Tea Leaves and House Bills — Our Look at the 2014 Session

We sift through pre-filed bills to predict the tax and fiscal ideas and themes which will define the 2014 legislative session.

“Tasseography” is a fortune-telling method that interprets patterns in tea leaves, coffee grounds, or wine sediment. To this list of divining substances we add the 279 pre-filed House bills posted last month by the Chief Clerk’s Office (described by Politics in Minnesota as “the Great Bill Dump”). We have taken a look at these early introductions in an attempt to foretell the major fiscal themes, ideas, and proposals in the upcoming 2014 legislative session.

Unusually, this year’s session doesn’t begin until February 25th, late even for a non-budget year. Moreover, with November looming, there is considerable interest in making this session short and sweet. But that doesn’t mean interesting discussions won’t take place. Here are some thoughts based on our review.

Taking a Tax Policy Mulligan – The suite of sales taxes on business-to-business (B2B) transactions enacted last year wasn’t wildly popular then, and it’s hard to find anyone who thinks highly of the idea now. The taxes have taken an absolute beating in the court of public opinion. Having been declared out of bounds by editorial pages and members of both parties (and aided hugely by a $1 billion prevailing wind otherwise known as a budget surplus), there is considerable interest in re-teeing and eliminating these provisions. We count 18 separate proposals — although some are identically worded bills — that would repeal these B2B taxes either in part or in full.

The repeal proposals have both DFL and Republican authors, but interestingly no individual bill has bi-partisan sponsorship; suggesting perhaps that DFLers and Republicans don’t want to share credit at the moment for any repeal as they position themselves for the upcoming election season. Equally interesting if not surprising: House DFLers in swing districts are frequently co-authors on these proposals. Unless the surplus forecasted in November morphs into something much smaller at the end of this month or negotiation mischief occurs, repeal of this entire suite of B2B taxes seems quite likely in 2014.

A “do-over” also seems to be a theme in the area of estate and gift taxes. But to keep the golf metaphor going, on this topic there seems to be no emerging sense on what club to use or, for that matter, where to aim.

Federal Conformity Becomes Real – The abstract, wonky concept of federal tax conformity is about to get injected with 100 cc’s of real world politics. As the filing season gets underway, Minnesota’s failure to conform to some recent federal tax law may mean that some Minnesotans are in for unpleasant surprises – finding out that they have unexpected income from sources like reimbursements from their employers for college classes (see our Practitioners Corner for more on this) or the value of debt forgiven on residences. Several news outlets have flagged these issues, but expect attention and interest to increase as returns are prepared.

“Unsession” Has Many Meanings – Legislators seem to be taking Governor Dayton’s idea of an “Unsession” seriously – but based on the pre-filed bills, the meaning of “Unsession” is clearly open to interpretation. For some, an “unsession” is about removing obsolete provisions from the state’s
“Income Inequality” is this year’s “Tax Fairness” – Every session seems to have a primary message or rallying theme. Last year the filter through which policy had to pass was “tax fairness.” Now that pretty much every drop of fairness has been wrung out of Minnesota’s tax system (practically, even if some believe there is still a lot more work to do), the companion idea of “income inequality” is prepared to take center stage. Minimum wage will dominate this discussion in 2014, but that doesn’t mean other related ideas won’t get traction. For example, one of the more ambitious proposals introduced last session and likely to be heard again would require economic inequality impact assessments for all major policies likely to have a measurable effect on income or wealth distribution in Minnesota. This session’s efforts on income inequality are likely to set the stage for a much longer-term debate between those eager to address this topic of growing national and federal interest here at the state level with others concerned about what state and local tax and fiscal systems can actually accomplish in this area, especially without creating unintended consequences.

