FISCAL FOCUS

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Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

Taking Inventory of the 2015 Tax Bills

A look at some of the potential fodder comprising forthcoming omnibus tax bills.

Committee deadlines have come and gone, and the 2015 Session's homestretch has commenced. Some early indications suggested the tax conference committee might be more sedate than usual – based on the Republican-controlled House Tax Committee's message of political pragmatism. In spite of House DFLers "double dog daring" their Republican counterparts to put forward a tax bill that uses the surplus to unwind the 4th tier of the income tax, Chair Greg Davids has expressed no interest in a highly political and functionally symbolic tax bill that Governor Dayton will not sign.

Yet, not only are there strong differences of opinion between the Senate and House, but their numbers are light years away from each other. Together, this creates the potential for some end of session fireworks. A closer look at the potential content for the omnibus tax bills reveals some likely focal points of discussion as well as messages about the current state of Minnesota's tax system.

> Its adoption would likely lead to an avalanche of special interest attempts to dedicate other sales tax streams to their preferred causes.

Sales Taxes: The Costanza Effect

In a memorable episode of *Seinfeld*, George Costanza, frustrated by how his life is turning out, achieves extraordinary professional and personal success by deciding to do the complete opposite of what his sense of good judgment tells him to do. Perhaps in light of the political and public fallout of recent ill-fated sales tax reform efforts, this year's sales tax bills exhibit signs of a "Costanza effect."

Two years ago some well intended, principle-grounded (if occasionally deeply flawed) bills attempted to modernize Minnesota's sales tax and improve state tax policy by broadening bases and lowering rates. Sales tax bills this year reflect a 180-degree turn – the tax policy equivalent of George's chicken salad on rye. Base broadening proposals are a distant memory replaced instead by sales tax ideas of dubious tax policy merit.

Of biggest concern are the proposals to strip sales taxes raised through auto part and tire purchases from the general fund and dedicate the revenues to transportation funding. The proposal is part of a larger GOP effort to dedicate existing general fund revenue streams for transportation. According to the Department of Revenue, sales tax revenues on auto parts sales alone will be about $384 million for the coming biennium, rising to around $500 million in FY 18-19.

Any popular appeal this idea might have is more than offset by considerable problems with respect to both tax administration and precedent. Since retailers do not record sales tax collections by item, the administrative costs associated with separately tracking and reporting the tax on selected items is prohibitive. As a result, the bill (HF 215/SF 1106) directs Revenue to estimate the percentage of total sales tax revenue attributable to these sales every four years, based on federal data and the department's consumption models. Which raises the question: if we are going to use (highly) educated guesses to allocate revenues, couldn't we accomplish the exact same outcome with far less time and effort while preserving future budget flexibility by simply appropriating $384 million from the general fund to transportation in the next biennium?

As problematic as the administrative issues are, the precedent this proposal would create is no less troublesome. Its adoption would likely lead to an avalanche of special interest attempts to dedicate other sales tax streams to their preferred causes. Back to school products to school finance. Mountain bikes to trails and parks. Smoke alarms and carbon monoxide detectors to underfunded police and fire pensions. All such proposals would be no less legitimate and all would face the same administrative and implementation challenges while making the tax system a de facto appropriations machine.

Other bills that head in the opposite direction of the sales tax policy ideal include the usual collection of tax expenditure proposals. Sponsors usually intend to support a special cause, group, or even economic development in a particular area. As of the Easter/Passover break we count 21 bills of this nature introduced this year, which would exempt a range of items from digital

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products to herbicide sales for invasive species to infant car seats to admission to nonprofit BMX racing tracks. Individually they are mostly very small carve outs of tiny fiscal impact. Collectively, they would join the well over $1 billion of sales tax revenue from consumer goods and services that is already foregone annually for various policy reasons.

