

July 1998

State Revenues Remain Above Forecast

Minnesota's net general fund receipts for F.Y. 1998 are now estimated to total \$10.341 billion, \$317 million, (3.2 percent) more than forecast in February. The individual income tax exceeded the forecast by nearly \$222 million. Corporate income tax receipts fell below expected levels by \$29 million, while the sales tax, the motor vehicle excise tax, and other tax and non-tax revenues all were greater than forecast. (See page 6.) Minnesota's general fund revenues grew by only 5.1 percent in FY 1998, significantly less than the average of the past decade, due to payment of the 1997 property tax rebate through the individual income tax system.

Summary of Tax Receipts: F.Y. 1998

| | <u>Forecast</u> | <u>Actual</u> | <u>Variance</u> | <u>Percent</u> |
|---------------|-------------------------------|----------------|-----------------|----------------|
| | -----Dollars in Millions----- | | | |
| Individual | 4,605.4 | 4,827.3 | 221.9 | 4.8 |
| Sales | 3,219.1 | 3,253.5 | 34.4 | 1.1 |
| Corporate | 787.2 | 758.5 | (28.7) | (3.6) |
| Motor Vehicle | 412.6 | 437.8 | 25.2 | 6.1 |
| Other | <u>999.4</u> | <u>1,063.7</u> | <u>64.3</u> | 6.4 |
| TOTAL | 10,023.7 | 10,340.7 | 317.0 | 3.2 |

The federal government and most other states also are reporting tax receipts greater than forecast. The economy's continued strength, further stock market gains, and changes in taxpayer behavior motivated by last year's changes to the federal tax code have all been identified as likely sources of additional revenue. Those factors undoubtedly are part of the explanation for Minnesota's positive revenue variance as well. In addition, property tax rebate claims, processed as part of the individual income tax, have, to this point, been less than anticipated, further increasing Minnesota's income tax variance.

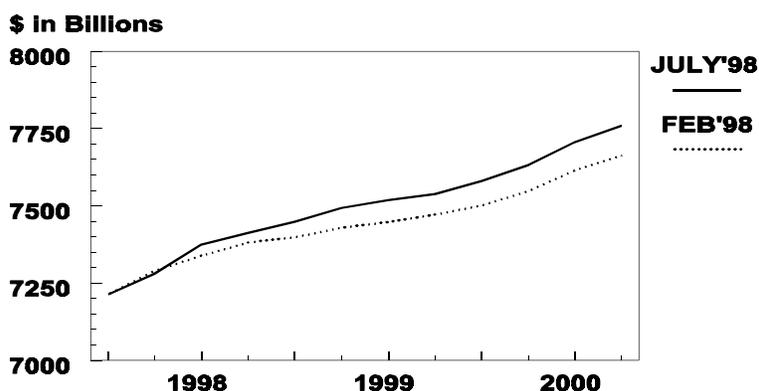
All F.Y. 1998 results are preliminary and subject to change. As is customary in this first report of receipts for the full fiscal year, estimates for some revenue sources have been adjusted to reflect anticipated accruals. A more complete set of F.Y. 1998 results will be provided in the October *Economic Update*. Final results will be available after the official closing has been completed and will be reported as part of the November forecast.

Consumer Spending Will Be the Key for the Remainder of 1998.

The U.S. economy's performance in early 1998 surprised everyone. No one anticipated the year would begin with real GDP growing at an annual rate of 5.4 percent, the second strongest quarter of economic growth in the nineties, or that consumer spending -- buoyed by low interest rates, further advances in the stock market, and unemployment rates last seen in the sixties -- would grow at an annual rate of more than 6 percent. That, coupled with an unprecedented \$100 billion increase in inventories, more than offset increasingly grim news on exports and the trade balance.

Unfortunately, the good economic news for 1998 is now behind us and, as predicted, Asia's economic weakness is spreading to the U.S. Most forecasters, including Data Resources Inc. (DRI), Minnesota's national macro-economic consultant, expect second quarter GDP reports to show the U.S. economic growth has slowed.

DRI Outlook for Real GDP Growth Improves



This slowdown could turn into a recession, but most forecasters believe the domestic economy has enough momentum to weather expected Asian shocks. DRI's projected growth rates for the remainder of 1998 now exceed those forecast in February. Real GDP is now expected to grow at annual rates of 3.4 percent in 1998 and 1.8 percent in 1999, up substantially from the 2.7 and 1.4 percent rates in February, and the U.S. economy is expected to end 1999 noticeably above February's.

