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# Government employment: Job insecurity

*Despite the imprimatur of job security, the ax has (belatedly) fallen on public sector employment, especially at the local level*

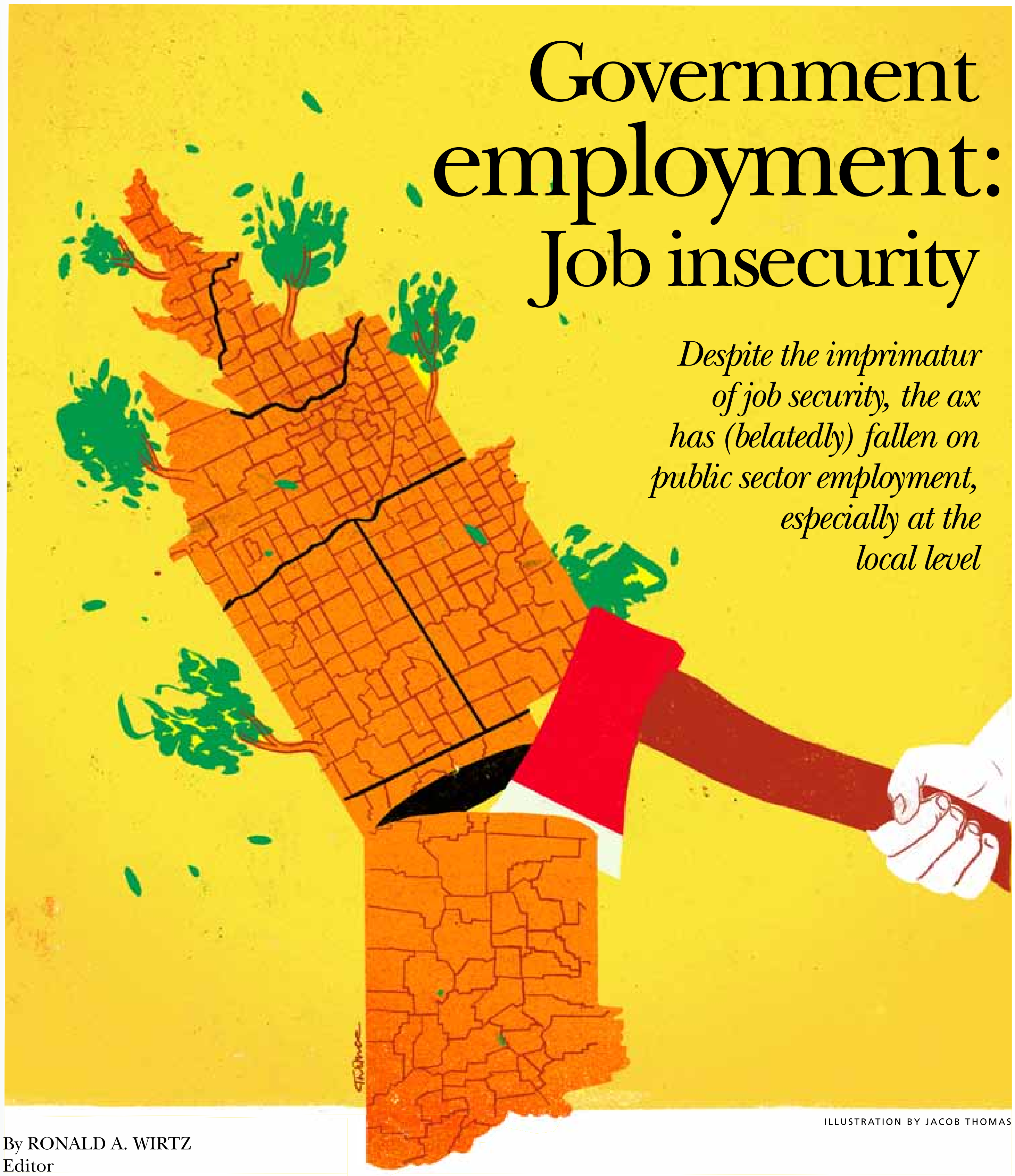


ILLUSTRATION BY JACOB THOMAS

By RONALD A. WIRTZ
Editor

Let's start with introductions. Public sector employment, meet Wile E. Coyote.

You've never met, but an introduction is in order because the two of you share a unique characteristic: You both know how to temporarily defy gravity.

Wile E., remember the time—actually, *those hundreds of times*—you ran off the cliff chasing the Road Runner but stayed suspended in the air in ignorance, until reality finally set in and you plummeted to earth, followed by a huge boulder for a little extra hurt at the bottom. Remember that?

Public sector employment, you were doing the same thing for a while across *thousands* of state and local government units. At the height of the recession, private employment was falling like it was tied to that boulder. But what did you do? You actually floated *higher*. But then reality set in for you, too, and look out below. It's been tough watching you fall because private employment is still trying to pick itself up off the ground below you.

It's a scene now uncomfortably familiar to thousands of government workers in the Ninth District. Public sector employment has fallen significantly over the past couple of years, following a similar—if delayed, and not quite as steep—decline experienced by the private sector during the recession.

Continued on page 2

**Government employment** from page 1

### The Quick Take

Government employment has seen significant job losses since 2010 across all levels of government and most district states. While private employment dropped dramatically with the recession, public sector employment actually rose, thanks to the federal stimulus. A slow economic recovery and the end of stimulus funding have led to hard budget decisions, particularly among local governments. Local governments in Minnesota and Wisconsin have seen the largest cuts. But rather than a recent phenomenon, local government employment in these states has fluctuated for the past decade, thanks to periodic state budget deficits and subsequently less state aid to local governments.

Today, the fact that people are losing jobs doesn't merit a lot of special attention, even for supposedly secure government jobs. It's almost like we're immune to the pain—like Wile E. Coyote dusting himself off after yet another death-defying fall. Yet it's worth tracing the arc of public sector employment over the past decade to better understand both the moment of levitation and the comparatively sudden fall.

Of course, this is not the first time government workers have lost jobs. But rarely have there been job losses of this magnitude—almost 19,000 from the first quarter of 2010 to the same quarter of 2012, or about 2 percent of the 1 million public sector workers in Ninth District states. In past recessions, public sector employment tended not to decline dramatically, in part because most recessions have been fairly brief, and governments often prefer belt-tightening to dramatic cuts in personnel.

The Great Recession from late 2007 to 2009 was a large—and somewhat ironic—exception to that rule: Public sector revenue and employment actually increased for many governments during and shortly after the recession thanks to the federal stimulus program, which shoveled tens of billions of dollars to state and local governments to stave off further unemployment in the economy.

But the effect was short-lived. A slow economic recovery has kept a lid on tax revenue, and once stimulus funds were gone, government budgets cratered. Tough decisions finally had to be made almost everywhere in the Ninth District, save for North Dakota, whose economy, government budgets and public employment are growing, in contrast to most of the country. Montana and South Dakota have lost public employees since 2010, and government payrolls in Minnesota and Wisconsin have been volatile, especially at the local level, for a decade.

Jobs have been lost at every level of government in recent years, but the biggest losses have been at the local level, in part because that's where most of the jobs are, but also because state aid to cities, counties and school districts has been cut back as states deal with their own fiscal shortfalls.

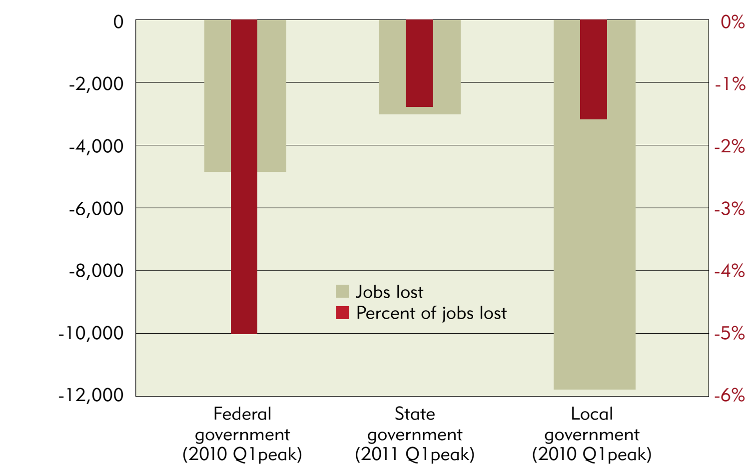
## Public sector score card

Explicit trends in government employment can be difficult to nail down given some 13,000 government entities just in Ninth District states. But breaking them down by government jurisdictions—local, state and federal—helps identify some of the broader trends. (See online chart tabs for district state breakdowns of local, state and federal employment trends.)

Chart 1

**Look out below**

Public sector job loss in Ninth District states*
Peak employment to Q1 2012




*Includes MN, MT, ND, SD, WI
Source: Bureau of Labor Statistics, Quarterly Census of Employment and Wages

**This is not the first time government workers have lost jobs. But rarely have there been job losses of this magnitude.**

Recent job cuts have been spread widely among local, state and federal government workers in district states (see Chart 1). Federal employment is the smallest share of total government employment in any district state (between 8 percent and 16 percent, depending on the state). Nonetheless, almost 5,000 federal workers across the district lost their jobs over this two-year period. But rather than being an artifact of the recession, federal job losses stem mostly from the buildup and subsequent wind-down of the decennial census.

State government employment saw steady growth in district states for the better part of a decade—even during the recession—largely thanks to growth of general administration, corrections, health and human services, and higher education, which is seeing record enrollments across the district. But that payroll trend pivoted in 2011, and more than 3,200 jobs were eliminated by the first quarter of 2012, almost two-thirds of them in Wisconsin, and most of the remainder in Minnesota.

But the lion's share of job losses occurred among local governments, with employment falling in 2010 and accelerating a year later, with almost 12,000 local government employees losing their jobs over this two-year period. More than 60 percent of those cuts occurred in Wisconsin, but every district state except North Dakota saw local government employment fall over this period.

But local government employment trends are diverse and complex, partially due to size and scale; roughly two-thirds of all public sector jobs in a state are at the local level, scattered among thousands of government bodies. Part of it is mission; local governments include county, city, township, school dis-

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One of the Minneapolis Fed's congressionally mandated responsibilities is to gather information on the Ninth District economy. The fedgazette is published quarterly to share that information with the district, which includes Montana, North and South Dakota, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

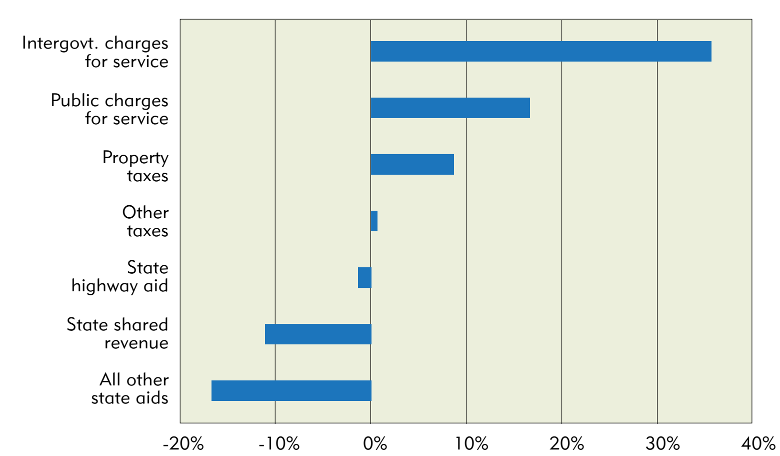
The opinions expressed in the fedgazette are expressly those of the authors or of attributed sources and are not intended to represent a formal position of this bank or the Federal Reserve System.



Chart 2

**Lagging local aid in Wisconsin**

Percent change in local government revenue
By source, 2005 to 2010 (2010 dollars)




Source: Wisconsin Department of Revenue

**Many laid-off government workers were victims of a budgetary vise that had been developing for much of the past decade: persistently falling financial aid from states and rapidly rising property taxes.**

ILLUSTRATION BY JACOB THOMAS

trict and special district units, each with its own public service niche. Lastly, part of it is geography and economy; local governments face different financial circumstances depending on their home state's economy, among other factors. Sources in booming North Dakota, for example, report very different concerns than those in Minnesota and Wisconsin.

## The pathway here

Most laid-off government workers ultimately lost their jobs because of the recession and its impact on tax revenues. But many were also victims of a budgetary vise that had been developing for much of the past decade, especially in Minnesota and Wisconsin: persistently falling financial aid from states and rapidly rising property taxes.

States pass along aid to local governments in various forms, and many of them have been flat or declining in real dollars for a decade or better. For example, so-called shared revenue is a formula-driven sum given to local governments. Local governments in South Dakota saw shared revenue fall by 10 percent from 2006 to 2011, according to the state's latest comprehensive annual financial report. (All dollar figures in this article have been adjusted for inflation.)

States also give categorical aids to help local governments manage things like roads and other services, and many of those aids also have fallen in real terms. Among the top seven sources of local revenue for Wisconsin local governments, all aid categories fell between 2005 and 2010, while property taxes and various charges for services rose (see Chart 2). Shared revenue dropped by 10 percent to $924 million and has continued to fall. According to recent figures from the state Department of Revenue, shared revenue this year is expected to be about 8 percent below 2010 levels.

States have tried to limit property tax increases, with varying success. Wisconsin local governments have been under property tax levy limits for 10 years, and a property tax freeze for the past two years, according to Richard Stadelman, executive director of the Wisconsin Towns Association. With cuts in shared revenue in three of the past 10 years, the effect on local government finance is "dramatic," he said.

In Minnesota, it's the same story, or worse. Total state aid to local (nonschool) governments has trundled steadily lower; in 2012, it gave towns, cities and counties $1 billion less in aid than a decade earlier (see Chart 3).

"For the last decade, there's been a significant shift in the financing of local government," said Jeff Spartz, executive director of the Association of Minnesota Counties. The state mandates that counties provide certain public services with the understanding that "it would fund what it said needed to be done," he added. "[But] the state has solved its own budget deficit by cutting back on aid to local governments." (See sidebar on page 4.)

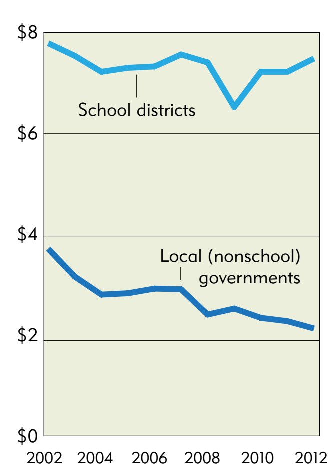
To fill out their budgets, local governments in Minnesota and elsewhere persistently chose to raise property taxes (see Chart 4), often along with fees and other revenue sources.

"The state has passed the buck to the local level for revenues," said James Hendrickson, clerk of Wang Township in Renville County, Minn. The town's expenses have risen "considerably" in recent years, he said, requiring the town to raise property taxes three years in a row to continue basic services, and also depleting the town's reserve fund. As of late October, "we are at the lowest level of financial reserves that we have ever been," he said.

Chart 3

**First aid?**

Minnesota state aid to local governments
Billions of 2012 dollars

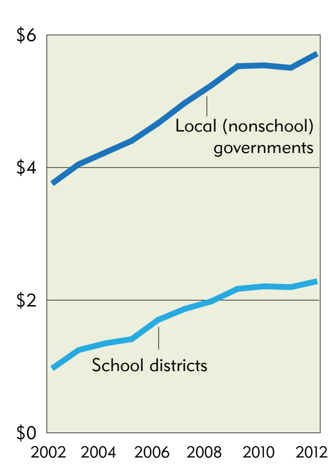



Source: Minnesota Department of Revenue

Chart 4

**Tax hike**

Property taxes collected
Billions of 2012 dollars




Source: Minnesota Department of Revenue

## A stimulating budget filler

The run on rapidly rising property taxes ended around 2008 or 2009, when property values started dropping. Like Wisconsin, many states have bent to voters' discontent over rising taxes by capping allowable increases in local revenue as well as property assessments, tax rates and levies—or sometimes all of the above.

In years past, this has been less of a problem, as cities, counties and school districts could depend on modest (or better) increases from the appreciation of property values. But with stagnant or dropping property values, these revenue handcuffs meant local government income grew more slowly and sometimes fell; meanwhile, many governments couldn't shed service requirements.

In Minnesota, for example, property tax revenue from 2002 to 2009 rose at an annual real rate of about 4 percent for Minnesota counties and towns, 5

Continued on page 5

# Please do this. Good luck

## Unfunded mandates and revenue handcuffs

ILLUSTRATION BY JACOB THOMAS

Even the most flexible, forward-thinking government can run into roadblocks not of its own making. Numerous local government sources said unfunded state and federal mandates often prevent cities, counties and school districts from cutting costs and becoming more efficient.

Don't believe it? Here's a simple example, born of tradition: Many states still require local governments to post meetings and other official news in a printed newspaper, when web posting is readily available, free and arguably more accessible to the public.