Property Taxes: Eyes on the State General Tax

After serving as a focal point of the tax committees in past years, local property taxes have been less conspicuous this year. High profile tax relief proposals have been replaced by the normal assortment of bills pertaining to increases or adjustments in local government aids, classification tweaking, various exclusions for pet property types or property characteristics, and TIF. One notable exception is the push for farm property tax relief. The Republican takeover of the House was the result of a rural tsunami, so unsurprisingly rural legislators of both parties have shown an interest in farm property taxes. Lawmakers have introduced a couple of proposals to reduce property taxes related to school debt on farmland.

On the other hand, legislators have given considerable bipartisan attention to the state general tax. Several bills have been introduced to either reduce the tax, change the tax base, eliminate the automatic inflator, refund the tax in certain instances, enact some permutation of these items, or get rid of the tax altogether. If business tax relief is part of a final tax agreement, the general tax will be a likely delivery vehicle as any business with property in Minnesota would benefit.

As testimony on these proposals highlighted, the state general tax routinely adds 25% to 30% to a business' property tax bill. **Table 1** demonstrates how the state general tax impacts Minnesota's property tax competitiveness on a regional basis, showing results from our most recent 50-state property tax comparison study with and without the tax. Commercial impacts are greater since Minnesota's exemption of personal property is more advantageous for industrial (manufacturing) properties. While most everyone agrees that the state general tax is bad tax policy (echoing the findings of the bipartisan 2012 Property Tax Working Group report), it's clear that revenue losses are the primary barrier to change.

Table 1: Payable 2013 Commercial Property Tax Burdens, Minnesota and Other Upper Midwestern States

Commercial Properties – With Minnesota Statewide General Levy

VALUE OF REAL PROPERTY:	$100,000		$1 Million		$25 Million	
States	**Urban**	**Rural**	**Urban**	**Rural**	**Urban**	**Rural**
Minnesota	**$3,434**	**$3,878**	**$43,434**	**$49,147**	**$1,124,380**	**$1,272,580**
Illinois – Chicago	4,231	--	42,313	--	1,057,835	--
Illinois – Remainder	3,867	2,710	38,668	27,105	966,691	677,624
Iowa	4,689	3,378	46,894	33,782	1,172,352	844,540
Michigan	4,895	3,449	48,951	34,491	1,223,773	862,274
North Dakota	1,400	1,248	14,001	12,483	350,036	312,068
South Dakota	1,780	2,320	17,804	23,200	445,095	580,000
Wisconsin	3,364	2,754	34,369	28,116	861,168	704,441
Upper Midwest Avg.	**$3,458**	**$2,820**	**$35,804**	**$29,761**	**$900,166**	**$750,504**

Commercial Properties – Without Minnesota Statewide General Levy

VALUE OF REAL PROPERTY:	$100,000		$1 Million		$25 Million	
States	**Urban**	**Rural**	**Urban**	**Rural**	**Urban**	**Rural**
Minnesota	**$2,630**	**$2,966**	**$34,515**	**$37,449**	**$856,914**	**$969,190**
Illinois – Chicago	4,231	--	42,313	--	1,057,835	--
Illinois – Remainder	3,867	2,710	38,668	27,105	966,691	677,624
Iowa	4,689	3,378	46,894	33,782	1,172,352	844,540
Michigan	4,895	3,449	48,951	34,491	1,223,773	862,274
North Dakota	1,400	1,248	14,001	12,483	350,036	312,068
South Dakota	1,780	2,320	17,804	23,200	445,095	580,000
Wisconsin	3,364	2,754	34,369	28,116	861,168	704,441
Upper Midwest Avg.	**$3,357**	**$2,689**	**$35,804**	**$28,089**	**$866,733**	**$707,162**

Source: *50-State Property Tax Comparison Study, Payable 2013*. Minnesota Center for Fiscal Excellence and Lincoln Institute of Land Policy. Includes unpublished data.

