



Bill Marx, Chief Fiscal Analyst for the Minnesota House of Representatives

An Interview with The Civic Caucus

2104 Girard Ave.S., Minneapolis, MN 55405

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Notes of the Discussion

Present : Dave Broden, Janis Clay, Pat Davies, Paul Gilje (coordinator), Randy Johnson, Ted Kolderie, Bill Marx, Wayne Popham (phone), Dana Schroeder, Clarence Shallbetter.

Summary of Discussion: The immediate priority for legislators in the 2013 session will be balancing the FY 2014-15 biennium budget, currently forecast to run a \$1.1 billion deficit, Bill Marx says. But the newly forecast \$300 million surplus in FY 2016-17 could put a reverse on tax and spending reform efforts, since that biennium's budget appears in good shape. He emphasizes that it is very difficult to remove the state from what happens in the economy and says that changes in the economy over the past 60 years, especially in recent years, have resulted in lost sales tax revenues. State and local revenue as a percentage of personal income in Minnesota (the price of government measure), he points out, has decreased from about 17 percent 20 years ago to about 15 percent this biennium. He encourages a more deliberative legislative process for reaching budget decisions. All of our funding formulas and structures, he concludes, encourage or allow one kind of behavior or another. We ought to think about that when we're putting them into law, he says, because they can be very difficult to change when you're trying to change behavior.

Background: Bill Marx is the Chief Fiscal Analyst for the Minnesota House of Representatives. His job responsibilities include monitoring, reviewing, and analyzing the state budget and its various components, tracking state revenues and expenditures and monitoring related programs. Marx works with the House Fiscal Staff to assure that all House members are provided with the fiscal information they need. He supervises the nonpartisan House Fiscal Analysis Department.

Prior to becoming chief fiscal analyst in 1997, Marx was a fiscal analyst assigned to K-12 education finance. He has worked with education and budget issues for the Minnesota Legislature since 1977. He is a graduate of Winona State University and has done graduate work in economics at the University of Minnesota.

Discussion:

The 2013 Legislature will be considering a budget for the fiscal year 2014-15 biennium, which runs from July 1, 2013, through June 30, 2015. It's important to note that most figures discussed here apply to a biennium, which is comprised of two individual fiscal years. FY 2014, for example, runs from July 1, 2013, through June 30, 2014, while FY 2015 runs from July 1, 2014, through June 30, 2015. Whenever two years appear after the fiscal year abbreviation (e.g., FY 2012-13), the date is referring to two fiscal years, or a biennium. Whenever one year appears (e.g., FY 2012), the date refers to one fiscal year.

The November 2012 state budget forecast projects a general-fund surplus for the FY 2012-13 biennium, a deficit for FY 2014-15 and a surplus for FY 2016-17. Bill Marx noted that the projected surplus for FY 2012-13 is \$1.3 billion; the projected deficit for 2014-15 is \$1.1 billion; and the projected surplus for FY 2016-17 is \$300 million.

The \$1.3 billion recently projected general fund surplus for FY 2012-13 has gone to pay off the K-12 education aid shift from previous years. After the November 2012 forecast predicted the \$1.3 billion surplus, the money was appropriated, as required by law, to reduce past years' education aid payment shifts. The shifts allowed the state to pay only part of the school aids owed to school districts in the current year and move the payment of the balance of those aids to the following year. The shift strategy has been used to reduce state spending on a one-time basis.

The education aid payment schedule was changed after the November forecast so that school districts will now receive 82.5 percent of the revenue they are due in the current fiscal year and the other 17.5 percent in the following year. That is an improvement for districts from the previous payment schedule (64% / 36%).

In response to a question, Marx pointed out that when school districts were getting paid only 60 percent of their promised aids from the state, the districts had to use reserves or borrow money. The shift payback allows districts a better ability to invest or pay back borrowing.