New unfunded mandates show up every year. In Minnesota K-12 schools, the state has mandated new personnel evaluations that are "very prescriptive in statute," said Gary Amoroso, executive director of the Minnesota Association of School Administrators. The new evaluations will go into effect for principals this year and for all teachers next year, none of which comes with any implementation dollars. "Nobody is arguing with accountability. The challenge is, where are the funds and time [for evaluations] going to come from?" said Amoroso. State legislators, he said, "don't want to have unfunded mandates. But they keep coming out."

Many mandates are minor, but others not so much. The Minnesota Inter-County Association (MICA) is a coalition of 12 large Minnesota counties (but does not include Hennepin or Ramsey). In its platform for the 2012 legislative session, it said that "relief from unfunded mandates … has been a recurring desire of counties." Of particular importance is relief from so-called maintenance of effort requirements, "where the state literally tells counties how much they must spend for certain programs and sanctions them if they do not."

The state also requires that counties share in the costs of certain state-mandated programs. In 2011, the Legislature raised counties' share of new sex offender civil commitment costs from 10 percent to 25 percent and counties' share of chemical dependency treatment costs from 17 percent to 23 percent.

Combined, MICA said these two mandates alone required some $430 million in annual county spending and should be repealed given "the Legislature's emphasis on living within existing resources without raising taxes. … The Legislature cannot have it both ways. Either give counties the legal authority to actually reduce their expenditures or stop criticizing them when they increase expenditures and the property taxes to support them to meet the requirements of state law."

**State caps on local revenue and property taxes**

| | Local revenue limits | Property tax levy limits | Property tax rate limits | Property assessment limits |
|---|---|---|---|---|
| MI | ✔ | ✔ | ✔ | ✔ |
| MN | ✔ | ✔ | | ✔ |
| MT | | ✔ | ✔ | ✔ |
| ND | | ✔ | ✔ | |
| SD | | ✔ | ✔ | |
| WI | ✔ | ✔ | ✔ | |

Source: Pew Charitable Trusts, "The Local Squeeze," June 2012

States are often cognizant of the problem and have sought input on reforms from local governments. The Minnesota Office of the State Auditor now has a repository of several hundred reform suggestions from towns, cities, counties and schools.

But the task of reform is complicated. "There is a lot of talk about mandate relief," said Jeff Spartz, executive director of the Association of Minnesota Counties. But mandates are often so entangled in both federal and state requirements "that [state] legislators just throw up their hands." One example is a recent effort to simplify the application for state-based medical assistance, which is administered by counties. In Nebraska, a person must fill out a two-page application, Spartz said. In Minnesota, the application ran 21 pages, much of it filled with questions (for data-gathering purposes) or resource information for the benefit of applicants. Efforts to simplify the application winnowed it to "just 17 pages," according to Spartz.

States have also bent to voters' discontent over rising taxes by capping local revenue increases, along with property assessments, tax rates and levies—or sometimes all of the above (see table). In years past, this has been less of a problem; cities, counties and schools depend on modest (or better) increases merely from the appreciation of property values. But with stagnant or falling property values, other caps can mean local governments are forced to lower budgets without the ability to also shed service requirements.

South Dakota has been under a tax freeze since 1997 that limits revenue growth at the rate of inflation plus an adjustment for new construction, according to Diane Worrall, executive director of the South Dakota Association of Towns and Townships. If a town wants to increase its property tax revenue, it must go through an opt-out process that requires voter approval. That affords some flexibility, and many cities, counties and school districts in the state have chosen this opt-out feature.

But, Worrall said, "there have been very few townships that have opted out—guessing, I would say no more than 20 percent." Part of the reason is that towns also face a property tax (or "millage" rate) cap of just 3 mils, so "most opt-outs for townships don't generate much revenue."

*—Ronald A. Wirtz*

**Government employment** from page 3

percent for cities and 8 percent for K-12 school districts, according to the Office of the State Auditor. In the three subsequent years, tax revenue for these same local governments increased by an annual average of 1 percent or less.

But the budget shock was offset considerably by the American Recovery and Reinvestment Act (ARRA)—a.k.a. the federal stimulus program—which funneled billions of dollars to state and local governments starting in 2009, enabling them to keep payrolls afloat. For example, about $750 million went to local governments at all levels and sizes in Hennepin County (home to Minneapolis), according to an October county report. The money supported government efforts in housing, infrastructure, job training, education, public health and a multitude of other priorities, many of them with the overarching goal of supporting public sector employment.

**But with stagnant or dropping property values, these revenue handcuffs meant local government income grew more slowly and sometimes fell; meanwhile, many governments couldn't shed service requirements.**

Hennepin County government received $12 million directly. But ARRA's goal of job creation, according to the report, "was challenging … because we rightly saw the infusion of federal funds as temporary, arriving at a time when our basic local and state resources were stressed by the recession. As a result, stimulus funds were often used for 'job retention' by replacing declining local funds" or hiring only on a short-term rather than permanent basis.

By 2010, a sluggish economic recovery and the end of the stimulus funding meant the start of hard choices for many, and job cuts were widespread. Wisconsin, however, saw the biggest decline. A federal database on stimulus funding shows that five district states received about $3 billion in education funding, with Wisconsin getting close to $1 billion, via some 3,000 individual grants, with all K-12 school districts receiving multiple grants. State aid to Wisconsin schools had been declining steadily for several years, yet school district employment in 2009 increased by more than 1,500 employees over the previous year, including almost 1,000 new teachers. Higher property taxes were making up for some of the lost state aid, but the federal stimulus was a well-timed budget filler.

But when stimulus funds ran out—starting in 2010 for some and by 2011 for virtually all school districts—jobs started to fall under the ax (see Chart 5). These cuts accelerated when the state Legislature passed Gov. Scott Walker's controversial plan (known as Act 10) to restrict collective bargaining rights of local and state government unions. It also required workers to pay more for health and pension benefits, and the state used those savings to cut aid to local governments to fill a $3.6 billion state budget deficit. Schools lost $600 million in state aid in the 2011-12 school year, according to Department of Public Instruction figures, and job losses mounted. That trend is not expected to quickly subside: The agency recently noted that 64 percent of the school districts will receive less aid for the current school year.

The long view of public sector jobs shows that state government jobs are growing, having added about 14,000 since 2001, despite recent losses (see Chart 6). Every district state saw these ranks grow, led by an increase of more than 5,000 in Minnesota.

But at the local level, the federal stimulus interrupted a long period of stagnant or falling local government employment, especially in Minnesota and Wisconsin. From 2001 to 2007, local government jobs grew by 2,000, a rounding-error increase of 0.3 percent amid 680,000 such jobs. Stimulus dollars saved and created thousands of jobs, but with the economy still struggling, the overarching trend reasserted itself once those funds were spent. Since 2001, total local government employment is pancake flat in district states—by 2012, there were just 13 more local jobs, according to federal data.

**The long view of public sector jobs shows that state government jobs are growing, having added about 14,000 since 2001, despite recent losses.**

However, district states have seen very different local government job trends. Minnesota has lost 8,000 such jobs over this period; Wisconsin saw considerable growth through the recession, but then shed it all in recent years, seeing a net loss of about 200 by 2012. Local governments in Montana and the Dakotas combined have added more than 8,000 workers to payrolls since 2001, much of it in growing metropolitan counties in those states and booming oil country in western North Dakota and eastern Montana.

## Which way is up?

Local governments facing tight budgets are reacting in a variety of ways, seeking greater efficiencies and choosing services to either protect or cut (see accompanying article on page 6).

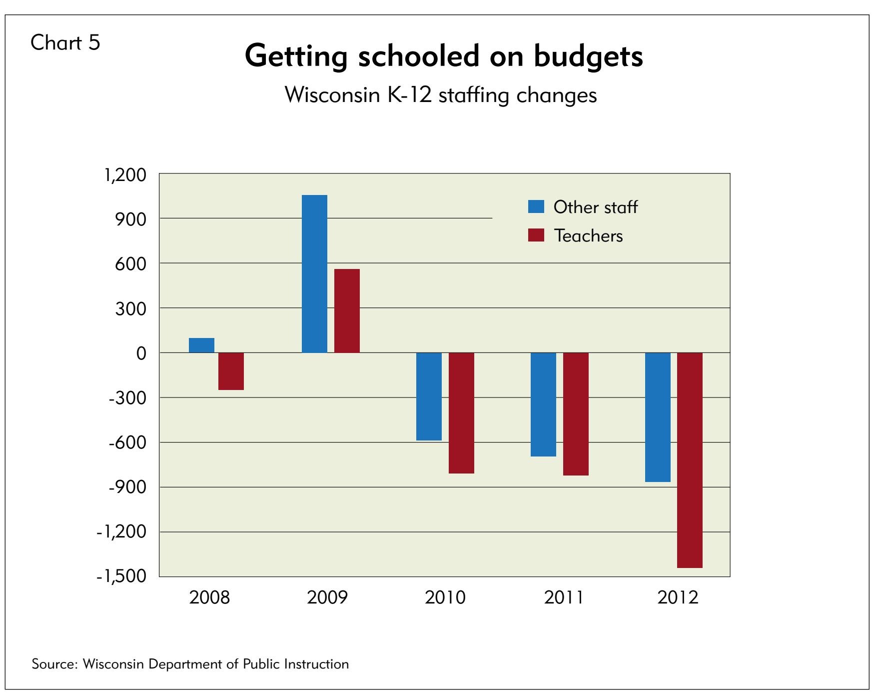
More cities appear to be feeling the floor beneath them, but they may be in the minority. In 2009, just 17 percent of Minnesota cities reported an improved ability to meet service needs. That proportion rose over the next two years, to 30 percent, and slightly more (31 percent) predicted more favorable conditions for 2012, according to the most recent State of the Cities report by the League of Minnesota Cities. The report manages to sound half full rather than half empty by stating: "Some challenges cities have dealt with over the last several years may be lessening, or at least not worsening."

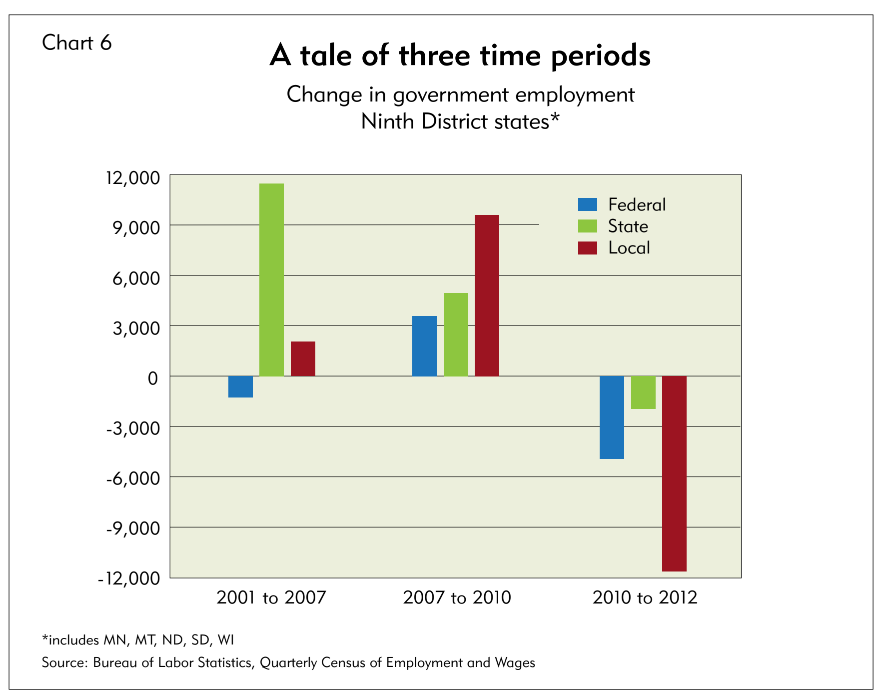
But until the economy gains its footing and state budgets rebound, most local governments are preparing for more of the same. Minnesota, for example, is facing a $1.1 billion state budget deficit.

"I think [local budgets] are going to be pretty difficult given the structural deficit at the state level," said Spartz, from the Association of Minnesota Counties. Barring dramatic political changes, he's not expecting any significant new revenue for counties. With baby boomers retiring, demands on county services will increase. Yet most counties expect that persistently tight budgeting is "the fiscal environment we're going to be in well into the 2020 era," Spartz said.

Tongue firmly in cheek, Spartz suggested that the only real relief from tight budgets, service requirements and rising costs would be a variation of Jonathan Swift's prescription for solving economic troubles in his essay, "A Modest Proposal." "Take geezers like me and put them on Lake Mille Lacs just before ice out." f

*Research Assistant Dulguun Batbold contributed data research to this article.*



# Local governments go to the barbershop

*Tight budgets mean many local services are getting a haircut, and some more than others*

ILLUSTRATION BY JACOB THOMAS

By RONALD A. WIRTZ
Editor

### The Quick Take

The recession has induced tighter budgets for many local governments. While payrolls have often been cut, governments have also employed a variety of strategies—cooperative agreements, compensation freezes, deferred maintenance and productivity improvements—to make budget ends meet. While most budget areas have been affected in some fashion, cutbacks on streets and other infrastructure could have consequences down the road.

Nobody likes a crisis. But oftentimes crises have a way of focusing the mind and clarifying some underlying, fundamental values.

State and local government budgets have come under considerable financial pressure in recent years—even before the recession in some states. Jeff Spartz, executive director of the Association of Minnesota Counties (AMC), said a tight budget has some silver lining to it because "it encourages you to see the most important things that you do. It's a good thing to do occasionally. But we're doing it chronically now."

For local governments in particular, tight budgets have put many public services in the barber's chair, with some getting a trim, others a buzz cut. Local governments are employing many strategies to make the numbers work and still provide service, including staffing cuts, contracting for services and "doing more with less" by seeking greater efficiency and productivity.

Not all local governments in the Ninth District are in the same fiscal boat because state economies have performed very differently over the past decade. Minnesota and Wisconsin governments have traveled the longest and hardest road; Montana and South Dakota have faced some rough sledding, but most of it has been recent. North Dakota's strong economy, and resulting tax revenue, continues to defy trends virtually everywhere else. Most of the discussion that follows will focus on Minnesota and Wisconsin because those states gather considerably more data on local government spending than Montana or the Dakotas, and both have endured more fiscal stress over the past decade, which offers a larger window for analysis.

## How tight the belt?

Local government budgets are determined by a variety of factors, like population growth, local real estate investment and property value appreciation. But many are also at the financial mercy of their state governments, which pass along considerable revenue aid (or not, as recent trends show), place mandates on many locally provided services and often limit the ability of those same local governments to raise local revenue (see cover article and sidebar).

In Wisconsin, local governments have labored under property tax levy limits for 10 years, and a property tax freeze for the past two years, said Richard Stadelman, executive director of the Wisconsin Towns Association. In three of the past 10 years, state shared revenue has also been cut. "It's dramatic," Stadelman said about local government finances. "Over time, it's gotten tighter and tighter."

What has resulted is often a stark separation of (inflation-adjusted) spending growth between states and their local governments. In Minnesota, local government revenue has shifted lower after each of the last two recessions, while state revenue has maintained consistently stronger growth (see Chart 1).

Tight budgets have forced local governments to find different ways to keep the books balanced, from straightforward cutting to reorganizing departments and increasing taxes and fees to contracting for services and holding the line on employee compensation.

In Minneapolis, the city's expenditures last year were about 20 percent lower than in 2009. Job cuts filled in much of the gap; the city eliminated 11 percent of its workforce (445 jobs) over this period. In anticipation of lower property taxes and federal and state aid this year, Mayor R. T. Rybak proposed further spending cuts of 3.4 percent. In announcing his budget, Rybak said, "Reform is not just an option, it's a necessity. We simply don't have the luxury of doing things the same old way."

Harold Blattie, executive director of the Montana Association of Counties (MACo), said his member counties were facing milder budget challenges than peers in other states, but revenues nonetheless were "not keeping up with operational costs in virtually every county in our state." Most counties have reacted by freezing current employee salaries or granting very small cost-of-living increases, he said, and keeping vacant positions unfilled longer.

Jeff Spartz, from AMC, noted that Minnesota counties have embraced so-called lean concepts—common in manufacturing—"that allow you to identify things that don't add value," like multiple workers and redundant tasks involved in a permit approval. "Most counties are looking to find ways of doing things more cost effectively."

In mid-2011, the League of Minnesota Cities started a database of budget-balancing anecdotes from local communities, and it now lists more than 500 actions either taken or considered by cities of all sizes. "It contains a good range from the simple, low-hanging fruit to the more complex," according to Rachel Walker, LMC manager of policy analysis, via email. The most common strategies identified—among a couple of dozen—involve contracting for services and doing more work cooperatively with other local governments, either formally or informally. Such strategies attempt to preserve service delivery while cutting back on employee wage and benefit costs, as well as equipment and other operational expenses.

