FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

November – December 2014 Volume XXXV No. 6

In This Issue:

Divided Again: 2015 Session Preview

The forecast is here, the cast is set, and the curtain is about to rise on the 2015 session.

The voters have spoken… but the question is, what did they say? Election night brought a mixed bag for Minnesota's two largest political parties. DFLers rejoiced as their slate of statewide candidates ran the table – largely through rolling up big margins in the state's largest cities. Governor Dayton becomes the first candidate since Arne Carlson in 1994 to win the governor's race with a majority of votes cast (50.07%) and the first DFLer to be re-elected governor since Rudy Perpich in 1986. However, legislative control is decided on a district-by-district basis, and large DFL margins in central cities didn't stop Republicans from picking up 11 seats to regain control of the Minnesota House. Somewhat astonishingly, Republicans did this while not losing a single seat they held during the previous two years. The result: a return to the divided government that Minnesotans have experienced for most of the past 40 years.

As the saying goes, "Elections matter", and these results will change the dynamics for the 2015 and 2016 legislative sessions in several important ways. Most obviously, Republicans will now control the committees and set the agenda in the Minnesota House. This, along with statements from DFL legislative leaders, suggests little appetite for general tax increases in either chamber. Expect the GOP majorities to focus their interest on tax relief, transportation finance, and environmental regulations, among other areas.

The House GOP caucus will also take on a considerably more rural flavor – with 10 of their new seats located in rural Minnesota. Although lots of attention prior to the election was focused on suburban races, in retrospect this rural gain shouldn't be too surprising. Take a look at a color-coded map of virtually any state's legislative districts, and you'll mostly see large swathes of GOP red with smaller islands of Democratic blue in urban areas. This trend has become more prevalent over recent years, both at the state and federal levels (Minnesota's Collin Peterson and Tim Walz are notable exceptions). With the GOP caucus now heavily influenced by rural Minnesota, expect a focus on outstate interests.

Even though the Senate was not up for reelection and remains in DFL control, the election results have consequences in that chamber, too. Six DFL senators – most notably Tax Chair Rod Skoe and Capital Investment Chair Leroy Stumpf – now share their districts with two Republican representatives. Given the 39-28 DFL majority in the chamber, a six vote swing would scuttle any otherwise party-line vote. Caucus leadership will likely try to hold swing votes on board in part by noting that the 2016 election, when all senators are again up for re-election, is a presidential election year – when the DFL has historically performed better at the polls.

Finally, the elections will change the dynamic between the major negotiating parties. In 2014 the "Big Three" (Governor, House Speaker, and Senate Majority Leader) featured two urban liberals – Governor Dayton and Speaker Paul Thissen. Rep. Kurt Daudt's elevation to Speaker will not only replace an urban negotiator with an exurban one but will also put Senate Majority Leader Tom Bakk in a much more central negotiating position between the Governor and House Republicans. It will be interesting to see how end-of-session negotiations develop with a one-time car salesman (Daudt) and a one-time union negotiator (Bakk) in the room.

Forecasting a Surplus that Isn't?

By now the state's November Economic Forecast isn't exactly breaking news. State officials are predicting that the current FY 2014-15 biennium will end on June 30 with a $556 million surplus. The budget reserve law passed last year requires the state to add one-third of that surplus – $183 million – to its budget reserve, bringing that total to $1.344 billion. (Side note: under state law, MMB currently recommends a budget reserve of $1.929 billion – or 4.9% of general fund non-dedicated revenues. The state will continue automatically dedicating one-third of any realized surplus to the budget reserve until reaching that recommended amount.)

At first blush, the picture for the upcoming FY 2016-17 biennium is even rosier. The forecast balance (which assumes that current law will continue unchanged) is $1.037 billion – $443 million higher than the balance projected at the end of the 2014 legislative session. As Table 1 shows, $116.3 million in new resources, $501.9 million in lower-than-forecasted spending, and a $184.3 million transfer to the budget reserve combine to create the additional budgetary balance. The decline in forecasted spending comes largely in two areas: $443.2 million in the Health and Human Services area (driven by lower-than-expected Medical Assistance expenses) and $60.3 million in the K-12 education area (driven by lower-than-expected enrollment).