The November 2012 forecast predicts a general fund deficit of \$1.1 billion in FY 2014-15, mostly due to increases in health and human services spending. Revenues for the FY 2014-15 biennium are predicted to be \$35.8 billion, while expenses are predicted at \$36.9 billion. Marx said debt service and an increase in K-12 pupils helped cause the projected increase in expenses, but "health and human services are the big driver." He pointed out that, although both revenue and spending were projected to be lower than was thought earlier, the projected \$1.1 billion deficit was the same in the November forecast as was projected at the end of the 2012 legislative session.

For the FY 2016-17 biennium, the forecast projects a \$300 million general fund surplus (\$38.7 billion in revenues and \$38.4 billion in spending). There is a structural problem in FY 2014-15, but not in FY 2016-17. "Whatever we do to solve FY 2014-15, unless we do it on one-time basis (e.g., through payment shifts), will also help FY 2016-17," Marx observed.

Most spending estimates in the forecast do not include adjustments for inflation. Marx said inflation adjustments, using projected Consumer Price Index figures in both FY 2014 and FY 2015, could add about \$900 million to spending in the biennium.

He said agency appropriations do not build in inflation for salary increases, supplies, utility costs, etc., and no inflation is built into K-12 funding formulas. Some human service formulas build in inflation, but in general inflation is not built into the forecast for spending. But inflation is somewhat built into the revenue side, since the forecasts take into account that people may move to different tax brackets if their incomes increase.

"In a simple way, inflation is not built into the spending side, but it is built into the revenue side," Marx summarized. "But the way things actually work is a lot more complex than that."

The November 2012 state budget forecast projects annual increases in general-fund revenues during four out of the next five years. Marx said the forecast projects the following annual changes in general fund revenues:

- FY 2013 up by 4.5 percent over FY 2012;
- FY 2014 down by 1.4 percent over FY 2013;
- FY 2015 up by 3.3 percent over FY 2014;
- FY 2016 up by 4.9 percent over FY 2015;
- FY 2017 up by 2.9 percent over FY 2016.

He pointed out that there is less certainty the further the projections go out into the future.

The drop in FY 2014 revenues was predicted for several reasons, primarily (1) an expectation that growth in employment will slow down or stay flat in FY 2014 and (2) the realization of more capital gains and companies' paying more dividends before Dec. 31, 2012, because of expected tax rate increases on those categories of income in 2013. Because of these factors, the forecast moved more revenue into FY 2013 from what had previously been forecast for FY 2014.

Federal grants make up the largest share, nearly one-third, of state revenue. For the \$61.9 billion in revenue for all state funds for the FY 2012-13 biennium (as of the end of the 2012 legislative session):

- Federal grants are the biggest slice of the revenue pie at 31.0 percent. That figure includes some federal stimulus money, so the federal grant money will drop a bit during the current year, because no more stimulus money will be coming into the state. The largest areas of the federal grant funds are for highways and health and human services, including Medicaid. This only includes federal funds administered by the state, so it does not include, for example, federal money that goes directly to the University of Minnesota.
- The income tax (at 26.3%) and the sales tax (at 18.4%) are the next biggest sources of total state revenue.
- Gambling revenue is only a miniscule part of total state revenue. In response to a question, Marx said lawful gambling taxes in FY 2012-13 are \$54 million, while taxes on pull-tabs, tip boards and the state lottery amount to \$62 million. This accounts for less than two-tenths of one percent of a \$62 billion budget, he pointed out.

Health and human services and K-12 education receive two-thirds of state spending. When breaking down the total \$62.6 billion in all-funds expenditures by program for FY 2012-13, health and human services (at 41.7%) and K-12 education (at 25.2%) together account for over two-thirds of the state budget. (As noted above, the state has now put \$1.3 billion into education to pay back a shift in education funding from previous years. That payback is not reflected in these figures.)

The general fund provides for more than half of all state spending.

- The general fund accounts for 53.2 percent of total state spending for the FY 2012-13 biennium.
- Federal funds are the next highest expenditure category, accounting for 29.0 percent of total state spending.

