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Sound tax policy. Efficient spending. Accountable government.

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Tom Gottwalt, *President*
Aaron Twait, *Research Director*
Mark Haveman, *Executive Director*
Linda Edstrom, *Executive Secretary*

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Postmaster, send address changes to:

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

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

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

HIGHLIGHTS OF MCFE'S 90TH ANNUAL MEETING AND POLICY FORUM

Evaluating the State of State Tax Administration

Our 2016 tax panel explored the current condition of state tax administration, discussed practitioners' process and procedural concerns, and offered ideas to advance a strong ethic and system of voluntary compliance in Minnesota.

It's not a topic that makes political headlines or trends on Twitter, but efficient, sound, and equitable tax administration is an important tax policy issue in Minnesota. With rumblings of discontent among some tax practitioners in the air and the likelihood that several controversial legislative proposals offered last year to address some of their concerns will crop up again in 2017, the focus of our tax panel at this year's annual meeting explored the state of state tax administration and procedural protections for taxpayers.

As background for the discussion, the day began with a presentation of findings from MCFE's survey of state tax practitioners conducted late this summer. The survey gathered information on practitioners' experiences and opinions regarding the current state of state tax administration, the adequacy of current taxpayer supports, and the merits of nearly 30 potential new or enhanced procedural protections with precedents either at the national level or in other states. (Our findings will be published in a forthcoming Issue Brief). A distinguished panel of tax experts followed to discuss these and related issues moderated by state tax icon and former Federation of Tax Administrators executive director Harley Duncan. Panelists included Cynthia Bauerly, Commissioner of the Minnesota Department of Revenue; Doug Lindholm, President and CEO, Council on State Taxation (COST); Senator Ann Rest, Chair of the Minnesota Senate Tax Reform Division; and John James, former Department of Revenue Commissioner and "father" of

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Health Care Finance, Cost Control, and the State Budget: Are We Making Progress?

Our 2016 fiscal policy panel delved into the complicated world of public health care spending and what it takes to achieve fiscal sustainability in this large, high profile part of the state government budget.

In 2009 the State Budget Trends Study Commission issued a report whose findings fell somewhere on the continuum between "bleak" and "apocalyptic." According to the report, if historical annual rates of growth in revenues (3.9%) and health care spending (8.5%) in the state's general fund were to continue over the following 25 years, by 2034 two-thirds of general fund dollars would be spent on health care. As a result, to balance the budget all other general fund program spending would have to remain flat over the 25-year period. If lawmakers were to also increase education spending by 2% per year over that time, they would need to cut every other area of state spending by 3.9% annually to compensate.

Now about one-third of the way into that forecast period, where do we stand today, what's the prognosis going forward, and what more needs to be done? Those were the questions at the center of our fiscal policy panel discussion. Moderated by former television anchor and investigative reporter Rick Kupchella, panel discussants were Commissioner Emily Johnson Piper, Minnesota Department of Human Services; Jim Schowalter, President and CEO, Minnesota Council of Health Plans; Donna Zimmerman, Senior Vice President, Government & Community Relations, HealthPartners; and Tom Forsythe, Vice President of Global Communications, General Mills and former MNSure board member.

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Evaluating the State...

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Minnesota's original Taxpayer Bill of Rights (TBOR) efforts in 1990.

The Current Landscape

Panelists began by discussing the current landscape of state tax administration, how Minnesota is currently positioned, and how we arrived where we are today. Doug Lindholm highlighted Minnesota's performance on COST's scorecard of administrative practices, on which we continue to rank among national leaders in the quality of our statutory framework for tax administration. Lindholm emphasized that the COST scorecard focuses specifically on objective standards with respect to the existence of administrative infrastructure and its characteristics; it does not attempt to evaluate subjective issues pertaining to how states operate within that framework. Citing a recent example from another state, he noted evaluating objective standards and subjective behaviors and attitudes within state tax administration can yield very different results.

Commissioner Bauerly provided an overview of the state's investments in taxpayer supports and efforts to upgrade and improve various tax administration processes. Emphasizing that "every taxpayer who had an obligation under the law is our customer and is someone we need to serve," the challenge for the Department has always been to find ways to meet the needs and demands of all filer types, of all sizes, in all geographic areas of the state, for all the different taxes the state has with the limited resources it has available. Towards this end, the Department has placed a major effort on "plain language" initiatives, taxpayer guidance, tools, website improvements and related information initiatives to try to make tax administration as clear and taxpayer-friendly as possible and reduce the need for and level of direct contact with the department itself.

She continued by noting that outreach efforts in the form of in-person classes have been another area where the Department has made major investments. As one example, the number of sales and use tax classes the Department has offered has more than quintupled – from 20 to over 110 – since 2007. With respect to administrative processes, the Department has created audit quality assurance teams to assure consistency and identify areas where additional training may be needed. Audit follow up surveys provide the Department with feedback on the audit process itself and on how well the auditor educated the taxpayer on the process and laws as applied. Regarding expressed concerns about appeals timelines, she noted the Department has been working hard to reduce the backlog and progress has been made. In 2011, there were 140 outstanding appeals cases over two years old –an unacceptable turnaround time. That is now down to 15.

There is too often a tendency to view the relationship between taxpayers and administrators as "us" versus "them" which is very different from the "customer" relationship which should be facilitated.

