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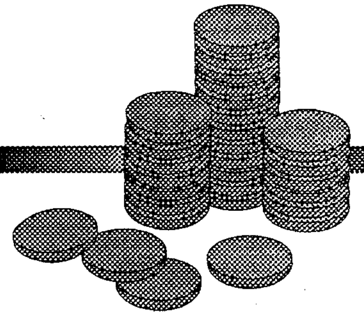
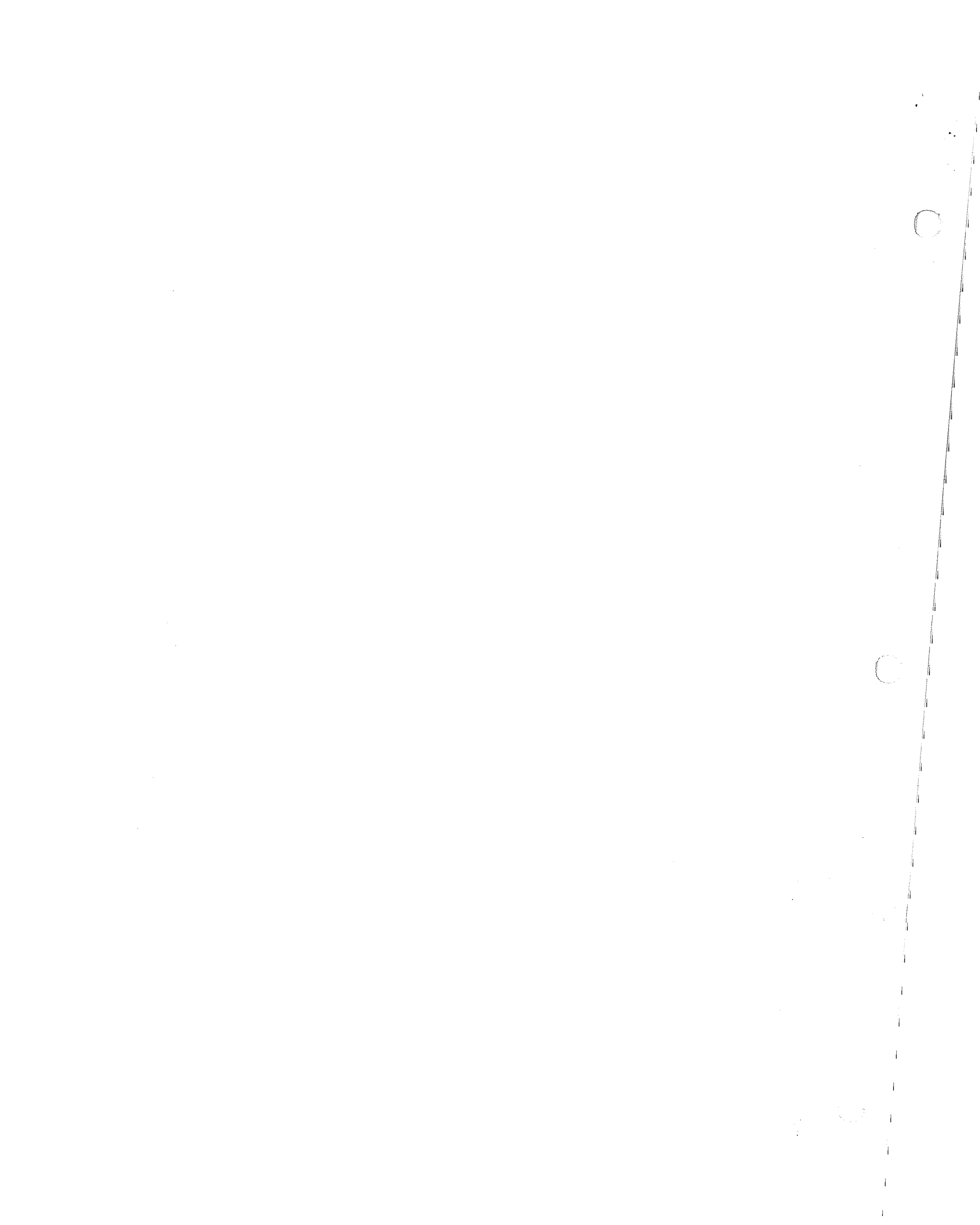
Long-Term Financial Management Reform



