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Money Matters

A Publication of the Minnesota House Fiscal Analysis Department on Government Finance Issues

Budget Issues in the 1997 Session

Abstract: *This paper provides a brief summary of some fiscal issues facing the 1997 Legislature. It is not intended to be exhaustive or to suggest what may happen with the issues. For more information in any particular area, please contact the fiscal analyst listed following that issue-area summary. The paper is organized according to the 1995-96 jurisdictions of the respective House fiscal committees and divisions.*

A variety of issues face the 1997 Legislature. The Legislature will have some additional funds available with which to work. (See a separate *Money Matters* paper on the November 1996 state revenue forecast.)

Economic Development, Infrastructure, and Regulation Finance

During the 1997 legislative session, much of the committee's attention will be focused on the ***Department of Economic Security***. The Department of Economic Security (DES) is a state agency responsible for the administration of Minnesota's unemployment compensation system. The DES is also in charge of ***job training programs, youth programs, low income energy assistance*** and several other functions.

Since the passage of federal welfare reform legislation, more pressure will be put on DES to prepare and help place unskilled persons into the workforce. The department is promoting its ***request to fund "Workforce Centers"*** to help place people into jobs. The workforce center is a one-stop approach that will give job seekers the assessment, training, and job counseling they need as well as access to computerized job listings across the state, all at one location. The Legislature appropriated $500,000 of the $1.8 million the agency requested during the 1996 session.

The ***Dislocated Worker program***, a program that provides retraining for the victims of business layoffs, may also be a topic of discussion. The Dislocated Worker fund is derived from a tax on an employer's payroll. Those employers subject to the unemployment payroll tax, are subject to an additional tax of one-tenth of 1 percent of payroll to fund the Dislocated Worker program. As in past sessions, it is expected that proposals to reduce or eliminate the program will be introduced.

Several programs formerly under DES jurisdiction have been moved to the Department of Children, Families, and Learning. One such program, LIHEAP or ***Low Income Home Energy Assistance Program***, was subject to federal cuts last year. Minnesota set a precedent by contributing $10 million to what had been strictly a federally funded program. For this federal fiscal year, the federal grant is expected to drop by an additional $3 million.

In addition to LIHEAP, the ***federal weatherization program*** was subject to budget cuts last year as well. The purpose of the program was to provide insulation and other energy related repairs to low income housing to reduce the burden of heating costs. The President's budget proposal includes further cuts in the program; it is unclear if congressional proposals will be similar or possibly include deeper cuts.

For more information on Economic Development, Infrastructure & Regulation Finance issues, contact John Walz, 296-8236.

Environment and Natural Resources Finance

In the 1997 session the committee will likely spend most of its time addressing the current activities of the environmental agencies, their success in meeting the directives in past legislation, and determining the correct level of funding and activities for the next budget period.

Specific issues likely to be addressed in the 1997 session include several items that were earmarked for study in 1996. One of those issues is the ***reorganization of the state's environmental programs and agencies***. In *Laws* 1995, Chapter 248, Article 5, it was required that both the legislative and executive branch study the current assignment of environmental and natural resources programs among the state agencies and make recommendations to the Legislature on changes to the structure to better coordinate the services.

The Legislature required interim studies or reports by the Department of Natural Resources on the following items: changes to the snowmobile grant in aid program to make additional funding available for the local organizations; a report on the implementation of the additional funding to the forestry programs; and implementation of the integrated resource management pilot project.

Another item under study during the interim is the ***ethanol producer subsidy program*** that is administered by the Agriculture Department. The Legislative Auditor is preparing a report on the program and will be sending it to the Legislature early in the 1997 session.

The ***Legislative Commission on Minnesota Resources*** has reviewed the applicants for funding in the FY 1998-99 budget and will be making final recommendations early in the session. The committee will then make decisions on these projects.

In reviewing the ***Pollution Control Agency***, the committee will likely be considering the changes to the point source water pollution programs as recommended by the task force created to study the issue. There is also likely to be some review of the actions taken by the PCA since last session regarding reorganization of the agency and it operations and the strategic goals of the agency.

For more information on Environment and Natural Resources Finance issues, contact Jim Reinholdz at 296-4119.