That cooperative strategy appears to have gained some traction since the recession. A May 2012 report from the Minnesota Legislative Auditor found that cooperative agreements increased among almost 80 percent of responding counties and 40 percent of cities from 2005 to 2010; less than 1 percent said they had decreased. A Michigan survey last spring of local government officials found that 37 percent of respondents in the Upper Peninsula expected more intergovernmental agreements, and 10 percent expected increased privatization and contracting for services.

One common cooperative agreement deals with public safety, as many small communities resort to the once unthinkable—putting police and/or fire coverage in the hands of another entity. Since 2009, the city of Mound, Minn., had seen its tax capacity drop by 39 percent, causing its budget to fall as well. Cutbacks followed across virtually all departments, and full-time employees were cut from 50 in 2009 to 41 last year. Several job cuts came in the police department, whose 2012 budget still accounted for more than one-third of all city expenditures, according to city officials.

Faced with further budget troubles, in September, Mound disbanded its police department and contracted with the nearby city of Orono for police coverage. The city reported that the contract will save taxpayers about 10 percent in annual costs, or about $200,000, much of it coming from the elimination of the police chief's position, which was officially vacant and being manned on an interim basis. None of Mound's 10 full-time officers lost their jobs.

The move is not uncommon. In a police survey last year by the LMC, one-third of respondents (nearly 150) reported that police service provisions in their community had changed over the past 10 years, but the actions taken varied. The most common change (16 percent) was a reduction in staff, including paid officers, while other cities entered new contracts with the home county for law enforcement services and created new cooperative agreements with nearby cities. A total of 81 cities (18 percent of respondents) said they were currently considering such options.

Canosia Township in St. Louis County, Minn., might be completing the life cycle. More than a decade ago, it had its own police force. Tight budgets convinced it to contract with the county sheriff's department. The township has not budgeted for future years, and "we are spending down the current balance. When this fund is exhausted, [the town is] not sure if we will do any sheriff contracting," said Scott Campbell, the town board chairperson.

## No money for brass tacks

When budgets get tight, priorities are often defined by the size of the cut because local governments appear to prefer an approach that spreads the pain widely.

The city of Waverly, a community of 1,300 located about an hour west of Minneapolis, has lost almost all of its state and federal aid over the past several years, forcing budget reductions of 13 percent from three years ago, according to Mayor Connie Holmes. The city lowered its property tax levy for 2013 by 3 percent in an effort to hold down property taxes. But a change in state requirements for calculating property tax capacity (and how taxes are allocated among property types) forced taxes on businesses to rise by 20 percent, and Waverly has lost businesses as a result.

Internally, the consequences for city services have been widespread. "All departments have had to cut … and our staff is doing more with less," Holmes said. All work on parks was eliminated, and spending for general administration and staff overtime has been cut. "Street repair and improvements are not possible. … Snow removal [is] not as often, and other repairs on infrastructure [have been] delayed," she said.

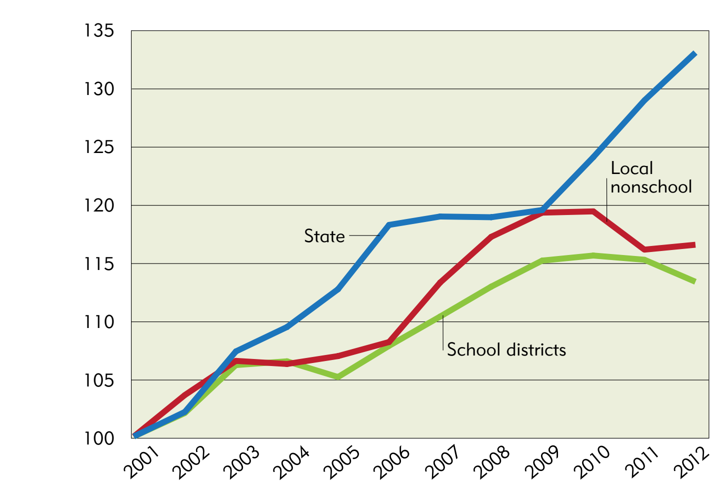
Other Minnesota cities appear to be taking a similar tack, according to an annual report on fiscal conditions by the LMC. To fill budget gaps from 2007 to 2011, cities depended less on raising taxes and more on decreasing spending—though cities were hardly going all in with either strategy (see Chart 2).

In terms of the services most affected, local spending reflects a "cut them all" approach. For Minnesota cities and counties, spending decreased virtually across the board from 2009 to 2012, according to data from the state auditor's office (see Chart 3). The only area of increase came in health care spending, the large majority of which occurs at the county level and includes various health care services and clinics, as well as restaurant inspections, the collection of vital statistics data and communicable disease control.

Local government sources were reticent about all service cutbacks. But infrastructure seemed to be a central concern

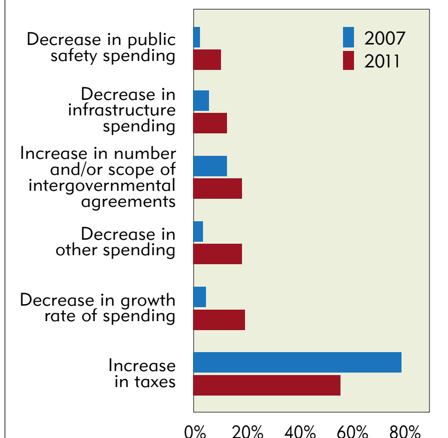
Continued on page 8

Chart 1
**Index of Minnesota public sector revenues**
2001 revenues = 100



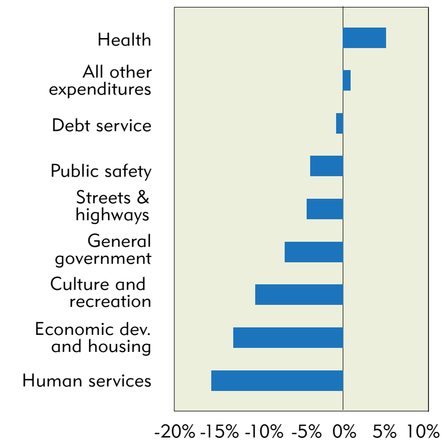

Source: Minnesota Department of Revenue

Chart 2
**Belt-tightening, kind of**
Specific budget-balancing actions taken by Minnesota cities




Source: League of Minnesota Cities, annual State of the Cities report

Chart 3
**The real belt tightening**
Percent change in expenditures,* all Minnesota cities and counties, from 2009 to 2012 (2012 dollars)




* Budget categories > $200 million
Source: Minnesota Office of the State Auditor

**Local governments** from page 7

for many. "When times are tough, [infrastructure needs] tend to be the first" on the cutting list, because these cutbacks are not immediately noticed, said Dan Thompson, executive director of the Wisconsin League of Municipalities. "You fire a crossing guard at the school, and parents notice immediately. Cut back on road resurfacing, and the average citizen doesn't notice. But 10 years from now, you'll have a serious problem."

Roads and other infrastructure didn't necessarily see the biggest spending cuts. But they are unique among many public services because they come with spending tails in the form of constant maintenance, and failure to keep up can create backlogs that get proportionately more expensive over time, like the leaking roof you let go for too long, causing eventual damage to your home.

Yet general road spending has been flat or declining in many places. In Wisconsin, inflation-adjusted road and highway spending (including current expenditures and capital outlays) by local governments fell by 3 percent from 2000 to 2010 (the most recent figures), with townships and municipalities sustaining the worst cuts (see Chart 4), according to figures from the state Department of Revenue.

"Highways aren't as good as they used to be. We see [towns] back off improvements, and as a result you have rougher roads and more potholes," said Richard Stadelman, head of the Wisconsin Towns Association. "The problem is compounded by increased traffic from heavy farm and other machinery, including more trucks carrying multiple loads of frac sand destined for oilfields," prematurely aging inadequately maintained roads. At the same time, federal and state gas taxes are not generating the same amount of revenue to be shared among highway agencies—the result of more fuel efficient vehicles and less driving due to higher gas prices. "There are greater needs, but less funding," Stadelman said.

**Tight budgets have forced local governments to find different ways to keep the books balanced, from straightforward cutting to reorganizing departments and increasing taxes and fees to contracting for services and holding the line on employee compensation.**

Minnesota offers a more recent picture of road spending, and it's similar to Wisconsin's. From fiscal years 2009 to 2012, total real road and highway spending in Minnesota fell by about 3 percent, with townships faring somewhat better and counties a bit worse than their easterly neighbor (see Chart 5). There is parallel evidence of slowly deteriorating roads. A Minnesota state transportation plan revealed that the percentage of roads with poor ride quality more than doubled from 2002 to 2011 for principal arterials (2 percent to 4.8 percent) and rose 350 percent on nonprincipal arterials (2.4 percent to 8.6 percent); the state's freeways ranked 44th out of 50 states (50th being the worst).

Road budgets also don't go as far as they used to because costs have been high and continue to rise. "Everything a road department does—from paving roads to crushing gravel—is driven by [high] petroleum prices," said Blattie, from MACo.

Roads also represent only part of a state's investment in infrastructure; other types of capital investment include drinking water and treatment systems, schools and other facilities. Since the mid-2000s, total capital outlays have been flat to negative at Minnesota's many levels of government. In Minnesota, real capital spending by the state government and counties has seen a sharp drop in recent years; school district spending has been flat for close to a decade, and cities saw a small and steady increase through 2011, but a sharp decrease last year (see Chart 6).

## Public opinion? Yes and no

Governments walk a tightrope between balanced budgets, greater efficiency and quality public services.

"It's a challenge to innovate and invest in this current climate," said Linnea Mirsch, deputy county administrator with St. Louis County in northern Minnesota. "Doing more with less has now become doing less with less." The county has cut staff and services or, in some cases, not added staff despite increased service demands, all of which lead to longer wait times for existing services. For example, health and human services has seen a significant increase in demand "due to the effects of the economy on the people we serve," yet the county has not added staffing, said Mirsch.

The recession and slow recovery have forced cities to adapt to a new normal. Some are likely much better at it than others. "The art of budgeting is to ask for what you want and take what you need," said Alec Hansen, executive director of the Montana League of Cities and Towns. He described municipalities there as "stable," which included modestly rising wages, while those of state workers have been frozen. "Generally, I think [Montana] cities are in pretty good shape. We could use more money, but we're getting by."

Some of that stability likely rests on a hardscrabble notion of being satisfied with what you have. "In small towns across the prairie, service levels might be lower, but they're adequate," said Hansen. "We get by with less. … [Tight budgets] are a condition of survival. It doesn't mean you can't do it."

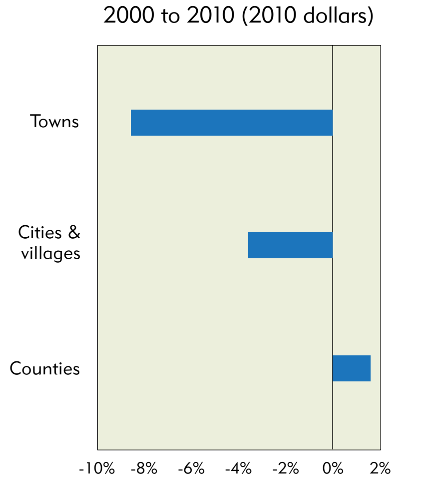
Montana cities have had a lot of practice, according to Hansen, going back to a 1986 law that froze property tax rates. "If you live under a property tax freeze for 26 years, you learn pretty quick what's needed." When budgets get tight, Hansen said the first to go are things like spending for parks and recreation that don't represent a "middle-of-the-night crisis with sirens."

Whether tight budgets are seriously eroding the quantity and quality of public services is ultimately a question for taxpayers, whose current attitude appears to run the gamut, according to district sources. Many said constituents have been patient and understanding because they know money is tight. Others said they've seen the ugly side of constituents who want services and believe local governments could offer them if only they weren't so wasteful.

In either case, tight budgets might be encouraging a better understanding of what local government is and does, and what services taxpayers are willing to pay for. Spartz, from the Minnesota counties group, said most people "don't deal with the county except when writing this big check twice a year" for property taxes, while counties' core services are for courts and social service programs like welfare and medical assistance. "Most of those are services people don't want to get entangled with."

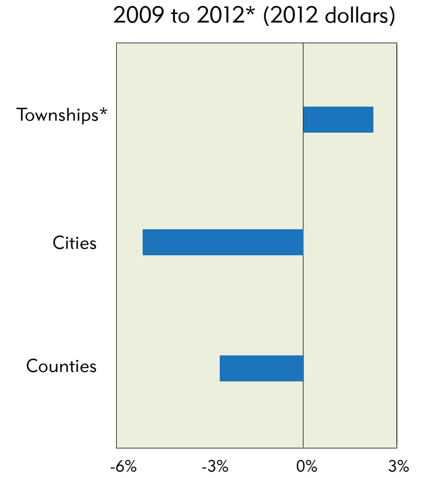
Blattie, from MACo, said that property taxes often disconnect the service from its cost for many taxpayers. "They think that 100 percent of their property taxes go for roads, another 100 percent goes to schools and another 100 percent goes for [other local services]," said Blattie. "[People] fail to value public services until something happens that you make a personal connection with. You don't need the fire department until you need the fire department." f

Chart 4 **Roads: A long view**
Change in Wisconsin local transportation spending
2000 to 2010 (2010 dollars)



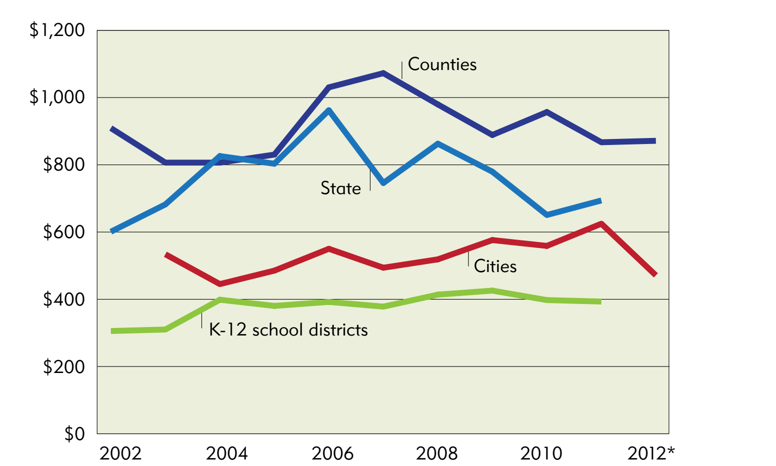

Source: Wisconsin Department of Revenue

Chart 5 **Roads: A shorter view**
Change in Minnesota local transportation spending
2009 to 2012* (2012 dollars)

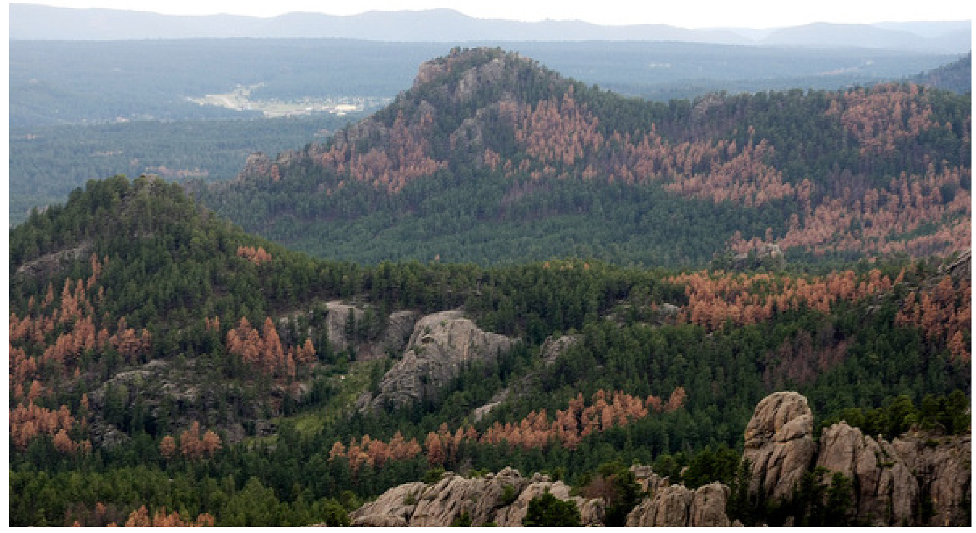



*Township figure is from 2009 to 2011, which is the most recent data year. Figures also adjusted to 2011 dollars.
Source: Minnesota Office of the State Auditor

Chart 6 **Capital outlays lagging in Minnesota**
Total capital outlays, by level of government
Millions of 2012 dollars




*2012 data are preliminary.
Source: Minnesota Office of the State Auditor



# The beetle and the damage done

*A pine-killing insect could be a game changer for forest products firms in Montana and South Dakota*

By PHIL DAVIES
Senior Writer

Mountainsides of dead trees surround Sun Mountain Lumber, a sawmill in Deer Lodge, Mont. Over the past three years, the needles of countless lodgepole pines turned brown, then red, then dropped off to expose gray, lifeless trunks. The trees were killed by the mountain pine bark beetle, an insect that has ravaged thousands of square miles of pine forests in mountainous areas over the past 15 years, including western Montana and the Black Hills of South Dakota.

