



January 15, 2010

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

The Honorable Loren Solberg, Chair  
House Ways and Means Committee  
443 State Office Building  
St. Paul, MN 55155

The Honorable Dennis Frederickson  
Ranking Minority Member  
Senate Finance Committee  
139 State Office Building  
St. Paul, MN 55155

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

RE: Budget Reserve Report

Dear Senators and Representatives:

In accordance with Minnesota Statutes 2008, 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 first 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.

The study found that an appropriate reserve level depends on several key assumptions which must be made by policymakers. Those assumptions include the length of time for which protection against systematic risk is desired and the acceptable failure rate, or the probability that a deficit in any particular period will exceed the reserve. The reserve calculation also explicitly requires the budget be structurally balanced at the start of the biennium. If the budget reserve calculation is to be expressed as a percentage of expenditures and transfers in the prior biennium, as required by statute, it is also necessary that expenditures and transfers in that biennium be equal to current resources. If that assumption is not met the budget reserve percentage must be applied to the amount of expenditures and transfers less the balance forward plus any balances in the reserve, cash flow account, or projected ending balance.

In 2008 MMB found that given existing levels of systematic risk a reserve between 4.1 and 4.6 percent of biennial revenues or biennial spending would be sufficient to cover potential state budget deficits in all but 5 percent of possible outcomes. To appropriately manage risk for a longer period, MMB's analysis showed that a reserve of 5.8 to 6.6 percent is necessary to provide the same rate of protection for two biennia or four years. The current ceiling for the state's budget reserve is \$653 million, or 1.9 percent, of expenditures and transfers in the 2008-09 biennium.

As required by statute, MMB has reviewed the process used to model Minnesota's general fund tax revenue volatility and determine the necessary size for the budget reserve to adequately manage cyclical risk. 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 report of the State Budget Trends Study Commission on January 12, 2009. MMB recommends that given the current imbalance between current resources and expenditures and assuming policymakers desire to limit to 5 percent the probability that a biennial deficit exceeds reserves, a budget reserve of 3.9 percent of the preceding biennium's general fund expenditures and transfers, or \$1.3 billion, is required for the current biennium.

MMB recognizes that use of the state's budget reserve has been a necessary part of the solution to recent budget deficits and the present balance in the reserve account is zero. While under current law any forecast surplus goes to rebuild the reserve account to the statutory ceiling of \$653 million, MMB notes that the state's statutory ceiling for the budget reserve is well below what is believed to be a level consistent with the underlying volatility of Minnesota's revenue structure. MMB will continue to periodically evaluate the adequacy of the statutory budget reserve based on any changes to the system.

Sincerely,



Tom J. Hanson  
Commissioner

cc: Governor Tim Pawlenty  
Matt Massman, Senate Fiscal Analysis  
Bill Marx, House Fiscal Analysis