A Call For Expansion
And Enforcement Of
Minnesota’s Current
“Taxpayer Bill Of Rights” *

Guest contributor Jerry Geis examines the state’s 25-year history with ensuring adequate procedural protections for taxpayers, examines why changing times have created new needs, and offers a series of proposals to begin the discussion.

In recent years, the phrase “taxpayer bill of rights” (or “TBOR”) has been synonymous with the contentious topic of state constitutional tax and spending limitations. But long before the phrase was co-opted as a marketing slogan by smaller government advocates, the idea had a much more substantive and meaningful interpretation: procedural protections for taxpayers to assure that all taxpayers would be accorded basic rights of fair and equitable treatment.

Such procedural protections are a critical, but often unappreciated, dimension of sound tax policy. They enhance fairness, ensure transparency, maintain faith in the system, and promote understandability. Minnesota has long recognized this important truth. The foundation of Minnesota’s tax administration is strong and acknowledged as one of the best in the nation. This year the Council on State Taxation gave Minnesota a grade of “A-” in tax appeals and procedural requirements.

Building on this foundation was the impetus behind TBOR. Under the leadership of then-Revenue Commissioner John James, Minnesota embarked on a two-year, multi-stakeholder process which resulted in Minnesota being one of the first states to enact a Taxpayer Bill of Rights in 1990.

Twenty-five years later, Minnesota’s TBOR provisions have not been substantially changed. The Department of Revenue does a fine job of administering them. However, the agency can only administer the laws as they are written. Meanwhile, several developments and trends have made existing provisions inadequate thus meritng attention from our elected officials.

The Taxpayer Bill of Rights in Minnesota is in significant need of an upgrade and update to address new problems that have surfaced and old problems that have new aspects not anticipated. Here we look at the history of federal and Minnesota TBOR, the problems requiring attention, and the enhancements and provisions that, in the opinion of the author, need to be enacted.

The Federal Precedent

Although the United States Constitution does not contain a taxpayer bill of rights, Congress has passed three separate taxpayer “bills of rights” (1988, 1996, and 1998), and the IRS administratively issued a fourth in 2004. As the name implies, these statutory bills of rights focus on procedural protections for taxpayers. For example, among other things, the initial 1988 legislation required IRS employees to apprise taxpayers of their rights before conducting formal interviews. It also authorized taxpayer reliance on written advice from the IRS.

The second taxpayer bill of rights, enacted in 1996, established the Office of the Taxpayer Advocate, an independent entity charged with assisting taxpayers and identifying problem areas where the IRS should improve its administrative practices. Today the Office is known as the Taxpayer Advocate System and is managed by the National Taxpayer Advocate, who oversees local taxpayer advocates dispersed in cities nationwide. This second bill of rights also expanded the IRS’s authority to abate interest and penalties in certain situations.

The third iteration, part of the Internal Revenue Service Restructuring and Reform Act of 1998, introduced a variety of new protective measures. For example, it provided that before the IRS seizes a personal residence to satisfy a tax lien, the agency must first obtain written approval from a Federal judge. It also included protections applicable to penalties and interest, such as zero rate of interest during periods of overlapping overpayments and underpayments.

The most recent federal TBOR is the first to be issued by the IRS. It is also the first to follow the form of the Constitutional Bill of Rights. The IRS TBOR recognizes

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basic principles that should govern the relationship between taxpayers and the IRS. Among these principles are taxpayers’ right to be informed, their right to quality service, their right to challenge the IRS’s position, and their right to privacy and confidentiality. This IRS effort may score well on rhetoric and symbolism, but it fails on substance. The IRS Bill of Rights is purely aspirational and does not endow taxpayers with any legally enforceable rights.  

