It’s All About that Base, ‘Bout that Base, (and No Trouble)

Guest columnist Chris Martin of PricewaterhouseCoopers examines a Minnesota bill to accomplish prospective or “rolling” federal tax conformity, the rationale for pursuing it, and why the issue has special relevance for 2016.

Lost in the tension and political drama marking the end of the last legislative session, a rather low profile bill was introduced in late April to stave off considerable headaches and stress for taxpayers, practitioners, and government itself next tax filing season. The bill, HF 2282, tackles the always important and ever present issue of federal tax conformity — but doing it prospectively rather than after the fact.

Since Minnesota bases the starting point for corporate, individual, and pass-through entity income on federal law, federal conformity is an issue that affects all taxpayers and arises every year. But timing is a recurring problem. Typically, Minnesota’s legislature adjourns in May while Congress regularly waits until December to extend certain expiring tax deductions and income adjustments — often for a two-year period. As a result, federal conformity bills are commonly at the very top of the agenda in the early weeks of Minnesota legislative sessions before tax filing season kicks into high gear. For example, last year Congress did not pass a 2014 federal tax extender bill until mid-December 2014 with Minnesota expeditiously conforming to most provisions by January 24, 2015.

The additional wrinkle for conforming to any impending 2015 changes is that, due to the renovation of the Capitol, Minnesota’s legislature is not meeting again until March 8, 2016 — a mere 5 weeks before tax filing day. As a result, individuals and businesses must either wait for the Minnesota legislature to decide which federal changes to adopt and file at the relatively last minute, or file earlier knowing they may well have to amend their return later. The motivation and purpose behind HF 2282 is to offer a third alternative: conform Minnesota’s tax laws prospectively to any federal tax extensions (temporary tax provisions that expired at the end of 2014) that Congress may adopt later this year.

The Bill Specifics

HF 2282 lays out the federal tax extender provisions to which Minnesota would conform, and in which order; contingent upon Congress adopting some or all of them later in 2015 when the Minnesota legislature is not in session. The bill lists 22 “eligible federal tax preferences” and the order in which Minnesota would adopt them given the amount of tax revenue each is expected to cost the state. The items include continued addback of 80% bonus depreciation, full Sec. 179 expensing conformity, discharge of cancellation of debt income from a principal residence, treating mortgage insurance premiums (“PMI”) as deductible interest, treating certain qualified tuition costs and costs of teachers as deductible expenses, treatment of certain charitable contributions, part F exception for active financing income, and several other individual and business income tax deductions.

The bill allocates $105 million from the general fund to a special contingent federal conformity account in anticipation of paying for these overall revenue reducers for tax years 2015 and 2016. (A second draft of HF 2282 — never formally introduced — was less ambitious in conforming to only one year of federal tax extensions and excluding full conformity to Sec. 179 expensing, reducing the cost to Minnesota’s general fund to $20 million.) Under the language of HF 2282, even if the legislature failed to act in the following year by passing a federal tax conformity bill, the provisions of HF 2282 would stand as law in outlining which sections of the Internal Revenue Code (“IRC”) Minnesota chose to conform.

Beware the Ides of April

The rationale for pursuing something like this has extra currency in 2016 given the highly compressed time frame. The impacts start with government. The headache felt by the Minnesota Department of Revenue (“Department”) whenever Congress extends the temporary tax provisions later in the year will likely be a migraine next year.

1 See Minnesota House File 2282 (introduced by Rep. Lenczewski on April 30, 2015).

2 Note: some of the tax extenders, such as bonus depreciation and Sec. 179 expensing, are considering “timing” differences and relate to which year a deduction can be taken, while other tax extenders, such as discharge of cancellation of debt income and taking education costs as deductions, are “permanent” items and if not conform, would be lost by Minnesota taxpayers.
with the legislature adjourned until March. Any delay in federal conformity would assuredly result in wasted effort and taxpayer dollars by the Department. Even if the Department knows federal conformity will likely be pursued in some form, it must still draft tax return forms and instructions based on current law as written and cannot assume Minnesota will follow the federal updates. If the Minnesota legislature were to update conformity in March, the Department must then update the forms and instructions a second time. Plus, the Department will spend additional resources processing and correcting any “now inaccurate” tax returns filed before the legislature conformed, sending out notices, and processing amended returns filed (likely in paper form) after Minnesota eventually conforms.

The prospects for taxpayers are not any better. With the Department and tax software providers unable to update tax forms and instructions until March, individual tax returns intended to be prepared and filed in January and February will be pushed further out toward the April 15 deadline. This is even more of a concern for corporate filers that have a March 15 deadline, without extension.