Income and sales taxes make up three-fourths of general-fund revenue. For FY 2012-13, individual income taxes make up almost half (46.8%) of general fund revenue, with sales taxes at 27 percent; the two together make up approximately 75 percent of general fund revenue.

Businesses and cabins pay statewide property taxes. In response to a question, Marx explained that since 2001, businesses (commercial-industrial property) and cabins (seasonal/recreational property) pay statewide property taxes (4.6 percent of general fund revenue). As a result, those properties do not pay property taxes for local school district operating fund referenda. The statewide property tax raises about \$800 million a year and is assessed at a uniform statewide rate. It is calculated as a dollar amount, adjusted for inflation, and the amount is not subject to legislative approval each year.

The principle behind this 2001 change is that the people residing in the school district, who vote on the local referendum levy, would actually pay for it. One of the other changes made in 2001 is that the local school district levy for the general education fund was eliminated. The statewide property tax has helped pay for that change.

In FY 2012, general fund revenue surpassed its previous high. Prior to now, general fund revenue was at its highest-ever annual level (\$16.6 billion) in FY 2008. It dropped after FY 2008, when income and sales taxes dropped due to the economy. We surpassed the FY 2008 level in FY 2012, when general fund revenue reached \$17.1 billion.

Nearly three-fourths of general-fund spending goes to K-12 education and health and human services.

- K-12 education (43.2 %) and health and human services (30.4%) are the two highest general-fund spending categories in FY 2012-13.
- The next highest general-fund spending is for property tax aids and credits, which includes local government aids (8.0%), followed by higher education (7.3%).
- Compared with FY 2010-11, projections show that general fund expenditures for K-12 education will increase by \$3.8 billion in FY 2012-13. The main reason for the increase is the payback of

former shifts in state payments of school aids. The shift artificially reduced FY 2010-11 payments and shift payback is artificially increasing FY 2012-13 payments. "These are not normal budget years," Marx commented.

- Health and human services general fund expenditures in FY 2012-13 are projected to increase by \$2.3 billion over FY 2010-11. Most of this growth is due to growth in Medical Assistance payments - both in the amount of the payments and the number of persons eligible.

In actual dollars (not adjusted for inflation) total state expenditures will have approximately tripled from FY 1991 to FY 2015. Total expenditures were about \$10.5 billion in FY 1991 and are projected to be \$32 billion in FY 2015.

But, Marx said, in comparison with growth in personal income, state revenue has not increased in 20 years. Minnesota's price of state and local government has increased and decreased over the last 20 years, but ended up in FY 2010 at about the same level as in FY 1991. The price of government is figured as state and local revenue as a percentage of personal income. Total state and local revenue amounted to approximately 16 percent of personal income in both FY 1991 and FY 2010, with nearly seven percent of that coming from local revenue and approximately 9.5 percent coming from state revenue in both years.

Several sources question whether the current general fund reserves of \$1 billion (\$350 million in the cash flow account and \$648 million in the budget reserve) are high enough. Marx said the National Conference of State Legislatures recommends that reserves should be at five percent of spending, which for FY 2012-13, would amount to a recommended reserve of \$1.8 billion. Also, a Minnesota Department of Management and Budget report several years ago recommended that the reserves should be higher and should float as a percentage of spending.

"\$1 billion is a little helpful in reserves, but we faced a \$5 billion problem two years ago," Marx observed.

Income and sales tax revenue and health and human services spending are very dependent on the economy. Marx explained that in a slowdown or recession, as people's incomes drop, more of them become eligible for health and human services programs. "If the economy slows or goes into recession, our two big revenue sources don't grow and one of our big spending categories does grow," he said.

He observed that a big issue facing Minnesota is "how to take the state's revenue and spending structure that has those big factors in it and make it more sustainable and economy-proof." He said the best revenue source for state and local governments from a stability perspective is the property tax, "but we like to stay away from the property tax."

