

Surplus Spending

**Where has all
the money gone?**

Fall 2000

**A special report from the Children's
Defense Fund of Minnesota**

DEAR LORD
BE GOOD TO ME
THE SEA IS SO
WIDE AND SO
MY BOAT IS
SO SMALL



Children's Defense Fund
Minnesota

Spending the surpluses: Where has all the money gone?

INTRODUCTION & SUMMARY

From 1997 through 2000, Minnesota's policy makers oversaw the distribution of an unprecedented—and unexpected—amount of state money. Following several years of projected budget shortfalls, which had required policymakers to cut spending below anticipated levels and raise taxes and fees, predictions for future year balances began to turn positive in 1996. Beginning in 1997, substantial surpluses were projected, to which were added tobacco settlement money, federal welfare reform block grant funds and other money freed up by legislators. This money, which totaled almost \$11 billion over a four year period, was spent on tax cuts and other spending.

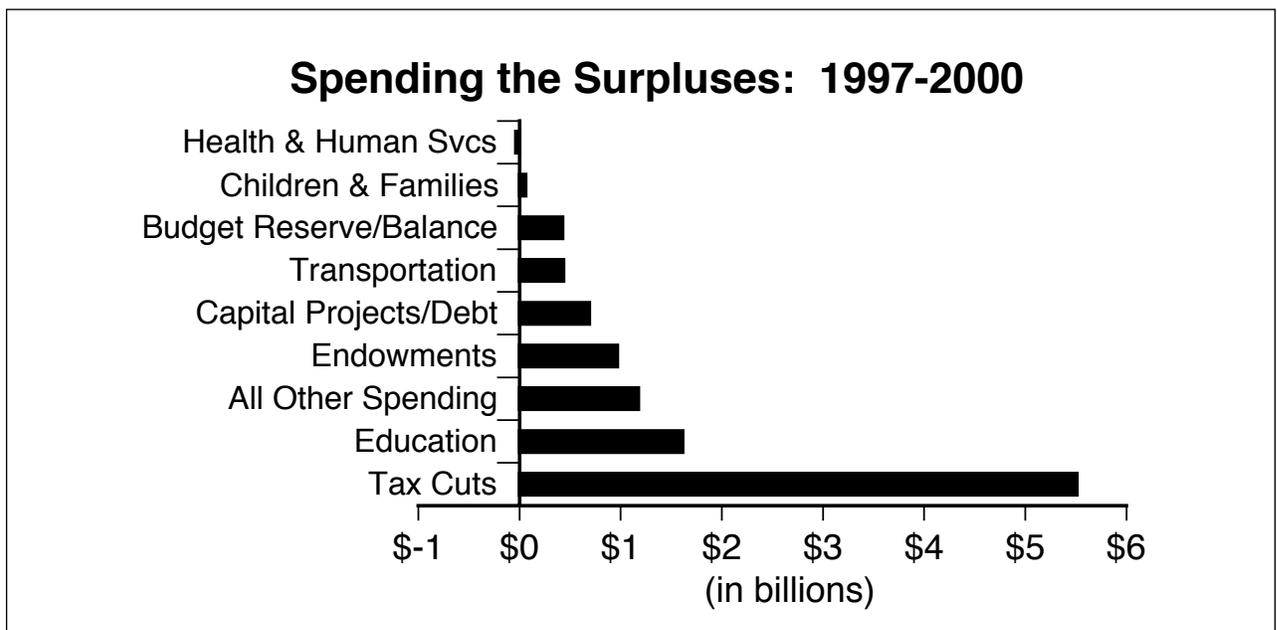
The surplus money, unlike the bulk of the state budget, represented true discretionary funds because there were no prior commitments for the use of the money. Governors Carlson and Ventura, and state legislators were constrained only by their judgments of the state's priorities and their ability to convince others of how the money should be spent.

The majority of the surplus went to cut taxes, either through rebates or permanent tax cuts. Minnesota led the country in tax cuts during these years. However, policy makers exercised restraint in terms of instituting permanent reductions in state resources. Almost two-thirds of the tax cuts were in the form of one-time rebates.

Policy makers also limited the future impact of much of the new program spending they approved. "One-time" spending commitments included increasing the budget reserve, paying cash for building projects, and setting up endowment funds. However, other one-time spending commitments were made for programs that are ongoing in nature, and for which pressure to continue their funding will be felt in the next round of budget talks.

