MINNESOTA Management & Budget

BUDGET RESERVE REPORT

September 2015

Background

Like most state governments, Minnesota sets aside reserve funds to help manage budgetary uncertainty. Reserves afford policymakers greater financial flexibility during economic downturns and promote long-term fiscal stability. In addition, well-funded reserves are viewed positively by credit rating agencies.

Economists at Minnesota Management & Budget (MMB) and the University of Minnesota have developed a data-driven method for determining an appropriate reserve size given the prevailing degree of volatility in Minnesota's revenue system. This report summarizes MMB's findings from the most recent annual review.

Budget Reserve Recommendation

In accordance with Minnesota Statutes (M.S. 16A.152), MMB economists have reviewed the process used to model the volatility of Minnesota's general fund tax structure and determine the recommended size of the state's budget reserve. This evaluation updates the January 2015 report to reflect both an additional year of data and tax law changes enacted by the 2015 legislature.

To adequately manage the underlying risks in Minnesota's general fund tax revenue system, MMB recommends a budget reserve target of 4.8 percent[1] of the current biennium's general fund non-dedicated revenues, or a $2.027 billion budget reserve for the 2016-17 biennium.[2] These conclusions assume the budget is structurally balanced through the remainder of the biennium, and policymakers desire a 95 percent level of confidence that a biennial deficit will not exceed budget reserves.[3]

Budget Reserve Report: September 2015

	Current $ Level	% of FY 2016-17 Non-Dedicated Revenues
MMB FY2016-17 Recommendation	$2.027 billion[2]	4.8%
Current Budget Reserve Account	$994 million	2.4%
Difference	$1.033 billion	

Note: The statutory reserve target is based on MMB's recommendation for the budget reserve account alone. The cash flow account is currently funded at $350 million. Together, the budget reserve and cash flow accounts total $1.344 billion, or 3.2% of FY 2016-17 non-dedicated revenues.

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

Standard & Poor's	≥4%
Moody's	≥5%

1. Rounded to the nearest tenth of a percent.
2. Based on End of 2015 Legislative Session *General Fund Balance Analysis.*
3. Changes made to the tax base or mix during the 2016 legislative session will be reflected in the September 2016 report.

Budget Reserve Status

Legislation passed during the 2014 legislative session includes two significant changes to Minnesota's statutory budget reserve policy established in M.S. 16A.152.

First, legislation establishes a new target for the budget reserve. The target is based on an annual evaluation of volatility in Minnesota's general fund tax system and the adequacy of reserves. It is set as a percentage of each biennium's revenues, allowing the reserve target to adjust with revenue changes over time. Previously, since 2001, the budget reserve account had been statutorily capped at a maximum dollar level of $653 million.

Second, actions taken during the 2014 legislative session create an automatic funding mechanism. Law requires that 33 percent of a positive unrestricted general fund balance determined in a November forecast be transferred into the budget reserve account until the target is reached. Following the November 2014 *Budget & Economic Forecast*, this provision automatically directed $183 million to the budget reserve account, increasing its balance to $994 million. The cash flow account, which is intended to offset potential cash shortages caused by a mismatch between monthly revenue collections and spending, remains at $350 million. Thus, the combined balance in Minnesota's budget reserve and cash flow accounts is currently $1.344 billion.

Despite recent allocations, the current funded balance in Minnesota's budget reserve remains below MMB's recommended level given the underlying volatility of Minnesota's tax system. Minnesota's current $994 million budget reserve account balance is 2.4 percent of non-dedicated revenue in the 2016-17 biennium. The transfer mechanism authorized in M.S. 16A.152 sets a target for the budget reserve account alone. The combined balance in the budget reserve and cash flow accounts is 3.2 percent of current biennial non-dedicated revenue.

Rating Agency Guideline Comparison

Minnesota's statutory 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 Standard and Poor's, Moody's, and Fitch Ratings 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. Fitch Ratings views 2.5 to 5 percent of biennial revenues as a general target for prudent reserve levels.

Summary and Conclusion

This report summarizes MMB's findings from the most recent assessment of state revenue volatility and reserve adequacy. Actions taken during the 2014 legislative session strengthen the state's statutory reserve policy. Law establishes an automatic funding mechanism as well as an adjustable target for the budget reserve account. MMB recommends a reserve target of 4.8 percent of current biennial general fund revenue, or $2.027 billion for the 2016-17 biennium, to adequately manage unforeseeable budgetary risks. By comparison, the balance in Minnesota's budget reserve account currently totals 2.4 percent of FY 2016-17 revenues, or $994 million.