Further economic deterioration in Asia remains number one on every list of concerns. Japan is now in recession, and many believe that recession will be longer and deeper than previously anticipated. The stakes are high since Japan is the world's second largest economy and a major trading partner for other depressed Asian economies. There is little hope that the rest of Asia will begin to grow while Japan is in recession. Many fear a devaluation in China and a second round of devaluations throughout Asia unless the Japanese economy strengthens.

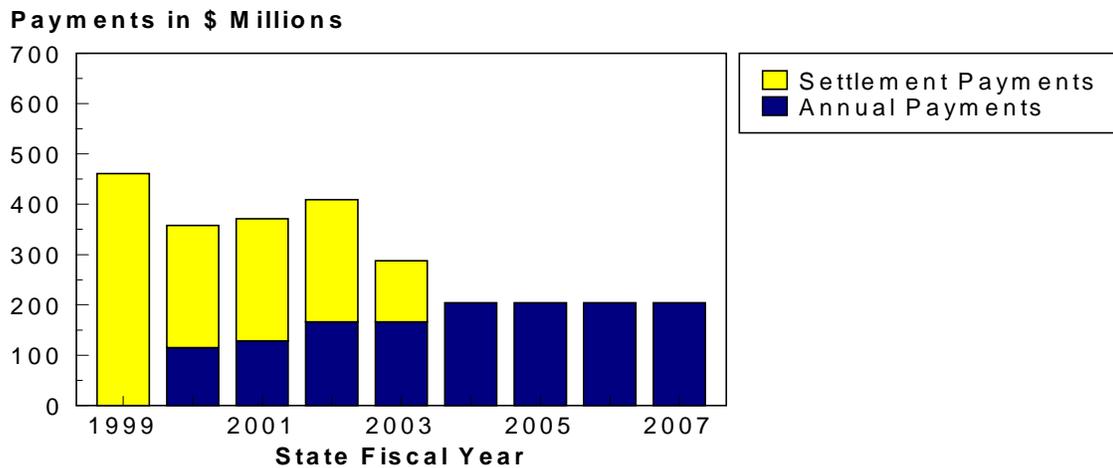
While acknowledging an increase in the risk to the forecast, DRI continues to assign a probability of 55 percent to the Control forecast, the same as in February. The principal alternative (probability 25 percent) is a Boom Bust forecast in which the economy enters a recession in 2000. A recession in 1999 is currently given a probability of 20 percent.

Tobacco Settlement Yields Additional General Fund Revenues

Public reports of a \$6.1 billion tobacco settlement are an estimate of the revenue the state will receive over the next 25 years. During the current biennium ending on June 30, 1999, the state’s General Fund will receive \$461 million from the tobacco industry. Total revenues through F.Y. 2003 are expected to be \$1.884 billion.

Payments will continue into perpetuity but amounts may differ significantly from current estimates. Policy makers must recognize a unique set of risks which may adversely affect the scheduled payments, including:

- Potential impacts of current federal law and the Health Care Financing Administration’s (HFCA) attempts to claim Medicaid recoveries;
- Tobacco companies’ long term viability and their financial capacity to make on-going state payments;
- Probable changes in tobacco sales and its impact on industry obligations;
- A new national settlement or tobacco related legislation.



Minnesota Tobacco Revenues, 1999 - 2007

Over the state budget planning period, fiscal years 1998-2003, money expected to be received by the General Fund includes *Settlement Payments* that total \$1.31 billion and *Annual Payments* that total \$574 million (see table on page 4).

Revenues actually received by the state must be appropriated by the legislature and approved by the governor before they can be spent. There are several issues which may affect the availability of these revenues, including:

- Current statutes automatically allocate slightly over \$600 million of any forecast surplus in November 1998 to a tax reduction account and replace state bonding with cash;
- The settlement provides that the Attorney General request one-half of the Settlement Payments be appropriated to a public health foundation. The state is under no obligation to approve the request;
- Prudent financial management suggests that a portion of the revenues be held in reserve due to the uncertainty of tobacco payments.