The effect of these practices is significantly less investment than was possible in efforts to position the state for the 21st century. While the state's fiscal health provided policy makers with an unique opportunity to make long-term, strategic investments, the vast majority of the surplus was not allocated for that purpose. This includes investments in the well-being of children and their families, education, and targeted efforts to prevent future problems. In fact, policy makers instead sometimes used money earmarked for efforts in these areas, including federal welfare block grant and tobacco settlement money, to free up state funds for larger tax cuts.

(For a discussion of how budget surpluses are determined, please see the appendix at the end of this paper.)



Source: CDF-MN analysis based on House Fiscal Staff Reports

OVERALL TRENDS

1. Cutting taxes was at the top of the agenda all four years. The tax cuts approved in the 1997 and 1999 legislative sessions were the largest in the country in terms of prior year tax collections, the second highest in 2000 and seventh highest in 1998. Of the \$10.8 billion lawmakers had, or made, available in the general fund, half went to tax cuts.

Almost \$3 billion of the over \$5 billion in total tax cuts went to a series of one-time rebates; \$1.7 billion went to permanent income tax cuts; and \$.8 billion went to property and other tax cuts, or tax-related provisions. Because the tax cuts were generally based on the amount of taxes paid, the bulk of the tax cut spending went to tax filers with higher incomes.

2. Kindergarten through grade 12 (K-12) education dominated the spending side, accounting for almost 15% of the surplus money spent during this period (\$1.6 billion). However, over one-third of this amount was spent in 1997 to remove spending caps that had previously been placed on K-12 education and would have kept spending below the level necessary to keep pace with inflation and enrollment growth.
3. Even with substantial general fund surplus money available, policy makers tapped into other funds that had been earmarked for specific purposes in order to provide larger tax cuts. These other funds included the federal welfare block grant, the workers' compensation assigned risk plan fund and money previously set aside to pay cash for building projects (instead of borrowing). Legislators also used the tobacco settlement annual payments to increase the general fund surplus, instead of devoting all of the money to health-related efforts.
4. Legislators sometimes 'spent' future surpluses, before they were forecast, even though they were in the midst of allocating already large surpluses. Additional spending (beyond that allowed by the forecast) was approved in the

event that more surplus money became available in the next forecast.

Legislators also directed future surplus money to be set aside in earmarked accounts, such as the property tax reform account.

5. A good deal of spending was "one-time," that is, approved only for the current biennium and/or year. Some of this money paid for items that truly were one-time in nature, such as the sales tax rebate or building up the budget reserve. However, some went to address issues that are likely to continue into the future, for example, assistance to parents who adopt children with special needs or funding for the poison control center.
6. Most of the spending that occurred over the last four years (with the exception of child care subsidies in 1997 and transportation funding in 2000) represented only incremental changes in government support for programs. Major new programs were not approved during this period, nor did the state substantially change its orientation toward government services or accountability.
7. While there was general agreement in the early years about the state's fiscal health, including the need to build up the state's financial reserves, consensus was more difficult to reach as time went on. Disagreement over how to calculate future budget balances dominated the 2000 session. If this is indicative of future budget negotiations, the state may find its budget battles elongated with less, rather than more, attention to the substance of state spending and taxing decisions. Table 1: General Fund Surplus Allocations: 1997 through 2000

The tax cuts approved in the 1997 and 1999 legislative sessions were the largest in the country in terms of prior year tax collections, the second highest in 2000 and seventh highest in 1998.

Policy makers were able to exercise a great deal of discretion in the allocation of the surplus money. Their priorities are reflected in their decisions.

SURPLUS SPENDING YEAR BY YEAR

The following table (on which chart 1 is based) lays out how policy makers allocated the surplus money that was available from 1997 through 2000. The source for these figures is the House of Representatives Fiscal Analysis Department's session summary papers, available from the staff or at the web site: www.house.leg.state.mn.us/fiscal/fahome.htm. The spending categories are those used by the Legislature and the Department of Finance, and reflect the Legislature's finance committee structures. "Other spending" includes higher education, environment and natural resources, state government, crime and judiciary, economic development and housing and other special appropriations, such as the Tornado Relief Act.

In the table below, tax cuts include the rebates and lost investment income caused by the rebates, as well as the K-12 education shift payment. The shift payment is categorized as a tax cut because it reduces school districts' need to borrow money to cover the lag in payments from the state; it does not increase resources for classroom training. The negative spending amount for Children and Families is due to the substitution of federal welfare block grant (Temporary Assistance to Needy Families--TANF) money for state general fund money. The decrease in Health and Human Services spending in 1997 represents a real decrease in state general fund appropriations, compared to what had been forecasted.

