FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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Questions Surrounding Pension Policy in 2023

Valuation reports are not out yet, but questions regarding some curious reported investment returns, the push to further embrace environmental, social and governance considerations in investment decisions, the fate of items left on the table in 2022, and economic conditions are giving the Pension Commission and lawmakers a lot to think about next year.

As taxpayers digest their quarterly 401k statements along with the stiff beverage needed to make the results go down easier, they may be wondering how well the state's pension funds are weathering the current environment. Valuation reports won't be out for another month or two, but investment markets, governance issues, and economic conditions promise a busy 2023 for the Legislative Commission on Pensions and Retirement. We take a look at some of the topics.

Private Equity Returns: Are Those Numbers for Real?

The Minnesota State Board of Investment has reported a net -6.4% return for the fiscal year ended June 30. It's a far cry from the assumed 7.5% return on which pension policy is based but a seemingly admirable accomplishment in light of what has happened in the equity and fixed income markets in the past fiscal year. The accompanying table breaks down the total return by asset class and shows most of the SBI's portfolio was not immune to the impact of rising interest rates and the bear market which officially arrived in mid-June. Nothing was spared; all traditional equity and fixed income asset classes were down substantially. However, in stark contrast, the returns of alternative investments – funds and assets that are not publicly traded consisting mostly of private equity – were nothing short of spectacular.

We have previously written about the rationale and appeal of investments in private equity for public pension funds, how increasingly important this asset class has been to meeting SBI's return objectives, and the headwinds it may face in the future.[1] But the magnitude of the difference in returns between alternatives and publicly traded assets is both striking and perhaps puzzling. Some discrepancy can be expected since one of primary benefits of investing in private equity is the resistance to "short-termism" and embrace of patient capital that avoids the endemic volatility of publicly traded companies. Yet new ventures and restructured/reorganized businesses comprising private equity portfolios are still exposed to the same general economic conditions all businesses face.

Most of the explanation appears to be a timing issue.[2] Unlike publicly traded invest-

[1] "Banking on 'A Superior Form of Capitalism'" MCFE Fiscal Focus, July/August 2020

[2] It is worth noting there are academic and investment professional contrarians who question how real private equity's consistently reported outperformance compared to public markets actually is. For example, see "Cliff Asness Questions Whether Investors in Private Equity Are Being Rewarded — or Penalized — for Taking Illiquidity Risk" *Institutional Investor*, June 2, 2022; and "An Inconvenient Fact: Private Equity Returns and the Billionaire Factory" Ludovic Phalippou, Said Business School, Oxford University, Journal of Investing, December 2020

Table 1: FY 2022 SBI Combined Funds Asset Class Performance Summary

Asset Class	FY Return	Market Value 6/30/22 (billions)
Domestic Equity	-14.2%	$26.8
International Equity	-17.4%	$12.0
Global Equity	-27.9%	$0.8
Fixed Income	-10.5%	$20.2
Alternative Investments		
Private Equity	22.1%	$14.8
Private Credit	21.3%	$1.6
Resources (Real Assets)	33.8%	$2.3
Real Estate	43.7%	$1.8
Total Public Equity	**-15.5%**	
Total Fixed Income	**-10.5%**	
Total Alternative/Private Markets	**24.8%**	

Source: MN State Board of Investment Quarterly Performance Report and Alternative Asset Holdings Report as of 6/30/22.

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ments whose values can be ascertained every day, private equity valuations are done quarterly. Given the time needed to assemble these valuations, private equity reporting is provided on a lagged basis – often 3 to 6 months –which can distort SBI end of fiscal year performance reporting. Most of the damage to the investment market was done in the last quarter of the state fiscal year (April-June) which the state's alternative returns have not captured.

The relevant issue for pension policy is that the SBI's fiscal year reported returns, used as the basis of pension fund valuations and determining contribution requirements, will have not factored in future asset write downs in nearly 20% of the state's investment portfolio.