Individual and Corporate Income Taxes: Tax Expenditure Ideas are Alive and Well

One of the interesting curiosities of tax policy in Minnesota has long been the conflicted and bifurcated thinking regarding the ability of taxes to affect behaviors. Policymakers are frequently skeptical that general tax policy influences either individual or business decision-making – the debate over the fourth income tax tier provides all the evidence one could want of this. At the same time, policymakers often place great faith in the notion that aligning economic incentives with outcomes matters when they want to advance a very specific social or societal outcome. This leads to all sorts of proposals to tweak the tax code in relatively tiny (but often administratively problematic) ways to incentivize certain decisions or reward desirable actions.

Such proposals abound (again) this year; as of this writing we count 45 bills attempting to incentivize or reward very particular actions. Unsurprisingly, the majority of these proposals are individual and/or corporate income tax credits, deductions, or subtractions. To illustrate, here is a partial list of behaviors income and corporate tax expenditures introduced this session would encourage filers to:

- Hire veterans
- Train employees
- Sell equipment to beginning farmers
- Sponsor school lunch programs
- Sponsor workforce housing development
- Sponsor school angel funds
- Hire ex convicts
- Sponsor Pre-K programs
- Implement renewable energy systems
- Give to community foundations

- Preserve old barns
- Complete a masters degree (teachers)
- Sponsor minority teacher programs
- Make home modifications for disabled residents
- Keep retired military veterans in state

Ironically, several of these proposals would provide benefits that would likely accrue more to higher income/wealth households, undercutting the much-heralded progressivity advancements made in Minnesota's tax system over the last few years.

In contrast to these relatively low impact, targeted initiatives, two tax expenditure proposals – with a stronger "relief" ambience about them – would have substantially larger fiscal impacts. The first would reduce or phase out taxation of Social Security income; the second would set a 7.85% maximum tax rate for active pass-through business income. The former comes with a price tag of about $120 million in the upcoming biennium (increasing to $326 million in the out-biennium) while the latter is priced at $355 million for FY 16-17. With the House Tax Committee chair's name on both proposals, these are prime candidates for the $2 billion House leadership has allocated for tax reductions.

From a policy standpoint these bigger proposals present some challenging issues. Ever-blunt David Brunori of State Tax Notes comments that there is simply "no theory of taxation" under which age alone should exempt a person, adding that "it doesn't square well with either the ability to pay or the benefit theories of taxation." As we have noted before, this preferential treatment is unlikely to score too well on horizontal equity considerations either. It's not difficult to dream up working families with similar incomes that pay much higher effective tax rates. The business pass-through rate reduction is symptomatic of a larger issue – that our tax system has a long history of favoring pass-through entity structures. An ideal tax system would neither favor nor disfavor particular organizational choices.

From The Director: What Public Pensions and Geology Have in Common

In 1915, German scientist Alfred Wegener published a paper that first proposed the theory of continental drift. His radical idea was based the striking similarities in rock and fossil records on the opposite sides of the Atlantic Ocean. For 50 years this transformational theory was met with tremendous resistance from the scientific community. It received considerable scorn, jeers, and derision – especially from those who were invested heavily in the geologic theories of the period. But those stubborn rock and fossil records still demanded some explanation. Over time other scientific evidence accumulated supporting his idea, and the well-established science of plate tectonics was born.


Mark Haveman

Watching Pension Commission hearings and observing members struggle with the arcane world and terms of actuarial science, I was reminded of this history. For a very long time something rather radical and fundamental has been gnawing at the edges of actuarial practice – and has been met with resistance by many actuaries and especially by those who employ them in the public pension world. As this issue notes, most of these calls for new thinking have come from the outside by financial economists and analysts.

