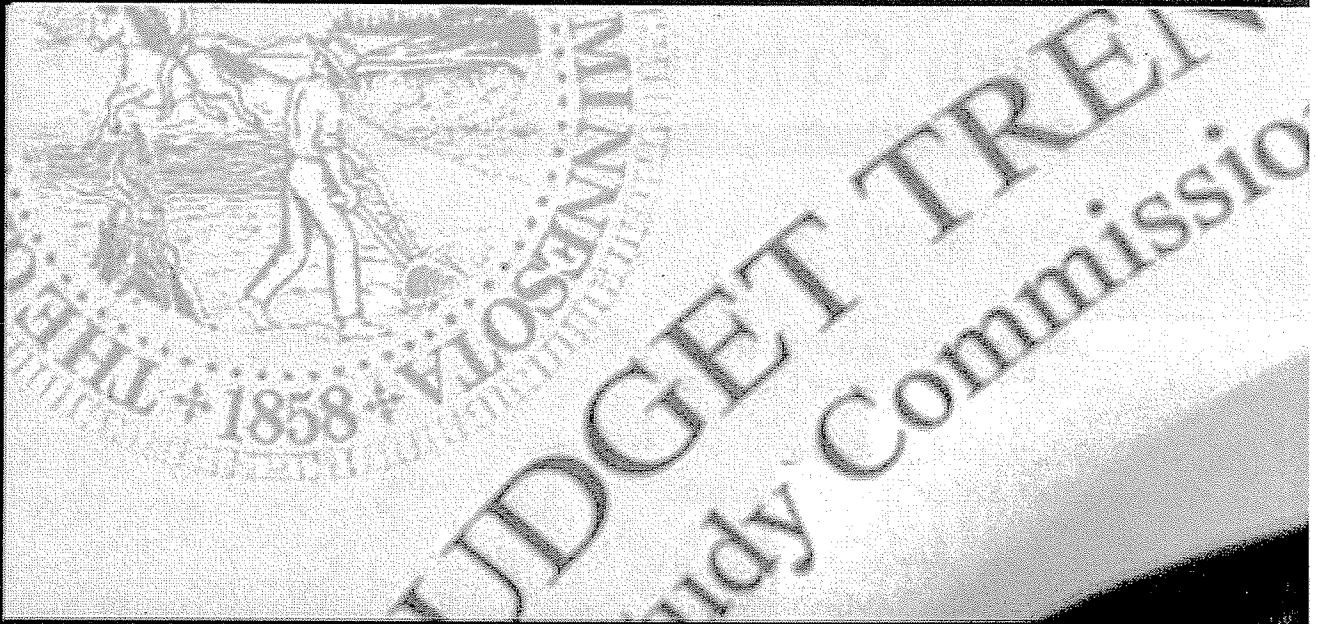
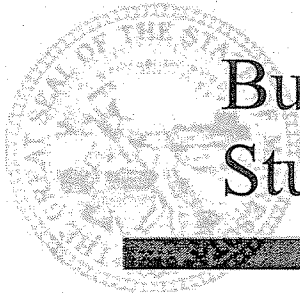


State of MINNESOTA



Budget Trends Study Commission

Commission Report to the Legislature
January 12, 2009



Budget Trends Study Commission

January 12, 2008

Representative Lyndon Carlson
Chair, House Finance Committee

Senator Richard Cohen
Chair, Senate Finance Committee

Representative Ann Lenczewski
Chair, House Tax Committee

Senator Tom Bakk
Chair, Senate Tax Committee

We are pleased to transmit the final report of the State Budget Trends Study Commission. The Commission was authorized by the Laws of Minnesota 2007, Chapter 148, Article 2 and was comprised of fifteen members including five members appointed by the governor; five by the senate and five by the house.

The Commission began meeting in the fall of 2007 and held fourteen meetings. The Commission reviewed financial recommendations from various studies completed over a 30 year period and heard presentations from numerous state officials with backgrounds in demography, education, health care, finance, and economics. We want to acknowledge the fine work of those individuals and the tremendous support that we received from the Minnesota Management and Budget staff.