Minnesota’s Current TBOR

Minnesota taxpayers have numerous rights that are set forth in various provisions of the state statutes, which are commonly called “Taxpayers’ Bill of Rights Act.” These rights are restated on the Commissioner’s website under “Taxpayer Rights” and the appeal rights are included as part of all tax orders and bills sent to taxpayers. By law the Commissioner is required to prepare and distribute to all taxpayers who are contacted their rights with respect to the tax determinations or to tax collection matters. (Minn. Stat. § 270C.28, Subd. 2 and http://www.revenue.state.mn.us/taxpayer_rights)  

The Commissioner must prepare statements that set forth in simple and non-technical terms:

- The rights and obligations of the Commissioner and the taxpayer during an audit;
- The procedures by which a taxpayer may appeal an adverse decision of the Commissioner, including administrative and judicial appeals;
- The procedures for filing refund claims and filing of taxpayer complaints; and
- The procedures that the Commissioner may use in enforcing the tax laws, including assessment, jeopardy assessment, levy and distraint, and the filing of liens. (Minn. Stat. § 270C.28, Subd. 1.)

Prior to an interview in an audit or collection matter, the Commissioner’s representative is required to explain to the taxpayer the audit or collection process and his or her rights under the process. The taxpayer may then request a delay of up to 30 days to consult with an attorney, accountant, or other tax representative, who may be present at the interview. (Minn. Stat. § 270C.285, Subd. 2.)

The Taxpayer Rights Advocate is employed by the Commissioner to help taxpayers who feel aggrieved by the way in which the tax administrative process is working in their cases. The Taxpayer Rights Advocate has the authority to issue a taxpayer assistance order if he or she determines that the actions or proposed actions of the Commissioner would create an unjust or inequitable result to the taxpayer. The order can direct the Commissioner to take, or refrain from taking, certain actions. Taxpayer assistance orders can be overturned only by the Commissioner (Minn. Stat. § 270C.37.)

These four remedies can be enforced in Court by taxpayers:

1. The Tax Court may award attorneys’ fees to taxpayers for both administrative and judicial actions if the Commissioner’s position was not substantially justified. (Minn. Stat. § 271.19)
2. Taxpayers may sue for damages if a Commissioner employee negligently fails to release a lien after the taxpayer has paid the lien. (Minn. Stat. § 270C.27)
3. Taxpayers may sue for damages if a Commissioner employee recklessly or intentionally disregards a state law or rule to collect delinquent taxes. (Minn. Stat. § 270C.275)
4. The Commissioner may be liable for attorneys’ fees and damages if a lien is filed erroneously and is not released within 14 days. (Minn. Stat. § 270C.63, Subd. 15)

The proposals are based on existing Federal rights or proposed changes to them and the provisions of TBOR laws in other states.

Changing Times, Changing Needs

These tax code provisions provide real and substantive rights to protect taxpayers from unfair and unjust treatment and enable them to challenge arbitrary and capricious government action. But several considerations and developments raise questions about the adequacy of these provisions in their current form.

First is the increasing number of self-representative, or “pro se” taxpayers. The number of these taxpayers filing appeals or engaged in audits and collection activities has continued to increase. While the DOR has taken steps in providing information to self-representative taxpayers via printed information and the DOR’s website, the fact remains that because of the complexity of our tax system and the difficulty of the administrative tax process, taxpayers are often overwhelmed with the prospect of prosecuting their own cases.

The situation is similar for taxpayers filing appeals in the Minnesota Tax Court. Approximately 55% of Commissioner-filed cases are conducted by self-representative taxpayers. The Small calendar or small claims division has 100% pro se representation. Unrepresented taxpayers navigating through the administrative appeals process can only be further confused and overwhelmed when prosecuting their own cases in the Tax Court. This is so even though the Tax Court was established to provide quick, efficient, and less costly litigation than the District Court.

