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In This Issue:

- *Budgeting Through the Constitution: Popular Appeal; Practical Problems*
- *Forecast Surprise*
- *The 8.5% Dilemma*
- *MTA Launchs Second Century Campaign*

Minnesota Taxpayers Association

Mike Engelmeyer
President
Linda Edstrom
Executive Secretary
Mark Haveman
Executive Director
Lori Milanowski
Research Associate
Aaron Twait
Research Director

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c/o Minnesota Taxpayers Association
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@mntax.org
Web Site: www.mntax.org

Budgeting Through the Constitution: Popular Appeal; Practical Problems

Unlike many states, Minnesota has largely resisted using the state constitution to usurp the legislative budget-building process. With the exception of our long history of dedicating transportation-related revenues (gas taxes and more recently motor vehicle sales tax receipts), the state constitution remained free from provisions prescribing how much government revenue could be raised or how that revenue must be spent.

That wall crumbled in 2008 with voter passage of the politically popular but fiscally irresponsible constitutional dedication of an additional 3/8th cent sales tax specifically for arts and natural resource related programs. One of the many concerns of its passage was that the experience in direct democracy would open the door for other budget endarounds. It shouldn't be surprising that two proposals to inject fiscal constraint into state government through voter approved constitutional amendments will be part of the discussion in the 2012 legislative session.

"Would You Like that Majority Supersized?"

The first proposal, HF 1598, would require a three-fifths supermajority of both legislative bodies to increase the rate or expand the base of state income and sales taxes. The supermajority provision would also extend to the statewide property tax as well as to the granting of any local government authority to impose or increase a property tax rate or levy without voter approval. The proposal does allow for tax policy changes without a supermajority vote but only if "the law also decreases taxes and does not, on a permanent basis, increase the total amount of revenues raised from state taxes and property taxes." It's a chapter from the playbook of sixteen other states that have supermajority provisions for tax increases. All but one are enshrined in state constitutions.

Proponents and opponents of supermajority provisions both invoke the preservation and strengthening of democratic government in support of their arguments. Proponents argue supermajorities prompt more responsible tax policy built on broader consensus and help insulate democracies against the "tyranny of the majority" in which the majority of voters force a minority to subsidize their preferred level of spending. Critics counter supermajorities actually weaken democratic systems by diluting the vote of the individual allowing powerful, well-connected minorities to gain power at the expense of the majority. In our review of literature from around the country, it was a bit humorous to see the staunchest proponents and the harshest critics both use the same James Madison quotations to support their positions.

Theory aside, the key issue is the impact supermajority vote requirements actually have on governance, budgeting processes, and tax and spending levels. One almost certain impact is that such requirements make substantive tax reform in response to changing demographic or economic realities much more difficult to implement. Reform often involves multiple adjustments to different tax bases and rates, many of which may increase revenue in some way regardless of whether or not the total reform package is revenue positive. Creating the need for supermajority approvals of these puzzle pieces in both legislative bodies in order to enact reform transforms the merely difficult into the nearly-impossible. Even modest but important changes such as those that ensure continued federal conformity – important because they reduce the time and burden associated with tax compliance – would be more difficult to enact.

The language in the bill intended to accommodate reform under a supermajority regime seems has its own implementation challenges. It is difficult to see how one could define or evaluate the concept of "permanent" revenue neutrality. In short, any supporter of a supermajority amendment should be extremely comfortable with the design and structure of Minnesota's existing state and local tax system.

All Hat and No Cowboy?

Do supermajority vote requirements impact tax revenue growth and spending? Simple comparisons of state budget histories have generated evidence of slower revenue and spending growth in states with these provisions. However, many other economic, political and demographic factors also influence state tax and spending trends. Studies isolating the influence of supermajority provisions while controlling for all these other factors provides a better understanding of their budgetary impact.

Such studies are far fewer in number but do exist. Perhaps surprisingly they show modest or even no effect. A 2009 study examining the revenue impact of supermajority requirements found no statistically significant impacts on the growth in sales taxes, income taxes, total revenue or total revenue per capita.[1] Another study examining 37 years of state spending and revenue growth concluded that supermajority rules "do not appear to affect the amount of revenues that government extract from their citizens," and states with supermajority rules "do not tax or spend on general projects differently than states without them."[2] However, this report did find that supermajority rules can impact the types of spending. Spending on health and human service programs in supermajority states was 7% lower compared to states without such provisions. The explanation: supermajority constraints are more likely to direct support toward public goods and services spending on which most elected officials can agree — and restrict spending on redistributive programs as a result.