Nearly \$5 billion was available in 1999.

**Table 1: General Fund Surplus Allocations
1997 through 2000 Legislative Sessions (\$'s in Millions)**

| | 1997 | 1998 | 1999 | 2000 | Total |
|-------------------------|----------------|----------------|----------------|----------------|-----------------|
| Tax Cuts/Rebates | \$771 | \$961 | \$2,746 | \$1,030 | \$5,509 |
| Budget Reserve/Balance | \$200 | \$91 | \$136 | | \$427 |
| K-12 Education | \$824 | \$125 | \$478 | \$186 | \$1,613 |
| Bonding/Debt | \$15 | \$497 | \$64 | \$116 | \$692 |
| Transportation | \$19 | | \$12 | \$404 | \$435 |
| Other spending | \$449 | \$181 | \$355 | \$192 | \$1,176 |
| Health & Human Services | -\$104 | \$58 | -\$25 | \$36 | -\$35 |
| Children & Families | \$133 | \$4 | -\$74 | \$-1 | \$62 |
| Endowments | | | \$968 | | \$968 |
| TOTAL | \$2,307 | \$1,917 | \$4,659 | \$1,963 | \$10,847 |

Source: CDF-MN analysis based on House Fiscal Staff Reports

A BRIEF REVIEW OF THE SURPLUSES

The 1997 legislative session represented the first year that lawmakers faced a substantial budget surplus. Until then, legislators and the Governor had operated largely with the goal of averting budget crises. An influential report released in the mid-1990's, *Within Our Means*, had predicted staggering budget shortfalls as the state entered the 21st century. Even though the state was not facing immediate deficits, this outlook prevailed until 1997, when the state's robust projections could no longer be ignored. Fears expressed that year that the good times might be short-lived were heard less frequently as more surpluses continued to be forecasted through 2001.

A pattern that repeated itself all four years was the projection of large surpluses in November, growing even larger by February, when legislators were in session. Legislators had only a few days between the February forecast and decisions regarding spending and taxing targets.

All four years, among the first responses was to "give it back" (or at least a portion of it) through temporary and permanent tax cuts. In 1997 and 1998, \$500 million in property tax rebates, based on property taxes paid, were sent out each year. In 1999 and 2000, sales tax rebates were approved, based on an estimate of how much tax filers had paid in sales taxes. The total rebate in 1999 was \$1.3 billion, and \$638 million in 2000.

In terms of permanent tax cuts, the focus the first two years was on property tax cuts, especially for business property. In those years, state money was used to offset the increases that would have occurred on homes to make up for the lost revenue from commercial and industrial property tax cuts. The focus shifted to income taxes in 1999, with the largest reduction—\$1.3 billion—approved that year. Most of the \$1.3 billion went to lower income tax rates, which primarily benefited higher income tax filers. In 2000, legislators used \$245 million to further lower income tax rates. Other permanent tax cuts included the reduction in motor vehicle registration fees in 2000, a marriage penalty credit in 1999 and incremental increases in the Working Family Credit all four years.

Kindergarten through grade 12 education received the next biggest chunk of the surplus. The largest appropriation—\$824 million—was in 1997. However, \$600 million of that amount went to remove spending caps that would have held spending levels below those forecast for education, based on infla-

tion and enrollment. (The spending caps had been placed on the K-12 education by the 1995 Legislature as a budget cutting

measure.) The state's child care subsidy program received a large increase in 1997 and \$400 million was appropriated for a transportation initiative in the 2000 legislation session. However, in general, there was few new major spending initiatives during these years.

A good deal of the spending approved during these four years was 'one-time,' that is, approved only for one, two, or three years. In contrast to traditional budget practices, which make continued authorization of new programs at their current level essentially automatic, programs approved on a one-time basis must be re-examined and re-approved for funding to continue. This practice limits the spending "tails" of programs (and shows a more positive future balance on the state books), but understates future spending pressures since demand for the program or service is likely to continue. It also subjects some programs to scrutiny that other programs (i.e., those with funding already assumed in the budget base) do not face. Examples of programs with one-time appropriations in 2000 include funding for the Poison Control System, and screening and testing for sexually transmitted diseases in the Department of Health.

Other spending choices that policy makers made that limited the state's future commitments included increasing the state's budget reserve to \$522 million in 1997 and \$622 million in 1998, using cash, instead of bonding, for building projects (a portion of which they later undid), and establishing two health related endowment funds using the \$1 billion in one-time tobacco settlement payments. These actions represent real one-time appropriations since they do not create expectations for future spending, and do not present the same drawbacks to programs or spending projections as the one-time spending approvals discussed above.

