

November 2007

HIGHLIGHTS

\$373 Million Deficit Projected for FY 2008-09 Budget

A weaker U.S. economic forecast has changed the state's budget outlook. General fund revenues now are forecast to fall \$739 million (2.2 percent) below end-of-session estimates, while spending is projected to be \$66 million (0.2 percent) higher. A budget deficit of \$373 million is now projected for the biennium. Previously a balance of \$294 million had been expected.

Slow Economic Growth Forecast through Mid-2008

Expectations of further weakening in the housing sector, higher oil prices, and tighter credit standards have led Global Insight (GII) to scale back their U.S. economic outlook. Economic growth in the last two quarters has been strong, but GII forecasts three quarters of very weak growth with annual real GDP growth rates of 2.3 percent in FY 2008 and 2.2 percent in FY 2009. In February's forecast real growth rates of 2.9 percent and 3.1 percent were used.

The long term economic outlook has also been cut back. Weaker growth in 2008 and 2009 leaves the economy starting the next biennium from a lower point than was assumed in February. Projected growth rates for 2010 and 2011 also are slightly lower due to a reduction in assumed long-term productivity growth.

GII's baseline forecast does not contain a recession, but the low growth rate projected for the near term leaves the economic outlook very fragile. GII assigns a probability of 55 percent to their baseline forecast and 35 percent to a more pessimistic scenario which includes a recession beginning in the current quarter. A more optimistic scenario is assigned a probability of 10 percent.

Structural Shortfall Expected in 2010-11 Biennium

Budget planning estimates for the next biennium show a \$211 million structural shortfall – a small shortfall in FY 2010 followed by a small balance in FY 2011. Projected spending levels for FY 2010-11 do not include general inflation. Adjusting for inflation would add \$337 million to the spending estimates in FY 2010 and \$697 million in FY 2011.

BUDGET UPDATE AND OUTLOOK

\$373 Million Deficit Projected for 2008-09 Biennium

The outlook for the U.S. economy has changed materially since mid-summer. Real GDP growth rates for the remainder of 2007 and the first half of 2008 now are expected to be significantly below those anticipated in February's GII baseline forecast. Only a few forecasters expect a recession, but everyone agrees that the probability of a recession by mid-year is much higher than normal. Prospects for the housing industry are worse than expected, and the housing market's problems have spread to the credit markets. Oil prices, now well above the \$60 per barrel anticipated when forecasts were made in early 2007, also will contribute to slower economic growth in 2008.

The weakness now projected for the U.S. economy through mid-2008 will reduce state revenue collections in the 2008-09 biennium and beyond. The state's general fund budget is now forecast to face a deficit of \$373 million at the end of the current biennium. At the close of the September 2007 special legislative session an ending balance of \$294 million had been expected. General fund revenues are now forecast to be \$739 million (2.2 percent) less than end-of-session estimates, while expenditures increase by \$66 million (0.2 percent). The deficit projected for the current biennium was partially offset by a \$139 million increase in the balance carried forward from fiscal 2007.

FY 2008-09 Budget

(\$ in millions)

	<u>End-of- Session</u>	<u>November Forecast</u>	<u>Difference</u>
Beginning Balance	\$2,106	\$2,245	\$139
Revenues	33,812	33,072	(739)
Expenditures	34,588	34,654	66
Reserves	<u>1,036</u>	<u>1,036</u>	
Balance	\$294	\$(373)	

Minnesota's budget reserve remains unchanged at \$653 million while the state's cash flow account continues at \$350 million. There is also a small \$33 million reserve dedicated to Human Services case management.

