MANAGEMENT AND BUDGET

Revenue and Economic Update

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State Revenues Above February Forecast

Minnesota's net general fund receipts totaled $5.027 billion during the months of July through September 2018, or $282 million (5.9 percent) more than projected in the February 2018 *Budget and Economic Forecast* adjusted for minor legislative changes. Receipts for all major tax types were above the forecast for the quarter.

Net individual income tax receipts were $67 million (2.5 percent) more than forecast for the first three months of FY 2019. Higher than expected gross receipts and lower than expected refunds both contributed to the positive variance. (See page 4 for details.) Payments associated with tax year 2018 economic activity—income tax withholding and estimated payments—were about $43 million above the forecast.

Income tax refunds for the quarter, which are largely associated with tax year 2017 filings, were $24 million lower than forecast. We will know final tax year 2017 income tax liability after all 2017 returns—including returns due October 15 from taxpayers requesting an extension—have been filed and processed. In early November we will estimate 2017 income tax liability based on returns processed to date.

Net corporate tax receipts were $88 million (24.6 percent) above the forecast. This was due to both higher than expected corporate tax payments and refunds that were below the forecast. Corporate estimated tax payments for the quarter are about 27 percent higher than in the third quarter of last year. At the end of November, we will have information from the Bureau of Economic Analysis (BEA) about third quarter growth in U.S. corporate profits, which may help explain the growth in corporate tax payments.

Other net revenues were $126 million above the forecast. The largest contributor to this variance is residual revenues, which were $52 million above the forecast. Most of the residual revenues variance—$47 million—was due to a higher than expected excess surplus from the Minnesota Workers' Compensation Assigned Risk Plan, and will be transferred from the general fund to the budget reserve per statutory allocation at the time of the November 2018 *Budget and Economic Forecast*.

Net sales tax receipts were $1 million (0.1 percent) above the forecast. Lower than expected sales tax refunds more than offset gross tax payments that were less than forecast.

Summary of Revenues: July-September 2018

($ in millions)	February 2018 Forecast[1]	Actual	$ Difference	% Difference
Individual Income Tax	$2,686	$2,753	$67	2.5%
General Sales Tax	1,284	1,285	1	0.1
Corporate Franchise Tax	356	444	88	24.6
Other Revenues	418	544	126	30.2
Total Revenues[2]	**$4,745**	**$5,027**	**$282**	**5.9%**

1. Adjusted for legislative changes.
2. Totals may not add due to rounding.

Contact: Chris Kelly | Director of Communications
651-259-3692 | Chris.Kelly@state.mn.us

Fiscal Year 2018 Revenues Above the Forecast

Net general fund revenues for the fiscal year that ended June 30, 2018, are now $376 million (1.7 percent) more than forecast in February, $28 million more than the $348 million variance we originally reported in the July 2018 *Revenue and Economic Update*. Sales tax and other revenues received between June 30 and the official close were higher than initially estimated, resulting in the improved revenue position. The next official forecast will be released in early December 2018.

U.S. Outlook Improves in Near-Term, Weakens after 2019

The 2018-2019 outlook for U.S. economic growth as measured by real GDP has improved somewhat since Minnesota's *Budget and Economic Forecast* was last prepared in February 2018, but the outlook for the following two years has weakened. The Bureau of Economic Analysis (BEA) estimates that real GDP grew at an annual rate of 4.2 percent in the second quarter, up from 2.2 percent growth in the first quarter. IHS Markit (IHS)—Minnesota's macroeconomic consultant—reports that a pre-tariff surge in soybean exports added over 0.5 percentage points to GDP in the second quarter, but that is likely to reverse in the second half of 2018. According to IHS, GDP will remain strong in the second half of 2018.

Overall, U.S. economic fundamentals remain solid. In the October 2018 outlook, IHS expects a pickup in annual real GDP growth from 2.2 percent in 2017 to 2.9 percent in 2018. In February, IHS had expected 2.7 percent growth in 2018. Growth in real consumer spending remains the largest contributor to real GDP growth. Fiscal stimulus from the Tax Cuts and Jobs Act (TCJA), rising personal income, increased inventory investment, and ongoing improvements in household portfolios are expected to support GDP growth of 3.0 percent in the second half of 2018. Average hourly earnings remain on an upward trajectory, increasing at 2.8 percent year over year. IHS expects GDP growth to slow from 2.9 percent in 2018 to 2.8 percent in 2019 and further to 2.0 percent in 2020, as rising interest rates and capacity constraints become larger drags on growth.

