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Sound tax policy. Efficient spending. Accountable government.

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The 2022 Session: Uncertainty in a Time of Abundance

Money doesn't buy happiness, and with respect to the upcoming legislative session, it doesn't provide clarity either. Three questions we're asking heading into 2022.

In the aftermath of the stunning November economic forecast, the focus now turns to what to do with all that money. When the 2022 session begins at the end of January, lawmakers will be dealing with a fiscal situation rivaling one of, if not the most, momentous and consequential budgeting environments in state history. In the February 1999 forecast, at the apex of the multi-year tech boom, the general fund available balance amounted to 15.6% of projected biennial spending.[1] Today it's 14.9% (17.0% including unallocated federal cash).

Respectable surpluses in the "off budget year" aren't unusual for the state. One has to go back to 2009 and the Great Recession to find a November economic forecast in an odd-numbered year that didn't convey a sizable surplus for supplemental biennial budget decision-making purposes. The difference in 2021 is three-fold.

First is the magnitude of the surplus. In the previous five odd-year November forecasts, the current biennium surplus was remarkably consistent ranging from a low of $880 million to a high of $1.65 billion. The estimate for the current biennium is over 6 times the average of that 10-year span. And unlike previous years in which a lot of surplus was rooted in yet-to-be realized expectations for the remainder of the biennium, today $3.2 billion is already "in the bank."

Second is the no less eye-catching out-biennium planning estimate. The last five odd-year November forecasts projected either negative structural balances for the out-biennium or modest positive balances that were mostly or completely offset when factoring in inflation. These estimates functioned as a cold shower on any new tax or spending plans with big tails. The latest planning estimate projects a $4.8 billion positive structural balance for FY 24-25 — even after subtracting over $1 billion in inflationary pressures.

Finally, on top of all this is the additional $1.1 billion in federal recovery dollars available to be spent in 2022. And thanks to Treasury's accommodating determination of how a state revenue system's return to normal in the aftermath of COVID is measured, this one-time money is available for general operations spending.

Put it all together, the wherewithal and temptation both exist to pursue far bigger tax relief and spending ambitions than what would be expected in a typical supplemental budget year. However, these interests face the realities of a polarized and divided legislature, election year and redistricting distractions, fragmented caucuses, federal spending coordination and complications, the compressed timeframes of short session, and inevitable efforts to leverage policy issues into tax and fiscal decision-making. Available resources are just one piece of a hugely complicated legislative jigsaw puzzle. A few of questions we are asking ourselves heading into 2022:

Will tax relief happen?

Given the numbers, it might be election year malpractice for lawmakers in both parties not to advocate for some type of tax relief. The runway appears clear as the state's relentlessly positive tax collection variances likely eliminates the danger of failing the federal government's "organic growth" requirement that could trigger a clawback of fiscal recovery funds. But as we saw in the failed attempt to give frontline worker bonuses at zero cost to the state, details and politics can thwart even the most publicly popular proposals.

DFL leadership has gone on record that ongoing tax reductions will not be a part of any compromise in this short session.[2] Taking this at face value, it indicates the universe of tax relief possibilities in 2022 will be limited to temporary relief for the current biennium propelling some form of tax rebate to the top of the possibilities list. A rebate offers both policy and political advantages. As one-time spending from revenue already collected, it reduces fiscal risk, and the size of the rebate itself can be scaled accordingly for the same purpose. It would also be the broadest and most inclusive "give back" mechanism with the ability to benefit both parties' constituencies simultaneously.