Commission Report to Governor Arne H. Carlson

February 19, 1992



February 19, 1992

The Honorable Arne H. Carlson
Governor, State of Minnesota
130 State Capitol
St. Paul, Minnesota 55155

Dear Governor Carlson:

The Commission on Long-Term Financial Management Reform is pleased to submit its final report to you. The Commission was formed in the wake of the Spring 1991 State budget crisis in order to help improve the long-term financial health and stability of the State.

One year ago, Minnesota faced one of the greatest financial challenges in the State's history. But, while you and the Legislature successfully dealt with a $2 billion shortfall during the last session, the latest Budget Forecast now points to a $1.4 billion gap in the 1994-95 biennium. Changing demographics, uncertain national and state economies, volatile revenue collections and depletion of the rainy day fund to address the previous shortfall will continue to threaten the State's already precarious fiscal position.

It is increasingly obvious that fundamental changes in Minnesota's financial management policies and procedures must be adopted to secure the State's fiscal future. Financial crises and short-term shocks to the system must not be allowed to determine the State's program priorities. Financial planning and management reform, that is linked to a long-term strategic framework, is necessary to introduce greater stability.

The following recommendations are provided for consideration by you and the Legislature to renew public confidence in the State's political process and to improve the long-term financial management and economic health of the State of Minnesota.

The recommendations address three areas:

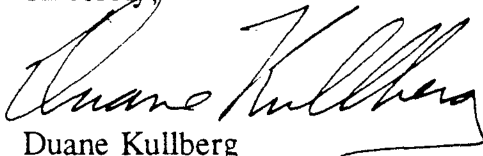
I. **Long-Term Financial Plan.** Development and enforcement of a long-term financial plan that is linked to an overall strategic framework is essential for the State's fiscal stability.

II. **Budget Management.** Greater management flexibility, responsibility and accountability should be built into the State's budgeting and financial management process, including contingency planning to deal with inherent economic uncertainties.

III. **State-Local Fiscal Relationships.** State-local fiscal relationships should be examined to ensure proper accountability, responsibility and fiscal prudence.

The Commission appreciates the opportunity to share its recommendations at this critical junction in the State's history. Inherent in every adversity is an opportunity. By taking action now, Minnesota can emerge from its current challenges, strong and in a better position to serve the future interests of its citizens.

Sincerely,



Duane Kullberg
Chairman

Commission on Long-Term
Financial Management Reform

Commission on Long-Term Financial Management Reform

Summary of Recommendations

The Commission on Long-Term Financial Management Reform was formed by Governor Arne Carlson to improve the long-term financial health and stability of the State. Financial crises must not be allowed to determine Minnesota's program priorities. Financial planning and management reform that is linked to a long-term strategic framework is necessary to help secure the state's fiscal future.

I. Long-Term Financial Plan

An ongoing, comprehensive financial plan should be adopted for the State. The Plan should cover 3-biennia, and should include the following components:

- **Strategic framework.** The Financial Plan should be developed within the context of the Milestones strategic framework. Minnesota must decide what its needs are, where it wants to go, what resources are available to get there, and what actions are appropriate to achieve its objectives.

- **Spending capacity guidelines.** Agreement should be reached on what percent of Minnesota's personal income should be devoted to public needs.

- o **Revenue guidelines.** The Plan should define the amount and percent of state and local revenues to be derived from income, sales and property taxes.

- o **Spending guidelines.** The Plan should specify the growth and proportion of total expenditures which will be allocated to broad programs areas.

- o **Structural balance.** A 3-biennia structural balance between revenues and expenditures should be maintained.

- o **Cash Flow Account.** A Cash Flow Account should be maintained separate from the rainy-day Budget Reserve to avoid short-term borrowing. An adequate working capital balance should be based on forecasted expenditure and revenue patterns. Changes in cash flow timing should be investigated to permanently reduce the current $400 million minimum requirement.