However in 2001 a seminal article appeared in the Society of Actuaries' *Pension Section News* with the provocative title "The Model Has No Clothes." For the first time a rock was being thrown at the stained glass window from inside the church. Two years later a no-less controversial paper appeared entitled, "Reinventing Pension Actuarial Science." The debate accelerated. Several years after that an article entitled "The Actuary's New Clothes" appeared in *Contingencies*, the magazine of the American Academy of Actuaries. It concluded with this:

> *The weaknesses in the traditional pension actuarial model must therefore be addressed. The principles of financial economics offer an important tool in addressing some of the weaknesses and developing a more robust actuarial model for the valuation of pension plans. The new model, to survive the next few decades,* ***must shift the focus from calculating expected values to assessing the risk of underfunding*** *and must strive to be more transparent (emphasis mine).*

All this could be dismissed as an incomprehensible, wonky math fight if so much wasn't on the line. Everyone – current employees, retirees, government officials and taxpayers (present and future) – have a mammoth stake in getting this right. And as this debate shows, the standard refrain used to justify the status quo – that governments are measuring their pension liabilities using assumptions that are consistent with the actuarial profession's standards of practice – conveys far less uniformity of opinion and confidence than it once did.

Despite the epithets thrown in Wegener's direction for so many years, the mystery of those rock and fossil records required an explanation. Similarly, as easy as it is to dismiss critics of current pension policy as nothing more than alarmist, anti-public sector zealots, the mystery of how average annual investment returns exceeding 10% for over 30 years can result in an $11-plus billion pension hole begs scrutiny.

— M. H.

Estate Taxes: Is Chasing Some Wealthy Away "Worth It"?

Legislators have also spent considerable time on Minnesota's estate tax this session. A year after repealing the state's short-lived gift tax, policymakers, with bipartisan interest, are focusing their energies in two areas: providing portability of unused spousal exemptions and increasing the amount of estate value exempt from taxation from the current $1.4 million for 2015 deaths (scheduled to increase to $2.0 million by 2018). More often than not, proposals to increase the exclusion amount would conform to federal law, which provides for a $5.43 million exclusion for 2015 deaths and increases annually with inflation; with other proposals offering a more modest increase. These proposals do come with a cost – bills to conform to the federal exclusion amount are projected to cost about $150 million in FY 2016-17 and $170 million in FY 2018-19; the cost of providing unused exclusion portability between spouses is as yet unknown.

Proponents of these changes point to a number of reasons for doing so, including difficulties some small businesses have in passing ownership from one generation to the next while maintaining viability, the high costs of complying with two different sets of estate tax rules, and the disincentive Minnesota provides to the wealthy to stay in the state during their retirement years because the state's exclusion amount is substantially lower than most other states that have an estate tax. Opponents' concerns generally fall into one of three areas: reducing the highly progressive estate tax would mitigate some of progressivity improvements the state made to its tax system in 2013-14, that the estate tax operates as a "backstop" to the income tax by imposing a tax on earnings – especially capital gains – that are not realized during an individual's lifetime and which would be passed along to heirs tax-free, and that other priorities – especially K-12 education, human services, and broad-based tax relief – should have a higher claim on the state's surplus.

By all indications, neither chamber's tax plan will be unveiled until the end of April, making for a frenetic end to the 2015 session. But when all is said and done, the ideas and positioning leading up to the conference committee may eventually turn out to be far more significant than the end result. That's because, with all legislators up for reelection in 2016, the process matters as legislators and candidates look to fire up their bases. As a commentator on tax policy said many years ago, even if bills don't get passed, they may create a different, and no less desirable, result – political contributions. ■

The "Devil's Dictionary Guide" to the End of Session

The approach of the tax conference committee and the end of session is not only hectic, but also confusing, with a lot of legislative terms thrown around. Fortunately, former Texas State Deputy Comptroller and *State Tax Notes* columnist Billy Hamilton has done everyone a favor by publishing two volumes of his "Devil's Dictionary of Taxation." In light of our educational mission, here are some of his definitions of tax-related terms likely to be heard over the next few weeks (with an additional one or two of our own).

Budget: A plan designed to make a series of political calculations look systematic and thoughtful.

Bill: 1) A proposed new law offered by a legislator who doesn't seem to realize that the state has gotten by just fine without the law for more than a century. 2) A small bomb waiting to detonate.