"The good news is, in this particular area, the beetle has kind of run its course," said mill manager Tony Colter. Sun Mountain, the largest private employer in the Deer Lodge Valley with 145 workers, has weathered a severe housing slump and subsequent recession; production has steadily increased since 2010.

But the mill might be undone by a bug the size of a grain of rice; the pine beetle epidemic has drastically reduced the local supply of healthy lodgepole pine, the raw material for two-by-four studs and other dimensional lumber produced by the mill. "The bad news is that it killed over 90 percent of the lodgepole pine, and it's probably not going to be merchantable within a year or two," Colter said. "This gray timber is really losing its value quickly."

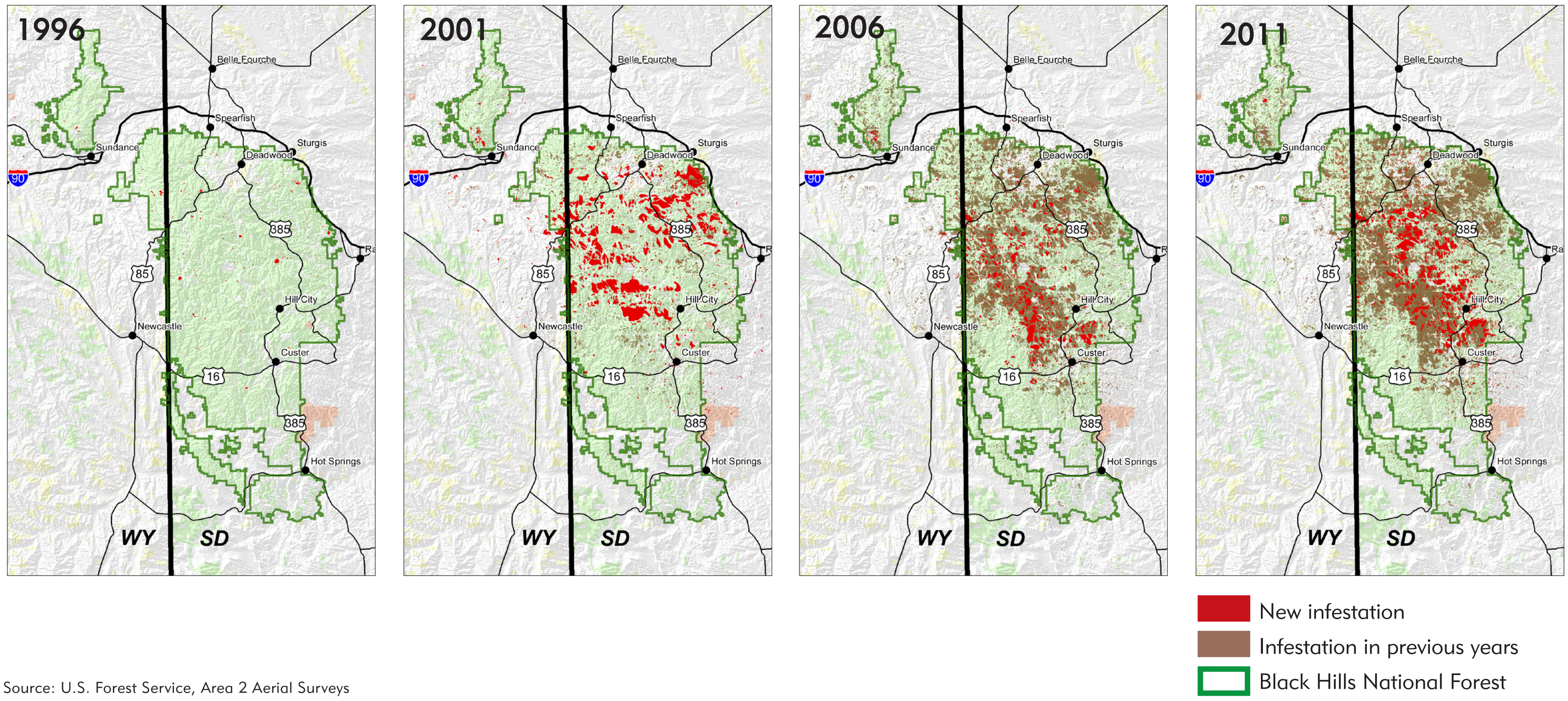
Continued on page 10

These photographs from the *Rapid City Journal* show the effects of mountain pine bark beetle infestation: dead and dying trees and diminished timber resources. The culprit is at top left. Note the blue tint on the sawed logs; a fungus carried by the beetles causes the stain, which can reduce the value of the lumber.

TOP LEFT PHOTO FROM PACIFIC NORTHWEST RESEARCH STATION; ALL OTHERS BY KRISTINA BARKER OF THE *RAPID CITY JOURNAL*

# A spreading plague

*Mountain pine bark beetle infestation in the Black Hills*




Source: U.S. Forest Service, Area 2 Aerial Surveys

**Beetles** from page 9

While the landscape effects of the pine beetle infestation are stark, the economic effects of the epidemic are more subtle. Pines killed by the beetles have inconvenienced tourists, blighted backyards and spurred efforts by the U.S. Forest Service and state and local governments to try to curb the outbreak by cutting down infested trees.

But the beetle attack has most seriously affected forest products firms—loggers, sawmills and manufacturers trying to bounce back from the housing crash and, in Montana, reverse two decades of industry decline. Here, too, the impact has been double sided: There are good uses for infected logs, and for now widespread cutting has boosted timber supplies for many forest products firms. But much lumber from beetle-killed trees is lower grade than that milled from healthy trees, and because of their short shelf life most infested trees will ultimately go unused.

Most ominously for the industry, over the next few years the epidemic threatens to slash the supply of usable pine logs—ironically, just when housing starts and lumber demand are expected to rebound. "The potential for mill closures is definitely there, especially if they aren't able to respond to increasing markets," said Todd Morgan, an expert on the forest products industry at the University of Montana's Bureau of Business and Economic Research.

## Beetles on the march

Each fall, a new generation of mountain pine bark beetles takes up residence in the district's western forests. Over the summer, swarms of the tiny, dark-shelled insect invaded pine trees, tunneling into the inner bark to lay eggs. The resulting larvae feed on the host tree—disrupting the flow of nutrients and eventually killing it—until the following summer, when they mature into adult beetles and take flight, infesting more trees.

Native to the western United States, the pine bark beetle thrives in old, dense pine forests under stress. Persistent drought combined with overcrowding due to over a century of wildfire suppression has weakened lodgepole, ponderosa and other species of pine, making them susceptible to colonization.

The current outbreak began in the mid 1990s and has steadily expanded its footprint to cover over 5 million acres of forest in Montana. The infestation appears to have peaked in the state—aerial surveys by the Forest Service in 2011 found 1 million acres of newly infested trees, about half the area affected the year before (Chart 1 on page 11). But the beetles are still gaining ground in the Black Hills (Chart 2 on page 11 and maps above).

Infestation has been spotty, with some areas of western Montana and the Black Hills affected much worse than others. For example, over the past decade beetles have left their mark on over 40 percent of the Helena National Forest in west-central Montana, and last year they made further inroads in the Bitterroot National Forest near the Idaho border. But so far, beetle kill has been light in the Flathead Valley and other parts of northwestern Montana.

In the Black Hills, the damage is concentrated in the central and northern hills, with heavy beetle kill on the northern edge of Custer State Park and hot spots near Lead, on the western fringes of Rapid City and around Mount Rushmore National Memorial—where for the past three years pines have been sprayed with protective insecticide.

To date, the infestation appears to have had little effect on tourism in Montana and the Black Hills—visitation numbers last summer were generally up over 2011 (see sidebar on page 12).

But the epidemic has imposed costs on taxpayers and private landowners. The state of South Dakota has budgeted $6 million for a three-year campaign to control the beetles by felling trees on state and private land. In both western Montana and the Black Hills, property owners have borne the expense of removing dead or dying trees from their own land or public parkland in urban areas. In January, the city council in Rapid City passed an ordinance giving the city the authority to cut down infested trees on private property and bill the owners. Helena, Mont., which has lost thousands of ponderosa pines to beetles, raised property taxes in 2010 to fund a decade-long, $1.5 million effort to cut infested trees on open recreational space.

However, tree removal costs—and indirect or less tangible costs such as travel delays because of blocked roads and marred views for residents and visitors—are minor in comparison with the impact of the beetle epidemic on those who depend on trees for their livelihood. Like termites in a wood-frame house, pine bark beetles threaten the foundation of the forest products industry.

## Salvaging value

Sawmills in the western part of the district have long complained about restricted log supply—or, more precisely, the cost of logs given declining production from many national forests—down 85 percent in Montana since the late 1980s. "That has really slowed the ability of [Montana] mills to get timber, even when [lumber] markets were good" in the 1990s and in the mid-2000s before the housing bust, Morgan said.

Thanks to the pine bark beetles' depredation, more timber is now flowing to sawmills in areas of western Montana hard hit by the infestation and in the Black Hills.

Chart 1

**The pine beetle outbreak may have peaked in Montana …**

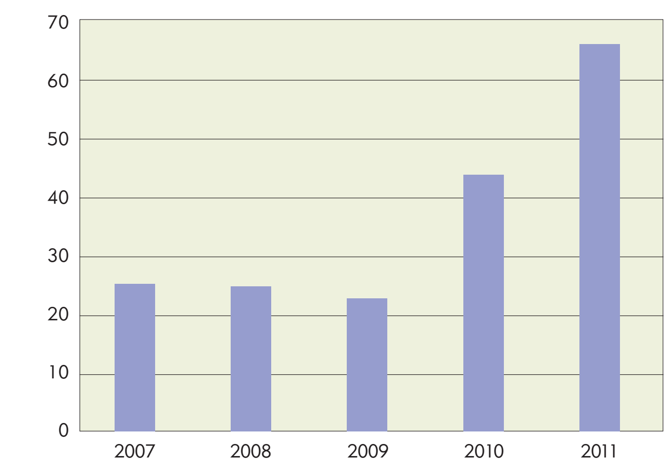
Thousands of newly infested acres


Source: U.S. Forest Service aerial surveys

Chart 2

**… but is on the rise in South Dakota**

Thousands of newly infested acres
Federal, state and private




Source: U.S. Forest Service aerial surveys

In Montana, over 90 percent of beetle kill has occurred in its national forests, yet commercial logging there hasn't increased. For the most part, Forest Service managers have focused on taking down beetle-killed trees where they pose a hazard to people or infrastructure—near settlements, along roads and power lines, and in campgrounds and other recreation areas. Much of this wood can only be sold for firewood or is left to rot.

But logging has increased on state and private lands in the state, offsetting the decline in Forest Service timber sales. Since 2007, commercial loggers have cut trees killed by mountain pine beetles and other insects on 7,000 acres of state trust lands, contributing to a 22 percent increase in state timber harvested in 2011 compared with 2010. Revenue from timber sales—mostly to local sawmills—supports state schools and public universities. "We've been very aggressive about trying to capture the value" of beetle-killed timber, said Montana State Forester Bob Harrington.

In the Black Hills, national forestland supplies about 90 percent of saw timber. The average annual cut permitted by the Forest Service over a 10-year period fell by one-third in 1997 and has remained at that level. But since 2007, annual timber harvest in the Black Hills National Forest has exceeded the average annual allowable cut. Forest officials attribute higher harvest levels to logging of beetle-killed stands, coupled with strong demand from mills in the region.

Beetle-related cutting on state and private lands has also bolstered wood supplies in South Dakota. Under the state Black Hills Forest Initiative, a joint project with several counties in the region, crews have cut down more than 215,000 infested trees in Custer State Park and on private property over the past year. Private landowners have cut and sold tens of thousands more on their own. (In addition, noncommercial "bug tree" removal has boosted business for tree service firms in Rapid City and other Black Hills communities.)

## A "blessing," but …

A surge of beetle-killed timber has helped forest products firms ramp up production to meet rising demand from a construction industry that, if not booming, is showing signs of life. During the recession, annual production at Sun Mountain Lumber in Montana dropped by more than half, forcing the firm to lay off 30 workers. Over the past two years, annual output has bounced back to about 120 million board feet, allowing the firm to restore those positions.

Increasing production would have been more difficult without the "blessing in disguise" of extensive beetle kill, said Colter, the mill manager. Over the past four to five years, Sun Mountain and other mills in west-central Montana have purchased large amounts of beetle-killed lodgepole pine, mostly from private landowners. Over two-thirds of the lodgepole processed at Sun Mountain is beetle killed. "If we didn't have the mountain pine beetle epidemic, there probably would be even less wood available for the mills that are operating," Colter said.

Beetle-killed timber has also helped to sustain loggers who work under contract to sawmills or who cut and sell timber independently. Keith Olson, executive director of the Montana Logging Association, said that logging activity has been "steady," even during the recession, because of beetle-related cutting on state and private land.

But there's a problem with such timber, an almost literal fly in the ointment: It's worth less than green wood because the beetles carry a fungus that leaves a blue tint on the outer rings of logs. This flaw makes much beetle-killed wood less desirable and has limited the amount of beetle-killed timber that mills can process.

Lumber marred by "blue stain" is structurally sound and fine for use in stud wall construction, where the wood is hidden behind sheetrock or paneling. But for some applications, this wood isn't good enough. Colter of Sun Mountain says that some customers are willing to pay 10 percent to 15 percent more for unstained lumber milled from uninfected trees. But such trees are increasingly rare in the Deer Lodge Valley, and "those customers who are willing to pay a premium for green lodgepole are getting harder and harder to satisfy," he said.

Some Montana mills, such as F. H. Stoltze near Columbia Falls, have shunned blue-stained wood, preferring to seek out uninfested lodgepole or use tree species unaffected by pine beetles, such as Douglas fir and larch.

Blue stain is particularly troublesome for forest products firms in the Black Hills, which primarily produce lumber for visible finish applications such as home interiors and decks. (In contrast, a higher proportion of Montana's output consists of basic framing lumber.)

Neiman Enterprises is the biggest forest products company in the Black Hills with 430 employees at mills in Spearfish and Hill City, S.D., and Hulett, Wyo. The bulk of its revenue comes from the manufacture of boards, paneling and molding for home construction and remodeling. But blue-stained ponderosa pine can't be used in those products, said resource manager Dan Buehler; consumers find the color off-putting, a sign of mold or rot. Instead, many of the 600,000 beetle-killed trees Neiman processes annually end up in particle board, crating and inexpensive painted furniture.

The company restricts its use of blue-stained logs to about one-third of its total intake. "If we get beyond that, we're basically making product that sits in the yard," Buehler said. "We can't make a profit if we can't get rid of it."

Because of blue stain and other problems with beetle-killed timber—it can be harder to process and its dryness increases fire risk in mills—the region's forest products industry can't process all the available beetle-killed wood, said Carson Engelskirger, former forest programs manager for the Black Hills Forest Resource Association. "This thing has festered, and now it's bigger than us," he said.

## A changed forest

The looming uncertainty for the forest products industry is how this infestation plays out over the next few years, with consequences for decades to come. Pine tree seedlings in regenerating stands take 60 to 100 years to grow into harvestable timber.

Some efforts are being made to stanch the beetle's spread. Forest Service officials in the Black Hills have proposed treating 248,000 acres of recently infested tree stands in hope of slowing

Continued on page 12

**Beetles** from page 11

or halting the advance of the beetles. A drought-ending change in the weather could also tamp down the infestation in some areas. But for the most part, the infestation is expected to run its course, abating when the beetles have consumed most of their preferred host—mature pine trees.

An ongoing severe infestation would put additional pressure on a beleaguered industry. In Montana, employment in wood products manufacturing fell by more than half between 2001 and 2011 as operations closed or consolidated (Chart 3). Logging and private forestry jobs also declined precipitously over that period. In South Dakota, wood products manufacturing has held up better, but the industry still shed about 500 jobs since 2004.

Further retrenchment wouldn't significantly harm the economies of either Montana or South Dakota; in both states, the forest products industry accounts for less than 1 percent of total nonfarm employment, according to government figures. But forestry, logging and wood manufacturing still support scores of jobs in communities such as Deer Lodge, Columbia Falls, Spearfish and Rapid City.

