FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

The Reasons Behind Minnesota's National Property Tax Rankings

Our enhanced 50-State Property Tax Comparison Study now offers new perspective on and understanding about what drives Minnesota's effective property tax rates and rankings.

Ever since we published our first *50-State Property Tax Comparison Study* over 20 years ago, we've cautioned readers that that the comparative property tax burdens and rankings each tax system generates are only part of a larger story. Context matters, and any particular property tax ranking is best interpreted – perhaps even rationalized – by also understanding the framework and environment in which that property tax system operates. How much of the responsibility for funding local services like K-12 education falls to the property tax? Do local governments have viable options to the property tax – like a local sales or income tax – to finance their operations?

Answers to these and other questions can have a major impact on how one interprets the study's rankings. Now thanks to a collaborative effort with our partners at the Lincoln Institute of Land Policy, this study offers new perspective and understanding on the causes and reasons behind the rankings.

Higher local government spending offsets most of the benefit a Minneapolis homeowner realizes from the state's classification scheme

The "Fiscally Standardized City"

If you're familiar with our *50-State Property Tax Study*, you'll notice differences in the newest edition – in a positive way. We spent a great deal of time over the last eight months working with our partners at Lincoln to overhaul the report. The result is evident with major upgrades in general readability and in how information is organized and presented. But, the most notable change is a creative piece of research and analysis on why effective property tax rates (taxes as a share of a property's value) differ between various locations.

Such an analysis was possible by matching our property tax work with an ongoing and groundbreaking research initiative at Lincoln: the "Fiscally Standardized Cities" (FiSC) database.

The challenge with making fiscal comparisons between cities is that public service delivery can be organized in very different ways in different cities. While in some places city governments provide a wide array of public services for their residents and businesses, in other places a variety of overlapping governmental units (think counties, schools and special districts like the Three Rivers Park District) share responsibilities more equally. Making fiscal comparisons using just city government data can thus be highly misleading, especially when looking across states.

The FiSC database accounts for these differences in how governments deliver services, making it possible to compare local government finances for 150 of the largest U.S. cities across more than 120 categories of revenues, expenditures, debt, and assets. Lincoln constructs the FiSCs for each city by estimating the proportion of each overlying government unit's revenues that city residents and businesses pay and the proportion of their spending that benefits city residents and businesses. They then add those estimates to the city's own revenues and spending. Thus, FiSCs provide a full picture of revenues local governments raise within each city and spend on their residents' and business' behalf.

Our *50-State Property Tax Study* includes 73 large U.S. cities that are also part of the Lincoln FiSC database. Lincoln research staff performed a regression analysis and found that four factors explain about 75% of the variation in the effective property tax rates for median-valued homes among these cities (at very high levels of statistical significance). Those factors are:

- The degree to which local governments rely on property tax revenues
- Business subsidization of homeowners' taxes
- Median home values
- Total local government spending

Minnesota Center for Fiscal Excellence

Susan Haffield, *President*
Aaron Twait, *Research Director*
Mark Haveman, *Executive Director*
Linda Edstrom, *Executive Secretary*

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Postmaster, send address changes to:

Fiscal Focus
c/o Minnesota Center for Fiscal Excellence
85 East Seventh Place, Suite 250
St. Paul, Minnesota 55101

Phone: (651) 224-7477 or (800) 322-8297
Fax: (651) 224-1209

E-mail: question@fiscalexcellence.org
Web Site: www.fiscalexcellence.org

Table 1: Influence of Various Property Tax Factors on Effective Tax Rate

Influence of Factor on Effective Tax Rate On the Median Valued Home	Rank (n=73)	Impact On Tax Rate
Tax Rate = 1.42%	27	N.A.
Property Tax Reliance	24	0.16
Median Home Value	27	(0.10)
Local Government Spending	20	0.12
Commercial Subsidization of Homeowners	17	(0.14)
Influence of Factor on Effective Tax Rate on the $1 million Valued Commercial property	**Rank (n=73)**	**Impact On Tax Rate**
Tax Rate = 3.35%	7	N.A.
Property Tax Reliance	24	0.17
Median Home Value	27	(0.11)
Local Government Spending	20	0.15
Commercial Subsidization of Homeowners	17	0.24

Notably, Lincoln found that these same four factors explained a substantial amount of the variation in effective tax rates for all four property types in the study – homes, commercial, industrial, and apartments – in a statistically significant way.