Bill Language (Language): The building blocks of a modern Tower of Babel.

Rule: The administrative provisions needed to explain what it was the legislature meant to do but did not achieve.

Omnibus Tax Bill: 1) Tax legislation that incorporates parts of many different legislative tax actions in a single, large terrifying bill. 2) A tax administrator's worst fears realized.

Tax Conference Committee: Multi-act political theatre in which the script is being written in real time behind closed doors down the hall.

Tax Commissioner: 1) The head of a tax agency. 2) A person hoping to soon move on to a more lucrative and less taxing occupation.

Non-Partisan Staff: 1) Gifted and dedicated individuals with a unique genetic mutation allowing them to remain utterly expressionless as zany ideas get discussed around them. 2) World's most dangerous poker players.

Loophole: Any provision of the tax code allowing a credit, deduction, or exemption that one opposes,

Incentive: Any provision of the tax code allowing a credit, deduction, or exemption that one supports.

Tax Credit: Allowing certain taxpayers to reduce their taxes as recompense for doing what they intended to do anyway but had the good sense to resist doing until the government anted up.

Tax Expenditure: 1) Government spending by other means. 2) A tax credit, deduction, or exemption predicated on the assumption that any money an individual or business holds actually belongs to the government.

Tax Incidence: The analysis and measurement of who lost the game of musical tax chairs.

Business Taxes: A tax on people passed through a middleman, usually with extra handling charges.

Estate and Gift Taxes: Government's effort to support the adage that you can't take it with you.

Gross Receipts Taxes (e.g. wholesale gas tax): An increasingly popular form of taxation created by people who weren't paying attention in their public finance classes.

Benefit principle: The theory by which you are charged for something for which you thought you had paid taxes.

Budget Reserve: The Mom's cookie jar of state finances, the location of which is known to everyone in the family.

Transparency: Burying the truth under piles of otherwise useless data.

Adjourn Sine Die: 1) Literally, "without day"—the end of a legislative session. Time to pack up, go home and see how mad the voters (and the spouse) are. 2) Even more literally, "time to party."

This Year in Pensions: Five Things We Learned

Rip roaring investment markets and new pension accounting standards changed a few things on the surface. Underneath, sustainability pursuits continue to be built on a foundation of sand.

To say confidence has been fully restored might be overstating things, but thanks to the 18.6% return the State Board of Investment (SBI) reported for 2014 the mood of legislators on the state Pension Commission and of the directors of Minnesota's public pension plans have noticeably improved. For those keeping score, that's now four times in the last five years that the SBI's pension-related investment returns have exceeded 14%.

So with pension plans reporting improved financial health, it's not surprising that the 2015 legislative session was a relatively quiet one for the Pension Commission. However, some developments are worth noting. And although these developments give the appearance of change, they also serve to illustrate how in the world of pensions, the more things change, the more they stay the same.

1. Public pension reporting now offers even more potential for confusion (if that's even possible)

One of the problems which has long plagued pension transparency is the existence of two sets of numbers that both describe pension plans' financial health. The primary barometers – funded ratios and contribution sufficiency levels – are reported using both the current market value of each pension plan's assets and the "actuarial value" of their assets, in which investment gains and losses are phased in over a five-year period. Although the official valuation studies use actuarial values, plan officials and government representatives have been emphasizing the current market value-based numbers; not surprising since the actuarial reports are currently excluding sizable investment gains.

The difference between these two sets of numbers can be very large – especially in times of significant market volatility like those we have experienced – offering two very different representations of pension health. **Table 2** illustrates the discrepancy for the three major statewide funds based on the latest reporting.