Human services programs received little of the surplus money available from 1997 to 2000. In fact, these programs, especially welfare, contributed to the surplus in two ways. First, because of the large drop in the welfare caseload, state spending on welfare decreased substantially below that forecast earlier, increasing the surplus by contributing

Until 1997, averting budget crises was a major issue.

A good deal of the spending approved during these four years was one-time.

savings. Second, by drawing down federal welfare funds, allowing policy makers to use federal, instead of state, money. Minnesota used the federal dollars to both supplant state money, that is reduce state spending for existing programs by substituting federal dollars (for child care and social services), and by using federal money to expand services, such as concurrent planning services for child welfare clients.

In fact, the federal block grant TANF money was a major source of financing for human service program increases over the last four years. Much of this spending was authorized for one-time only, including money to provide food stamps to legal non-citizens, delay the welfare payment to recipi-

ents in subsidized housing, and pay for transitional child care for former welfare clients and concurrent planning for child welfare clients.

The state also dipped into money earmarked for other purposes to increase the size of its tax cuts. In addition to the welfare block grant money, this included converting \$400 million of the building projects back to bonding in 1999, and transferring \$125 million in unspent money in 2000 from the Workers' Compensation Assigned Risk Pool.

Potential future money was also tapped into and 'spent.' In 1997, for instance, legislators authorized more spending for education tax credits and deductions in the event of a surplus forecasted in November. In 1998, they earmarked future forecast money for a tax reform and reduction account. In 1999, they approved a \$50 per pupil increase in K-12 education in the event of a November forecast.

STATE SPENDING TRENDS

Despite the increase in state spending the surpluses allowed, it has remained fairly constant (around 8%) when compared to the total personal income of all of the state's residents.

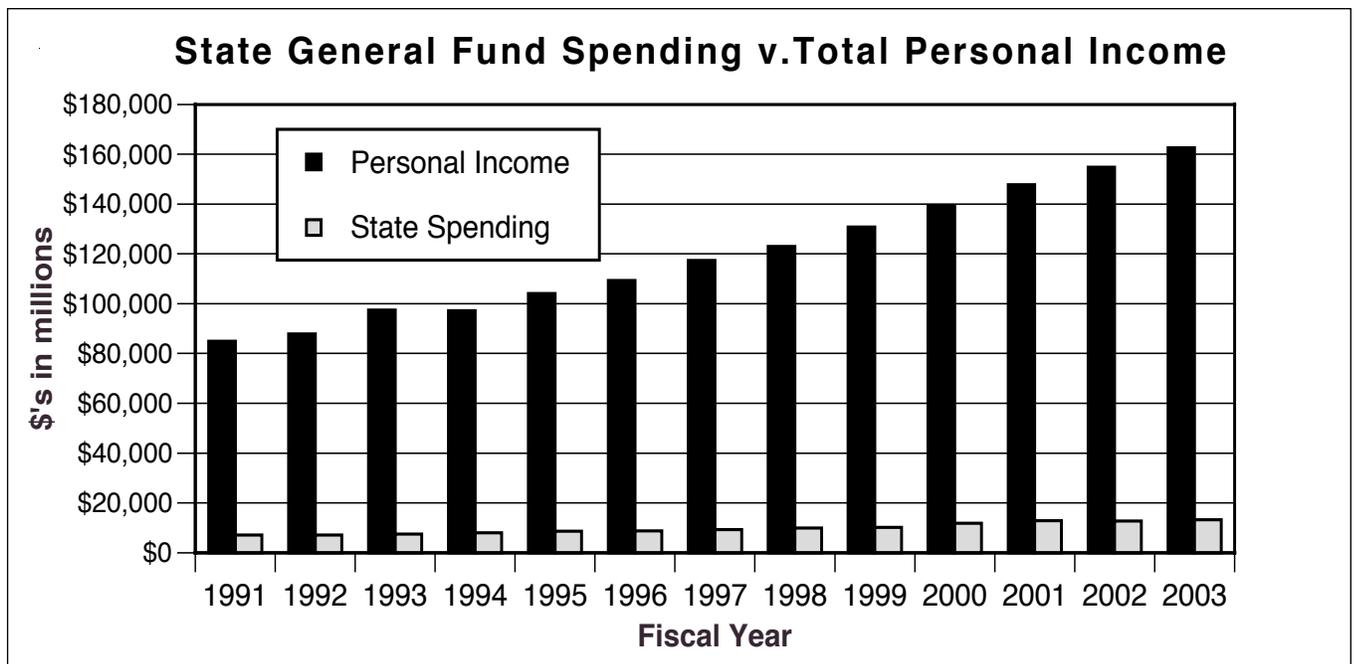


Chart 2 Source: Department of Finance

STATE SPENDING TRENDS, CONTINUED FROM PAGE 5

There has been a decrease in the proportion of total personal income equivalent to government revenues (which includes things such as college tuition, as well as taxes and government imposed

fees). This is reflected in the following chart which compares total state and local revenues to total personal income (the so-called Price of Government index).