The final report identifies fourteen primary findings on demographic and fiscal trends that include:

- Minnesota is currently experiencing a major, long-range demographic shift.
- Despite continuing to rank high among many key social and economic indicators, Minnesota's economy has underperformed recently relative to the nation.
- Minnesota has a long-term structural budget problem, with long term expenditure growth likely to outpace revenue growth.
- Health care growth will become the most important factor in controlling rising state expenditures
- Adjusting the mix of state taxes, while leaving tax base and revenue growth rate neutral, cannot significantly reduce revenue volatility without a radical change in tax rates and a dramatic reweighting of tax revenue sources to the system.
- Minnesota's statutory budget reserve ceiling has not grown to an appropriate level to adequately manage the underlying risks in Minnesota's tax system over time.

I. Introduction

For a cold place at the end of the road, Minnesota's economic performance over the past half-century has been very successful. Prudent and adequate investments in education, infrastructure, and technology have fueled enhanced productivity, innovation, and global competitiveness. Overall, Minnesota's economic growth rate has outpaced the national average and the state has led in many social and economic indicators.

Past performance, however, does not ensure future success. Despite continuing to rank high in many key areas, Minnesota's population and employment growth, for example, have slowed considerably since 2002 relative to the experience of the 1990s. These, along with growth in per capita personal income and per capita GDP, have more recently begun to lag national growth for the first time in over a decade.

Minnesota is experiencing a period of rapid and critical change. Some of the recent economic underperformance can be attributed to short-term fluctuation in the business cycle, such as the slump in new housing construction. Likewise, Minnesota has not benefitted from strong growth in national defense spending or energy production and has suffered from challenging times in the airline industry. Looking longer term, however, it is now critically important to consider how these current economic concerns will influence Minnesota's growing challenges coupled with an aging population, a changing workforce, rising health care costs, and slowing taxable consumption.

Today, as the first of Minnesota's 1.4 million baby-boomers begin to reach retirement age, the state has reached an inflection point - a moment of profound change that produces an immediate shift from recent trend. This milestone requires a complete reassessment of the way the state's economy is perceived. No longer can Minnesota sit by and watch as the crest of this giant aging wave grows larger. As Minnesota's population begins to transform, new, long ranging factors will begin to weigh more and more heavily on the state's tax base, spending needs, and overall economic progress. The wave is beginning to break and policymakers have not adequately prepared for the overwhelming implications this will have on state government finances.

The 1995 *Within Our Means* report issued by Minnesota Planning made the following prescient appeal:

"If there is a time to solve the state's fiscal problems, it is now. The economy has been strong. The percentage of Minnesotans of working age is still growing and will reach an all-time high in 2010, before beginning a long-term decline. Over the next 15 years, the combined proportion of children and elderly — the age groups most dependent on support from others — will be less than at any time since 1950. From now to the year 2010, the state will have a maximum percentage of people in their peak earning years. After 2010, solutions will be more difficult, as the percentage of Minnesotans of working age begins to decline."

- Within Our Means, 1995

Unfortunately, as a consequence of the relative strength of Minnesota's economy throughout the late 1990s, this call for action was fundamentally ignored. Today, the economy is weaker and the state's fiscal problems have grown more apparent. Despite this, however, the plea for meaningful attention is now more critical than ever. Whether designed with intention or not, the policies established today will form long-range expectations that will be very difficult to modify in the future. If Minnesota wishes to have the prosperity it had in past decades, the solutions will need to be robust, effective, and immediate.

II. Charge of the Budget Trends Study Commission

The Budget Trends Study Commission was established by the 2007 Minnesota State Legislature. The Commission is charged with studying the impact Minnesota's changing demographic trends will have on the long-term stability of state budget conditions, including examining revenue volatility and trend growth rates, current spending pressures, long term revenue forecasts, and projected expenditure obligations. The Commission was informed by past commission reports and consulted with various state agencies, including the Minnesota departments of Revenue and Education, the State Demographic Center, the Office of Higher Education, and Minnesota Management & Budget (MMB), on current demographic data and analysis, long-term projections of revenues and expenditures, and analysis of tax base volatility.

This report contains the Commission's findings and recommended actions. Additional information, including the full content of presentations made to the Commission, can be found on MMB's web site. It is the Commission's hope that this report will assist the Governor and State Legislature in proactively addressing long term budget stability.

III. Background: Past Commission Reports

The Budget Trends Study Commission builds on the valuable work of previous Minnesota commissions and work groups that have convened over the last 25 years to address state government finances. Many of the issues the state is currently facing have been discussed for decades and remain relevant today. The Commission has mindfully incorporated their insights into this report.