Given the circumstances, many taxpayers may want to file their 2015 tax returns in order to see how Minnesota will conform to the federal tax extenders. Taxpayers could decide to file returns before the legislature returns in March in order to request a refund for overpayment of taxes rather than waiting until April to file. According to IRS data, nearly 75% of individual taxpayers claimed a refund when filing 2014 federal returns with the average refund nearing $2,800. One would expect a similar percentage of Minnesota taxpayers receive a refund. Whether one views tax refunds as an interest-free loan to the government or a forced-savings vehicle, the number of taxpayers anticipating, and possibly relying on, their tax refund in a timely manner is not insignificant. Any delays in conformity or in processing returns due to inaccuracies or due to a large volume of filers in March and April may impact households expecting a refund.

Not only do many taxpayers file for refunds, a sizable percentage file returns close to the deadline. Nearly one-third of federal individual income tax returns filed by the original due date were filed with the IRS in the three weeks preceding April 17, 2015. Assuming a similar ratio in Minnesota, any delay in conformity would likely mean an even greater percentage of returns will need to be prepared, filed, and processed by the Department during the last several weeks before April 15.

Given the potential ramifications for so many different stakeholders, it is not clear why this issue generally and the bill specifically went under the radar. A big part of the problem was timing—the bill was introduced after the House Tax Committee passed its omnibus tax bill. Meanwhile, tax practitioners and taxpayers may not have been aware of the impending consequences of the later start date for the 2016 legislative session, were focused on filing existing 2014 tax returns, or were distracted by tax policies the 2015 Minnesota Legislature was proposing to modify. Nevertheless, this issue will become very palpable next year, especially for tax preparers, practitioners, and taxpayers faced with an even shorter and busier spring tax filing season.

Concerns: Practical, Policy, and Constitutional

For all the advantages potentially offered by this bill, it is important to recognize some potential limitations and concerns. For starters, if Congress were to make any additional changes to federal taxable income beyond the 22 common federal tax extenders included in HF 2282, then this bill would not conform Minnesota’s tax laws to those additional provisions. As a result the Department would need to update the forms once in January and then again in March when the legislature returned. Some may say that conforming to most of the federal changes that affect Minnesota taxpayers is better than nothing, but it demonstrates how difficult it is for Minnesota to fully address the issue of contingent conformity.

The more important concern with HF 2282 relates to the policy implications. Government in general — and elected officials, specifically — should be held accountable for their action and inaction. A case can certainly be made that blindly conforming to federal tax law without a robust debate among Minnesota legislators bypasses the discussion of the policy rationale for conforming to or not conforming to certain federal tax provisions. Worse, conforming based solely on the amount of resources available for conformity does not lead to good tax policy. Without knowing which provisions are truly at stake, it seems difficult to have a debate on which ones to conform to and in which order.

A skeptic might argue that HF 2282, if it were to be heard in Committee, would not yield a vigorous debate among legislators on all 22 extenders since the bill is contingent upon Congress passing them. For example, it is unlikely legislators would spend time discussing whether to conform to some or all of the numerous charitable contribution provisions, or whether to conform to education expenses for teachers but not PMI as deductible interest, and in which order since it would all be hypothetical. While HF 2282 on its face seems to solve the problem of conforming prospectively, an engaged taxpayer should want its legislators to thoughtfully consider which provisions to adopt based on what is good for Minnesota’s citizens and businesses.

There may also be constitutional concerns with HF 2282. The bill itself cites Wallace v. Commissioner, 289 Minn. 220 (1971), the seminal case that found that per the Minnesota Constitution current legislatures can...

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3 In odd years, the legislature is required to begin session during the first week of January, leaving plenty of time for Minnesota to update its tax rules. In even years, the legislature sets its own start date, usually in late January or early February, with still enough time to address a time crunch for taxpayers.

4 Tax software providers, such as TurboTax and H&R Block, would also need to expend additional resources in writing and re-writing the software code used in the tax preparation programs.


7 All of the legal, political, and policy implications that go along with the fact that 35 states piggyback off of the federal tax code and use some line from the federal tax return as its own starting point are beyond the scope of this article. For an in depth discussion, see Ruth Mason, Delegating Up: State Conformity with the Federal Tax Base, 62 Duke L.J. 1267 (2013).
From The Director:
Doing “The Work of Angels”

Seventy-five years ago an effort was launched to make academics and government professionals the protectors and guardians of governmental research. Seventy-five years later what’s left of independent, citizen-supported research on government is needed more than ever.