The problem of pro se representation is compounded by the fact that Minnesota’s TBOR is highly fragmented. Currently, there is no consolidated statement of core taxpayer rights and responsibilities in the Minnesota tax chapters. Instead, key provisions and rights are scattered throughout Minnesota tax laws. Because taxpayers have no simple way to identify or locate them, they may not take advantage of them. Adding to this confusing and uncertain landscape is the fact
that, despite general recognition that federal conformity is an important tax policy objective, Minnesota has not conformed to provisions from the 1996 and 1998 federal taxpayer bill of rights.

But perhaps the fundamental reason to look at amending the Minnesota Taxpayer Bill of Rights is that times change, and revisiting and reexamining TBOR is quite simply overdue. Rights can lose their influence and functionality over time when they are not updated to reflect the current environment or fine-tuned to account for changes in tax administration. Gaps in coverage result and the development of new situations creates new needs. Much has changed in the world of taxation since the 1990s, but TBOR has not.

An Agenda for Reform: Some Proposed Amendments

What should TBOR amendments and TBOR expansion focus on? Simply put, it should provide for additional protections for taxpayers in audit, appeals, collection, and the procurement of information.

Embedded in TBOR expansion is the important and very legitimate question regarding balancing additional taxpayer protections with placing additional burdens on tax administration. The proposals listed below are, in the author’s opinion, beneficial and needed, but reasonable people can disagree on the need, efficacy, policy, or burden of the provisions. These are only offered to begin this important discussion.

The proposals themselves are based on existing Federal rights or proposed changes to them and the provisions of TBOR laws in other states. Many of these would not require new legislation, but rather could be accomplished through administrative action by the Department itself. As noted previously, the 1990 Minnesota TBOR took two years of discussions with the DOR, legislators, and interested groups before consensus was reached on the correct approach. I envision a similar process here.

One More Requirement: Give TBOR Teeth

After the establishment of these additional rights, a remaining consideration is whether there is a meaningful mechanism by which to enforce the provisions of the State Taxpayer Bill of Rights if they are violated. If non-compliance with a TBOR provision fails to generate repercussions or penalties, the whole purpose of having a TBOR can be called into question because there is no remedy for the aggrieved taxpayer.

This is an issue because under current Minnesota law the failure to comply with a

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4 The suggested legislative changes are not meant to be “exhaustive.” There may be other procedural changes that should be enacted. For instance, the IRC Code Section 7491 and the shifting of the burden of proof or a prohibition of ex parte communications between appeals officers and other DOR employees would be examples. The intent here is to engender discussion and review.

5 See MBNA America Bank, N.A. & Associates v. Commissioner of Revenue, 694 NW2d 778 (Minn. 2005), reversing Tax Court Docket No. 7589-R (Minn. T. Ct. July 27, 2004). The Minnesota Supreme Court held that the Commissioner’s assessment order did not explain the procedures for filing refund claims, as clearly required by the Taxpayer Bill of Rights and, therefore, the taxpayer’s refund claim was timely, even though filed 21 days after the statute of limitation for filing claims had expired. While the TBOR provision was silent as to what effect nonconformity should have on the statute of limitations for the taxpayer’s refund claim there was an ambiguity, and any ambiguities in the law must be interpreted in favor of the taxpayer. As a result of this nonconformity, MBNA’s refund claim did not trigger the 1-year period for filing a refund claim provided under Minn. Stat. § 289A.40, Subd. 1, until the DOR properly instructed the taxpayer on its refund rights. But the legislature subsequently amended the statutory law in 2005 and the result in MBNA was reversed and the effect of the amendment was confirmed by the courts. Failure to comply with a provision contained in the Taxpayer Bill of Rights does not invalidate the assessment or refund determination after the 2005 legislative amendment. See Deanna L. Byers v. Commissioner of Revenue, 741 N.W.2d 101 (Minn. 2007).


