



2 copies

890292

This document is made available electronically by the Minnesota Legislative Reference Library as part of an ongoing digital archiving project. <http://www.leg.state.mn.us/lrl/lrl.asp>

Minnesota

Department of Finance

Department of Revenue

State Planning Agency

December 1988

Fiscal Stability

In the early 1980's, a pair of economic recessions forced the State to endure a painful series of special legislative sessions, tax hikes, and spending cuts.

When I took office in 1983, I vowed to restore a stable fiscal structure. Substantial progress has been made toward that goal. I am very pleased that we have overhauled our tax system and reduced many rates. I am also pleased that we have begun the process of clarifying state-local fiscal relationships.

However, risks to our budget remain. I am concerned, for example, about weaknesses in the national economy and their potential effect on Minnesota. Therefore, last spring I directed a review of fiscal stability issues, and this Report is the product of that work.

I fully support the Report's central recommendations that our Budget Reserve should be increased to 5 percent of biennial general fund appropriations. This recommendation and the other Fiscal Stability goals and tools discussed in this Report are central to a well-managed government and permit us to deliver on the promises we make to the Citizens of Minnesota.

I commend the interagency Task Force members who worked on this project and who are identified in the introductory section of the report. Comments or questions should be directed to Commissioner of Finance Tom Triplett, who served as Task Force Chair, at (612) 296-9721 or the address below.

RUDY PERPICH
Governor

HC
107
.M6
F57
1988

LEGISLATIVE REFERENCE LIBRARY
645 State Office Building
Saint Paul, Minnesota 55155

FISCAL STABILITY IN MINNESOTA STATE GOVERNMENT

THE BUDGET RESERVE AND OTHER TOOLS

Since taking office in 1983, Governor Rudy Perpich has stressed fiscal stability for Minnesota state government. The Governor's interest was largely prompted by the economic turmoil of the early 1980s.

During that period, a number of factors contributed to a seemingly endless series of special legislative sessions, tax hikes, spending cuts, and accounting shifts. State agencies and local governments were forced to cut back on important programs, local property taxes and fees began to rise beyond desirable levels as state support for local programs dropped, and the public began to lose confidence in the ability of state government to manage its fiscal affairs.

The Fiscal Stability Initiative was launched in 1983 by Governor Perpich in response to these problems. Its goal was to make structural changes in state systems in order to substantially reduce the risks from future, unanticipated economic downturns.

Fortunately, the Initiative has enjoyed strong, bipartisan support from the Legislature. Among its key successes have been:

- establishment of the Budget Reserve which proved its value during a period of economic slowdown in the 1986-87 biennium,
- enactment of major tax system overhauls which broadened tax bases, reduced tax rates, and greatly simplified tax administration,
- improvements in revenue and expenditure forecasting which reduced forecast error from a range of 8-9 percent during the period 1980-86 to a range of 4-5 percent through the first ten months of the current year, and
- an increase in the state's bond rating to AA+ by Standard & Poor's rating agency.

The Fiscal Stability Initiative is not yet completed. Additional reform is needed in several key areas.

At the direction of Governor Perpich, analysis continued on fiscal stability issues after the conclusion of the 1988 legislative session. Coordination of this work was focused

in three agencies: the Departments of Finance and Revenue, and the State Planning Agency. Commissioner of Finance Tom Triplett chaired a Task Force consisting of: Brian Roherty, Peter Sausen and Tom Stinson of the Finance Department; John James, John Tomlinson and Gordon Folkman of the Revenue Department; and Steve Nelson of the Planning Agency.

This Report summarizes the past several months' work on Fiscal Stability issues. The Report provides the following:

- an historical overview of Fiscal Stability initiatives
- analyses of the degree of fiscal risk now facing the state
- descriptions of alternative tools available to mitigate that risk, and
- conclusions and recommendations

HISTORY OF FISCAL STABILITY INITIATIVES

After a long period of economic growth and steadily increasing state budgets, the State of Minnesota entered the 1981-82 economic recessions with a tenuous budget situation. The state's projected fund balance for June 30, 1981 was only \$3.7 million (0.05% of appropriations for the biennium).

The financial risks associated with such a low projected ending balance were enormous, and those risks became unfortunate fact with the recessions. Periodic reforecasts of revenues during that period resulted in the Governor and the Legislature having to meet in six special legislative sessions to increase taxes and reduce expenditures.

These economic troubles prompted the use of a number of short and long-term tools to reduce the risks associated with economic downturns. Governor Quie and the Legislature resorted to numerous emergency budget-balancing measures including tax increases, spending cuts, short-term borrowing, and accounting shifts which transferred scheduled state payments to the following biennium.