How does the current administrative landscape compare to the situations and circumstances 25 years ago which prompted the enactment of Minnesota's original TBOR? Former Revenue Commissioner John James argued the Department is now "light years ahead" on these issues; noting that much of what practitioners take for granted today didn't exist back then. The original TBOR effort was focused on establishing that infrastructure – an effort to "bring order out of chaos". Today, he claimed, our concerns are rooted in the procedural side: "fairness, understandability, and efficiency."

In several ways, he reflected, the landscape is the same now as it was then – best encapsulated by a genuine desire on behalf of both the Department and taxpayers to make the system work for everybody. But James asserted that the procedural world of today's state tax administration presents some new and significant challenges. It begins with numbers – many more business and resident taxpayers and 10% fewer departmental employees than in 1990. There is much more employee turnover at DOR and with it a loss of experience and expertise across tax types. To maximize returns on administrative investment, the department has chosen to organize staff – including legal staff – around tax type divisions. This has increased coordination of policy, process and education in tax areas; but has also likely led to increased frustration among tax professionals regarding their ability to access departmental attorneys. Globalization, degradation of IRS code and audit functions, and Congress' inability to "act rationally with respect to the federal tax system" all present additional obstacles for fair and efficient state tax administration. The key to tackling all these challenges, he contended, is stronger communication between the Department as an institution and practitioners. He argued a commissioner or assistant commissioner is in no position to fully understand the fine details and sources of frustration occurring in these highly complex areas.

Are legislators sensitive to these concerns and the ongoing needs of efficient tax administration? Senator Rest began by noting that the tax committees "jealously guard the idea we are the policy makers – the legislature and governor, not the Department. The Department does not make policy nor should they." Such arrogance, she continued, has not been on display here. Legislators do depend on the Department for expert advice on the administrative dimensions of any policy initiative. She noted that the one avenue the Department has to directly influence policy – its annual technical and policy bills – is limited to non-controversial material. If any committee member objects to any provision it's removed without further discussion.

However, Senator Rest could not recall a time where tax committees have ever paid much attention to the details of income and sales tax system administration. For example, she said, legislators don't hear a lot from the tax community on taxpayers' ability to navigate the sales tax system or other administratively complex taxes. In stark contrast, constituent feedback ensures that legislators are keenly attuned to and consumed by the details of property tax administration at the state and local levels.

Desiring Clarity, Consistency, and Certainty

Minnesota has high-quality infrastructure supporting tax administration, has made substantial investments in taxpayer supports, and has legislative bodies that take their responsibility for being the sole developers and gatekeepers of tax policy seriously. Despite this, practitioners responding to our survey identified several administrative issues and concerns on the minds of taxpayers. One key theme was significant frustration regarding a persistent environment of ambiguity and uncertainty within state administration that creates serious difficulties for voluntary compliance – particularly in the sales and use tax and income tax areas.

The problem respondents most often cited was an unwillingness to promulgate new regulations through the rulemaking process with input from the tax community. The publication and use of revenue notices (which, panelists noted, look like law but are only statements about the Department's interpretation of the law) is used instead as a less expensive, less cumbersome, more efficient way to provide guidance on administrative interpretation than formal administrative rulemaking. However, respondents communicated frustration with both the lack of revenue notices on important topics and a persistent lack of clarity/interpretive ambiguity within the revenue notices themselves, creating significant exposure for taxpayers.

When asked about this tension and what can be done about it, Commissioner Bauerly emphasized that if legislators or taxpayers don't agree with the Department's interpretation of the law, the law can be changed to clarify and refine lawmakers' intent and a revenue notice can be revoked and/or reissued. She noted a significant uptick in the number of revenue notices the Department has published recently compared to previous years. All revenue notices, she said, are shared with both tax committees for comment before publication, and the Department also uses informal processes to collect input from affected parties before releasing them. As a way to strengthen the desirable "opportunity for comment, obligation to respond" feature of formal rulemaking within a revenue notice framework, John James suggested that taxpayers take the initiative to draft revenue notices themselves and submit them to the Department for adoption.

Doug Lindholm cautioned that a "if we get it wrong we'll just revoke it" attitude toward revenue notices is disturbing because it creates a lack of certainty and predictability for business. He suggested stakeholders consider establishing a business advisory group as a sounding board for the Department. Based on his experience, however, he cautioned that such groups only succeed when there is a foundation of trust which allows departments to feel confident in exploring difficult interpretive areas and businesses to provide honest feedback. Moreover, he continued, the cultural issues influencing this topic must be addressed. There is too often a tendency to view the relationship between taxpayers and administrators as "us" versus "them" which is very different from the "customer" relationship which should be facilitated. Departments of revenue have to understand that because companies are competing in the marketplace and taxes are a cost of doing business, competitive issues – and not animosity toward the department – drive companies' tax decisions. If departmental staff feel companies are too aggressive in the many complex "gray areas" of tax administration, they should interpret this as a need to revisit the law itself and take the matter to the legislature, not internalize it as "they are trying to put one over on me."

Commissioner Bauerly echoed this concern noting the shift to a "customer focus" is a major departure for DOR. The Department operated under compliance initiatives for much of the recent past – adding auditors and collectors and booking the revenues it was expected they would bring in. Establishing a customer-focused relationship has been a challenge both for the Department and for businesses which for many years have been navigating this increased compliance activity. Senator Rest remarked that legislators have become rather jaded about compliance initiatives. Dong Lindholm argued aggressive compliance initiatives can have unintended long-term consequences on voluntary compliance.

