Minutes*

Senate Committee on Finance and Planning
Tuesday, April 6, 2010
2:00 – 3:45
238A Morrill Hall

Present: Judith Martin (chair pro tem), Jon Binks, Sarah Chambers, Jennifer Dens, Devin Driscoll, Steen Erikson, Lyndel King, Thomas Klein, Joseph Konstan, Fred Morrison, Paul Olin, Terry Roe, Mandy Stahre, Thomas Stinson, John Worden, Aks Zaheer

Absent: David Chapman, Lincoln Kallsen, Kara Kersteter, Russell Luepker, Kathleen O'Brien, Richard Pfutzenreuter, Gwen Rudney, Michael Rollefson, Karen Seashore, Michael Volna, Warren Warwick

Guests: Julie Tonneson (Office of Budget and Finance)

[In these minutes: (1) Minnesota budget and economic outlook; (2) cost pools]

1. Minnesota Budget and Economic Outlook

Professor Martin convened the meeting at 2:35, explained that Professor Luepker was out of town, and welcomed Professor (and State Economist) Tom Stinson to the meeting to discuss the state's budget and economic outlook.

Professor Stinson distributed copies of a set of PowerPoint slides describing the budget outlook.

In February, 2009, a $4.6 billion deficit was projected for the state. The legislature and Governor solved $1.9 billion of that shortfall, leaving a $2.7 billion deficit; the Governor solved that remainder with unallotments and executive actions. After the Governor's actions, the state budget was in balance for 2010-11. The revenue forecast was then revised down in November, 2009, leaving another $1.2 billion deficit even after the unallotments. In February's forecast, the projected deficit fell by about $209 million as a result of increased revenue and lower spending, leaving a deficit of $994 million. That is where the state will be on 6/30/11 if all goes as forecast: with an approximately $1 billion deficit. The state is not (constitutionally) permitted to borrow money across biennia for operating expenditures (although it can for capital projects).

It is a good thing that the state cannot borrow across biennia, is it not, Professor Martin inquired? It is, Professor Stinson agreed, because without the financial discipline imposed by the state's Constitution it would be very tempting politically to allow spending to spiral out of control over time.

The projected $1 billion deficit the legislature and Governor are dealing with is on a state budget of about $31 billion, or about 3.2%.

The spending forecast is based on several key assumptions, Professor Stinson said. First, it incorporates the Governor's unallotments and executive actions (the $2.7 billion), but those unallotments are only effective in the biennium they are imposed. The savings from unallotments disappear in the 2012-13 biennium. Additional action will also be required if the court challenge to them is upheld. The

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forecast does not include the reinstatement of General Assistance Medical Care (GAMC) that the Governor and legislature agreed on this spring, which is $164 million. The federal stimulus funds, $2.5 billion this biennium, are also in the forecast, but they will not recur in 2012-13.

Professor Stinson noted that health and human services account for most of the savings in the spending forecast. K-12 education saw only a very small reduction, as did property tax aids credits and all other categories (including higher education, the DNR, etc.). The health and human services category spending will be reduced by $150 million.

The forecast for revenues for 2010-11 has been reduced by $1.131 billion, primarily in income taxes (down $874 million) and in "other" categories (down $426 million). Sales tax revenue is projected to be flat and corporate taxes to rise by $14.8 million. What is not widely recognized is that for three major taxes, the state is expected to receive less revenue in this biennium than it did in the 2006-07 biennium. Also, state receipts in the second half of calendar 2009 were 8 percent less than receipts in the second half of 2008. The state definitely faces a fiscal problem since it is committed to spending more than the current revenue system can support.

Professor Martin commented that she has heard the state could get rid of the corporate tax. At the rate corporate revenues are currently declining, Professor Stinson joked, it will not be long until the corporate tax revenues are trivial. But he also noted that he did not believe it would be a good idea to eliminate it, because one result likely would be that individuals would incorporate for a variety of reasons, thus significantly eroding the tax base. He also added that state corporate tax rates are not as important a factor in plant location as is generally perceived because the tax base is the share of corporate profits generated in the state and the allocation factor used is percentage of sales.

"We have gone through a great recession," Professor Stinson said. By historical standards, it will take much longer to recover this time; typically we lose one year of growth in a recession, but this time we expect to lose three years of growth, and the growth rate coming out of the recession is slower than has been the case in the past. We have gone through the longest and deepest recession since WWII. A graph plotting the increases and decreases in the GDP over the 16 quarters following the start of the recession demonstrates that for the recessions of 1980-82, 1990-91, and 2001, the recovery was quicker and stronger than for the period 2007-09. The forecast is for GDP to increase by only 4% above the point it was at at the start of the current recession. That is considerably less than the 10% increases observed following the three previous recessions. The question is why, Professor Stinson said. One would have thought that the 1980/82 recessions would have had a slow recovery, but they did not. The explanation that most economists accept is that the population demographics are different. The prime buying group (ages 20-40) has declined from 47% to 37% of the population, while the age cohort that is saving for retirement (ages 40-65) has increased by 10%. That group has lost so much wealth that it is expected to be focused on rebuilding savings and not on spending.