1. The Budget Reserve

With the inauguration of Governor Rudy Perpich and the convening of a new Legislature in 1983, interest focused on a Budget Reserve or "rainy day fund" as a more desirable fiscal stability tool. The Reserve was to be an appropriated fund available only in the event that revenues were projected to be below committed expenditures.

With the strong support of the Department of Finance, Governor Perpich proposed a Budget Reserve of \$250 million in his 1983 Budget Message. The Legislature appropriated the full request, and since that first enactment, the Reserve has become an accepted Fiscal Stability tool in Minnesota.

Although the retention of a Budget Reserve has become accepted budget policy in Minnesota, there has never been official recognition of the desirable size of the Reserve. In a 1986 report by the Department of Finance entitled "State Budget Stability" (hereafter referred to as the SBS Report), the department concluded that factors such as forecast error, alternative stability management techniques, and cash flow needs should be considered in determining the appropriate size for the Reserve. However, the Report did not recommend a specific amount.

Since the Reserve was first implemented in 1983, the statutes have specified particular dollar amounts for the Reserve without reference to any standard from which those numbers were derived. Beginning with \$250 million in 1983, the Reserve grew to as much as \$450 million.

Cash shortages depleted the Reserve in 1986, and it was restored to its \$250 million level in 1987. Most recently, the 1988 Legislature increased the Reserve to \$265 million and specified that any additional general fund balances, as projected by official forecasts, would accrue to the Reserve to a maximum of \$550 million. That \$550 million goal was reached with the November, 1988 forecast.

2. Other Fiscal Stability Tools

Between 1983 and the present day, other Fiscal Stability tools were also used by the Legislature. Contingent taxes or "trigger taxes" were enacted in 1983 and 1987 (but repealed in following sessions), and the Governor's authority to "unallot" spending was expanded in 1987. All of these tools were designed as back-up measures in the event the Budget Reserve proved inadequate to meet the need.

Also during this period, substantial progress was made on structural changes designed to reduce the volatility of Minnesota revenues and expenditures. Several tax rates were lowered, various tax bases were broadened, and most tax systems were simplified. In addition, initial steps were taken to control local aid expenditure growth and to more clearly define state and local spending responsibilities.

THE DESIRABLE SIZE OF BUDGET PROTECTION

As noted above, Minnesota law has never established a formula for determining the size of budget protection to be provided by the Budget Reserve and other fiscal stability tools. This section of the Report reviews the issue of appropriate size by analyzing various factors including revenue risk, expenditure risk, cash flow needs, concerns of bond rating agencies, experiences of other states, and analyses from other sources.

Although no formal risk standard has been adopted in law, the Department of Finance and others have often said that the appropriate degree of risk protection is 5 percent of the state's budget. This "informal" 5 percent standard has been referenced in private and public budget practices, but it has not been the subject of careful analysis.

The following discussion is designed to establish a permanent risk measurement standard for the state. However, it is clear that the degree of risk in existence at any single point in time will vary depending on economic conditions. For instance, current economic conditions (e.g., growing inflation and large national budgetary and trade deficits) suggest that the forecast risk in the coming biennium might be greater than for many other periods. (For a more extended discussion of current economic conditions, see Department of Finance, Minnesota Financial Report, November, 1988, pages 4-23.)

1. Revenue Risk.

The possibility that state revenues will not meet the revenue forecast is the principal factor determining the desirable amount of budget protection.

One method of measuring the risk of revenue forecasting error is to track the history of prior error. The SBS Report found an average absolute error of 8.5 percent in biennial revenue forecasts made between 1980 and 1986. A 1982 study by the Minneapolis Federal Reserve Bank found an average annual error rate of 5.3 percent for biennial forecasts made between 1971 and 1982. As noted above, recent analysis indicates that monthly variances for CY88 have been between 4 and 5 percent (not counting refund variances from tax year 1987).

Another method of measuring revenue risk requires analysis of the process used in deriving the revenue forecast.

Minnesota's revenue forecasts begin with national economic forecasts provided by Data Resources, Inc. (DRI), the state's national economic forecasting consultant. Each month, DRI issues a series of economic projections, the most likely of which is titled "Control." Minnesota's revenue forecasts are always based on Control.