However, a closer look at the table shows some reason for concern. The additional balance is being created by the higher-than-

Minnesota Center for Fiscal Excellence

Susan Haffield, *President*
Aaron Twait, *Research Director*
Mark Haveman, *Executive Director*
Linda Edstrom, *Executive Secretary*

The Minnesota Center for Fiscal Excellence is a nonpartisan, non-profit corporation founded in 1926 to advance economy and efficiency in government.

Fiscal Focus is published bimonthly for $150 per year by the Minnesota Center for Fiscal Excellence, 85 East Seventh Place, Suite 250, St. Paul, Minnesota 55101. ISSN # 1042-847X. UPS #519130. Periodical paid at St. Paul, MN 55101.

Postmaster, send address changes to:

Fiscal Focus
c/o Minnesota Center for Fiscal Excellence
85 East Seventh Place, Suite 250
St. Paul, Minnesota 55101

Phone: (651) 224-7477 or (800) 322-8297
Fax: (651) 224-1209

E-mail: question@fiscalexcellence.org
Web Site: www.fiscalexcellence.org

Table 1: FY 2016-17 General Fund Forecast and Comparison to End-of-Session Projections

Item	End of Session (July 2014)	Forecast (Nov 2014)	$ Change	% Change
Balance Forward	1,216,647	1,745,224	528,577	43.4%
Tax Revenues	40,633,918	40,252,578	(381,340)	(0.9%)
Non Tax Revenues	1,412,598	1,400,411	(12,187)	(0.9%)
Dedicated Revenue	2	1,000	998	499.0%
Transfers from Other Funds	196,062	156,314	(39,748)	(20.3%)
Prior Year Adjustments	50,000	70,000	20,000	40.0%
Total Resources Available	**43,509,227**	**43,625,527**	**116,300**	**0.3%**
K-12 Education	16,879,132	16,818,839	(60,293)	(0.4%)
Higher Education	2,899,030	2,892,530	(6,500)	(0.2%)
Property Tax Aids and Credits	3,371,266	3,375,110	3,844	0.1%
Health and Human Services	13,200,416	12,757,252	(443,164)	(3.4%)
Public Safety & Judiciary	2,025,402	2,006,509	(18,893)	(0.9%)
Transportation	211,522	213,072	1,550	0.7%
Environment & Agriculture	333,277	337,738	4,461	1.3%
Jobs, Economic Development, Housing & Commerce	352,730	358,594	5,864	1.7%
State Government & Veterans	941,116	957,371	16,255	1.7%
Debt Service	1,278,082	1,277,493	(589)	(<0.1%)
Capital Projects	272,802	268,401	(4,401)	(1.6%)
Cancellation Adjustment	(20,000)	(20,000)	—	0.0%
Dedicated Expenditures	2	0	(2)	(100.0%)
Dedicated Expenditures	2	0	(2)	(100.0%)
Total Expenditures & Transfers	**41,744,777**	**41,242,909**	**(501,868)**	**(1.2%)**
Balance Before Reserves	**1,764,450**	**2,832,618**	**618,168**	
Cash Flow Account	350,000	350,000	—	
Budget Reserve	810,992	994,339	183,347	
Stadium Reserve	0	1,390	1,390	
General Fund Budgetary Balance	**603,458**	**1,036,889**	**443,431**	

Note: Dollars in thousands, parentheses signify reductions or negative balances.
Source: November 2014 Economic Forecast; Minnesota Management and Budget

expected FY 2014-15 surplus that carries forward to the next biennium. The forecast projects tax revenues will be almost 1% – or $381.3 million – lower than expected. This is largely the result of lower projected GDP growth at the national level. Moreover, the forecast estimates that inflation will largely eat up the surpluses project for both the FY16-17 and FY18-19 biennia (although we have a ***lot*** to say about inflation elsewhere in this edition of *Fiscal Focus*). In short, the picture may not be as rosy as an initial glance might suggest.

Implications for Lawmakers in 2015

The forecast is also predicting that Minnesota's economy will outperform the nation's over the next few years, which is why the drop in projected GDP growth isn't translating – as is often the case – into a budget deficit. Compare this to the claims being made 5-10 years ago that Minnesota had lost its economic luster as our historic national leadership in income growth faltered. We said then that rumors of our demise were greatly exaggerated which certainly seems to be the case. Now, our diverse, economy is once again a significant outperformer.