Table 2: Funded Ratio and Contribution Deficiency (Sufficiency) for Major Statewide Pension Plans, as of July 1, 2014

Pension Plan	Actuarial Value Basis		Market Value Basis	
	Funded Ratio	Contribution Sufficiency (Deficiency) % of payroll	Funded Ratio	Contribution Sufficiency (Deficiency) % of payroll
MSRS General	82.97%	(1.82%)	92.41%	1.02%
TRA	77.61%	(3.47%)	89.17%	(0.07%)
PERA General	73.51%	(2.05%)	81.78%	0.52%

Source: 2014 Plan Valuation Studies

Table 3: Funded Ratio: Three Different Perspectives

Pension Plan	Reported Funded Ratio July 1, 2014, Selected MSRS Pension Plans		
	Market Value Basis	Actuarial Value Basis	Financial Report
MSRS General	92.39%	82.97%	87.64%
MSRS Correctional	78.14%	70.41%	64.80%
MSRS Judges	58.87%	52.82%	46.02%

Now yet another curve ball has been introduced, thanks to reforms the Government Accounting Standards Board has enacted. Under the new GASB rules, the discount rate a pension plan employs to calculate the present value of its future liabilities for financial reporting purposes may be different than the rate it uses when determining its funding requirements. So a curious person with a careful eye might notice some material differences between what a pension plan's valuation study says and what its audited financial reports say – with implications for funded ratios and measures of contribution adequacy – as illustrated in **Table 3**.

Like an actuarial Old Country Buffet, there is now an even bigger selection of options to choose from for information on the status of pension plan health – with greater potential for confusion among stakeholders, reporters, and the public in the process.

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2. Accounting standards reforms in Minnesota have done what many predicted: little of consequence

The new GASB accounting standards address only financial reporting, so anyone expecting them to suddenly transform state pension policy was destined for disappointment. However, the aforementioned standard regarding the discount rates used in calculating the present value of a pension plan's liabilities had real potential for fueling reform discussions. That's because any change had the capability to radically alter perceptions about public pension fund conditions.

Unsurprisingly this particular standard was the hot button issue and the focal point of the reform debate. It pitted financial economists and analysts against most state and local governments, and their highly influential retirement advocacy and research organizations. The former group urged the use of government bond or bond-like rates to discount pension liabilities – a practice employed by all public sector defined benefit plans outside of the United States as well as private sector defined benefit plans in the United States. State and local government representatives and stakeholders tended to argue for the continued use of expected investment returns to discount liabilities.[1] The prospect of suddenly adding billions upon billions in unfunded liabilities to pension plans' financial statements across the country with resulting

[1] For an excellent overview and analysis of comments submitted to GASB, see "Lobbying Behavior of Government Entities: Evidence from Public Pension Accounting Rules", Allen and Petacchi. Working Paper 15-043, Harvard Business School, December 2014

political pressure to "do something" was at stake in this decision.

The standard GASB actually implemented allows pension plans to continue to use their expected rates of return to discount liabilities unless pension assets (including projected contributions and projected investment returns) are scheduled to "run out" before all pension obligations are covered. Any remaining obligations must be discounted a lower bond based rate to calculate the remaining debt.

As a political compromise, the new standard was a stroke of genius. As practical reform, it left a lot to be desired. The Rockefeller Institute of Government stated, "recent accounting rule changes by GASB have not addressed (this issue) properly." [2] Other critics were far more blunt, noting that aside from simply being inadequate, GASB's discount rate reform actually turns financial logic completely on its head. As Barton Waring, retired Chief Investment Officer of Barclays Global Investors – and staunch defined benefit plan supporter – stated in his submission to GASB:

> *"From the point of view of a rational discount rate scheme supported by sound financial principles, this is completely upside down, with the (more or less) risk-free rate applied to the unfunded and therefore most risky portion of the portfolio, and the risky expected return on the asset portfolio applied to the most free-of-risk portion of the portfolio, the portion that is fully funded!*
>
> *It's a bad compromise, completely backwards to what actually happens when financing anything else, anywhere else. And backwards in a manner that continues to hide the biggest portion of the true monetary size of governmental pension deficits."*

For Minnesota's pension plans, the new standard has had essentially no policy effect. Most every plan passed its "run out" test – assisted by using some of, if not the, highest assumed rates of investment return in the nation (7.9% to 8.5% depending on the plan). With the exception of a couple smaller plans, therefore, most pension plans in Minnesota will continue to be able to use their assumed investment return rate to discount all of their liabilities. And as noted earlier, the fact that the numbers do look worse on financial statements for those few plans does not impact funding decisions.

