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In This Issue:

Is the Fourth Time A Charm?

Following the 2020 regular session and three special sessions, the state remains in a holding pattern with respect to a tax bill, a bonding bill, and budget repair. With November elections looming and the clock ticking on the 91st Minnesota Legislature, legislative action – or lack thereof – in the next special session will have a lot to say about the state's fiscal and political future.

In mid-August, in about the time it takes to play a round of golf, the third Special Session of 2020 came and went. Its brevity was preordained as the dictates and demands of the state's August bond sales prevented the state from doing anything substantively on state budget and fiscal matters. Thirty million in CARES grants were approved to help service providers for adults with disabilities.

Some time was spent on the usual ill-fated attempt to terminate the Governor's emergency powers. The Senate interjected some unexpected and blood pressure-elevating political drama by refusing to confirm the governor's Department of Labor and Industry commissioner after over a year in office citing performance concerns. But with respect to state fiscal matters, tuning into the monthly state special sessions is reminiscent of watching summer television reruns – the plot is familiar, the dialogue recognizable, and the end of season cliffhanger remains unresolved.

The Roadblock: Emergency Powers

Looking back to the end of the second special session, a negotiated conclusion seemed tantalizingly within reach. A hybrid bonding and tax bill (which included full 179 conformity) plus a supplemental budget bill appeared to have the support of majorities in both legislative bodies and the governor. The appearance of a finish line turned out to be a mirage as the House Republican caucus, whose votes were needed to pass the bonding bill, declared the package dead on arrival. House republicans cited process objections (including being left out of the bonding bill's final negotiations and combining a bonding and a tax bill in the first place); substance concerns (a light rail provision in the bonding bill was called a "poison pill") and inadequate attention to the current deficit.

But the continuation of the governor's existing emergency powers was the primary obstacle, or as one House member on the floor described it, what "tied everything together." House members argued the threat of COVID will be with the state for a very long time, state emergency powers law was never designed or intended to be used for such an indefinite and protracted period, and the Legislature needs to have a role in deciding how to respond to the pandemic.

Between the special sessions, staff discussions and proposals were exchanged between the Governor and the House Minority Leader Daudt on legislative emergency executive order review procedures, emergency management act authorities, and the termination of existing executive orders. However, nothing came of this discussion resulting in the current stalemate. What exactly transpired is uncertain and we only have an incomplete perspective on the offers and counteroffers. According to a letter from the Governor to Minority Leader Daudt in the aftermath of the failed negotiations, here some relevant points regarding the compromise effort:

- The Governor was willing to codify the elimination of 33 specific executive orders. Many of these had already expired or were rescinded, modified, or supplanted by new orders as conditions and circumstances evolved (e.g. the "stay at home" order replaced by subsequent phased reopening orders).
- House republicans sought the elimination of Executive Order 20-74 which constitutes "Phase 3" of the Stay Safe MN Plan. This order provides the latest guidance, requirements, and measures for business reopening and public gatherings. It is not clear if the House republicans proposed an even more "relaxed" version of this order or – we suspect much more likely – simply eliminating all state-level restrictions and restraints.
- House republican sought to eliminate the requirement that the Legislature must affirmatively act to end the peacetime emergency and instead allow either chamber to end the emergency by failing to ratify it.
- House republicans sought to require affirmative majority of votes by the Legislative Coordinating Commission to extend any executive order beyond 30 days.
- The Governor proposed to give the Legislative COVID-19 Response Commission (a bipartisan group already approved by the four caucuses for COVID management) the authority to terminate an executive order thirty days after the order is approved if a majority of the members from the House **and** the Senate vote to do so. It's worth noting the same "protection" the House now gives the Governor to exercise emergency powers would also exist here given the structure and configuration of the Commission.

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The day after this post-mortem correspondence on the negotiations was transmitted, the Governor issued Executive Order 20-81 requiring masks to be worn in certain settings. It's an order certain to be added onto to any Republican "hit list." How wearing masks has come to be so hyper-politicized is guaranteed to be the subject of dissertations for years to come. A June report by Goldman Sachs concluded a national mask mandate would buoy the country's GDP by 5 percent. It's interesting to note 35 of the 50 states have mask mandates, eleven of which are under republican governors.