The Bureau of Labor Statistics (BLS) reports that U.S. employers added 134,000 jobs in September, slightly less than the trend of approximately 200,000 new jobs per month over the prior six months. The decrease is likely the result of temporary, distorting impacts from Hurricane Florence. The unemployment rate was 3.7 percent in September, the lowest unemployment rate since 1969. IHS expects unemployment to average 3.9 percent over this year and fall to an average of 3.5 percent in 2019.

Compared to the February 2018 outlook, IHS lowered growth expectations for 2020 and 2021. IHS now expects 2.0 percent real GDP growth in 2020 compared to 2.1 percent in February. They forecast 1.6 percent growth in 2021, down from 1.9 percent in the February outlook. Cumulatively, IHS has lowered growth expectations for the period of 2017-2021 since the February forecast.

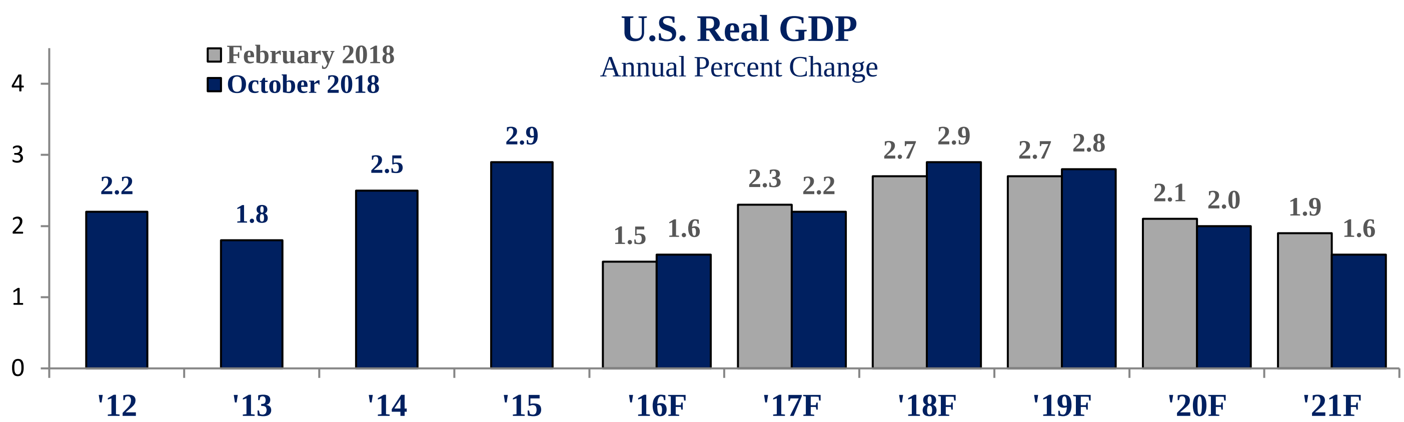
The October IHS outlook incorporates the effects of new 25 percent U.S. tariffs on Chinese goods, as well as China's retaliatory tariffs on U.S. goods. In the forecasts for 2019-2021, net exports are a larger drag than IHS expected in February. In the October outlook, net exports subtract more than 0.5 percentage points from real GDP growth in 2019, 0.4 percentage points in 2020, and 0.2 percentage points in 2021.

The IHS October baseline forecast for 2018 is consistent with the Blue Chip Consensus, the median of 50 business and academic forecasts, which also expects 2.9 percent growth in 2018. The Blue Chip Consensus calls for 2.6 percent growth in 2019, a bit slower than IHS' 2.8 percent forecast for that year.

As expected, the Federal Open Market Committee (FOMC) raised the federal funds rate target range by 25 basis points to 2.0-2.25 percent in September. This was the third increase of 2018, and is consistent with the Fed's view that the labor market is tightening. IHS' October outlook assumes one more 25-basis-point increase in the federal funds rate this year. IHS expects additional rate hikes to bring the upper end of the target range to 3.50 percent in 2020.

Forecast risks include the length of the current economic expansion and international trade. On September 24, the United States imposed tariffs on $200 billion worth of Chinese imports in addition to the $50 billion in tariffs enacted earlier this year. China retaliated by targeting an additional $60 billion in American exports. As a result of the second wave of tariffs, nearly 50 percent of all Chinese imports into the United States will be subject to tariffs. IHS expects the net impact of tariffs on GDP growth, overall, to be negative, but modest. While trade policy uncertainty represents a risk to this forecast, a revised North American Free Trade Agreement (NAFTA)—now called the U.S. Mexico Canada Agreement (USMCA)—reached on September 30 alleviates uncertainty about trade policy among the U.S., Canada, and Mexico.