3. Assumptions change when it's deemed affordable to do so

Back in 2009 actuaries for all three major statewide funds recommended reducing the assumed rate of investment return to 8.0%. The resulting implications for funded ratios and annually required contributions (ARC) were a recipe for heartburn given the economic circumstances at the time. As a result, the actuaries' recommendations lay dormant for years. (Legislative enactment in 2011 of an 8.0% rate for five years followed by a return to 8.5% thereafter gave the appearance of change but had no long term actuarial impact.)

Current Minnesota pension policy wants it both ways – the high returns associated with riskier asset classes, but the most modest and stable contribution policy possible.

Now fast forward to 2015, when Pension Commission members are proposing an omnibus pension bill that would lower the assumed rates of investment return for some, but not all, pension plans. Both MSRS and PERA as well as the pension plan for teachers in St. Paul have now endorsed lowering their assumed rate of return to 8.0%. Even though they remain underfunded, on a market value basis contributions to all of these plans now exceed the ARC, creating more ability to accommodate the recommendations of their actuaries. (MSRS has an added incentive: this move would avoid triggering a 0.5% increase in the annual cost of living adjustments for retirees, thereby keeping more money in the fund.)

Then there is TRA. According to TRA testimony before the Pension Commission, lowering the assumed rate of return from 8.5% to 8.0% may be good timing for others "but not for TRA" as it would add about $1 billion in additional unfunded liabilities. With plan officials anticipating that additional sustainability measures may be forthcoming, it's clear that making those efforts more challenging on paper at the present time is not in their interest.

4. More responsibility for protecting the public interest in pension policy is now in the hands of pension plan officials

Who should be trusted more to look out for the public interest in pension policy: elected officials or pension plan trustees? It's an interesting question and the answer is perhaps less intuitive than one might initially think. At first glance, it would appear plan trustees by definition would tend to subordinate the public interest to advancing the private interests of plan members and beneficiaries. Examples of such behavior over the years are not difficult to find. However, pension plan officials must deliver on their fiduciary responsibility, and promoting ultimately self-defeating policies that put benefits at risk over the long-term conflicts with that responsibility. Meanwhile, if pension disasters elsewhere around the country tell us anything it's that elected officials are too often unwilling to implement the contribution levels needed to support these plans.

This is the context for a subtle but noteworthy change in pension contribution policy this year. Under the proposed omnibus bill, pension plans' governing boards will have more authority and flexibility to establish contribution rates. The current mechanisms that require pension trustees to make virtually automatic rate adjustments when circumstances dictate will be relaxed, giving trustees greater latitude to consider circumstances before recommending contribution changes to the Pension Commission. Importantly, the contribution changes governing boards make remain "opt-out" – legislators will continue to need to override any changes. Plan officials and local government lobbyists support this change on the basis that the current rate adjustment mechanisms do not provide the appropriate flexibility needed to fine tune contribution changes and timing in light of economic and budget realities.

The acid test of this new arrangement, which will indicate whether pension boards will make the tough calls to responsibly serve the public interest, may come sooner rather than later. As part of the rate adjustment mechanism changes, each pension

[2] *Strengthening the Security of Public Sector Defined Benefit Plans,* Rockefeller Institute of Government, January 2014

plan's governing board could reduce contribution rates down to the ARC-plus-1%. As the appearance of contribution sufficiencies materialize under assumed returns of 8.0% or 8.5%, pressures to lower employee and employer contributions will likely mount. It might seem ridiculous to suggest pension plans would inflict financial damage on themselves anytime in the near future through contribution cuts. However, it's worth noting that one long time Pension Commission member has gone on record saying full funding of pension plans is not a good idea because it builds pressure to raise benefits, which in turn creates new funding issues.