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<tr>
<th>TBOR Provision</th>
<th>Additional Notes and Comments</th>
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<td>1. The establishment of a core group of rights accorded and afforded to each taxpayer. These rights would be similar to the Federal proposed core taxpayer rights propounded by the IRS and other interested parties. They would include (a) the right to be informed, (b) the right to be assisted, (c) the right to be heard, (d) the right to pay not more than the current amount of tax, (e) the right to appeal, (f) the right to certainty, (g) the right to privacy, (h) the right to confidentiality, (i) the right to representation, (j) the right to a fair and just tax system, and (k) the right to quality DOR service.</td>
<td>Such estoppel is contingent on a determination that (i) the method at issue was previously audited with no additional tax assessed, (ii) the method under consideration in the current audit is the same as the method used in the prior audit, (iii) there has been no applicable statutory or regulatory change in the interim, and (iv) the taxpayer has detrimentally relied on the fact that the method resulted in no additional tax in the previous audit.</td>
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<td>2. Impose an affirmative statutory duty on the Commissioner to ensure that DOR employees are instructed and familiar with, and act in accordance with all taxpayer rights protections.</td>
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<td>3. Establish that the DOR may not make a sales tax assessment in the course of a current audit of the taxpayer’s returns, if no assessment was made in a prior return and the taxpayer’s practices have not changed. Specifically, the DOR is estopped from assessing additional tax resulting from the use of a previously audited method for any period prior to the notification by the Commissioner or his agent during the current audit that the use of the previously audited method would result in additional tax being due.</td>
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<td>4. In an audit, the auditor must, at the request of the taxpayer, provide written information as to what records constitute the minimum requirements for record-keeping. If the auditor recommends changes in the record-keeping process, these recommendations must be provided in writing to the taxpayer.</td>
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<td>5. The DOR would be required to furnish copies of the agent’s audit papers and the written narrative explaining the reasons for the assessment to the taxpayer.</td>
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<td>6. The taxpayer would be guaranteed the right to request a meeting with the auditor and, if there is disagreement to the auditor’s findings, to discuss the auditor’s proposed assessment.</td>
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<td>7. The right to request a supervisor to be involved in resolving a matter if the initiating DOR auditor is unwilling or unable to resolve an issue.</td>
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<td>8. The right to have one DOR representative deal with a tax issue from start to finish until the issue is resolved.</td>
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<td>9. The DOR must waive interest and penalty assessed against a taxpayer when it is determined by the DOR that the negligence or unreasonable error of an employee of the DOR resulted in undue delay either in assessing the tax or notifying the taxpayer of the liability owned or in resolving an appeal.</td>
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The whole purpose of the TBOR is to assure that all taxpayers will be accorded basic rights of fair and equitable treatment. In order to carry through on that objective, violations of TBOR must have consequences. Government generally, and in this case the DOR specifically, must be held to a high standard of conduct in dealing with taxpayers. The statutory provisions governing substantive standards and procedures for taxation, including the administrative review process, are premised on the concept that government will act scrupulously, correctly, efficiently, and honestly. It is assumed that the DOR will exercise its governmental responsibilities in the field of taxation conscientiously and in good faith.

The primary obligation is for the DOR to comport itself with integrity, and in so doing the agency will carry out the guiding principles of fundamental fairness in...
From the Director: Taxpayer Reformation Day

Our thanks to longtime MCFE board member Jerry Geis for his important, insightful, and authoritative contribution to this edition of Fiscal Focus. For readers who may be unfamiliar with the author, Jerry has iconic status in the Minnesota tax community, and his perspective always merits serious consideration. In his opinion piece, the Notre Dame graduate offers a respectable impersonation of Martin Luther by nailing 27 theses onto the doors of Minnesota’s legislative chambers.

Tax policy debates typically revolve around dollars and political slogans, not the gears by which the system operates. Auditing, appeals, and enforcement is a highly complex, even mysterious world of taxation most people never see. But it’s a world with considerable potential for frustration, anger, and expense—especially for taxpayers who find themselves navigating these waters without a hand to guide them. Good policy requires a tax system that runs effectively, efficiently, fairly, and predictably. TBOR is a crucial cog in delivering on these objectives.