Why do these findings suggest that supermajority provisions are often more symbolism than substance? Researchers conclude state governments have innate political limits within their institutions, processes, and, above all, re-election cycles that act just as effectively as a brake on raising taxes. Minnesota's own experiences with tax policy over the last ten years and the changes in power at the Capitol are Exhibit A for this argument. At best supermajorities appear unnecessary. At worst they can severely hamstring the ability of government to modify tax policy in response to demographic conditions, economic realities, and federal changes.

Budgeting by Economic Modeling

Meanwhile in the Senate, the focus is on using the state constitution to restrain spending. SF 1378 proposes a constitutional amendment that limits general fund appropriations to a maximum of 98% of the estimated general fund revenue for that biennial budget period at the time of the February economic forecast. Any excess revenues would accrue to a budget reserve account to fund expenditures "necessary to respond to emergencies involving the health, safety, and welfare of the citizens of Minnesota" which would be subject to a three-fifths supermajority vote. The proposed amendment would automatically cut the state sales tax rate if growth in the budget reserve account would grow to 5% of projected general fund revenues, unless the state adopted some other form of tax relief.

Supporters have argued that such provisions would have allowed Minnesota to avoid the difficult budgetary situation we find ourselves in now. To see how this provision might have affected budget reality, we modeled its effects through the Great Recession to the present using the February 2007 economic forecast as our starting point. Two critical assumptions: adjustments to enacted budgets to eliminate budget deficits would require the new budget to be set at 98% of newly projected revenues; and revenues would remain the same under the spending limitations. Based on the February 2011 economic forecast, this amendment would have limited the maximum allowable budget for the current (FY 2012-13) biennium to $32.66 billion – or $1.68 billion less than the $34.34 billion enacted in the special session. At the same time – as of the November 2011 forecast – the budget reserve would have grown to $1.79 billion over four years or some 5.3% of projected general fund revenues, potentially requiring some form of tax relief as of July 1, 2012.[3]

Clearly, the primary impact of such an amendment is to mandate an "all cuts" approach to any necessary mid-stream budget repairs. But the apparent simplicity of this idea on paper also masks potential complexity and some long term consequences of putting it into practice:

- **Downward "Ratchet Effect" on the Budget.** The continual sweep of unencumbered revenues which can only be appropriated following a three-fifths vote of each legislative body in response to an emergency linked to specific circumstances makes reductions in the state sales tax rate or some other form of tax reductions very likely – even in the most challenging budget circumstances as demonstrated above. Assuming that such reductions are permanent, they would then become a part of future economic forecasts and create a negative feedback loop lowering revenue projections, and in turn permissible general fund appropriations.

- **Growth in Dedicated Spending.** Like water following the path of least resistance, legislators will almost assuredly pursue paths to safeguard preferred spending programs from harm. Most likely, legislators would take favored spending programs out of the general fund and support them with fees or other new forms of dedicated revenues.

- **Uncertain Impacts on Redesign and Reform.** Theoretically, stiffer competition for more constrained general fund dollars might prompt more energy and investment in government redesign. On the other hand, practical experience has long shown that revenue provided by occasional surpluses is the best grease for lubricating reform. Moreover, any redesign efforts requiring transfers and modifications of duties and responsibilities between state and local governments could be immensely complicated by this type of limitation.

- **More Amendments.** Once public familiarity and momentum builds for direct democracy of this nature, it is difficult to put the genie back in the bottle. Colorado, the grandfather of the expenditure limitation movement, is a tutorial on how amendments of this sort beget new amendments. As the various consequences play out – both intended and unintended – cottage industries of aggrieved parties and interests form to take their cases directly to the voters. Over time, the layering of these often contradictory provisions can create an incomprehensible state/local fis-

[1] Meagan Jordan, "The Revenue Impact of State Legislative Supermajority Voting Requirements," *Midsouth Political Science Review*, 2009 Vol 10.

[2] John Bradbury and Joseph Johnson, "Do Supermajority Rules Limit or Enhance Majority Tyranny? Evidence from the US States: 1960-1997

[3] For simplicity we assume none of the outlays between February, 2007 and February 2011 would have been enacted pursuant to the amendment's "emergency" provision.

cal system severely constraining governments' flexibility to respond to changing circumstances and conditions.