Dr. Mordecai Lee, Professor of Urban Planning and Government Affairs at the University of Wisconsin, delivers such a tale in “Colluding to Create the American Society for Public Administration and the Consequent Collateral Damage.” It’s a fascinating, behind the scenes look at how the American Society of Public Administration (ASPA) – the largest and most prominent professional association dedicated to advancing the art, science, teaching and practice of public administration – rose to prominence 75 years ago by essentially demolishing the Governmental Research Association (GRA).

Once upon a time, the GRA was the only government research game in town. The GRA was formed in 1914, comprised of bureaus of municipal research rooted in the turn of the century Progressive Era movement, taxpayer associations, and similar organizations emphasizing citizen education about, oversight of, and participation in government. At its peak, GRA membership numbered over 400 and included non-profits, university based research centers, and governmental units. (Our two “parent” organizations, the Minnesota Taxpayers Association and the Minnesota Institute for Government Research – which merged together in 1956 – were both members, and MCFE continues its membership today.)

But frustration had been brewing within and outside the organization over time. Concerns about the quality of research (which ranged from awful to respectable), and the efficiency-focused orientation of many GRA member organizations created unease. Above all, there was a growing desire to advance the professionalization of public administration and “science” of government research, unfettered by the premises of participatory governance, citizen education, and public oversight that tended to dominate GRA perspectives and interests. The interest in reform grew, but to advance this agenda, the GRA needed to be neutered.

As tempting as it may be to “leave government to the professionals,” our society doesn’t and can’t work that way.

How could such a coup be orchestrated? Why using research, of course. As Professor Lee’s narrative describes, the turning point was a research project launched in 1937 purportedly designed to objectively appraise the current state of governmental research. In practice, the project was craftily designed to cause considerable consternation, anxiety, and fractures among the GRA membership, only to be unceremoniously dropped at precisely the right moment in a brilliant strategy of obfuscation and misdirection that would make K Street lobbyists envious. Outmaneuvered and broke, with a whiff of “anti-government” now hanging over the organization, the GRA quickly began to shrink in size and role yielding its historic influence to the newly-minted American Society of Public Administration. The ascendance of the professionalization of government research and the “science” of public administration was now at hand.

The situation today is a culmination of the reality created 75 years ago. ASPA now boasts nearly 8,000 practitioner and academic members, 21 “interest sections” covering the full gamut of government operations, a large and impressive array of scholarly journals, and a large range of professional development, education and training programs. Many members operate out of university-based centers of government and schools of public affairs and administration – the “go to” place for any grant-makers and foundations interested in supporting public policy research.

In sharp contrast, the GRA has shrunk to 26 organizational members. While a couple remain relative research and education powerhouses in their respective states; many others scrape along as best they with limited staff and even more limited budgets. As Dr. Lee himself said to attendees at the GRA Annual Conference in 2013, “You guys are in a really tough situation…You are doing the work of angels but nobody wants to fund you.”

This severely diminished state of citizen-based government research wouldn’t matter if government professionals and academics could deliver on all the informational and educational objectives government research needs to fulfill. But there are several reasons why – now more than ever – independent citizen-supported research remains an essential complement in support of good government.

For starters, government at all levels has grown exponentially over the decades in both size and complexity. With that growth, the need for investigations regarding the efficiency, effectiveness, and performance of government and government policy has grown as well. We now live in an era that requires an “all hands on deck” mentality with respect to government research.

More fundamentally, an “outsiders” analysis of government data, operations, and research findings is often necessary to generate a more complete, and therefore more accurate, perspective and representation of government activity. Our expanded analysis of the Price of Government, our practical assessment of the feasibility of value capture theory in transportation finance, our com-
mentary on misleading impressions about Minnesota tax and fiscal policy derived by simply equating tax incidence findings with tax fairness, and our exposure of the systemic, mathematically-grounded flaws in pension design are examples from just this past year of how outside analysis on government data and research findings offers necessary perspective to public policy debates.

Historically, however, the greatest contribution from citizen-supported research is filling research needs and gaps on tax prices and government cost structures. It’s worth noting that ASPA’s four core values are accountability and performance, professionalism, ethics, and social equity. Efficiency, the raison d’être of much of the historical GRA, is notable for its absence.

But the most important reason is that the role of the citizen in governance — and therefore the importance of citizen education — cannot and will not go away. Many committed individuals have dedicated their professional careers to the study, practice, and administration of government. As tempting as it may be to “leave government to the professionals,” our society doesn’t and can’t work that way. Indeed, the ASPA — founded largely as a professional antidote to the perceived GRA populism of the early 1900’s — fully recognizes and embraces the continuing importance of citizen engagement in and understanding of government.

