THE MINNESOTA POLICY BLUEPRINT

PRESCRIPTION FOR PROSPERITY

Policy Recommendations for All Minnesotans to Thrive

CENTER OF THE AMERICAN EXPERIMENT

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Tom Mason, Project Director
Peter J. Nelson, Editor

CENTER OF THE AMERICAN EXPERIMENT

The Minnesota Policy Blueprint is dedicated to the next generation of Minnesotans. Your elders, who are supposed to be wise and protective of your future, have signed a promissory note for a government and lifestyle they do not intend to pay for and cannot afford. In doing so, they have mortgaged your future. This book is our way of sounding the alarm, lighting the way and trying to pay down that debt through robust private sector growth rather than state-directed programs.

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PREFACE

Chuck Spevacek, J.D. and Ron Eibensteiner

In 1999, Mitch Pearlstein, founder and president of Center of the American Experiment, and Annette Meeks, the project's director, led an effort to create the *Minnesota Policy Blueprint*, a comprehensive analysis of virtually every aspect of state government, complete with recommendations. At the time, it represented what was perhaps the most ambitious project ever undertaken by a regional think tank. Its success was so far-reaching that copies of that book can still be seen in the offices of state legislators some 15 years later.

As members of the Center's board of directors, we agreed with the urgency that it produce another *Blueprint*. We had all watched how the 2013 and 2014 sessions of the Minnesota legislature exposed lawmakers who were trapped in the priorities of the past.

Instead of innovating ways to deliver more value to Minnesota taxpayers, lawmakers addressed a $600 million budget deficit by raising taxes by $2.1 billion. Instead of making the education system more accountable and accessible to parents and students, lawmakers predictably chose policies that favored unions. And instead of identifying how to better connect people with solid well-paying middle-class jobs, lawmakers upped the minimum wage.

We knew these attitudes would persist until a strong alternative policy vision would capture the hearts and minds of Minnesotans. This *Blueprint* sets up that vision with wide-ranging policy recommendations aimed to enable *all* Minnesotans to thrive in their personal and financial pursuits.

It's worth noting that the chapters that follow are not traditional "academic" white papers. They were written to appeal to broad public sensibilities. They do not merely *admire* problems, but drive practical, deliverable policy solutions.

We think these proposals represent a comprehensive and thematically consistent first step toward building a culture of prosperity in Minnesota. We call it a *Prosperity Agenda*—an agenda to deliver real hope and change to all Minnesotans.

To us, prosperity includes a whole array of benefits that help Minnesotans achieve a rich and fulfilling life. Economic success is only part of it.

- It means enabling *all* Minnesotans to raise their families in a safe and healthy and fulfilling environment.
- It means creating opportunities and incentives for personal enrichment.
- It means rewarding hard work, personal responsibility and individual initiative.
- It means access to jobs—*well-paying* jobs.

Quality jobs sustain our culture and our economy. Minnesotans believe in work. Work contributes to the sense of dignity and self-reliance that is the best-known antidote to entrenched poverty.

Someone once said, "Work is the elixir of life." We've also heard it said that the best housing policy is a job, that the best education policy is a job, that the best healthcare policy is a job, and the best family policy is a job.

We agree. But our emphasis is on *quality* jobs. If people are forced to work ungodly hours at multiple jobs, with no benefits, and no time for their families, we *aren't* adding to the Minnesota's culture of prosperity.

Issues are important. Every Minnesotan should have the tools, the framework, and the opportunities they need to achieve their full potential.

We want to see policies that enable Minnesota to achieve its full potential. Because if it does, all Minnesotans will get an opportunity to achieve their full potential—economically, socially, across all aspects of the spectrum of what constitutes prosperity.

Minnesota has long been an economic powerhouse. The foundations of our success have been powered by our diverse economy, our location at a crossroads of commerce, our civic engagement and our industrious, entrepreneurial, and well-educated workforce.