1 We reduced the available balance for 2000-2001 by $356 million to approximate 2021 budget reserve policies.

2 State DFL, Republican leaders make plans for budget surplus, MPR, December 8, 2021

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Minnesota could draw on its turn-of-the-century experience with sales tax rebates (a.k.a "Jesse checks") which taxpayers received for three straight years. These rebates were based on mimicking the estimated sales tax burdens paid by Minnesotans based on the individual's amount of income – a methodology blessed by the IRS at that time employing the Department of Revenue's incidence database. Because the sales tax is a mildly regressive tax, sales tax rebates would be mildly progressive smoothing over omnipresent fairness arguments and political disagreements over making a rebate on an already highly progressive income tax also progressive. (It's worth noting the primary reason for employing a sales tax rebate around the turn of the century was to avoid having the rebate subject to federal tax. Now with the SALT cap, federal taxability is a negligible consideration.)

However, Minnesota has a history of bipartisan skepticism toward one-time tax rebates. In 2006 Governor Pawlenty rejected the idea arguing "we should do real tax relief, like permanent tax relief for low-income or middle-income people," but also adding "we'd be also well-served by using some or all of that money on some of our other priorities like reforming education."[3] In 2015, Governor Dayton rejected the idea arguing one-time rebate checks were not a responsible way to manage government and was dismissive of the size of the benefit equating the projected $240 per family average rebate at that time with what is spent on several weekends of takeout food.[4] And most recently in 2018, then Senate Majority Leader Gazelka, also balked at the concept questioning the bang for the buck gained from the "Jesse check" experience, arguing the money should be used to repair roads and bridges.[5]

Minnesota has a history of bipartisan skepticism toward one-time tax rebates.

Objections to rebates based on a lack of "bang for the buck" and meaningful relief is interesting given how relatively little attention these issues often receive in other tax relief proposals and how relatively little benefit they can confer on taxpayers. The prospects of an average $240 rebate from a few years ago may not have kept up with household pizza demand but it is over twice the $8.50 per month average tax relief generated by the 2019 2nd tier rate cut and ten times the $2 per month average relief generated from the 2019 Social Security subtraction change.[6]

Having a surplus many multiple times larger than anything recent history has offered might change opinions about a rebate's practicality and merit. But as these lawmaker comments in the past indicate, hesitancy toward rebates is also influenced by an interest in keeping options open and powder dry for other and bigger ambitions. For Republicans it's providing bigger and more permanent tax relief, preventing non-general fund tax increases by directing existing general fund support to non-general fund spending, and perhaps using available revenue as leverage for implementing spending reforms. For the DFL, it's the pursuit of new social program and other spending. Or, in the words of a sales tax rebate critic from the turn of the century now being echoed almost verbatim today – "not lose out on a great opportunity to collectively create the future of our state." [7] Rebates have a "go big or go home" quality to them — a lot of money is needed to provide a noticeable benefit to very large numbers of taxpayers. As a result, both parties may prefer to let more of the surplus "ride" in anticipation of gaining leverage for their respective agendas in 2023.

Other tax proposals paid for by one-time money will likely get airtime. Such proposals come in two flavors: "voter pleasing" and "politically unsatisfying." The former are highly targeted tax relief efforts favoring specific types of taxpayers, taxpayer circumstances, or taxpayer actions. This has been a staple of Minnesota tax relief thinking for a very long time. In 2022 a lot of this interest is likely to be directed toward property taxpayers. Recent Truth in Taxation statements sent shockwaves to many homeowners due to rising home values (especially among homeowners in metro area cities often least able to afford big property tax increases) combined with pandemic-influenced commercial valuation declines and sizable local levy increases. Bills for temporary enhancements of the state's circuit breaker and special refund programs along with more complicated proposals like additional state levy buydowns would seem rather likely. Another popular target is likely to be seniors. Full exemption of Social Security income would have significant tail impacts beyond the current biennium which the DFL has declared (at least at this time) a non-starter. But the pressure to do something to benefit this influential voting bloc will be significant.