Governor Walz's mask mandate has likely quietly and indirectly aided the state's business community by making government a scapegoat and no longer putting businesses in the potentially awkward position of alienating customers with their own policies regarding mask use. Yet from news and social media reports there remains large amounts of resistance to this perceived intrusion into personal liberty and government nannyism. Lawsuits have been filed over the order, and a number of Minnesotans continue to circumvent this mandate claiming health issues prevent them from wearing masks. In many of these cases these underlying health conditions might be diagnosed as civic neuropathy – numbness to the idea that individual rights ought not be divorced from individual and societal responsibilities.

Between now and the next special session colorful political rhetoric will not be lacking – "dictatorial," "tyranny," and a "monarchy that may never end" have all been already employed in describing the current state of affairs. What is in shorter supply is an understanding of how the legislature would tackle the pragmatic challenges accompanying a full and immediate repeal of the governor's emergency power authority. In a review of the 40 or so executive orders the governor wants to have remain in effect at this time, we count 85 references to Minnesota statutes, provisions, and administrative rules covering a wide variety of processes and procedures that have been been waived, suspended, or otherwise modified to respond to the spread of the virus and/or its impacts. This count does not include Executive Order 20-07 giving state agencies the "flexibility to hire staff, schedule, assign, and reassign employees without adherence to existing limitations in collective bargaining agreements, memoranda of understandings, compensations plans, statutes, administrative rules, and administrative procedures and policies that present barriers to the needs of state agencies to efficiently and effectively mobilize and deploy their workforce…"

Most, if not all, of these orders state they "remain in effect until the peacetime emergency is terminated or until it is rescinded by proper authority." Sifting through these orders and provisions to determine what to toss, what to keep, what to modify, how to modify, and for how long (might have we gained some better understanding of bureaucratic procedures and processes that aren't necessary?) to deal with non-emergency or chronic COVID conditions would seem to raise the prospects of a multi-week special session unto itself, especially with a divided legislature.

Such homework would appear rather important to terminating the emergency, but little evidence exists that much thought has been given to these issues. On the other hand, there appears to have been considerable bipartisan comity surrounding what one might expect would be a prime area of executive powers controversy: the use and disbursement of federal COVID dollars. There have been no apparent major dustups over appropriations from the COVID Minnesota Fund or on CARES requests. With respect to one particular potentially contentious topic – disbursement of federal aid to local governments – Governor Walz acquiesced to both the Legislature's greater local share of funds and distribution method. Together, it raises the question of how much of the emergency powers agitation is being driven by political messaging as well as actual policy concerns.

The September special session will likely offer some insight on that. With time running out it will be interesting to see if this topic still has the same session game-breaking influence. Whatever frustration and anger reside in the public and among legislators about the continuation and Governor's use of his emergency powers, the failure to pass a bonding bill and a tax bill with full 179 conformity will offer its own contributions to taxpayer frustration and perhaps anger.

The Numbers: Two Deficits to Contemplate

Since the pre-COVID days of last November, MMB has reduced their forecasted tax revenue collections for the current biennium by $3.5 billion or 7.3%. Each MMB forecast came with cautions and asterisks galore due to the tremendous unpredictability and volatility, but so far the numbers are tracking projections. According to the July Revenue and Economic Update, closing revenues for FY 2020 are estimated to be $58 million lower than the May interim budget projection, or (0.3%).[1]