It’s tempting to think only economic considerations, like tax collections, refunds, and lowering the cost of tax compliance lie at the center of TBOR. But it’s safe to say doing TBOR right and doing it well offers secondary benefits with respect to public attitudes and trust in government. At least some of the public’s resentment, cynicism, and cynicism toward government undoubtedly is based on how individuals are treated in those relatively rare moments when they must deal with government and its processes on a very personal level. In this respect, TBOR is no different from the many other efforts state government is already pursuing to improve customer service and responsiveness.

Not all important tax reform results in revenue changes. We now have a menu of opportunities to consider for strengthening our tax system and investing in our good government legacy. Let’s start this discussion now.

—M.H.

Dealing with taxpayers. If taxpayers are required to submit to deadlines and procedures, and their failure to comply incurs substantial penalties, the DOR should also have consequences for failure to carry out the TBOR provisions to the fullest extent. This is what should be required and expected of our government.

To put teeth into TBOR some remedies or protections to the taxpayers can be directly incorporated into the applicable statutes. Examples would be the abatement of tax, interest, and penalty for reliance on erroneous written DOR advice or the abatement of interest and penalty for the DOR’s negligence or unreasonable error causing delay in assessment or audit or appeal. As indicated, these remedies would be incorporated in the applicable statute mandating a course of action by the DOR.

Other violations of TBOR rights may not lend themselves as readily to new and specific statutory remedies. For these TBOR violation enforcements a return to the previously mentioned 2005 case law is in order. This established the rule that, in a situation where the statute is silent as to a remedy, a violation of TBOR would stay the action until the violation or infraction is cured by the DOR. Such an approach would necessitate the repeal of statutory provisions found in Minn. Stat. § 270C.28, Subd. 2 (“Failure to receive the statement does not invalidate the determination or collection actions, nor does it affect, modify, or alter any statutory time limits applicable to the determination of collection action, including the time limit for filing a claim for refund.”) and Minn. Stat. § 270C.33, Subd. 2(b) (“Failure to provide all of the required information does not invalidate the assessment, determination, or order for purposes of satisfying statutory notice requirements if the assessment, determination, or order contain sufficient information to advise the taxpayer that an assessment has been made.”).

Yet another alternative would be to establish a statutory right to sue the DOR, if any officer or employee recklessly or intentionally disregards any tax laws or DOR-published procedures by permitting an action for damages to be filed in the District Court or the Tax Court. This would be an expansion of the existing right to sue now found in the case of the collection of delinquent taxes under Minn. Stat. § 270C.275.

TBOR without enforcement mechanisms is aspiration, not policy. Reasonable persons can disagree about what those appropriate remedies or enforcement mechanisms should be, but the need of an actual remedy for a violation cannot be questioned or disputed.

Starting the Discussion

Minnesota has a solid base of taxpayer rights that have existed since 1990, but additional protections for taxpayers in auditing, appeals, and tax collection are needed. Gaps in coverage, the development of new situations, the continued increase of self-represented taxpayers, and federal conformity all suggest a renewed investment in TBOR is warranted.

What would we get out of such an effort? First, procedural fairness would be ensured. All taxpayers would be treated the same from a procedural point of view. This is not a guarantee of results but a promise that laws would be applied equally across the board to all taxpayers.

Second, there would be complete transparency between the DOR and the taxpayer and his/her representatives. The audit, appeal, and collection processes would be open and easy to navigate.

Third, an enhancement or amendment of TBOR would increase faith in the tax system. The voluntary system is based on taxpayers’ belief that the system is inherently fair and provides a mechanism for resolving tax disputes that is quick and cost efficient. The current tax system is a partnership of the taxpayer, his/her representatives, and the DOR based on cooperation and trust. These proposed amendments would further that ideal.