Ironically, academic centers and professional research programs have now been built around GRA ideals from which the ASPA wanted to distance itself. The Sloan Foundation-sponsored National Center for Public Performance at Rutgers University specializes in “research and teaching in the engagement of citizens,” and “citizen-driven government performance.” In celebration of its recent 75th anniversary, ASPA members identified the 75 most influential articles from Public Administration Review — its professional journal. It’s striking how many have a strong citizen engagement theme. Examples from the last few years include “Citizen Participation in Decision-Making: Is it Worth the Effort?” and “The New Governance: Practices and Processes for Stakeholder and Citizen Participation in the Work of Government.” The idea that the merits of citizen participation could ever be questioned or would be considered a “new governance” model would make GRA founders roll over in their graves.

It would be ridiculous to suggest that the professionalization of governmental research specifically and public administration generally hasn’t yielded extraordinary “good government” benefits. Minnesota’s good government history is rooted in the strong ethic, capabilities, and professionalism of government administrators and the educational institutions that developed them. But it would be equally ridiculous to suggest that independent research and citizen education is now passé thanks to the professionalization of government. GRA-type organizations are in fact essential partners in the pursuit of good government, whether government interests realize it or not.

— M. H.

not bind future legislatures nor can current legislatures delegate their authority to make laws to the commissioner of an agency or to Congress. 8 Section 1 of HF 2282 states that it is consistent with the Wallace decision because the bill’s language is specific as to which federal provisions to adopt and in which order. However, this may be up for debate. The bill gives the Department the power to calculate the tax impact of the federal tax extenders, or to rely on congressional fiscal estimates as applied to Minnesota, listing which provisions Minnesota would adopt depending on when the contingency fund runs out of money. This could be viewed as giving the Department the power to determine where to draw the line regarding which provisions become law and which exceed the $105 million threshold.

Under HF 2282, the legislature would be conforming to federal tax extenders Congress may or may not pass. If Congress extends the tax provisions but modifies the language with respect to how they are implemented or computed, the legislature would be adopting those measures sight unseen. Or if Congress adopted twelve of the extenders, but sidestepped passing the other ten, the Minnesota legislature would be agreeing prospectively to conform to the twelve without knowing exactly which twelve those are. A constitutional challenge to a bill like HF 2282 would certainly raise the need for state resources to defend it and additional resources to adjust taxpayer returns already filed, if it were struck down.

Special Session Vol. III?

Since HF 2282 did not receive a hearing, what are other solutions to addressing federal conformity for 2015 and future years? One possibility would be for Minnesota to automatically conform to the IRC as seventeen states and the District of Columbia do. 9 However, automatic conformity would likely require a constitutional amendment 10 given the constitutional concerns outlined above.

Another option would be for Governor Dayton to call a special session in early January once it is clear which federal tax extenders Congress adopted. It may lack the emotional tug of a walleye lake, but it may be a wise decision and a lot more popular. The prospect of unhappy individual taxpayers unable to file tax returns claiming a refund during an election year is a situation every state elected official should want to avoid — and on a bipartisan basis. This would also allow the Department the chance to update tax forms and instructions, tax software providers to update their software code, more time for tax practitioners to prepare returns, and taxpayers to file timely, accurate returns. 11 If the legislature does not meet until March 8 as currently scheduled and even assuming the legislature passes a federal tax confor-

8 See Wallace v. Commissioner, 289 Minn. 220 (1971), citing Minn. Const. Art. X, s. 1, which reads in part, “The power of taxation shall never be surrendered, suspended or contracted away.”

9 See http://www.taxadmin.org/fta/rate/rgts_pts.pdf. States that automatically conform to the IRC for individual income tax purposes include Colorado, Connecticut, Delaware, Illinois, Kansas, Louisiana, Maryland, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Rhode Island, and Utah.

10 Missouri did just this in 1968. See Missouri Constitution, Article X, Sec. 4(d).

11 Special sessions may be called by the Governor and adjourned by the legislature. WCCO reported that special sessions cost taxpayers approximately $51,000 per day. Given the amount of time and resources to be saved by having clarity on Minnesota’s tax law, the cost of a special session may be well worth it.
Sometimes the perfect can be the enemy of the good, and while the language of HF 2282 was not perfect, it may have served its purpose by setting the stage for increased awareness of potential trouble brewing next spring. If the taxpayer and tax practitioner community come together and bring this concern before the Governor and legislators, a one-day special session in January may be just the fix needed that avoids constitutional concerns and makes the spring tax filing season as stress-free as possible for all those involved.