How should we move forward? Harley Duncan asked each panelist to offer their key takeaway idea or recommendation. John James recommended the Department implement a technical advice process that can be used in audits so that legal staff can ensure the issue is properly framed factually in a cooperative effort by the tax administrator and the taxpayer. Senator Rest expressed a desire to have thorough hearings on tax policy administration in both the House and Senate. Doug Lindholm said not to forget to make continued investments in computer and systems support since systems glitches can wreak havoc with tax administration and undercut the painstaking efforts to improve taxpayer/departmental relationships. Commissioner Bauerly remarked that the Department has a lot more work to do in improving communication, noting that DOR already has policies and procedures addressing seven of the top ten recommendations survey respondents identified. She expressed strong interest in strengthening the lines of communication.

There is a lot at stake in keeping this conversation going and moving this agenda forward. Ensuring procedural fairness; easier-to-navigate audit, appeal, and collection processes; and greater clarity for the taxpayer all promote increased trust and faith in the tax system. That is especially needed among larger members of Minnesota's business community. Even though tax administration must be responsive to all taxpayers, greater acknowledgement of and responsiveness to administrative concerns that multistate and multinational businesses inevitably find themselves in because of their more complex tax situations would be a smart investment. That's true not just because of their tax contributions but also their role in Minnesota's economy overall. It's not favoritism, just wise tax administration. ■

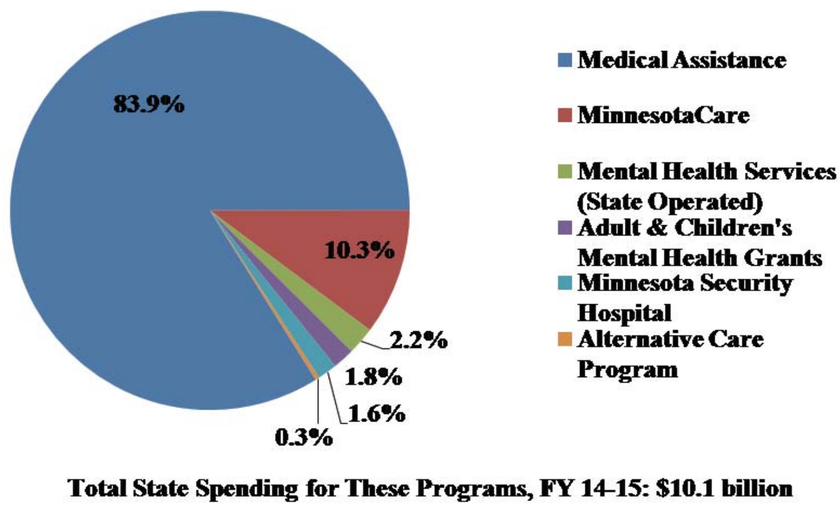
Health Care Finance...

(Continued from P.1)

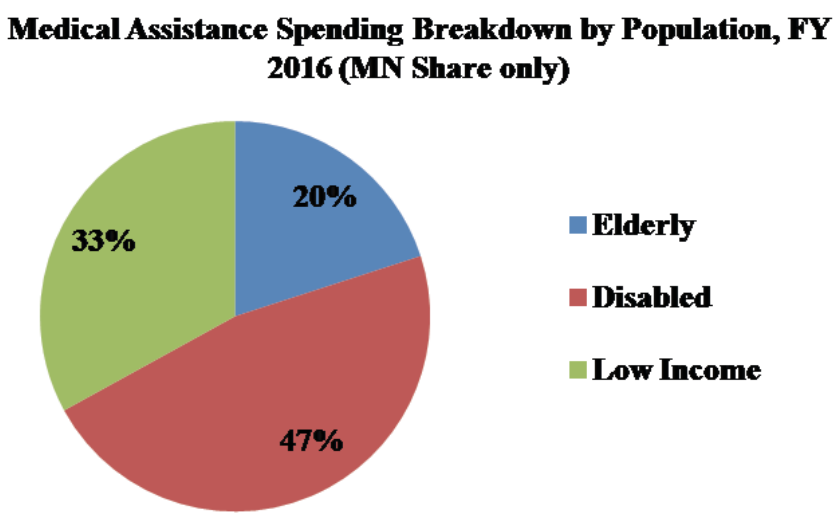
How Bad Is It?

The accompanying pie charts break down the details of state-financed spending on health care and the populations on which that money is spent. The good news, according to the panelists, is that progress has been made. Commissioner Piper noted that the Commission's rather stark predictions haven't been borne out. Since that report was published, DHS has experienced average annual spending increases of 3.7% in Medical Assistance and MinnesotaCare. In 2009 human service spending made up 28% of the state budget; today it makes up just slightly more – 28.8%. This can be attributed, she noted, to efforts we have made to reform health care spending and delivery including competitive bidding for managed care contracts and developing accountable

State Financed Health Care Spending is Dominated by Medical Assistance…



…Which is Comprised of Three Segments of Populations Served



care organizations by partnering with provider groups to support alternative delivery models and payment reform.

Jim Schowalter, who during his tenure at Minnesota Management and Budget worked on the Commission's report, confirmed that the trends to date have been much better than the projections. He noted another key factor contributing to the improved trend line: the Commission did not anticipate the Affordable Care Act, which resulted in the federal government assuming more costs from the state. Nevertheless, Schowalter cautioned that total health care spending keeps growing. In the past few years it grew at rates roughly equal to GDP but that ended last year. Underneath the recent numbers the volatility, pressure, and risks captured in the Commission's report are still very much in play.