Few people actually care about the GDP, Professor Stinson commented; what they care about is employment and the unemployment rate. The U.S. economy has lost 8.4 million jobs since December, 2007, and employment is not expected to return to pre-recession levels until the end of 2012. But since the workforce will have grown during that five-year period, the unemployment rate is projected to remain high, finishing 2012 at just under 8%.

When jobs are lost wages decline, and this recessing has been particularly hard on wages. For the first time since WWII total wages paid in the U.S. declined. Current estimates are that in 2009 total wages were 4% less than in 2008. Wages fell for four consecutive quarters; since WWII wages had fallen in only one quarter before 2009.

The loss of jobs and wages are the reason that tax receipts in Minnesota were down, Professor Stinson said. Employment in Minnesota was down 4% during this recession; wages fell by 5.5%. A 5.5% drop in wages creates a "big disturbance" in income tax receipts, Professor Stinson noted.

Minnesota is facing significant long-term budget problems, Professor Stinson told the Committee. Many may not realize this is not a one-time problem, and is long-term, because they do not recognize that the recession permanently reduced the base for future revenues. In February of 2007, the outlook was that state revenue and expenditure lines were roughly in balance looking toward the future. With the onset of the recession, revenues dropped noticeably below expenditures. Revenues are now predicted to grow at roughly the same rate as expenditures—but from a lower base than before, creating a long-term structural deficit. The gap between revenues and expenditures can be filled in on a one-time basis with shifts and other emergency measures, but if the path of revenues and/or expenditures is not changed, those one-time steps just push the problem into the future. Unallotment and budget shifts did not solve the problem and a substantial structural gap remains for the next biennium.

Professor Martin asked if the revenue and expenditure projections were based on current law. They are, Professor Stinson said. Changes in tax law would change the slope of the revenue line and a permanent change in state expenditures would change the slope of that line. Professor Konstan asked whether, if economic recovery or increased taxes or a structural change in taxes produced additional revenue, how much increased revenue would be offset by automatic expenditure increases. Professor Stinson said virtually none because there are very few automatic spending increases in the state budget.

The current estimate of the 2012-13 state budget gap is $5.8 billion, Professor Stinson reported. Resources are projected at $32.9 billion; spending is projected at 38.7 billion. The resource number reflects about a 10% increase in revenues over 2010-11. The spending projection includes only mandated cost-of-living increases, but no adjustment for general inflation. If inflationary increases are included ($1.181 billion), the projected budget gap grows correspondingly larger.

Mr. Driscoll asked if it is true that Minnesota is the only state that does not include inflation in its budget projections. It is, Professor Stinson said, but few states do five-year projections. He said that ignoring inflation is bad financial management and that it causes the official numbers to understate the size of the budget problems the state will face in the next biennium, but he also noted that the inflation number is well-known and visible in the state forecast.

Professor Konstan asked Professor Stinson if his office has looked at the impact the new health-care law will have; will there be increased expenses or savings? Professor Stinson said they have not looked at it because their forecast horizon goes only through FY2013, and the biggest changes occur in 2014 and beyond. It may be, however, that the state will receive some earlier funds from changes in the healthcare law which could help solve the 2010-11 budget deficit.

Professor Stinson went on to caution Committee members that they will in upcoming months hear a lot of numbers about the 2012-13 budget gap, and the numbers will vary depending on whether one adds in inflation, repays the K-12 aid shift, counts the unallotments, and so on. No matter what is done, it is almost impossible to get the projected deficit below $3 billion.

What is the impact if the unallotments are repeated, Professor Morrison asked? Professor Stinson, noting again that the Governor's actions totaled $2.7 billion in reductions, said that $400 million was in one-time accelerations that cannot be repeated. Of the remaining $2.3 billion, $500-600 million is a change in the property-tax recognition shift that is not scheduled to be bought back. The school-aid shift is scheduled to be bought back in 2012-13, so that $1.2 billion is available for unallotment, as is some additional spending that has been temporarily reduced or eliminated, but the amounts available fall far short of solving the projected 2012-13 budget shortfall.

Professor Morrison observed that nominally the University's base budget would spring back to $702 million it began the biennium with, but he said he is not optimistic it will stay there. Professor Stinson assured Professor Morrison that he should certainly not be optimistic.