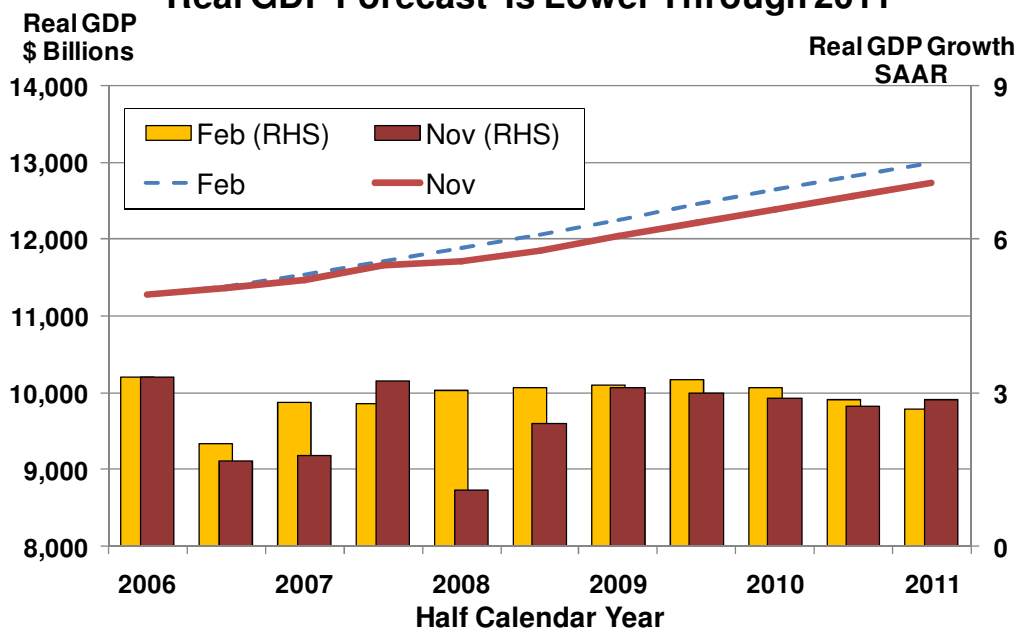
U.S. Economic Growth Rate Expected to Slow Through Mid-2008

The U.S. economy put in a strong performance during the second and third quarters of 2007. Unfortunately, a slowdown appears underway. The continuation of the current slump in residential housing is the source of much of the anticipated weakness. But, there also are other, potentially more serious, problems. The greatest concern is that the financial sector’s problems will eventually restrict the availability of credit throughout the economy. The Federal Reserve and the European Central Bank have injected additional liquidity, but lending standards have already tightened, and further tightening is likely. Risks of a more severe slowdown are compounded by substantially higher than anticipated oil prices. Few economists expect a recession, but all agree the probability of a recession by mid-2008 is much higher than usual.

Most economists have factored further weakening in housing into their forecasts. Where there is disagreement is on the fallout from further defaults on mortgage loans. The near term outlook for oil prices also is a matter of concern. Almost every 2008 forecast has been reduced but November’s baseline forecast from Global Insight Inc. (GII), Minnesota’s national economic consultant, is now among the least optimistic. GII’s projected real GDP growth of 1.9 percent for calendar 2008 is well below the Blue Chip consensus estimate of 2.4 percent.

GII’s less rosy outlook for the housing and financial sectors and their assumption that oil prices will average \$90 per barrel in the current quarter and \$80 per barrel in the first quarter of 2008 reduces real GDP growth to just 1.1 percent during the first half of 2008. February’s baseline called for a real growth rate of 3.0 percent during that period. Real growth rates of 2.3 percent in FY 2008 and 2.2 percent in FY 2009 are now expected. February’s baseline called for real growth rates of 2.9 and 3.0 percent. Global Insight assigns a probability of 55 percent to their baseline forecast. A more pessimistic scenario which includes a three quarter recession starting before year end is assigned a 35 percent probability. A more optimistic outlook is assigned a probability of ten percent.

Real GDP Forecast Is Lower Through 2011



Revenue Forecast for 2008-09 biennium down by \$739 million

General fund revenues for the 2008-09 biennium are now expected to total \$33.072 billion, down \$739 million (2.2 percent) from end-of-session estimates. Fiscal 2008 revenues are now projected to be \$219 million (1.3 percent) below previous estimates, while the forecast for fiscal 2009 is down \$522 million (3.0 percent). Corporate income taxes were the source of the largest decline in both dollar and percentage terms. Corporate tax revenues are now projected to be \$318 million (14.3 percent) below earlier estimates. Projected sales tax revenues fell \$309 million (3.3 percent) from prior estimates, while the individual income tax collections are expected to be \$31 million (0.2 percent) above previous estimates.

Forecast Revenue FY 2008-09

(\$ in millions)

	<u>End-of- Session</u>	<u>November Forecast</u>	<u>\$ Change</u>	<u>% Change</u>
Individual Income	\$15,628	\$15,659	\$31	0.2
Sales	9,467	9,158	(309)	(3.3)
Corporate	2,216	1,899	(318)	(14.3)
Motor Vehicle Sales	317	313	(3)	(1.0)
Statewide Levy	<u>1,402</u>	<u>1,437</u>	<u>36</u>	<u>2.5</u>
Subtotal	29,029	28,466	(563)	(1.9)
Other Taxes	2,412	2,228	(184)	(7.6)
Non-Tax Revenues	1,525	1,537	13	0.8
Dedicated, Transfers	<u>846</u>	<u>840</u>	<u>(5)</u>	<u>(0.6)</u>
Total Revenues	\$33,812	\$33,072	\$(739)	(2.2)

Corporate tax receipts have been well below projections since February. That reduction in the starting point was the largest source of change in the corporate tax projections. The decline in projected sales tax receipts is driven by weaker outlooks for the U.S. and Minnesota economies. Since the decline is all prospective, a disproportionate share of the reduction in the forecast occurs in fiscal 2009.