The other category includes items that are really more about clean up than tax relief *per se*, but do offer administrative and timing benefits for taxpayers that are affected by them. This would include:

- Cleaning up remaining temporary and partial federal COVID response conformity items
- Immediately allowing deduction of the disallowed amounts of section 179 allowances for tax years before full conformity applied – say in equal amounts in tax years 2022 or/and 2023
- Increasing the percentage of bonus depreciation allowed in the year the property is placed in service and allowing faster deduction of previously disallowed amounts

These changes would have one-time effects and would free up resources and provide budget flexibility in the future. But their adoption also means less money on the table for 2023. Moreover, they offer little or no political appeal for either party. Republicans and their constituencies will not consider them as real tax cuts, and Democrats won't want to do them because they do not advance their policy agenda in any way.

In short, whether and to what extent tax relief actually materializes in 2022 is a function of much more than the size of the surplus. Even though expectations are likely elevated, we would not be particularly surprised if the primary tax-related deliverable

3 "Pawlenty: No Rebates" MPR News, October 12, 2006

4 "Reality Check: Minnesota's Budget Surplus" WCCO, December 4, 2015

5 "Should taxpayers get a cut of Minnesota's $1.5 billion budget surplus?" St. Paul Pioneer Press, December 6, 2018

6 According to MN Revenue, the reduction of the 2nd tier rate was estimated at the time to reduce 1.37 million returns an average of $101 while the subtraction change was estimated to reduce 178,300 returns an average of $24.

7 Rebates, Tax Cuts Come at State's Expense, Minnesota Daily, April 3, 2000

of the 2022 session was political signaling for the November elections and the 2023 session rather than actual relief.

How will unemployment insurance tax increases be dealt with?

Ironically, in the context of a large surplus, one of the 2022 session's lightning rod issues is an impending tax increase. Over the course of the pandemic, Minnesota borrowed over $1 billion from the federal government to cover its share of unemployment insurance payments. This spring the bill is coming due. Unemployment insurance tax hikes on Minnesota employers of all sizes and types were already going up to restore trust fund reserves depleted during the pandemic. They will go up even more if they need to pay back the federal loans and the interest being charged by the federal government.

The size of the potential hit on employers can vary significantly based on their experience rating (the less unemployment that an employer's workers have experienced, the lower the organization's experience rating is) and the compensation levels of employees. But an employer with an average experience rating with an employee base earning $38,000 or more could see a tax increase of more than 40% or around $400 per employee in 2022.

Minnesota is not alone facing this situation. Many states around the country have chosen to use federal COVID support funds to pay back the federal government. According to the latest information we have seen, nine states have used federal American Rescue Plan funds to completely eliminate their trust fund debt. At least seven other states that didn't need a federal loan in the first place have nevertheless directed federal recovery resources into their trust funds to replenish their reserves. In addition, at least 23 states used previously provided federal CARES Act money to pay out unemployment claims or otherwise replenish their trust funds. In the cause of using one time money for one time spending to address the economic aftereffects of COVID, many states have made restoration of their UI trust funds a top priority.

When asked about this issue at his news conference following the release of the November forecast, Governor Walz replied "we'll fix it." But the clock is ticking as first payments with the new tax rates are due at the end of March, giving lawmakers about two months to implement a fix. And the lack of any sense of urgency to date, or detail of what such a fix should/might entail, coming from the DFL suggests this may become one of those high priority, highly sensitive policy issues that will be used for maximum leverage in end of session budget negotiations.

Such was the case last year in dealing with federal conformity to the Paycheck Protection Act in the 2021 session. One could have tied Paycheck Protection Act conformity to a chair, blindfolded it, and snapped a picture of it holding the daily newspaper and it couldn't have looked more like a hostage. But there is a fundamental difference in using the threat of unemployment tax rate increases as negotiation leverage. This year's hostage would be most of Minnesota's employment base rather than a relatively small subset of it. And the issue is a significant tax increase, regardless of an employer's profitability or ability to pay, in a critical period of economic recovery, not a special tax break on positive taxable income earned during a pandemic.