An interviewer commented that we could operate the income and sales taxes in the same way as the property tax: set the needed revenue levels and float the rate. Marx agreed that would be possible.

Changes in the economy have resulted in lost sales-tax revenue. An interviewer asked how much

revenue is lost because of not collecting sales taxes on many Internet sales transactions. Marx replied that the estimate is that the total FY 2011 lost sales-tax revenue from such untaxed transactions totals \$400 million: \$149 million in lost taxes on Internet sales; \$55 million on catalog sales and \$190 million on sales by remote sellers who do not collect sales taxes.

Marx pointed out that the mix of purchases of goods vs. services has changed radically in the last 60 years. In 1950, consumer purchases were 61 percent for goods and 39 percent for services. By 2010, the numbers had more than reversed: consumers spent 67 percent for services and 33 percent for goods.

Because Minnesota generally applies sales taxes to goods and not services, sales-tax revenue is not growing as fast as income-tax revenue. Marx said that health-care provider taxes apply to some things, but there are no sales taxes on physician fees, lawyer fees, etc.

"Our economy is changing," Marx said. "Maybe our tax structure should be, too." In discussing the need for tax reform, Gov. Mark Dayton has said that the outdated sales tax code hurts Minnesota's Main Street retailers.

The immediate priority for legislators in the 2013 session will be balancing the FY 2014-15 budget, currently forecast to run a \$1.1 billion deficit. He emphasized that it is very difficult to remove the state from what happens in the economy. When an interviewer asked if the state needs to do reform instead of tweaking, Marx responded that the November forecast "could put a reverse on reform efforts, because it says FY 2016-17 is OK. More people will be looking at what can we do to make things even better."

He predicted there will be a greater recognition of things like the Internet sales tax issue. "Lots of people want to redo things," he said. "The Governor is looking at a broad array of taxes for tax reform. On the spending side there is not as extensive discussion."

He continued. "There are those who would argue we've done a lot of changes in human services in the last few years, where we've reduced services or restricted services or tried to deliver services in different ways. Some have been successful; some have not. In education, it's hard to predict there will be lots of changes. Education is a tough area to deal with; it's hard to give school districts less than they're getting now."

It's hard to get people to take a long-term view of taxes and spending. An interviewer commented that no attention is given to what it could cost to run government services at the federal, state and local levels. "There is no indication anybody out there is running a parallel agenda that attempts to attack the fundamental costs of any of these big systems. They're totally captured by the existing ways of doing things."

Marx responded, "It's really hard to get people to look at the longer term." He suggested there should be more time for deliberations on budget decisions, recalling that the Governor, the Speaker of the House and the Senate Majority Leader made the final decisions on the FY 2011-12 budget. "There's not a lot of detail there. It doesn't leave a lot of room to be deliberate." He suggested that perhaps there could be a process for the Governor, the House and the Senate to "buy in earlier."

The state is the most efficient raiser of revenue, but local governments are making the decisions on the vast amount of state spending. An interviewer commented that the ultimate signature on the checks for the vast amount of state spending is a local signature, such as a school district or county official. "The spending is local in the end," he said. "The state is appropriating the money and the locals are spending it."

"It goes back to who's the most efficient raiser of revenue," Marx replied. "In 1971, we decided the state is more efficient at collecting revenue and it's better to raise money for education through the income and sales taxes than through property taxes. Local governments are much less efficient at collecting local sales and income taxes than the state."

When asked if there is any way to get local governments to handle the spending more productively, Marx replied that it's a political question as to whether the state or local governments make better spending decisions.

In response to a comment that the state needs to be structuring incentives right, Marx asked, "Should you allow small school districts to continue operating by giving more sparsity aid or should you force something else to happen? All of our funding formulas and structures encourage one kind of behavior or another or certainly allow one kind of behavior or another. Those ought to be thought about when we're putting them into law, because they get to be very difficult to change when you're trying to change behavior."