General Fund Non-Dedicated Revenues
(in \$ Millions)

| <u>Fiscal Year</u> | <u>Settlement Payments</u> | <u>Annual Payments</u> | <u>Total General Fund</u> |
|--------------------------------|--------------------------------|----------------------------|-------------------------------|
| 1998 | 0.0 | 0.0 | 0.0 |
| 1999 | 460.8 | 0.0 | 460.8 |
| 2000 | 242.6 | 114.8 | 357.3 |
| 2001 | 242.6 | 127.5 | 370.1 |
| 2002 | 242.6 | 165.8 | 408.3 |
| 2003 | <u>121.6</u> | <u>165.8</u> | <u>287.3</u> |
| Total, FY 1998-2003 | 1,310.0 | 573.8 | 1,883.8 |

Settlement Payments end after five years. Annual Payments are intended to be on-going revenues to the General Fund, increasing to \$204 million per year in F.Y. 2004 and each year thereafter.

In addition to monies received by the state treasury, the settlement establishes two other accounts. These accounts are to be administered by the court and are not subject to the appropriation process. These non-state funds include a *Smoking Cessation Account* established with a one-time payment of \$102 million and a *National Research Account* funded with \$100 million over ten years.

Non-State Money for Dedicated Activities
(in \$ Millions)

| <u>Fiscal Year</u> | <u>National Research Account</u> | <u>Smoking Cessation Account</u> |
|--------------------------------|--------------------------------------|--------------------------------------|
| 1998 | 10.0 | 0.0 |
| 1999 | 10.0 | 102.0 |
| 2000 | 10.0 | 0.0 |
| 2001 | 10.0 | 0.0 |
| 2002 | 10.0 | 0.0 |
| 2003 | <u>10.0</u> | <u>0.0</u> |
| Total, FY 1998-2003 | 60.0 | 102.0 |

Fiscal 1998 Variance Estimates Include Unusually Large Accrual Estimates

The end-of-fiscal year revenue variances reported in July *Economic Updates* always include adjustments to reflect revenues received but not posted to the state's accounting system by June 30. To minimize changes in the reported end-of-fiscal year variance between that provided in the *Update* and the final closing, forecast levels are typically reduced by amounts consistent with the amounts which accrued to the fiscal year between June 30 and closing in past years.

Those adjustments are typically small. This year though, the accrual estimates are much larger, and the difference between the estimated accruals and the end of fiscal year actuals reported at final closing, could have a material impact on the F.Y. 1998 revenue variance, and on perceptions of the state's financial position.

Combining the filing for the property tax rebate with individual income tax filing increased the number of returns and the time required to process the 1997 individual income tax. On June 30, payment of all refunds due those who filed tax returns on April 15 had not yet been completed. Since at final closing these remaining refunds will be assigned to fiscal 1998, an estimate of the refunds remaining to be paid must be factored into the calculations of the current variance to avoid overstating the true variance in FY 1998 revenues. In this report, the individual income tax refund forecast has been reduced by \$85 million to more accurately reflect the actual variance which will be shown at closing. The \$85 million adjustment, however, is only an estimate of the amount of refunds remaining to be paid. Actual payments could exceed or fall short of that estimate by more than \$20 million.

Much of Any Potential F.Y. 1998-99 Forecast Gain Already Allocated

The 1998 Legislative Session has already allocated the first \$609 million of any forecast surplus for the current biennium. Under current law, following release of the November forecast, the first \$9 million of any reported surplus, including the General Fund's F.Y. 1999 share of the tobacco settlement, is required to be used to bring the budget reserve up to its statutory level of \$622 million. The next \$200 million is dedicated to a special Tax Reduction and Reform Account. Following that, up to an additional \$400 million is required to be transferred to a capital account and used to replace bond proceeds in funding the capital budget approved in the 1998 Legislative Session. For F.Y. 1998-99 only surpluses beyond \$609 million will be available for allocation in the 1999 Legislative Session.