Past reports have focused on some combination of three topics: improving tax policy; promoting economic growth; or adjusting budget processes. The most common focus has addressed revenue system changes and policies directed toward achieving enhanced revenue stability. A recommendation often encouraged is a broadening of the sales tax base to increase revenue predictability and fairness in the tax system. Other revenue themes included the need to maintain simplicity in the tax system by decreasing the number of tax credits, deductions, and exemptions allowed. Others suggested improving predictability by minimizing annual changes in the tax law. (Appendix A includes a summary of the past reports and their key findings.)

Past reports also address the need to use better financial management tools and spending controls in order to improve budget stability. Many of these recommendations form the basis for the state's current practices. Maintaining an adequate budget reserve, defining revenue and spending targets, and using more comprehensive long-range planning tools have all been recommended in the past. Previous commissions have recommended establishing spending controls, such as setting fixed spending targets for major expenditure areas that do not fluctuate based on forecast or entitlement changes. Establishing formal contingency plans in the event of insufficient revenues has also been suggested.

The Budget Trends Study Commission has built on an extensive body of work provided by previous commissions. As much as these past reports provided a base for this commission to work from, topics such as the impact of demographics on revenues and spending, the size of the budget reserve, and the issue of budget volatility were not directly addressed. It is our intention that the Budget Trends Study

Commission's recommendations be added to this body of knowledge so that it might help to frame current and future budget discussions.

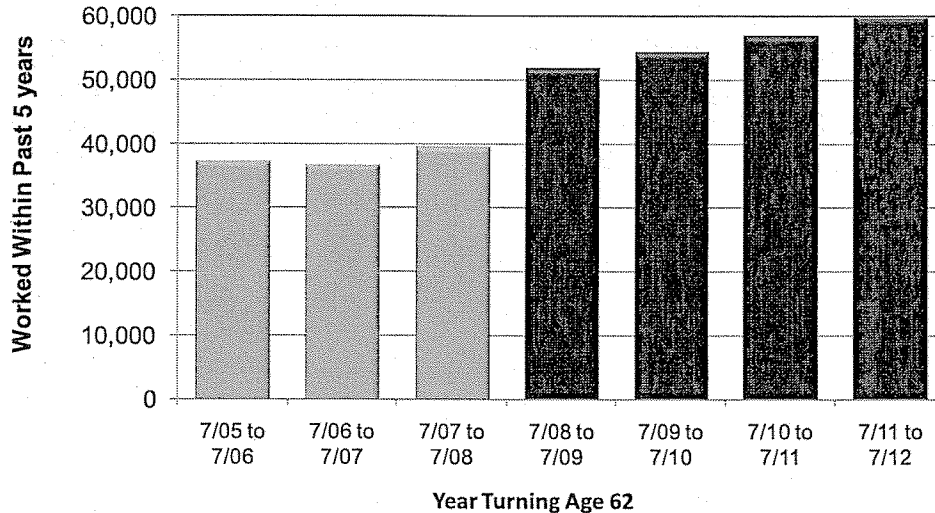
IV. Commission Findings

Over the last year of deliberations, the Budget Trends Study Commission carefully considered numerous presentations on current demographic analyses, policy area overviews, and original economic research and analysis. These presentations provided the source for 14 principal findings, which are listed below.

Finding #1: Minnesota is currently experiencing a major, long range demographic shift.

The first of Minnesota's 1.4 million baby boomers started to reach traditional retirement age in recent years and are now becoming eligible for Social Security benefits. Beginning in 2008, the state will see a 30 percent increase in the number of workers turning age 62. The aging of Minnesota's largest generational cohort will continue to accelerate over the next 12 to 13 years and their pending retirement will put an incredible strain on the state's labor force, private and public sector employers, tax revenues, and priorities for public spending moving forward. Although little has been done to prepare for this demographic shift, it will have extraordinary implications for the state's economic and workforce development priorities, health care, economic assistance, social service, and education programs.