We might see a classically Minnesotan effort to segregate employers by "deserving" and "undeserving" of protection from these tax increases based on employment size or some other crude assessment, but adding administrative complexity and cost to a fix in the process. However, this may get resolved, a failure to act and act promptly strikes us as a high risk, low reward proposition with respect to the state's economic interest — especially given all the resources available.

How supplemental will supplemental budget proposals be?

It's tough to get a fix on how lawmakers are thinking about the 2022 session. On the one hand, leadership on both sides have said the right things about waiting until the state's February economic forecast is released to obtain more information on the state's finances and pandemic developments before making decisions regarding the surplus. On the other hand, lawmakers are already offering some very big ideas with price tags that extend far beyond the current biennium. For example, as already mentioned, among Republicans there is clear interest in exempting all Social Security income from taxation (that's about $1.1 billion in tails for the 24-25 biennium). Meanwhile the recently released "Phase 1 Report" of the Governor's Council on Economic Expansion contains $2.8 - $3.5 billion of new spending recommendations. That's just "Phase 1" — a second set of recommendations is due next summer.

All parties could compromise on a package of one-time spending and tax relief consistent with the idea of 2022 being a "bonding session" accompanied by some mid-biennium budget adjustments to address current needs and conditions. Constraining such actions just to the resources already banked still offers about $4.2 billion for "adjustments" which is a lot even in a COVID-inflicted economy. That's one of the reasons why the idea of doing some cash bonding has already gotten some discussion. Tack on the additional $4.5 billion in forecasted gain this biennium and factoring in another $4.5 billion of projected positive structural balance in the out-biennium and it's easy to see why lawmakers' minds are drifting toward much bigger, bolder, and more permanent proposals.

The release of the Governor's supplemental budget and the legislature's response to it may tell us a lot about whether the 2022 session ends with bang or a whimper. If it reflects traditional off year supplemental budget proposals with minimal tails, then an avenue for compromise seems possible even if the initiatives and the accompanying dollar figures are bigger than normal. But the more it encompasses "golden opportunities" as the Governor has described longer-term spending and investment interests, the more likely the session ends with a thud. In the same way DFL leadership has stated ongoing tax reductions are off the table in 2022, Republicans are almost certainly inclined to treat permanent spending increases the same way.

Regardless of how the 2022 session evolves, one thing we are certain of: big surpluses in a time of divided government create risks as well as opportunities. On the basis of that 1999 February forecast lawmakers enacted the first sales tax rebates and reduced income tax rates while increasing biennial general fund spending by 14.1% (on top of the average 14.5% biennium spending growth rate that occurred over the three biennia before that). As a long-time member steeped in Capitol experience told us, the circumstances we face today are tailor-made for "unholy compromises that throw caution to the wind and commit to do unsustainable amounts of both priorities." ■

Why Does Minnesota Spend So Much More Than the National Average on Health and Human Services?

We take a look behind the numbers reported in our latest edition of "How Does Minnesota Compare"

Reports that compare and rank states provide interesting perspective and information but typically prompt far more questions than answers. Such is the case with MCFE's national comparison of state and local government taxation and spending, *How Does Minnesota Compare* (HDMC), which is based on the data releases from the Census Bureau's Survey of State and Local Government Finances.

Our latest edition based on FY 19 information is now available, and one of the more attention-getting findings is again Minnesota's comparative spending on what the Census calls "public welfare." That label is a bit unfortunate as it conjures up direct cash transfers and related assistance when in fact it is mainly health care spending and encompasses a much broader array of human service programming, targeting not just low-income individuals and households, but the disabled and the needy elderly as well. Our HDMC findings are not a comparison of benefit levels to recipients. Rather, it captures the overall cost of the public assistance system in each state including the administrative and operational costs of state and county systems for delivering public welfare services and any related capital spending as well as the direct payments to individuals and payments to vendors who provide these services.