A prolonged beetle infestation would likely inflict more hardship on forest products firms in the Black Hills than those in western Montana. In both places, tighter pine supplies could drive up log prices, especially if demand for lumber rises with an expected housing rebound. But Montana sawmills have a greater ability to adapt their product lines to whatever logs are available at the lowest price. Beetle-proof Douglas fir makes up about 30 percent of incoming logs at Sun Mountain. Colter foresees that percentage increasing if healthy lodgepole pine becomes more expensive. "At least as far as our mill is concerned, there will be a shift to more Douglas fir," he said.

Switching to other types of trees isn't an option in the Black Hills, because loggers and wood products firms depend on a single species, ponderosa pine, growing in a region cut off from other sources of logs. Shipping in timber from other states such as Montana or Idaho is too expensive. "We're on an island, and we have this bug epidemic, and it's chewing through the forest. … If we let the island get eaten up, we lose; everybody loses," Engelskirger said.

Buehler of Neiman Enterprises said that if the epidemic worsens, the company may have no option but to close one of its mills, perhaps within five years.

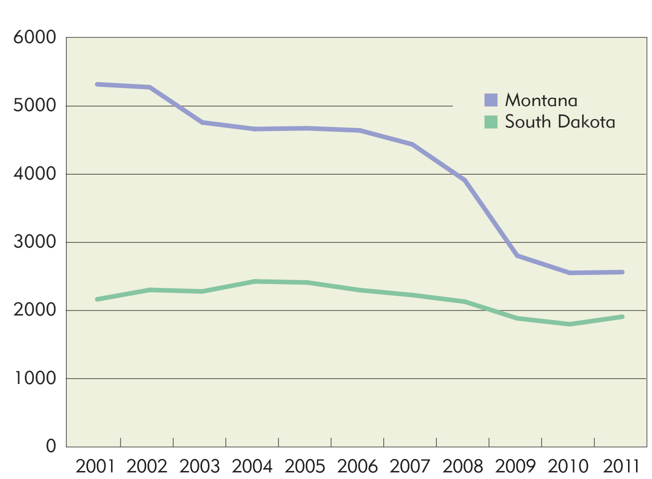
More trees and forest products jobs could be lost in Montana and the Black Hills if large wildfires break out in dead pine stands—a scenario feared by tourism businesses and many residents as well as sawyers and mill operators. Fire has scorched thousands of square miles of forests decimated by pine bark beetles in Colorado, Idaho and other states.

What's certain is that after the pine beetle infestation subsides, other insect pests and diseases will afflict trees and vex forest products firms in the district. Last year's Forest Service aerial survey identified over 1 million acres in Montana affected by western spruce budworm, a moth that attacks spruce and fir trees.

To endure, the forest products industry must adapt not only to changing market conditions, but also to "whatever comes out of the forest, given the different disturbances, whether it's fire or different kinds of insect diseases," Morgan said. f

Chart 3

**Fewer jobs in wood products manufacturing**




Source: U.S. Bureau of Labor Statistics

KRISTINA BARKER OF THE *RAPID CITY JOURNAL*

# Tourism survives beetle attack

The invasion of the pine bark beetles has changed the vacation experience in some parts of western Montana and the Black Hills of South Dakota. Many visitors this past summer found familiar vistas transformed and roads to campgrounds and popular attractions temporarily closed by fallen trees. But so far, the epidemic hasn't had any measurable impact on visitation to either region, according to official tourism figures.

Densely forested western Montana drives the Treasure State's tourism industry. Yet there's no apparent beetle effect on Montana's visitation numbers. Preliminary figures from the Institute for Tourism and Recreation Research show that in the first half of 2012, the state attracted 4.1 million travelers from other states, a 5 percent increase over the same period in 2011. Tourist visits also increased year over year in 2011 after two consecutive years of heavy beetle activity.

In the Black Hills, an intensifying beetle infestation "hasn't turned off visitors," said Nort Johnson, president of the Black Hills, Badlands and Lakes Tourism Association. "It was a great spring and great early summer, and that's continued." Early warm weather boosted motel occupancy and visits to attractions and special events, according to association figures; Mount Rushmore saw 8 percent more visitors through July of 2012 than in the first seven months of 2011, and traffic counts for the Sturgis Motorcycle Rally in August were up 5 percent over the previous year's tally.

Tourism in the Black Hills could feel the beetles' bite this year; several sources said dead or dying trees were more evident near attractions and along roads last summer—a possible deterrent to return visits. For now, tourism officials and businesses are keeping their fingers crossed and emphasizing the positive aspects of the infestation. For example, Johnson noted that some tourists have commented on "some amazing new outcroppings of rocks that we haven't seen for a couple of generations" revealed by deforestation.

*—Phil Davies*

# The unnatural trend in natural disasters

*Natural disaster declarations are on the rise in the Ninth District, and while weather is an important factor, it's likely not the only one*

By DULGUUN BATBOLD
Research Assistant

From floods to hurricanes to blizzards, natural calamities can threaten livelihoods and devastate entire regions. Unfortunately for many, natural disasters appear to be getting harder to avoid.

Since 1953, the number of disaster declarations—unique disaster events—issued each year has increased significantly, according to a recent report by the Congressional Research Service (CRS). In the 1960s, there were about 18 major disaster declarations per year in the nation. But from 2000 to 2009, annual declarations reached 56, and 2011 was the busiest year on record, with 99 major disaster declarations.

Disaster declarations in the Ninth District closely follow the national trends. The number of major disaster declarations in the district more than doubled from an average of 2.6 per year in the 1960s to well over five per year in the past decade, according to data from the Federal Emergency Management Agency (FEMA).

As a result, the number of disaster areas, which are declared by FEMA at the county level, also has been rising strongly, even if you ignore the comparatively small number of disaster-declared counties during the 1980s (see Chart 1, top panel). From the 1960s to the 2000s, the average number of disaster-declared counties in the Ninth District nearly tripled. This growth has been particularly prominent in the Dakotas and Montana, where disaster counts per year show a nearly sevenfold increase.

Disasters tend to be regional events; therefore, annual disaster counts in district states do not often coincide with those at the national level (see Chart 1, bottom panel). However, both national and district disaster counts follow a similar, rising trend line since the 1960s, though the rate of increase in disaster declarations is slightly higher at the national level.

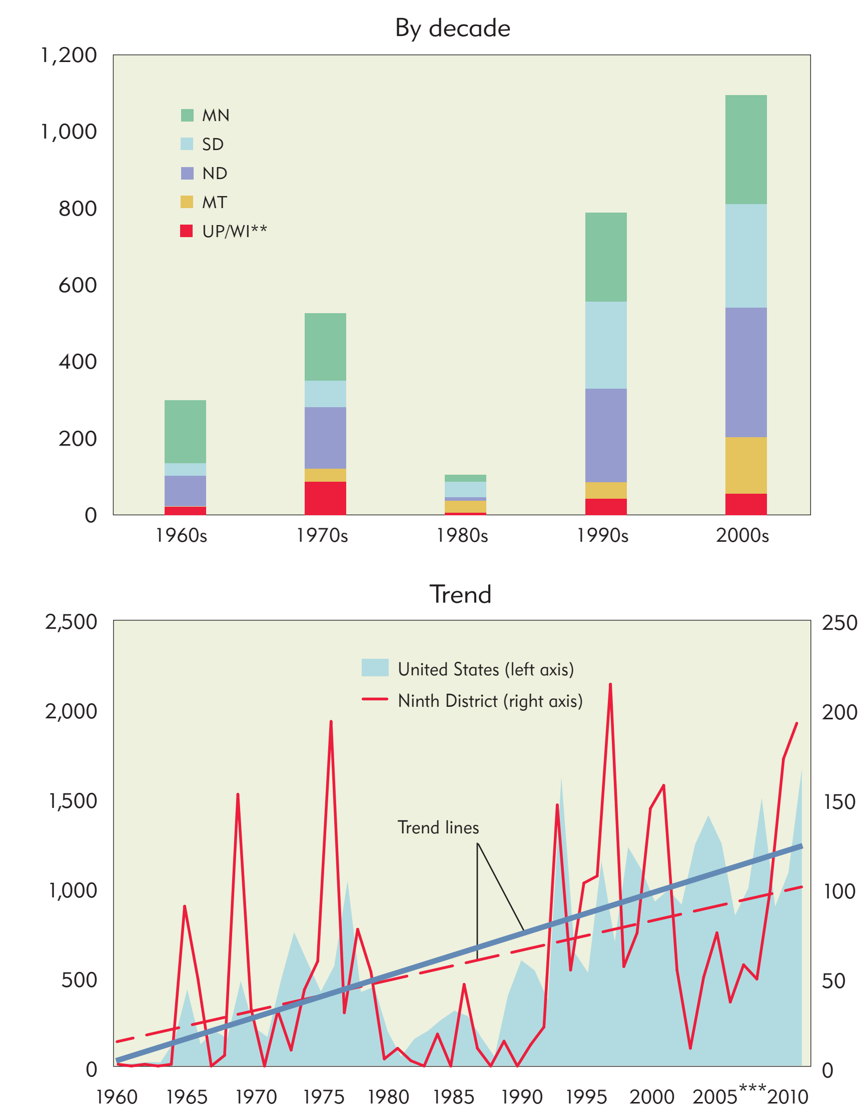
Floods and severe storms are the biggest sources of FEMA declarations in the Ninth District, accounting for more than two-thirds of all disaster declarations. But each state has a unique disaster profile, based on geography and climate. More than half of FEMA declarations in Montana since 1953 are the result of fire, easily the largest share among district states (see Chart 2, bottom panel). South Dakota also has a high incidence of fire. In 2000, more than 1 million acres burned in the northern Rockies, and FEMA declared disaster areas in over 54 counties in Montana. Wildfire-related declarations have been recurring in Montana almost every year since then.

In terms of reported fatalities and injuries, tornadoes traditionally posed the highest risk to human life in district states, particularly if they hit densely populated areas. The tornadoes that tore through counties near Minneapolis-St. Paul in 1965 caused over 700 reported injuries and fatalities. However, injuries and deaths related to tornadoes have declined over time, from about 1.8 deaths and injuries per

Continued on page 14

Chart 1

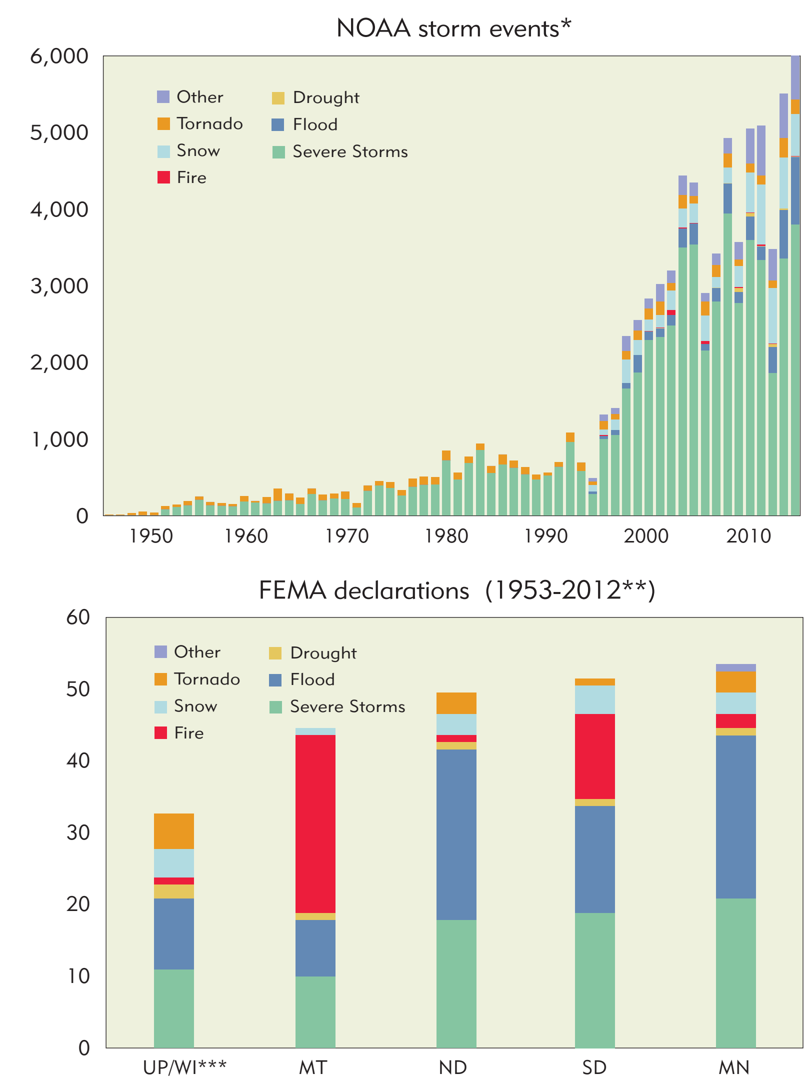
**Number of FEMA-declared counties**
(1960-2012*)




* Data through May 2012
**Ninth District counties in the Upper Peninsula of Michigan and northwestern Wisconsin
***Excludes 1,870 counties declared for Katrina evacuation purposes in 2005
Source: Federal Emergency Management Agency

Chart 2

**Disasters in Ninth District states by category**




*Severe storms include damaging thunderstorm winds, hail and lightning.
**Data through May 24, 2012 (excludes Katrina-related declarations)
***Ninth District counties in the Upper Peninsula of Michigan and northwestern Wisconsin
Sources: Federal Emergency Management Agency; National Oceanic and Atmospheric Administration, Storm Events Database

**Disasters** from page 13

reported tornado during the 1970s to just 0.2 per tornado in the 2000s. The combined territory of the Upper Peninsula of Michigan and northwestern Wisconsin (roughly two-thirds the size of Minnesota) has comparatively fewer disasters, but a relatively large share of them are tornadoes.

The growing number of disasters appears to come from several sources. Most obviously, there has been an increase in the incidence of severe weather events as reported in the Storm Events Database by the National Oceanic and Atmospheric Administration, which catalogs severe weather incidents that resulted in fatalities, injuries or property/crop damage since 1950 (see Chart 2, top panel).

There are several other possible sources for the increase in disaster declarations, according to the CRS report. For example, the uptick in storm events is likely a function—to some unknown degree—of greater interest in and improved measurement of severe weather. The U.S. population also has roughly doubled since the 1950s, with the Ninth District population growing by about two-

**Whatever the source of disaster, the other notable trend is rising costs. Over the past decade, average FEMA grant amounts have skyrocketed.**

thirds, and developed acreage has correspondingly increased. As a result, severe weather events are more apt to affect people and property—triggering disaster declarations—today than in the past.

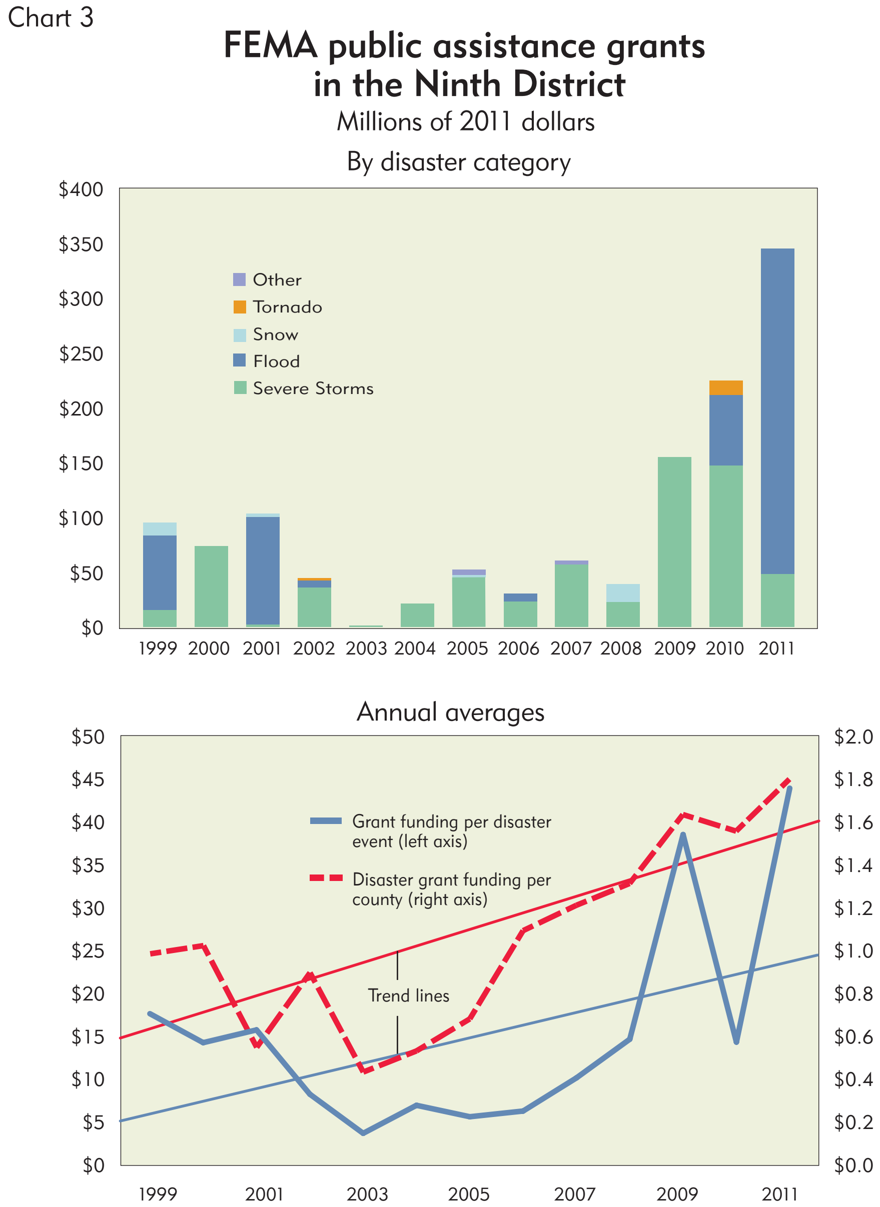
The report added that declarations might well be influenced by tight state budgets (which demonstrate financial need), the enhanced capabilities of professional state and local emergency services in identifying and quantifying disaster costs, and even "declaration creep"—the tendency of states to seek aid received by others for the same disaster, assisted by the political pressure generated by 24/7 news coverage.