Donna Zimmerman echoed the theme that significant changes have taken place in the past several years to help bend this cost curve. She noted 88% of Health Partners claims spending with medical groups are no longer based on payments for every service delivered but rather for improving the health of their patient population as a whole. But progress is slow because it involves "changing the way doctors, nurses, and pharmacists work on the front line." She added that the prescription drug market presents a major challenge going forward, arguing "it doesn't behave like any other part of the health care market." Noting that Health Partners prescription drug spending is now equal to their hospital spending, she argued it's imperative to look upstream and evaluate the "value equation" for new drugs in terms of efficacy and cost.

Tom Forsythe cautioned against overlooking the root cause behind disturbing budget trends in the public segment and rapidly rising insurance rates in the private market segment – a completely dysfunctional health care market. In a market where pricing doesn't exist and consumers can't play a role in making decisions, cost trends like those we are witnessing now and facing in the future shouldn't be a surprise. We need new models and mechanisms to pay for health care based on pricing and market discipline, otherwise there won't be enough dollars to go around. Noting that the median family income in Minnesota is $62,000 while the median family health care plan costs $18,000, he argued the sustainability challenge is as difficult as it was before and will likely worsen.

Points of Light

Given that so many of these challenges transcend state actions and boundaries, can state policy ever make a material impact? Schowalter commented the state still has an opportunity to take a leadership role but "we have to be cognizant of the environment in a way we haven't in the past." We need to be very aware of and responsive to federal developments; then we can work to adapt, respond and innovate faster than everyone else. Commissioner Johnson Piper argued that the primary future cost driver, elderly care, offers the state considerable opportunities to innovate in areas like community and family supports for the elderly and disabled.

Some of these policy innovations are already in place and making a difference. The Return to Community program identifies individuals going into nursing homes who are private pay and provides them with the necessary supports to allow them to return to their own homes instead of spending down their assets and being placed on Medicaid. Since 2010, the program has enabled 3,700 nursing home residents to move back into the community saving the state an estimated $21 million. The state's "Own Your Future" initiative is morphing from an educational campaign on the need for long-term care planning to a program to establish new "term to long-term care" care insurance policies. As state long-term care spending is expected to triple or quadruple from its current $1 billion per year levels, additional innovation is essential.

Tom Forsythe agreed that there has been

	Single Biggest Takeaway Idea	The One Thing Has to Happen to Make Health Care Sustainable
Commissioner Johnson Piper MN Dept. Human Service	Our primary health care challenge is the "silver tsunami," and Minnesota is ahead of the curve compared to other states in planning for it.	Redouble efforts in controlling cost of long-term care especially policies supportive of family care giving.
Jim Schowalter MN Council of Health Plans	Insurance premiums are expensive because health care is expensive. Focusing energies on cost shifting and sharing is not a recipe for success.v	Fix how people can buy insurance on their own. If we can't get everyone covered, the "hot potato" game of cost passing commences and everything starts to go backwards.
Donna Zimmerman Health Partners	We need to get over biases that more health care is "better." Must focus on prevention, behavior changes, and avoid high cost products of marginal/no benefit.	Invest in health of young children and make sure their starts are successful
Tom Forsythe	Insurance access and rate increases distract us from the core problem: the health care market is dysfunctional because pricing of health care doesn't exist.	Payment reform at the federal level. If the federal government would reform, states could follow suit and innovate.

some very innovative thinking at work in the state's public sector health care programs. He noted, however, that the other part of the market – the private pay insured market – is showing significant signs of stress and is ultimately connected to the state-supported programs. He argued Minnesota must come to grips with the fact that our health care costs are no longer below average, that we are not different from everyone else, and that we must get back to the bipartisan effort to seek and adopt solutions which worked so well for us in the past.

Why are we getting more costly? Jim Schowalter noted total spending on the state side has changed – its now more about elderly and disabled coverage. But a big part of the problem is that we are thinking of elderly and disabled health care policy almost exclusively in budgetary terms – entitlement, program eligibility, etc. – rather than as part of a necessary broader social conversation. "These are deeply personal, difficult things to talk about," he said, and high quality cost effective health care has to include social determinants of health. Using the example of people being discharged from the hospital to a homeless shelter, he argued tackling this long-term issue effectively can't just be about the program. Rather, real progress will come from understanding how all the parts of the puzzle – providers, support systems, care givers, and community – work together.

Studies of Medicare claims information have suggested one-third of spending is not necessary and can be considered "waste." What can be done about this? Donna Zimmerman asserted that the key to tackling this issue is creating accountable care organization models – integrative partnerships focusing on where cost of care is high, where experience indicates there is a lot of variation in treatment, where there is a lot of information consumers need to make the right choices, and where the potential for "overtesting" exists. Health Partners reports bending the cost curve by 30% over the last six years. There is nothing particularly glamorous about these efforts, she maintained, but you have to "line them all up" and do all of them to realize the cost saving potential that exists. She noted Health Partners has now applied this strategy to working with the state in the public health care segment.

These innovations and advances, Rick Kupchella noted, operate in a demographic context in which, by 2050, the 65+ population will double, the 80+ population will triple, and the 90+ population will quadruple. What responsibility do stakeholders have to begin a serious conversation about end of life care? All the panelists agreed such conversations simply have to happen. The problem is, while such conversations can be encouraged, they are ultimately deeply personal and outside of the influence of policy.