How big a correction remains to be seen. *Pension & Investments* reports "investors are in for a rude awakening on alternative investment returns" when actual June data is reported. A managing partner with Maketa Investment Group (whom the SBI also uses as a consultant) recently told another state investment committee to expect write downs in the next three or four quarters to reflect what has happened in the public markets, because "they are not immune to what happens in the general economy or to the capital markets at large, and that has not yet been reflected in the portfolio." [3]

The relevant issue for pension policy is that the SBI's fiscal year reported returns, used as the basis of pension fund valuations and determining contribution requirements, will have not factored in future asset write downs in nearly 20% of the state's investment portfolio. The state's actuarial practice of asset smoothing – factoring in annual investment gains or losses over a five-year period – will mitigate the immediate reporting impact on fund valuations when they are realized, but they will still exist.

It would be worthwhile for the SBI to preview what might be expected over the next 6 months and what consideration any of this should be given in next year's pension policy decision-making. For that matter a pension commission hearing to hear from officials and other experts on the continued reliability of these historically outsized returns, their growing relevance to reported pension health, and possible transparency improvements would be welcome. Fifteen years ago, alternatives comprised just 10% of the SBI asset mix; today the targeted allocation is 25% of the SBI portfolio. Minnesota and other states are placing billions of dollars into this extremely opaque, exceedingly complex, and decidedly untransparent area of investment with potentially profound public finance implications.

How's Liquidity Looking?

Even though private equity and other pension plan assets are invested with a long-term perspective, enough liquid and near liquid assets must always be available to pay state employee pension benefits now totaling $5.4 billion a year and growing. A reader in the banking industry brought to our attention the fact that times like these may also be impacting sources of plan liquidity. Many shorter duration securities commonly held for such purposes have experienced unprecedented changes in pricing and are significantly underwater. The relevant issue for pension plans is whether and to what extent the impact on liquidity demands is disrupting the funding needed to obtain long term expected returns.

This issue can be exacerbated by the fact that one of the underappreciated characteristics of mature defined benefit plans like Minnesota's, is the existence of negative plan cash flows – i.e. benefit payments and expenses exceeding contributions and aids going into the plans. Investment returns are only as good as the money made available to invest. Collectively, $2.61 billion more went out of state pension plans than went into them in FY21, and that figure also continues to grow.

Does the ESG Debate Have Any Real Bearing on Pension Management?

Seldom does pension investment policy make the news let alone become a topic in a state office race. But such a two-fer is taking place right now in the debate surrounding "ESG investing" which stands for Environment, Social and Governance. It's a movement to consider environmental protection, social justice and equity issues in investment decision-making all based on the reasoning that better investment risk management and investment opportunity are both served by identifying companies understanding and acting on these issues. As *MinnPost* observed, in the State Auditor race it is a topic injecting some liveliness into an election battle usually bereft of interesting topics to talk about. [4]

ESG's relevance to state pension policy revolves around the marketing of it, the substance of it, and how those two get intertwined in politics. With respect to marketing, those who may casually dismiss this as nothing more than an ethereal, fringe concept being pushed by the left haven't been paying attention to what has been going on in the investment industry. According to Morningstar, ESG fund investing is the fastest growing segment in the asset management industry growing 53% year on year to $2.7 trillion worldwide at the end of 2021, while Bloomberg Intelligence reports expectations of an astonishing $50 trillion of ESG assets under management worldwide by 2025. Nearly every investment industry powerhouse around the world now has sustainability vice presidents or chief investment officers employing swat teams of freshly-minted MBAs and exploding numbers of sustainability consultancies and rating agencies, all eager to sell analytical methodologies and services to dig into the operating policies, practices, and data of companies and their supply chains.

Why this topic is giving off a Dutch tulip bulb vibe is another question. To some extent, the answer lies in high school economics: where

3 "Investors Are In For a Rude Awakening on Alts Returns" *Pensions & Investments*, September 19, 2022

4 "Wait? There's a 'real issue' in the state auditor's race?" *MinnPost* September 15, 2002

there is an increase in demand there will be a supply response, especially when the demand is created and legitimized by the supply side. For example, in 2019 CEOs of the U.S. Business Roundtable, representing 200 of the biggest corporate heavyweights in the world, advocated for embracing sustainability practices to advance the interests of employees, communities, and the environment as well as shareholders. CEOs in the banking and investment industry were quick to echo and market the idea that being a responsible corporate citizen can yield better shareholder returns. Private equity ESG funds have now entered the arena arguing patient capital is the best capital for realizing this marriage of doing good with doing better (and ownership control doesn't hurt either). As a result, one industry that has clearly demonstrated the return potential from ESG thinking is the investment industry itself. According to a Wall Street Journal report, ESG ETF funds average 43% higher fees than standard ETF products. [5]

The substance of ESG is a lot more complicated as recent research is bearing out: [6]

- Researchers in a paper published in the *Journal of Finance* analyzed the Morningstar sustainability ratings of more than 20,000 mutual funds. Although the highest rated funds in terms of sustainability attracted more capital than the lowest rated funds, none of the high sustainability funds outperformed any of the lowest rated funds.