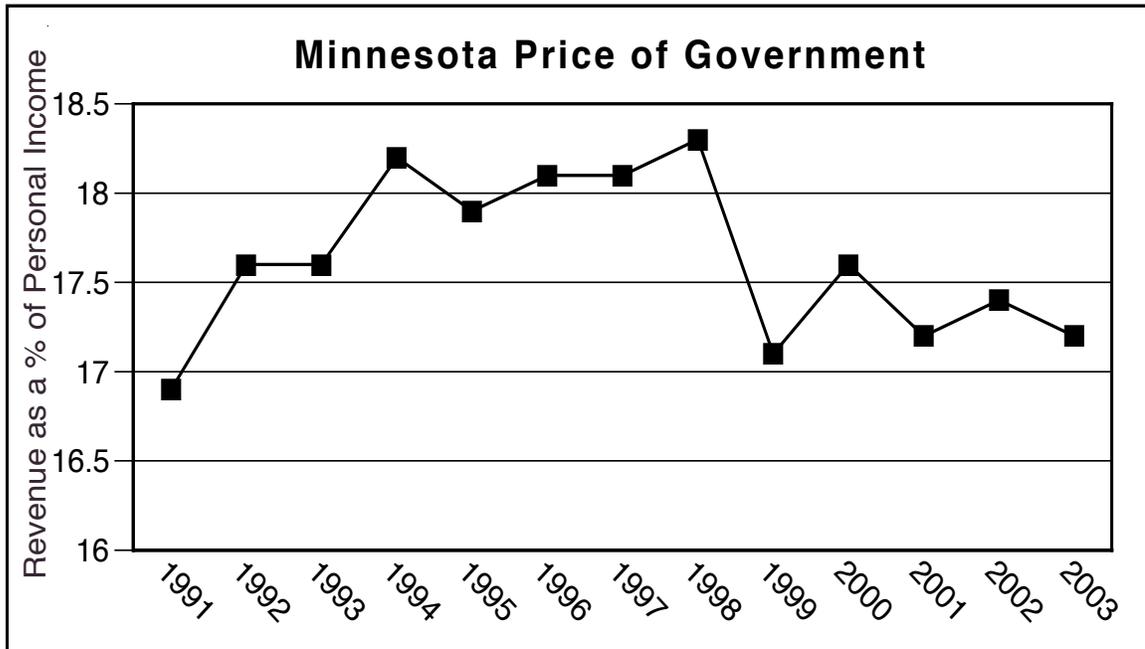


Chart 3 Source: Department of Finance (February, 2000 Forecast)

THE FUTURE

Over the course of the last four years, the state has addressed many of the long-standing fiscal issues it had not been able to during the leaner years. It provided more tax cuts to its citizens than any other state, established a healthy budget reserve, invested in its information systems and caught up with inflation in some areas.

Among the challenges the state still faces are those related to a changing workforce and the impact the number of hours worked by parents has on their children's well-being.

However, there are still many areas of the state budget which experienced reductions over the last several years which have not been made whole (e.g., nursing home workers' salaries, higher education tuition support, health care provider reimbursement,) or where adjustments have not been made to keep pace with

inflation (e.g., child care tax credits). Furthermore, the state has not taken a proactive look at many areas where it needs to think about changing the way it invests in government programs or provides services that are over due for re-examination, (e.g., higher education, preventive health care, child welfare, etc.).

In fact, the state is not in quite as good a position as it may appear because of the wide use of one-time funding. Since many of these programs provide services for which demand has not decreased, there will be continued pressure to fund them. Unfortunately, policy makers may not have sufficient information available to evaluate these and other government programs because adequate performance monitoring mechanisms are not in place. Despite a strongly voiced concern about program performance and accountability, legislators elimi-

THE FUTURE CONTINUED

nated state agency performance reports in 1999. The effectiveness of the remnants of the evaluation effort left in place remains to be seen. However, if policy makers decide not to increase spending but expect programs to do more with the same amount of money, they should have some method for determining whether or not that is occurring.