Since February, IHS has changed the probabilities assigned to the baseline and alternative scenarios. They assign a probability of 60 percent to the October baseline outlook. They assign a 25 percent probability to a more pessimistic scenario, in which a loss in consumer and business confidence trigger a three-quarter recession starting in the fourth quarter of 2019, slowing annual real GDP growth to 2.6 percent in 2019 and -0.6 percent in 2020. In IHS's more optimistic scenario, low inflation amid a strengthening economy and continued improvements in household net worth support growth to 3.4 percent in 2019. This scenario gets a 15 percent probability.



Source: Bureau of Economic Analysis and IHS Markit.

Comparison of Actual and Forecast Non-Dedicated Revenues

($ in thousands)

	Fiscal Year 2018			July-September 2018		
	FORECAST REVENUES[1]	ACTUAL REVENUES	VARIANCE ACT-FCST	FORECAST REVENUES	ACTUAL REVENUES	VARIANCE ACT-FCST
Individual Income Tax						
Withholding	9,057,300	9,067,189	9,889	2,157,300	2,173,021	15,721
Declarations	2,614,200	2,699,772	85,572	440,784	468,444	27,660
Miscellaneous	1,429,000	1,609,962	180,962	140,388	140,297	(91)
Gross	13,100,499	13,376,923	276,423	2,738,472	2,781,762	43,290
Refund	1,649,100	1,593,422	(55,677)	52,614	28,799	(23,815)
Net	11,451,400	11,783,500	332,100	2,685,858	2,752,963	67,105
Corporate Franchise Tax						
Declarations	1,199,742	1,230,271	30,530	305,587	388,756	83,169
Miscellaneous	278,293	222,614	(55,679)	73,895	63,928	(9,967)
Gross	1,478,035	1,452,885	(25,149)	379,482	452,684	73,202
Refund	176,934	138,360	(38,574)	22,983	8,403	(14,581)
Net	1,301,100	1,314,525	13,424	356,498	444,281	87,782
General Sales and Use Tax						
Gross	5,694,663	5,684,120	(10,543)	1,309,858	1,301,533	(8,326)
Mpls. sales tax transferred to MSFA	1,855	1,855	(1)	605	605	(0)
Sales Tax Gross	5,696,518	5,685,975	(10,544)	1,310,463	1,302,138	(8,326)
Refunds (including Indian refunds)	207,900	232,911	25,011	26,628	17,299	(9,329)
Net	5,488,618	5,453,064	(35,555)	1,283,835	1,284,839	1,003
Other Revenues						
Net Estate	199,700	213,416	13,716	32,325	65,943	33,618
Net Liquor/Wine/Beer	90,750	91,748	998	17,317	18,563	1,246
Net Cigarette/Tobacco	583,990	563,311	(20,679)	94,143	111,975	17,832
Deed and Mortgage	249,022	250,158	1,136	56,910	52,654	(4,256)
Net Insurance Premiums Taxes	394,263	396,472	2,209	95,955	95,241	(714)
Net Lawful Gambling	71,200	74,821	3,622	14,171	15,873	1,702
Health Care Surcharge	287,233	287,376	143	18,395	17,303	(1,092)
Other Taxes	10,555	13,108	2,553	-	2,236	2,236
Statewide Property Tax	804,976	811,376	6,399	16,312	15,919	(393)
DHS SOS Collections	69,500	79,577	10,077	17,875	20,280	2,405
Investment Income	32,000	55,402	23,403	6,500	15,975	9,475
Tobacco Settlement	157,260	166,931	9,672	100	100	-
Dept. Earnings & MSOP Recov.	208,585	218,070	9,485	33,814	37,543	3,730
Fines and Surcharges	74,254	76,065	1,810	5,427	12,625	7,199
Lottery Revenues	64,562	66,400	1,838	8,782	8,916	134
Revenues yet to be allocated	(0)	0	1	-	306	306
Residual Revenues	152,032	151,582	(451)	1,658	53,867	52,209
Other Subtotal	3,449,881	3,515,813	65,932	419,683	545,319	125,636
Other Refunds	5,305	5,197	(108)	1,376	848	(527)
Other Net	3,444,576	3,510,616	66,040	418,307	544,471	126,164
Total Gross	23,724,934	24,031,596	306,662	4,848,101	5,081,903	233,802
Total Refunds	2,039,239	1,969,891	(69,348)	103,601	55,349	(48,252)
Total Net	21,685,695	22,061,705	376,010	4,744,500	5,026,553	282,054

1. February 2018 *Budget & Economic Forecast* adjusted for legislative changes.