An Agenda Forward

Kupchella concluded the discussion asking each panelist to offer their biggest takeaway idea and the one thing that "has to happen" to make health care sustainable. As the table above shows, there are many different agendas that need simultaneous attention. When the 2017 session commences it appears we will not be at a loss for new roadmaps, strategies, and policy recommendations to tackle this issue. Whether we can navigate the political complexities, philosophical controversies, and conflicts of interest that accompany these proposals will determine whether we can realize lasting progress. ■

An Insurance Market in Crisis

Annual meeting luncheon speaker, Michael Guyette, President and CEO, Blue Cross and Blue Shield of Minnesota exposed the harsh economic realities of the current individual insurance market and presented a call to action to restore the health of this integral part of the health care system.

While the 2016 health care panel concentrated on the long-term issues and their state budget implications, our annual meeting luncheon examined a more immediate concern: a Minnesota individual health insurance market in crisis. Michael Guyette, President and CEO of Blue Cross Blue Shield of Minnesota, offered a blunt assessment of the extraordinary challenges facing the individual insurance market and offered a health insurance policy prescription for the future.

Guyette began by noting the current problems of the individual insurance market are everyone's problem, not just those customers in this segment exposed to the rapidly rising premiums. While the individual market is the smallest insurance segment, currently serving only about 250,000 Minnesotans, everyone – including group insured, self funded plans, and those on public health coverage – are ultimately connected to it, affected by it, and need to have it fixed quickly. He noted pressure in one segment of the health care system inevitably moves to other segments of the marketplace. No one should feel immune from this issue. "This is a big deal for the state," he said, and it's not a matter of "if" the challenges facing the individual market affect other segments, but "when."

With respect to the BCBS' recent withdrawal from the individual market, Guyette offered a frank analysis on how that decision was reached. He began by acknowledging the hugely painful, disruptive nature of the decision, its direct effect on over 100,000 people's lives, and noted that every possible avenue to avoid this decision was pursued. However, the decision was deemed necessary because continued participation in this segment under the current policy framework, "put 2.8 million other Minnesotans covered under Blue Cross plans at risk."

The numbers and economics are stark. The individual market today, he continued, is underfunded by about $300 million, and has shrunk in recent years from 290,000 to 250,000 people. Every 10,000 people leaving the market represents $50 million in lost premiums. Moreover, based on the three years of data now available, it's become clear that those who have left the market are the healthiest individuals. High claim rates in the individual segment are now higher than what is was three years ago. "The claims are there; the premiums are not there to support it; the basics of insurance are broken."

He noted BCBS is on track to lose $500 million in three years on the individual market due to this significant payment gap. As a non-profit health care insurer, such economics pose a direct threat to BCBS' public mission of supporting the health care of all Minnesotans -- "no margin, no mission." Guyette stated his concern that if changes aren't made and soon, there won't be an individual market in 2018 for sole proprietors, early retirees, and many others.

"If we can't solve this, we're all going to have to pay for it," he continued. Echoing a point made in the earlier panel, Guyette noted the state's historical health care cost advantage has eroded – Minnesota's cost of care is now 5th highest in the nation by one report he has seen. He expressed dismay that all the parties have not been able to come together to address the problem and emphasized that action is needed in the timeframe of months, not years.

What can be done? With respect to the big picture he agreed with earlier panelists that payment reform is ultimately the biggest issue that needs to be fixed, but added that it will also take the longest time to fix. With respect to the immediate challenges in the individual insurance market, he remarked that there is no silver bullet. However, he offered four key ideas that need to be part of a policy agenda to stabilize the individual market:

- **Revoke Minnesota's "guaranteed renewability" law.** Current law provides that when an insurance carrier puts out a plan it stays there forever, and carriers cannot withdraw the plan and replace it with something similar or different. The only way to withdraw a plan is to leave the market entirely. Guyette noted this made sense in the 90s when people had to go through underwriting to get covered and the provision kept people from falling through the cracks but "those days are over." People have guaranteed coverage and the market has changed. Carriers like Blue Cross have plans out there that cause them to be adversely selected against without the ability to adjust product portfolios accordingly.

- **Need to verify special election enrollments.** The combination of no upfront eligibility requirements combined with a grace period for premium payments leads to extraordinary opportunities to game the system. Guyette cited examples of out of state citizens claiming local hotels as a Minnesota residence for coverage purposes and then leaving the state after treatment – costing Blue Cross "tens of millions" of dollars and more for the state.

- **Prevent financially conflicted third party payments.** The health care system is also being gamed by foundations that provide premium assistance to individuals for care but are incentivized by private company donors to move people from less expensive government care to private care because the reimbursement rates are greater. Arguing that we should "go after" such clear conflicts of interest, Guyette said Blue Cross has identified $25 million in extra costs that these practices generate.

- **Need to create a new high risk pool in Minnesota.** Guyette argued Minnesota needs to get a waiver from the federal government to reestablish something like the old MCHA program to avoid the death spiral resulting from increasingly higher concentrations of individuals who would historically have been turned down for private coverage being the primary customers in the individual market.

He concluded by emphasizing again these issues connect everyone in all health insurance segments. Costs are rising and competitiveness issues are at stake. It is everyone's interest to address these issues promptly. ■

Lessons From Fully Funded Defined Benefit Pension Plans

With another round of public pension fixes imminent, what are the keys to having healthy traditional defined benefit plans in this day and age? Some answers to that question can come from an unexpected place: the retirement plans Minnesota public sector unions offer their own employees.