- Researchers at Columbia University and the London School of Economics compared the ESG record of U.S. companies in 147 ESG portfolios and that of U.S. companies in 2,428 non-ESG portfolios. They found that companies in the ESG portfolios had worse compliance records for both labor and environmental rules.

- A European Corporate Governance Institute paper compared the ESG scores of companies invested in by 684 institutional investors that signed the United Nation's Principles of Responsible Investment and 6,481 institutional investors that did not sign the principles. The financial returns were lower and the risk higher for signatories.

[5] "Tidal Wave of ESG Funds Brings Profit to Wall Street" *Wall Street Journal*, March 16, 2021

[6] "An Inconvenient Truth About ESG Investing" *Harvard Business Review* March 31, 2022

Despite the considerable attention devoted to this topic, no universal, objective, rigorous framework for ESG Investing exists. Researchers at MIT and the University of Zurich examined data from six prominent ESG rating agencies and found the correlations between their assessments fall between .38 and .71 compared to a .92 correlation between credit rating agencies. They concluded such results "make it difficult to evaluate ESG performance of companies, funds and portfolios." [7]

The most interesting argument questioning the wisdom of ESG investing is laid out by an ultimate insider. In "The Secret Diary of a Sustainable Investor," Tariq Fancy – former Chief Investment Officer of Sustainable Investing for BlackRock, the world's largest investment firm – describes how his thinking evolved from being an evangelizing supporter of ESG and its goals to decrying it as "a dangerous placebo that harms the public interest." He discusses the many conceptual and practical conflicts, challenges, and trade-offs inherent to ESG in fulfilling fiduciary responsibilities and the problems with "good sportsmanship leads to more three-pointers" thinking. But he also argues that ESG is a feel-good distraction from tough discussions and decisions that need to be made regarding regulations and rules under which capitalism operates.

So how should the State Board of Investment handle the sensitive politics and practice of ESG which progressives tend to laud and conservatives tend to criticize if not ridicule? (An example of the latter was featured in the previously referenced *MinnPost* article in which a legislator observed, "What we don't want to do is use that as a baseline to let some woke shitheads take all our pension funds and put them into solar roadways or some other boondoggle projects.") From our review of SBI's 2021 ESG Stewardship Report, the answer to that question is pretty much exactly what they are doing right now.

SBI divides their ESG work into two parts: stewardship and incorporation. Stewardship largely consists of membership in and engagement with the numerous associations, agencies, coalitions, and research institutions which have blossomed around this concept and participating in proxy voting on ESG proposals before companies. It has also hired a consultant to work with the SBI specifically on the high-profile climate change issue. This satisfies lawmaker and public interest in seeing state engagement and activity on this topic, and to the extent some useful ideas or information might be gleaned from this involvement, all the better.

[7] "How ESG Investing Came to a Reckoning" *Financial Times*, June 5 2022

With respect to integration – where investment rubber meets the road – the SBI appears to be taking a more careful approach surveying public and private market managers on their ESG practices (what they do with the responses isn't exactly clear) and engaging in some quite limited screening as dictated by legislation or Board resolution. Most importantly, the SBI appears to be coming at the integration issue from a perspective of better portfolio risk management in response to a changing technological and regulatory environment. That's an approach to investment due diligence which even solar roadway skeptics should appreciate.

How Will the Proposed 2022 Benefit and Funding Provisions Fare in 2023?

