Fiscal Analysis Department
Minnesota House of Representatives

ISSUE BRIEF

Planning Estimate Inflation in State Budget Forecasts

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Since November 1991 planning estimate inflation has been included in state general fund expenditure forecasts. Law enacted in 2002 prohibits its use in future forecasts. This repeal of planning estimate inflation reduced expenditure estimates projected in the February 2002 state budget forecast for the FY 2004-2005 biennium by $1,127,300,000. This paper provides history and background on the use of planning estimate inflation.

Inflation Is Added to Projected Expenditures to Represent Potential Cost Increases

Planning estimate inflation has been defined by the Department of Finance as an amount reflecting the impact of expected price increases on the cost of government operations. Planning estimate inflation has been a tool used in projecting expenditures for the next biennium (the biennium after the biennium for which appropriations are currently being made). To determine the amount of planning estimate inflation, a percentage reflective of projected consumer price index (CPI) growth is added to the base level forecasted appropriations for each year of the next biennium.

Example 1

	Current Biennium		Next Biennium	
	FY 2002	FY 2003	FY 2004	FY 2005
Base Level Expenditures	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Inflation at 2.5% per Year			$25,000	$50,625
Planning Estimates Expenditures			$1,025,000	$1,050,625

Inflation Calculation

Appropriations estimates (or base level appropriations) for the next biennium are determined using statutory funding formulas or current biennium appropriations levels. Then, as illustrated in Example 1, a percentage increase similar to the forecasted consumer price index (CPI) for those years is added to the base level appropriation to determine the amount that becomes the expenditure forecast for each year of the next biennium.

Planning Estimate Inflation First Used in November 1991

Amounts for planning estimate inflation were included in Department of Finance budget forecast documents from November 1991 through February 2002. Law passed in 1994 directed the Commissioner of Finance to include expenditures "…projected to occur as a result of inflation…" to be included in the expenditure portion of the forecast. [1] As part of the budget balancing bill enacted in late February 2002, the law directing the commissioner of finance to include an amount for inflation in forecasts of future biennium's expenditures was repealed and the commissioner was instead directed not to include an inflation allowance in future forecasts of expenditures. [2]

The chart below shows the impact planning estimate inflation has had in general fund budget forecasts since it has been included in November 1991. As the chart shows, inflation amounts do represent a substantial addition to the base level of expenditures.

Date of Forecast	Biennium Affected	Inflation Percentage	General Fund Inflation Amount
Nov. 1991	1994-95	3.6%	$572.8 million
Feb. 1992	1994-95	3.6%	$540 million
Nov. 1992	1994-95	3.5%	$632 million
Mar. 1993	1994-95	3.0%	$860 million
Nov. 1993	1996-97	3.0%	$87 million (a)
Mar.1994	1996-97	3.0%	$81 million (a)
Nov. 1994	1996-97	3.0%	$92 million (a)
Feb. 1995	1996-97	3.0%	$91 million (a)
Nov. 1995	1998-99	3.0%	$428 million (b)
Feb. 1996	1998-99	3.0%	$431 million (b)
Nov. 1996	1998-99	3.0%	$440 million (b)
Feb. 1997	1998-99	3.0%	$757 million
Nov. 1997	2000-01	2.5%	$778.9 million
Feb. 1998	2000-01	2.5%	$778.6 million
Nov. 1998	2000-01	2.5%	$798.5 million
Feb. 1999	2000-01	2.5%	$797.2 million
Nov. 1999	2002-03	2.5%	$906.0 million
Feb. 2000	2002-03	2.5%	$907.0 million
Nov. 2000	2002-03	2.0%	$736.5 million
Feb. 2001	2002-03	2.0%	$735.3 million
Nov. 2001	2004-05	2.5%	$1,127.2 million
Feb. 2002	2004-05	2.5%	$1,127.3 million

(a) Spending caps for K-12 Education, Higher Education, and Health and Human Services eliminate any planning estimate inflation in those areas.

(b) A spending cap in K-12 Education eliminates approximately $330 million in planning estimate inflation in that area. That spending cap was repealed prior to the February 1997 forecast.

[1] Laws 1994, Chapter 587, Article 7, Section 2, Subdivision 1
[2] Laws 2002, Chapter 220, Article 13, Sections 1 and 2

Inflation Was Part of Discussion on Four Year Budget Planning

In the late 1980s, some expenditure forecasts included inflation (for example, the March 1989 forecast included 5.1 percent inflation in the expenditure estimates for the FY 1992-93 biennium). In the early 1990s, as budget forecasts were consistently presented with a projection of expenditures over a four year period (the biennium for which appropriations are being made or have been made and the next biennium), the Department of Finance included inflation on expenditures for the second biennium in each forecast. The Department argued that inflation pressures would affect the ability of the state to deliver services. The effect of inflation is recognized in the revenue portion of the forecast (salary and price increases affect income and sales tax revenue) so inflation's effect should also be recognized on the expenditure side. In the November 1991 Budget Forecast booklet, the Department of Finance states that the "F.Y. 1994-95 planning estimates also include the estimated cost of providing general inflationary adjustments beyond those specified within current law." The forecast booklet goes on: "The inclusion of discretionary inflation is not intended to suggest that inflation will be built into the F.Y. 1994-95 budget base. Rather, it helps establish an upper bound on the state's current law obligations. The estimates make no assumption about possible recommendations by the governor or action by the 1992 legislature." [3]

With the addition to the budget forecast of revenue and expenditure amounts for the next biennium, a goal became balancing the state general fund budget over the four year period or achieving a "structural balance". Structural balance meant that projected revenues in the next biennium would be greater or equal to projected expenditures in that biennium. The addition of planning estimate inflation to the expenditures made structural balance more difficult to achieve.