"Urgency" is a word that doesn't get used much in the world of Minnesota public pension policy. The primary reason is that major problems can fester for years before affecting government budgets. It doesn't help that stakeholders and their consulting experts have classically conditioned lawmakers with phrases like "on track for full funding in 30 years" and "long-term perspective" anytime they get even the least bit fidgety about pension health.

But even in the protracted timeframes of pension policy, things can move relatively fast. For example, a report this summer from the Pew Charitable Trusts on government defined benefit pension plans identified Oregon as one of only three states with fully funded plans.[1] At the same time Pew released this report – based on 2014 data – Oregon's public pension plans were reporting a unfunded liability for 2016 of $21.8 billion.[2] That's the fallout from underperforming investment returns over the last two years combined with an acceptance that return expectations needed to be reduced. As a result, schools, cities, state agencies and other public employers across Oregon will have to pony up an extra $885 million over the next biennium to fund public pensions – about 10% more than previously forecast and a 44% increase from the current $2 billion per biennium cost.

Given the veto of this year's omnibus pensions bill, Minnesota lawmakers will be addressing our own unfavorable investment results[3] and the prospect of adjusting economic

1 The State Pension Funding Gap: 2014 Pew Charitable Trusts, August 2016

2 "PERS: Oregon's public pension costs will go up $885M next year" *The Oregonian*, August 8, 2016

From The Director

"In my opinion the Minnesota Center for Fiscal Excellence is the most visible and vibrant non partisan organization on spending and tax policy in Minnesota, and, I believe in the United States."

— Jerry Geis, Recipient, 2016 MCFE Director Emeritus Award, MCFE 90th Annual Meeting

Mark Haveman

My thanks to the 200 members and guests who joined us for our 90th Annual Meeting of Members and Policy Forum and made helped make the program such a success. Thanks, too, to our extraordinary group of panelists and moderators who engaged on very challenging policy topics with such thoughtfulness, wisdom, and passion. I think it was a great illustration of just why Minnesota's good government reputation is well-deserved.

And on behalf of our members and the board of directors, special congratulations to Jerry Geis for his recognition as Director Emeritus of the MCFE. As a true icon of the Minnesota tax community, everyone knows when Jerry speaks, it's a comment or perspective that deserves attention. So we certainly won't quibble with his assessment of the organization he has served so faithfully for 40(!) years.

Like Jerry, I also believe our annual meeting reflects the very best of our organization and its unique role in Minnesota public policy. It's a role only made possible by your membership support and your charitable contributions to our Foundation arm.

If you liked what you heard saw and believe our perspective and analysis is one that must remain part of the state's policy dialogue, please consider joining the MCFE or increasing your membership support if you are already a member. And as "Give to the Max" day approaches and United Way campaigns kick into gear, please also remember us in your end of year charitable giving. Visit our updated "donate" webpage to make an on-line donation today at ***https://www.fiscalexcellence.org/account/donate.html***.

As always, thank you for investment in fiscal responsibility and good government in Minnesota! — M.H.

assumptions when they revisit the issue of sustainability in 2017. And it seems a sense of urgency on these matters is creeping into the legislature. Senator Sandy Pappas, who will likely have the pension commission gavel next session if the DFL retains control of the Minnesota Senate, has said she will "put forward a long term fix."[4] The unresolved issue is the nature of the "fix" – the reforms lawmakers will enact to reestablish a healthy traditional defined benefit pension plan.

Hints at what such measures might be necessary can be gained by examining the practices of defined benefit pension plans that have maintained full funding through the recent economic and investment turmoil. Given the bleak condition of public pension plans around the country, it seems appropriate that such an investigation is best based on whatever points of light exist in the dwindling universe of private sector defined benefit plans. Our review of annual reports filed with the IRS finds some plans very close to home worth considering. Two such plans are the Education Minnesota Employees Pension Plan and the AFSCME Employees Pension Plan.

"One of these things is not like the other… "

As a private, single-employer defined benefit plan, the Education Minnesota Employ-

[3] According to the State Board of Investment, the "combined funds" in which pension system assets are invested had a return of -0.1% in FY 2016

[4] Veto Still Bugs House Republicans – *Capitol Report* October 3, 2016

Comparison of Selected Features, Teachers Retirement Association and Education Minnesota Employees Pension Plans

	Teachers Retirement Association	Education Minnesota Employees Pension Plan
Funded Ratio	79.97% *	133.6%*
Final Average Compensation	Based on highest 5 earning years	Based on highest 3 earning years
Monthly Accrued Benefit	1.9% of final average compensation	2.0% of final average compensation
Normal Retirement Age	67	62
Early Retirement	"Rule of 90" for members enrolled before July 1, 1989; none for more recent participants	Attainment of age 55 with 5 years of vesting service
Early Retirement Penalty	Final benefit reduced based on formula	No reduction – monthly accrued benefit remains
Total Annual Contribution as a percent of salary	15.97%	Estimated at approximately 20% **
Employee share of contribution as a percent of salary	7.5%	Zero – employees do not contribute
Special Retirement Benefit	None	Available to executive staff employees, associate executive staff employees and officers
Discount rate used to calculate present value of plan liabilities in determining funding requirements	8.44%	6.45%

* Market value basis, as of July 1, 2015. Market value basis chosen for comparative purposes as Education MN employee plan reports asset values on a market value basis. Education Minnesota funded ratio based on valuations as of 9/1/2014. Independent auditors report for 9/1/2015 shows funded ratio of 129.6.
** Estimate based on matching total contributions reported on Form 5500 Schedule SB with salary totals reported on Education Minnesota's tax return (Form 990).
Sources: Education Minnesota Employee Plan Form 5500 Schedule SB (March 2016) and accompanying independent auditors report (Harrington Langer & Associates); 2015 TRA Actuarial Valuation Report

ees Pension Plan files actuarial information annually with the Internal Revenue Service.[5] According to its latest filing the plan serves 144 active employees, 160 retirees and their beneficiaries, and 33 vested participants no longer employed by the union. Unlike the struggling TRA plan in which the union's own membership participates, the pension plan providing retirement security for Education Minnesota employees features a funded ratio of 133.6%, which represents a surplus (current assets in excess of the present value of future liabilities) of approximately $20 million.