Education — Higher Education Finance

Preliminary budget information indicates that the requests in higher education will be approximately $411 million above the adjusted base budget of $2,078 billion, an increase 19.7 percent. The University of Minnesota Board of Regents has approved a new partnership proposal that will ask for $231 million over their FY 1996-97 recurring base ($928 million), an increase of almost 25 percent.

The Board of Trustees of the Minnesota State Colleges and Universities has not yet approved their request, but preliminary information shows that they plan to ask for a $114 million in General Fund appropriations over their FY 1996-97 recurring base ($909 million), an increase of 14 percent. MnSCU is also considering a proposal on financial aid involving $14 million in lottery proceeds.

The Higher Education Services Office, the state's financial aid agency, is currently considering a variety of options but has not approved a final request. Their biennial adjusted base is $241 million. Options that are being forwarded to the board for approval would cost $66 million over their recurring base, a 27 percent increase. It should be noted that increases are over the adjusted base rather than over actual appropriations for the FY 1996-97 biennium. The 1995 and 1996 higher education bills contained approximately $93 million in so called "one time funds." If actual spending for the current biennium is considered, higher education requests will amount to a 19.1 percent increase.

For more information on Higher Education Finance issues, contact Doug Berg at 296-5346.

Education — K-12 Education Finance

Appropriations limits, part of the compromise reached by the Governor and Legislature in 1995, will reduce the ***general education formula allowance*** in 1997-98 and after from $3,505 per pupil unit to $3,430 (—$75) and reduce the weighting applied to secondary students from 1.3 to 1.25 in 1997-98 and 1.2 in 1998-99. School districts are planning on a loss of $337 million next biennium as a result of these limits. It would cost the state about $270 million to restore the funding (the difference is because of some complications in the way the limits are structured). If, on top of repealing the limits, discretionary inflation of 3 percent per year is added to the K-12 appropriations, the cost is an additional $330 million.

In addition to the appropriations limits, funding increases in the general education formula allowance and other areas will be an issue. A one-dollar increase in the general education formula allowance costs about $1 million.

A number of proposals to reform the property tax system and ***move school financing off the property tax*** were introduced in the 1996 session. Discussion of these options has continued and several plans may be introduced in 1997.

Some voucher-related issues will likely be discussed in 1997. Besides more traditional voucher proposals, discussion also includes ***tax deductions and credits for private school expenditures.*** (Minnesota law currently allows a tax deduction for school costs of up to $650 for elementary school students and $1,000 for secondary school students.)

A variety of proposals will be presented dealing with the ***use of technology in education***. The Governor has already made a three-part proposal for technology in K-12 education. It includes expansion of the statewide network, establishment of a learning academy for teacher training in use of technology and $50 million in challenge grants to put technology in place at the local level that would have to be matched locally.

For more information on K-12 Education issues, contact Bill Marx at 196-7176.

Health & Human Services Finance

The *Personal Responsibility and Work Opportunity Reconciliation Act of 1996* (federal welfare reform) enacted on August 22, 1996, brings major issues to the 1997 Legislature. Although the legislation reduces the flow federal funds coming into Minnesota, the reduction is not its greatest impact. The number and scope of decisions turned over to the States will have a far greater impact on Minnesota.

Welfare reform ended the federal entitlement to cash assistance to poor families. States will receive a fixed block grant to provide cash assistance to families with children. The new block grant is called Temporary Assistance to Needy Families (TANF). Currently, a typical family such as a single mother with one child, receives $5,244 or with two children $6,384 in cash assistance per year.

For the first time the Minnesota Legislature will determine:

- Who receives cash assistance,
- How long a family could receive it — up to five years,
- How much assistance they will receive,
- The employment activities required to receive cash assistance, and
- County agencies' administration funding.

The ***federal work participation requirements*** specify that 25 percent of the AFDC caseload must participate in work activities in the first year. By the year 2002 the requirement reaches 50 percent for all families. Minnesota's current employment rate for AFDC families is less than 20 percent. Many questions remain in the interpretation of the new law such as whether post-secondary education is allowed as an employment-related activity. The Legislature will determine the employment and training programs necessary to comply with the requirements. This may involve

costly ***job subsidization and job creation programs***. As an example, Wisconsin's estimated 1997-98 employment program budget for the AFDC population is more than $1 billion.