But we can never forget that past economic success does not guarantee future returns. The State faces new challenges from increasing global competition, aging demographics, declining education outcomes and weakening families. No one is suggesting Minnesota is no longer a state that works, but Minnesota needs certain course corrections to meet and overcome future challenges.

We believe the *Minnesota Policy Blueprint* delivers a comprehensive package of course corrections that steer Minnesota back toward the economic, personal and cultural prosperity all Minnesotans want to pass on to the next generation.

Chuck Spevacek and Ron Eibensteiner both serve on the Board of Directors at Center of the American Experiment, where each has served as chairman. Spevacek is a partner at Meagher & Geer, a Minneapolis law firm. Eibensteiner is president of Wyncrest Capital, a Minneapolis-based venture capital firm.

INTRODUCTION

Mitch Pearlstein, Ph.D. and Kim Crockett, J.D.

In a famous *Time* magazine story in 1973, Minnesota was epitomized, not just as a particularly well-run state, but as *the* "State that Works." Other states might have been close in the eyes of editors but those places didn't wind up having their governor holding up one of their state's iconic fish on an iconic cover, as Wendy Anderson did with a northern pike.

Forty-two years later, Minnesota is still held up by national publications like the *New York Times* as the poster child for the "Blue State" model. A favorite pastime of journalists is comparing Minnesota to Wisconsin, extolling the virtues of a "high tax, high service" model for state government. Minnesota's relatively strong and diverse economy is used to disparage our next door neighbors who just chose conservative Scott Walker again as their governor.

This 2015 *Minnesota Policy Blueprint* makes clear that we do in fact enjoy a good and diverse economy, for which we are grateful. But more pointedly it shows that we are resting on our laurels, as Minnesota is just not the same impressive outlier we were in 1973. In fact, we are an outlier in reverse when measuring the achievement gap, road quality, estate and income taxes, venture capital and other significant features predictive of a robust, opportunity society. Following the enactment of a new gift tax in 2013, *The Wall Street Journal's* editors, citing the Center's research, declared Minnesota one of the "Die Harder States" and awarded Minnesota "The grand prize for self-abuse…." That editorial tolled like a bell throughout the state, facilitating the repeal of the gift tax the next year.

At the very same time that Minnesota has been regressing to national means when it comes to urban and myriad problems, other states have been upping their game, especially when it comes to increasing their attractiveness as places where entrepreneurs are best able to create jobs, often prolifically. Several of these states, not incidentally, also are places where older Minnesotans of means increasingly are choosing to retire, taking their philanthropic contributions and venture capital with them. Not that retirees are the only ones leaving, as men and women in their peak earning years are likewise finding greener pastures elsewhere.

In a 2013 study, Peter J. Nelson, American Experiment's director of public policy, calculated that, "Between 1995 and 2010, an average of $340 million in income—based on 2010 dollars—moved each year from Minnesota to other states, a movement totaling more than $5 billion over 15 years." While Nelson of course acknowledged that "people move for all sorts of reasons," he nevertheless wrote that "a closer look at this data strongly suggests that state tax policies are influencing movement to and from Minnesota."

Lest you think we measure most everything in dollars, we are more worried about losing the accumulated experience and warmth of legions of grandparents and others when they are annually forced to prove they've been out of Minnesota for six months and a day, in case the Department of Revenue comes calling. Foregone income and tax revenues can be measured; foregone time with loved ones is beyond measure.

To the extent the vibrancy of a state can be captured in a few words, life in Minnesota remains good, often exceptionally so for most residents. But that is not to say enough leaders and others adequately grasp our position in the global economy or sobering facts about an aging population and other demographic trends that increasingly will demand a fundamental redesigning of programs and refiguring of priorities (which is to say spending) across a wide range of areas. This new *Minnesota Policy Blueprint* is focused on tackling, not merely patching, problems like these by comprehensively building a *culture* of prosperity.

A culture, more precisely, grounded in full appreciation of the importance of opportunity and earned success; one which appreciates how individuals crave the ability to contribute and shape the world in which they live, not just have their material needs met. A culture which grasps that the wealth we enjoy is a product of many efforts, and that our bounty will grow even faster if we enable many more men and women to join in its creation.