**Is Minnesota as Fiscally Healthy as We Seem to Be?**

A new national ranking study finds that, at least compared to other states, Minnesota may have some room for improvement. According to Minnesota Management and Budget’s (MMB) most recent Economic Update, the state finished FY 2015 with $555 million more than projected in the February Economic Forecast. That’s on top of the $865 million legislators left unallocated after crafting the state’s FY 16-17 budget and the $1.3 billion in the state’s budget reserve and cash flow account. So if asked what financial shape Minnesota is in, the correct response would appear to be, “just dandy, thank you.”

But whether or not general fund revenues are

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**MCFE News and Notes: Annual Meeting and More**

Be sure to reserve Wednesday, October 7 on your calendar today to join us at the St. Paul River Centre for our 89th Annual Meeting of Members and Policy Forum. We are especially pleased to announce Ecolab Chairman and CEO Doug Baker will be our distinguished luncheon speaker this year. Our policy forum features two timely topical sessions: the first on business tax fairness with respect to national and international tax policy; the second on what to do with our large and seemingly growing surplus.

Visit the annual meeting webpage on our website — www.fiscalexcellence.org — for a complete agenda and registration information. As always, anyone who is not an MCFE member is more than welcome to join us for the policy sessions and our annual meeting luncheon. So bring a friend or colleague and introduce them to the MCFE!

**Recent Release – Just How Accurate is Self-Reported Property Tax Information?**

We can tell you as well as anyone: comparing property tax burdens across locations is challenging. Tens of thousands of local jurisdictions nationwide have authority to tax property. Since these taxing jurisdictions often overlap, many states have thousands of unique rate combinations. An abundance of other structural features further complicates comparisons. For all these reasons, our 50 state property tax comparison study is limited to selected cities across the nation.

One way around these challenges is to use self-reported census data from property taxpayers themselves. But the accuracy of these findings is, of course, subject to the accuracy of the underlying self-reported data. The nature of the property tax and common public hatred towards it raises questions about how accurate this self-reporting is. Might homeowners exaggerate their burdens? Do they accurately estimate their home’s value? And do the biases, errors, or subjectivity often associated with self-reporting affect the accuracy of any effective property tax rates this data is used to compute?

With assistance from the Minnesota Department of Revenue, we examined these questions and published our findings in a Lincoln Institute of Land Policy Working paper (available for download at https://www.lincolnist.org/pubs/Working Paper #18 at the time of this publication). Among other things, we found that actual property tax burdens fell within the Census’ confidence margins of error two-thirds of the time in individual years and only half of the time in the three-year period studied. Concerning property valuation, we find that actual home values fell within the survey confidence margins 30% of the time when we looked at one-year data and in only 20% of instances when we reviewed records that cover three years. Homeowners overestimated the value of their residences nearly 90% of the time in the one-year data and over 80% of the time in three-year data. We do note these rather striking findings are likely influenced by the extraordinary turbulence of real estate values covering our study period.

Perhaps above all, evidence strongly suggests survey respondents do not factor in the effects of Minnesota’s homestead property tax refund programs when reporting property tax burdens. That’s not surprising but it’s something worth recognizing in all the constant public frustration expressed over property taxation. People are very aware about the dosage of tax medicine but tend to forget about all the spoonfuls of sugar the state offers to make it go down easier.

**Pension Guide Updated**

We have also updated (again) our Citizens Guide to Public Pensions, available on our website under the “studies” tab. This update includes 2015 law changes as well as including an expanded discussion of what is by far the greatest issue of contention in Minnesota public pension policy: the use of expected investment returns to discount pension liabilities.

Discounting pension liabilities using expected returns is often argued as the responsible way to avoid “over-contributing” for pension promises. As we point out, it’s just the opposite. There is no better way to threaten the long-term viability of defined benefit plans than by making them appear cheaper than they really are and undercutting necessary and fiscally responsible contribution policies as a result.
sufficient to cover a desired level of spending is only one dimension of fiscal health. For example, only about half of the state’s spending (52.7% in FY 14-15) is run through the general fund. The state collects and spends billions outside of the general fund, using what are instead called “special funds” to – among other things – provide financing for trunk highways or debt service or to account for federal dollars. In addition, a state’s fiscal health is also influenced by long-term obligations and by the capacity to respond to changing needs, demands and circumstances.

These facts about Minnesota state finances resonated when we picked up Ranking the States by Fiscal Condition, a new report issued by the Mercatus Center at George Mason University. Based on a methodology developed and first published in the Journal of Public Budgeting and Finance, the report provides a wide-ranging perspective on state fiscal health by ranking state fiscal health based on several dimensions of both short-term and long-term government solvency. Each solvency ranking is based on two or three quantitative indicators or measures of performance.