The federal legislation provides separate ***child care block grants*** to support Minnesota's employment and training programs funded to support the current level of participation. Over the next two to three years the state appropriation for the ***Child Care Fund*** may need to be doubled from the current biennium amount of $72 million to comply with the new participation requirements.

Federal legislation passed in 1996 also eliminated the guarantee of benefits to ***legal immigrants and some disabled citizens***. States have the option of continuing benefits by replacing lost federal dollars with state and local funds.

Disabled persons receiving Supplemental Security Income (SSI) who are legal immigrants and those whose primary diagnosis is Drug Abuse and/or Alcoholism are no longer eligible to receive benefits. They would have received $484 per month (100 percent federal funds) with which to live. With rare exceptions, these adults are not employable. Comparable state programs include: the General Assistance program that provides $203 per month, and a residential program such as Group Residential Housing (GRH) which costs about $420 per month. Other residential programs cost can cost up to $6,000 per month in state and local dollars. Often replacing the federal dollars to keep the adult living independently would be more cost-effective than funding a more costly residential facility. Due to a change in the disability standard, a redetermination for continued SSI eligibility will apply to about 3,500 children in Minnesota. About 2,000 children are expected to lose eligibility because of the redetermination.

According to Social Security Administration estimates, Minnesota has about 9,000 SSI clients that will lose eligibility due to federal changes.

Minnesota has approximately 13,000 to 16,000 legal immigrants receiving benefits from federal programs such as SSI and food stamps and joint federal/state programs such as Medical Assistance and AFDC. This number includes approximately 100 seniors in nursing homes.

Legal immigrants in the United States at the time of the new federal law's enactment lost their federal guarantee of eligibility for essentially all public programs. States have the option of granting eligibility to those legal immigrants for AFDC and Medical Assistance using their federal and state dollars. The legislation bars immigrants that entered the country after August 22, 1996 from receiving **any** federal benefits for five years. Providing benefit to the new immigrants would have to come from 100 percent state and local dollars.

For more information on Human Service Finance issues, contact Bill Marx at 296-7176.

Judiciary Finance

Major Crime legislation. Both the Governor's office, and Attorney General Humphrey with DFL House and Senate members, recently released major crime packages. The Governor's crime package focuses on prevention, enforcement, corrections and the judicial system. The DFL crime package focuses on targeting gangs and violent crime, taking guns off the streets, targeting out-of-state criminals, and violent juveniles, taking back neighborhoods, prevention and law enforcement. The estimated costs are $60 million for the Governor's package and $43 million for the DFL package.

The costs for the new prison at Rush City are currently coming in at five to 10 per cent more than the $89 million that was approved. The Department of Corrections is working on a plan to address the overruns.

Another issue will be the correctional facility at Red Wing. A Legislative Auditor's report showed this facility to have a very high recidivism rate. A Legislative committee is now looking at what the best plans for this facility should be.

The recommendations could range from closing the facility, privatizing the facility, or changing its focus.

Many reports in the criminal justice area are due in the new session. These major reports will deal with the following: inmate recidivism, study and recommendations on criminal justice information access and retention issues, a probation caseload reduction study, a statewide evaluation of corrections, an evaluation of prison industries, and victim services in Minnesota

For more information on Judiciary Finance issues, contact Gary Karger at 296-4181.

MinnesotaCare Finance

The MinnesotaCare program is funded through the Health Care Access Fund (HCAF), a dedicated special revenue fund. By statute, the HCAF must remain in balance for the current and succeeding biennia. When the 1996 session concluded, the forecasted balance in the fund was a surplus of $339 million at the end of FY 1999. The new forecast indicates that the surplus at the end of FY 1999 will be $419 million, with the surplus at the end of FY 2001 at $590 million. The primary reason for the increase in the surplus amount is the conversion of MinnesotaCare to managed care. The Department of Human Services is currently entering into managed care contracts for MinnesotaCare enrollees, and those contracts are coming it at a lower cost than was expected when the February 1996 forecast was released.

