



January 15, 2015

The Honorable Tom Saxhaug, Chair
Senate State Departments Budget Division
328 Capitol Building
St. Paul, MN 55155

The Honorable Sarah Anderson, Chair
State Government Finance Committee
583 State Office Building
St. Paul, MN 55155

The Honorable Roger C. Chamberlain
Ranking Minority Member
Senate State Departments Budget Division
129 State Office Building
St. Paul, MN 55155

The Honorable Sheldon Johnson
Ranking Minority Member
State Government Finance Committee
259 State Office Building
St. Paul, MN 55155

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

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

Subject: 2015 Budget Reserve Report

Dear Senators and Representatives:

In accordance with [Minnesota Statutes 2014, section 16A.152, subdivision 8](#), the commissioner of Minnesota Management and Budget (MMB) must develop and annually review a methodology for evaluating the adequacy of the state's budget reserve based on the volatility of Minnesota's general fund tax structure.

The statutes also require the commissioner to report by January 15 of each year to the chairs and ranking minority members of the legislative committees with jurisdiction over MMB the percentage of the current biennium's general fund non-dedicated revenues recommended as a budget reserve. Please find the 2015 Budget Reserve Report attached below.

January 15, 2015

Page Two

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

Sincerely,

A handwritten signature in blue ink, appearing to read "Myron Frans". The signature is fluid and cursive, with the first name "Myron" and the last name "Frans" clearly distinguishable.

Myron Frans
Commissioner

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

Background

Like most state governments, Minnesota sets aside reserve funds to help manage budgetary uncertainty. Officially known as the budget reserve and cash flow accounts, these reserves afford policymakers greater financial flexibility during economic downturns and promote long-term fiscal stability. In addition, an established reserve fund policy is viewed positively by credit rating agencies.

In 2008, as part of analyses prepared for the State Budget Trends Study Commission, economists at Minnesota Management & Budget (MMB) developed a data-driven method for estimating the amount of reserves Minnesota would need to set aside to adequately manage state revenue volatility. This report summarizes key findings from the most recent review.

Budget Reserve Recommendation

In accordance with Minnesota Statutes ([M.S. 16A.152](#)), MMB has reviewed the process used to model the volatility of Minnesota's general fund tax structure and determine the recommended size for the state's budget reserve. This evaluation is updated from that reported in January 2014 to reflect both an additional year of data and tax law changes enacted by the 2014 legislature.

To adequately manage the underlying risks in Minnesota's general fund tax system, MMB recommends a budget reserve policy of 5.1 percent¹ of the current biennium's general fund non-dedicated revenues, or a \$1.990 billion reserve for the 2014-15 biennium. In the coming 2016-17 biennium, MMB recommends a budget reserve policy of 5.2 percent of non-dedicated revenues, reflecting the effects of projected changes to Minnesota's revenue mix. Based on the current law revenue forecast for FY 2016-17,² this amounts to a \$2.166 billion reserve.

These conclusions assume the budget is structurally balanced at the start of each biennium,³ and policymakers desire to limit to 5 percent the probability that a biennial deficit will exceed reserves.

Budget Reserve Report: 2015

	Current \$ Level ²	% of FY 2014-15 Non-Dedicated Revenues	% of FY 2016-17 Non-Dedicated Revenues
Budget Reserve Account	\$994 million	2.5%	2.4%
Cash Flow Account	\$350 million	0.9%	0.8%
Total Current Reserves Balance	\$1.344 billion	3.4%	3.2%
MMB Recommendation: FY2014-15	\$1.990 billion	5.1%	-
FY2016-17	\$2.166 billion	-	5.2%

Rating Agency Top Scores Guideline (% of Biennial Revenues):

- | | | |
|--|-------------------|-----|
| 1. Rounded to the nearest tenth of a percent. | Standard & Poor's | ≥4% |
| 2. November 2014 <i>Budget & Economic Forecast</i> . | Moody's | ≥5% |
| 3. Changes made to the tax base or revenue mix during the 2015 legislative session will be reflected in the January 2016 report. | | |

Budget Reserve Status

Legislation passed during the 2014 legislative session included major changes to Minnesota's budget reserve level and policy established in [M.S. 16A.152](#). First, \$150 million was directly appropriated to the state's budget reserve, increasing the account to \$811 million on July 1. Second, new legislation establishes an adequate and adjustable budget reserve target. Previously, since 2001, the budget reserve account had been statutorily capped at a maximum dollar level of \$653 million. Under the new law, a target is set as a percentage of each biennium's revenues. The commissioner of MMB specifies the percentage following an annual evaluation of revenue volatility and the adequacy of reserves. Finally, recent legislation creates a new, automatic mechanism that transfers 33 percent of future November forecast balances until the target is reached. Following the November 2014 *Budget & Economic Forecast*, this new provision automatically directed \$183 million, or 33 percent of the forecast balance, to the budget reserve account, increasing the balance from \$811 million to \$994 million. The cash flow account remains at \$350 million. Thus, the combined balance in Minnesota's budget reserve and cash flow accounts is \$1.344 billion.

Despite recent allocations, the current funded balance in Minnesota's budget reserve and cash flow accounts remains well below MMB's recommended level given the underlying volatility of Minnesota's tax structure. Minnesota's current \$994 million budget reserve account balance is 2.5 percent of non-dedicated revenue in the 2014-15 biennium. If the cash flow account is included, reserves equate to about 3.4 percent of current biennial non-dedicated revenue.

Rating Agency Guideline Comparison

Minnesota's new formal budget reserve policy establishes a target that is comparable to what rating agencies believe to be consistent with responsible financial management practices. 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, for example, states with statutory reserve levels of 4 percent or more of biennial (two-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 5 percent of biennial revenue.

Summary and Conclusion

Like most state governments, Minnesota sets aside reserves to help manage budgetary uncertainty. Recent actions taken during the 2014 legislative session increase Minnesota's reserve fund levels and strengthen the state's reserve fund policy. The state's new formal budget reserve policy establishes a target that is comparable to what rating agencies believe to be consistent with responsible financial management practices. Nonetheless, the current funded balance in Minnesota's budget reserve and cash flow accounts remains well below MMB's recommended level given the underlying volatility of Minnesota's tax structure. To adequately manage unforeseeable budgetary risks, MMB recommends a budget reserve policy of 5.1 percent of current biennial general fund revenue, or a reserve account of \$1.990 billion for the 2014-15 biennium. By comparison, the combined balance in Minnesota's budget reserve and cash flow accounts currently totals \$1.344 billion, or 3.4 percent of FY 2014-15 revenues. As required by statute, MMB will continue to evaluate the adequacy of the statutory budget reserve based on any significant changes in the tax system.