- **Cash solvency** (or liquidity) – the ability to pay its immediate bills over a 30-60 day time frame
- **Budget solvency** – the degree to which the state will end the fiscal year in surplus or deficit
- **Long-run solvency** – the ability to meet its long term commitments
- **Service-level solvency** – how much fiscal “slack” a state has to increase spending if necessary or demanded or respond to economic shocks
- **Trust fund solvency** – long term solvency analysis that also includes liabilities from pensions and other post employment benefit obligations

What makes this study unique – and less susceptible to the methodological faultfinding and nitpicking that occurs whenever a ranking study reports less-than-flattering results – is that most of the data come from state governments’ own Comprehensive Annual Financial Reports (CAFR). As a result, the report’s findings are based on a standardized and audited set of financial statements enabling consistent measurement and comparisons across states. In addition, when assembling the final rankings researchers standardized the raw values associated with each indicator by converting them into “z-scores”, which signify how many standard deviations each indicator is above or below the 50-state average. Standardizing the scores in this way provides a much better sense of each state’s relative fiscal health than using numerical rankings.

The area with serious potential for methodological quibbling is the weighting associated with each solvency area when calculating the overall scores. Researchers weighted the solvency areas based on their “budgetary immediacy” – i.e., measures with shorter

### Table 1: Financial Indicators Used to Measure Fiscal Condition, FY 2013: Minnesota Results

<table>
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<tr>
<th>Financial Indicator</th>
<th>Definition</th>
<th>Interpretation</th>
<th>Minnesota Results</th>
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<tr>
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<tr>
<td>1 Cash Ratio</td>
<td>(cash + cash equivalents + investments)/current liabilities</td>
<td>Higher ratio indicates greater cash solvency</td>
<td>28 1.48</td>
</tr>
<tr>
<td>2 Quick Ratio</td>
<td>(cash + cash equivalents + Investments+ receivables)/current liabilities</td>
<td>Higher ratio indicates greater cash solvency</td>
<td>32 2.01</td>
</tr>
<tr>
<td>3 Current Ratio</td>
<td>current assets/ current liabilities</td>
<td>Higher ratio indicates greater cash solvency</td>
<td>33 2.24</td>
</tr>
<tr>
<td>4 Operating Ratio</td>
<td>total revenues/ total expenses</td>
<td>1 or greater indicates budget solvency</td>
<td>12 (tie) 1.07</td>
</tr>
<tr>
<td>5 Surplus (Deficit) per Capita</td>
<td>change in net assets/population</td>
<td>Positive ratio indicates budget solvency</td>
<td>19 (tie) $437.74</td>
</tr>
<tr>
<td>6 Net Asset Ratio</td>
<td>restricted and unrestricted net assets/total assets</td>
<td>Higher value indicates greater long-run solvency</td>
<td>19 (tie) 0.13</td>
</tr>
<tr>
<td>7 Long-Term Liability Ratio</td>
<td>long-term (noncurrent) liabilities/total assets</td>
<td>Lower value indicates greater long-run solvency</td>
<td>26 0.28</td>
</tr>
<tr>
<td>8 Long-Term Liability per Capita</td>
<td>long-term (noncurrent) liabilities/population</td>
<td>Lower value indicates greater long-run solvency</td>
<td>19 $1,638</td>
</tr>
<tr>
<td>9 Tax Income Ratio</td>
<td>total taxes/state personal income</td>
<td>Higher value indicates lower service-level solvency</td>
<td>43 (tie) 0.08</td>
</tr>
<tr>
<td>10 Revenue Income Ratio</td>
<td>total revenues/state personal income</td>
<td>Higher value indicates lower service-level solvency</td>
<td>29 (tie) 0.14</td>
</tr>
<tr>
<td>11 Expenses Income Ratio</td>
<td>total expenses/state personal income</td>
<td>Higher value indicates lower service-level solvency</td>
<td>26 (tie) 0.13</td>
</tr>
<tr>
<td>12 Debt Income Ratio</td>
<td>total primary government debt/state personal income</td>
<td>Higher value indicates lower level of trust fund solvency</td>
<td>8 (tie) 0.03</td>
</tr>
<tr>
<td>13 Unfunded Pension Income Ratio</td>
<td>unfunded pension liability/state personal income</td>
<td>Higher value indicates lower level of trust fund solvency</td>
<td>40 (tie) 0.35</td>
</tr>
<tr>
<td>14 Other Postemployment Benefits (OPEB) Income Ratio</td>
<td>OPEB/state personal income</td>
<td>Higher value indicates lower level of trust fund solvency</td>
<td>1 (tie) 0.00</td>
</tr>
</tbody>
</table>

Overall State Fiscal Condition Rank: 31

Source: Ranking the States by Fiscal Condition. Mercatus Center at George Mason University.
time horizons were given greater weight. Thus, cash and budget solvency together account for 70% of a state’s final rank while the three remaining areas account for the remaining 30%. It is important to note that the Mercatus analysis is based on FY 2013 data, reflecting lag times for government releases of financial information that are common.