Classification Benefits Offset by Higher Spending

A closer look at these findings yields some interesting insights into the relative influence these factors have on effective property tax rates in these 73 cities.

The effective tax rate on a median-valued home in Minneapolis in 2015 was 1.42%, which ranks 27th highest of these 73 cities. The 3.35% tax rate on a $1 million-valued commercial property ranks the city 7th of 73. The accompanying table shows how each of the four factors Lincoln identified is expected to change the effective tax rate in Minneapolis relative to a scenario where the city had the average value for that variable. For example, local governments in Minneapolis had the 24th highest reliance on property taxation. Based on the statistical modeling, this higher-than-average reliance on property taxation increases the effective tax rate on a median-valued home by 0.16 percentage points. Another way to interpret the data: if Minneapolis' local governments had just average property tax reliance and all other relevant tax and spending characteristics were unchanged, the effective tax rate on median-valued homes would be 0.16 percentage points lower, which at 1.26% would fall to 34th among the 73 cities.

The comparative influence of local spending and business subsidization of homeowner property taxes is particularly noteworthy. Lincoln estimates that Minnesota's higher-than-average business subsidization of homeowner taxes lowers Minneapolis homeowners' effective property tax rates by about 0.14%. Thus, if businesses provided only a national "average" level of subsidization, the owner of a median-valued home in Minneapolis would have a tax rate of about 1.56% – moving the rank of 27th up four spots to 23rd.

Interestingly, this classification just about offsets the higher property taxes that result from higher-than-average local government spending in the city. In other words, higher local government spending offsets most of the benefit a Minneapolis homeowner realizes from the state's classification scheme.

The reverse is true for owners of business commercial property. The 3.25% effective rate the owner of a $1 million commercial property pays ranks 7th in the nation. That high ranking is influenced by both higher-than-average local government spending (a 0.15% bump) but also by the classification scheme (a 0.24% bump). From a competitiveness standpoint, it's a one-two punch. Reducing the effective rate on commercial properties down to 2.86% would effectively put Minneapolis in a tie with Milwaukee, with the 10th highest rate.

Tax Prices Matter

A fundamental tenet of this organization is that accurate tax pricing is a cornerstone of good government. It's a key to ensuring that the levels of service that citizens demand of government are well matched with their desire to pay for them. While federal and state aids and other mechanisms provide important assistance in addressing public policy needs and not every citizen is equally able to pay for government services, Minnesota's tax system should not unduly insulate the majority of voters from financing government spending.

This is especially true for property taxes, where lawmakers' desire to protect voters from the tax is as least as strong as the public's hostility toward the tax itself. But preferential tax treatment arrangements like classification can backfire by distorting local tax prices and increasing demand for public spending beyond what the public would otherwise be willing to support – eventually leading to higher property tax burdens for everyone.

Our Issue Brief on the Minnesota-related findings of the 50-State Property Tax Study provides more data to support this hypothesis. As we have done for many years, the Issue Brief compares trends in property collections between states that subsidize homeowner property taxes and those that do not. As **Table 2** shows, between 1998 and 2013 property tax collections have grown more slowly per capita, and fallen twice as fast relative to income, in the ten states that offer little or no homeowner subsidy.[1]

We don't claim causality in these findings; lots of factors are obviously at play in this relationship. However, we do not believe that these 15-year trends are mere coincidence either. It makes fundamental sense (and academic research supports this idea) that greater homeowner sensitivity to property taxation would play a role in slowing overall property tax growth.

This highlights the political and fiscal problem for state lawmakers always so eager to protect citizens from the financial implications of their own local decisions. Over time, local property taxpayers can become so desensitized to the actual tax cost of providing local services that even eminently reasonable and affordable increases in local property tax prices will seem excessive and unjustifiable. Juxtaposing Voss report findings with ongoing complaints about property tax levels provides plenty of evidence of this phenomenon. It's something we urge policymakers to keep in mind when the next round of requests for more state spending on aids for local government inevitably come along. ■

[1] Those states being Delaware, Kentucky, New Jersey, Nebraska, New Hampshire, Nevada; North Carolina, Washington, Wisconsin, and Wyoming.