The Control scenario used in the November, 1988 forecast called for fluctuating but constantly positive growth through the 1990-91 biennium. Annual real GNP growth during the period was projected to be 2.3 percent in calendar year 1989 ("CY89"), 1.9 percent in CY90, and 3.2 percent in CY91. When these national projections are applied to a model of the Minnesota economy, the forecast estimated that the state will generate total revenues from all sources of \$13.34 billion in the biennium ending June 30, 1991.

DRI's monthly projections also include at least one scenario--thought less likely to occur--which is more pessimistic than Control. Applying this more pessimistic scenario to the Minnesota economy provides another method of measuring the risk of downside forecast error.

DRI's "Weak" scenario offers a slightly more pessimistic forecast than the November, 1988 Control forecast. The "Weak" economic projection sees a broad-based slowdown in the national economy during 1989 but does not include a formal "recession" (which is defined as two consecutive quarters of negative growth). Growth returns to more normal levels in 1990 and 1991.

Applying this "Weak" scenario to revenue projections for the four major taxes during fiscal years 1990-91 ("FY1990-91") means that revenues would be \$317 million (2.4 percent of total biennial revenues) less than forecast under Control. A full recession occurring during the biennium would reduce revenues substantially more.

"Economic" risk--the possibility that the economy would not perform as forecast--is only the first source of risk in the revenue forecast. The second source of revenue forecast error is termed "technical" risk.

The SBS Report defined technical risk as errors associated with the application of the economic forecast to particular tax laws. Technical errors arise from two principal sources: (1) problems in anticipating taxpayer behavior, particularly after major tax law changes, and (2) severe data restraints caused by long lags before receipt of necessary information on tax receipts for the previous year.

Technical risks have been very visible in 1988. Even though the national economy has outperformed all forecasts, a number of states--most notably New York, California and Massachusetts--have revenue shortfalls due to difficulties in estimating the impact of the federal Tax Reform Act of 1986 on state tax receipts. This risk will continue until additional data on taxpayer behavior under the new tax laws becomes available.

While there are no easy ways to quantify downside technical risk, some indication of the potential size of that risk can be obtained by modifying assumptions about taxpayer behavior used in income tax simulations. Finance Department staff is very concerned, for example, about taxpayer behavior in respect to capital gains recognition, use of home mortgage equity loans, and changes in consumer interest expenditures. Applying a series of plausible, more conservative assumptions on these factors to the "Weak"

scenario results in a drop of income tax revenues of \$292 million (2.2 percent of total biennial revenues).

Thus, application of a more pessimistic economic scenario and more conservative technical factors constitute together a second measure of revenue risk. Finance Department staff estimate that about 60 percent of past forecast error has been due to "economic" error, and about 40 percent has been due to "technical" error.

The following chart summarizes the net effect on the November, 1988 forecast of using the DRI "Weak" scenario with more conservative "technical" assumptions. The combined impact of these two types of risk would be to reduce FY1990-91 revenues by \$608 million (4.6 percent of projected expenditures).

To emphasize again, the "Weak" scenario does not anticipate a recession occurring any time during the upcoming biennium. The appearance of a formal recession would reduce revenue significantly below the level forecast under the "Weak" scenario.

**ESTIMATED STRUCTURAL AND TECHNICAL RISKS TO
NOVEMBER, 1988 REVENUE FORECAST**

	(Dollars in Millions)			
	<u>F.Y. 1990</u>	<u>F.Y. 1991</u>	<u>TOTAL</u>	<u>% of F.Y. 90-91</u>
<u>STRUCTURAL RISK</u>				
Individual income tax	\$ 61.6	\$ 72.9	\$134.5	
Sales tax	57.6	60.5	118.1	
Corporate income tax	41.7	12.6	54.3	
Motor vehicle excise	5.9	3.8	9.7	
Total Structural Risk	\$166.8	\$149.8	\$316.6	2.4
<u>TECHNICAL RISK</u>				
Individual income tax	\$135.3	\$156.3	\$291.6	2.2
<u>Estimated TOTAL REVENUE RISK</u>	\$302.1	\$306.1	\$608.2	4.6

Structural risk is defined as the difference between the revenues produced using DRI's November Control forecast and those obtained using DRI's November WEAK forecast.

2. Expenditure Risk.

As noted above, revenue risk is the most significant factor influencing the desirable size of the fiscal stability tools. A second factor is the risk that expenditures will exceed forecast. Although expenditure risk is less than revenue risk, it does exist and must be accommodated in an overall fiscal stability program.

Approximately 60 percent of the state's General Fund budget is controlled by "open" or "entitlement" spending. Spending levels for those items are influenced by factors outside of the immediate control of state government.