And Then There’s Bonding – Of course even-year sessions are usually about two things in the end: bonding and elections – and there is most certainly a strong, loving, intimate relationship between the two. Of the 279 pre-filed bills, 57 deal with bonding or just over 20% of the total proposals. The politics of bonding give Republicans an opening – the DFL caucuses lack the 60% majorities they would need to pass bonding bills unilaterally, giving the minority some leverage in end-of-session negotiations – something they lacked in 2013.

Tea leaf readers look for shapes which symbolize and communicate something important about the future. We don’t know where this session will go and what actions will ultimately be taken, but in the stack of bills we see people leaving a voting booth. ■


The state’s report on homestead property tax affordability came out in January. The lack of coverage and attention given to the report tells you everything you need to know about what it says.

Scotland Yard Detective: “Is there any other point to which you would wish to draw my attention?”

Sherlock Holmes: “To the curious incident of the dog in the nighttime.”

Scotland Yard Detective: “The dog did nothing in the nighttime.”

Sherlock Holmes: “That was the curious incident.”

Several weeks ago the latest edition of the Department of Revenue’s “Voss Report” was released, the one-of-a-kind study which matches homestead property tax burdens with homestead income. It’s one of the most important and valuable tax-related studies in state government for one simple reason: its ability to cut cleanly through all the emotion and political rhetoric to answer the fundamental question of just how onerous Minnesota’s homestead property tax burdens really are.

Since property taxes were a primary focus of the tax changes enacted last session and remain in the political spotlight, the silence accompanying the report’s release seemed odd. From what we could tell, there were no press releases, no media reports, no press conferences, no tweets, no political statements or blog postings regarding its findings. Given the new property tax relief the state provided last year, we would expect any evidence of growing property tax affordability problems to be politically welcomed and highlighted — especially with the relief attempts under greater scrutiny as a result of the higher levies recently proposed by local governments. But the property tax watchdogs did not bark, and as Sherlock Holmes would say, “that is a curious incident.”

The summary table helps explain the silence and is frankly nothing short of amazing. Keep in mind the results for property taxes payable 2011 capture the property tax reality in which the 2013 legislative debate took place with its resulting decision to spend approximately $400 million in new property tax aids and credits.

In Greater Minnesota the median homestead property tax price (after refund) for all local services (city, county, schools, libraries, and all other special taxing jurisdictions) in payable 2011 was $1,309, or $109 per month. In four of these regions, the median property tax price was less than $80 per month – less than a gallon of gas a day. Median net homestead taxes in the seven-county metro area averaged 82% higher than for their greater Minnesota counterparts in payable 2011 even though homestead income averaged only 33% higher. After factoring in the effects of the property tax refund, the result is a 37% higher median property tax burden for metro residents. Past consumers of Voss reports will find these results very consistent over time, suggesting that in the big geographical picture not much has changed with respect to horizontal equity issues in property taxation.

The really interesting perspective comes from comparing the findings from the payable 2007 report with the most recent report for payable 2011. Remember, this comparison captures homestead property tax trends during a period of relentless messaging and media coverage about the devastating property tax repercussions arising from state aid policies:

• Over this four-year period median homestead property tax burdens (net tax after refund divided by homestead income) declined in 5 of the 10 outstate regions and 5 of the 10 metro regions, and were unchanged in one outstate and metro region. Two outstate regions experienced declines in the median burden of almost 10%. Looking statewide, the median post-refund homestead property tax burden fell by nearly 3%.

• Higher homeowner incomes typically more than offset any property tax increases that did occur. The 8.2% median increase in net taxes payable in Greater Minnesota was offset by a 9.3% median increase in homestead incomes. Similarly, in seven of the 10 metro areas median

1 For consistency, we use the same definition of “property tax burden” as the DOR report does: “The Net Tax divided by Homestead Income.”
homestead incomes grew faster than median net property taxes.

- The common use of communicating property tax increases in terms of percentage growth often significantly distorts the actual and continuing affordability of the tax. For example, four outstate regions can claim seemingly disconcerting median homestead property tax increases exceeding 14% over this four year period. However, on a dollar basis the growth in property tax burdens in these regions ranged from $24 - $45 per year (or a whopping $2.00 - $3.75 per month).