What all these political and economic tea leaves suggest is that the 2015 session will be fairly quiet on the fiscal front. Legislative leadership will give the tax committee and the various appropriations committees some new money to spend, but if legislators choose to make inflationary changes to the various budget areas there likely will be little money left for major new spending initiatives.

So where does this leave us? On the tax front, several issues are most likely to receive attention.

- **Rochester Destination Medical Center (DMC)** Every session seems to have a tax need that has to be solved ASAP. In 2015, it's likely the Rochester DMC. The inadequacies in the legislative language authorizing the various incentives associated with it have been well documented and by many accounts are preventing investment in the project. Given that new House Tax Chair Greg Davids hails from southeastern Minnesota and that the DFL represents a substantial part of the Rochester area, expect a bill fixing this issue to move through the process early in the session.

- **Federal conformity** Also a seemingly perpetual issue, federal conformity may also be on the fast-track to enactment. Of particular concern are the federal tax provisions that are likely to pass by the end of the year. These provisions would extend certain tax deductions and credits – notably those related to mortgage debt forgiveness, state and local sales taxes, higher education expenses, and K-12 educators' expenses – for tax year 2014. Minnesota has historically favored conforming to federal tax law, but the price tag (as of yet, unknown) may make this a difficult sell. If this is going to happen, expect to see a bill early in session to minimize the impact on taxpayers as filing season begins.

- **Residency factors** The Senate's Tax Reform Division considered Minnesota's residency factors in the last biennium, but the Department of Revenue has demonstrated reluctance to open the topic for discussion. With GOP leadership in the House and apparent interest in the topic by the Senate, look for much more discussion of this issue during the next two legislative sessions.

- **Transportation finance** Although other committees will look at potential ways to increase efficiency, the tax committees will certainly get drawn into discussions about how to fund Minnesota's future transportation needs. The gas tax will certainly be a central issue, and a healthy bonding proposal is a given, but other funding sources – ranging from a sales tax on gasoline to value capture mechanisms – will likely enter into the discussion.

- **Corporate income tax** Minnesota's "sticker rate" of 9.8% is an outlier – third in the nation behind Iowa's top rate of 12.0% (in a graduated system) and Pennsylvania's 9.99% flat rate. Regardless of state-to-state differences in the tax bases, this high rate is a public relations issue when trying to recruit new businesses to Minnesota, and politicians across the spectrum know it. If money is available a reduction in the corporate rate is possible, although if paired with an increase in the base the overall tax reduction may not be very large at all.

- **Statewide property tax** Our multi-state property tax comparison study consistently ranks commercial properties in Minnesota near the top of the list. Minnesota's statewide property tax – which represents somewhere around 30% of the total business property tax burden statewide – is a big reason for this. Policymakers may focus on this tax, which affects all businesses that own properties, rather than the corporate income tax, which probably has more political baggage and doesn't affect businesses in years when they are not profitable. If there's movement in this area, look for a reduction in the overall levy amount and/or a move to eliminate the annual inflationary adjustments in the levy. It is also worth noting that the elimination of this levy was a recommendation of the bipartisan 2012 Property Tax Working Group.

- **Individual income tax – pass-through income** The debate over the competitiveness implications of Minnesota's new 9.85% fourth income tax tier continues. Many point to the impact on businesses that file and pay taxes through the individual income tax regime – sole proprietorships, S-corps, and LLCs – as a competitiveness issue. There is interest in this camp in exempting some proportion of pass-through income from the income tax.

The status quo often prevails in an era of divided government. Combine that with a modest surplus, both legislative chambers already preparing for the 2016 elections, and restoration work on the legislative chambers scheduled to begin promptly after session is completed – with cost ramifications if it doesn't – we would not be surprised to see a relatively quiet session that will come to an orderly end. ■

From The Director

"Reality is an illusion, albeit a very persistent one." — A. Einstein

If you have been reading recent issues of *Fiscal Focus* and our blog *Fiscal Fitness*, you've no doubt noticed that we have spent a fair amount of time in recent months investigating and discussing several rather technical matters pertaining to government finance – discount rates employed on nominal government spending and pension liabilities, measuring the price of government, and now in this issue the debate about whether inflation should be "in or out" of the economic forecast. We did this for a reason: even though these topics are as dull as ditchwater, their influence on public perception about government generally, and taxes and spending specifically, is positively enormous. You don't have to look deep into newspaper sections, or spend much time perusing political blogs and social media to see the truth of that statement.