Mr. Klein asked if there have been any thoughtful recommendations about the state's economy. This is beyond his charge as an economist, Professor Stinson commented, but the 2010 election will be very important because it will decide who draws the redistricting boundaries that determine electoral districts for the next ten years. Because the elections are so important, neither party wants to alienate any significant portion of the electorate. Restructuring the state budget would mean some groups would be adversely affected, so it is in the interest of both parties to downplay the problem going into the election. So there is a shared interest in pushing out solutions into the future, Mr. Klein commented. Past the election, Professor Stinson agreed. He said he did not believe it would be possible to push the problem past the next legislative session.

Is either of the tax committees trying to address the issues, Mr. Driscoll asked? The chairs of both House and Senate tax committees understand the issues, Professor Stinson said. People understand the problems; it is just not in their interest do anything about them, especially because there is no possibility of reaching agreement, given the current relationship between the legislature and the Governor.

Professor Konstan said he thought there are two long-term problems. If the state gets on the path to closing the budget gap that is not patching, then it needs to develop a budget model to deal with economic cycles; is anyone thinking about dealing with downturns? They are, Professor Stinson said, and Minnesota has a good history of doing so. It has built and used up budget reserves a number of times in recent years. In 2008 the legislature directed his office to conduct a long-term budget study to look at the volatility of state revenues so that the state can make predictions about the use of reserves (the study called for a larger reserve than the state had at the time. The legislature also asked about changes in the tax system to reduce volatility. One possibility is to reduce the tax rate on capital gains and increase the tax rate on higher incomes in a revenue-neutral manner. Another possibility is to move away from taxing corporate incomes and increase the property taxes on corporations.

Professor Morrison inquired about the budget projects on one of the slides. If the projected 2012-13 state budget gap is $5.8 billion, half of that is $2.9 billion, so what are they looking at in terms of budget problems in May of 2011? For each of the following two years? "Who knows?" Professor Stinson replied. The unpleasant arithmetic is that K-12 is much of the budget and it is pretty well protected. Health care and human services are pretty well protected. That puts a lot of the budget off limits. So the legislature will have to turn to property tax aids and credits and the $7 billion in other state spending. There is only a limited amount that one can cut state operations, so higher education looks like an attractive target.

The changes in funding for higher education tracks demographic changes in the population, Mr. Driscoll commented. The population is getting older, so a tax structure based on sales and consumption will produce less revenue. Professor Stinson agreed. The changing growth rate of taxes reflects the changing demographics

Professor Morrison said he worried about the internal University budget for each of the two years in the biennium, not the biennial total. In theory the budget base will spring back to the $702 million it was before the unallotments and reallocations of the past couple of years, but that is not realistic. The state is short about 20% of its annual budget. A 20% cut times the University's $702 million base budget equals a cut of about $140 million from that base. The budget instructions from the state in August or September will provide the starting point, Professor Stinson said, but they will come from the current administration. The Governor elected in November will be the person who prepares the budget proposals for 2012-13 for submission to the legislature.

If there are changes on the revenue side, Professor Konstan said, the pressures will be different; they will be to protect spending priorities. Can they raise enough or will they just raise some, while still making cuts? Professor Stinson said the state would need a 30% increase in revenues to solve the problem, and that is not possible, so the response will require a mix of solutions.

Professor Martin thanked Professor Stinson for his report.

2. Cost Pools

Professor Martin turned to Ms. Tonneson from the Office of Budget and Finance to review the cost-pool budgets.

Ms. Tonneson distributed a handout and began by reviewing the budget-development timeline for both support units (in the fall) and academic units (in the winter/spring). She pointed out that they do not develop the cost-pool rates first; they set the budgets for each support unit, and then the rates come out at the end of the process. At the end of the process (this year not until June), the President presents a recommended budget to the Board of Regents, first for review and then for action.

The budget decisions for service units focus on three major items: compensation, strategic academic priorities, and infrastructure and related costs. The unit heads meet with Senior Vice Presidents Cerra, Jones, and Sullivan, Vice President Pfutzenreuter, and her; that group makes budget decisions (subject to final approval by the President and Board). More often than not, right now, they are saying "no" to proposals, Ms. Tonneson reported, or are telling units they will have to fund them from internal reallocation—so there is no impact on the cost pool. Another source, for a few units, is generation of additional revenue. The approved unit budgets are added to the appropriate cost pool. It is during this period that they also assign budget cuts. The same process and major foci occur for academic units, and they also discuss the impact of any change in the cost pools.