How did Minnesota turn out? Based on FY 2013 data, Minnesota ranked 31st among the 50 states in fiscal health. Table 1 lists each metric, its definition and interpretation in the context of the report, and Minnesota’s value and national rank for the measure. Following the table are some comments on each area.

Cash solvency: Although Minnesota ranks relatively low nationally at 31st, having $1.48 in cash and near cash for every dollar of current liability is certainly a reasonable position to be in with respect to paying the bills. (It’s certainly better than the 14 states whose short term liabilities exceeded their cash reserves.) We suspect our lower rank likely reflects the lingering reality of having raided the balances of so many state special funds to balance the general fund budget and our slower progress in 2013 on replenishing a budget reserve relative to some other states.

Budget solvency: By far our strongest area of performance. We can pay for our expenses and our per capita surplus was twice that of the national median. Take a bow, Minnesota.

Long-run solvency: Our ability to meet long-term obligations places us toward the middle of the pack nationally. Our net asset ratio is better than the national mean and median while the proportion of long-term liabilities to total assets is right around the national average. On a per capita basis, our long-term liabilities are 41% and 15% less than the national mean and median respectively.

Service-level solvency: This group of metrics reflects much of the conceptual thinking behind the Minnesota Price of Government but puts Minnesota’s situation in a one-year national context rather than a context that looks back over multiple years of in-state results. While the Price of Government report suggest that state and local government revenues relative to personal income have declined since the early 1990s, these results indicate that state government claims a relatively high amount of personal income compared to other states. Some argue that the decline in the Price of Government over time represents a decline in Minnesota’s investment in public goods and services and see that as a liability. Interpreting these metrics through the lens of service-level solvency illustrates how such figures can be interpreted differently: that state government’s relatively high claim on economic activity is a potential liability limiting our ability to respond effectively to another economic shock.

Trust fund solvency: Report rankings here may be a bit misleading. States like Minnesota — where local government employee pension plans are administered at the state level — have those local plans included in the analysis. However, in some states local pension plans are operated locally, and the analysis does not include those locally-operated plans. States where pensions are operated this way will have their pension liabilities underestimated vis-à-vis states such as Minnesota — making their rankings look better. Including all municipal pension plans across the country — understandably difficult at best — would likely push Minnesota’s ranking a little higher.

Nevertheless, part of our lower ranking reflects a methodological treatment that is necessary to compare legacy cost liabilities between states fairly. Reported pension plan health is hugely dependent on the rate chosen to discount future liabilities and states differ significantly in their use of discount rates. Minnesota has historically directed its actuaries to discount pension liabilities using rates that are among the highest in the nation.

To adjust for these discrepancies and allow interstate comparisons, the researchers discounted the pension liabilities each state reports using a risk-free discount rate. Regardless of whether one agrees with this method or not, it treats each pension plan the same. Moreover, because the rankings are based on the relative differences between each state’s standardized z-score and the 50-state average, increasing liabilities for every state does not bias the results to favor any particular philosophy.

So how does this change affect Minnesota? Using the state-specific discount rate assumptions, the combined funded ratio for the state pension plans places us 29th. Using the risk free discount rate drops our ranking by four places — to 33rd. The drop in rank is a testament to the power that the assumptions underlying the valuations have on an evaluation of a pension plan.

A Peek Ahead to 2014

This analysis covers FY 2013—a year for which the budget framework was enacted in

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Table 2: Financial Indicators Used to Measure Fiscal Condition, FY 2013 and 2014: Minnesota Results

