



January 15, 2014

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

Subject: 2014 Budget Reserve Report

Dear Senators and Representatives:

In accordance with Minnesota Statutes 2013, 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. Please find the 2014 Budget Reserve Report attached below.

As required by statute, MMB will continue to periodically evaluate the adequacy of the statutory budget reserve based on any changes in the tax system.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Schowalter", written over a horizontal line.

Jim Schowalter
Commissioner

cc: Governor Mark Dayton
Eric Nauman, Senate Counsel, Research & Fiscal Analysis
Bill Marx, House Fiscal Analysis

Background

In 2008, as part of analyses prepared for the State Budget Trends Study Commission, economists at Minnesota Management & Budget (MMB) 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 volatility inherent in cyclically sensitive tax revenue streams.

Budget Reserve Recommendation

In accordance with Minnesota Statutes 2013, section 16A.152, subdivision 8, MMB has reviewed the process used to model the volatility of Minnesota’s general fund tax structure and determine the recommended size for the budget reserve. Following this evaluation, MMB economists determined that it was necessary to update the variables and coefficients in the formula to include significant tax law changes enacted by the 2013 legislature. This report updates the percentage of the preceding biennium’s general fund expenditures and transfers recommended as a budget reserve from that reported in January 2013 to reflect these changes to the state’s tax base and mix of taxes.

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 policy of 4.9 percent of the preceding biennium’s general fund expenditures and transfers (henceforth general fund non-dedicated revenue), or a \$1.9 billion reserve account to adequately manage cyclical risk in the coming 2014-15 biennium.

Budget Reserve Report: January 2014

	Current \$ Level	% of FY 2014-15 Non-Dedicated Revenues (Two-Years)	% of FY 2014 Non-Dedicated Revenues (One-Year)
Budget Reserve Account	\$661 million	1.7%	3.5%
Cash Flow Account	\$350 million	0.9%	1.8%
Total Current Reserves Balance*	\$1.011 billion	2.6%	5.3%
MMB Recommendation	\$1.900 billion	4.9%	10.0%
Rating Agency Top Scores Guideline:			
	Standard & Poor’s		≥8%
	Moody’s		≥10%

* November 2013 Budget & Economic Forecast

Budget Reserve Status

Statutory provisions following February 2013's *Budget & Economic Forecast* directed \$12 million to the budget reserve account, including a \$9 million allocation of the projected biennial forecast balance for restoring the state's budget reserve to the \$653 million current law statutory ceiling (M.S.16A.152 Subd.2) and a \$3 million residual from requirements governing school shift buyback percentages (M.S. 16A.152 Subd. 2). Likewise, statutory provisions in November 2013's *Budget & Economic Forecast* directed a \$5 million excess balance in the workers' compensation assigned risk plan (M.S. 79.251 Subd. 1) to the budget reserve. The total excess surplus was actually \$14 million, but \$10 million was incorporated into the FY 2014-15 budget solution. After these automatic deposits, the present balance in the budget reserve account is \$661 million, or \$8 million above the \$653 million statutory ceiling.

Rating Agency Guideline Comparison

While recent actions to restore the budget reserve improve the state's underlying fiscal condition, Minnesota's current \$661 million budget reserve account balance (and \$653 million statutory ceiling) is just 1.7 percent of non-dedicated revenue in the FY2014-15 biennium. If the cash flow account is included, reserves equate to about 2.6 percent of biennial non-dedicated revenue. That places Minnesota's current reserve balance 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. State bond ratings depend on a number of factors, but both Standard and Poor's and Moody's specifically include a measure of the adequacy of statutory budget reserves in their credit analyses. In Standard and Poor's analytical framework, states with statutory reserve levels of 8 percent or more of annual (one-year) general fund revenue or spending receive top scores. Moody's ratings guidelines indicate that Aaa-rated states should have statutory reserves of at least 10 percent of annual revenue. By comparison, Minnesota's current budget reserve account balance is equivalent to just 3.5 percent of annual (one-year) non-dedicated revenues in fiscal year 2014. If the cash flow account is included, reserves are about 5.3 percent of annual non-dedicated revenue. MMB's updated recommendation is comparable to 10.0 percent of annual non-dedicated revenues.

Summary and Conclusion

To adequately manage the volatility underlying Minnesota's general fund tax structure, MMB recommends a budget reserve policy of 4.9 percent of the current biennium's general fund non-dedicated revenues, or a reserve account of \$1.9 billion for the current 2014-15 biennium. By comparison, the state's current budget reserve and cash flow accounts total \$1.011 billion, or 2.6 percent of non-dedicated revenues in the FY2014-15 biennium. That places Minnesota's formal budget reserve policy well below MMB's recommendation for an appropriate size reserve and what rating agencies believe to be consistent with sound financial practice. MMB will continue to periodically evaluate the adequacy of the Minnesota's budget reserve based on any changes to the state's tax base or mix of taxes.