FY 2021 got off to a seemingly good start as preliminary net general fund revenues for the month of July were 15.4% above forecast. All major state tax revenues exceeded expectations as general sales tax revenues topped the monthly forecast by 47% or $71 million and corporate income collections exceeded forecast by 102% or $64 million. As always, MMB is quick to note that "great caution" needs to be exercised in interpreting a single month's worth of data that will also be subject to revision. That interpretive caution is even more deserving considering the role and magnitude of the federal government's fiscal response. A truly remarkable statistic: in Q2 gross domestic product fell by 9.5% but current-dollar personal income **rose more than six-fold** in the quarter and real disposal personal income increased by **$1.53 trillion**. While the phased in reopening of the state economy is certainly contributing to the positive revenue trends, higher than expected tax receipts are also reflecting the afterglow of the massive amounts and variety of federal stimulus and income support provided to individuals and businesses earlier this year. Their discontinuation is likely to be seen in future revenue updates. A recent analysis finds that, based on the latest data, eliminating the Federal Pandemic Unemployment Compensation supplement would lead to a 44% decline in local spending.[2]

MMB's latest update also provides our first revised look at the upcoming biennium. Based on the assumptions used for the state's May interim budget projection, the planning estimate for FY22-23 is a deficit of $4.7 billion – a $5.2 billion flip from the

[1] The original update in early July estimated a positive closing variance for FY 2020 of $168 million, but noted that not all the final income tax payments for 2019 had been received and processed. An update to the update on July 31 flipped net income tax receipts to $226 million below the May projection resulting in the negative variance for FY 2020.

[2] "The Effect of Fiscal Stimulus: Evidence from COVID-19" Casado, Glennon, Lane, McQuown, Rich, and Weinberg, NBER Working Paper No. 27576, August, 2020

$465 million surplus projected in February. No detail was provided on revenues and expenditures to show how that number was derived. The continued use of the May model inputs and assumptions did not sit well with some legislators who wanted another interim forecast based on updated information. However, MMB argued that the forecast's accuracy in projecting closing FY 2020 numbers makes it acceptable for use in planning.

Absent some unexpected developments, a November forecast featuring a projected multibillion dollar out-biennium deficit on top of an existing multibillion current biennium deficit is likely. The pending tax and spending agreements expected to be on the table would create about $300 million in additional tails to add to the FY22-23 budget challenge. (We don't think the nearly $500 million from the budget reserve which was part of last year's deal to pay for FY22-23 spending and achieve structural balance in the out-biennium has been factored into this planning estimate.) Meanwhile over 90% of the federal CARES funds provided to Minnesota to deal with the health and economic expenditures from COVID's fallout have been committed. As of mid-August, of the $2.187 billion in CARES funds provided to the Minnesota, only $192 million remains unallocated to deal with any new and emerging COVID triggered spending needs through the end of the year.

All this demonstrates that THE critical development to watch for is the action of the federal government in providing another round of relief. The prospects at this moment do not look particularly promising as Congress is dealing with its own political impasse on these matters. Congress adjourned without agreement on three big issues relevant to the state budget: additional stimulus, unemployment insurance support, and additional aid to local governments to compensate for lost revenues as well as any virus-related matters.

The President's subsequent executive orders, intended as a workaround of the legislative gridlock, are weak tea with respect to the magnitude of fiscal challenges states, local governments, and citizens face. They also entail some administrative problems. The optional payroll tax holiday appears to be a nonstarter in the business community due to the payback requirements. The new federal "lost wages assistance" program uses $44 billion in FEMA funds and requires states to construct essentially a new program to administer the additional $300 per week supplement to existing unemployment insurance (compared to the now expired $600 from the CARES Act).[3] As of this writing over the half the states have applied and been approved to get a minimum of three weeks of additional payments. Minnesota will be applying, but with demand so high and limited funds available, the duration of any support that eventually comes our way is questionable.

In short, there is no escaping the fact that meaningful and substantive action requires Congress' "power of the purse." With the bodies about $1 trillion apart and recessed until September 8, Minnesota remains in wait and see mode. State budget repair has the look of a Texas hold 'em poker game with everyone checking and rechecking in order to see the federal river card flipped before taking any action.

The Politics: The Deficit as an Asset

With a healthy budget reserve, other time-buying maneuvers such as transfers and shifts at their disposal, and respectable odds that eventually some form of additional federal assistance is forthcoming, the patience lawmakers are demonstrating on state budget action is understandable. But the virtuousness of patience does have its limits. The tighter the timeframe demanded for remedial budget actions, the harsher the adjustments and resulting effects will be. Many might have expected that six months into the pandemic, the control of the virus and our fiscal trajectory in responding to it would be a lot clearer. That doesn't seem to be the case and raises the question of how much more clarity we will have six months from now. Even though taking some action now on the deficit would be prudent, that's not likely to happen for a few reasons.