According to our latest findings, Minnesota continues to rank second in the nation on public welfare spending, now totaling $26,556 per person at or below 150% of the federal poverty level. That's $7,000 more than was spent in FY 2018 and 112.5% more than the national average. In the past when we've been asked for additional insight on the reasons for the large difference, our best response has been because it's simply always been in the state's DNA to do so. Our high public welfare spending rank and spending levels have been a fixture of our HDMC reports going back over 50 years. Even though we have tweaked the way we compare states over the years, Minnesota has consistently ranked in the top ten nationally and spent a fair amount of the past half-century in the top five. The state has always placed a very strong budget priority on helping and providing security for the needy and disadvantaged.

In 2019, Medicaid accounted for 63% of all Minnesota users of public assistance and 75% of all public welfare spending in Minnesota. No other state public assistance program accounted for either 5% of total recipient payments or overall spending.

Yet it's worth trying to get a better understanding of the differences, if for no other reason than the general fund budget pressure such a commitment creates. Lawmakers are increasingly aware of its influence perhaps best demonstrated by the unusual feature of the 2019 budget deal requiring a blue-ribbon commission to find $100 million in savings in state health and human services spending. State Health and Human Service (HHS) spending now comprises 29% of current general fund spending —nearly a third larger share than twenty years ago — and is currently projected to increase to 34% of general fund spending in 3 years. According to the most recent MMB forecast, HHS spending is expected to increase by 20.3% this biennium, or by $2.76 billion consuming 54% of all the projected increase in FY 22-23 tax revenues.

With this in mind we attempted to dig a little deeper in the numbers behind our comparisons to see if any additional insights could be offered to specifically explain the per-person spending spike in our most recent report and more generally highlight what may be distinctive about Minnesota public welfare spending that propels us to the top of the nation. This effort is meant only to illuminate, not critique, HHS spending differences as we are in no position to evaluate this extraordinary complex area of government. Like the HDMC report itself, these findings probably prompt more questions than answers.

How we compare spending contributes to the size of the difference, albeit likely in a relatively minor way.

We use spending per person at or below 150% of the federal poverty level as our basis for comparison to better align government spending with its ultimate users and beneficiaries. Eligibility for federal public assistance programs most often run from 100 - 200% of the federal poverty level. A clearly superior measure for comparing states would be total population counts being served by public welfare spending in each state, but to our knowledge no collection of such information on a national level exists.

Although 150% of poverty is the best representative measure when comparing all states, it likely contributes to the large gap between Minnesota and the national average. As shown in Table 1, Minnesota consistently has one of the lowest poverty ratios in the country (48th in the nation in 2019) which spreads all public welfare spending over a proportionately smaller number of individuals falling into this lowest income group, all else being equal. Moreover, when economic conditions improve and the numbers of persons in this economic cohort decline even further, it can lead to big dollar "shocks" in the spending measure. Such was the case in our findings this year which reported a dramatic $7,000 spike in public welfare spending per individual. That can be directly linked to the fact that the number of individuals at or below this poverty level in the state fell by 228,000 in FY 2019, or 25.8%. The effect is compounded in states like Minnesota that have

Table 1: Minnesota Poverty Ratio and Public Welfare Spending

	2014	2015	2016	2017	2018	2019
Number of People Eligible	5,398,000	5,417,000	5,458,000	5,430,000	5,619,000	5,684,000
Number of People 150%/Below	977,000	896,000	833,000	776,000	885,000	657,000
Poverty Ratio	18.1%	16.5%	15.3%	14.3%	15.8%	11.6%
U.S. Rank (out of 51)	43	48	50	50	47	48
Per Person Spending	$14,020	$16,111	$19,276	$20,204	$19,533	$26,556
U.S. Rank (out of 51)	4	3	2	2	2	2
Total Spending (billions)	**$13.7**	**$14.4**	**$16.1**	**$15.7**	**$17.3**	**$17.4**