- o **Budget Reserve.** A rainy-day Budget Reserve should be restored and maintained to manage cyclical economic volatility. Objective economic indicators should govern the Budget Reserve, rather than budget considerations. The reserve should not be used to cover spending forecast inaccuracies, nor to increase spending above levels specified in the 3-biennia Financial Plan. New or increased spending should not be permitted until the Budget Reserve is completely restored.

- o **<u>Debt management guidelines</u>.** Current administrative guidelines should be formally adopted. New guidelines should recognize possible future liabilities.

- o **<u>Enforcement provisions</u>.** The Financial Plan should be formally proposed by the Governor in January of each odd-numbered year, and should be adopted by the Legislature by March 15, prior to debate on specific budget proposals. The plan should be legally required to demonstrate that balanced budgets can be forecasted over the entire 3-biennia planning horizon.

II. Budget Management

The State should introduce greater management flexibility, responsibility and accountability into its budgeting system.

- o **<u>Contingency plans</u>.** Risk sharing and formal contingency plans should be included in the adopted budget. Specified offsets in lower priority program areas could be identified, and increased management flexibility in entitlement programs should be provided to deal with possible shortfalls.

- o **<u>Unallotment authority</u>.** With the advice of the Legislative Advisory Commission, the Governor should be permitted to unallot funds once the rainy-day Budget Reserve is depleted, but prior to use of the Cash Flow Account.

- **Baseline budget process.** In order to provide an accurate perspective, financial forecasts should be based on current law and the impact of inflation on both revenues and expenditures. However, financial plans and budget development should not automatically incorporate allowances for inflation or salary increases. This will help ensure that trade-offs among entire programs will be evaluated, rather than only marginal changes in the base budget.

III. State-Local Fiscal Relationships

Because transfers to local units of government represent about one-half of the State budget, state-local fiscal relationships must also be examined and reformed.

- **Accountability.** Continuing reform is necessary to resolve the inherent accountability problem of taxing at the state level and spending at the local level.

- **Local funding options.** If local accountability is increased, local responsibility should also be increased by providing greater access to alternative funding sources, including the removal of artificial limits on local property tax levies.

- **Unfunded mandates.** The State should pay for programs it mandates, and programs that local governments choose to provide should be funded by local resources.

I. Long-Term Financial Plan

The principal recommendation of the Commission is that an on-going, long-term financial plan should be adopted for the State.

The major weakness of Minnesota's budgeting process is the lack of a long-term, comprehensive financial planning perspective. The current system results in an incremental, piecemeal allocation of available resources, and does not consider strategic objectives or long-term, total spending and revenue issues. Better review of spending capacity and basic program priorities should take place to ensure that policy goals are met.

A. Financial Planning Perspective

The state's long-term financial plan should be developed within the context of an overall strategic planning framework for Minnesota's future. No organization, public or private, can survive without a strategy to meet its objectives within its available resources.

In order to prosper in the coming decades, the State of Minnesota must decide what its needs are, where it wants to go, what resources are available to get there, and what actions are appropriate to achieve its strategic objectives.

- **Strategic framework.** The Milestones project, which is currently underway, provides a good basis for the development of a strategic framework. However, the results of this planning effort must be linked to a long-term financial plan to ensure implementation. In order to accomplish this linkage, the second phase of the Milestones project should specifically address such questions as:

  - What needs will evolve as a result of changing demographic patterns in the State?
  - Which public service and program needs should be addressed within available resources?
  - How should service requirements be met, and who should most appropriately deliver those services: the state, local government agencies, not-for-profit organizations or private institutions?

The limits of government are increasingly apparent, and must be recognized in the strategic framework section of a long-term financial plan.

  - **Planning horizon**. Service objectives and financial goals should be established for a 3-biennia period to extend the planning time-frame beyond near-term economic and political considerations.

Certain programs might require an even longer-range planning horizon to recognize demographic trends.