Prime examples of these entitlement spending programs are welfare (influenced by the number of persons qualifying for benefits), state-paid elementary and secondary school aids (influenced by the number of students enrolling in public schools), the homestead credit (influenced by the number of homesteads and changes in their market values), and property tax refunds (influenced by the number and incomes of qualifying recipients and changes in rental markets).

Over the past four years, the average annual forecast error for these types of programs has varied from a high of 20 percent variance for the Work Readiness program to a low of 1.4 percent variance for the AFDC program. Translated to dollar terms, the degree of risk for the three larger programs during this period has been \pm \$57 million for the welfare programs, \pm \$90 million for education aids, and \pm \$6 million for the property tax refund programs.

Based upon these experiences, it is reasonable to project a total potential biennial expenditure error of 1 percent (\$133 million for FY1990-91). This potential negative variance is independent of revenue errors and, in a period of declining economic activity, would be additive to the revenue risks discussed above.

3. Cash Flow Needs.

The principal use for the Reserve and the other Fiscal Stability tools is to help balance the budget in the event of revenue or expenditure forecast error. However, a second --but very important--use of the Reserve is to cushion periodic cash flow problems.

Minnesota's Constitution requires the state to maintain a balanced budget. Expenditures cannot exceed revenues. The problem, however, is that a "balanced budget" does not mean that the state's bank balances are necessarily positive on every day. Rather, it means that the budget on the last day of the biennium must not show more expenditures than resources.

The flow of revenues to the state does not match expenditure outlays, and this results in periodic imbalances in the state's cash position. Cash available as a result of the Budget Reserve is used to make scheduled payments where cash-on-hand is not other-

wise available. Without the Reserve to help balance cash flow needs, the state would be forced to resort, as it did in the early 1980s, to expensive short-term borrowing.

It is possible to analyze, with a high degree of accuracy, the daily cash flow needs of the state. Based upon such an analysis over the past four years, the Budget Reserve needs to be at least \$250 million in order to meet the state's cash flow needs (and thereby avoid expensive short-term borrowing).

4. Bond Rating Agency Concerns.

The State of Minnesota sells general obligation ("GO") bonds to finance infrastructure improvement projects such as college facilities, state agency office buildings, and wastewater treatment plants. Currently, the state of Minnesota has approximately \$1.5 billion of its GO bonds outstanding.

Before state bonds become marketable, they must receive a rating from the two major Wall Street rating agencies. All issuers of bonds seek to have the highest possible rating from the agencies. The higher the rating, the lower the interest rate on the bonds, and the less the state must pay in debt service.

Until the fiscal crises of the early 1980s, Minnesota's GO bonds had been rated AAA by both rating agencies. As a result of the economic problems of 1981-82, the agencies reduced their ratings to AA. The most recent Minnesota GO issues have been rated AA+ by Standard and Poor's and AA by Moody's Investors Service.

The rating agencies are very interested in a state's fund balance and reserves. The larger these numbers, the more likely the state will be to make its bond payments, even during an economic downturn.

Minnesota Finance Department staff have been advised by rating agency executives that they consider the Budget Reserve as a key indicator of the overall financial management of the state. They have expressed to Department staff strong support of the implicit 5 percent Reserve goal.

5. Experience of Other States.

In evaluating the desirable size of the Budget Reserve and other fiscal stability tools, it is also relevant to examine the practices of other states. Those practices should not be controlling in Minnesota, but they do give an idea of how other governors and legislators deal with the same issues now affecting this state.

No information is readily available about the use of all fiscal stability tools in other states. However, some information is available about the use of reserves or "rainy day funds."

At last count, 31 states had statutory provisions for Budget Reserves. These Reserves vary substantially in size from \$0 in seven states to \$422 million (6.3 percent of annual revenues) in Michigan.

Table 1 (derived from data collected by the National Conference of State Legislatures) compares Minnesota's Budget Reserve with comparable funds in states bordering Minnesota and with those states that are comparable in budget size and procedure. The states having Budget Reserves are divided into two categories: those having annual appropriations cycles, and those, such as Minnesota, with biennial cycles. (Note: the tally was prepared by NCSL prior to Minnesota's increase of its appropriated Reserve from \$265 million.)

In analyzing the practice of other states, it is unclear whether states with biennial budget cycles base their reserve goals on annual or biennial budgets. Conversations with staff from the National Conference of State Legislatures (NCSL) indicate that a reserve standard based on an annualized budget is the position most recently adopted by the relevant NCSL committee. In addition, NCSL staff say an annualized budget standard is probably more common among states. However, they also advise that each state should individually evaluate its risks.