The Omnibus Pension bill passed last year consisted of mostly administrative, non-controversial elements. However, a "second" omnibus-type bill, made it relatively close to the finish line in each body but died with the session. This second bill contained the benefit and funding provisions that capture the interest of beneficiaries and should capture the interest of taxpayers. A look at some of the elements and how their discussion might play out in 2023:

- **Increase the Post-Retirement Cost of Living Adjustment (COLA)** – This was a big push by the plan beneficiaries last year, and in light of the inflation rates we have experienced, one can wager it will be a full court press in 2023. Last year's proposal essentially sought to bring all plans up to a 1.5% annual COLA increase. The issue is likely an especially sensitive one for public safety retirees whose pensions are not coordinated with (i.e. do not receive) Social Security and its 8% annual benefit increase that has just been announced. The challenge is that larger COLA adjustments can get expensive in a hurry because of their compounding features. Since the state has developed a skill set for cutting targeted checks out of surpluses, we wouldn't be particularly surprised to see a proposal for some kind of one size fits all "13th check" to retirees to provide some additional compensation for recent inflation. What we absolutely should not do is reprise the 80's when high rates of inflation resulted in retirees receiving the "excess returns" above the assumed rate of return triggering double digit compounding base benefit increases for several years.

- **Lower the assumed investment rate of return from 7.5% to 7.0%** – This effort really should be renamed the "lower the required discount rate from 7.5% to 7.0%" since the primary economic relevance of this assumption lies in its faulty use as a discount rate for determining the present value of future liabilities (which calls into question the dependability of the valuations themselves.) What the SBI actually returns or expects to return on its investments is irrelevant to the proper valuation of pension liabilities. Ironically, the recent rise of interest rates does a better job of serving that purpose than this proposal would. Be that as it may, an assumed rate of return is still needed to develop appropriate contribution policies, and there is consensus supported by the actuaries that a 50 base point cut needs to be done.

- **Lower employee contribution rates** – The proposal included a provision for employees in most all of the plans to see a reduction in employee contribution rates ranging from 3.3% to 32% as a percentage of pay. Many times over the years, the term "shared sacrifice" had to be invoked in which retirees, current employees and government employers would all take a hit in pension repairs. In light of the state surplus and a whopping 30% return on investments in FY21 which propelled several of the funds to near fully funded status and generated "contribution sufficiencies" on a current market value basis, these contribution cuts qualify as a "shared benefit."

Upcoming valuation reports, market conditions, and the economic forecast will have much to say about how much of this agenda stays intact. As of this writing the S&P 500 is down an additional 5% from fiscal year end. More disconcerting is that the US Bureau of Labor Statistics reports that productivity suffered its weakest first half performance since the agency began recording data 75 years ago. Core personal consumption inflation is still well over the Fed's target suggesting more rate hikes to come (with likely implications for the assumptions used in plan valuations). In short, the same words of caution MMB expresses with every economic forecast given the volatile conditions we are facing should apply no less to decision-making in the "off-budget" world of state pension policy. ■

The Landscape for 2023 Property Tax Policymaking

A look at the findings of some recent property tax research reports and what they foretell for 2023.

As November approaches, local governments are preparing their final budgets and preparing for Truth in Taxation hearings. Proposed property tax levies and the impact on tax bills will be in the spotlight, and taxpayer reaction to them will capture the attention of legislators next year. We take a look at some research findings offering insights on two issues — homeowner impacts and tax competitiveness — that always have an outsized role in influencing state property tax policy.

The percentage of homesteads with burdens exceeding 5% are at an all-time report high across all regions of the state and across every income cohort.

Homeowner Frustration

Perhaps the most under acknowledged and underappreciated research report the state publishes is the Department of Revenue's one-of-a-kind "Residential Property Tax Burden Report," also known as the "Voss Report." By linking a homestead's net property taxes (which includes the state property tax refund) with the homeowner's income, the Voss report generates a unique measure of "property tax burden," providing perspective on homestead property tax effort, affordability, and trends. The report presents median results for 10 Twin Cities Metro regions and 10 Greater Minnesota regions. The most recent release from early this year is for taxes payable in 2020 since data cleaning requires some time and effort. Payable 2021 results are expected around the start of the 2023 session.

Results from 2020 show that property taxes continue to make a greater relative claim on homeowner income in the metro area than in greater Minnesota. The median property tax burden is 2.9% in the ten metro regions versus 2.3% in the outstate regions. Perhaps surprisingly, the median burden in most areas of the state is still lower than when the first Voss Report was published for 2007 taxes year payable. In fifteen of the twenty state regions the median burden is still at or – in most cases – below the reported 2007 median burden meaning the property tax's claim on household income for the majority of homeowners in these regions is no greater than it was over a decade ago. The five regional exceptions have median burdens 0.1% - 0.3% higher but still have some of the lowest property tax burdens in the state.