Fourth, and perhaps most importantly, greater clarity for the ordinary taxpayer. Tax laws are complex and technical. Most taxpayers are not equipped to navigate the system. All taxpayers should have an opportu-
nity to resolve disputes without a procedural footfall, forfeiting his or her right to win a case on a technicality.

Legislative changes are needed to improve and update TBOR. On TBOR’s 25th anniversary taxpayers, their representatives, tax administrators, and interested groups should once again come together to discuss these as well as other proposals, engage their local legislators, and begin the push for reform.

Reasonable, Supportable, and Irresponsible

Recent Pension Commission hearings on plan assumptions demonstrate again that keeping contributions in check takes priority over fiscal responsibility.

Behind the ongoing debate about public pensions is the black box of actuarial valuations – a mysterious container filled with the precision of sophisticated mathematics and the imprecision of assumptions about the future. Occasionally, the lid on this box is lifted and lawmakers review and discuss the assumptions used to derive the funding requirements for the state’s pensions. Such was the case this fall in hearings by the Legislative Commission on Pensions and Retirement. These hearings again exposed one of the biggest unappreciated problems with public pensions. Actuarial work is a discipline fundamentally devoted to the assessment of risk. But in public pensions risk management doesn’t just take a back seat to funding policy, it’s locked away in the trunk.

One Step Forward, Another Step Back

Although the Commission has not yet formally adopted the actuaries’ recommendations, testimony revealed the impact on reported plan health is significant. Reductions in wage and price inflation expectations would bring total liabilities down; working against them is a powerful demographic trend – increasing life expectancy. But the 500 pound assumption gorilla remains the assumed return on investment which is used to calculate the present value of future benefit payments and determine contribution requirements. For many years, plan actuaries recommended reducing the assumed return to 8%. That recommendation was finally adopted in 2015 by two of three major state plans (MSRS and PERA), and all indications are TRA will join them this year.

These assumption changes, combined with lackluster returns over the last year, portend deterioration of reported pension fund health and more sustainability fixes. According to pension plan estimates for forthcoming 2015 valuations, when including all these assumption changes, the total estimated unfunded liability (based on current market value) for just the three largest plans (MSRS General, PERA General, and TRA) is $14 billion. Plan funded ratios for these plans would decline, ranging from 75.9% to 83.9% while contribution shortfalls would range from 1.6% to 4.2% of payroll.

As always, most of the Commission’s discussion and scrutiny was directed to the assumed investment return. At 8% this assumption remains among the highest in the United States. (The National Association of State Retirement Administrators reports the average assumed return is now 7.68%.) Yet the inherent “blessing” of plan actuaries combined with the confident assurances of the State Board of Investment makes the 8% assumption easily justifiable. Indeed, the state’s consulting actuary, who reviewed the work of each individual plan’s actuaries concluded, “the selected investment return assumption of 8.0% is reasonable and supportable.” What makes this conclusion a bit more interesting is that a part of the consulting actuaries’ testimony appeared to directly contradict it.

Risk management in public pensions doesn’t take a back seat to funding policy, it’s locked away in the trunk.

Heads or Tails?

Two actuaries are duck hunting. They see a duck in the air and they both shoot. The first actuary’s shot is 20 feet wide to the left. The second actuary’s shot is 20 feet wide to the right. The actuaries give each other high fives, because on average they shot it.

— Actuarialjokes.com

There are an infinite number of ways the SBI can achieve an “average annual 8% return” over a defined period of time, but the sequencing of investment returns over time matters. Unlike shooting fall mallards, investment “misses” from expectations compound and grow with time. As a result, return projections that recognize sequencing and compounding effects (“geometric returns”) are preferable to modeling based on a simple arithmetic mean. According to testimony by the state’s consulting actuary, “the industry trend is toward a preference of geometric returns.” (The fact that this was described only as a “trend” and a “preference” in the industry should give pause – more on this later.)