To properly manage pension risk pension boards should take a chapter from the playbook used by Minnesota Management and Budget with respect to recommending the size of the state budget reserve in accordance with state law. MMB evaluates the adequacy of the budget reserve based on the state's general fund revenue volatility and recommends a budget reserve that would be needed to accommodate 95% of recessions. What funding level would pension plans need to accommodate 95% of market downturns assuming the volatility and market risk of investment portfolios designed to yield 8.0% or 8.5% returns in perpetuity? We wouldn't be surprised if such a study concluded plans ought to achieve funded ratios of 120% or more –and, of course, contribution levels would need to remain high to get there.

Table 4: Investment Performance of SBI-Managed Pension Assets, FY 1990-2014

Fiscal Year	Annual Return (%)
2014	18.6
2013	14.2
2012	2.4
2011	23.3
2010	15.2
2009	(19.6)
2008	(4.8)
2007	18.5
2006	12.6
2005	11.0
2004	16.6
2003	1.9
2002	(8.2)
2001	(7.4)
2000	10.5
1999	11.3
1998	22.2
1997	21.8
1996	18.8
1995	15.8
1994	2.1
1993	14.4
1992	14.5
1991	6.7
1990	10.8

Source: Legislative Commission on Pensions and Retirement

5. The fiscal illusion persists

The need for such a study is based on the perpetuation of the fiscal illusion surrounding public pension plans. Demonstrating the illusion is best accomplished by considering the accompanying table describing the investment performance and results of the Minnesota State Board of Investment over the last 25 years.

To say the SBI's performance has been outstanding is an understatement. The simple mean return (excluding compounding effects) over this period is 9.72% – exceeding the historically assumed rate of return by a whopping 122 basis points. (Going back further into history SBI's annualized return exceeds 10%.) SBI realized double-digit returns in 17 of the past 25 years compared to only four years of actual losses.

And yet, despite this historically amazing performance, on a current market value basis our public pension plans collectively are reporting $11.24 billion in unfunded liabilities. That's even after discounting the value of future pension liabilities at an 8.5% rate, making them appear as low as any state or local government would attempt to present them. Every stakeholder needs to ask how this is even possible.

The only explanation is a problem in pension governance – practices that have prevented the money from being there to turn those paper returns into actual pension wealth. Two issues are often recognized as contributing factors. First, a sizeable chunk of the problem can be traced to the atrocious benefits policies of years past when "excess" investment returns were given to retirees in the form of base benefit increases. Policymakers fixed that many years ago, but having assets distributed rather than invested created a compounding hangover that persists today. Second, lag times between when contributions are needed and when they are implemented also contribute to the problem.

But another part of the problem is systemic – discounting practices which mask the true costs of pension benefits and result in chronic underfunding. This systemic problem continues to be ignored by lawmakers and plan trustees. Whether through lack of understanding or willful inattention, there is no recognition of the mathematical fact that difference between expected returns and actual returns accumulate and compound over time making actual pension fund wealth to pay benefits more volatile and risky with time, not less as commonly believed. As a result, choosing to invest in riskier asset classes (which we most certainly do) demands being willing to also accept much more volatile contribution levels. Current Minnesota pension policy wants it both ways – the high returns associated with riskier asset classes, but the most modest and stable contribution policy possible. And discounting liabilities at assumed rates of return is the enabling mechanism.

Come to grips with this fiscal illusion, and the accompanying myths surrounding it, and the real world juxtaposition of SBI performance and current pension condition makes sense. A British plan trustee has called the idea that the composition of the assets should determine the size of the liabilities "one of the weirdest emanations of the human mind. It's a metaphor – like saying that the advent of jet planes made the Atlantic narrower – and metaphor has limited place in finance." To offer another metaphor, building pension sustainability on this premise is a house of sand. ■

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