Source: U.S Census Bureau

Table 2: 2019 State Medicaid Spending per Enrollee – Full or Partial Benefit

	All Full or Partial Benefit Enrollees	Seniors	Individuals with Dis-abilities	Adults	Children	Newly Eligible Adult
MN Spending Per Enrollee	$9,669	$27,980	$40,430	$5,115	$3,270	$7,654
U.S. Average	$6,556	$14,343	$19,588	$3,840	$2,837	$5,225
Percent Above U.S. Average	47.5%	95.1%	106.4%	33.2%	15.3%	46.5%
MN Rank	**3**	**2**	**1**	**23**	**19**	**3***

* Excludes 16 states which have not participated in the American Care Act Medicaid expansion
Source: Kaiser Family Foundation based on analysis of data from the Preliminary CY 2019 Transformed Medicaid Statistical Information System (T-MSIS).

greater program eligibility/spending above the 150% threshold.

To what degree this measurement choice affects the size of the differential in spending between Minnesota and the national average is difficult to assess. One mitigating factor is that good and bad economic conditions shared by states are likely to have similar effects around the country. For example, in FY 2019, forty-seven states reported decreases in poverty rates with increases in per person spending. Based on revisiting older reports using per capita and personal income measures, we feel this measurement choice could elevate Minnesota's rank by 1-3 spots.

State Medicaid program design, accessibility, and features are the big difference-maker.

Unsurprisingly, health care is both the most utilized service and the most expensive component of state public welfare spending. In 2019, Medicaid, which now includes MNCare under its Basic Health Plan, served 1.17 million Minnesotans, accounted for 63% of all Minnesota users of public assistance and 75% of all public welfare spending in Minnesota. No other state public assistance program accounted for either 5% of total recipient payments or overall spending.[8]

States have the flexibility to design their Medicaid programs to best meet the needs of their residents, as long as the program meets the minimum federal guidelines. As a result, Medicaid program designs, income eligibilities, and service levels vary widely among the states making attempts to compare and "rank" state programs difficult at best. Such efforts usually focus on three categories of measurement: spending, quality, and access/eligibility. For example, a 2021 report by HealthInsider ranked Minnesota 5th in spending, 8th in quality, and 9th in access. Quality and access rankings feature greater variability due to greater subjectivity in what to measure and weighting schemes, but cost measurement is more straightforward and objective focusing on the amount of spending on beneficiaries and Medicaid spending as a share of state budget. Table 2 offers some additional perspective on where the sources of spending differences lie by Medicaid enrollment group.

The organization and administration of state/local public assistance spending deserves a closer look

Although Medicaid dominates the fiscal landscape of public welfare, eight other assistance programs are managed in the Department of Health and Human Services. Combined, these programs provided assistance to approximately 1.86 million Minnesota recipients in 2019 (although it's important to note the total number of recipients can double count people using more than one program and does not equal the number of people eligible for assistance). All these programs have spending on administration, operations, capital expenditures and related costs.

We subtracted Minnesota payments to recipients and providers of recipient services from total public welfare spending reported to the Census by Minnesota state and local governments to derive an approximation of this other spending. We calculate that in 2019 Minnesota state and local governments spent $2.3 billion on administrative, operational, and all related program management spending or about 15 cents for every dollar of payments.

Interestingly, this was a $376 million increase over FY 2018 even though the total number of public assistance spending recipients declined by nearly 50,000 in FY 2019. To some extent this should not be surprising. The economics of public welfare programming are somewhat analogous to K-12 economics in that even though headcounts may decline — especially in better economic times — the administrative infrastructure demands to deliver services have a strong fixed cost dimension to them.