Table 2: Property Tax Collections, FY 1998 and FY 2013, for States With No Homeowner-Specific Assessment Limitations and With Classification Ratios < 1.05 and Remaining States

Fiscal Year	States with no homeowner-specific limited market value provisions and Classification Ratio < 1.050 (n = 10)		Remaining States (n = 41)	
	Prop Tax Per Capita	Prop Tax per $1,000 of Income	Prop Tax Per Capita	Prop Tax per $1,000 of Income
1998	$989.48	$37.66	$830.04	$32.51
2013	$1,617.56	$36.16	$1,412.58	$31.83
Percent Change	**63.5%**	**(4.0%)**	**70.2%**	**(2.1%)**

Property tax and population data from Department of the Census; income data from Bureau of Economic Analysis. Calculations by MCFE.

Pension Politics in 2017 Just Got A Lot More Interesting

Thanks to the Governor's veto of the 2016 pension bill and further deterioration of fund health, the table is set for some very complicated and controversial pension politics in 2017.

The governor's somewhat surprising veto of the 2016 omnibus pension bill was disappointing to many pension stakeholders but celebrated by others. That split reaction alone portends a rather interesting pension policy debate in 2017. But recent developments and their policy implications guarantee the hearings on the 2017 pension omnibus bill will be memorable. Here are three reasons.

1. **Another year of significantly missed investment return expectations (and likely more of them going forward) will add to the fiscal and political challenge.**

The end of the fiscal year marks the date when the snapshot on which pension fund valuation reports are based is taken. Even though the reports themselves won't be published until nearly Christmas, the start of the new fiscal year always offers a visit from the "Ghost of Actuarial Future" and "pension things yet to come." That's because the one-year performance of the State Board of Investment's benchmark indices offers a glimpse into what investment returns we can expect will be reported and in turn, the decision-making context legislators are likely to face in 2017.

Table 3 presents the performance of SBI's benchmark indices for the recently completed fiscal year. It's worth noting these reported returns are not influenced by Brexit-induced fret as the market had essentially recovered the vast majority of its post-Brexit losses by June 30th. Actual SBI returns will, of course, vary from what this table reports but don't be surprised to see the SBI report essentially flat returns later this year.

For the second year in a row, returns will have missed expectations badly, and fund conditions will weaken further. Because the state directs actuaries to phase in any individual year's investment gains or losses over a five-year period, the actuarial valuations might preserve superficial appearances as the final realization of gains from the post-Great Recession market boom offset 20% of these unmet expectations. But on a market value basis, the condition of these pension funds will unquestionably be worse. Thus, as advocates for the sustainability measures the governor vetoed this spring attempt to resurrect them, the sustainability challenge will have grown. It would not be surprising to see PERA also seek corrective actions similar to what TRA, MSRS, and St. Paul Teachers have been looking for.

Moreover, if some of the nation's foremost investment advisors are correct, any hopes of sustained bull markets need to be severely tempered. As Table 4 indicates, expectations for U.S. equities in the near term range from sluggish to pathetic, especially when evaluated against the return expectations our pension system is based on. The prognosis for fixed income is not any better as the end of June also ushered in an all-time low in the 30-year Treasury yield while negative bond yields are proliferating in developed economies around the world. Because the pension system's fulcrum is set at returns of

Table 3: Investment Returns of SBI Benchmark Indicies, FY 2016

Asset Class	Benchmark Index	7/1/15	6/30/16	% Change	Weight*	Weighted
Domestic Stocks	Russell 3000	1,236.12	1,236.62	0.0%	46.3%	0.0%
International Stocks	MSCI ACWI ex U.S.	44.18	38.99	-11.7%	14.4%	-1.7%
Bonds	Barclays Capital Aggregate Bond Index	108.78	112.61	3.5%	24.7%	0.9%
Alternative Investments	Q1-Q3 actuals, Q4 est based on 10-year avg			3.1%	12.6%	0.4%
Cash	S&P/BGCantor U.S. Treasury Bill Index, 0-3 months	215.91	216.20	0.1%	2.1%	0.0%
Weighted Total						**-0.4%**

* Weights determined using average of actual SBI holdings, 1st quarter 2015 through 1st quarter 2016.

Table 4: Expected Nominal Returns for U.S. Equities from Selected Investment Firms

Firm	Ave. Annual Nominal Return (%)	Horizon (years)
Bogle and Nolan	7	10
Charles Schwab	6.3	10
Goldman Sachs	4.7-5.5	5
GMO	-0.1	7
J.P. Morgan	7	10-15
McKinsey	6.0-9.0	20
Morningstar	6-7	Next few decades
Research Affiliates	3.2	10

Source: "The Funding of State and Local Pension Plans: 2015-2020" Center for Retirement Research, Boston College, June 2016

8%, a protracted period of underperforming – although positive – returns can be just as or even more damaging as a one-year major market correction. That's especially true for underfunded plans needing superior investment returns to both dig out of an existing hole and fund new obligations.