Mark Haveman

Presentations of "reality" and encouragements to "acknowledge reality" are the raw material for another biennial budget session beginning shortly. "Reality" is a very powerful word. It's also an exceptionally intimidating word – no one wants to be labeled as someone operating on the other side of that fence. But as we have tried to show throughout this series, it can be an overused and occasionally misleading word. Contrary perspectives and opinions do exist and the information supporting them has merit and is very much worth considering. We think that's an important reminder as the table gets set for yet another biennial budget session.

As the year draws to a close, we want to once again thank our members for their support of this organization. We would also ask everyone consider a year-end, tax-deductible contribution to the Minnesota Foundation for Fiscal Excellence. Contributions made to our supporting arm fund our public purpose education and research initiatives such our most recent and popular publication, "Understanding Your Property Tax Changes" – a taxpayers guide to knowing why property tax bills change and what's responsible for the change. If you appreciate educational publications like these, the benchmarking and comparison studies we develop, and the analysis we offer, a year-end gift is a great way to show your support.

On behalf of Linda and Aaron, let me wish all of you a joyous holiday season and a healthy and prosperous 2015.

— M. H.

The Debate On Acknowledging Reality

Should expenditure inflation be formally reinstated in the economic forecast? It's a more complicated issue than is typically acknowledged, and several questions deserve very careful consideration.

The arrival of this year's November Economic Forecast means several things – an approaching legislative session, stirrings of a new biennial budget, and renewed criticism about a provision enacted over a decade ago that influences how the biennial budget is developed. It's the requirement to exclude the impacts of inflation on government spending from the Economic Forecast.

Lawmakers enacted this exclusion in 2002 as a political convenience, when the prospects of a big, looming budget deficit following the November elections had the potential to complicate matters for some legislative leaders and others with gubernatorial aspirations. With a stroke of the pen, forecasted spending no longer included inflation and the budget balancing challenge in 2003 became that much easier. Many view this as the grandfather of the accounting conveniences, shifts, and other budget balancing manipulations of years past. With these other detractions from "honest budgeting" now in the rearview mirror, this big one remains.

Critics of this practice include a "who's who" of state public finance experts past and present including four former commissioners of finance, several professors of economics, state economists, and former Governor Arne Carlson. These critics seldom mince words when describing their opinion of the current practice – "inane," "irresponsible," and "fiscally and intellectually bankrupt" are just some of the invectives used to describe this policy. Ever since 2002, opinion and editorial pages in newspapers across Minnesota have picked up on this criticism and echoed these calls for change.

Another notable voice on this matter is the Minnesota Council of Economic Advisors (CEA) – a group of macroeconomists from the private sector and academia who independently review forecast content. As they state in the November forecast:

> *As it has done every year since 2003, the CEA recommends that budget planning estimates for the next biennium include expected inflation in both the spending and revenue projections. The CEA noted that Minnesota's current practice of excluding inflation from the spending estimate is fundamentally misleading. It is inconsistent with both sound business practices and CBO methods and potentially encourages legislators and the public to regard the state's financial position more optimistically than the facts warrant. The omission of inflation in the spending estimates in the February 2014 Budget and Economic Forecast understated projected spending for FY 2016-17 by more than $1 billion, and thus made the difference between projected revenues and spending appear to be larger than it actually is.*

The 2009 Budget Trends Study Commission sounded yet another call for change, concluding, "financial forecasts should be based on current law and inflation (or deflation) of both revenues and expenditures to provide an accurate planning perspective." And even before the adoption of the 2002 change, various state finance reports affirmed the importance of including inflation in spending estimates.[1]

As our companion article in this issue highlights, the implications of reversing course and reincorporating spending inflation as part of the forecast has big budgetary consequences: the November forecast estimates inflation for FY 16-17 at $916 million and for FY 18-19 at $2.894 billion – enough to eat up the excess revenues projected for those periods and then some.