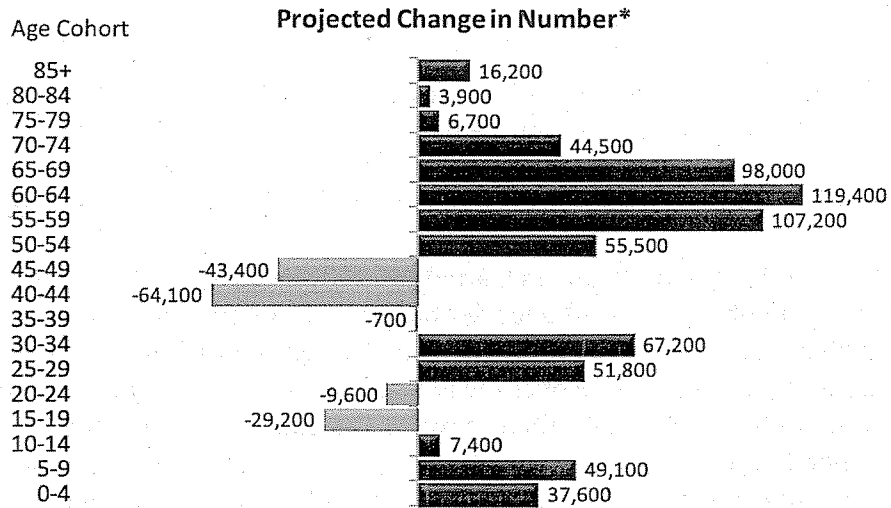
Minnesota will see a 30 Percent Jump in Workers Turning Age 62 Beginning 2008



Source: Minnesota State Demographic Center & American Community Survey (2005)

Interpreting the impact of this demographic trend was a significant element of the Brandl-Weber report entitled *An Agenda for Reform*. Written in 1995, it argued that current spending trends are unsustainable given the demographics of the state and the nation. The report recommended changes to the spending and budgeting processes. These were ultimately obscured, however, by a short-lived increase in revenues beginning in the late 1990s.

From 2005 to 2015, the Fastest Growth in Minnesota will be from Ages 55 to 69

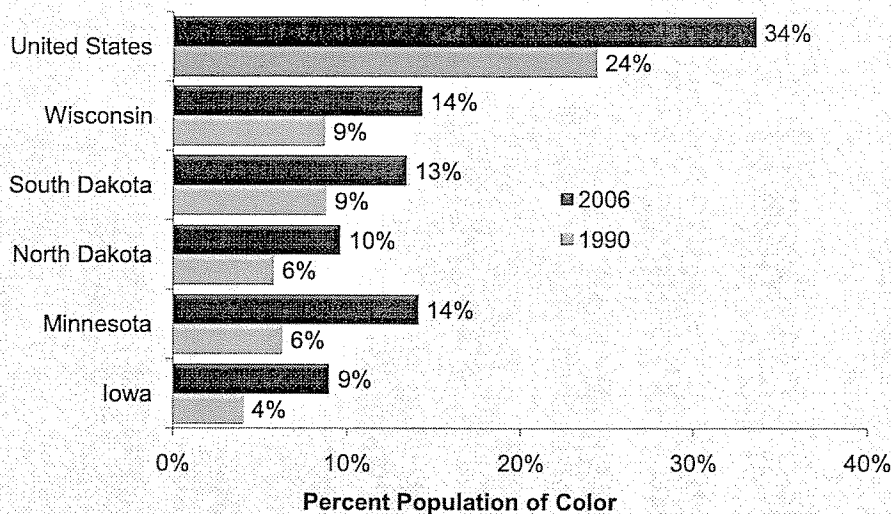


Source: Minnesota State Demographic Center
 *Numbers are rounded

Finding #2: Minnesota has become more diverse in recent years and this will continue to increase as economic growth depends on attracting new workers to the state.

Net migration, both domestic and international, continues to increase the diversity of Minnesota's population. Most migrants are younger, thus migration has slowed the societal aging process and is adding workers to the labor force. Younger migrants also increase Minnesota's fertility rates. Without migration, the population of Minnesota and the United States would currently be older and have fewer births.

Upper Midwest Becoming More Diverse But Still Less Than The Nation



Note: Population except white alone, not Hispanic, 2006 Census Bureau estimate
Source: Minnesota Demographic Center

While net migration has diffused the aging process, it has not reversed. For the next two decades, while most of the growth in the state and national population will be from people in their 60s and 70s, much of Minnesota's workforce growth will be migrants from other states and countries. The demand for new workers to replace the retiring workforce drives both international and domestic migration and will be increasingly necessary as Minnesota faces a reduction in the working age population. Minnesota's economic performance will be increasingly tied to the ability to attract new workers.

Finding #3: Public spending priorities will need to shift as Minnesota's economically dependent population grows larger and relies more heavily on fewer workers.