The considerably healthier condition of the Education Minnesota pension plan is not a function of being less generous plan than its TRA equivalent. In fact, it's just the opposite. The Education Minnesota employees plan substantially exceeds the TRA plan covering the union's members on both eligibility features and generosity dimensions – and 100% of contributions come from Education Minnesota via member dues, with no contributions from employees themselves. The one big design difference is that, unlike TRA, Education Minnesota does not seem to offer any post-retirement cost of living adjustments. However, since Education Minnesota employees contribute nothing from their own paychecks to support their retirement plan, they are more able than TRA members to establish their own independent retirement accounts to protect against the effects of inflation during their retirement years.

How is this combination of solid financial health and comparatively more generous benefits possible? The answer doesn't lie in the investment portfolio. Notably, the Education Minnesota Employee Plan asset schedule is completely devoid of the whiz bang (and relatively expensive) "alternative investment" products which have become an increasing staple of public pension funds across the nation in their scramble for higher yield. Rather, the portfolio reflects what might be found in your highly cost-conscious grandmother's Schwab statement – a collection of very low cost mutual funds. Nearly 40% of their assets are in simple index funds.

The answer appears to be rather simple – they pay for it. We estimate that Education Minnesota's contributions to its employee pension plan are about 20% of salary. Compare that to the 15.97% contribution rate for TRA – which comes from school districts ***and*** employees. Four percentage points may not seem like much of a difference, but for TRA that amounts to $189 million in additional investable assets in just this past year. Considering that TRA has experienced a contribution deficiency (where contributions have fallen short of what their actuaries say are necessary to pay for new benefits and to amortize unfunded liabilities) in every year since FY 2006, it's pretty clear to see how having one-third higher contributions over the last decade would have made their current valuation reports look a little different.

The pension plan for the American Federation of State, County, and Municipal Employees (AFSCME) is classified as a multiple employer defined benefit plan – serving the employees of individual councils across the nation but funded as if a single employer employed all the participants. Like its educational sibling, this union employee pension plan is also in excellent shape with a funded ratio of 116.87% as of its most recent available Schedule SB filing dated July 23, 2015.

Because it is a multi employer plan and its Minnesota members represent union employees in both the state employee (MSRS) and local employee (PERA) plans, a side by side comparison is beyond the scope of this article. Like the Education Minnesota Employees Plan, the AFSCME plan is also relatively generous compared to the plan in which those they represent participate (e.g. final average compensation based on "high 3" salary with an accrual rate of 2.4% of final average compensation). However, there are some interesting differences between the two plans:

Notable Differences Between AFSCME and Education Minnesota Employees Pension Plans

	AFSCME	Education Minnesota Employees Pension Plan
Employee contributions	6%	None
Normal retirement age	65	62
Reduced benefits for early retirement?	Yes	No

In addition the AFSCME plan has some interesting features that may also assist in ensuring its ongoing sustainability:

- A cap on pensionable earnings (it's a huge cap, but still a cap nevertheless)
- A post retirement cost of living adjustment equal to only one-half of the Consumer Price Index
- A benefit rate for future years of service that seemingly adjusts to reflect fund conditions and can actually ***decline*** if necessary

One key element is similar: the discount rate AFSCME uses to calculate the present value of the plan's current liability to determine funding requirements is also substantially lower (6.52%) than its public sector counterparts.

The ERISA Difference

So what explains the discrepancy in health between these private and public sector defined benefit plans? The answer is largely attributable to old fashioned federal regulation – from which public plans are exempt but private plans are not.

Congress enacted the Employee Retirement Income Security Act of 1974 (or ERISA) to address the danger that terminating defined benefit pension plans with large unfunded liabilities would threaten millions of Americans' retirement income. A cornerstone of the legislation was the creation of the Pension Benefit Guarantee Corporation (PBGC) to backstop pension plan defaults. But by 2005 dark clouds loomed on the horizon. Faced with several large pension plan defaults and a PBGC deficit of $22.7 billion, an engineered bailout of the agency was becoming increasingly likely.

As a result – with a majority of 68% in the House and 95% in the Senate – Congress passed the Pension Protection Act (PPA) in 2006. It is regarded as the most comprehensive reform of the nation's pension laws since ERISA in 1974. Lawmakers designed the PPA to increase the minimum funding requirements for defined benefit plans and

5 Sections 104 and 4065 of the Employment Retirement Income Security Act (ERISA) of 1974 require filing of Form 5500, Schedule SB. Unless otherwise noted, all descriptive information for the Education Minnesota Employees Pension Plan comes from their latest federal filing dated March 18, 2016.

strengthen the pension insurance system by correcting for several weaknesses of the existing rules. According to a Congressional Research Service[6] report those weaknesses included the following:

- Sponsors of underfunded plans were not required to make additional contributions as long as their plans were at least 90% funded
- Neither plan assets or liabilities were being measured accurately
- Plans that were underfunded were sometimes able to amortize their funding shortfalls over periods as long as 30 years

Those weaknesses reflect policies that should seem rather familiar.