Dissenting Voices: It's a Budget Tool Too

Given the political motivations behind the origin of the exclusion and the expert voices urging change, it may seem odd that the move hasn't been reversed. But dissenting voices do exist. For example, the 2009 Budget Trends Study Commission's report also states:

> *"Not all members of the Commission agree with this recommendation. Opponents of this recommendation believe the official forecasted surplus or deficit should continue to be based entirely on current law (though they agree the impact of inflation should continue to be noted), and that automatically including inflation adds confusion to the policymaking process and tends to promote spending."*

Are these concerns justified? Advocates for including inflation in the state's economic forecasts dismiss this claim on the grounds that it fails to distinguish the difference between planning from budgeting. Just because a forecast includes inflation, they note, does not introduce spending bias. The forecast is just a planning tool, they note; lawmakers are free to enact whatever combination of spending and tax changes they deem appropriate.

Dissenting voices see this largely as a distinction without a difference because policymakers also use the revenue forecast as a budgeting tool. According to a 2002 Issue Brief by House Fiscal Analysis discussing the history of planning estimate inflation:

> *"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."* [2]

"Several hundred million" in 2002 is almost $1 billion today – which is a large, comfy, and alluring cushion. In practice, including inflation enables considerable spending on new or expanded programs without having to recognize it as "new government spending" relative to the forecasted amounts. Similarly, when budgeted appropriations grow year on year but fall shy of forecasted spending as adjusted for inflation, many will label such increases as "cuts." It is in this context that public perceptions about the adequacy of state revenues and spending are created.

Proponents of including inflation in the economic forecasts maintain that the current practice diminishes honesty and transparency in the state's budgeting process. Dissenters argue that including inflation introduces the same potential. Choosing not to acknowledge that the economic forecast is also a budgeting tool is a failure to recognize a different but no less important reality – that economics cannot be divorced from politics. For dissenters, treating inflation as we currently do allows policymakers to act on the information in a responsible way without creating a bias for new spending in the budgeting process.

The challenge for resolving this debate may be to figure out a way to acknowledge and accommodate both economic and political reality. We suggest five questions that deserve consideration toward this end.

1. What inflation measure should be used?

- "The result will be yet another financial forecast that does not provide an accurate understanding of our state's finances."
- "We need an accurate forecast to inform the budget making process."
- "Accurate information improves the quality of public debate."

Quotes from "Minnesota's Experts Call on Policymakers to Fix the State's Financial Forecasts" – a statement of endorsement for including expenditure inflation coordinated by Minnesota is Watching.

As these excerpts make clear, "accuracy" is a major motivation behind the call for reinstituting expenditure inflation in the forecast. Given this motivation, it is worthwhile noting that inflation estimates in past forecasts – including the "unofficial" ones used since the 2002 change – are calculated using projected changes in CPI, a measure of consumer inflation. When compared to estimates of future revenues, which are determined using sophisticated econometric

[1] State Budget Stability: The Limits of Forecasting, Creating a Manageable Budget MN Department of Finance, 1986; and Carlson Commission on Long-Term Financial Management Reform 1992.

[2] *Planning Estimate Inflation in State Budget Forecasts*, House Fiscal Analysis Department, 2002

modeling with adjustments for known differences and variances between the state and national economy and law changes, broadly applying a consumer inflation measure to aggregate state spending seems rather unrefined. Without making too much of this, the current generic nature of this estimate does seem better suited for an informational by-line than as an embedded "fact" of forecasted spending – especially when viewed through the lens of accuracy.

Perhaps in recognition of this, many policy observers, including members of the Council of Economic Advisors, argue that the implicit price deflator for state and local government (IPD) – a specialized inflation index based on actual nationwide state and local government purchases – would be a better inflation measure. Indeed, most economists would likely agree that the preferred use of an input price index like the IPD is for forecasting and internal budgeting purposes.

But as we have reported in past issues of Fiscal Focus, applying the IPD to a particular state has its own accuracy concerns. Because the IPD is based on aggregate national spending, bigger states – like California, New York, Texas, Pennsylvania and Illinois – have a much bigger impact on the IPD than states like Minnesota. And since the largest subcomponent in the IPD by far is employee compensation, compensation-related inflation in those states, which includes addressing their considerable pension and legacy cost issues, has a disproportionate impact on the IPD. The implication: differences between states in the inflationary pressures on government inputs are not only significant but likely to increase in future years and may overstate Minnesota government inflation.

Ideally, inflation estimates would be based on the inputs governments in Minnesota purchase and forecasted Minnesota-specific price trends of those inputs. That doesn't exist, so what is the best surrogate? CPI? IPD? Both depending on the expenditure? A hybrid? Something else? If accuracy in public finance is the principal concern, then the choice of an appropriate inflation measure deserves careful consideration.