Constitutional amendments that constrain fiscal-decision making have popular appeal but their philosophical problems and the practical mischief they can introduce into state and local fiscal systems make this poor policy. Whatever form the proposed constitutional amendment eventually takes, it is expected to be part of a larger "Reform 2.0" package intended to make government – in the words of Republican leadership – "more accountable, cost-effective and efficient." It's doubtful other elements comprising Reform 2.0 will be any less controversial. But if these other components attempt to meaningfully address cost structures, efficiency, transparency, and productivity in government service delivery, they automatically have more intrinsic merit and potential value than anything that might show up on the ballot next November. ■

Table 1

FY 2012-13 Budget Summary ($ in millions)

	End of Session	November Forecast	Difference
Beginning Balance	$725	$1,289	$564
Forecast Revenues	33,724	33,700	(24)
Projected Spending	34,339	33,991	($348)
Reserves [4]	95	122	$27
Projected Balance (Allocated To Reserves)	$15	$876	$861

[4] Includes cash flow account and budget reserve. Sourse: MMB.

Forecast Surprise

By now you've likely heard that the November Economic Forecast threw a curveball at everyone predicting yet another budget deficit in the office pool. Thanks to higher than expected revenues ($358 million) carried forward from the previous biennium, and lower than expected health and human service spending, the forecast projects an $876 million surplus for FY 2012-13.

After a seemingly endless string of deficit projections, a sense of relief is understandable. However, state economist Tom Stinson continued to emphasize the fragility of Minnesota's economy and state budget situation. Projected revenues for FY 2012-13 actually declined from the previous forecast thanks to lowered economic growth estimates; the next (FY 2014-15) biennium still shows a general fund deficit of $1.3 billion; and all of the current surplus is needed simply to shore up depleted cash flow and budget reserves.

Remember a few years ago when claims abounded that Minnesota had lost its economic luster as our historic national leadership in income growth faltered? For whatever reason our dogged, tortoise-like economy (compared to the hares of the last decade) is now significantly outperforming the national economy in both wages and employment. The key to our immediate budget future is not only a continuation of this relative outperformance nationally but also decoupling to the greatest extent possible from any fallout from the European sovereign debt crisis.

In short, the forecast is a very welcome respite but not an opportunity to relax. All the structural budgetary challenges and demographic headwinds remain, and the need to develop "intrapreneurism" within government is just as essential whether you have $15 million or $876 million in the savings account. ■

The 8.5% Dilemma

"It is only in pension finance that the discount rate for a liability is based on the expected return. Not in banking, not in investment banking, not in project finance, not in home mortgages or consumer finance—and not in government finance. No one else; nowhere else; nothing else."

—M Barton Waring, *Pension Finance: Putting the Risks and Costs of Defined Benefit Plans Back Under Your Control*

Albert Einstein is purported to have once said that the most powerful force in the world was compound interest. The story may be apocryphal, but the truth of the statement is reflected in the world of public pension funding and politics.

The assumed rate of return on the state's pension fund investments was the subject of extensive discussion and debate this fall at three Legislative Commission on Pensions and Retirement hearings. Minnesota's current 8.5% annual assumed rate of return on pension fund investments is the highest in the nation according to a public fund survey conducted by the National Association of State Retirement Administrators. This crucial assumption has profound implications for the reported health of funds and for the levels of contributions pension funds require. This fall, the commission heard extensive testimony on whether the current 8.5% is too optimistic and what the implications would be if this assumption was lowered.

How big a deal would this be? **Table 2** prepared by the Teachers Retirement Associa-

Table 2

Financial Impact of Moving from 8.5% to 8.0% Investment Assumption

	MSRS	PERA	TRA
Projected Liabilities	Increase by $600 million	Increase by $1 billion	Increase by $1.3 billion
Funded ratio	Decrease from 87% to 82%	Decrease from 76% to 72%	Decrease from 78% to 73.5%
Sufficiency/ (Deficiency)	(1.0%) deficiency rises to (3.1%) deficiency	1.0% sufficiency becomes (0.8%) deficiency	(0.4%) deficiency rises to (3.2%) deficiency

Source: TRA Memo to Legislative Commission on Pensions and Retirement

From the Director

Mark Haveman

MTA Launches Second Century Campaign

I am excited to announce that at its recent December meeting, the MTA board of directors reviewed and approved the "Second Century Campaign" a special fundraising effort to address several critical needs and position the MTA for a second century of excellence in fiscal policy research, education, and advocacy.

The purpose is to address two primary organizational development areas. The first is information technology and communications. Anyone visiting the MTA website knows we have major "issues," but this is just symptomatic of a need to completely overhaul the organization's IT and communication infrastructure. Part of the campaign will support a complete remake of MTA's website and information technology systems allowing us to dramatically improve both the visibility of our work and our advocacy efforts, while creating new value-added features for members. Expected improvements include "real time" access to bill introductions and summaries and an on-line searchable research library of MTA publications and research reports.