<table>
<thead>
<tr>
<th>Financial Indicator</th>
<th>FY 2013</th>
<th>FY 2014</th>
<th>% Change</th>
<th>Change Positive/Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Cash Ratio</td>
<td>1.48</td>
<td>2.04</td>
<td>+37.7%</td>
<td>Positive</td>
</tr>
<tr>
<td>2 Quick Ratio</td>
<td>2.01</td>
<td>2.53</td>
<td>+25.6%</td>
<td>Positive</td>
</tr>
<tr>
<td>3 Current Ratio</td>
<td>2.24</td>
<td>2.78</td>
<td>+24.4%</td>
<td>Positive</td>
</tr>
<tr>
<td>4 Operating Ratio</td>
<td>1.07</td>
<td>1.06</td>
<td>-1.1%</td>
<td>Negative</td>
</tr>
<tr>
<td>5 Surplus (Deficit) per Capita</td>
<td>$437.74</td>
<td>$379.45</td>
<td>-13.3%</td>
<td>Negative</td>
</tr>
<tr>
<td>6 Net Asset Ratio</td>
<td>0.13</td>
<td>0.16</td>
<td>+22.2%</td>
<td>Positive</td>
</tr>
<tr>
<td>7 Long-Term Liability Ratio</td>
<td>0.28</td>
<td>0.28</td>
<td>-0.4%</td>
<td>Positive</td>
</tr>
<tr>
<td>8 Long-Term Liability per Capita</td>
<td>$1,638</td>
<td>$1,768</td>
<td>+7.9%</td>
<td>Negative</td>
</tr>
<tr>
<td>9 Tax Income Ratio</td>
<td>0.08</td>
<td>0.09</td>
<td>+2.1%</td>
<td>Negative</td>
</tr>
<tr>
<td>10 Revenue Income Ratio</td>
<td>0.14</td>
<td>0.14</td>
<td>-0.3%</td>
<td>Positive</td>
</tr>
<tr>
<td>11 Expenses Income Ratio</td>
<td>0.13</td>
<td>0.14</td>
<td>+0.8%</td>
<td>Negative</td>
</tr>
<tr>
<td>12 Debt Income Ratio</td>
<td>0.03</td>
<td>0.03</td>
<td>+8.0%</td>
<td>Negative</td>
</tr>
<tr>
<td>13 Unfunded Pension Income Ratio</td>
<td>0.35</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>14 Other Postemployment Benefits</td>
<td>0.00</td>
<td>0.00</td>
<td>+12.0%</td>
<td>Negative</td>
</tr>
</tbody>
</table>

Sources: FY 2013: Ranking the States by Fiscal Condition. Mercatus Center at George Mason University. FY 2014: MOCE calculations using data from State of Minnesota FY 2014 CAFR.
the context of a turbulent three-week government shut down with no new revenues. Of course, the following budget period – which lawmakers spent the first months of calendar year 2013 crafting – saw the passage of a major tax increase and the benefits of economic recovery. How has our situation now changed?

Table 2 (page 7) re visits these indicators based on the latest information, from the state’s 2014 CAFR. Perhaps unsurprisingly, liquidity improved dramatically. Interestingly, however, budget solvency measures declined over FY 2013. From what we can tell, that is primarily a function of non-general fund “business type activities” which includes such areas as the MNSCU system, the lottery, and unemployment insurance fund. In FY 2013 the charges these entities imposed for their services and the operating grants and contributions they received exceeded expenses, creating net revenue of about $200 million. Contrast that with FY 2014 when business-type activities instead spent more than they raised, to the tune of around $150 million – a $350 million swing from the previous year. Long-run and service-level solvency measures presented a mixed bag of changes. Of course, any change in Minnesota’s rankings for FY 2014 will depend just as much – if not more – on the decisions made in the other 49 states.

Inherent Limitations, Inherent Potential

Of course, the absolute measures themselves are ultimately much more important than any relative state rankings based on them. A state may have a ratio that is completely adequate and acceptable by general standards and practices of financial management but appear “bad” only when compared to other states. Or, a state can be the best-performing patient in a 50-state ICU. Like any relative ranking or comparison study, context still matters.

However, the report does prompt two welcome and important trains of thought. First, the report drives home the dangers of evaluating governments’ fiscal health using a limited perspective. Focusing entirely on the general fund while ignoring the $18-$20 billion in revenue and spending that passes through the state’s special funds creates a sizable blind spot in any evaluation of financial health. Moreover, ignoring the balance sheet in favor of an income statement-only perspective runs the risk of missing important trends in state liabilities and assets that have direct bearing on fiscal performance and sustainability. Taking a holistic perspective of the state’s finances is critically important.

Second, methodologies like this offer opportunities to benchmark and compare government financial performance. Comparing governments is irresistible, and there is no shortage of methods – developed both within the public sector and outside of it – for comparing the finances of state and local governments. Many of these methods are frequent targets of criticism because of the “uniqueness” of individual governments. But audited financial statements based on uniform accounting standards offer the possibility of transcending a significant amount of the complexity introduced by how governments have designed their budgets and their financial operations. It’s something we plan to look at much more closely over the coming months.