and federal welfare-to-work (TANF) resources, the supplemental budget bill provided a 6% increase in reimbursement rates to child care providers, appropriated funds to reduce the waiting list for child care assistance, and provided a higher reimbursement rate for accredited child care providers. Despite the additional resources for child care assistance for the FY 2006-07 biennium, the state's general fund investment will still be about \$105 million less than what it was in FY 2002-03, a 45% reduction. In the next biennium, state general fund support for child care assistance will once again approach FY 2002-03 levels, although over the last six years, inflation has obviously significantly eroded the purchasing power of these funds.

Jobs and Economic Development (additional \$30 million for FY 2006-07)

Resources in the supplemental budget bill for workforce and economic development went almost entirely to two projects – \$15 million for the University of Minnesota/Mayo Clinic **Partnership in Biotechnology and Medical Genomics** and \$11.5 million to the **21st Century Minerals Fund** to create infrastructure related to a new steel mill planned in Itasca County. Some additional general fund and Workforce Development Fund resources went to fund **employment and training programs for at-risk youth and people with disabilities**, areas that have been cut severely in recent years.

The supplemental budget bill did not include any funding for **affordable housing**. The Capital Investment bill, however, did contain \$19.5 million in bonding for housing projects, including \$17.5 million for permanent supportive housing and \$2 million for transitional housing programs.

Environment, Agriculture, and Natural Resources (additional \$17 million for FY 2006-07)

The single major investment in this area was \$15 million in one-time funding for the **Clean Water Legacy** program. The funding will help Minnesota restore the state's contaminated waters and meet federal water quality standards. Advocates, however, estimate the cost of fully funding the Clean Water Legacy proposal to be \$75 to \$100 million per year.⁷

State Government (additional \$6 million for FY 2006-07)

Most of the additional funding was used to address funding shortfalls and enhance **services for Minnesota veterans**.

Transportation (additional \$692,000 for FY 2006-07)

Funding for the state's transportation needs has hit significant road blocks in recent sessions. In 2004, no major budget bills were approved. In 2005, a transportation bill that included an increase in the gas tax was approved by the House and Senate, but vetoed by the Governor. This session, the Transportation Finance Conference Committee failed to reach a compromise. In the end, only two minor transportation appropriations – **defibrillators for state patrol vehicles** and a **radio tower in Roseau County** – were included in the supplemental budget bill.

In November, voters approved an amendment to the Minnesota State Constitution that will dedicate 100% of the motor vehicle sales tax (MVST) to transportation. Prior to the amendment's passage, just under 54% of the tax was dedicated to transportation, with the remaining funds paying for other state needs. The share of MVST revenue dedicated to transportation will gradually increase over five years. According to the November forecast, the amendment will provide \$155 million in additional funding for transportation in the FY 2008-09 biennium, but it will also create a corresponding \$155 million "hole" in the state's general fund. The impact of the amendment could reach approximately \$538 million in the FY 2012-13 biennium, when all of the MVST revenue will be dedicated to transportation.

Public Safety (additional \$20 million for FY 2006-07)

Two-thirds of the supplemental funding for public safety was used to fund a **salary increase for Department of Corrections employees**. The bill also included additional funds for various Office of Justice programs, such as the **Gang Strike Force** and **crime victim intervention**.

The Omnibus Tax Bill

Despite much rhetorical emphasis on property taxes during the 2006 Legislative Session, the 2006 omnibus tax bill (HF 785) did not take action to reduce property taxes. Instead, the bill largely focused on more technical issues. The omnibus tax bill reduced state tax revenues by \$94 million in the FY 2006-07 biennium.

A significant portion of the omnibus tax bill is related to **federal conformity**. When Minnesotans calculate their state income taxes, the starting point is their federal taxable income.

⁷ Clean Water Action Alliance of Minnesota, *2006 Legislative Summary*, <http://cleanwateraction.org/mn/priority.html>.

Whenever Congress makes changes to federal taxable income, the Minnesota Legislature must decide whether to conform to that change. Conforming generally makes Minnesota's tax forms simpler, but there is a cost when federal tax changes reduce tax liability. The 2006 omnibus tax bill's federal conformity provisions reduce state taxes by \$36 million in FY 2006-07.

The federal conformity issue that received the most attention in 2006 related to married couples who claim the standard deduction (rather than itemizing their deductions) on their federal income taxes. Minnesota had not yet conformed to an increase in the federal standard deduction that started in 2005. The 2006 omnibus tax bill conforms to the federal change, which will provide a \$74 tax reduction to more than 419,000 married Minnesota couples in 2006. A Senate provision to provide a similar reduction retroactive to 2005 did not prevail.

The omnibus tax bill also reduced the number of Minnesotans subject to the state's **Alternative Minimum Tax (AMT)**. In addition, the bill partially reversed a timing shift enacted in 1983 to help address state budget deficits. Under the **June Accelerated Sales Tax**, vendors must submit a portion of their June sales tax liability at the end of June; for all other months, sales tax liability is due on the 20th of the following month. This has the effect of shifting the June payment into an earlier fiscal year. The 2006 omnibus tax bill reduces the amount of sales tax liability that must be paid early, at a one-time cost to the state of \$23 million.

Looking Ahead to 2007

The people of Minnesota have many challenges to tackle in the coming years, such as retiring baby-boomers leaving our workforce and placing increasing pressure on our health care system. When challenged in the past, Minnesotans have risen to the occasion, demonstrated exceptional leadership, and invested in public structures that contributed to the state's current prosperity and high quality of life. Today we face new challenges, but we once again have both the opportunity and the capacity to act.

The state's latest financial forecast, released at the end of November, revealed that Minnesota's fiscal situation has improved. The forecast predicts a \$2.2 billion surplus for the FY 2008-09 biennium.⁸ Although the news is positive, there are some important caveats. About half of the surplus (just over \$1 billion) is what is expected to remain unspent at the close of the current FY 2006-07 biennium. This portion of the surplus is one-time revenue that should not be used to fund anything that has ongoing costs. The other half of the surplus (\$1.1 billion) is the result of higher than expected revenues and lower than projected spending for the FY 2008-09 biennium. This portion of the surplus is available to fund ongoing commitments. However, just covering the costs of inflation for the state's current level of services would require an estimated \$1.0 to \$1.2 billion of the ongoing surplus.

The state appears to have returned to financial stability, but it has come at a cost and many Minnesotans continue to pay the price. As the financial picture improves, policymakers will need to reconsider Minnesota's commitment to issues such as improving access to quality health care and child care, adequate funding for all levels of education, and providing affordable housing options. The 2007 Legislative Session will undoubtedly see many proposals to address the work left undone in recent sessions, as well as many new ideas as 53 new legislators take office in January. The forecast shows that the state currently has limited resources to start making progress in addressing these issues, but policymakers should work to craft solutions so that Minnesota will have enough resources to ensure a successful future.

⁸ Minnesota Department of Finance, *November 2006 Economic Forecast*, www.finance.state.mn.us/ffeu/index.html.