Whatever the source of disaster, the other notable trend is rising costs. Over the past decade, average FEMA grant amounts have skyrocketed (see Chart 3). The majority of these grants are allocated in response to severe storms and floods, which tend to affect a greater number of counties per occurrence. Floods in 2011 inundated 120 counties in the Dakotas and Minnesota and cost U.S. taxpayers $436 million in public assistance grants and aid to individuals.

But the incidence of natural disasters is volatile and unpredictable, which is evident now; things have been rather quiet in the district, at least in some respects. Drought has gripped the district and much of the nation, and wildfires have been a problem in Montana and South Dakota. But lack of rain tends not to destroy commercial or residential property; nor do wildfires because they usually occur in forested areas with comparatively sparse development. Through October 2012, FEMA had declared three major disasters in the district—two in response to severe storms and flooding in northern Minnesota and Wisconsin and one related to wildfires in Montana.

What happens in 2013 in terms of natural disasters is unknown, of course, but that's apropos given their connection to the notoriously unpredictable weather in the Ninth District.

Chart 3




Source: Federal Emergency Management Agency

# Late for more than just class: Student loan defaults rising

No one needs reminders that it's a tough job market out there. But more college grads are getting reminders every month when they have to make a payment—or, more accurately, fail to make a payment—on their student loans.

New data from the U.S. Department of Education show that student loan defaults are rising across the country and the Ninth District. District states have rates that are generally well below the national average; however, every state is following the national trend of steadily higher default rates. Montana and South Dakota saw particularly large increases in the two-year default rate of those entering payment in fiscal year 2010.

The student loan default rate measures those entering repayment in one federal fiscal year (Oct. 1 to Sept. 30) and defaulting by the end of the following fiscal year. Student loans are not in default until they are 270 days late. So, by the traditional two-year tracking window, ex-students have just 12 to 24 months to fall more than nine months behind in loan repayments.

A few years ago, Congress decided that window was too short, so it asked the Department of Education to extend the tracking window to three years. This was the first year that the agency officially released so-called three-year cohort default data (for the cohort group entering payment in fiscal year 2009). The data show a trend similar to the two-year default data, only worse, as should be expected given the longer tracking window. Again, students in district states performed better on loan repayments than the national average, but all saw rates increase rather significantly, with South Dakota's rate topping 10 percent (see table).

For more background, detail and layman's methodology on student loan defaults in Ninth District states, see the April 2012 articles, "College Finance 101: Not all their (de)fault?" and "The fine print on student default rates" online at minneapolisfed.org.

*—Ronald A. Wirtz*

| | Two-year default rate | | Three-year default rate | |
|---|---|---|---|---|
| | FY 2009 | FY 2010 | FY 2008* | FY 2009 |
| MN | 6.0% | 6.9% | 6.7% | 9.0% |
| MT | 3.5% | 6.7% | 3.7% | 5.8% |
| ND | 3.4% | 4.1% | 4.3% | 5.1% |
| SD | 6.5% | 8.5% | 7.4% | 10.3% |
| WI | 5.2% | 6.0% | 6.5% | 8.0% |
| U.S. | 8.8% | 9.1% | 13.8% | 13.4% |

*First year that three-year default data were collected on trial basis, and the Department of Education considers these data unofficial.

# Minnesota farmland has bumper crop of $$$

It's no secret that the farm economy has been robust for a considerable stretch. That persistent strength can be seen in the market value of farmland in Minnesota, especially when compared with other types of property, particularly residential, which is by far the state's largest segment of so-called real property.

It's almost like agriculture didn't get the memo on the recession and slow recovery. Thanks mostly to steadily strong crop prices, farm property saw exceptional growth during the recession through 2010 (see Chart 1). The last two years have been flatter—but still growing—in stark contrast with virtually all other real property. Like corn during a good growing season, farmland value as a share of all real property grew, from 16 percent in 2007 to 24 percent in 2012 (see Chart 2).

—*Ronald A. Wirtz*

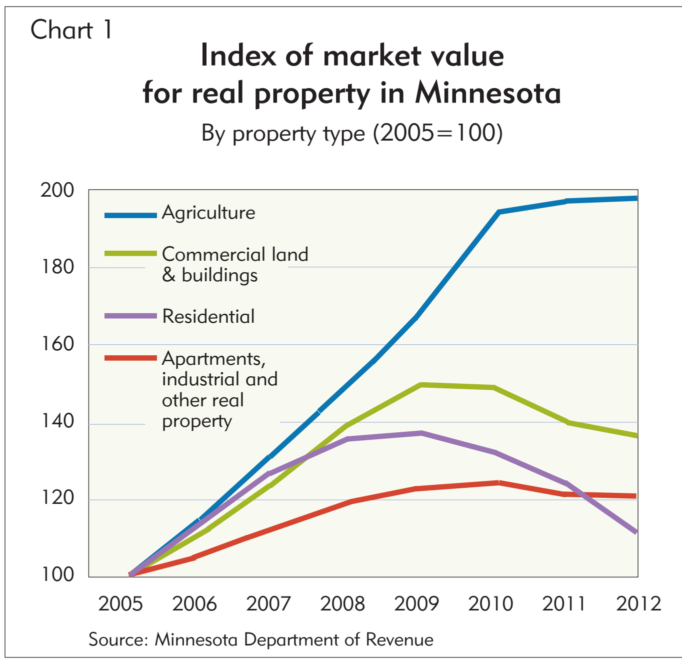



Chart 1
Index of market value for real property in Minnesota
By property type (2005=100)
Source: Minnesota Department of Revenue

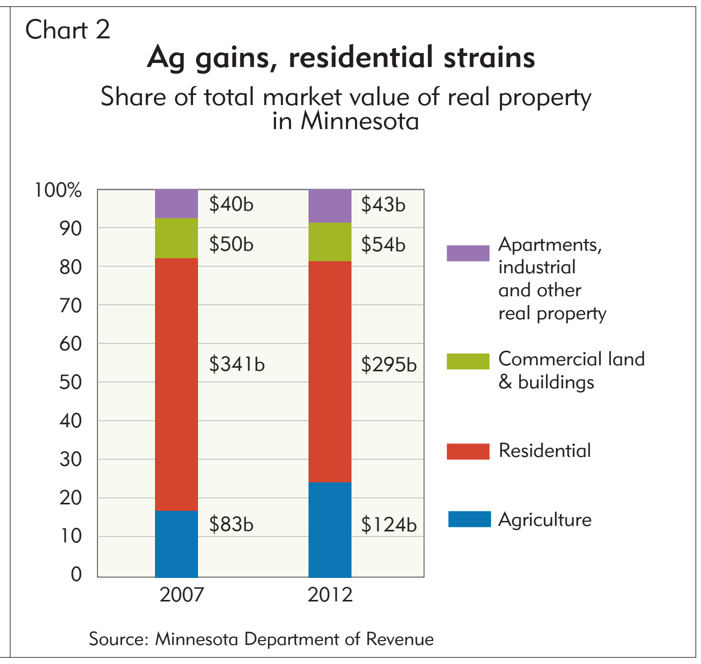



Chart 2
Ag gains, residential strains
Share of total market value of real property in Minnesota
Source: Minnesota Department of Revenue

# Local governance has a home in the Ninth District

Minnesota and some other Midwestern states are widely regarded for good governance. Maybe that comes with practice, because Minnesota and other Ninth District states practice a lot of governance.

Despite having just 4.4 percent of the country's population, five Ninth District states—Minnesota, Montana, the Dakotas and Wisconsin—have more than thrice that share (14.2 percent) of local government units in the country, about 12,600 in all, according to the U.S. Census Bureau. A good deal of that share stems from a preponderance of town and township units that govern the rural expanses that dominate much of the district and have few if any paid employees. Indeed, only 20 states recognize these geographically small units of government. But at every jurisdiction, the share of local governments in the district is more than double its share of total population (see Chart 1).

Nationwide, there is a unit of local government of some type for about every 3,500 people. Minnesota has the most units of local government in the district, with about 3,600, or one for roughly every 1,500 people. With 2,700 local governments, North Dakota has a local government unit for every 260 people.

Since 2007, most states have seen the number of local units decline, mostly as rural townships get annexed onto cities, or two similar units of government merge into a single larger unit. But among district states by 2012, there was a net gain thanks almost exclusively to Minnesota's increase of 106 units, many of them special district governments for things like watershed management and other special purposes (see Chart 2).

—*Ronald A. Wirtz*

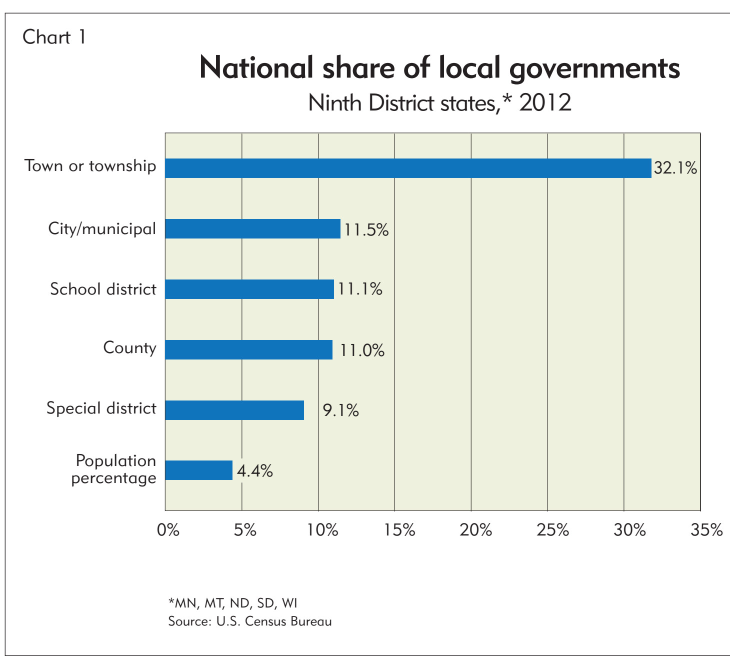



Chart 1
National share of local governments
Ninth District states,* 2012
*MN, MT, ND, SD, WI
Source: U.S. Census Bureau

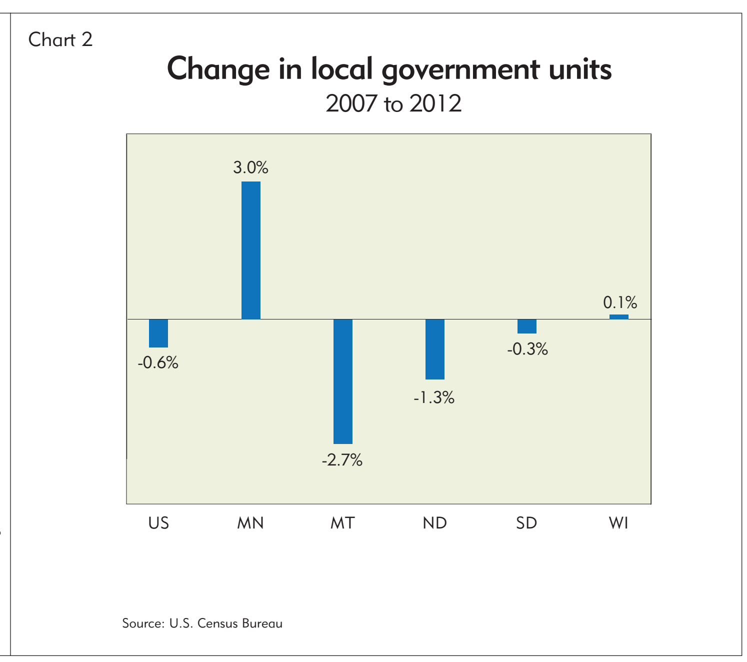



Chart 2
Change in local government units
2007 to 2012
Source: U.S. Census Bureau

# Moderate rise in rail rates powers district coal

The Powder River Basin in southeastern Montana and northeastern Wyoming is by far the largest supplier of coal for U.S. power plants; the region provides almost half of the roughly 900 million tons burned annually to produce electricity. Low sulfur content is one reason why Powder River coal is popular. Another is low prices; huge surface mines produce coal for $8 to $15 per ton—less than one-sixth the price of coal mined in the Appalachian Mountains.

A recent government report shows that Powder River coal became an even better deal for power companies over the past decade, thanks in large part to only moderate increases in rail transportation costs.

Trains carry more than 70 percent of U.S. coal used to generate electricity, so changes in rail rates can have a big impact on the total cost of coal delivered to power plants. That's especially true for Powder River coal, hauled in long unit trains over hundreds of miles; transportation accounts for more than half of the total delivered cost of coal from the region.

The U.S. Energy Information Administration tracked rail shipment prices to power plants from 2001 to 2010 and found substantial differences among the six major U.S. coal basins. EIA analysts found that, adjusted for inflation, rail transport rates for Powder River coal increased less than those for coal from other coal-producing regions. Powder River carriage rates rose less than 2 percent annually over the nine-year period, although they rose faster from 2009 to 2010.

However, average increases in rail rates between Powder River mines and specific states varied widely. For example, rates for shipping Wyoming coal to Minnesota power plants increased 7 percent annually, while costs for Wyoming coal headed to Wisconsin plants rose only 3 percent per year.

In addition, EIA found that rising mining costs in other parts of the country have made Powder River coal more cost competitive nationally. From 2007 to 2010, average delivered prices for district coal increased 22 percent—less than half of the price hike for coal from mines in Kentucky and West Virginia. As a result, Powder River producers have made inroads into Midwest and southeastern markets once predominantly served by central Appalachian coal.

— *Phil Davies*

# Forecast models and surveys point to steady growth in 2013

By ROB GRUNEWALD
Economist

JOSEPH MAHON
Economic Analyst

Results from the Minneapolis Fed's forecasting models and economic outlook surveys point to steady growth in 2013, with strong growth expected in North Dakota due to oil-drilling activity.

The housing sector is showing signs of recovery and, despite drought in some areas, the agriculture sector remains in good shape. However, concerns remain over government fiscal issues, a recent manufacturing slowdown and global economic conditions. Personal income and employment are expected to grow in 2013.

## Cautious optimism

Respondents to the business outlook poll are optimistic overall, but more pessimistic than respondents a year earlier (see page 18). District business leaders are cautious about economic conditions in the nation and in their respective states, but are more optimistic about prospects for their own businesses.

One place for renewed optimism is the housing sector, where sales and building are bouncing back. According to the Minnesota Realtors Association, closed sales in Minnesota increased 13 percent in November from a year earlier. In Sioux Falls, S.D., November closed sales were up almost 20 percent.

Stronger sales have contributed to lower inventories and higher prices. In third quarter 2012, prices in the Minneapolis-St. Paul metropolitan area increased 13 percent from a year earlier; in Sioux Falls, S.D., and Fargo, N.D., prices increased 5 percent and 4 percent, respectively.

Construction crews had more homes to build in 2012. Through November, housing units authorized were up across all district states. However, other than in North Dakota, housing units authorized totals are still far off their peak levels. According to results of the business outlook poll, overall housing starts are expected to increase during 2013. The Minneapolis Fed's forecasting models are mixed regarding the 2013 housing outlook (see page 19).

## A holiday hiccup in consumer spending?

During 2012, consumer spending showed moderate gains; however, initial measures indicate that holiday shopping was relatively mild nationally. Regionally, district retailers were cautiously optimistic for the holiday season. For example, according to the University of St. Thomas Holiday Spending Sentiment Survey, households in the Minneapolis-St. Paul area were expected to spend 10 percent more on holiday gifts than a year earlier. According to retail business contacts in the district, holiday sales in the region were probably somewhat stronger than in the nation.