2. What parts of the general fund budget should be subject to an inflation estimate?

It may come as a surprise, but the current practice of excluding inflation was historically the norm. According to House Fiscal Analysis, the state added planning estimate inflation to the expenditure side of general fund budget forecasts in 1991. At that time, the Department of Finance applied inflation to most expenditure items but not to debt service appropriation, certain property tax aids and credits, other appropriations with inflationary adjustments already built in, or certain other appropriations like pension programs.

That changed in 1997 when all expenditures except for debt service and certain capital projects appropriations became subject to inflationary adjustments. As House Fiscal Analysis noted in 2002, "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."

Today the "almost" no longer applies. The forecast's informational inflation estimate is generated by inflating all general fund spending – including debt service and one time capital appropriations. Since the whole process became "unofficial" after 2002, state officials presumably simplified this process because 1) it would have been hard to justify spending significant staff time on something that, by law, was excluded from the forecast; and 2) accuracy was less of an issue.

Two things are worth noting about this "inflation application creep." The first is that practically there is no such thing as an "unofficial" inflation estimate. While state finance experts are probably very aware that they would want to modify the current methodology if the estimate became "official" once again, that subtlety is lost on the public and in journalists' reporting on the forecast. Media report this inflation estimate as "fact" without any qualification or recognition that it may be significantly overstated. Opinion pieces that report this unofficial estimate using phrases as "the true fiscal condition," "the proper adjustment" and "the real cost" reinforce this perception. There may be no intention to distort, but the practical impact on public perception and debate is very real.

The second is that in supporting accurate, intellectually honest budgeting practices, it seems essential to do a careful job of identifying which areas of general fund spending truly merit inflationary adjustments. Unquestionably, some areas should be off-limits. For example, it doesn't make sense to forecast inflation in items that are either one-time appropriations (such as capital investment) or are costs that are fixed over time (such as debt service).

Another set of areas that should probably be off-limits are those where the forecast already includes some inflationary adjustment. Many state programs serve a defined set of individuals – for example, K-12 education and many health and human service programs, especially Medical Assistance. These programs have two major cost drivers: changes in uptake and changes in per-unit costs. State law explicitly directs the economic forecast to provide for projected changes in uptake or caseloads.

The problem arises when forecasters layer the macro-level CPI inflation adjustment on top of some other existing cost-per-unit inflationary measure. This is apparently the case in a major area of the state budget: health care spending. As one advocacy group has noted:

> *As a result of the soaring rate of inflation in health care costs, it was determined that an expenditure forecast that ignored inflation in this area would be absurd. As a result, inflationary pressures in the health care portion of the state budget – equal to approximately 30 percent of all state general fund spending – are factored into the official state forecasts, statutory prohibitions notwithstanding.*[3]

Inflating a large chunk of state spending twice over the same period offers the very real possibility that the inflation estimate is overstating the "real cost" of state commitments.

Still other items need to be carefully evaluated before being inflated in the forecast. Chief among this are the hundreds of millions of dollars the state provides directly to individuals via property tax refunds and general purpose aids to governments. Here the state is not providing a direct and tangible service where cost changes can be evaluated. Instead, the state either is trying to mitigate the costs of property taxes on homeowners and renters or is providing revenue streams for local governments to support cost structures over which they,

[3] *Inflation's Impact on State Spending,* Minnesota 2020, February 26, 2013.

and not the state, exercise primary control. Both represent a much more amorphous and indirect relationship between financing and cost trends.

To sum: a huge amount of state general fund spending consists of transfer payments to individuals and institutions and not purchased inputs that go directly into the provision of a public good or service. At a minimum, it would seem appropriate to require an articulation of the rationale behind inflationary adjustments to these kinds of transfer payments.

3. Should the fact that government exercises considerable direct influence and control over inflation in its largest purchased input have any implications for how inflation is treated in the forecast?

Employees are governments' primary purchased input. Not surprisingly, changes in employee costs have by far the largest impact on rates of government inflation as demonstrated by the IPD. According to the federal Bureau of Economic Analysis (which computes the IPD), employee compensation changes accounted for 63% of the growth in state and local government inflation since 1999. Put another way, it's more than three times the impact of inflation purchases of professional services, durable goods like police cars, consumables like fuel, or any other categories of goods commonly cited as unique and distinguishing characteristics of government purchasing. While compensation is a relatively small piece of the state budget, billions in aids eventually turn into compensation expense for schools, counties, cities, and other local governments.

