



January 15, 2011

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: Budget Reserve Report

Dear Senators and Representatives:

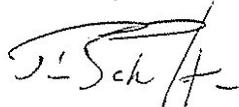
In accordance with Minnesota Statutes 2010, section 16A.152, subdivision 8, the commissioner of Minnesota Management & Budget (MMB) must annually review the formula used by the department to estimate the percentage of the preceding biennium's general fund expenditures and transfers recommended as a budget 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 second 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 2010. 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 4.1 percent of the 2010-11 biennium's general fund expenditures and transfers, or \$1.3 billion, is required to adequately manage cyclical risk in the 2012-13 biennium.

The present balance in the budget reserve account is \$9 million. While under current law (M.S. 16A.152 Subd.2) the commissioner of MMB is required to allocate any positive unrestricted budgetary general fund balance for the close of a biennium to restore the budget reserve to a statutory maximum \$653 million, or 1.9 percent, of expenditures and transfers in the 2010-11 biennium, those provisions were suspended by actions taken in the October 2010 special legislative session since federal law prohibits any state savings resulting from the higher Medicaid matching rate contributing directly or indirectly to state reserves. MMB notes that while use of the state's budget reserve has been a necessary part of the solution to recent budget shortfalls, the state's statutory ceiling for the budget reserve remains well below what rating agencies believe to be consistent with sound financial practice. The 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,

A handwritten signature in black ink, appearing to read "J. Schowalter". The signature is fluid and cursive, with a long horizontal stroke at the top.

Jim Schowalter
Commissioner

cc: Governor Mark Dayton
Matt Massman, Senate Fiscal Analysis
Bill Marx, House Fiscal Analysis