Another possible perspective on this issue is that the standard should be based on the period for which major budget allocations are made. This theory says that a Reserve should be adequate to cover reasonable risk during the normal budget cycle. In Minnesota's case, the "normal" budget cycle would be a biennium.

Applying the annualized and biennial budget standards to Minnesota, 5 percent of the average annual projected expenditures for FY1990-91 would mean a Reserve of \$334 million. Using a 5 percent biennial standard would mean a Reserve of \$668 million.

**STATE BUDGET STABILIZATION FUNDS
STATES BORDERING MINNESOTA
OTHER BIENNIAL BUDGET STATES WITH RESERVE FUNDS**

<u>State</u>	<u>Projected F.Y. 1989 Ending Balance</u>		<u>Procedures for</u>	<u>Procedures for Expendi-</u>
	<u>Dollars in Millions</u>	<u>% of Gen. Fund</u>	<u>Deposits to the Fund</u>	<u>tures from the Fund</u>
<u>Florida</u> Reserve for Emergency Operating Expenses	\$140.6	1.5%	Year-end surplus up to 10% of previous year General Fund.	By appropriation.
<u>Iowa</u> Economic Emergency Fund	\$ 0.0	-0-	Year-end surplus.	By appropriation.
<u>Indiana</u> Counter Cyclical Reserve & Economic Stabilization Fund	\$230.0	5.8%	(Annual growth rate in personal income - 2%) x previous year Gen. Fund revenues. If fund balance exceeds 7%, excess flows to property tax relief fund.	Funds are transferred to Gen. fund if growth rate less than 2%. Current fiscal year short falls are covered automati- cally up to the amount transferred that year.
<u>Kentucky</u> General Fund Surplus Fund	\$ 2.0	0.1%	By appropriation.	By appropriation.
<u>Maine</u> Maine Rainy Day Fund	\$ 25.0	1.9%	By appropriation.	By appropriation.
<u>Minnesota</u> Budget Reserve Account	\$550.0	4.5%	By appropriation (year- end surplus dedicated up to \$550,000,000).	By appropriation or trans- fer by Commissioner of Finance to cover revenue shortfall.
<u>New Hampshire</u>	\$ 28.6	4.9%	Surplus revenues; ceiling of 5% of prior fiscal year revenues.	Requested by treasurer to offset deficit in prior year. Approved by Governor and Legis. Fiscal Commit- tee.
<u>North Dakota</u> Budget Stabilization Fund	\$ 0.0	-0-	Transfer of biennial surplus when biennial surplus exceeds \$40,000,000.	Governor's order when revenue projected is 5 per- cent less than forecast.
<u>Ohio</u> Budget Stabilization Fund	\$392.0	3.5%	(Annual growth rate in personal income - 1.4%) x previous year Gen. Fund revenues If year-end balance ex- ceeds 10% of fiscal year revenue, legislature may appropriate excess.	Funds transferred when personal income is nega- tive.

<u>State</u>	<u>Projected F.Y. 1989 Ending Balance</u> <u>Dollars in Millions % of Gen. Fund</u>		<u>Procedures for</u> <u>Deposits to the Fund</u>	<u>Procedures for Expendi-</u> <u>tures from the Fund</u>
<u>South Dakota</u> No reserve fund				
<u>Vermont</u>	\$ 13.2	2.3%	Budget surplus not ex- ceed 2% of Gen. Fund ap- propriation from previous year.	Treasurer uses to offset deficit from prior fiscal year
<u>Washington</u> Reserve Fund	\$ 0.0	-0-	(Projected growth in real personal income - 3%) x previous Gen. Fund revenues	By appropriation
<u>Wisconsin</u> No reserve fund				
<u>Wyoming</u> Budget Reserve Account	\$ 20.0	5.7%	Year-end surplus plus ap- propriations.	By appropriation.

6. Analyses from Other Sources.

In adopting an implicit 5 percent standard for the Reserve, the Department of Finance relied in part on an informal accounting standard often used in both the private and public sectors. However, as noted above, there has never been a formally adopted "official" statement or standard on point.

During its deliberations on the November, 1988 forecast, the Governor's Council of Economic Advisors (CEA) reviewed the issue of forecast risk. The CEA concluded that the degree of risk of recession posed by factors such as the federal trade and budget deficits argued strongly for a state Budget Reserve based on 5 percent of biennial expenditures. As the Council said:

Even a 5 percent (biennial) budget reserve will only protect the state from minor deviations in economic performance from the Control scenario. It will not be sufficient to fully protect state expenditures from a full scale recession. (Department of Finance, Minnesota Financial Report, November, 1988, page 5.)