That said, the trends in the relationship between the number of beneficiaries served and the administrative and related spending

8 Minnesota public assistance program listing, cost, and access numbers are taken from the "Family Self-Sufficiency and Health Care Program Statistics", October 2021 MN Department of Human Services. Non-Medicaid programs are Supplemental Nutrition Assistance Program, Supplemental Social Security Income, Minnesota Family Investment Program, Minnesota Supplemental Aid, Child Care Assistance, General Assistance, Housing Support, and Child Only Program.

to serve them arouse curiosity. In 2019, state HHS programs served 78,501 more persons than it did in 2014, a 4.4% increase. But based on our calculations from Census of Government data, Minnesota state and local governments collectively reported $854 million more on spending outside of payments to beneficiaries and providers than it did in 2014, a 59% increase. Just looking at state employment trends over this period, DHS agency employment supported by the state General Fund grew by 682 full time equivalent (FTE) employees between Q4 2014 and Q4 2019 or an average of 136 new FTEs per year.

What we do know from our national spending comparison

As we noted, this brief look behind the numbers prompts more questions than answers. It can't document the specific reasons why the state spends significantly more than the national average on health and human services. It offers no insights on if or how state Medicaid program design, delivery and administration can be improved from the standpoints of cost effectiveness and return on investment. It sheds no light to the extent our relative public welfare spending levels might be influenced by human capital, organizational structure, administrative and program design, and coordination issues at the state and local level. And it offers no evidence to criticize the spending levels on the human, technology, and capital infrastructure needed in this insanely complicated area to deliver efficient, effective, and accountable health and human services to Minnesotans.

What we do know from our HDMC findings is this: Minnesota's long-standing commitment to the quantity and quality of health and human service delivery comes with a major responsibility: a relentless and aggressive pursuit of innovation, efficiency, and reimagination in their delivery. Otherwise, costs explode, taxes increase, and other spending no less critical to the health and welfare of citizens and the state economy will be crowded out. ■

State Pension Plans: Great Returns Don't Assure Peace in the Valley

A 30.3% investment return in FY 2021 by the State Board of Investment should pave the way for a rather quiet year for Legislative Committee on Pensions and Retirement. But nothing is ever quite that easy in pension land.

Much has been made of the bifurcated nature of the post-TCJA/Covid era economy. But if a comprehensive list of the era's "winners" was being assembled, we could now confidently include Minnesota state and local government employers and employees on that list.

The 2021 state pension plan valuation reports are in, and the results are no less stunning than the size of the state's budget surplus. Thanks to the Minnesota State Board of Investment's (SBI) 30.3% fiscal year return – continuing a multi-year trend that places the SBI in the first percentile of performance for public plans bigger than $20 billion — most of the state's plans have flipped from deficit to surplus on a current market value basis with current contribution levels often well in excess of what is needed to pay for new benefits earned each year. On an actuarial basis in which investment gains and losses are smoothed over 5 years to accommodate and manage inherent risks from market volatility, most plans remain slightly to moderately underfunded (with the exception of a couple of chronic laggards). Yet the $19 billion in investment returns the SBI performance represents makes state and local plans look the best they have in twenty years, regardless of the perspective taken.

It's interesting to consider how much of this improvement in public employees' economic interest and welfare stems from the actions taken by Minnesota's biggest rhetorical and political villains. During tax and government finance committee hearings in the 2021 session, public union and employee testimony along with several legislators highlighted and excoriated the findings of a Washington Post analysis that examined the financial results and actions taken by 50 of the biggest U.S. corporations during the Covid economy. That examination found nine out of ten turned a profit, collectively distributing more than $240 billion to shareholders through dividends and stock buybacks while cutting 100,000 employees. What did not get any recognition was the fact that according to its domestic public markets asset listing, the State Board of Investment had a $15.2 billion equity position in these 50 corporations at the end of 2020 representing over 50% of the value of the state's entire domestic equity portfolio.[9] Such is the mental compartmentalization demanded in debating the modern political economy.

Be that as it may, this is also excellent news for current and future taxpayers whose checkbooks and public services are exposed to the demands of retirement obligations. With respect to pension policy, the focus can shift a bit away from "what do we do to fix things," toward "how do we make the most of this opportunity." With unfunded obligations at a twenty-year low, now would be a highly opportune time to explore the wide variety of structural reform options available in defined benefit, defined contribution, and hybrid plans. However, with plans currently looking as good as they have in a very long time, the motivation for such exploration is almost certainly non-existent.