First, voting on specific tax increases and spending cuts just as citizens prepare to head to the polls is a high risk/low reward endeavor. Especially in highly contested districts, it can amount to electoral seppuku. In addition, both parties are adhering to pre-COVID positions in spite of the dramatically changed fiscal circumstances. For example, when state labor contracts were being ratified as the COVID crisis began, there was zero DFL interest in reopening and renegotiating the second year of the contract even though it created hundreds of millions of dollars in tails in the out-biennium and increased the prospects of state workforce reductions. Similarly, there has been no apparent Republican moment of retrospection or reconsideration of the tax cuts enacted last year nor any interest in adjustments to rate schedules or other tax system features to try accommodate revenue neutrality while pursuing federal conformity actions. As Speaker Hortman noted, "at the moment the political philosophies are so different, the question is, should we start attacking this year's deficit today? I don't think that's going to happen." [4]

Finally, the existence of the deficit functions also serves as a political asset to both parties. One of the major questions Republicans face is how much down ballot impact the presidential election will have. The prospects of a $5 billion state budget deficit in the hands of "unchecked" DFL control will undoubtedly be a prominent message to attract independents and bring any wavering Republican voters back into the fold. Similarly, the tax ambitions of the DFL in recent years have been stymied by the existence of budget surpluses. The deficit shifts the framing of these proposals from "want" to "need" heading into 2021. Given the current political environment, some DFLers may think it pays to wait not just on budget repair, but on bonding and tax bills as well, banking on a takeover of both bodies this November.

Put it all together and budget repair is almost assuredly off the table. The best we might expect is a "Hippocratic oath" of doing no further harm to the current biennium budget. Instead, it appears we will use the surplus to navigate the current biennium deficit and enter the regular 2021 session hoping additional federal action and COVID's evolution cooperate to keep us from facing the prospects of building a biennial budget facing a deficit akin to that coming out of the Great Recession. All this makes for an easier November but also a 2021 session to remember. ■

[3] Because of FEMA matching requirements under the Stafford Act which funds this program, only workers receiving at least $100 a week in state employment benefits would be eligible for the additional payment.

[4] "Despite projected deficit, Minnesota in no rush to implement budget cuts" MinnPost, August 7, 2020

Banking on "A Superior Form of Capitalism"

For over two decades Minnesota public pensions plans' investments in private equity have delivered the outsized investment returns needed to meet Minnesota's defined benefit plans' high return expectations. In today's persistent low interest rate environment, the demand for private equity is greater than ever. But all is not well in Camelot.

The Minnesota State Board of Investment (SBI) has reported a 4.2% return for FY 20 for its Combined Funds which includes the assets for both active and retired public employees in the statewide retirement systems. Considering the economic chaos engulfing the second half of the fiscal year it's a welcome achievement, even though many are scratching their heads over the disconnect between the economy and stock markets. Regardless, a 4.2% gain still falls short of the assumed 7.5% on which Minnesota's defined benefit plans are based. That will be reflected in the valuation reports later this year.

With fixed income yields hovering around historic lows and expected to continue for the foreseeable future, defined benefit pension plans face challenges achieving their expected returns.[1] As the Wharton Pension Research Council notes, defined benefit plans have "three options to improve their funding levels in a chronic lower-return future: increase contributions, reduce costs, or increase risk." [2] Assuming more risk has been a staple of Minnesota pension funding in part because of SBI's excellent track record in "alternative investments"—particularly the world of private equity. Whether past performance is predictive of future returns is another question.

The Appeal

Private equity are investments made in companies that are not publicly traded. Participation in control-oriented investments/buyouts and venture capital investments are the two key private equity sub-segments; the former making up the majority of private equity investment activity in the country. Over the years private equity has come to play a hugely expanded role in the nation's economy. According to the Institutional Limited Partners Association, businesses backed by private equity employ more than 8.8 million Americans accounting for a stunning 5% of U.S. GDP. And according to the Milken Institute, by the middle of 2018, private equity owned more companies than the total number of businesses listed on all the U.S. stock exchanges combined.