Ms. Tonneson next reviewed the FY09 cost-pool charges, by each of the 17 cost pools, the dollar change from the previous year, the percent change, FY10 charges/dollar change/percent change, and the same for FY11. She also provided the same data by category of expenditure (compensation, student financial aid, building operations/utilities, etc.).

The total cost-pool charges in FY09 were $465.5 million, an increase of $21.5 million or 4.7% over the previous year. The FY10 charges were $480.7 million, an increase of $5.1 million or 1.1%. The FY11 charges are to be $497.5 million, an increase of $16.8 million or 3.5%. Ms. Tonneson noted that the cost pools saw $19 million in base budget reductions during FY10, which is what limited the increase to 1.1%.

Committee members touched on a few of the datapoints.

-- Professor Martin inquired what a 25% cut in the General Purpose Classrooms cost pool implied. Mr. Todd said it meant their ability to upgrade classrooms would be slowed; they are facing a 32% cut in FY11, which means they will be able to cover only ongoing technology costs and will have only half as much money for upgrades as they had previously.

-- Professor Konstan asked if the Student Services—Graduate cost pool, which increased by 1.68% from FY10 to FY11, masked changes. There were decreases as well as increases within the cost pool, Ms. Tonneson confirmed, but they were not all related to organizational changes in the Graduate School.

-- Professor Konstan suggested that the 3.1% increase (FY10 to FY11) in Support Service Units Systemwide would likely attract attention. Does the money go to units? It goes into the same broad categories she mentioned, Ms. Tonneson said: compensation, cuts, etc. They include changes in OSHA requirements as well as support for postdocs in the Office of Equity and Diversity.

-- The Student Services—Undergraduate, which is primarily financial aid, increased from $43.4 million to $50.4 million (FY10 to FY11), an increase of 43.7%. Ms. Tonneson observed that about one-half of the increase in the total cost-pool budget was due to increases in undergraduate student financial aid.

The Committee will meet in two weeks with the authors of the Faculty Senate motion requesting an "audit" of expenditures, Professor Konstan said. It will be an interesting challenge to distill these numbers down so that they are clear in what they mean—here is what is being cut, increased, new, and so on—so that people can decide if they are glad the University invested money in one place and cut it in another. This has nothing to do with a financial audit; it looks at dollars and ties them to functions.

Mr. Klein asked if there were any examples of support units that identified innovative ways to solve problems, approaches outside the norm. Ms. Tonneson said it was difficult to think of any without the record of each unit in front of her; she mentioned that the combination of emergency-responder services was one (which will involve reducing staff) and the innovations begun in Facilities Management this year and still being phased in.

Professor Martin said she was surprised to see a 9% increase in utilities, because that is different from what the Committee heard about utilities. Ms. Tonneson noted that the 9% is an estimate for FY11 while the number for FY10 is planned spending. Professor Martin said she would ask Associate Vice President Berthelsen to provide a report to the Committee.

Professor Zaheer asked if there are incentives to units to permit them to keep savings. To the best of their ability, that is what they do, Ms. Tonneson said. Aside from utilities, they did not do well in FY10 because of the large cut in the state appropriation; for FY11 they are trying to leave savings in cost-pool spending in the units. What about tuition increases, Professor Zaheer asked? Tuition revenue is a critical way units control revenues and add to investments; will the administration be sweeping them? The undergraduate colleges and the Graduate School do not control tuition increases, Ms. Tonneson noted; the increase will be 7.5% in order to balance the budget (they would much prefer to recommend a lower number). They will look at what 7.5% and stable enrollment will generate for each unit and what is spent in each unit—they will not have total discretion. If they have an enrollment increase and additional revenue, expenditure of those funds will be at the discretion of the unit. In the case of the professional schools, if they wish to increase tuition more than 7.5%, it is their money to spend. If they increase LESS than 7.5%, that is a cost to the University in balancing the budget—but they will not necessarily insist that the unit give funds back to the University.

Professor Konstan said it would be ideal if academic units can retain savings in cost-pool expenditures. Does that same rule apply to central cost pools? If Facilities Management saves $10 million, it should not be allowed to spend it on $10 million in Facilities Management priorities; perhaps it should retain $1 million and the remainder spent on University priorities. A vice president who saves money should not be allowed to spend the savings on his or her priorities. Ms. Tonneson agreed but said it is difficult to think about that problem in the face of so many cuts. A lot of support units are small, so they cannot achieve significant savings. In the large units, if there were a major change in activities and savings, that would warrant discussion.

Ms. King suggested that the website with cost-pool information indicate the units that are part of each cost pool. Ms. Tonneson agreed that was a good idea.

Professor Martin thanked Ms. Tonneson and adjourned the meeting at 3:35.

-- Gary Engstrand

University of Minnesota