Unlike households that have little influence over the price of the products and services they consume beyond the ability to shop competitively, the price of the primary input government buys is largely a function of collective bargaining agreements. The distinction made between the forecast as a planning tool and the forecast as a budgeting tool is especially relevant here. As a planning tool, inflation-adjusted spending amounts could reasonably estimate the cost of keeping the existing government employee base whole. As a budgeting tool, cost of living adjustments would already have been included in the forecast as a "given" and it seems likely negotiations would tend to begin from that base.

4. How is the pursuit of government innovation, efficiency, and productivity improvements affected by the decision to reinstate inflation?

The most powerful and compelling argument for reinstating inflation in some appropriate way is that it improves accountability by capturing the real cost of state commitments and recognizing the long-term implications of budget decisions. As advocates for including inflation point out, accurate pricing of public goods and services is a critical and necessary tool to manage the public's expectations for implementing new initiatives, expanding current programs, or cutting taxes. As a result, the inclusion of inflation may create conditions more supportive of government innovation and redesign. Meaningful attempts at government redesign will not happen absent a fiscal challenge, and a fiscal challenge is more likely to exist with inflation leading to higher forecasted spending.

If there is a counterpoint to this idea, it's that inflation-adjusted spending is actually a poor proxy for the supposed "real cost" of state commitments. This argument is based on the idea that government is simply not anywhere close to operating on its efficiency frontier. As a result, inflation-adjusted spending estimates are only a mechanical calculation of the cost of maintaining the status quo in government service delivery. Dissenters believe that rather than prompting serious investigations into needed reforms, the higher expenses created by including inflation in the forecast will only be used as a drumbeat to raise taxes to preserve current methods and practices. In short, planning inflation's impact on the pursuit of government innovation and efficiency is likely in the political eye of the beholder.

5. If inflation is included in forecast planning estimates then doesn't the state have a responsibility to do everything it can to expose the nature and causes of that inflation to taxpayers?

If there is irony in this whole inflation debate, it's that for all the emphatic messages about restoring honesty and transparency to public finance, state government does not appear particularly motivated to help taxpayers understand what the sources of Minnesota government inflation actually are. If acknowledging reality means recognizing inflation in the cost of inputs, it would seem sensible to allow taxpayers to see what the cost trends of Minnesota government inputs actually look like.

We have worked for some time on efforts to require local governments to budget spending by expenditure type (in addition to the much more commonly-used program or department view) to expose underlying cost structures and trends affecting local government budgets – i.e. the sources of inflation. When discussing these efforts, local government advocates have frequently pointed out that state government doesn't do this. That's a very legitimate point.

Exposing the causes of inflation extends beyond simply presenting government budgets in a different way. It also means exposing statutory and other limitations that reduce governments' ability and flexibility to respond to inflationary pressures. Governments in Minnesota are limited in direct and indirect ways from responding to operating cost concerns. The limitations – both in law and in negotiated agreements with employees – touch on areas from compensation to outsourcing. Government might be supporting other important objectives like equity and service quality through these limitations, but it would seem important to get this "inside baseball" on the table so that taxpayers can weigh and debate the costs and benefits of these provisions.

What do we conclude from all this? We first looked at this technical topic eight years ago but our general conclusions then still apply:

1) this issue, which seems superficially simple at first glance, is actually quite complex;

2) the bright line of demarcation between the economic activity called "planning" and the political activity called "budgeting" is actually very blurry in government; and

3) how you include inflation matters as much as if you include inflation.

Completely ignoring the effects of inflation may be disingenuous and be a detriment to responsible fiscal planning. But slapping the CPI on the entire general fund, declaring it the "real cost" of current law, and having the biennial budget framed and negotiations proceed in a context where every dollar of government spending is effectively indemnified against inflation doesn't exactly serve the cause of acknowledging reality either. ■

UNITED STATES POSTAL SERVICE®

Statement of Ownership, Management, and Circulation (All Periodicals Publications Except Requester Publications)

1. Publication Title	2. Publication Number	3. Filing Date
FISCAL FOCUS	5 1 9 - 1 3 0	Oct. 2014
4. Issue Frequency	**5. Number of Issues Published Annually**	**6. Annual Subscription Price**
BI-MONTHLY	6	161