So what does such a geometric return analysis suggest? The table below was presented in testimony to the Commission by the state’s consulting actuary. The median geometric return – which is by definition the return expected to be met half the time – is 6.97%. The primary finding, however, lies at the bottom right of the table. The probability of exceeding an 8% return over the next 20 years is only slightly better than 1 in 3. The probability of exceeding a 7% return – a full 100 basis points below what our pension system is based on – is equal to a coin flip.

<table>
<thead>
<tr>
<th>Distribution of 20-year Average Geometric Net Nominal Return</th>
<th>Probability of Exceeding 8.5%</th>
<th>Probability of Exceeding 8.0%</th>
<th>Probability of Exceeding 7.0%</th>
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<tr>
<td>25th</td>
<td>50th</td>
<td>75th</td>
<td>20%</td>
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<tr>
<td>1</td>
<td>3.88%</td>
<td>5.90%</td>
<td>7.96%</td>
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<td>2</td>
<td>4.75%</td>
<td>6.63%</td>
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<td>3</td>
<td>4.69%</td>
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<td>4</td>
<td>5.06%</td>
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<td>5.46%</td>
<td>7.54%</td>
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<tr>
<td>6</td>
<td>5.48%</td>
<td>7.74%</td>
<td>10.06%</td>
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<tr>
<td>Average</td>
<td>4.89%</td>
<td>6.97%</td>
<td>9.09%</td>
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Source: Presentation to LCPR by Delloite, state consulting actuary, November 3, 2015
Practically, the odds are likely even worse because public pension contributions are notorious for “tardiness.” The time when an economic downturn hits and investment markets decline is precisely when additional contributions are most needed. But as Minnesota itself has demonstrated, budget circumstances that come with economic downturns make it very difficult for governments to divert additional money from their budgets and/or employee paychecks toward pension support. At best, contribution increases are phased over a period of several years, missing out on a lot of market recovery in the process.

So why did the state’s consulting actuary still declare the 8% return “reasonable and supportable”? The consulting actuary noted another geometric model with more optimistic findings. Benchmarking against other states’ assumed returns also offered a sense of reassurance. But the primary justification was simply the SBI’s own past investment performance and its own future projections.

“Hiding Risk is a Far Cry from Managing Risk”

“The use of the expected return assumption as the discount rate virtually guarantees the eventual failure of any plan using it.”

—Barton Waring, author of Pension Finance: Putting the Risks and Costs of Defined Benefit Plans Back Under Your Control, in testimony to the Government Accounting Standards Board

Policy makers are keenly attuned to the question of whether Minnesota can beat these odds and continue to meet or exceed these investment targets. The more important question never gets asked: what is the logical justification for valuing future cash flows that the state absolutely has to pay based on hopes about what an investment portfolio can earn?

Financial economists and practitioners, public finance and government scholars9, the Nobel-winning “father” of the capital asset pricing model and the Nobel-winning “father of modern finance,” 8 business executives, even public sector defined benefit pension managers in other countries have all expressed considerable concern and a fair share of ridicule at how expected investment returns are used in U.S. public pension policy.9 They argue what a portfolio is expected to make is absolutely irrelevant; financing needs instead need to be based on the riskiness of the cash flows. They point out engaging in this practice understates the cost of pension benefits and exposes future taxpayers to considerable risks and unknown costs. They point out this practice cannot be found in any other area of public or private sector finance. They point out the fact that states have failed to make adequate contributions to their pension funds shouldn’t be a surprise to anyone; this practice essentially guarantees pension underfunding.

The practice persists in large part because of the recommendations and justification offered by pension actuaries backed by their actuarial standards of practice. But not all actuaries are comfortable with what is going on and how their profession has acted.

Jeremy Gold is the Vice Chair of the Pension Practice Council of the American Academy of Actuaries and Chair of the Pension Risk Management Task Force of the Society of Actuaries. In a September presentation to the annual conference of the MIT Center for Finance and Policy, he began with the statement, “I’m here to tell you a story about how a profession has failed to fulfill its duty to the public and thus enabled and abetted the very real crisis in public pension plans.” From there he delivered a withering critique of his own profession and its role in contributing to the current state of public pensions around the country (available at http://cfp-web.mit.edu/pictures-slides-and-videos-from-the-second-annual-cfp-conference/ for those who find MMA takedowns entertaining).