The stated investment appeal for Minnesota pension funds has several dimensions. They include:[3]

- **Necessary diversification** – to industry type, capitalization, stage of business development, location, and other considerations
- **Value improvement through operational improvement** – in many if not most cases, the investment is associated with ownership or majority control of the company allowing the ability to make changes to business strategy, operations, and capital structure to improve efficiency and profitability
- **"Patient" capital / resistance to "short-termism"** – Private equity is seen as taking a longer term view of the business and resistant to the pressure to forsake long term strategy/business objectives for short term results that can be endemic to publicly-traded companies
- **Greater flexibility** – ability to reach into areas of the global economy that have large demands for capital that public markets are unable to provide

Put all this together and many see an asset class able to offer the rarest of combinations – the potential for obtaining higher returns with lower volatility/risk as compared to public equity markets. That belief is reflected in the enthusiastic statements made by institutional investors around the country. The Chief Investment Officer of the mammoth $372 billion California Public Employees' Retirement System has said "we need private equity, we need more of it, and we need it now." [4] Others go even further extolling private equity's role and contributions to the economy and society in general. The head of Yale University's endowment has declared private equity, "a superior form of capitalism." [5]

Minnesota's historical experience with private equity bears the accolades out. According to the most recent SBI performance report dated June 30, 2020, the state's 5, 10, and 25 year private equity returns are 12.6%, 13.5%, and 15.3% respectively. These returns are all net of the expensive and often criticized fees routinely charged by private equity managers (routinely 2% for assets under management and 20% of any gains on its investments after a certain return is achieved.) making them even more impressive. Currently, the SBI has 140 investments in private equity funds spread across 54 investment managers representing $16 billion in multi-year commitments.

There are two other important aspects of private equity that don't get discussed as much but contribute no less to the popularity and attractiveness of this asset class to public pension funds. The first is lower return volatility resulting from valuations that are established by the judgments of an accounting firm that works for the private equity fund, not by the market. As Kurt Winkelmann, former Managing Director at Goldman Sachs and currently Chair of the Advisory Board for the Heller Hurwicz Economics Institute at the University of Minnesota, told us:

> *"An investor (such as a public pension fund) wants to smooth out accounting statements from the effects of large economic shocks. Large drops in public equity returns can have significant adverse effects on pension accounting and required contributions. Including assets whose returns are naturally smoothed can dampen the effects of such shocks even if the true economic exposure is the same. Private equity is such an asset, because of the infrequent valuations."*

In a moment of considerable candor this natural smoothing effect of reported and actual risks has been described by the Chief Investment Officer of the Public Employee Retirement System of Idaho as "phony happiness."[6]

The second is the use of large amounts of debt. The high return targets for public funds can't be achieved without using some

[1] The same low interest rate environment also increases the present value of pension plan liabilities but we pretend that is not the case by using expected asset returns as discount rates.

[2] "Getting More from Less in a Defined Benefit Plan: Three Levers for a Low-Return World," in *How Persistent Low Returns Will Shape Saving and Retirement*, Wharton Pension Research Council, University of Pennsylvania, 2018

[3] Summarized from "Tab P" in the Minnesota State Board of Investment's "Investment Policies and Management Practices," 2013, pp 371-379

[4] "Calpers Wants to Double Down on Private Equity," *Wall Street Journal*, March 17, 2019

[5] "Private Equity: Overvalued and Overrated?" *American Affairs*, February 20, 2018

[6] Ibid

form of leverage. As Winkelmann notes, “Private equity gives public funds leverage without having to tell anyone.” Private equity tends to substantially increase the amount of leverage in the firms over which they take control. A 2018 study by the global asset management firm Verdad found that private equity firms leverage up the businesses they buy 70 percent of the time — typically doubling the amount of debt on the balance sheet from 2.5 times EBITDA (earnings before interest, taxes, depreciation, and amortization – a common measure of cash profitability) to 5 times EBITDA. Today, according to the Bain 2020 Global Private Equity Report, deals with debt multiples higher than 6 times EBITDA now constitute more than 75% of the total. Bain adds, “the true leverage of many deals may be even greater, as banks commonly allow borrowers to calculate multiples based on projected earnings instead of actual results.”