B. **Revenue and Spending Guidelines**

The 3-biennia plan of taxing and spending should be based on a forecast of economic growth for the State, and should contain the following elements:

- **Spending capacity guidelines.** The financial plan should be related to the capacity of the State's residents and businesses to support public spending. The Executive and Legislative branches should adopt a basic agreement as to what percent of Minnesota's personal income should be devoted to public needs over a 3-biennia forecast of economic growth. This agreement would then become the blueprint for the State's fiscal policy.

- **Revenue guidelines.** Long-term financial guidelines should be developed and adopted to govern the appropriate mix of tax and other revenue sources. Consideration should be given to revenue stability and fairness by setting 3-biennia guidelines for what amount and percent of state and local revenues should be derived from income taxes, sales taxes and property taxes. In addition, the potential impact

of tax law changes on the state's economic base should also be considered.

- **Spending guidelines.** The financial plan should contain specific guidelines for the levels of acceptable growth, and the percent of total expenditures which will be allocated to broad program areas, including open appropriations and entitlements. All spending programs should be included, even those not funded with General Fund resources, such as transportation, environmental and economic development programs. Every two years, the Governor and Legislature would construct a comprehensive budget that conforms to these spending guidelines.

- **Structural balance.** In order to ensure a more stable financial environment for the state, the long-term financial plan should be based on a structurally balanced budget in the proposed budget biennium, as well as on forecasted balanced budgets for the next two biennia. Structural imbalances between on-going revenues and expenditures should not be allowed to shift current problems into subsequent biennia. This provision also ensures that spending proposals recognize the long-term spending implications of programs which may start small, but will have large future expenditure requirements. Public

expectations should not be raised beyond the capacity of the State to deliver services over the long-term.

C. <u>Cash Flow Account and Budget Reserve Guidelines</u>

Guidelines for maintenance of the State's reserves should be adopted, recognizing their dual purpose as both a cash flow account and a rainy-day budget reserve for periods of weak economic growth.

In order to clarify the dual purpose of the State's financial reserves, it is recommended that two separate accounts should be formally established: (1) Cash Flow Account, and (2) Budget Reserve.

- **<u>Cash Flow Account</u>.** Principles for management of the Cash Flow Account should include:

  - **<u>Short-term borrowing</u>.** Short-term borrowing should not be used. Borrowing for current operations only exacerbates structural imbalances, creates an immediate interest expense and increases long-term credit costs through probable reductions in bond ratings. Neither interfund loans, nor capital market borrowing should be used to meet short-term needs.

- **Purpose of the Cash Flow Account.** A minimum Cash Flow Account for working capital is necessary to smooth out uneven revenue and expenditure patterns during the State's fiscal year. The Cash Flow Account should not be used to offset unanticipated forecast volatility. As a result, policies for managing the State's cash flow should be clearly differentiated from policies regarding use of the rainy-day Budget Reserve.

- **Size of the Cash Flow Account.** The appropriate balance in the State's Cash Flow Account should be established by the Department of Finance, based on forecasted expenditure and revenue patterns during the 3-biennia planning horizon. The Department of Finance's current estimate that $400 million (based on current revenue and spending practices) is necessary to avoid short-term borrowing, appears to be reasonable.

- Management of cash flow. The Governor and Legislature should investigate actions, such as changes in revenue and expenditure timing, which would permanently reduce the need for a large Cash Flow Account to cover short-term cash requirements, particularly in December. Using available budget

balances to permanently correct (buy-back) the timing of payments should also be considered to "reverse shift" expenditure payment dates.

- **Budget Reserve.** A rainy-day Budget Reserve should be restored and maintained, since it represents Minnesota's principal means of managing cyclical economic volatility. To ensure long-term fiscal stability, the Governor and Legislature should adopt more explicit principles regarding the size, use and restoration of the Budget Reserve.

  - **Purpose of the Budget Reserve.** The purpose of the Budget Reserve is to help stabilize basic program spending, and to forestall major program impacts during economic downturns. The Budget Reserve can provide a fiscal cushion against unexpected downturns in the economy. This rainy-day reserve should be used to maintain basic program spending at an acceptable level, without raising taxes. The Budget Reserve should also be available to cover program spending which is driven by economic downturns. Most importantly, it should be replaced when revenues recover. Use and restoration of the Budget Reserve should be governed by principles based on the

full economic cycle, rather than a single budget cycle. Temporary fluctuations in the business cycle should not drive Minnesota's tax policy or program commitments.