Comparison of Actual and Estimated Non-Restricted Revenues (\$ in thousands)

| | 1998 Fiscal Year to Date | | | April - June 1998 | | |
|------------------------------------|--------------------------|--------------------|----------------------|----------------------|--------------------|----------------------|
| | Forecast Revenues | Actual Revenues | Variance Act-Fcst | Forecast Revenues | Actual Revenues | Variance Act-Fcst |
| Four Major Revenues: | | | | | | |
| Individual Income Tax | | | | | | |
| Withholding | 4,164,305 | 4,168,698 | 4,393 | 1,021,678 | 1,098,026 | 76,348 |
| Declarations | 903,340 | 933,336 | 29,995 | 360,428 | 387,917 | 27,489 |
| Miscellaneous | 514,271 | 495,418 | (18,853) | 429,851 | 410,998 | (18,853) |
| Gross | 5,581,916 | 5,597,452 | 15,536 | 1,811,957 | 1,896,941 | 84,984 |
| Refunds | 976,500 | 770,182 | (206,318) | 929,901 | 723,583 | (206,318) |
| Net | 4,605,416 | 4,827,271 | 221,855 | 882,056 | 1,173,358 | 291,302 |
| Corporate & Bank Excise | | | | | | |
| Declarations | 780,073 | 743,040 | (37,033) | 196,361 | 142,805 | (53,556) |
| Miscellaneous | 91,728 | 104,168 | 12,440 | 15,371 | 30,208 | 14,837 |
| Gross | 871,801 | 847,208 | (24,593) | 211,732 | 173,013 | (38,719) |
| Refunds | 84,632 | 88,752 | 4,120 | 18,000 | 20,966 | 2,966 |
| Net | 787,169 | 758,457 | (28,712) | 193,732 | 152,047 | (41,685) |
| Sales Tax | | | | | | |
| Gross | 3,347,087 | 3,375,962 | 28,875 | 942,687 | 958,787 | 16,100 |
| Refunds | 128,000 | 122,499 | (5,501) | 36,940 | 39,899 | 2,959 |
| Net | 3,219,087 | 3,253,463 | 34,376 | 905,747 | 918,888 | 13,141 |
| Motor Vehicle Excise | 412,600 | 437,815 | 25,215 | 103,900 | 128,836 | 24,936 |
| Other Revenues: | | | | | | |
| Inherit/Gift/Estate | 40,487 | 62,140 | 21,653 | 9,896 | 29,050 | 19,154 |
| Liquor/Wine/Beer | 56,407 | 57,446 | 1,038 | 15,745 | 18,181 | 2,436 |
| Cigarette & Tobacco | 174,868 | 176,937 | 2,069 | 54,399 | 59,415 | 5,016 |
| Deed and Mortgage | 105,600 | 119,942 | 14,342 | 22,556 | 35,491 | 12,935 |
| Insurance Gross Earnings | 155,000 | 163,096 | 8,096 | 57,725 | 86,489 | 28,764 |
| Lawful Gambling | 63,150 | 64,834 | 1,684 | 20,537 | 22,403 | 1,866 |
| Health Care Surcharge | 118,090 | 122,366 | 4,277 | 27,706 | 36,552 | 8,846 |
| Other Taxes | 3,480 | 3,715 | 235 | 2,707 | 2,952 | 245 |
| General Fund RTC Revenues | 33,503 | 35,842 | 2,340 | 6,289 | 7,756 | 1,467 |
| Income Tax Reciprocity | 37,872 | 37,872 | 0 | 0 | 0 | 0 |
| Investment Income | 142,964 | 150,257 | 7,293 | 34,705 | 27,685 | (7,020) |
| Tobacco Settlement Rel. Rev. | 0 | 297 | 297 | 0 | 297 | 297 |
| Other and Unallocated | 79,350 | 86,849 | 7,499 | 15,497 | 14,112 | (1,384) |
| Other Subtotal | 1,010,770 | 1,081,593 | 70,823 | 267,762 | 340,384 | 72,622 |
| Other Refunds | 11,338 | 17,870 | 6,532 | (3,245) | 6,160 | 9,405 |
| Other Net | 999,432 | 1,063,723 | 64,291 | 271,007 | 334,224 | 63,217 |
| Total Gross | 11,224,174 | 11,340,031 | 115,857 | 3,338,038 | 3,497,961 | 159,923 |
| Total Refunds | 1,200,470 | 999,302 | (201,168) | 981,596 | 790,607 | (190,988) |
| Total Net | 10,023,704 | 10,340,729 | 317,025 | 2,356,442 | 2,707,353 | 350,911 |