There are signs that households are moving toward a better position to spend. Household balance sheets have generally improved during the past few years as many have paid down debt. Combined with recently increased home values, the debt pay-down has given households relatively more wealth.

Furthermore, consumers continue to face relatively stable prices. The consumer price index in November was up 1.8 percent compared with a year earlier. Home heating costs remained in check, as natural gas prices were relatively low during the early part of the winter. Minnesota gasoline prices in December were about the same as a year earlier. The core rate of inflation, which excludes energy and food prices, was up 1.9 percent from a year ago.

One area where consumer spending has been consistently strong is vehicle sales. Throughout 2012, district auto dealers have enjoyed substantial gains in sales. For example, during the first 10 months of 2012, registrations for new cars and light trucks increased 31 percent in Minnesota compared with a year earlier. Registrations were up 13 percent nationally.

The Minneapolis Fed's forecasting models suggest that personal income will grow in 2013, which will help support consumer spending (see page 18). According to the business outlook poll, 30 percent of respondents expect increased consumer spending in their communities, while 25 percent expect decreases.

## Employment expected to grow moderately

Employment in district states during November grew 1.4 percent from a year earlier, the same as in the nation (see chart at left). Natural resources and mining posted the strongest growth (+10.7 percent), followed by construction (+2.6 percent) and education and health services (+2.5 percent). Leisure and hospitality was the only sector with year-over-year employment losses (-.4 percent).

Gains in natural resources and mining were supported by continued expansion of oil drilling in western North Dakota and eastern Montana, the location of the Bakken oilfield. In September, 21.4 million barrels of oil were produced there, up from 13.2 million a year earlier, and accounted for 11 percent of U.S. oil output.

The number of active drilling operations in North Dakota decreased somewhat in recent months as oil companies cut costs and increased efficiency after drilling a number of initial producing wells to meet leasing requirements. While employment continues to grow rapidly in the area, the brisk pace of growth has eased somewhat as evidenced by a leveling in the number of online job postings in the North Dakota portion of the Bakken. Meanwhile, drilling in Montana has picked up recently as oil companies have expanded exploration in the western part of the Bakken.

Growth in construction employment was supported by increases in home building. Employment gains in education and health services continue in a sector that has consistently posted increases over the past few years.

According to the Minneapolis Fed's forecasting models, nonfarm employment will grow moderately in 2013, with stronger growth expected in North Dakota and Minnesota. Employment growth in the Upper Peninsula of Michigan will remain sluggish. Unemployment rates are predicted to drop in all areas. The unemployment rate in North Dakota is expected to drop to 2.8 percent (see page 19).

Despite employment gains, respondents to the business outlook poll indicated that securing workers will be challenging, but a bit less so than a year earlier. In the recent survey, 39 percent expect securing workers to be a challenge or serious challenge in 2013, down slightly from 41 percent in the prior survey.

Respondents to the business outlook poll expect modest employment gains in their communities during 2013 and somewhat stronger increases in employment at their own businesses. Respondents to the manufacturing survey expect level employment for their state economies and moderate gains at their own companies (see page17).

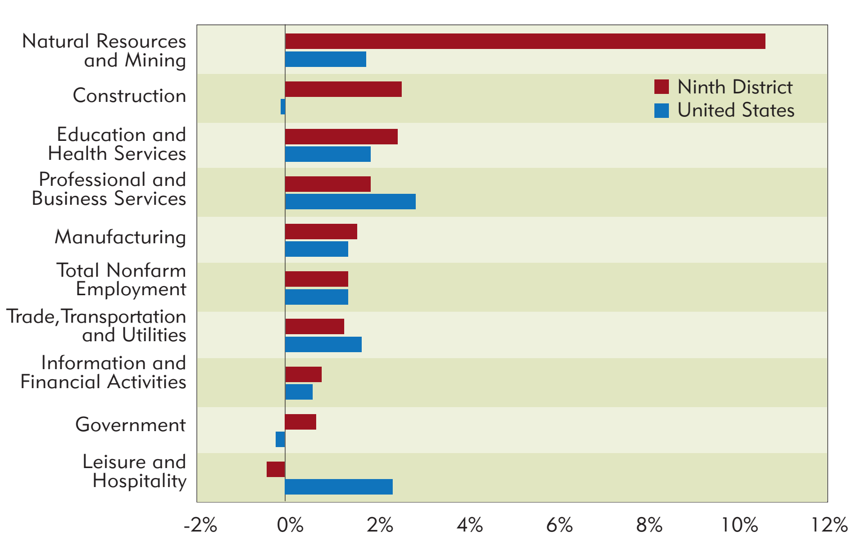
## Signs of caution

Despite the overall positive tenor of the forecast, several risks are causing district businesses to remain cautious. Respondents were concerned about fiscal cliff negotiations and other budget issues. Business leaders seem to be looking for a clearer picture of what to expect for tax and spending policy before making some decisions on capital expenditure and hiring plans. With the "fiscal cliff" deal reached on Jan. 1, some concerns will be alleviated.

Concern was also expressed over a slowdown in manufacturing, which has been a key component of the recovery. According to a survey of purchasing managers by Creighton University (Omaha, Neb.), manufacturing activity in Minnesota and South Dakota decreased for five straight months before posting a gain in December, while manufacturing in North Dakota posted relatively strong growth throughout 2012.

One drag on the manufacturing sector is slowing growth in exports due in part to economic malaise among several trading partners. Through October 2012, manufactured exports among five

**Employment gains for most industries**
Nonfarm employment, percent change from a year earlier, November 2012




Source: Bureau of Labor Statistics

district states (not including Michigan) increased 5 percent compared with a year ago, down from 11 percent growth for the full year of 2011. Manufactured export growth ranged from a high of 25 percent in North Dakota to a 4 percent decrease in Montana.

District manufactured exports to Europe, where struggles continue with government debt and other fiscal issues, decreased 3 percent through October 2012. Manufactured exports to China were flat during this period. District manufactured exports to China have typically posted strong growth rates, including 13 percent in 2011 and 35 percent in 2010. While China's economy continues to grow, its growth rate has dropped recently, which has dampened demand for district exports.

Despite the recent slowing in the district manufacturing sector, year-over-year employment levels are up, and respondents to the manufacturing survey are relatively upbeat for their companies' orders, production and employment levels in 2013.

## Agriculture remains strong despite drought

From early in the growing season, many agricultural producers were concerned about how 2012 would turn out. In contrast to 2011, a year marked by substantial flooding around the district, 2012 was a year of drought. Fortunately, much of the Ninth District was spared the worst of the dryness, and low production elsewhere put upward pressure on prices, boosting farm incomes. Livestock and dairy producers haven't fared as well, however, as higher feed costs squeezed margins. The outlook for both crop and animal product prices remains strong in 2013.

In 2012, farmers and ranchers saw big increases in prices for their products from their already strong 2011 levels (see table below). And in contrast to many agricultural states, the district saw production increases from 2011 for most crops, including corn (+5 percent), soybeans (+7 percent), wheat (+28 percent) and sugar beets (+32 percent). Dramatic production increases for sugar beets and for wheat and other small grains largely reflect a return to normal, since 2011 production was set back by flooding. While prices for several farm inputs, including fertilizer and chemicals, increased during 2012, these prices were offset by gains in crop prices.

According to the Minneapolis Fed's third-quarter (October 2012) agricultural credit conditions survey, 2012 was a strong year for agricultural income, with 95 percent of respondents reporting increased or steady income following several quarters of increases. Household spending and capital investment increased similarly. Agricultural lenders are somewhat optimistic for farm profits in the final quarter of 2011, with 60 percent expecting increased income and only 6 percent expecting decreased income.

Animal producers enjoyed continued strong prices (see table). After 2011's large increases, prices retreated slightly for hogs and milk (both down 8 percent), while cattle prices continued to rise (7 percent increase). These prices weren't enough to offset higher feed costs faced by meat and dairy producers.

Again, the outlook for 2013 is upbeat, as agricultural producers invest their profits. In addition to positive returns on investment, output prices are expected to rise. According to U.S. Department of Agriculture forecasts, 2013 prices for corn, soybeans, wheat, cattle, hogs and dairy are expected to increase. However, this outlook depends on whether the 2012 drought persists or fades into memory. f

# Manufacturing activity up again in 2012; stable activity expected for 2013

By TOBIAS MADDEN
Regional Economist

In spite of a sluggish economy, manufacturers have seen solid gains in recent years, and they expect continued growth in the coming year, according to the November survey of manufacturers conducted by the Federal Reserve Bank of Minneapolis and the Minnesota Department of Employment and Economic Development.

The multiyear manufacturing expansion that started in 2010 moderated in 2012. Orders were up in 2012 for half of survey respondents and down for 27 percent. About a third reported increased employment in 2012, while 27 percent reported reduced staffing. Manufacturers also reported higher prices and productivity, but lower profits. The Dakotas reported the strongest growth in 2012. Large and medium-sized firms also saw stronger performance compared with small employers. Wages and benefits grew about 2.2 percent in 2012.

Manufacturers across the district expect stable growth in 2013, with the exception of those in the Upper Peninsula of Michigan. Orders and total production are expected to increase, buoyed by solid productivity gains and higher selling prices. As a result, profits should increase (see chart below).

**One-quarter of respondents expect manufacturing employment to grow in 2013, while 16 percent expect job cuts.**

One-quarter of respondents expect manufacturing employment to grow in 2013, while 16 percent expect job cuts. Wages and benefits are again expected to increase by around 2 percent. Increased exports are anticipated across the district in 2013.

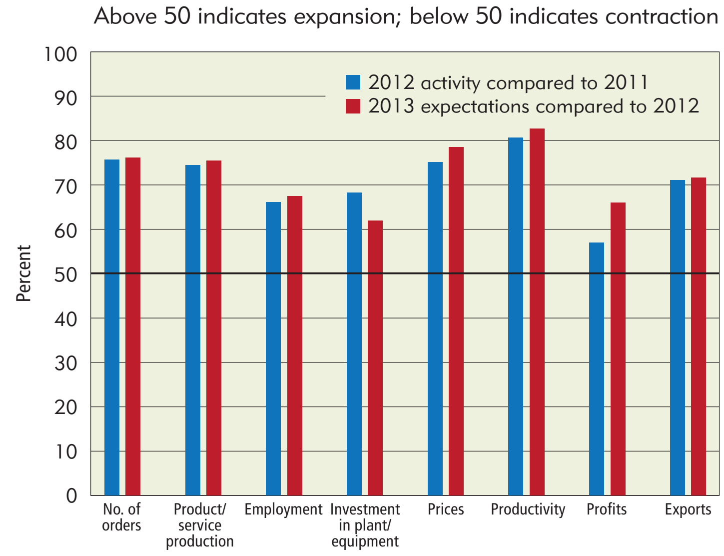
This industry optimism runs counter to the negative outlook many have for their state economies. Respondents expect declining state economic growth and decreases in overall corporate profits, capital investments and consumer spending. However, the boom should continue in North Dakota, as all indicators are up. Inflation is also a concern, as 60 expect higher inflation, while only 1 percent foresee lower inflation. f

### Crop, meat and dairy prices expected to increase in 2013
Average farm prices

| | 2009/2010 | 2010/2011 | Estimated 2011/2012 | Projected 2012/2013 |
|---|---|---|---|---|
| (Current $ per bushel) | | | | |
| Corn | 3.55 | 5.18 | 6.22 | 6.80-8.00 |
| Soybeans | 9.59 | 11.3 | 12.5 | 13.55-15.55 |
| Wheat | 4.87 | 5.7 | 7.24 | 7.70-8.30 |
| | **2010** | **2011** | **Estimated 2012** | **Projected 2013** |
| (Current $ per cwt) | | | | |
| All milk | 16.29 | 20.14 | 18.50-18.60 | 19.15-19.95 |
| Steers | 95.38 | 114.73 | 122.85 | 124-134 |
| Hogs | 55.06 | 66.11 | 61.1 | 63-67 |

Source: U.S. Department of Agriculture, estimates as of December 2012

### Manufacturing activity up in 2012; increases expected in 2013
Above 50 indicates expansion; below 50 indicates contraction




Source: Federal Reserve Bank of Minneapolis; Minnesota Department of Employment and Economic Development

# Many business leaders expect sluggish economic growth in 2013

By TOBIAS MADDEN
Regional Economist

As many look for the economy to grow faster, business confidence has become something of a buzzword or phrase, holding one of the keys to better traction. In the Ninth District, optimism for the year ahead varies widely, according to the *fedgazette's* annual business conditions poll of 335 business leaders conducted in November.

Business leaders in the Dakotas are very optimistic, thanks largely to the oil boom there, while others are more tempered in their enthusiasm. Companies across most of the Ninth District expect sales to increase in 2013, and they also plan to invest more in capital equipment and hire more people.

Firms expect to raise prices and increase wages, but are concerned about government regulation. More broadly, business leaders expect housing starts to rise, but were mixed in their local assessment of consumer spending, employment and business investment. They also expect higher inflation and slow growth at the national level.

## Companies expect growth in 2013

"Demand for our products continues to be strong," said a western Wisconsin agricultural producer, which reflects the overall mood of higher sales among most industries and geographic areas across the district (see Chart 1). Respondents from the Minneapolis-St. Paul area and North Dakota are the most optimistic about sales growth, while respondents from greater Minnesota are the least optimistic about sales.

Retailers, real estate professionals and manufacturers expect the biggest gains in sales. In addition, sales prices are expected to rise, as 30 percent of all respondents expect to raise prices in 2013, compared with 20 percent who expect to drop prices. With drought covering much of the United States, 47 percent of agricultural producers expect increases, and only 13 percent expect decreases.

Almost 70 percent of business leaders also saw higher productivity last year, a trend that should continue, as capital investment is expected to increase across all geographic areas and most sectors. "We expect high demand for our services that automate back office processes for organizations," commented a Minneapolis area technology company. In addition to increases in capital investment, slight to modest employment increases are expected at firms across much of the district and most business sectors.

Respondents indicated that they may have an easier time financing capital expenditures because access to credit has improved over the past three months. Seventeen percent of respondents indicated that access to bank credit has improved some or improved a lot versus 9 percent who noted deteriorating conditions. This improvement occurred across industry sectors, save for services, and across district states with the exception of North Dakota and the Michigan's Upper Peninsula.

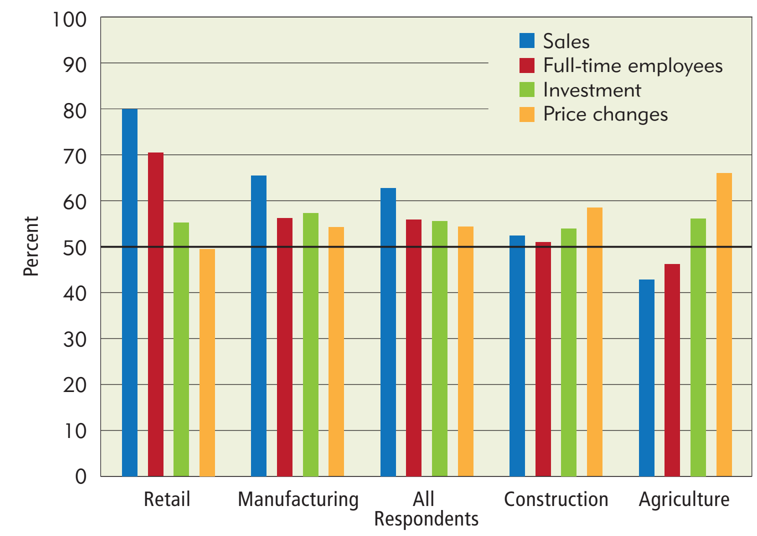
District businesses face some challenges. More than two-thirds of the respondents said that complying with government regulation was a challenge or serious challenge. In addition, 39 percent said that securing workers was a challenge. This labor concern varied across the district, with a high of 68 percent of the respondents from North Dakota and a low of 26 percent from Montana reporting difficulty.

## Modest state, sluggish U.S. growth expected

Fewer leaders were optimistic about their state economies compared with 2011 (see Chart 2). Optimism is strong in the Dakotas, while respondents from greater Minnesota and western Wisconsin are somewhat pessimistic (see Chart 3). "Due to the Bakken oilfield, our state and region are experiencing unprecedented prosperity," commented a North Dakota transportation respondent. This optimism/pessimism also flows into the outlook for state economies.