It is also possible the low median homestead property tax burdens for payable 2011 could have been even lower if Minnesotans had taken full advantage of the old property tax circuit breaker. Approximately two-thirds of those who are eligible actually claim the property tax refund. Concerned about the perceived lack of awareness of the program (and perhaps a bit frustrated politically by public indifference to the state's generosity) legislators included a provision in the 2013 tax bill requiring Revenue to notify a subset of homeowners who the Department determines are eligible for refunds in excess of $1,000 (approximately 40,000 – 50,000 Minnesotans).

Anyone taking an objective view of the new Voss data would be hard pressed to find evidence of significant and widespread homestead property tax affordability problems in Minnesota. Homeowner property taxes generally remain affordable on both an absolute and relative-to-income basis, and if anything, the trends suggest they are now more affordable than they were before the Great Recession.

These findings – combined with levy information reported by local governments – also suggest that local officials across the state have been extremely reticent to raise levies over the past several years. On the one hand, such reluctance is a tribute to fiscal restraint in tough times. On the other hand, such reluctance in light of the very modest tax burdens frequently being imposed on the average homeowner suggests that a lot of Minnesotans have been conditioned to expect and demand local services below cost and on the cheap. That is an unappreciated problem that various forms of aid or relief can’t solve but can exacerbate.
Breaking Down the Meltdown

The latest state and local pension valuation reports now show a collective deficit of $17 billion. We break down how we got to this point by reviewing valuation report histories and assigning numbers to the various contributing factors.

Once upon a time the phrase “public sector pension benefits” was guaranteed to trigger nothing more than a yawn. Hot off an incredible decade of investment returns, the majority of the big state and local pension plans (see Table 2 for list) were “overfunded” (assets exceeding liabilities) despite having handed out annual base benefit increases to retirees for several years that often approached 10% or more. According to the July 1, 2001 valuation reports, the largest state and local plans collectively had $187.2 million in assets in excess of liabilities.

Twelve years later, based on the recently released valuation reports, these plans collectively now have a tad over $17.25 billion in unfunded liabilities. Two of the major local plans no longer exist having been absorbed into “healthier” state plans that are struggling with their own funded status. Two other major local plans are in significant financial distress and in a sort of limbo as the legislature decides what to do with them.

To better understand how and why the unfunded liabilities grew so far so fast, we reviewed the past twelve years of actuarial valuation reports and assigned the growth in unfunded liabilities to the various contributing factors. Among other things, actuarial valuations measure the extent to which various factors generate either actuarial losses (adding additional unfunded liabilities) or actuarial gains (eliminating unfunded liabilities) when actual experiences deviate from the assumptions under which the plans operate.

The chart below shows how selected factors contributed to the $17.25 billion increase in unfunded liabilities over the period we are considering. Anything above zero added to the unfunded liability; anything below zero reduced the unfunded liability. Following is brief description for each bar on the chart, along with a few comments and takeaways.

Contribution deficiency: In Minnesota, pension contributions come from employees and employers, occasionally supplemented by state aids. The contribution deficiency captures the extent to which these contributions failed to cover the cost of three items: 1) new benefits accrued during the year or

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<thead>
<tr>
<th>Table 2: Public Pension Plans Included in Analysis</th>
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<tbody>
<tr>
<td><strong>Statewide General Employee Plans</strong></td>
</tr>
<tr>
<td>MSRS General</td>
</tr>
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<td>PERA General</td>
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<th><strong>Statewide Specialty Plans</strong></th>
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<tbody>
<tr>
<td>MSRS State Patrol</td>
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<tr>
<td>MSRS Correctional</td>
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<tr>
<td>MSRS Judges</td>
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<tr>
<td>PERA Police and Fire</td>
</tr>
<tr>
<td>PERA Correctional</td>
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<td>PERA MERF Division</td>
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<tr>
<th><strong>Local Plans</strong></th>
</tr>
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<tbody>
<tr>
<td>Minneapolis Employees (MERF)</td>
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<tr>
<td>Minneapolis Teachers (MTRFA)</td>
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<td>Duluth Teachers (DTRFA)</td>
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<td>Saint Paul Teachers (SPTRFA)</td>
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Figure 1: Combined Changes in Unfunded Liabilities, by Selected Factor, Major Statewide and Local Minnesota Public Pension Plans, FY 2002 – FY 2013