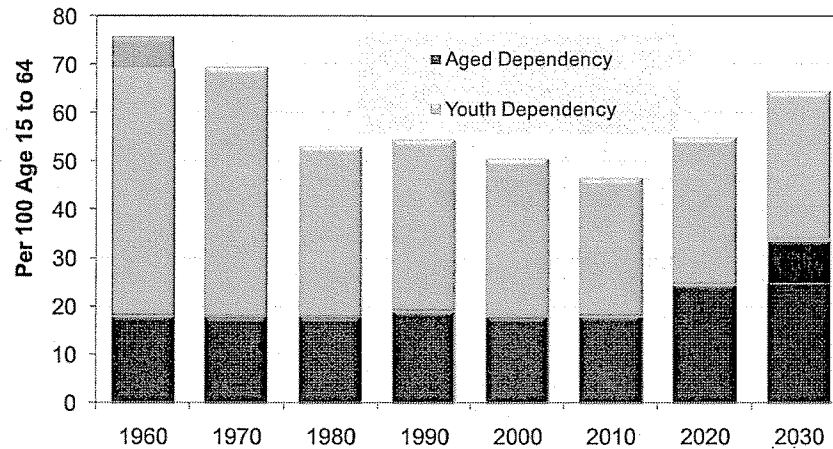
Since the 1980s, Minnesota's economy has benefited from having a peak level of workers in their peak years of productivity and earnings. This has fueled extraordinary economic growth and productivity gains. As the boomer generation begins to exit the labor force, however, a very large cohort in their late 40s to early 60s will be followed by a much smaller, younger, and less experienced generation currently in their 20s and 30s. As a result, the labor force will begin to grow at a much slower pace than encountered in the recent past and it will be necessary that new workforce entrants are adequately prepared to be productive contributors to the Minnesota economy.

The dependency ratio, which is a measure of the population that is traditionally active in the labor force versus those who are not, is currently at a record low. As baby boomers reach retirement age and Minnesota's labor force growth rates start to decline, the dependency ratio will begin to rise. This will mean that the earnings of the working age population will need to be stretched further to support the state's economically dependent population.

A rising dependency ratio will have profound implications on virtually all aspects of state and local government. For instance, a larger dependent population will put upward pressure on government expenditures. Dependent populations rely more heavily on health care, education, economic assistance, and social service programs. For example, when individuals in their late 40s and early 50s move into

their late 50s and early 60s, annual health care costs double, thus the aging of the baby boomers will have large effects on state human services, health care, and related expenditures.

Minnesota's Dependency Ratio is at an Historical Low and is Beginning to Increase Rapidly*



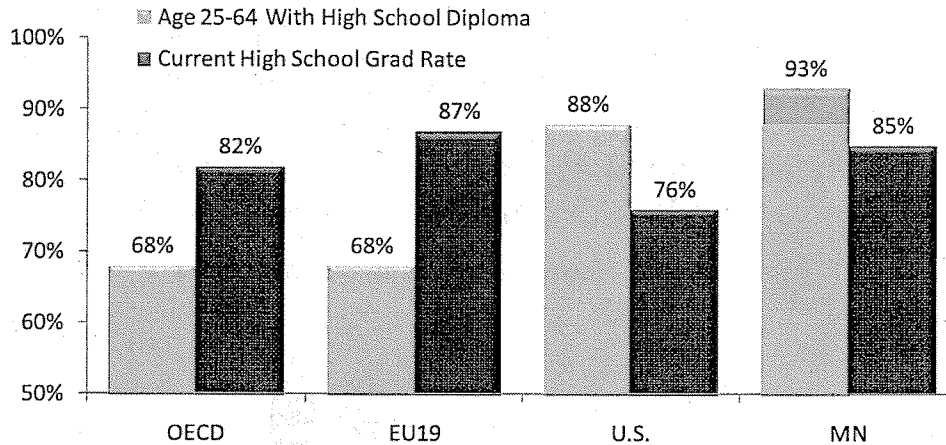
*The dependency ratio is calculated by comparing the number of people between the ages 0-14 and 65 and over to the number of people between the ages of 15-64.

As the demand for services targeted toward seniors increases there will not be a corresponding decrease in the demand for other essential state services, such as K-12 education. Current trends signify that by 2020 the number of seniors in the state of Minnesota will exceed the number of school age children for the first time. However, this change is due to the unprecedented number of individuals reaching age 65, not to a drop in the school age population. Over the next twenty years, the number of school age children in Minnesota will actually be increasing.