These regional median results would suggest property tax burdens are largely in line with past burdens. However, when regional results are broken down further by income level, a couple of interesting findings emerge:

- In the highest income cohort in all 10 metro regions (incomes above $125,000) and all 10 Greater Minnesota regions (incomes above $90,000), the 2020 median property tax claim on homeowner income is the highest it has ever been since the study began. Notably, homeowners in these two segments represent just under half of all home ownership in the state.

- The report also documents the frequency of burdens that exceed 5% of household income – an after-refund level of property taxation which could be considered an indicator of tax stress. The accompanying table shows that the percentage of homesteads with burdens exceeding 5% are at an all-time report high across all regions of the state and across every income cohort.

If the forthcoming 2021 results show these trends have continued, it suggests a ripe environment for conveying property tax frustration to lawmakers.

Some consolation might be found in the recent release of our *50 State Property Tax Comparison Report for Taxes Payable 2021*, a joint venture of the MCFE and the Lincoln Institute of Land Policy. From a pure property tax perspective, there are certainly worse places to own a home than Minnesota. Minnesota median value homestead property taxes are in the middle of the pack nationally (24th urban and 20th rural). Compared to the largest cities in each state, Minneapolis' 1.235% effective tax rate on the median valued home is again below average – for the 12th time in the last 15 years. That shouldn't be too surprising given homeowner protection from the state's commercial-homestead classification ratio (still 18th highest in the nation), the homestead valuation exclusion, and the state's relatively strong education finance responsibilities compared to other states. If a Voss-like national property tax burden rank was able to be constructed, Minnesota's national homeowner rank would be even lower since our *50 State Comparison* results do not include the effect of our income-tested and special refund programs which are among the most, if not the most, generous and accessible in the nation. Such findings are a useful reminder that state reliance on taxes differ and tax burden is always best evaluated from a whole system perspective.

Table 2: Percent of Homesteads With Tax Burden Over 5% After Refunds

	2007	2014	2020
Above $90k Household Income			
Greater Minnesota Total	0.5%	0.6%	1.3%
Metro Total	3.3%	3.6%	4.5%
Statewide	2.5%	2.6%	3.3%
$65k - $90k Household Income			
Greater Minnesota Total	1.3%	1.0%	3.0%
Metro Total	6.6%	5.2%	9.8%
Statewide	4.3%	3.2%	6.4%
$45k - $65k Household Income			
Greater Minnesota Total	2.8%	1.9%	5.5%
Metro Total	11.9%	7.5%	16.8%
Statewide	7.5%	4.6%	10.7%
$10k - $45k Household Income			
Greater Minnesota Total	13.7%	9.8%	17.4%
Metro Total	36.4%	22.4%	38.8%
Statewide	23.9%	15.1%	26.2%

Source: MN DOR Voss Reports for payable years 2007-2020. We added 2014 as an additional reference year since that was the low point for residential property tax burdens over the report's 13-year history.

Tax Competitiveness

The property tax competitiveness discussion centers primarily on the state general tax. As a non-dedicated state levy paid only by certain types of property (business and seasonal recreational) there is nothing like it anywhere in the country. Ironically, "interstate tax competitiveness" was one of the policy rationales in the creation of the tax in the first place in conjunction with the state takeover of the general education levy. The idea was to make future policy discussions on interstate business property tax competitiveness a state policy (and budget) issue rather than a local government issue. If business property tax levels and competitiveness became a concern, the governor and legislators could use the state general tax as a "relief valve" and dial down the levy accordingly.

From its beginning, however, the state general levy was treated primarily as a general fund revenue source adding a modicum of revenue stability to the General Fund, not as a regulatory mechanism for managing property tax competitiveness. For several years the state general levy was on inflation-indexed autopilot. Over the years efforts to restore the inflation adjustment and other bills to raise more revenue from the tax have been introduced but failed to pass.

In recent years, policy adjustments have headed in the other direction. The levy has been chipped away at a couple of times with levy reductions enacted in 2017 and 2019 and another one left on the table in 2022. A $100,000 market value exclusion was also enacted in 2017 providing additional relief to smaller businesses owning real property.