3 The data is incomplete in one respect: 23 of the 136 actuarial valuations we studied did not isolate the actuarial gains or losses generated by salary increases. We requested the information from the pension funds but were told that in most cases it did not exist, although we did receive additional data for two of the valuations. The missing salary-related actuarial gains and losses is included in “other factors.”
"normal cost"; 2) administrative costs associated with operating the plan; and 3) the cost of amortizing any unfunded liabilities. Over the twelve-year period in question the collective contributions made by public employees and government did not cover these costs – creating $4.53 billion in additional unfunded liabilities.

Contribution deficiencies have impacted PERA General, which covers most local government employees, especially hard. It is the only plan to have a contribution deficiency in each of the 12 years under consideration. Importantly, this in spite of an increase in employer contributions from 5.18% to 7.25% of salary (a 40% higher rate) and employee contributions increasing

You might think defenders of defined benefit plans would heed the words of someone so knowledgeable and committed to defined benefit protection and pursue corrective action accordingly. On the contrary, they either ignore these issues, or even more offensively, portray them as right wing conspiracy theories. Because to acknowledge them would immediately raise huge questions and deep reservations about the sustainability of the status quo.

You might think that given Minnesota’s oft-touted sustainability fixes and the relentless self-congratulation about our responsible pension management, we are immune from these criticisms. We aren’t – we have all of them in spades.

As a result, we are very slowly but steadily embarking on the biggest intergenerational transfer of cost and fiscal headaches in Minnesota history. It is both enabled and hidden from public view by using highly questionable investment expectations and dubious accounting practices that violate precepts of sound pension management and that literally cannot be found in any other area of public or private sector finance. Even with the very best wallpapering job to hide the problem; we still find ourselves $17 billion in the red. The plans own 2013 actuarial valuations directly state these liabilities will never be paid off if contributions and assumptions don’t change. How often do you get to read a sentence like this?

“Furthemore, based on current contributions, the unfunded liability as a percent of pay will increase without limit to an infinite amount”

So, not surprisingly, new bills will be introduced in a matter of days to increase both government and employee contribution rates yet again in 2014, diverting more dollars from checking accounts and operating budgets, and making the hamster wheel spin faster. The additional contributions may or may not be enough to get that uncomfortable sentence taken out of next year’s valuation reports. But it will be back.

And the ultimate irony is this – there is zero accountability for the people failing to act and keeping reforms at bay. By the time economic reality finally triumphs over accounting convenience – perhaps 10, 15, 20 years from now – those who perpetuated the myths, obfuscated the arguments, and leveled the ad hominem attacks on anyone who dared to call the Emperor out for his wardrobe will be retired – leaving behind a legacy of higher taxes and cannibalized public services.

— M.H.
Practitioners Corner:
Federal Non-Conformity – The Bane of Taxpayers & Tax Professionals Alike

One small example of the chronic failure to understand and appreciate the full effects of nonconformity.

Most legislators and policy experts agree that federal/state conformity is good tax policy. It enhances compliance, eases administrative burdens and reduces the cost of collection and enforcement. Why, then, is it so difficult for politicians to enact legislation that achieves this goal?

The primary objection is always the state’s inability to afford the cost of conformity. It’s a legitimate issue. But failure to conform is compounded by a deeper and more fundamental problem: a chronic failure to truly understand and appreciate the full effects of nonconformity.