7. Complete Mailing Address of Known Office of Publication *(Not printer)* (Street, city, county, state, and ZIP+4®)
85 E. 7th Place, SUITE 250
ST. PAUL, MN 55101

Contact Person: LINDA EDSTROM
Telephone *(Include area code)*: 651-224-7477 x 101

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9. Full Names and Complete Mailing Addresses of Publisher, Editor, and Managing Editor *(Do not leave blank)*

Publisher *(Name and complete mailing address)*
SAME AS ABOVE

Editor *(Name and complete mailing address)*
SAME AS ABOVE

Managing Editor *(Name and complete mailing address)*
SAME AS ABOVE

10. Owner *(Do not leave blank. If the publication is owned by a corporation, give the name and address of the corporation immediately followed by the names and addresses of all stockholders owning or holding 1 percent or more of the total amount of stock. If not owned by a corporation, give the names and addresses of the individual owners. If owned by a partnership or other unincorporated firm, give its name and address as well as those of each individual owner. If the publication is published by a nonprofit organization, give its name and address.)*

Full Name	Complete Mailing Address
Minnesota Center for Fiscal Excellence	85 East 7th Place
	Suite 250
	St. Paul, Mn 55101

11. Known Bondholders, Mortgagees, and Other Security Holders Owning or Holding 1 Percent or More of Total Amount of Bonds, Mortgages, or Other Securities. If none, check box → ☒ None

Full Name	Complete Mailing Address

12. Tax Status *(For completion by nonprofit organizations authorized to mail at nonprofit rates) (Check one)*
The purpose, function, and nonprofit status of this organization and the exempt status for federal income tax purposes:
☒ Has Not Changed During Preceding 12 Months
☐ Has Changed During Preceding 12 Months *(Publisher must submit explanation of change with this statement)*

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13. Publication Title: FISCAL FOCUS

14. Issue Date for Circulation Data Below: July/Aug 2014

15. Extent and Nature of Circulation: STATEWIDE		Average No. Copies Each Issue During Preceding 12 Months	No. Copies of Single Issue Published Nearest to Filing Date
a. Total Number of Copies *(Net press run)*		185	180
b. Paid Circulation *(By Mail and Outside the Mail)*	(1) Mailed Outside-County Paid Subscriptions Stated on PS Form 3541 (Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)		
	(2) Mailed In-County Paid Subscriptions Stated on PS Form 3541 *(Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)*	171	169
	(3) Paid Distribution Outside the Mails Including Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Paid Distribution Outside USPS®		
	(4) Paid Distribution by Other Classes of Mail Through the USPS (e.g., First-Class Mail®)		
c. Total Paid Distribution *(Sum of 15b (1), (2), (3), and (4))* ▶		171	169
d. Free or Nominal Rate Distribution *(By Mail and Outside the Mail)*	(1) Free or Nominal Rate Outside-County Copies included on PS Form 3541		
	(2) Free or Nominal Rate In-County Copies Included on PS Form 3541		
	(3) Free or Nominal Rate Copies Mailed at Other Classes Through the USPS (e.g., First-Class Mail)		
	(4) Free or Nominal Rate Distribution Outside the Mail *(Carriers or other means)*		
e. Total Free or Nominal Rate Distribution *(Sum of 15d (1), (2), (3) and (4))*			
f. Total Distribution *(Sum of 15c and 15e)* ▶		171	169
g. Copies not Distributed *(See Instructions to Publishers #4 (page #3))* ▶		14	11
h. Total *(Sum of 15f and g)*		185	180
i. Percent Paid *(15c divided by 15f times 100)* ▶		100%	100%

16. ☐ Total circulation includes electronic copies. Report circulation on PS Form 3526-X worksheet.

17. Publication of Statement of Ownership
☑ If the publication is a general publication, publication of this statement is required. Will be printed in the NOV/DEC 2014 issue of this publication.
☐ Publication not required.

18. Signature and Title of Editor, Publisher, Business Manager, or Owner

Date: 9-12-14

I certify that all information furnished on this form is true and complete. I understand that anyone who furnishes false or misleading information on this form or who omits material or information requested on the form may be subject to criminal sanctions (including fines and imprisonment) and/or civil sanctions (including civil penalties).

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85 East Seventh Place
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