The projected surplus will be a key issue for discussion in the 1997 Legislature in the MinnesotaCare program. With excess money available, one issue that will be discussed will be reducing the taxes on providers, hospitals and insurers that fund the program. In addition, ***increasing eligibility for single adults and adults without children*** will also be considered, given that when the program was initially adopted, the income limit for this group was expected to be the same as that for families with children, 275 percent of the Federal Poverty Level (FPL), and that current eligibility for adults without children and single adults is 135 percent of FPL. Finally, given the size of the surplus, there might also be attempts to move other health care expenditures not related to MinnesotaCare into the HCAF.

For more information on MinnesotaCare Finance, contact Greg Crowe at 296-7165.

State Government Finance

In 1996, $1 million was appropriated for an impact analysis and staffing in the Department of Administration related to issues with ***the "Year 2000" and state information systems***. The Governor had requested $7.2 million for "Year 2000" issues in 1996. The "Year 2000" problem is that most computers are not programed to handle the year change from 1999 to 2000. Computers use the last two digits of the year, so 2000 will be "00" and the difference between 1999 and 2000 will be 99 years rather than 1 year. This affects many calculations done by computer (age, years of employment, eligibility for various programs) and no easy solution has yet appeared.

Implementation of the Statewide Systems Project continues. This is the new state accounting system that includes components for accounting and procurement, employee management, and information access. The 1996 Legislature did not fully fund the Department of Finance (DOF) costs for the continued implementation of the system but instead allowed DOF to bill state agencies for any operating deficit. The costs billed to state agencies totals $6.2 million for FY 1997.

The Governor has created an ***Office of Technology***. This office is to monitor and develop technology requests for state and local governments. It will review all technology related requests in the state budget.

For more information on State Government Finance issues, contact Bill Marx at 296-7176.

Taxes

As a response to the anticipated budget surplus, the Governor has stated that he will propose a one-time individual income tax rebate and unspecified permanent changes in tax law to reduce state revenue. It is likely that some members of the Legislature will advocate using part of the budget surplus to fund property tax reform or relief rather than an income tax rebate.

Individual Income Taxes

Federal Update: More than One Hundred Law Changes. The structure of the state income tax is closely tied to the federal Internal Revenue Code: Minnesota uses federal taxable income as the starting point for the state income tax. Between August and October 1996, Congress enacted four major federal bills containing more than a hundred tax law amendments that affect individuals, businesses, employee benefits, employment taxes, insurance, pensions and retirement, financial institutions, tax-exempt organizations, and federal excise taxes. Many of these provisions have a direct bearing on Minnesota's income tax. Other provisions may affect state tax collections indirectly and over time, as taxpayers and the economy respond to the new federal tax laws. The Minnesota Supreme Court has held that the Legislature cannot prospectively conform to federal law, so in the next session lawmakers must decide, item by item, whether to tailor the state tax code to fit the new federal pattern. Revenue estimates for "federal update" legislation are not available yet, but full conformity would result in a net gain in state revenue.

Governor's Proposals

One-time rebate or permanent tax cut? With individual income tax receipts contributing more than 60 percent of the forecast revenue surplus, Governor Arne Carlson told news reporters in November that once again he is "exploring" a one-time (nonrecurring) income tax rebate. Twice before (in 1993 and 1995) when there were temporary revenue surpluses the Governor floated the idea of an income tax rebate, but he did not include a rebate in any of his budget proposals. He told reporters at a post-forecast news briefing on November 26 that any permanent income tax cuts would be targeted to families with children.

New Tax Credit, Expanded Deduction for K-12 Education Expenses. On December 3, the Governor announced his ***"Access"*** tax credit/deduction initiatives, evidently replacing his controversial 1996 school voucher proposal.

- Governor Carlson advocates ***a new income tax credit*** for tutoring, summer school and alternative learning fees, or private school tuition. Families with income less than $39,000 could claim a credit up to $1,000 per child but limited to a maximum $2,000 per family. Families who educate their children at home could claim a $1,000 credit under the proposal. (The initial announcement was short on details such as how 'family,' 'income' and 'alternative learning' are defined, or how this credit would interact with other tax credits and the education expenses deduction.)