Other commentators have also suggested goals for budget reserves and other fiscal stability tools.

- a. **National Conference of State Legislatures, *NCSL Legislative Finance Paper #64: State Budget Actions in 1988***. The paper references a five percent annual standard as being "widely regarded as the minimum prudent reserve" and as used by "Wall Street analysts in evaluating state financial conditions." Steve Gold, director of tax policy for NCSL, indicated that a 5 percent annual standard may not be adequate if other measures for a particular state suggest greater revenue risk.
- b. **Litterman and Supel, *Using Vector Autoregressions to Measure the Uncertainty in Minnesota's Revenue Forecasts*** (Minneapolis Federal Reserve Bank, 1983). This study analyzed Minnesota forecast variances for the period 1971-1982 and concluded that the year-ahead forecasts for that period had a mean absolute error of 5.3%. (In their paper, the authors also caution against quantifying risks based only on pessimistic economic scenarios although they do not support their cautionary warning with analysis in the article.)
- c. **Pollock and Suyderhoud, *The Role of Rainy Day Funds in Achieving Fiscal Stability***, National Tax Journal (1986). These authors evaluate four different models and cite the "implicit rainy day fund" as "the most straightforward regime to promote fiscal stability." This system of complicated mathematical modeling is deemed preferable to explicit rainy day funds which, the authors contend, can be destabilizing if "mis-timed."
- d. **Vasche and Williams, *Optimal Governmental Budgeting Contingency Reserve Funds, Public Budgeting and Finance*** (1987). This study describes California's revenue es-

timating history. It notes that California's average percent error due to economic and related factors was 5.9 percent for the annual revenue forecasts between 1974 and 1985. It concludes with a recommendation that a 5 percent reserve standard be established for that state.

- e. **National Association of State Budget Officers and National Governor's Association Center for Policy Research, *Budgeting Amid Fiscal Uncertainty* (1985).** This paper reviews the rainy day fund concept, presenting both pro and con arguments for such funds, as well as giving some dated information on the status of state rainy day funds. The paper references the 5 percent standard as a "national norm" but it also concludes that "the appropriate size of the fund must be separately determined for each state and that no national number will be appropriate as a universal rule for every state."
- f. **The Corporation for Enterprise Development, *Making the Grade: The 1988 Development Report Card for the States*. (1988).** In evaluating the fiscal health of each state, CFED uses a nine-factor analysis for its "Fiscal Stability and Balanced Revenue Sources Index." One of those factors is:

Rainy Day Fund. States received 10 points if they had a rainy day fund and four points for every percentage point up to 5 percent of general revenue in their fund. (page 119)

7. Summary

The preceding analysis argues for maintaining a strong fiscal stability program for the state. An adequate stability program is needed to protect against revenue shortfalls and unanticipated expenditures, to meet state cash flow needs and to encourage higher bond ratings for the state.

The risk that revenues will not meet forecast is the greatest risk to the overall forecast and is therefore the most important determinant of the appropriate size of protection needed from the Budget Reserve and other tools. The size of the risk is suggested by the following:

- a revenue forecast variance history of
 - 5.3 percent per year for the period 1971-82
 - 8.5 percent per biennium for the period 1980-86
 - 4.5 percent for the first 10 months of 1988,
- a total "economic" and "technical" forecast variance in the most recent forecast of 4.6 percent of total revenues (\$608 million) (which is premised on a more pessimistic national growth scenario and more con-

servative taxpayer behavior assumptions but still does not assume a recession occurring any time in FY1990-91),

- expenditure variance risks which add another 1 percent to the risk (\$133 million in FY1990-91), and
- current extraordinary risks associated with fundamental weaknesses in the national economy.

Although technically not "risks," additional factors influencing the size of the Reserve are cash flow balancing needs of \$250 million and savings to the state from higher bond ratings (which are in part premised on a sizable Reserve).

Unfortunately, little help is available from outside commentators on the desirable size or type of Fiscal Stability tools. Those states having Reserves appear to be more likely to premise them on a standard of 5 percent of annual revenues. However, commentators on the issue are quick to say that each state should perform its own evaluation of its relative risks.

Based upon the foregoing quantitative analysis, it appears that the state's fiscal stability program should provide total risk protection equalling at least 6 percent of biennial revenues (or \$800 million for FY1990-91).