2. Pressure for new direct or indirect state pension aids will increase.

In testimony before the Legislative Commission on Pensions and Retirement this year, school district officials made it abundantly clear they didn't have the capacity in their budgets to absorb increased pension costs and wanted state aid to pay for it. Our recent education finance study validates these concerns as we projected that for about 75% of districts, growth in compensation costs through FY 2017 (assuming historical trends remain unchanged) would exceed the 2% per year increase in basic formula aid the state enacted in 2015. There is no reason to believe the position of school boards and administrators will change in 2017. As pension plans' conditions worsen, we can expect the approximate $45 million needed to cover districts' additional pension costs in 2016 to climb northward in 2017.

Not only would a special appropriation for school pension support be a lightning rod of political controversy, it would open a Pandora's box of brand new "fairness" concerns among all public plans while establishing an increasingly expensive precedent. State agency managers would justifiably want to see larger appropriations to offset the impact of their higher cost structures. Meanwhile, local governments would commit lobbying malpractice if they didn't argue what's right for schools is also right for cities and counties. In fact, the policy position of the influential League of Minnesota Cities already states,

> *"for the PERA General Plan, any further increases in employer contributions should only be considered by the Legislature after other measures have been considered, including:*
>
> *a) an increase in employee contributions so that employees and employers truly bear the same responsibility to bring the pension plans to full funding; or*
>
> *b) the removal of the cap on PERA Pension Aid payments so the state equalizes the contributions of employees and employers."*

The other option will be to advocate for major increases in existing operating aid programs with additional money directed to pension support. If very visible aid increases specifically dedicated for pensions are too politically uncomfortable, expect big pushes for major increases to the school aid formula, LGA, and County Program Aid instead. While such pursuits would have their own political obstacles, the primary political advantage is that stakeholders can market the additional money to the public and press as "investment in our communities and schools" instead of as an additional expense for the same pension benefits.

The biggest disadvantage of defined contribution retirement plans – sequence risk – is infecting state defined benefit plans.

3. Major cracks in the foundation of "shared sacrifice" start to appear

Pension plan boards and public employee unions work very hard to keep all the different sub-interests singing not just from the same hymnbook with respect to pension policy, but also from the same page. That's not easy to do. The interests of younger active employees may conflict with those approaching retirement which in turn may conflict with retiree interests. As a result, stakeholders and lawmakers are extremely sensitive to the notion of spreading any discomfort corrective actions create around as fairly as possible. As the governor's veto demonstrated, policy initiatives can collapse when even the appearance of an imbalance in "shared sacrifice" arises.

The standard recipe for shared sacrifice has always been equal parts employer and employee rate increases plus a dash of lowered cost of living adjustments for retirees. But even these carefully measured ingredients don't guarantee fairness will be baked into state pension policy. For example, with respect to a permanently lowered cost of living adjustment, the accompanying table illustrates why recent retirees might ask just why they are being treated in the same way as longer-term retirees – many of whom have already benefitted from an increase in their base pension benefit since their retirement that is well over two times the rate of consumer inflation.

On the contribution side, pressure is building to deviate from historical policy which has more or less required employees and employers to fund the system equally. With more and more dollars being directed to take care of existing unfunded liabilities, there is increasing reticence to saddle current government employees with the pension costs of their predecessors. The vetoed 2016 omnibus bill would have set the employer contribution rates for the general MSRS plan and TRA one percentage point higher than the employee rates, on the grounds that current employees should not be penalized because retirees are living longer than expected.