Preliminary estimates indicate that individual income tax liability for tax year 2006 exceeded February's estimate by more than \$100 million. Tax year 2007 individual withholding and individual estimated payments have exceeded February's forecast by \$94 million. This combination of a higher base and stronger year-to-date receipts partially offsets the weaker economic assumptions for 2008 and 2009. The extended slowdown in housing sales reflected in the November baseline led to a \$105 million reduction in forecast mortgage and deed tax revenues.

Forecast Spending Slightly Higher

General fund spending for the current biennium is forecast to be \$34.654 billion, up \$66 million (0.2 percent) from end-of-session estimates. Of the \$66 million spending increase, one-half (\$33 million) represents appropriations carried forward in various spending areas when the books were closed for FY 2007.

Forecast Spending, FY 2008-09

(\$ in millions)

	<u>End-of- Session</u>	<u>Nov Forecast</u>	<u>\$ Change</u>	<u>% Change</u>
K-12 Education	\$13,781	\$13,788	\$7	0.0
Property Tax Aids & Credits	3,109	3,154	45	1.5
Health & Human Services	9,695	9,718	23	0.2
Debt Service	913	876	(37)	(4.1)
All Other	<u>7,090</u>	<u>7,119</u>	<u>29</u>	<u>0.4</u>
Forecast Total	\$34,588	\$34,654	\$66	0.2

Small changes in spending occurred primarily in four areas. K-12 education estimates increased by \$7 million, with lower forecast Q-Comp spending offsetting increases from slightly higher pupil estimates. Within health and human services programs, lower Medical Assistance estimates partially offset higher projections for General Assistance Medical Care and Chemical Dependency services, resulting in a net increase of \$23 million. Property tax aids and credits estimates have increased \$45 million reflecting slower income growth among eligible filers. These spending increases were partially offset by a \$37 million decrease in forecast debt service costs for the biennium.

FY 2010-11 Planning Estimates Turn Negative

The reductions in the 2008-09 revenue forecast combined with the underlying growth in projected spending, result in a \$211 million structural shortfall in the next biennium. This compares with a \$1.137 billion structural balance projected at the end of September's legislative session. Planning estimates for the next biennium now show general fund revenues of \$35.713 billion and projected spending of \$35.924 billion. The difference between ongoing revenues and spending has decreased by \$1.348 billion from end-of-session estimates.

FY 2010-11 Revenue-Expenditure Balance

(\$ in millions)

	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2010-11</u>
Projected Revenues	\$17,341	\$18,372	\$35,713
Projected Spending	<u>17,763</u>	<u>18,161</u>	<u>35,924</u>
Difference	(422)	211	(211)
<i>Forecast Change</i>	<i>(648)</i>	<i>(700)</i>	<i>(1,348)</i>
Estimated Inflation (CPI)	337	697	1,034

The expenditure projections do not include any adjustment for projected inflation. The November baseline forecast shows the Consumer Price Index (CPI) increasing by 1.9 percent in both FY 2010 and 2011.

The expenditure and revenue planning estimates make no assumptions about any actions that might be taken in the 2008 legislative session to balance the FY 2008-09 deficit or to resolve the structural shortfall for the 2010-11 biennium. The FY 2010-11 planning estimates are simply a benchmark to determine if ongoing spending exceeds 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 for the FY 2010-11 biennium.