The size of the risk should not automatically determine the desirable size of the Reserve. It is important to look at risk protection provided by other mechanisms. Only then can a determination be made of the appropriate size for the Reserve itself.

ALTERNATIVE PROTECTION DEVICES

1. The Budget Reserve.

The Reserve has been defined by implication in the preceding sections of this Report. However, it is useful, in the context of the discussion of alternatives, to formally define the Reserve at this point.

The Budget Reserve is a fund established in the state treasury by action of the Legislature. Amounts in the Reserve are appropriated by the Legislature, either directly in law or indirectly through laws which dedicate revenues from forecast variances to the Reserve.

Under current Minnesota law, the Reserve can only be used if an official forecast by the Department of Finance projects that resources will fall short of appropriated expenditures before the end of the current biennium. In such a case, funds from the

Reserve will be spent, but only to the extent of the projected resource shortfall. The Reserve can only be used to pay for already appropriated expenditures.

2. Legislative Tax Increases or Expenditure Reductions.

A second remedy for projected shortfalls is, of course, action by the Legislature. In the event a major economic downturn occurs between regular legislative sessions, it is always possible for the Governor to call the Legislature into special session. Indeed, Governor Quie was forced to call six special sessions during the economic crises of the early 1980s.

Special sessions should, however, be used only as a last resort. The goal of the Fiscal Stability Initiative has been to rely on other budget balancing techniques to solve short-term budget problems.

3. Unallotment.

The Governor, acting with the advice of the Legislative Advisory Commission, has extensive authority to reduce expenditures. In the event a forecast shortfall is projected to exceed the Reserve, the Governor may order spending reductions ("unallot") in virtually every area of state finance. (Minnesota Statutes, Section 16A.15)

However, the effectiveness of the unallotment mechanism varies substantially depending upon the date in the biennium when the mechanism is employed. The later in the biennium, the less unexpended dollars will be available.

Also, if unallotment of local aid programs is contemplated, it should be implemented early enough to permit school districts and local government units to adjust their local property tax levies to at least partially offset the decrease in state aids.

Finally, unallotment is also limited in its applicability to "entitlement" programs. It would be very difficult, and of doubtful policy desirability, to unallot human services programs where program recipients have few options for restoring the lost funds.

In recognition of these limitations on the unallotment power, Finance Department staff estimate that this fiscal stability tool would ordinarily provide protection equalling no more than 1 percent of projected expenditures (\$133 million in FY1990-91).

4. Trigger Taxes.

"Trigger taxes" are contingent tax increases. For example, state law could specify that in the event of a future projected shortfall, income tax rates would automatically increase by a percentage necessary to cover the projected deficiency.

Trigger taxes have been enacted in Minnesota on two separate occasions in recent years, 1983 and 1987. However, the Legislature quickly repealed those laws amidst great public furor. Arguments against the trigger taxes included distrust of the mechanisms that would be used to "trigger" them and the fear that the taxes would be counted against the state in various interstate tax measures even though they would not have been formally implemented.

Legislators also seem to have been persuaded by the comments of an official of one of the New York rating agencies. In speaking to Minnesota staff persons, a vice president of Moody's Investors Service noted that to her knowledge trigger taxes had never been actually implemented in any state that adopted them. As a result, she indicated her rating agency does not apply great weight in measuring a state's credit worthiness to the fact that the state may have trigger taxes in law.

5. Short-term Borrowing.

Short-term borrowing is the issuance of state certificates of indebtedness to finance the cash flow needs of government operations. Certificates are sold at the time of the projected cash shortfall and are repaid with interest by the last day of that biennium.

In 1982, the State of Minnesota issued short-term debt certificates totalling up to \$850 million. The debt was repaid by 1985.

Short-term borrowing has a major drawback as a Fiscal Stability tool. It is costly, both in terms of direct interest and issuance costs, and it usually tends to harm a state's credit rating on long-term bonds.

6. Accounting Shifts.

A final fiscal stability tool is accounting "shifts." The use of shifts as a budget balancing tool was another mechanism used during the fiscal crises of the early 1980s.

Shifting involves delaying expenditures from one biennium into the next. Thus, an expenditure such as a portion of state aids to schools would be deferred from before July 1 of an odd-numbered year until after July 1 of that year. The schools would receive their promised aid, but the date of payment would be moved to another accounting period.

The advantage to the state of shifting is an immediate--albeit "paper"--reduction in expenditures. The disadvantage of shifting is, of course, that if the shift is ever "reversed," it would require a double expenditure in that particular accounting period (with one of those expenditures being a "paper" expenditure). A second disadvantage of shifting is that the recipients of the deferred state payments may encounter cash flow problems resulting from the deferral.