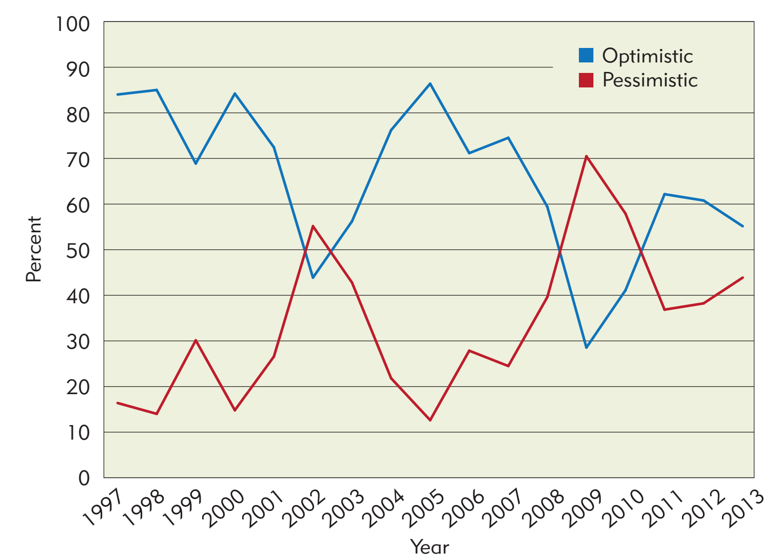
Expectations for local communities generally followed the same pattern. Respondents from the Dakotas were positive about employment, business investment and consumer spending. Respondents from greater Minnesota were negative, and even more so in the U.P. Most industry sectors were slightly posi-

Chart 1 With regard to your own company, how do you see operations changing during the next year?
Above 50 indicates expansion; below 50 indicates contraction



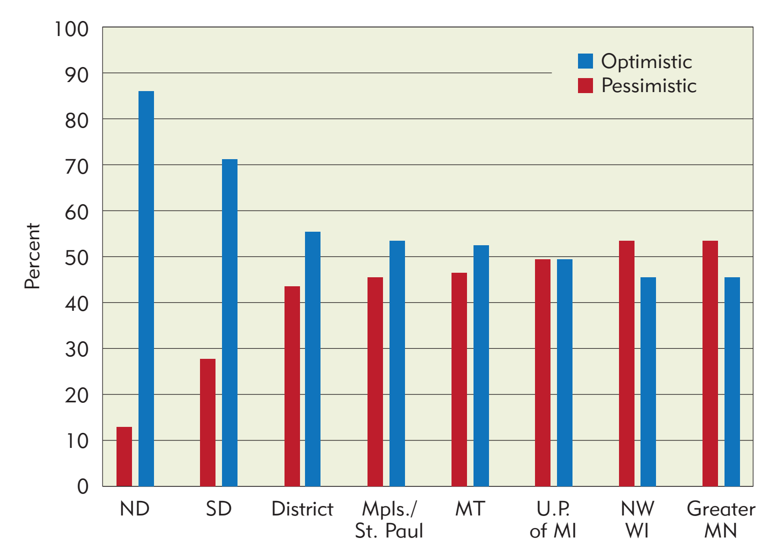

Source: Federal Reserve Bank of Minneapolis, annual business outlook poll

Chart 2 Overall, what is your outlook for your community's economy in the next 12 months?




Source: Federal Reserve Bank of Minneapolis, annual business outlook poll

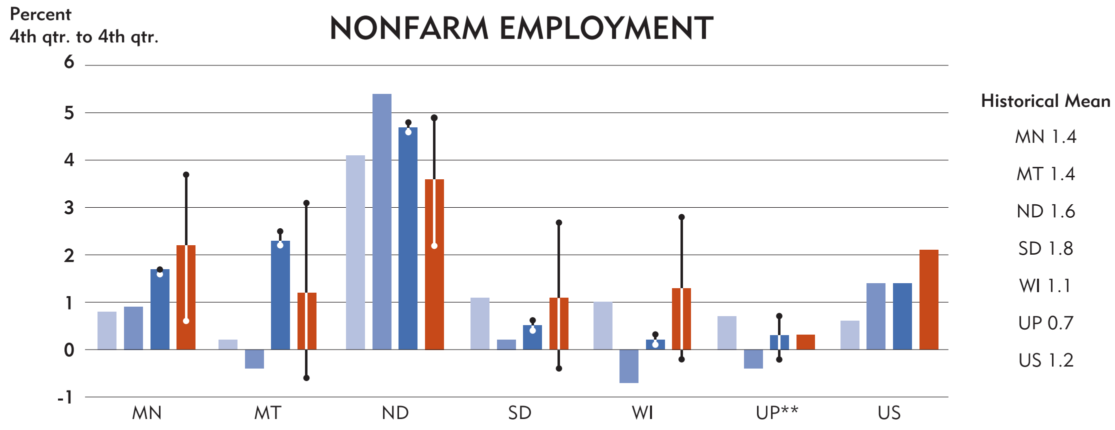
Chart 3 Overall, what is your outlook for your community's economy in the next 12 months?




Source: Federal Reserve Bank of Minneapolis, annual business outlook poll

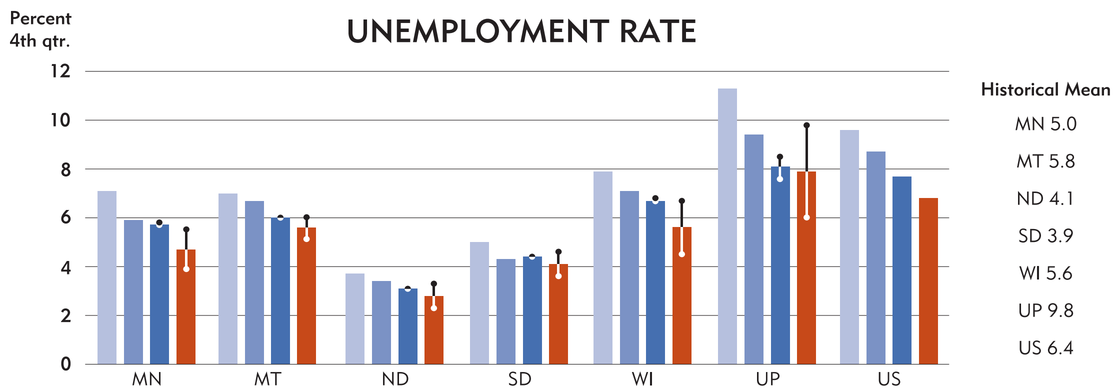
## District Forecast

Employment is expected to grow moderately. In 2012, nonfarm employment grew in all areas of the district after posting decreases or slow growth during 2011. North Dakota saw a strong growth rate of 4.7 percent in 2012, building on a 5.4 percent increase in 2011. The slowest growth during 2012 was in Wisconsin and the Upper Peninsula of Michigan, where nonfarm employment grew slightly. In 2013, nonfarm employment will grow moderately with stronger growth expected in North Dakota and Minnesota. Growth in North Dakota will ease to 3.6 percent, while growth in Minnesota will increase to 2.2 percent. Employment growth in the U.P. will remain sluggish.

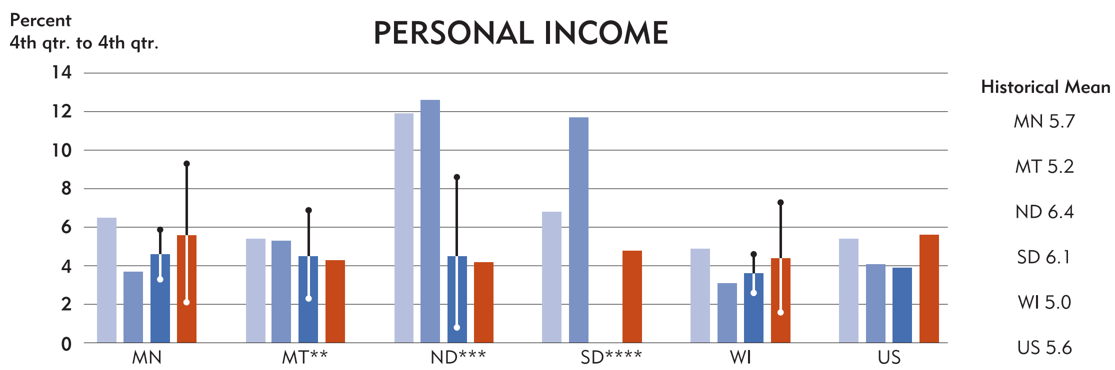



**Confidence interval for 2013 is –2.3 to 2.8.


Unemployment rates are expected to decrease. During 2012, unemployment rates decreased in all areas, but remained above historical averages, except in North Dakota and the U.P., where rates were below their historical averages. In 2013, rates will drop in all areas to historical averages or below, except in South Dakota, where the rate will remain slightly above its historical average. The unemployment rate in North Dakota will drop to 2.8 percent.

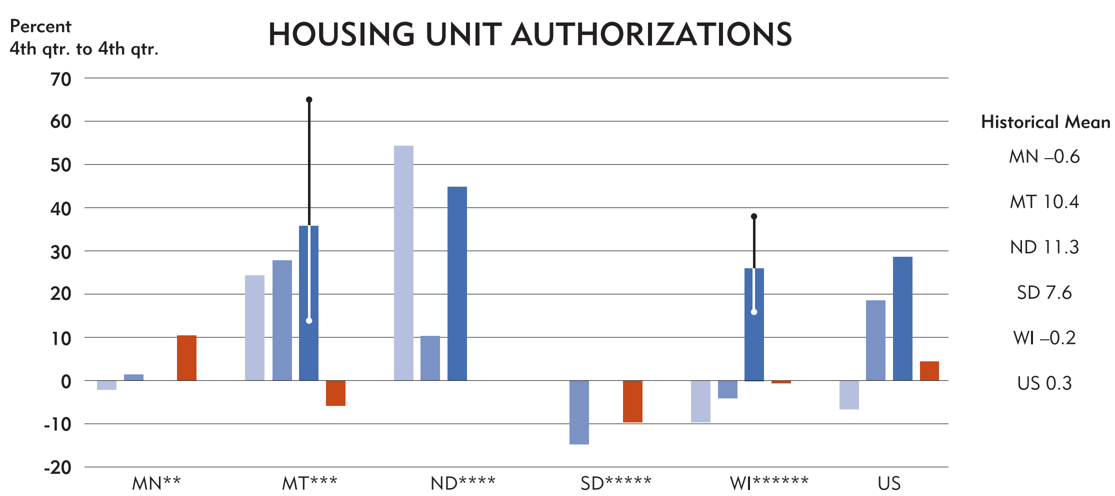



The forecast calls for the pace of growth in personal income to pick up somewhat. In 2012, personal income growth dropped from strong 2011 rates in Montana and the Dakotas. Personal income levels actually decreased in South Dakota. Meanwhile, personal income growth increased in Minnesota and Wisconsin after relatively mild growth during 2011. In 2013, personal income will grow faster in Minnesota, South Dakota and Wisconsin compared with 2012. Growth will be positive in Montana and North Dakota, but slightly slower than in 2012. Note that the confidence interval surrounding the North Dakota forecast is relatively wide, indicating a high degree of uncertainty.




**Confidence interval for 2013 is –0.7 to 9.6.
***Confidence interval for 2013 is –4.3 to 13.6.
****Value for 2012 is –1.4. Confidence interval for 2012 is –3.3 to 0.6 and for 2013 is –0.3 to 10.4.

Housing units authorized posted strong improvement during 2012, but the forecasting model is mixed regarding the 2013 outlook. During 2012, housing units authorized posted strong gains in all district states. Authorizations more than doubled in South Dakota. In 2013, housing units authorized will increase in Minnesota, increase only slightly in Wisconsin and decrease in Montana and the Dakotas. However, the confidence intervals for home-building predictions span a relatively wide range, indicating a much higher degree of uncertainty compared with forecasts for employment, unemployment rate and personal income.




**Value for 2012 is 85. Confidence interval for 2012 is 67.4 to 105.6 and for 2013 is –20.2 to 54.3.
***Confidence interval for 2013 is –42.0 to 53.3.
****Confidence interval for 2012 is 12.8 to 95.0. Value for 2013 is –32.9. Confidence interval for 2013 is –63.1 to 21.3.
*****Value for 2010 is –43.6. Value for 2012 is 164.2. Confidence interval for 2012 is 116.7 to 231.0 and for 2013 is –45.0 to 48.5.
******Confidence interval for 2013 is –26.4 to 37.4.

tive about their state economies, except agriculture, which was negative about employment and consumer spending.

Most areas of the district expect statewide housing starts to increase in 2013 compared with 2012. The only exception is the U.P. Respondents from the construction, retail, services and finance, insurance and real estate sectors were very optimistic about housing starts.

Wages are also expected to rise modestly, with 62 percent seeing 2 percent to 3 percent increases, while 31 percent expect 0 percent to 1 percent increases. Respondents from North Dakota expect much more robust wage increases; 44 percent expect increases of 4 percent or more. Among industry sectors, construction and manufacturing expect the largest wage increases, while the retail sector expects the lowest increases.

Respondents are pessimistic about national economic conditions. About a quarter expect a recession, while 61 percent expect 1 percent to 2 percent growth in GDP in 2013. The national outlook remains highly uncertain due to federal fiscal policy and implementation of new regulations, particularly in federal health care. Inflation is also a concern, as 26 percent expect CPI to increase by 4 percent or more, and a third expect inflation of around 3 percent. f

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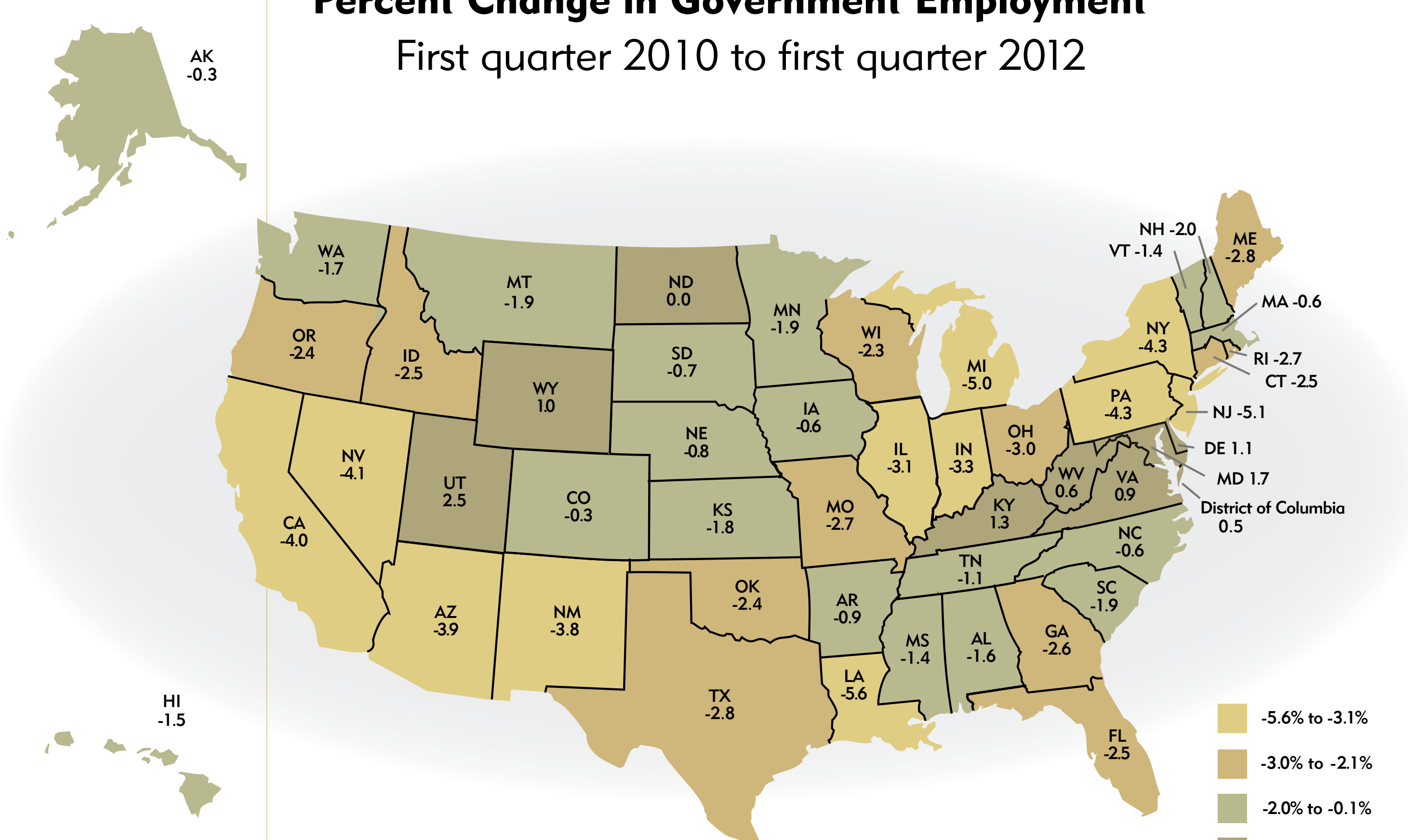
**Government employment**

January 2013



## Percent Change in Government Employment*

First quarter 2010 to first quarter 2012




*Federal, state and local
Source: Bureau of Labor Statistics, Quarterly Census of Employment and Wages