> **The main driver of private equity investment returns has not been business and operational improvements like revenue growth or operating margin expansion but rather “multiple expansion” – a willingness by others to just pay more for a dollar of company earnings.**

There is a difference between a beneficial capital restructuring by assuming a reasonable amount of new debt and taking a company’s leverage to levels far beyond industry standards and what is serviceable endangering the company itself. Crossing that line has given private equity a public black eye in many circles (perhaps best captured by the satirical news website The Onion in its recent headline, “Protestors Criticized For Looting Businesses Without Forming Private Equity Firm First”). One development that has mitigated this risk for private equity investor interests is the increasing use of “covenant-lite” loans. These loans lack the usual safeguards protecting lenders. Covenant-lite loans can even turn traditional finance topsy-turvy by subordinating debt to equity and allowing private equity holders first claim on assets. A record 89% of institutional loans issued last year by private equity backed borrowers were covenant-lite — compared to only 6% in 2010. *Institutional Investor* has described this lending behavior as a “potential disaster in the age of private equity.” [7]

Headwinds in Creating Value

There is no sign that interest in private equity is diminishing. Private equity today has a record $1.5 trillion cash on hand ready to be put to use. However, value creation and obtaining the type of superior investment returns that have come to be expected from private equity is a lot more difficult today for several reasons.

Asset inflation is at the top of the list. Cheap debt and eager investors have driven prices up for private companies of all types. Private equity firms historically bought companies at much lower valuations making larger returns easier to engineer. At the same, deals now entail much larger amounts of debt than before. As one private equity observer notes, “there is a big difference — bigger than most realize — between what private equity used to do (buy companies at 6-8 times EBITDA and a reasonable 3-4 EBITDA of debt) and what private equity does today (buy companies at 10-11x EBITDA with a dangerous 6-7x unadjusted EBITDA of debt).” [8] The average multiple of enterprise value to EBITDA for a leveraged buyout has now reached 11.5x in the US. Over 55% of US buyout deals in 2019 had an EV/EBITDA purchase price multiple above 11x. [9]

According to the Bain’s 2020 Global Private Equity Report the number one source of anxiety among private equity executives (70% of respondents) is overheated asset valuations. The global head of private equity for the megafirm Blackstone has said, “this is the most difficult period we have ever experienced…You have historically high multiples of cash flows and low yields (as) I’ve ever seen in my career. It’s the most treacherous moment.” [10]

In difficult macro conditions and amid stiff competition for assets, creating the value private equity investors have come to expect is difficult. One of the biggest red flags is found in the Bain report: since 2010, the main driver of private equity investment returns has not been business and operational improvements like revenue growth or operating margin expansion but rather “multiple expansion” – a willingness by others to just pay more for a dollar of company earnings. In Bain’s study of fully realized buyout deals completed in the last decade, growth in multiples led to nearly half of the increase in enterprise value. In another examination, Bain found average operating margins were 3.3% below deal model forecasts, with 71% of investments falling short, including 14 of 18 that identified margin improvement as critical to value creation. The report concludes, “the game is getting harder as asset prices soar,” while noting “returns of private and public equities have started to converge in the U.S.”

No Substitute for the Fundamentals: A Modest Proposal

Many factors are still working in private equity’s favor. One consequence of COVID is that it’s likely creating some very ripe conditions to snap up troubled companies at bargain basement prices. Cheap money does not appear to be going away anytime soon. Specific sectors especially in enterprise software and IT services are still said to present considerable opportunity. But perhaps the biggest thing private equity has going for it is that it is approaching “too big to fail” status — if it hasn’t already achieved it. [11] As noted earlier, private equity has fundamentally woven itself into the very fabric of the U.S. economy, affecting millions of workers directly and millions of others through their retirement plans. It is worth noting some of the strongest advocates for enabling private equity to access PPP and other federal COVID support programs have been Democrat congressional leaders.