The Wall Street bond rating agencies dislike shifting as a budget balancing tool. They tend to view shifts as transparent, false solutions which ignore real, structural problems in a state's economy and its revenue and expenditure systems.

The Governor and the Legislature have adopted positions opposing additional accounting shifts as budget balancing tools. In addition, they have expressed interest in reversing shifts, especially those which have placed harmful burdens on Minnesota taxpayers, as soon as available resources permit.

CONCLUSIONS

The volatility of Minnesota revenues and expenditures argues in favor of strong fiscal stability mechanisms. Although the accuracy of the state's forecasts is improving, past history has demonstrated that revenue shortfalls are a likely future occurrence. In addition, current economic conditions seem to pose an unusually high risk to the most recent economic forecast.

There is no absolute answer to the question of the desirable degree of protection to be afforded by the Reserve and the other Fiscal Stability tools. However, given the degree of error experienced in recent years, and the size of downside risk suggested by more pessimistic economic scenarios, it appears that the tools together should provide protection equalling 6 percent of the biennial budget (or about \$800 million).

Only two of the Fiscal Stability tools discussed above--the Budget Reserve and unallotment--should be used to provide this protection. The remaining tools have significant weaknesses:

- Special legislative sessions, with their attendant tax increases and spending reductions, are an undesirable method of conducting the state's business in the event of unanticipated revenue shortfalls.
- Recent history suggests the unlikelihood of additional state trigger taxes being enacted by the Legislature. These contingent taxes are viewed as significant detractors to the state's attempts to develop and maintain jobs.
- Further use of short-term borrowing and accounting shifts should be discouraged because they merely postpone current economic problems.

Of the two remaining Fiscal Stability alternatives discussed above, principal reliance should be placed on the Budget Reserve. Given the practical and political difficulties associated with spending cuts, especially with cuts occurring later in the biennium, the unallotment authority will only provide limited supplemental assistance--about 1 percent of biennial expenditures--to the Budget Reserve.

After accounting for unallotments, and after analyzing past Minnesota forecast errors, the risks from pessimistic scenarios, the cash flow needs of the state, and advice from sources such as the Council of Economic Advisors, it is reasonable to conclude that the state needs a Budget Reserve totalling 5 percent of appropriated biennial general fund expenditures. This amount would be at least \$668 million, based on current spending expectations, for FY1990-91.

In order to gain the most use from the Budget Reserve, it should be defined in statute as a percentage of appropriated general fund expenditures rather than as a specified dollar amount. The percentage approach is consistent with the method used in calculating risk and has the additional advantage of not requiring periodic legislative readjustment (and thereby being subject to current spending pressures).

If current projected resources are not adequate to allow an appropriated increase for the Budget Reserve, the Governor and the Legislature may want to consider retaining the provision in current law which provides for automatic increases to the Reserve based upon official Finance Department revenue forecasts.

The funding of an adequate Reserve, and the maintenance of unallotment authority, should be complemented by continuing efforts to reduce the volatility of Minnesota's tax and spending systems.

RECOMMENDATIONS

By the measures discussed above, the \$550 million currently provided for the Budget Reserve is inadequate.

The Budget Reserve for Minnesota State Government should be increased to 5 percent of the biennial budget. This percentage standard should be expressed in law in lieu of a specific dollar amount. This method will permit an automatic increase or decrease in the Reserve as the budget changes from biennium to biennium.

Because of the expected tight budget year in 1989, it may not be possible to appropriate additional dollars to increase the Reserve to 5 percent.

Minnesota Statutes, Section 16A.1541, which provides that the size of the Reserve is automatically increased if official forecasts indicate that revenues are coming in faster than projected, should be continued in law. However, the maximum size of the Reserve, which is now expressed as \$550 million, should be deleted and be replaced by "five percent of the total general fund appropriations for the current biennium as established by the most recent legislative session."

The Reserve will only provide partial protection.

The existing unallotment authority should be preserved as an additional Fiscal Stability tool to help remedy resource shortfalls in excess of the 5 percent Reserve.

The Reserve and unallotment authority, while necessary Fiscal Stability tools, are nonetheless treatments of symptoms; they do not correct underlying causes of fiscal instability.

The Governor and the Legislature should continue their efforts to reduce the volatility of Minnesota's revenue and expenditure systems. These efforts should focus on tax base strength and simplification, a more careful differentiation between state and local fiscal obligations, and reductions in the number of expenditure programs which are driven by automatic formulas.