- The Governor also backs ***a three-fold increase in the existing state income tax deduction for education expenses*** from a maximum of $650 to $1,950 per child in grades K-6 and from $1,000 to $3,000 per child in grades 7-12. The deduction currently covers actual expenses for nonpublic and public school fees, tuition and qualifying expenses. Carlson would expand eligible expenses to include computer hardware and software purchases, tutoring, alternative learning, after-school enrichment and other (unspecified) expenses. Currently, Only parents who itemize deductions on the federal tax return can take this deduction on the state return. The combined tax expenditure for the new credits and deduction expansion is an estimated $150 million per biennium.

- The Governor also will bring back his ***"EdVest"*** proposal which would allow each taxpayer to set aside up to $2,000 per year in a "higher education trust" toward tuition and post-secondary expenses of a family member. (A married couple could set aside $4,000 per year.) Both contributions and investment income would be exempt from state income taxes after the accounts are held for at least 5 years if the proceeds are used for qualifying purposes. Last year when EdVest was in the Governor's budget, the Department of Revenue estimated that the tax expenditure was between $30 and $34 million for an initial biennium, with rising revenue losses in each successive fiscal year. That estimate assumed that about one-fourth of taxpayers with children and federal adjusted gross incomes between $50,000 and $100,000 per year would use the program, while 60 percent of taxpayers with children and FAGI more than $100,000 would participate.

Sales and Use Taxes

Eliminating the Sales Tax on Replacement Capital Equipment, Parts and Accessories. The sales and use tax rate on replacement capital equipment (for manufacturing, fabricating, mining and refining tangible personal property for sale at retail) is being reduced in stages to an ultimate rate of 2 percent beginning in July 1998 (FY 1999). In 1996, the Sales Tax Advisory Council (STAC) recommended eliminating the tax altogether on the target date. The Governor included this recommendation in his 1996 session budget. The House voted to eliminate the tax (on a later effective date) and to convert the refund to an up-front exemption in its Omnibus Tax Bill, but the proposal was lost when that bill did not emerge from conference committee. A recent revenue estimate for repeal, using July 1, 1997 as the tax repeal date, (and based on the March 1996 forecast) projected a fiscal year revenue loss of roughly $22 million each year for FY 1998-2000 and $35 million in 2001, assuming that the tax exemption continues to be administered as a refund. New revenue estimates based on the November forecast, a different effective date, or administration as an up-front exemption will produce different figures. Eliminating the tax (currently 2.5 percent) on new farm machinery and logging equipment would add roughly $7.5 million per year to the tax expenditure.

Exempt Goods Used or Consumed in Performing Taxable Services. Under current law, materials (called "production inputs") used or consumed in industry, agriculture, mining and refining to produce products for sale at retail are exempt from the sales and use tax. By contrast, inputs consumed in providing taxable services generally are taxable to the service provider business. The STAC recommended giving taxable service providers an exemption analogous to the products production exemption. This proposal requires a tax expenditure of approximately $6.5 million per fiscal year. (Taxable services include: building cleaning and maintenance; linen supply and cleaning; parking and car washes; pet grooming and boarding; sports, health and country club memberships; nontherapeutic massage; lawn and tree care; and detective, armored car and security services.)

Other Sales Tax Advisory Council Recommendations. The STAC will meet on December 19 to prepare its final report and recommendations. The Council has not taken any specific positions but, in addition to the subjects listed above, the members voted to develop policy statements on: repeal of the June sales tax shift; capital equipment purchased by nonmanufacturing businesses; extending the *de minimis* use tax exemption to business consumers; vendor allowances; local option sales taxes; the complexity of the sales tax on certain health care and food products; sports and health club memberships and user fees; and, recodification of the general sales and use tax and the motor vehicles sales tax . Additional items will come to the Council from a working group that studied many highly-complex sales and use tax issues, and from a report by the Department of Revenue on its two-year Sales Tax Policy Project.

Permanently Exempt Used Farm Machinery. Last year the Governor recommended the repeal of the sales tax on used farm machinery. After a one-year extension passed in 1996, used farm equipment is temporarily exempt through June 1997, when the 2.5 percent tax rate will be restored. The tax expenditure for an extension or permanent repeal of the tax is approximately $1.7 million per fiscal year.