A culture which recognizes there is simply no substitute for successful private businesses providing good jobs for people of all backgrounds and skills. Minnesota's great success in the 20th century was built on continuous streams of successful new businesses, each of which decided that Minnesota was a good place to grow. But if we continue discouraging new businesses from starting or growing in Minnesota, we will not have the resources to assure that our children and grandchildren will have better lives than we have. Or even matching our lives, for that matter.

A culture, moreover, that rewards hard work, creative talent, and risk-taking by recognizing the limits of what government can do while placing few limits on what individuals can do for each other. A way of governing which affords job creators greatest possible freedom in pursuing new ideas and technologies by recognizing that conducive tax, regulatory, and related policies are not perks to the affluent but indispensable means forward for all.

In sum, the *Blueprint* is grounded in the recognition that Minnesota, for all its virtues, is insufficiently hospitable to business and is widely understood as such. Among other results of this mixture of fact and perception are phone calls and perpetual pitches from governors and other officials across the country inviting owners and managers of Minnesota-based businesses, especially young firms of great potential, to relocate to their respective states with friendlier tax and regulatory climes. Invitations that are accepted too often.

We alluded above to how this wasn't American Experiment's first *Minnesota Policy Blueprint*. It's actually our second, with the first released sixteen years ago in 1999, with that iteration taking both different and similar tacks. Most notably, whereas the first *Blueprint* focused on specific departments and agencies, this new one focuses on issues which routinely cut across departments and agencies.

Several explicit principles animated the several-year project which resulted in the 1999 *Blueprint.*

- Government's reach must be limited and individual opportunity and responsibility must be enhanced.
- Identifiable institutions and individuals should be held accountable for what government does.
- Growth is best served by economic liberty, which includes low-tax and flexible regulatory policies.
- State policies and programs should be based on time-tested family and social values.
- And competition (which is not always the same as "privatization") should almost always be sought in the delivery of public services.

Spelled out similarly herein are assumptions like the next four, as cited by former American Experiment Chairman Chuck Spevacek at a major kick-off event for this project, attracting more than 200, at the University of St. Thomas last June. That session was keynoted by economist Stephen Moore, late of the *Wall Street Journal* and currently at the Heritage Foundation.

- We believe in equal *opportunity*, as the frequent obsession with equality of *outcomes* is shortsighted and counterproductive. Forward-looking economic policies should stop fretting about redistributing individual slices of Minnesota's economic pie and instead focus on making the pie bigger.
- There are extremely important functions that must be performed by government as they can't be performed well by other institutions or anyone else. But a government that tries to do too much won't do anything well. We need a government that knows its boundaries and that strives to provide tangible value in everything it does.
- If Minnesota were a country our GDP would rank around 40th in the world, and as such, policymakers need to view our economy by world standards. We must successfully compete with, as well as attract, the world's most talented people.
- And one more time, the creation of private-sector jobs is always the foundation of a growing and prosperous society. We enable job creators to do what they brilliantly and invaluably do by providing strong talent (think strong education), a high-functioning infrastructure (think good roads), and a jobs-friendly regulatory environment (think sunset commissions among other steps).

The ten chapters rising from these assumptions and principles were released serially, from July 10 through October 15, 2014. Each paper was presented by one or more of its authors at ten events—which drew 50 to 80 people each time—hosted by chambers of commerce, businesses, or educational institutions across the Twin Cities metropolitan area as well as just outside of St. Cloud. Our great thanks to authors and presenters for their first-tier work as well as to our institutional hosts for their similar hospitality.

In the order as they appear in the pages that follow, here are brief excerpts from each paper's description of the main problems in need of fixing.