The PPA introduced new funding requirements for private sector defined benefit plans. It established new rules for calculating plan assets and liabilities. It obligated pension plans to calculate the present value of their liabilities based on bond rates that reflected the length of time until when those liabilities would need to be paid. It required plans to be fully funded and required that any unfunded liability be amortized over 7 years. And it established a new "at risk" category for defined benefit plans whose sponsors are required to make larger contributions to offset the greater liability of these plans. The federal "at risk" threshold is 80% funded – which paradoxically is the same funding threshold many advocates have used to label public sector pension plans as "healthy."

The Price Tag of Fiscal Responsibility

Ten years later, private sector sponsors that could deal with the new stringent demands of fiscal responsibility in providing these types of plans – like Education Minnesota and AFSCME – have kept them. Those that couldn't have either closed or eliminated them. Trends suggest most private sector sponsors fall into that latter camp.

As this trend continues, the disappearance of defined benefit plans in the private sector has created a perception problem for public sector retirement advocates. In their efforts to explain this discrepancy and justify the continued viability of DB plans, these advocates appear eager to throw the regulations designed to protect retirees and the public interest under the bus. The National Institute for Retirement Security, a retirement research organization governed by public plan officials and state investment councils, blames the decline of the private sector DB plan on excessive regulation:

> *Private sector employers have been closing and freezing their pensions due to onerous laws and regulations enacted since the 1970s, including the Pension Protection Act of 2006. These rules created complicated funding rules, and increased contribution volatility when employers need steady, easy-to-estimate costs from year to year.*
>
> — *Who Killed the Private Sector DB Plan?* National Institute for Retirement Security, March 2011

This claim deserves two responses. First, "spectacular" doesn't begin to describe the irony of these advocates' complaints about onerous, over the top regulation on this issue. To criticize the federal government's attempt to rid the private sector of the very practices that are now plaguing public sector DB plans across the country and placing state and local government budgets in such long-term fiscal jeopardy is a truly remarkable demonstration of a lack of self-awareness and the definition of chutzpah.

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Second, the whole premise of having stable, predictable contributions while at the same time basing pension financing on riskier asset classes is deeply flawed. If stakeholders insist on embracing higher risk investment strategies, accepting much greater contribution volatility has to be part of the deal. Why? Because higher risk investment strategies yield results that are inherently more volatile than a portfolio oriented toward lower risk fixed income investments. This in turn makes the yearly changes in the required contributions also more volatile. You cannot reach for higher expected returns to lower present funding costs and at the same time expect (or demand) "steady, easy to estimate costs from year to year." [7]

These ideas are mutually exclusive and portend trouble if you try to marry them (as we in Minnesota – along with others – do). As former State Board of Investment executive director Howard Bicker said, "If you look at our annual returns, very seldom have we been anywhere around 8. It's been 15 or 2 or 20. And that's just the reality."[8] Responsible contribution policy has to reflect that reality. It's also why Education Minnesota's pension "surplus" (assets in excess of liabilities) reflects responsible defined benefit practice based on higher risk asset portfolios. Having a surplus provides the funding cushion a pension plan with a more volatile investment portfolio needs to navigate difficult economic times.

So – what should Minnesota lawmakers do in 2017? One course of action would be to adopt requirements for the state's public sec-

[6] *Summary of the Pension Protection Act of 2006*, CRS Report for Congress, October 23, 2006

[7] Many argue that our current practice of "actuarial smoothing" in which investment gains or losses are phased in over five years is the mechanism by which pension plans can obtain the benefits of both lower cost plan funding (via investments in higher risk assets) and more stable, predictable contribution policies. Smoothing could serve this purpose if 1) public plans were required to make the full actuarially required contribution each year, and 2) the liability discount rate was appropriately conservative. Since neither of those preconditions exist in Minnesota, actuarial smoothing practices amount to nothing more than hiding the true funded status of plans while protecting weak governance structures by making it more difficult to enhance benefits or cut contributions in the wake of good investment years.

[8] "And Many Happy Returns: Howard Bicker Retiring" *Teachers Retirement Information Bulletin*, Fall 2013

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tor pension plans that mimic the rationale and strategy behind the PPA – embrace more conservative investment and discounting assumptions, reduce the amortization periods for unfunded liabilities, and set contributions equal to what the system requires on an immediate (rather than phased in) basis. Depending on how affordable these changes are to lawmakers, structural tweaks like those found in the union plans could be necessary – caps on pensionable earnings, reductions in benefit accrual rates going forward, even further reductions or the complete elimination altogether of post-retirement cost of living increases. It would also mean resisting benefit increases and contribution cuts after these measures restore the plans to full funding to allow a reserve to be created.

To say this policy agenda would "trouble" most every pension stakeholder (including taxpayers) is a world class understatement. The direct costs would likely require new taxes, redirection of tax dollars away from existing programs, or both. As a result, the best odds are that lawmakers will once again tweak the system in a necessary, but ultimately insufficient, way.

Minnesota's defined benefit pension plans are without question a high quality retirement benefit for public employees. They are also without question a lot more expensive that we currently choose to admit – a reality we have to come to grips with. The real urgency surrounding our pursuit of a lasting, fiscally responsible pension fix in 2017 revolves around an understanding and acceptance of that latter truth. ■