MINNESOTA Management & Budget

January 15, 2013

The Honorable Richard Cohen , Chair
Senate Finance Committee
121 Capitol Building
St. Paul, MN 55155

The Honorable Lyndon Carlson Sr., Chair
House Ways and Means Committee
479 State Office Building
St. Paul, MN 55155

The Honorable Michelle Fischbach
Ranking Minority Member
Senate Finance Committee
15 State Office Building
St. Paul, MN 55155

The Honorable Mary Liz Holberg
Ranking Minority Member
House Ways and Means Committee
349 State Office Building
St. Paul, MN 55155

Re: 2013 Budget Reserve Report

Dear Senators and Representatives:

In accordance with Minnesota Statutes 2012, 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 fourth 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. Following this evaluation, MMB economists determined that it was necessary to update the variables and coefficients in the formula, incorporating comprehensive data on the recession that began in late 2007. At the time of the 2008 study the severity of the recession was not known. This update changes the percentage of the preceding biennium's general fund expenditures and transfers recommended as a budget reserve from that reported in January 2012.

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 now recommends a budget reserve policy of 4.9 percent of the preceding biennium's general fund expenditures and transfers, or a $1.7 billion reserve account to adequately manage cyclical risk in the coming 2014-15 biennium.

The Legislative Special Session of 2012 required the commissioner of MMB to reduce the budget reserve account by $45 million and reduced the November 2012 budget reserve forecast requirement to $612 million, ensuring that if the forecast is positive, any surplus will be used to buy back school aid payment shifts. Other statutory provisions in the November forecast, however, directed an additional $32 million to the budget reserve account, including a $26 million excess balance in the workers' compensation assigned risk plan (M.S. 79.251 Subd. 1) and a $6 million residual from requirements governing school shift buyback percentages (M.S. 16A.152 Subd. 2). After these automatic deposits, the present balance in the budget reserve account is $644 million, just $9 million below the $653 million statutory maximum.

While 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 FY2012-13 biennium. That places Minnesota's statutory maximum well below MMB's estimate of the level consistent with the underlying volatility of Minnesota's general fund tax structure. Minnesota's formal budget reserve policy is also 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 assigned to states with "a formal budget reserve relative to (one-year) revenue or spending that is above 8 percent." Minnesota's current statutory maximum level is equivalent to just 3.7 percent of annual revenues, whereas MMB's recommendation is comparable to 9.8 percent of annual revenues.

As required by statute, 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
Eric Nauman, Senate Counsel, Research & Fiscal Analysis
Bill Marx, House Fiscal Analysis