Substantial progress has been made on many of the issues facing the state (including taxes), but there are new challenges that have yet to be met. These include the impact a changing work force has on the number of hours worked by mothers and fathers, with implications for their children's well-being; an aging population, with implications for government revenues and service demands; and changing labor force skills needs, with implications for K-12 and higher education, welfare and employment training. According to Eugene Steuerle, an economist and columnist for *Tax Analysts*, "A current surplus may not mean a lot if future expenditures are expected to be well in excess of expected taxes." Proposals for future spending or taxing changes should take the long view into account, considering as much as possible the revenue and spending changes likely to occur from future demographic and economic shifts. Future generations will face higher taxes if we fail to address issues now that will drive future government spending.

These long-standing issues have "tails." They require a shift in thinking from short-term, one-time solutions, to long-term approaches that can respond over time to changing circumstances and new information. The state's current fiscal health not only allows for these issues to be addressed in

a more sustained way than in the past, but also allows systems to shift from being crisis-oriented to prevention-oriented. Such a shift is best made when the two approaches can be maintained for a short time until prevention efforts begin to have an effect (e.g., child abuse and protection).

If the economy hits hard times, the state will face less revenues and increased demand for services. The demand for those services and the impact on revenues could be mitigated if measures are taken now to make the state's economy and its workforce as flexible and resilient as possible.

The last four years provided the state with an opportunity that was new to most of those working in government finance. While many policy makers and analysts who began their careers in the 1980's had a good deal of experience dealing with budget crises, few had experience with the luxury of budget surpluses. New approaches to budgeting are necessary. Current circumstances call for moving from minimizing long-term commitments to proactively considering the future, with an emphasis on flexibility and accountability. With the same creativity that policy makers addressed past budget crises, the opportunity provided by the current abundance can result in effective responses for the 21st century.

**"A current surplus may not mean a lot if future expenditures are expected to be well in excess of expected taxes."
—Eugene Steuerle**

APPENDIX

Background: Budget “Surplus” Defined

Budget surpluses (or shortfalls) occur because it is not possible to accurately predict the state’s economy and the needs of its residents. The budget forecast, which is done twice a year in Minnesota (in November and February), compares how much money the state expects to take in through taxes, fees and other revenue generating activities, to how much it expects to spend over the same period. Forecasters have to predict economic conditions that are likely to affect the state’s fiscal health, as well as cost-of-living increases and changes in the state’s populace. A stronger state economy generally creates more jobs and/or higher wages, resulting in more tax revenues and less demand for some services. A weakening economy, or recession, will mean less revenues and possibly more demand for government services.

When predicting spending, forecasters base their assumptions on requirements already in law. Current tax rates and spending commitments (for example, the amount of money a school district receives for each student) are assumed and adjusted based on estimates of other factors likely to affect spending levels (for example, declining or growing school enrollment and inflation).

Many projected increases in spending are built into the forecast. That is, it is assumed that they will be approved when the Legislature meets

again. For instance, if there are more people in nursing homes than expected when money was last appropriated for their care, the forecast for state spending is automatically adjusted and money to pay for their care will not have to come out of the ‘surplus.’ The Legislature will still have to pass a law appropriating the additional money when it meets again, but this is assumed when the economist forecasts future spending levels. Similarly, if spending is expected to decrease in a program from levels previously anticipated, for instance due to drops in the welfare caseload, the forecast assumes less state spending and incorporates the money saved into the next budget forecast. Only certain programs are treated this way in the forecast—mostly education, health care and welfare.

A surplus is projected if there is money left over, after spending is compared to revenues. A shortfall is predicted if sufficient money is unlikely to be available to cover expected expenses.

The “planning estimates,” which are estimated for the two years following the forecast, are calculated differently and are necessarily less precise. Nevertheless, the planning estimates have had a major impact on budget negotiations over the last several years, as emphasis has been placed on the estimated effect of budget decisions three to five years ahead.

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A copy of this report is available at CDF-Minnesota’s web site: www.cdf-mn.org.

The Children’s Defense Fund-Minnesota was established in 1985 and is a state office of the national Children’s Defense Fund. CDF-Minnesota conducts research and analysis on issues facing children and families, publishes results and then advocates at both the state and national level to make positive changes in the lives and futures of children. Special attention is paid to those children and families that face numerous challenges including poverty, health care, disabilities and domestic violence.



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