Historically Minnesota has had a very well educated population, with a high percentage of the population having a high school diploma. High school graduation rates, however, are declining in Minnesota and throughout the United States. This decline will threaten our ability to compete in the global economy. One particular concern is the drastic difference in graduation rates between white and minority students. High school graduation rates for black students, for example, are currently 27% lower than graduation rates for white students in Minnesota. There is an even wider gap reported in some publications that use a different methodology for measurement.¹

¹The graduation rates cited are provided by the Office of the State Demographer. There is currently not a clear consensus on the methodology for measuring graduation rates. The federal government is working on rules to standardize the methodology. The Minnesota Department of Education is moving toward the use of the National Governors Association Graduation Rate. The NGA rate is a four-year, on-time graduation rate agreed to by all 50 states. This methodology results in lower graduation rates than those provided above. More information can be found on the MDE website at www.education.state.mn.us

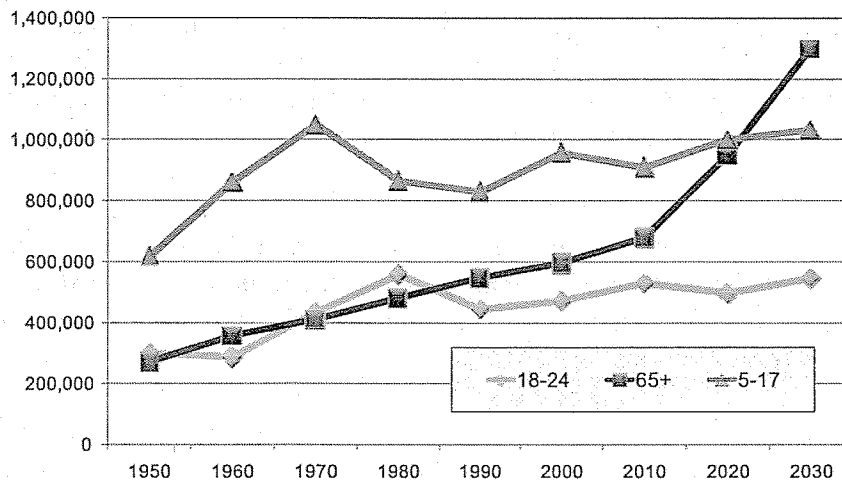
High School Graduation Is Declining In The US & MN While Increasing In Our Competitor Countries



Source: OECD Education At A Glance, 2005

The demographic shift will also impact the state's budget by placing downward pressure on revenues. A large percentage of the income seniors report on their tax returns is tax exempt. According to a recent study by the Minnesota Department of Revenue, two-thirds of Social Security, one-quarter of pension and IRA income, and 28% of the total income of the average Minnesota senior is tax exempt. The study also found that once an individual turns 60 years old the amount of income tax they pay declines much faster than their total income declines. For example, in Minnesota total income for individuals aged 65 to 69 is approximately 18 percent less than for those aged 55 to 59, while average income tax paid is approximately 40 percent less.

Critical Age Shifts of School Age and Senior Populations Beginning in 2008-2011 will Result in Changing Spending Priorities

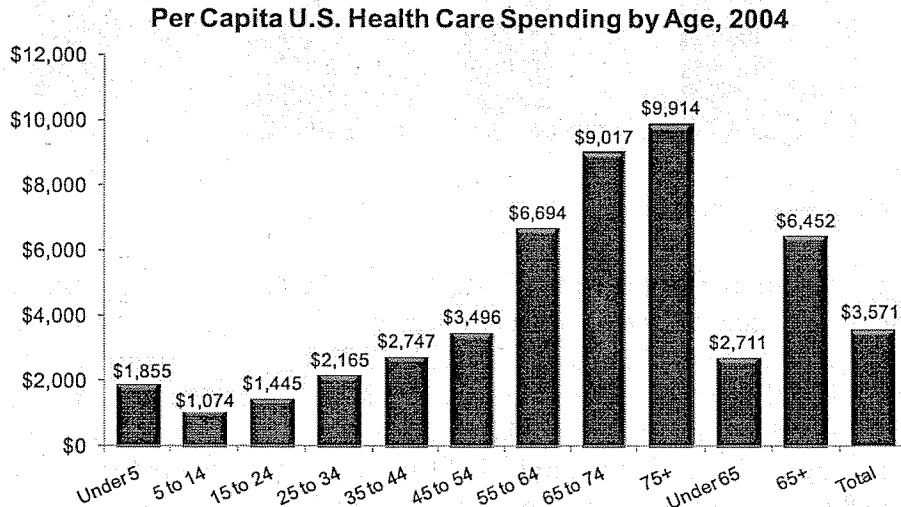


Census counts & State Demographer projection, revised 2007

Seniors also pay less sales tax than non-seniors. Based on a 2004 study of consumption differences by age, Paul Menchik of Michigan State University suggested that aging alone would reduce sales tax