7 “When Buyout Firms Step In, Watch Out” Institutional Investor, April 3, 2019

8 “Private Equity: Overvalued and Overrated?” *American Affairs*, February 20, 2018

9 *Global Private Equity Report, 2020*, Bain and Company

10 “Private Equity: Overvalued and Overrated?” *American Affairs*, February 20, 2018

11 “Too Big To Fail, COVID Edition: How Private Equity is Winning the Coronavirus Crisis” *Vanity Fair*, April 9, 2020

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But even with these supporting factors, it's clear with the headwinds facing this sector the State Board of Investment will likely face more challenges delivering the outsized returns private equity has been provided for the past couple of decades. The key success factor appears to be "Minnesota exceptionalism" – managing the investment program carefully and prudently and being able to do the due diligence necessary to find and participate with above average performers.

Even more importantly, regardless of how well the SBI manages its private equity program, how much it grows, and how big the returns are, it will never supplant adequate contributions as the key to state pension sustainability. In their study examining different strategies to improve funding levels in a lower return future, the Wharton Pension Research Council concluded "increased contributions deliver the most powerful combination of certainty and impact on portfolio performance" as compared to cost cutting or assuming greater portfolio risk via alternative investment strategies including private equity. [12] Unfortunately, as we have learned over the years, increased contributions also deliver the most powerful combination of indigestion and annoyance to lawmakers, government administrators, and public employees.

As the University of Minnesota's Heller Hurwicz Economic Institute has observed, "the root cause of public pension funding woes is poorly designed governance." Contribution policy is Exhibit A of this malady. Constitutionally-mandated balanced budgets automatically tilt policy towards the management of short-term budgets. In addition, since pension deficits are not included on state balance sheets, there is no natural accounting mechanism that penalizes long-term underfunding. As the Institute concludes, states have few, if any, incentives to maintain their required contributions. [13]

Minnesota's track record of meeting its annually required pension contributions over the years has been abysmal. Necessary contributions have been ignored, put off, then when reluctantly adopted, gradually phased in over time to maximize their political acceptability while reducing their beneficial impact. According to the plans' annual actuarial valuations, since FY 2002 contribution deficiencies by themselves have added $7 billion to the state's unfunded pension liabilities. It's a major reason why the funded ratios for state plans have not improved all that much during a period when SBI has routinely thumped its investment targets.

All this hints at a radical pension proposal that would also be a fascinating test of just how deep the confidence among lawmakers and government administrators really is in our pension system: enact a constitutional amendment requiring the actuarial annual required contributions to be made.

Minnesota could pass a law requiring the annual required contributions to be paid every year, but lawmakers can always change laws as circumstances demand and as they see fit. An amendment to the state constitution, however, could make that requirement permanent. Such a proposed amendment presents an interesting thought exercise. Would elected officials support the idea knowing the political distress it would likely trigger and the additional demands it would place on state and local budgets if passed? If not, what would the arguments be for opposing what actuaries and defined benefit experts tell us we need to do to deliver on our long-term promises and be fiscally responsible while doing it? State contribution requirements are already based on five years of "asset smoothing" to avoid unnecessary overreactions to the market, so any arguments of that nature would be irrelevant.

We won't hold our breath that such a proposal will materialize. But it would jump start a real pension reform discussion and examination. In one way, a constitutional amendment could be thought of as the "private equity version" of pension reform: a higher risk strategy one might prefer not to have to rely on but because of problems elsewhere, it has to be pursued. ■

[12] "Getting More from Less in a Defined Benefit Plan: Three Levers for a Low-Return World," in *How Persistent Low Returns Will Shape Saving and Retirement*, Wharton Pension Research Council, University of Pennsylvania, 2018

[13] "Revisiting Why Pension Reform Is So Hard" *Pension Policy Brief #11*, Heller Hurwicz Economics Institute, University of Minnesota