Take, for instance, just one recent and particularly irksome example: Minnesota’s 2013 decision to tax federally exempt employer-paid higher education reimbursements. Conceptually it seems inconsistent to encourage investments in higher education while discouraging more employer investment in their employees by taxing it when the federal government does not.

But it does increase revenue collections – about $15 million in a $38 billion biennial budget. That’s the visible part. The hidden cost is the level of consternation the decision to tax this fringe benefit causes both employers and employees. We have to believe that if the legislature really understood the full ramifications it would have at least hesitated and may have completely abandoned the idea.

Consider first, the number of affected taxpayers – something the state does not even know with any sense of certainty. Without legislative action to re-conform to this federal tax provision, employees who had already enrolled in, or perhaps completed, classes whose cost was reimbursed by their employers, will see extra 2013 Minnesota taxable income of up to $5,250. Using the 6.25% supplemental income tax withholding rate, an employee who feels the full brunt of this failure to conform would see their annual Minnesota tax liability increase by $328. Given the annual $7.5 million price tag, this translates to a minimum of approximately 23,000 affected employee-students and likely involves hundreds of their Minnesota employers. Further, because this modification increases household income for purposes of determining any potential property tax refunds, the tax cost is potentially much higher for certain low income taxpayers. Since many students are typically just starting their careers and have limited incomes, this has a disproportionately negative and perverse effect on the very people these tax provisions are designed to assist.

Now consider the time required by the Human Resources, Payroll, Legal and Corporate Tax departments to understand this provision, change internal systems, inform the affected employees, answer their questions, and adjust their Forms W-2 to reflect more income for Minnesota purposes than for federal purposes. Taxes for these 23,000 or more employee-students will increase and many of them may not fully realize it until they file their 2013 tax returns in the coming weeks. They will need to spend time understanding the change (and probably complaining about it) and they may be discouraged from obtaining future education because of this experience.

In developing our own employers’ response to this change, we reached out via a questionnaire to other large Minnesota employers whose tax professionals are members of the Tax Executives Institute, the world’s preeminent association of in-house tax professionals. Like us, many of them were investing significant time and effort across their organizations in evaluating the effects of this change and determining the best course of action. Should we terminate our reimbursement program? How will we communicate this to our employees? Could the reimbursements be exempt under another, more narrow, provision regarding job-related training? If so, who will make that determination and how will they do it? How must we change our reimbursement forms, policies and procedures? How will we properly withhold income taxes? Will we compensate affected employees for the extra taxes, thus increasing the cost of the program? To be sure, most large Minnesota employers have the resources to deal with these questions but these resources can certainly be put to better use than dealing with the compliance complexities and employee relations and communication headaches caused by this issue. And what of Minnesota’s smaller employers who support their employees’ educational aspirations? Are they able to comply? Will they comply?

The Department of Revenue, for its part, has to change its systems, forms and processes; add FAQs and explanations to its website; field inquiries and complaints from taxpayers; and send notices to those taxpayers whose employers failed to properly implement this change.

Is all this effort really worth $15 million out of a $38 billion biennial budget that is now in a surplus? Is it worth affecting the lives of 23,000 hardworking, employee-students? Is it worth the aggravation created for Minnesota’s employers? Is it worth the use of oversubscribed Department of Revenue resources?

This is but one small, single instance of the mischief caused when legislators abandon the long standing and well understood policy goal of maintaining federal/state conformity. There are rare occasions when non-conformity may be necessary, but these are the exception rather than the rule. The legislature should work to make federal conformity a top priority as one of its first orders of business in the 2014 legislative session.

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Changes in plan provisions: This measures how changes in plan benefits affected unfunded liabilities. In other words, this mostly captures the impact of the oft-heralded “sustainability fixes” which were enacted a few years ago – much of which dealt with reducing or eliminating annual cost of living adjustments. All told, changes in plan provisions over the years put a dent in the problem by reducing unfunded liabilities by $6.38 billion.