revenue by 5 percent in the typical state between 2000 and 2030. In contrast, a more recent analysis by Peter Fisher of the University of Iowa suggests that aging by itself will increase sales tax revenues by 0.3% between 2005 and 2030. For Minnesota, Fisher estimates a small reduction in sales tax revenue of 0.2% due to aging. Overall, there are other reasons to worry about the future of sales tax revenues. For example, the general growth in the largely untaxed services sector and the inability to collect tax on many internet and catalog sales is more concerning than the aging of the population.

Individuals ages 45-54 Spend Nearly Half the Amount on Health Care as those ages 55-64



Source: Agency for Health Care Research and Quality, Medical Expenditure Panel Survey, data for per capita spending by age group in the Midwest. Excludes spending for long-term care institutions.

Finally, another likely impact of a rising dependency ratio will be an increase in the importance of information technology (IT) and its role in delivering state services. At a minimum, increasing IT capacity will be necessary to boost productivity of the remaining workforce. It will also be needed to support complex government programs and keep pace with the demands of the citizenry regarding customer service, access to information, and system integrity. Government currently depends on a loosely coordinated network of county and state workers to navigate a complex array of regulations and program objectives. This strategy will certainly not work for the future without support for information systems that provide necessary controls over funds, convenience for customers, and provide policy makers better and timelier information.

Finding #4: Despite continuing to rank high among many key social and economic indicators, Minnesota's economy has underperformed recently relative to the nation. Accordingly, the Governor and Legislature should be conscious of assumptions regarding future economic growth when proposing budgetary changes.

Minnesota's economic performance has outpaced the national average over the past half-century. In 1960, for example, Minnesota ranked 25th in the nation in personal income per capita. By 2006, the state ranking was 14th.

Past performance, however, does not ensure future success. The vibrant "dot-com boom" economy of the late 1990s left Minnesota with strong momentum moving into the 2001 recession. This arguably

helped dampen the severity of the downturn. During the subsequent recovery, however, Minnesota's population and employment growth slowed significantly relative to the experience of the 1990s. Despite continuing to rank high in many key areas, by 2004, both indicators had begun to significantly lag national growth for the first time in at least a decade.

While there are additional factors that could weigh more heavily on the state's economy than on its national counterpart, some of the recent economic underperformance can be attributed to short-term fluctuation in the business cycle, such as the slump in new housing construction, abnormal financial market conditions, or the sharp decline in spending for automobiles and household durables. Likewise, Minnesota has not benefitted from strong growth in national defense spending or energy production and has suffered from challenging times in the airline industry. A satisfactory explanation for this phenomenon, or whether Minnesota's recent economic underperformance will continue, will not likely be available until well into the recovery.

Finding #5: Demographic and economic factors will lead to lower growth of state tax revenues over the next 25 years.

Minnesota's economy will grow over the next 25 years, but both state and national real (inflation adjusted) growth rates are expected to be well below those experienced during the late 1990s. Between 1996 and 2000 real GDP grew at an average annual rate of 4.1 percent. Between 2026 and 2030, Global Insight's trend growth forecast shows real GDP growth rates averaging just 2.4 percent. That slowdown in national economic growth rates is expected to produce slower general fund revenue growth in Minnesota.

As Minnesota's population ages over the next 25 years, retirees become an increasingly larger proportion of the tax payer base. Between 2005 and 2030 the number of Minnesotans age 65 to 69 will increase by 120 percent; the number between age 70 and 74 by 140 percent. Both the slowdown in projected real economic growth rates and the increased percentage of the taxpayer base over age 65 will affect the long-term state revenue outlook^{2,3}.

² Long Term Revenue Forecast Assumptions: Projected state tax revenue growth rates for the next 25 years were prepared for the Commission's use by Minnesota Management and Budget's economic analysis division using economic assumptions taken from the Global Insight, Minnesota's national economic consultant, trendlong scenario prepared in February, 2008. The long-term projections assume the economy suffers no major mishaps between spring 2008 and the end of the 25 year forecast horizon. In that scenario actual output is assumed to be equal to potential output and no recessions are included in that projection.