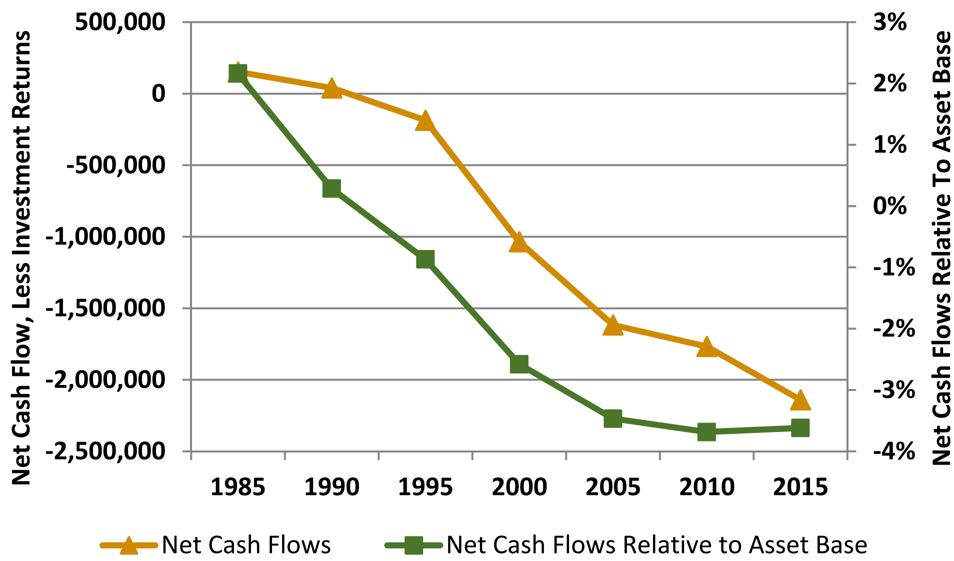
The problem, of course, is that from a practical perspective, the differentiation between an employee and employer contribution is not that clear cut. Local governments and state agencies may remit pension contributions to the SBI, but similarly to business taxes a lot of incidence of those contributions will ultimately fall on government employees. Based on plan valuation reports

Table 5: Comparison of Retiree Benefit Increases to Inflation, Selected Pension Plans

Retirement Year	Cumulative Change Through 1/1/2016			
	Consumer Price Index (CPI-W)*	MSRS-General Retiree Benefit	PERA-General Retiree Benefit	TRA Retiree Benefit
1990	89.1%	200.1%	182.8%	188.4%
1995	59.2%	137.5%	123.9%	128.3%
2000	42.0%	53.8%	44.9%	47.8%
2005	25.6%	27.4%	20.1%	22.5%
2010	10.6%	12.6%	6.2%	8.2%

* Weights determined using average of actual SBI holdings, 1st quarter 2015 through 1st quarter 2016.

Figure 1: Net Cash Flows and Net Cash Flows Relative to Asset Base for Major Minnesota Public Pension Plans (less investment returns), 1985 through 2015



we estimate that by the end of FY 2015, increased contribution rates for Minnesota's major public pension plans above their FY 2009 levels directed an additional \$1.4 billion in resources to pension support. Or to put it another way, that's over \$500 million in redirected takehome pay and another \$900 million of potential salary growth that never materialized. The prospects of government employers having to commit larger and larger shares of potential compensation dollars to pensions is likely to hang like a dark cloud over wage negotiations in union contracts for the foreseeable future.

As a result, bigger grumblings from within over the fairness of "shared sacrifice" proposals in 2017 seem very likely to emerge. A temporary 1% reduction in the cost of living increase on a retiree's benefit (which in conjunction with Social Security already is designed to replace over 90% of the income from one's peak earning years[2]) will likely be on the table again next year. Meanwhile, school districts and teachers are already collectively directing 15% of payroll to pay for pension support. Will going up to 16% or more of wage compensation seem like equivalent sacrifice to a college loan-stuffed young teacher, especially when the benefit will not be realized for 30 to 40 years?

[2] According to the report *Retirement Plan Design Study*, published by the Minnesota State Retirement Plans, in June 2011, state defined benefits plans are designed to replace 85%-90% of pre-retirement income in conjunction with Social Security. However, since retirees no longer pay into Social Security, Medicare, or their pension plans – which totals roughly 13-15% of pre-retirement income – the pension-plus-Social Security effectively replaces even more than 85%-90% of the preretirement income retirees actually had available to spend.

Our Margin for Error is Vanishing

In large part, the 2017 pension bill will be about making the money pension funds need available to them as soon as possible. That objective already faces some self-imposed policy obstacles which facilitate chronic underfunding, like elevated return expectations, extended amortization periods, and protracted contribution phase-in periods. Even though some of these practices drive the actuarial required contributions (ARC) for the pension plans down, collectively the state's major public pension plans have still not made the required ARC for 12 years in a row. That's not an accident.