The second area involves organizational marketing and membership engagement. Membership support will always remain the lifeblood of this organization, and funds will be used in several ways to grow the organization, improve its stability, and engage members more directly in the agenda and work activities of the organization.

What outcomes can MTA members expect?

- Better, quicker information about tax and fiscal policy to members and policymakers
- A more fiscally stable organization with the resources to improve communication of our positions
- More members, more membership interest, and stronger member advocacy
- Ultimately smarter state tax and fiscal policy.

In the near future members will be receiving additional information including an opportunity to pledge to the campaign either as supplemental dues to the MTA or as a charitable contribution to the Minnesota Center for Public Finance Research. Our fundraising goal is $100,000, and I am very pleased to note that the enthusiastic support from several of our members have already provided us with a fantastic start.

We look forward to sharing further developments with you. In the meantime, on behalf of Linda, Aaron and Lori, let me offer you our very best wishes for a joyous holiday season and a prosperous 2012.

— MH

tion (TRA) highlights the impact of lowering the investment assumption by 50 basis points to 8.00%. For the three major state funds[5], projected unfunded liabilities would increase by an additional $2.9 billion (on top of the current $10.9 billion in unfunded liabilities in the three statewide general employee plans as of July 2011). But even more important are the implications for contributions to these funds. A contribution sufficiency occurs when existing funding efforts are adequate to pay for current obligations and whatever additional contribution is needed to pay off any unfunded liabilities by the target amortization date. A contribution deficiency means the opposite – funds are falling further behind, creating more unfunded liabilities. The lower assumed return switches PERA from sufficiency to deficiency status while causing further deterioration to the existing contribution deficiencies in MSRS and TRA. Translation: absent additional changes to the benefits being offered, changing this assumption would likely require more contributions from employees, government, or both. Importantly, this analysis includes future contribution increases already scheduled in law.

The debate does not end here. As we have reported in the past, the Government Accounting Standards Board is expected to promulgate new pension reporting standards that would require governments to reduce expected asset return rates in situations where unfunded liabilities exist. In testimony this fall before the pension commission, representatives from the state's investment board described the potential GASB reporting standard changes as a "major problem." This comment perfectly captures the insular world of pension debates: unfunded liabilities, continuing contribution deficiencies, and taxpayer exposure are not the "problem," but rather accounting treatments that provide a more intellectually honest and ac-

[5] Includes Minnesota State Retirement System (MSRS), covering state employees; TRA, covering teachers and school employees with teaching licenses; and PERA, covering other local government employees.

curate presentation of pension fund health to taxpayers.

But even this GASB modification is considered wholly inadequate by many pension experts. Barton Waring, quoted above, is a retired Chief Investment Officer for Barclays Global Capital who literally wrote the book on defined benefit pension plan finance. Notably, he is an enthusiastic and unabashed **supporter** of defined benefit plans. Yet in his testimony to GASB on the proposed reporting standards, he argued forcefully that assumed asset return rates are not only the wrong discount rate to use, they are exceedingly dangerous to defined benefit plan survival because either assets will not be available to pay benefits in the future or contribution levels will eventually go out of control.[6] Waring argues that government-sponsored pension plans must join the rest of the financial world and discount liabilities using risk-free rates of return because doing so provides superior risk control, greater cost stability, lower long term funding costs, and less volatility in pension contributions.

To Waring and others, the hotly-contested GASB reforms are actually weak tea. They argue that instead of prolonging the mirage with a GASB-manufactured compromise between basic economic principles and politics, we should accept the real economics of these plans, take our medicine, begin a transition to discounting liabilities using risk-free rates, and make whatever adjustments are necessary to defined benefit plans accordingly.

Such an approach has zero chance of being adopted in Minnesota. In pension commission testimony this fall, Andrew Biggs of the American Enterprise Institute estimated that pensions now reported as 80% funded would likely be only about 40% funded using a risk-free discount rate. The shock waves and contribution hikes triggered by such a decision would be untenable. Instead, it appears some minor tweaking of the assumed rate down from 8.5%, perhaps temporarily, might be in store. However, even that is likely to face challenging political obstacles. In the meantime, the significant contribution and funding risk assumed by future taxpayers continues largely unabated. ■

[6] For a synopsis of the important ideas in this argument see "A Critique of the State Retirement Plan Design Study" Fiscal Focus, May/June 2011. Or view Barton Waring's GASB comment submission at http://www.bartonwaring.com/2011/10/waring-comments-on-gasbs-accounting.html

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