Have these efforts yielded competitiveness benefits? Our *50 State Study Payable 2021* offers strong circumstantial evidence it has made an impact. Since 2017, Minnesota's $1 million urban commercial rank[8] has fallen from 8th to 15th in the nation. Effective tax rates have declined from 38.8% above the national average to 34.4% above the national average. Looking specifically at the Upper Midwest region, as the table shows Minnesota is now below the regional average for $1 million urban commercial, although still at a noticeable disadvantage with states on the western border. Similar results exist for industrial property (17th to 19th nationally), the difference influenced by Minnesota's preexisting advantages in exempting industrial personal property. (See Tables 3 and 4 on the next page.)

Our 50-state study also offers some perspective on how the state's classification system continues to influence business effective tax rates. Four city factors have been shown to be statistically significant ($p < 0.01$) as correlates of cities' effective tax rates: property tax reliance, median home value, local government spending, and the classification ratio. The Lincoln Institute's Fiscally Standardized City Database allows cross city comparisons to determine the influence of each of these factors on the effective tax rate relative to 74 other cities in this investigation. Minnesota's commercial homestead classification ratio has a 0.33 impact on the urban effective tax rate

[8] For our commercial rankings we use office property for two reasons. First, it's the predominant form of commercial property in Minnesota (in 2018 our modeling based on NAICS sectors indicated it represented about 55% of total commercial property value.) Second, the idea of tax competition in property taxation applies most readily to commercial office space as most other types of commercial properties (grocery stores, restaurants, retail etc.) are tied to local population centers and the goods and services consumed there, and the concept of "interstate competitiveness" doesn't really apply.

Table 3: Minnesota Regional Competitiveness for Commercial Property Valued at $1 Million With and Without the State General Tax (Payable 2021)

Largest Urban Cities - Upper Midwest Region						
Locations	Total Tax		National Rank		Tax vs Regional Average	
	With SGT	Without SGT	With SGT	Without SGT	With SGT	Without SGT
Minneapolis, MN	**$30,041**	**$23,547**	**15**	**20**	**-3.4%**	**-22.5%**
Chicago, IL	$45,400	$45,400	2	2	45.9%	49.4%
Indianapolis, IN	$33,792	$33,792	6	6	8.6%	11.2%
Des Moines, IA	$34,951	$34,951	4	4	12.4%	15.0%
Detroit, MI	$50,548	$50,548	1	1	62.5%	66.4%
Omaha, NE	$24,122	$24,122	20	19	-22.5%	-20.6%
Fargo, ND	$12,795	$12,795	46	46	-58.9%	-57.9%
Sioux Falls, SD	$16,537	$16,537	34	34	-46.8%	-45.6%
Milwaukee, WI	$31,786	$31,786	11	11	2.2%	4.6%
Upper Midwest Avg.	**$31,108**	**$30,387**	—	—	—	—

Table 4: Minnesota Regional Competitiveness for Industrial Property Valued at $1 Million (50% Personal Property), With and Without the State General Tax. (Payable 2021)

Urban Cities - Upper Midwest Region						
Locations	Total Tax		National Rank		Tax vs Regional Average	
	With SGT	Without SGT	With SGT	Without SGT	With SGT	Without SGT
Minneapolis, MN	$30,041	$23,547	19	30	-11.0%	-28.9%
Chicago, IL	$51,281	$51,281	2	2	51.9%	54.9%
Indianapolis, IN	$48,896	$48,896	3	3	44.8%	47.7%
Des Moines, IA	$33,510	$33,510	16	16	-0.8%	1.2%
Detroit, MI	$48,753	$48,753	4	4	44.4%	47.2%
Omaha, NE	$33,018	$33,018	17	17	-2.2%	-0.3%
Fargo, ND	$12,795	$12,795	51	51	-62.1%	-61.4%
Sioux Falls, SD	$16,537	$16,537	40	40	-51.0%	-50.1%
Milwaukee, WI	$29,131	$29,131	20	19	-13.7%	-12.0%
Upper Midwest Avg.	**$33,774**	**$33,052**	—	—	—	—

which is 11th highest among the 74 cities. This means if Minneapolis had the average classification ratio of the 74 cities but all other three characteristics of the city were unchanged (tax reliance, etc.) the city's commercial effective tax rate would be 0.33 percentage points lower. Notably, the tax rate impact of the other factors – property tax reliance, median home value, and local government spending – are all lower (0.00, - 0.14, and 0.12 respectively). The moral is, despite considerable class rate compression over the years, Minnesota's classified property tax system still has a material impact on effective tax rate differences among peer cities.