***Strengthening Families and Rescuing Marriage: Reducing Very High Fragmentation Rates and Strengthening All Families*, by Mitch Pearlstein.**

Very high rates of family fragmentation in the United States are subtracting from what very large numbers of young people are learning in school and holding them back in other ways. This, in turn, is damaging our country economically by making us less hospitable to innovation while also making millions of Americans less competitive in an increasingly demanding worldwide marketplace. All of which is leading, and can only lead, to deepening class divisions in a nation which has never viewed itself or operated in such splintered ways. The same dynamic is destined to play out in Minnesota unless attitudes, behaviors, and numbers change.

***Education: Student Achievement and Prosperity: The Indispensability of Competition and Choice in Minnesota K-12 Education*, by Mitch Pearlstein.**

Minnesota must narrow not just one achievement gap but three. As commonly used in Minnesota, the term "achievement gap" refers to uncommonly large gulfs between the academic performance of white students and minority students. But there is also the gap between *all* Minnesota students (as well as all American students) compared to *all* students in much of the industrialized world, with young people in many countries routinely learning more across the board. And another gap exists between Minnesota and America's *strongest* students compared to the strongest students in much of the rest of the world, with such young people elsewhere, once again learning more.

***Aligning Taxes with Economic Growth*, by John A. Spry.**

Understanding the problems with Minnesota's tax code first requires an understanding of the principles that should guide the state's tax policy. Sound tax policy should promote three core principles: economic efficiency and growth, equal taxation of equally situated people, and simplicity. These principles generally favor *low tax rates* levied on a *broad tax base*. The basic problem with Minnesota's tax code is that it fails to follow these principles. Instead of low tax rates, Minnesota's personal, sales, and corporate tax rates are among the highest in the nation. The state boasts the 2nd highest personal income tax rate on the bottom bracket, 4th highest personal income tax on the top bracket, 7th highest sales tax rate, and 3rd highest corporate income tax rate.

***Rethinking Energy: Supplying Competitive Electricity Rates*, by Bill Glahn.**

Not long ago, Minnesota's energy policy focused on providing "adequate and reliable service at reasonable rates." As a result, Minnesota benefited from low and competitive electricity prices. This gave Minnesota businesses an important advantage, spurred job growth and provided relief for strained family budgets. Over the past decade, however, Minnesota electricity prices rose faster than other states. Minnesota is now among the twenty states with the highest electricity prices. It is no coincidence that Minnesota electricity prices started rising faster after state energy policy shifted its focus to subsidizing and mandating green energy.

***Smart Budgeting for an Era of Limits*, by King Banaian and Peter J. Nelson.**

Minnesota's state budget continues to grow and grow, even after adjusting for inflation and population. Total spending in Minnesota's current FY 2014-15 budget grew by 9.8 percent over the previous budget, which translates to a hefty $1,130 per Minnesotan. As spending grows, the state budget continues to face long-term challenges from an aging population, rising health care costs, unfunded pensions and uncertainty over federal spending. Minnesota's competitiveness will suffer if we do not gain control of state spending. . . . Future budget challenges will almost certainly require higher, economically damaging taxes if nothing is done soon to control spending.

***Transportation: Moving People and Commerce Where They Want and Need to Go*, by Fritz Knaak and Amy Roberts.**

Efficient road traffic fuels Minnesota's economic engine and is essential to job creation and improving the quality of life for all Minnesotans. . . . [But not] only is congestion increasing, it is happening on even poorer quality roads. In 2002, 310 miles (2 percent) of state highways were in poor condition. By 2011, the miles of poor roads rose to 940 (7 percent) and MnDOT expects the mileage to rise to 1,300 (9 percent) by 2016. In the National Highway System, the pavement condition of Minnesota's rural highways ranks 43rd. The pavement condition of Minnesota's urban highways ranks much higher at 16th. However, comparing urban interstates, the state ranks 41st.