- **<u>Size of the Budget Reserve</u>.** The size of the Budget Reserve should be determined by considering various factors, for example, the average length of an economic cycle, the average revenue decline during a recession, margins for forecast error in revenue (not expenditure) forecasts, the positive correlation between business downturns and increased economic assistance grants to individuals, the volatility of revenue sources, and other budget management tools available to the Governor, such as automatic reallocations, unallotment and line-item veto authority. Various past studies have recommended that the combined Cash Flow Account and Budget Reserve should be five percent of the State's biennial budget.

- **<u>Use of the Budget Reserve</u>.** In order to guard against depletion of the Budget Reserve merely to perpetuate structural spending imbalances, it is recommended that use of the rainy-day Reserve should be triggered by objective measures which reflect

downturns in the state's economic cycle, such as reduced GDP (Gross Domestic Product) growth or reduced growth in per capita personal income. The Reserve should not cover spending forecast inaccuracies, and should not be used to increase spending above the levels specified in the 3-biennia financial plan.

- **Restoration of the Budget Reserve.** In order to ensure adequate restoration of the Budget Reserve when economic recovery begins, new or increased program spending should not be permitted above the levels outlined in the 3-biennia financial plan, until the Budget Reserve is completely restored. In addition, restoration of the Budget Reserve should be triggered by objective measures which reflect upturns in the State's economic cycle.

D. Debt Management Guidelines

Policy guidelines should also be adopted for the debt management of the State. Although the State has followed various administrative principles during recent years, these policies should be formally affirmed as an integral part of the Financial Plan.

- **Credit rating.** One objective of the State's Debt Management policies should be to regain the AAA credit rating through prudent financial management practices. Minnesota's general obligation bonds are currently rated AA+ by two rating services and Aa by one. The higher the credit rating received by the State, the lower the interest costs for Minnesota's bonds.

- **Debt ratios.** Three ratio guidelines have been used administratively in the past to guide Minnesota's borrowing practices. These capacity guidelines should be formally adopted as part of the Financial Plan:

  - **Debt service vs non-dedicated revenues.** The first guideline limits appropriations for General Fund debt service to an appropriate percentage of General Fund non-dedicated revenues. This guideline has generally been the most constraining on proposed capital spending during recent years, but should not be relaxed.

  - **General obligation debt vs personal income.** The second guideline limits the ratio of total general obligation debt to an appropriate percentage of the total personal income of the State.

- **Public debt vs personal income.** The third guideline limits the ratio of total debt of State agencies, public corporations and the University of Minnesota to an appropriate percentage of the personal income of the State.

- **Future liabilities.** Guidelines should also be developed to recognize future liabilities of the State which will impact its financial position. Examples would include pension, health insurance or economic development payment guarantees.

E. Plan Adoption, Monitoring and Enforcement

Comparable with the recommendations of the previous Latimer Commission, the Financial Plan should be formally proposed by the Governor and adopted by the Legislature, prior to debate on specific budget proposals.

- **Plan proposal.** A 3-biennia Financial Plan should be formally proposed by the Governor, early in the legislative session of each odd-numbered year, at the same time that specific budget proposals are presented. This generally takes place in January.

- **Plan adoption.** The Legislature should adopt the Financial Plan by March 15, prior to debate on specific budget proposals, which are typically enacted in May.

- **Plan update.** In each even-numbered year's legislative session, the Governor should provide an update on the status of the Financial Plan, along with any recommended modifications.

- **Balanced budget requirement.** Similar to biennial budget requirements, the adopted Financial Plan should be legally required to demonstrate that balanced budgets can be enacted for the next biennium, and can also be forecasted for the subsequent two biennia.

- **Plan monitoring.** The Department of Finance should be required to report on the effects of any legislative proposals which would significantly impact the adopted 3-biennia budget plan. This monitoring process should be coordinated with current budget tracking and fiscal note procedures.

- **Plan enforcement.** In order to ensure that the Long-Term Financial Plan serves a meaningful purpose, it is recommended that the process used to establish and monitor the plan should be enacted into law.