"Plan B" to make the most of the opportunity would be to at least make further fixes to the flawed funding policies and reporting practices that make fiscally responsible and financially sustainable defined benefit plans more difficult. At the very top of that list is the discount rate employed to value pension plan liabilities in today's dollars. Minnesota plans (and for that matter all public defined benefit plans) use their assumed investment return as their discount rate which is a problem in its own right.[10] Using a more aggressive return assumption compounds the problem. Minnesota's assumed return of 7.5% is 50 basis points above the national median.

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9 According to SBI Comprehensive Performance Report for the quarter ending December 31, 2020, the total market value for the domestic equity portfolio was $28 billion.

10 Basic principles of economics dictate the correct way to convert future cash flows to current dollars is with discount rates that reflect the riskiness of those cash flows. Cash flows to pay pension benefits are low risk – they have to be paid. This is why the federal government requires defined benefit plans in the private sector to use very conservative, high-quality corporate bond rates to value their future pension liabilities. Discounting pension liabilities using expected returns heavily based on risk equities of all types is often argued as the responsible way to avoid "over-contributing" for pension promises when in reality it's just the opposite. There is no better way to threaten the long-term viability of defined benefit plans than by making them appear cheaper than they really are and undercut necessary and fiscally responsible contribution policies in the process. Or as defined benefit pension expert Barton Waring, author of Pension Finance: Putting the Risks and Costs of Defined Benefit Plans Back Under Your Control, has said: "The use of an inaccurate discount rate creates real and consequential differences in the health of the pension plan as the use of the expected return assumption as the discount rate virtually guarantees the eventual failure of any plan using it"

Battle Lines are Forming

The Panel believes it is prudent to lower the rates immediately. The Panel also supports future study to refine these assumptions, ***as well as to examine the investment return versus discount rate assumptions independently of each other. This is a first step, as additional reductions to the rate will likely be needed in the future.*** (emphasis ours)

Recommendations to Governor Dayton from the Blue Ribbon Panel on Pension Reform, December, 2016

On the basis of this recommendation five years ago, Minnesota's public pension plans (eventually) lowered their discount rates to the current 7.5%. In the latest valuation reports the actuary for both the state employees (MSRS) and local employees plans (PERA) reports this 7.5% rate "deviates materially from the guidance set forth in the Actual Standards of Practice" and recommends a discount rate in the range of 5.71% - 7.00%. At recent pension plan board meetings, PERA (on a 7-4 split vote) voted to recommend legislation to go down to 6.5%. The MSRS board is proposing legislation to go down to 7.0%. The actuary for the teachers' plan (TRA) – which we note remains the weakest of the three major plans – remains comfortable with a 7.5% rate and as a result TRA is proposing no change at this time.

Meanwhile, the entire universe of pension beneficiaries — 22 different state public sector union and retiree advocacy organizations – have submitted a letter to legislative leaders, agency management, and pension plan boards opposing "any proposals which lower the assumed rate of return for our pension funds without first doing a comprehensive analysis and having up to date experience studies," adding that the focus instead "should be on the most pressing concern, additional state funding to address the lost purchasing power of retirees' pension benefits."

It's important to understand what does not and does happen with a discount rate (a.k.a investment return assumption) change. It doesn't change what the SBI invests in nor their future actual returns. It doesn't change existing statutorily determined benefit levels. It doesn't change statutorily determined member and employer contribution rates. It would, however, significantly affect the all-important perception game. More accurate reflection of the present value of existing pension liabilities help keep benefit increases or contribution cuts at bay while preventing some ongoing state contribution supports from terminating due to "premature" full funding reporting.

We applaud PERA and MSRS for their leadership on this issue which is likely to frustrate if not upset a significant subset of their respective memberships. We expect to have much more to say on this issue and the arguments raised in the months ahead. ■

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