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 Current Biennium Forecast Comparison
November 2007 vs End-of-Session
General Fund
(\$ in thousands)

	9-07 Enacted FY 2008-09	11-07 Fcst FY 2008-09	\$ Difference	% Change
<u>Actual & Estimated Resources</u>				
Balance Forward From Prior Year	2,106,087	2,244,935	138,848	6.6%
Current Resources:				
Tax Revenues	31,441,264	30,694,562	(746,702)	-2.4%
Non-Tax Revenues	1,524,720	1,537,268	12,548	0.8%
Subtotal - Non-Dedicated Revenue	32,965,984	32,231,830	(734,154)	-2.2%
Dedicated Revenue	156,998	156,998	0	0.0%
Transfers In	638,579	633,476	(5,103)	-0.8%
Prior Year Adjustments	50,000	50,000	0	0.0%
Subtotal - Other Revenue	845,577	840,474	(5,103)	-0.6%
Subtotal-Current Resources	33,811,561	33,072,304	(739,257)	-2.2%
Total Resources Available	35,917,648	35,317,239	(600,409)	-1.7%
<u>Actual & Estimated Spending</u>				
K-12 Education	13,780,961	13,787,666	6,705	0.0%
Higher Education	3,155,158	3,155,162	4	0.0%
Property Tax Aids & Credits	3,109,342	3,154,482	45,140	1.5%
Health & Human Services	9,695,010	9,717,974	22,964	0.2%
Public Safety	1,886,474	1,886,633	159	0.0%
Transportation	249,402	249,641	239	0.1%
Environment, Energy & Natural Resources	448,020	450,037	2,017	0.5%
Agriculture & Veterans	183,984	187,257	3,273	1.8%
Economic Development	389,116	396,853	7,737	2.0%
State Government	656,096	664,277	8,181	1.2%
Debt Service	913,145	875,761	(37,384)	-4.1%
Capital Projects	20,500	20,500	0	0.0%
Estimated Cancellations	(21,164)	(21,164)	0	0.0%
Subtotal Expenditures & Transfers	34,466,044	34,525,079	59,035	0.2%
Dedicated Expenditures	122,198	129,410	7,212	5.9%
Total Expenditures & Transfers	34,588,242	34,654,489	66,247	0.2%
Balance Before Reserves	1,329,406	662,750	(666,656)	
Cash Flow Account	350,000	350,000	0	
Budget Reserve	685,667	685,667	0	
Budgetary Balance	293,739	(372,917)	(666,656)	

November 2007 Forecast vs End-of-Session

General Fund
(\$ in thousands)

	9-07 Plng Est FY2010-11	11-07 Plng Est FY2010-11	\$ Difference	% Change
<u>Actual & Estimated Resources</u>				
Balance Forward From Prior Year	1,329,406	662,750	(666,656)	-50.1%
Current Resources:				
Tax Revenues	34,585,863	33,392,891	(1,192,972)	-3.4%
Non-Tax Revenues	1,505,194	1,520,981	15,787	1.0%
Subtotal - Non-Dedicated Revenue	36,091,057	34,913,872	(1,177,185)	-3.3%
Dedicated Revenue	89,426	136,026	46,600	52.1%
Transfers In	612,745	613,319	574	0.1%
Prior Year Adjustments	50,000	50,000	0	0.0%
Subtotal - Other Revenue	752,171	799,345	47,174	6.3%
Subtotal-Current Resources	36,843,228	35,713,217	(1,130,011)	-3.1%
Total Resources Available	38,172,634	36,375,967	(1,796,667)	-4.7%
<u>Actual & Estimated Spending</u>				
K-12 Education	13,701,275	13,805,385	104,110	0.8%
Higher Education	3,191,030	3,191,030	0	0.0%
Property Tax Aids & Credits	3,120,645	3,203,756	83,111	2.7%
Health & Human Services	11,066,296	11,071,694	5,398	0.0%
Public Safety	1,906,291	1,906,244	(47)	0.0%
Transportation	212,054	212,054	0	0.0%
Environment, Energy & Natural Resources	375,534	376,155	621	0.2%
Agriculture & Veterans	166,304	166,184	(120)	-0.1%
Economic Development	281,272	281,318	46	0.0%
State Government	621,406	621,429	23	0.0%
Debt Service	1,009,391	987,305	(22,086)	-2.2%
Capital Projects	20,500	20,500	0	0.0%
Estimated Cancellations	(20,000)	(20,000)	0	0.0%
Subtotal Expenditures & Transfers	35,651,998	35,823,054	171,056	0.5%
Dedicated Expenditures	54,626	101,226	46,600	85.3%
Total Expenditures & Transfers	35,706,624	35,924,280	217,656	0.6%
Balance Before Reserves	2,466,010	451,687	(2,014,323)	
Cash Flow Account	350,000	350,000	0	
Budget Reserve	653,000	653,000	0	
Budgetary Balance	1,463,010	(551,313)	(2,014,323)	
Structural Balance	1,136,604	(211,063)	(1,347,667)	