Those policies could be fixed (at considerable political risk and government expense), but there's a bigger issue that cannot. Thirty years ago, Minnesota's pension plans brought in more from contributions than they paid out in benefits, allowing for the excess to be invested to meet future retirement commitments. Thanks to changing demographics, that is no longer the case. Figure 1 graphs the 30-year history of the net cash flows for Minnesota's major public pension plans, after taking out investment returns. Last year alone, these pension plans paid over \$2 billion more in benefits than they received in contributions from all sources. It puts the \$85 million "fix" from the increase in employer contributions proposed this year in some perspective.

Why does this matter? As this trend continues, and less capital is retained to invest, it will become more and more difficult to rely on investment performance alone to solve these pensions' financial problems. In the process the primary advantage of even having defined benefit pensions plans – risk mitigation – is being undermined.

From a retirement interest perspective, the strongest argument in favor of preserving defined benefit pension plans is that they eliminate "sequence risk". Numerous studies have demonstrated how two people in defined contribution plans with identical salaries and salary growth, identical career lengths, identical investments, and even identical average annual returns can have differentials in wealth at retirement in the hundreds of thousands of dollars due only to "when" they started investing. Sequence risk results from getting the "right" returns in the "wrong" order – like having the bad years closer to retirement when more wealth is exposed. In theory, defined benefit plans eliminate this risk because stable pools of cash flows going in and out relative to the size of the asset base makes "how" investment returns materialize irrelevant. But if defined benefit plans experience big cash flows in either direction, sequence risk is back on the table.

As **Figure 1** shows, once upon a time sequence risk was a non-issue for state defined benefit plans. Growing contributions from an increasing public sector workforce and positive worker to retiree ratios kept net cash flows in good shape helping to insulate plans from bad market years. Today the demographics have flipped and billions more go out than come in – even with our recent history of employee and employer contribution increases. Nor have past contributions increases put a dent in net cash flows relative to the asset base – in this regard, the sustainability repairs of recent years are better described as "treading water."

As a result our margin for error in occasionally "missing" investment return expectations is vanishing. The impact of any bad year or string of poor years is aggravated by gradually declining net cash flows within pension funds. And with these negative cash flows the biggest disadvantage of defined contribution retirement plans – sequence risk – is infecting state defined benefit plans.

All this together points to a "new normal" of increasing contribution pressures. Whether legislators will come to grips with this or simply continue to apply the same band aids of "shared sacrifice" remain to be seen. ■

MINNESOTA CENTER for
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85 East Seventh Place
Suite 250
St. Paul, MN 55101
(651) 224-7477

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Save the Date!
Wednesday, October 5

MCFE Annual Meeting and Policy Forum

Be sure to reserve Wednesday, October 5th on your calendar today to join us at the St. Paul River Centre for our 90th Annual Meeting of Members. Once again we are developing an agenda filled with national and state experts to discuss tax and fiscal policy topics making headlines.

We are especially pleased to announce our tax panel this year will examine the state of state tax administration. As debate in the 2016 session illustrated, Minnesota tax administration appears to be an enigma wrapped in a riddle. A prestigious national benchmarking study continues to show that Minnesota ranks near the top of the nation in the quality of statutes and rules governing administrative processes that impact taxpayers' perceptions of fairness and efficiency. Yet many state tax practitioners are voicing considerable and growing frustration with the current state of state tax administration, leading to calls for an upgrade of Minnesota's existing "taxpayer bill of rights" to better guarantee fair and equitable treatment.

Why the incongruity? What has changed? What are tax practitioners' primary process and procedural concerns? Can they be addressed without creating unintended consequences or undue administrative costs? And what administrative and procedural matters should we be thinking about now as we look ahead to the evolution of state and local tax issues? A distinguished tax panel will explore these questions as well as findings of an MCFE survey of state tax professionals in discussing how to advance a strong ethic and system of voluntary compliance through fair, efficient, and equitable tax administration.

Immediately preceding our policy forum, our annual meeting will begin with a morning business session. Please join us for this session as well since it is an excellent opportunity to network with other members and to become more familiar with the activities, initiatives, and accomplishments your membership support has made possible.

As always, individuals who are not MCFE members are more than welcome to register and join us for the policy forum portion of the conference and the conference luncheon. Bring a friend or colleague and introduce them to the MCFE.

Look for much more information including the complete agenda as well as registration details in the very near future. Annual meeting information will also be posted on our website, www.fiscalexcellence.org

We hope to see you on October 5! ■