II. Budget Management

The second major recommendation of the Commission is that the State should introduce greater management flexibility, responsibility and accountability into its budgeting system. Increased contingency planning and continued use of baseline budgeting techniques are suggested as ways to accomplish these objectives.

A. Contingency Planning and Management Flexibility

Greater contingency planning should be incorporated into the budget management system to dampen volatility in Minnesota's expenditure structure. When revenues decrease during recessions, the current system is unable to readily adjust to cover on-going commitments and entitlement programs established during healthier fiscal times. Long-term program commitments should not be based on short-term prosperity, but should recognize the implications of economic cycles. In order to enhance flexibility to deal with expenditure volatility, as well as adhere to adopted expenditure guidelines, the following two measures are recommended:

o **Contingency plans.** Risk sharing and formal contingency plans should be incorporated into adopted budgets. For example, specified offsets in lower priority program areas could be identified to allow for the

possibility that spending might exceed estimates for certain higher priority entitlement programs. It is not realistic to treat all entitlement programs as sacrosanct; priorities should be assigned. Increased management flexibility in entitlement programs should also be considered to allow for the possibility of shortfalls. There is currently very little administrative authority to manage these programs.

- **Unallotment authority.** The unallotment process should be strengthened to permit the Governor, with the advice of the Legislative Advisory Commission, to unallot funds once the rainy-day Budget Reserve is depleted, but prior to use of the Cash Flow Account. If the Department of Finance determines that spending will exceed the enacted budget and exhaust the Budget Reserve, an unallotment should be permitted, absent specific legislative direction for automatic reallocation.

B. Baseline Budget Process

The current baseline budget approach should be continued. This system allows policy officials to plan for and track the impact of changes in current trends, rather than to automatically build increased spending into base budgets. However, proper financial planning must recognize the reality of inflationary

pressures. Inflation should be treated differently for forecasting and budgeting.

- o **<u>Financial forecasts</u>.** Financial forecasts should be based on both current law and trend projections. This means that forecasted inflation should be included in both revenue and expenditure forecasts so that a consistent picture of future trends is available on which to base policy and budgeting decisions. This does not mean that inflation should be built into budget development, only that forecasts for planning purposes should reflect trends based on extensions of current commitments.

- o **<u>Financial plans and budgets</u>.** While financial forecasts should reflect the impacts of inflation, the development of financial plans and budgets should not automatically incorporate allowances for inflation and salary increases. Until last year, state budgets had been constructed from a base that incorporated automatic inflators. Policy discussion was then focused only on "change" requests that were either additions to or cuts in the already inflated base. Inflationary increases should receive the same level of review as all other changes. Policy debates should also address the continued usefulness of the priorities reflected in base spending. By excluding inflation from the base budget, the Governor

and Legislature will be more likely to evaluate trade-offs that include entire programs, rather than just focusing on marginal changes in the budget.

III. State-Local Fiscal Relationships

Because transfers to local units of government represent about one-half of the State budget, state-local fiscal relationships must also be examined in any reform of the State financial planning and management system.

The fiscal restraint and prudence shown by the Governor and Legislature in solving the $2.0 billion budget crisis must be built upon by other levels of government. While many local agencies have responsibly responded to current economic realities, others have failed to adjust. For example, certain school districts need to acknowledge that their independence does not absolve them from making careful spending decisions, and from the need to ensure that contract settlements are reasonable.

A. Accountability

Corrective action should be undertaken to resolve the inherent problem of taxing at the state level and spending at the local level. Such a structure encourages local spending without local accountability.

B. Local Funding Options

If local accountability is to be increased, local responsibility must also be increased. This means that local officials should be provided greater access to alternative funding sources. As an initial measure, artificial limits on local property tax levies should be removed immediately.

C. Unfunded Mandates

A more careful fiscal separation of state-mandated and local discretionary programs should also be made. State mandates should be funded by State resources, and non-mandated programs which local governments can choose to provide should be funded by local revenues.

COMMISSION ON LONG-TERM FINANCIAL MANAGEMENT REFORM

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