***Met Council Power Grab: How the Dayton Administration Intends to Transform the Twin Cities Region for Decades to Come*, by Katherine Kersten and Kim Crockett.**

The Met Council has rejected the mission the legislature assigned it—to *accommodate growth* in the region by planning for and delivering regional services—and flipped the mission to *directing growth* by leveraging its power over planning, transportation, and sewers. *Thrive MSP 2040* is the Dayton administration's 30-year plan for development in the Twin Cities seven-county region. The plan entrenches a model of regional administration that neuters the power of local elected officials and centralizes decision-making authority in the unelected, unaccountable bureaucrats of the Met Council. *Thrive MSP 2040* seeks to commit future administrations to reshape the region to reflect an urban-centric vision of an "ideal society" that is planned and administered by people who have not been elected by the region's residents.

***Pensions: Keeping the Promise: Securing Retirement Benefits for Current and Future Public Employees*, by Kim Crockett.**

Minnesota's public employee pension system is broken. The state's reported unfunded liabilities are estimated by the state to be $17.3 billion. If reasonable economic assumptions are used, the amount is far larger. This is a ticking fiscal time bomb for Minnesota. Escalating costs will force us to choose between reducing spending on core services that are essential to our quality of life, raising taxes by a far larger amount than the Legislature did in 2013, or breaking our promises to retirees. These choices can be avoided if we redesign the system now. Ignoring the problem puts everybody at risk—current and future retirees, taxpayers and consumers of public goods and services.

***Health Care: State Solutions in an Era of Federal Control*, by Peter J. Nelson.**
In 2010, Congress passed the Affordable Care Act (ACA), also known as Obamacare. Unfortunately, the ACA puts Minnesota's health care system at serious risk. The federal law tends to double down on everything that's currently driving dysfunction in our health care system. Thus, the ACA tends to aggravate problems, not solve them. All the while, the federal law took problem-solving flexibility away from states like Minnesota that were doing many things right. The ACA in combination with other health care trends is diminishing patient control over their own health care, including their relationship with their doctor, their health records, and their privacy.

***Unleashing Minnesota's Job Creating Potential*, by Ron Eibensteiner, Ted Risdall, and John Gaylord.**
Minnesota's history of successful business enterprises now extends well beyond the companies that sprouted from the state's prairies and forests, proving that the people of Minnesota are the state's most valuable resource. The diversity and success of Minnesota businesses now form the foundation of an enviable economy. These positives point to the biggest risk facing Minnesota's economy: complacency. Minnesota's past performance does not guarantee future results. . . . Despite Minnesota's low unemployment rate, there are a number of weak spots in the labor market. Though Minnesota regained jobs lost during the recession quicker than many states, job growth fell behind the national average in the past two years. . . . In addition, startup activity is down, and IRS data show income leaving the state.

The 1999 *Blueprint*, all 400 pages of it, is still frequently perused by legislators, legislative staff and others (a state senator recently proudly showed Mitch her well-worn copy). This again will be the case with the 2015 *Blueprint*, as our business plan stresses engagement with legislators and other policy leaders as a top priority. This means the Center will focus, as much as our staffing and funding allow, on turning *Blueprint* ideas into law.

To be successful, this work will need to be reinforced and propelled by the multiple coalitions of key players we have been pulling together since last summer and with whom authors consulted frequently in writing their particular chapters. Updating and flip-siding the cliché, the scores of recommendations filling American Experiment's new *Minnesota Policy Blueprint* will not go unexamined on dusty shelves or unopened in website archives.

Mitch Pearlstein, Ph.D.
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Minneapolis, Minnesota
November 2014

EDUCATION

Student Achievement and Prosperity: The Indispensability of Competition and Choice in Minnesota K-12 Education

Mitch Pearlstein, Ph.D.

EXECUTIVE SUMMARY

The Problem

K-12 education in Minnesota faces many problems. Here are four mega-ones.

- Too few Minnesota students are learning enough to adequately support themselves and their families in the future.
- Too few young people are leaving school prepared to contribute to Minnesota's prosperity.
- Too few Minnesota graduates and non-graduates are leaving school equipped to help the United States remain the world's economic powerhouse.
- All with too *many* Minnesotans complacently assuming we're doing better educationally than we really are.

