



January 13, 2012

The Honorable Claire Robling, Chair
Senate Finance Committee
226 Capitol Building
St. Paul, MN 55155

The Honorable Mary Liz Holberg, Chair
House Ways and Means Committee
453 State Office Building
St. Paul, MN 55155

The Honorable Richard Cohen
Ranking Minority Member
Senate Finance Committee
109 State Office Building
St. Paul, MN 55155

The Honorable Lyndon Carlson
Ranking Minority Member
House Ways and Means Committee
283 State Office Building
St. Paul, MN 55155

Re: 2012 Budget Reserve Report

Dear Senators and Representatives:

In accordance with Minnesota Statutes 2011, section 16A.152, subdivision 8, the commissioner of Minnesota Management and Budget (MMB) must annually review the formula used by the department to estimate the percentage of the preceding biennium's general fund expenditures and transfers recommended as a budget reserve. The statutes also require the commissioner to report by January 15 of each year to the chairs and ranking minority members of the House of Representatives Committee on Ways and Means and the Senate Committee on Finance the recommended percentage level for the budget reserve. This is the third of those required annual reports.

In 2008, as part of analyses prepared for the State Budget Trends Study Commission, MMB economists examined the volatility of Minnesota's tax structure. This research provides an empirical basis for estimating the appropriate size for the state's budget reserve, an important risk management tool available to state financial managers to reduce disruptions in state services caused by the short term variations inherent in cyclically sensitive revenue streams.

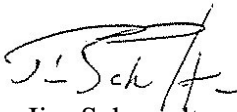
As required by statute, MMB has reviewed the process used to model the volatility of Minnesota's general fund tax structure and determine the necessary size for the budget reserve. The department's review concludes there have been no significant changes to either the general fund tax base or the mix of revenues since the last annual review was reported in January 2011. If it is assumed that the budget is structurally balanced at the start of the biennium and that policymakers desire to limit to 5 percent the probability that a biennial deficit will exceed reserves, MMB recommends a budget reserve of 4.2 percent of the preceding biennium's general fund expenditures and transfers, or \$1.3 billion, is required to adequately manage cyclical risk in the current biennium.

The November Economic Forecast of state revenues and expenditures is projecting a positive budgetary general fund balance of \$876 million for the 2012-13 biennium. Current law (M.S.16A.152 Subd.2) requires the commissioner of MMB to allocate \$621 million of that biennial forecast balance to restore the state's budget reserve, which had been depleted as a necessary part of the solution to recent budget deficits. This additional funding, combined with \$27 million received in July from an excess balance in the workers' compensation assigned risk plan, increases the budget reserve account from zero at the end of the legislative session to a present balance of \$648 million, just \$5 million below the \$653 million statutory maximum.

While these recent actions to restore the budget reserve improve the state's underlying fiscal condition, Minnesota's \$653 million current law statutory ceiling is just 1.9 percent of expenditures and transfers in the current biennium. Minnesota's formal budget reserve is well below what rating agencies believe to be consistent with sound financial practice.

In Standard & Poor's analytical framework, for example, the top score on their measure of budget reserve adequacy is reserved for states with "a formal budget reserve relative to revenue or spending that is above 8 percent." Minnesota's statutory maximum is also well below MMB's estimate of the level consistent with the underlying volatility of Minnesota's general fund tax structure. MMB will continue to periodically evaluate the adequacy of the statutory budget reserve based on any changes in the revenue system.

Sincerely,



Jim Schowalter
Commissioner

cc: Governor Mark Dayton
Brent Gustafson, Senate Counsel, Research & Fiscal Analysis
Bill Marx, House Fiscal Analysis