Estimates of the changes in the age distribution of Minnesota taxpayers were made based on projections provided by the State Demographic Center. The models used in the long-term revenue forecast exercise were the same as those used in the twice yearly biennial revenue forecast with one important exception. The income tax model was adjusted so that the filer base in 2033 reflected not only the income growth that occurred over the 25 year forecast horizon, but also the change in the age distribution and the accompanying changes in the composition of income that would occur given the changes in age distribution. Finally, an analysis of the impact of individuals moving from no-filer to filer status conducted by Minnesota Department of Revenue staff showed no material effect on projected revenue growth rates.

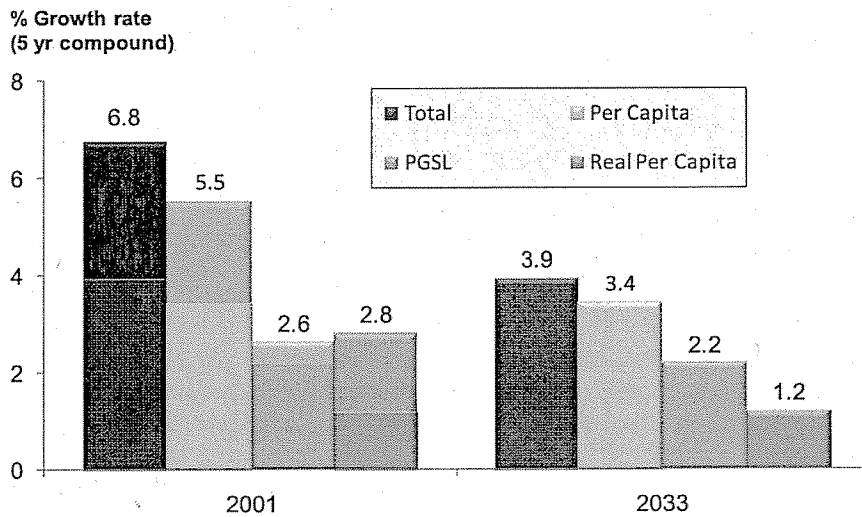
Labor force growth rates used in Minnesota were below the national average between 2020 and 2030 of the forecast horizon. The slower work force growth used in the long-term projections was not due to a declining labor force participation rates among those 16 to 64. The projected growth rate for that group, 81.1 percent, was still well above the projected national average of 75 percent. Nor was it due to lower than average participation rates for those over age 65. Minnesota remained above the projected national average participation rate for that age cohort as well. The reason labor force growth is expected to be below the national average is that the number of Minnesotans over the age of 65 is growing faster than the national average and the number of Minnesotans 16 to 64 is not expected to grow as fast as the US average.

The long-term revenue projections indicate that state policymakers should expect significantly slower revenue growth over the next 25 years than occurred during the late 1990s. Between 1996 and 2001 state revenues grew at a compound annual rate of 6.8 percent. Looking to the future, expected revenue growth between 2028 and 2033 is 3.9 percent. After adjusting for population growth and inflation, real per capita revenue grew at a compound rate of 2.8 percent between 1996 and 2001. Between 2028 and 2033 real per capita revenues are expected to grow by 1.2 percent.

The Impact of Changing State Law

The impact of changing state law with respect to the tax treatment of social security and pension income was also examined. Exempting social security was estimated to reduce the compound growth rate of state revenues by 0.14 percentage points, while exempting all pensions would reduce state revenue growth by 0.26 percentage points. If both pensions and social security were exempted from taxation state revenues would grow at a 3.4 percent compound annual rate for the 25 year study period, 0.37 percentage points less than baseline growth. In the latter instance state revenues in 2033 would be about 8.5 percent less than under current law, income tax revenues would be 14.4% less.

5 Year Compound Growth Rates of Minnesota State Revenues: 2001 & 2033



Source: Analysis from Minnesota Management & Budget (MMB)
 * PGSL is the price deflator for State and Local Government purchases of public goods and services.

³ Long-term Revenue Forecast Sensitivity: To examine the sensitivity of the long-term growth rate as a result of shocks to the economy, a series forecasts were made using less optimistic assumptions. In general, results were relatively robust with compound growth rates between 2008 and 2033 changing only modestly. Using long-term growth rates for wages and consumer spending taken from Global Insight’s cycle scenario reduced the long-term growth rate from 3.8 percent to 3.4 percent. Using the cycle’s projected growth rates for nominal wages and consumer spending and reducing the forecast growth rate for non-wage portfolio income by 2 percentage points from that used in the trend forecast produced a compound growth rate of 3.0 percent between 2008 and 2033.