Property Taxes

Property Tax Reform Proposals Will Be Introduced. Numerous comprehensive property tax reform proposals were introduced during the 1995 and 1996 sessions, and it is likely that more will be introduced during the upcoming session. Common features of many of the proposals have included simplifying and compressing the class rate structure, increasing state funding of K-12 education, eliminating Homestead and Agricultural Credit Aid ("HACA"), altering the distribution of Local Government Aid ("LGA"), and increasing direct property tax relief to taxpayers through the income-based "circuit breaker" property tax refund. The Senate has adopted a property tax "freeze" during the last two sessions, to which the House has refused to agree. If the Legislature does not pass a comprehensive property tax reform bill during the upcoming session, there is a possibility that it will pass a property tax freeze bill instead.

Public Utilities Will Seek Relief From Personal Property Taxes. The "Koch bill" adopted during 1996 session contained a provision requiring the department of Revenue to conduct a study of the taxes paid by public utilities. The finding of that study will be useful to legislators examining tax policy under the newly deregulated energy market. The public utility industry in Minnesota is particularly concerned with personal property taxes, because the states surrounding Minnesota do not impose personal property taxes on public utilities.

Tax Increment Financing Continues To Be Controversial. The Legislative Auditor issued a report in March, 1996 which demonstrated that excess revenues from older tax increment financing ("TIF") districts were being used by some cities to fund their general government expenditures rather than to provide incentives for development to increase the tax base. Newer districts are subject to newer, more restrictive laws which prevent such abuses. It is likely that legislation will be introduced to impose restrictions on the older TIF districts. Such legislation will be strongly opposed by organizations representing cities, who believe the restrictions imposed on newer TIF district are too extreme. In addition, controversies are being generated by the enforcement activities of the Office of the State Auditor regarding TIF districts. A recently enacted law transferred responsibility for ensuring compliance with TIF laws to that office. The State Auditor's staff has discovered numerous alleged unlawful practices or situations where sufficient records were not kept to demonstrate compliance.

Other Tax Issues

The SCORE Tax Requires Modifications. — Local governments and the Department of Revenue have experienced considerable confusion and difficulty attempting to comply with and administer the SCORE ("Select Committee on Recycling and the Environment") tax. The SCORE Tax Task Force, a working group established during the 1996 legislative session to study the tax on solid waste management services, will make recommendations to the state legislature by January 15, 1997. The task force recommendations will address the manner in which the tax is collected and the proceeds distributed to fund local solid waste management services.

Tax Policy And Environmental Protection Policy May Be Linked — A bill introduced during the 1996 session, called the Economic Efficiency and Pollution Reduction Act ("EEPRA"), was intended to promote desirable environmental protection activity by shifting tax burden from economic "goods" such as capital investments and labor to environmental externalities such as pollution from carbon-based fuel consumption. The issue has been studied over the interim and a joint hearing of the House committees with related jurisdictions will take place early in the 1997 session.

For more information on Tax issues, contact: Bill Connors, 296-5813; M.J. Hedstrom, 296-1237; or Matt Shands, 296-4162.

Transportation Finance

The 1997 legislative session will again address the issues of funding road construction and mass transit. As in past sessions, several remedies to funding problems and traffic congestion will be proposed. Some of these are:

- A metro area sales tax increase that would be used to fund transit service.
- A constitutional amendment that would allow gas tax revenues to be used for transit.
- Congestion pricing or toll roads to fund road construction.
- A gas tax increase.

Metro Transit funding continues to be a problem due to cuts in federal aid to the Metropolitan Council Transit Operations. Recent fare increases were necessary to keep pace with increasing costs and as expected with a fare increase, ridership dropped slightly. No further fare increases are anticipated in the immediate future, but remain a possibility unless the federal or state contributions increase.

Although gas tax ***revenues for road construction*** continue to increase, the Department of Transportation contends that funding has fallen greatly when measured against inflation. Raising taxes for roads has not received enough support from the public, the Legislature, or the Governor to make increased funding a reality. With the growing transportation needs and continued metro area sprawl, funding for transportation needs will be a major issue in this coming session.

For more information on Transportation Finance issues, contact John Walz at 296-8236.