An executive branch appointed Commission on Long-Term Financial Management recommended in early 1992 that "forecasted inflation should be included in both revenue and expenditure forecasts so that a consistent picture of future trends is available." The commission recommendations state "forecasts for planning purposes should reflect trends based on extensions of current commitments."[4]

Spending Caps Eliminated the Effect of Inflation

Although an amount representing planning estimate inflation has been included as an expenditure in budget forecasts since November 1991, the effect of inflation was substantially limited for several years in the mid-1990s. As a way to project a balanced general fund budget in the next biennium, spending caps were enacted in 1993 to apply to appropriations in fiscal years 1996-97 for K-12 Education, Higher Education, and Health and Human Services. Spending caps enacted in 1995 applied to K-12 Education for fiscal years 1998-99. The spending caps set a maximum expenditure level in each of these three areas for the next biennium. The effect of the caps was to limit potential spending increases and eliminate or severely limit any inflation of expenditures. The state's general fund budget appeared balanced in the next biennium but that balance was achieved only by applying limits to funding formulas in law and eliminating planning estimate inflation.

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[3] November 1991 State Budget Forecast, Minnesota Department of Finance, pp. 33 and 36

[4] Summary of Recommendations of the Commission on Long-Term Financial Management Reform, January 3, 1991

Inflation Applied to Most Expenditure Areas

When planning estimate inflation was first added to the expenditure portion of the general fund budget in November of 1991, the amount of inflation was calculated as a percentage of certain expenditures. The percentage was an amount similar to the consumer price index for the affected years as projected in a budget forecast. The percentage was applied to most expenditure items but was not applied to the debt service appropriation, to appropriations for property tax relief aids and credits or to certain other appropriations such as those for pension programs. Inflation was not applied to appropriations where inflation was not likely to occur (debt service) or where inflation was already built into the funding formula (several property tax aids).

The application of inflation was changed beginning with the November 1997 forecast. Since that time, inflation has been applied to all expenditures in the general fund forecast except for debt service and certain capital projects appropriations. Rather than try to differentiate to which appropriation items inflation should be applied, the decision was made to apply the inflation adjustment to almost every appropriation.

The issue of which appropriations inflation is applied to has been discussed in recent years but no change has made. Of particular issue are appropriations that already have an inflation factor built into their statutory formula. For example, various local government aids are increased between 2.5 and 5.0 percent per year. [5] Under the current application, if a committee is considering increasing an appropriation for such a program, the cost of the increase is the base level plus the statutory inflation plus planning estimate inflation.

Even though the inflation adjustment is applied to most appropriations, the Department of Finance has always argued that inflation should not be seen as a commitment to adding funding to any particular program to offset the impact of inflation in the next biennium. Those interested in any one appropriation need to know that inflation will not be automatically added to the appropriation when the appropriation is considered for the biennium currently represented by the planning estimates. In fact many actual appropriations are made at the base level, the planning estimate minus planning estimate inflation.

Planning estimate inflation had been illustrated in fund balance statements as being added to each base level appropriation. Beginning with the November 2001 forecast, planning estimate inflation was added as a line item in the total expenditures but was not added to each appropriation item. This allows fund balance statements to more accurately reflect the intent expressed by the Department of Finance – that inflation represents the general price pressures on the delivery of government services.

Planning Estimate Inflation has been a Budget Planning Tool

Inclusion of planning estimate inflation in state budget expenditure projections shows those interested in a state's budget (for example, bond rating agencies) that the state is planning for future spending pressures. It suggests that before implementing new spending programs or revenue reductions, the state will cover the effects of inflationary pressures.

[5] Minnesota Statutes, Section 477A.03, Subdivision 3

Planning estimate inflation has also been a tool to provide more flexibility for a Governor and Legislature in assembling a new budget. The inflation creates a cushion of several hundred million dollars that is already counted as spending in the budget forecast. For example, in the November 1998 forecast for fiscal years 2000-01, almost $800 million was set aside as planning estimate inflation. That amount allowed the Governor to make budget recommendations for $800 million of spending above the base level budget that did not count as new spending relative to the budget forecast. The Governor recommended just under $100 million for various inflation related base adjustments, mostly salary adjustments, in state agency appropriations. The remaining $700 million was available for adjustments to other budget areas. Arguments can be made that the $700 million went for inflation adjustments in the K-12 formulas, higher education, health and human services and other areas.
However, the inflation increases are all increases that have not been built into current law formulas or base budgets. In difficult budget times, inflation increases are likely to be one of the first items to be removed.

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