Changes in actuarial assumptions and methods: This factor measures the extent to which changes in actuarial assumptions or methodologies employed in the valuations affect the level of unfunded liabilities. The drawn out saga and process which eventually eliminated the “Post Fund” – a fund which segregated assets for retirees drawing pensions from the statewide funds – triggered actuarial changes that resulted in a $1.08 billion reduction in unfunded liabilities.

Other factors: The black box of pension valuations is chock full of other assumptions about what the future holds. "Other factors" measures the extent to which reality mirrored these economic and demographic expectations. It includes gains and losses relative to expectations about retirement ages, how long employees work, when beneficiaries die, and many other items. Over time, the deviations from these assumptions have generated $1.42 billion in unfunded liabilities.

What to make of all this? For starters, it brings into sharp relief how the calculation of unfunded liabilities and contribution deficiencies – which determine how the public perceives pension plans – is so dependent on decisions made by policymakers. Given the special influence assumed investment returns and chosen timeperiods for paying off unfunded liabilities have on reported health, governments exercise considerable control over the presentation of pension reality they want to give to taxpayers.

The link between the investment income and the required contributions – higher expected returns lower the contributions needed – puts Minnesota’s chronic failure to make the necessary contributions in an interesting light. There’s a powerful incentive to lower current pension costs by assuming the money will work harder which Minnesota pursues with a vengeance using an expected return of 8.5%. Yet we still failed to make the necessary contributions – $4.5 billion short across all governments over 12 years – even though the most aggressive return expectations in the nation helped drive contribution requirements about as low as they could possibly go.

Finally, the difficulties of investing our way out of this are pretty clear. An 8.5% return is essentially treading water – making up $17 billion on top of that is a tall order for the state’s investment managers. As a rough illustration, think back to the Dow Jones Industrial Average numbers we quoted before. As a point of reference, an 8.5% compounded return beginning in July 2001 would have the Dow at nearly 81,000 by the end of June of 2026 – another 13 years down the road. To get there from where we’re at, the pension plans need to realize returns of nearly 14% for the next 13 years. Meanwhile any investment shortfall – even if it’s a positive return that’s less than 8.5% – creates new actuarial losses making the journey back to full funding that much more difficult.

from 4.75% to 6.25% of salary (a 32% higher rate) since July 1, 2001. All three statewide general employee plans – which cover the bulk of the state’s public employees – have seen their employee and employer contribution rates increase by at least 20%.

Salary increases: The normal cost for an additional year of benefits is computed using certain assumptions, one of which relates to salary growth. If salaries grow faster than anticipated, more money is needed to fund benefits, and there is an actuarial loss as actual costs come in above projections. Conversely, if salaries grow more slowly than anticipated, less money is needed to fund benefits and there is an actuarial gain. Influenced by two recessions during this period – one not so great, the other “Great” – government salary growth overall was consistently lower than expected, resulting in an actuarial gain for these retirement plans of $3.92 billion on a combined basis, offsetting some of the overall growth in unfunded liabilities.

Investment Income: When are near-all time record highs in investment markets not enough? The answer: when you are dependent on more than what those markets have given you. Investment income captures (in this instance) the collective impact of failing to meet the state’s expected investment returns of 8.5% annually. It is clearly the largest contributor to the actuarial losses, and the main driver in changes to these retirement plans’ financial health. Over this twelve-year period, sustained failures to hit the 8.5% return target created a staggering $22.69 billion in additional unfunded liabilities. To provide some sense of perspective on both the expectations and the “miss,” an 8.5% compounded return on the Dow Jones Industrial Average beginning in July 2001 would have the Dow at 28,120 today.

4 Technically the assumed return is 8.0% for the next four years then resuming to its normal 8.5% in perpetuity thereafter. The temporary 5 year decline was a negotiated measure to demonstrate some sensitivity and action on this issue.