- On the big picture: “What we have is a knowledge problem and a governance problem. The knowledge problem: actuaries shamelessly, although often in good faith, understate the value of future pension payments by as much as 50%. Their clients want them to. The governance problem: actuarial standards of practice allow pension actuaries to cater to their clients while ignoring potential harm to third parties.”

- On Actuarial Standards of Practice (or ASOPs): “Despite the Actuarial Standard Board’s assertion that ASOPs are principles-based they’re neither principle-based nor prescriptive. They are driven by practice from the bottom-up, defer frequently to professional judgment, and assert “appropriate” practice not “best” practice….In many cases the only required action is for the practicing actuary to consider something….Don’t let an actuary fly your plane.”

- On what pension actuaries are really accomplishing: “Actuaries keep contributions low. Actuarial methods and assumptions continue to kick the can down the road and suppress true pension costs….Low current contributions cater to current taxpayers but burden future generations with great risks and unacknowledged costs.”

- On the failure of the profession to deliver on its principal professional obligation – risk assessment: (Actuaries) should have been risk managers, not risk camouflagers…Actuarial smoothing is a poor substitute for real risk management. Hiding risk is a far cry from managing risk.”

- On the political failure of the profession: “What the profession has done is enable and abet those whose decisions and benefit levels and funding have brought us to a crisis point. Actuaries should have been the cops.”

- On what should be done about all this: “Get angry.”

Looking for a Cop

When the construction work picks up this spring following the shortened legislative session, the situation will likely be as it has been. Thanks to our Lake Wobegon-like investment acumen (where all the investments are above average), Minnesota will continue to reduce the pressure on contribution policies by discounting its future pension cash flows at a rate roughly 50 basis points above what the average public pension plan in the United States thinks is prudent and hundreds of basis points above what Finance 101 demands.

7 Donald Boyd and Peter Kiernan, Strengthening the Security of Public Sector Defined Benefit Plans, Rockefeller Institute of Government
8 William Sharpe and Eugene Fama, respectively
9 Perhaps the most entertaining criticism came from financial industry executive and former New York City mayor Michael Bloomberg who said in response to a New York actuarial recommendation to reduce the expected return: “The actuary is supposedly going to lower the assumed reinvestment rate from an absolutely hysterical, laughable 8 percent to a totally indefensible 7 or 7.5 percent. If I can give you one piece of financial advice: If somebody offers you a guaranteed 7 percent on your money for the rest of your life, you take it and just make sure the guy’s name is not Madoff.”
Author Upton Sinclair once noted it’s difficult to get a person to understand something when that person’s self-interest depends upon not understanding it. There’s probably no better or simpler explanation for the state’s unwillingness to address this issue. Government administrators and public employees both benefit from lower contributions and shifting current government costs onto future taxpayers. Pension plan trustees who are charged with proper plan governance are mostly comprised of current and future pension beneficiaries. Pension actuaries are paid to provide the analytical justification for current practice and risk losing business if they move away from standard orthodoxy. The self-interest of traditional money managers is well-served by the status quo. And as the struggles of underfunded plans result in the chase for higher returns in the world of “alternative investments,” private equity managers and the like are only too happy to oblige and reap their large fees.

The group we should rely on to introduce financial reality and responsibility into this debate is our elected officials. Because they are charged with balancing the private interests of those working in government with the public interest in a fair and fiscally responsible way, they offer the best hope. But if a corollary to Sinclair’s observation is also true — that it’s difficult to get someone to understand something when an election certificate depends upon not understanding it — we should brace ourselves for a future of both higher taxes and reduced government services. It’s not a matter of if, but of when.