Looking Ahead to 2023

The Department of Revenue's Preliminary Levy Report is not out yet, but if news reports of city decisions are representative of the state, it's highly likely we will exceed this year's 4.2% year-on-year total increase. 2023 also offers some potential wild card issues. At the top of the list is the shifting of existing and new levy burden across property types due to some dramatic valuation changes exacerbated by state classification.

While homestead values have skyrocketed in many areas of the state, the value of a lot of commercial property has likely been hit by COVID and its economic after effects. For example, in a recent NBER Working Paper,[9] researchers documented large shifts in New York City office lease revenues, office occupancy, lease renewal rates, lease durations, and market rents as firms shifted to remote work in the wake of the Covid-19 pandemic. The study found large effects on both current and expected future cash flows for office buildings. Taking into account pandemic-induced cash flow and discount rate effects, researchers estimated a 45% decline in 2020 office values and projected a 39% decline in the longer-run totaling $453 billion of property value destruction just in New York city. As the authors concluded in perhaps the most understated way imaginable, "these valuation changes have repercussions for local public finances." Effects like these are exacerbated in classified property tax systems as the multiple of lost tax capacity from classification results in rate increases with shares of tax burden sloshing over to homeowners and other property types.

In light of all this we can expect the full gamut of property tax relief ideas to be on the table in 2023. That would include more income-tested refunds (and a reprise of the transformation of the renter's credit in a refundable income tax credit), more general purpose aid for cities and counties, pushes for extensions of local sales tax authority, levy limits, and the usual potpourri of burden shifting strategies such as assessment limits, and targeted exemptions for favored property uses or types. Income taxation may be the headline generator these days, but when all is said and done, Minnesota's property tax system is guaranteed to have its moment in the sun. ■

9 Work From Home and the Office Real Estate Apocalypse" Gupta, Mittal, and Van Nieuwerburgh, NBER Working Paper 30256, September 2022.

Register Today!

96th MCFE Annual Meeting of Members and Policy Forum

Wednesday, November 16, 2022

9:00 am – 12:00 pm

Our annual meeting and policy forum will once again (and hopefully for the last time) be a virtual event.

Stop by for a particular session or join us for the full morning.

Anyone is welcome to register.

To register, contact Charisse at 651-224-7477 or email her at *ctester@fiscalexcellence.org.* A webinar zoom link will be sent to you in the near future.

AGENDA

9:15 AM – 9:45 AM

DEPARTMENT OF REVENUE UPDATE:

Lee Ho, Deputy Commissioner,
Minnesota Department of Revenue

Deputy Commissioner Ho will provide an update on the current tax administration environment and what's on the Department's radar screen heading into the 2023 session.

9:45 – 10:30 AM

TRENDS AND DEVELOPMENTS IN STATE TAXATION IN THE "POST" COVID WORLD:

Fred Nicely, Senior Tax Counsel,
Council on State Taxation

The landscape of state taxation has changed dramatically over the last several years in the wake of the pandemic and the federal government's extraordinary responses to it. Fred Nicely will highlight notable state and local tax developments and trends taking place around the country, COST initiatives to improve tax administration and administrative actions of relevance to states, and what state lawmakers and taxpayers should be thinking about in 2023.

10:45 – 11:45 AM

2022 ELECTION RESULTS AND IMPLICATIONS FOR THE 2023 SESSION:

Todd Rapp, CEO, Rapp Strategies

Chas Anderson, Co-CEO and Senior Principal,
Park Street Public

Peter Callaghan, State Government Reporter,
MinnPost

Our distinguished panel of Capitol observers will dissect the 2022 election results and discuss what it means for the 2023 legislative session.

ATTENTION MCFE MEMBERS:

The MCFE Business Session will be held from 12:00 – 1:00 pm

Incudes election of board members and the executive directors report. All members are strongly encouraged to participate as we will be unveiling some changes to our organization and our operations. A separate meeting link will be sent to all MCFE members.

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