Turning around such dangerous prospects will be hard under the best of circumstances. But to succeed, Minnesota must narrow not just one achievement gap but three.

- As commonly used in Minnesota, the term "achievement gap" refers

to uncommonly large gulfs between the academic performances of white students and minority students.
- But there is also the gap between *all* Minnesota students (as well as all American students) compared to *all* students in much of the industrialized world, with young people in many countries routinely learning more across the board.
- And another gap exists between Minnesota and America's *strongest* students compared to the *strongest* students in much of the rest of world, with such young people elsewhere, once again, routinely learning more.

This report focuses on all three gaps.

Consequences of Not Acting

What are the likely consequences if these gaps are not appreciably reduced? Minnesota will come to be economically less competitive both domestically and internationally. Enormous numbers of citizens won't merely have hard times finding and keeping good first jobs. Rather, the entirety of their work lives will be abridged. This, in turn, will constrain mobility, spur inequality, and deepen class divisions in a state which has never viewed itself as divided so. And while the United States will remain economically powerful, it will become comparatively less innovative and prosperous if these problems fester nationally.

What Needs to be Done?

To suggest that the best antidote to the problems we face is for young and older Minnesotans to learn a lot more may sound like a cliché. But what better routes are there? Trying to do so, however, without allowing greater competition and choice to spur educational improvement will continue proving impossible. Here are three broad proposals to improve learning, each with strengths in narrowing the three achievement gaps undermining Minnesota's future prosperity.

- **Adopt Vouchers**. When it comes to elementary and secondary education in Minnesota and especially the Twin Cities, vouchers represent the single most promising approach for reducing huge achievement gaps between white and many minority students.
- **Significantly Expand Charter Schools.** Charter schools have been one of the most important educational reforms over the last few decades and it's essential for Minnesota to take greater advantage of them, as they offer real hope to many.

- **Significantly Expand Digital Education**. If vouchers will best serve many struggling students, an expansion of digital education has exceptional potential for helping all Minnesota students.

Likely Results

What can be said with confidence about these proposals is they afford young Minnesotans—be they strong students, struggling students, or somewhere between—larger opportunities to be all they can be. Expanded and better-fitting choices will increase their chances of achieving nearer their potential, for both their sake and our state and nation's sake. This is the case because when it comes to intricate organizations—very much including schools and school systems—barnacled obstacles are best cleared, and new roads best discovered, by competition.

THE PROBLEM

Elementary and secondary education in Minnesota face many problems. Here are four mega-ones.

- Too few Minnesota students are learning enough to adequately support themselves and their families in the future.
- Too few young men and women are leaving school prepared to contribute to Minnesota's prosperity.
- Too few Minnesota graduates and non-graduates are leaving school equipped to help the United States remain the world's leading economic power.
- All with too *many* Minnesotans complacently assuming we're doing better educationally than we really are.

Turning around such dangerous prospects and perceptions will be hard under the best of circumstances. Trying to do so without allowing greater competition and choice to spur educational improvement—just as they accelerate improvement in countless other spheres of American life—will continue proving impossible.

Nevertheless and in fairness, even with a fundamental design flaw in which entrenched interests—starting with Education Minnesota—perpetually seek to stymie anything more potent than constricted competition, K-12 education in Minnesota is not without relative victories. A good example is the way in which Minnesota ranked as high as first and second, among all states, in several rankings reported by the National Assessment of Educational Progress in 2013. Students and educators here deserve to take some pride.

Yet as encouraging as news like this was, it must be understood in full context, which is to say an international one, as Minnesota's main economic competitors in coming years increasingly will not be other states but other nations. And when it comes to other nations around the world, Minnesota doesn't rank anywhere near the top in important educational measures. For instance, Minnesota, with more than 10 percent of its students at the advanced level in math, ranks second in that category among the 50 states. That's the good news. The bad news is we nonetheless trail 16 other countries, winding up roughly equal with the likes of Slovenia.[1] Such middling achievement will exact larger and larger costs, year by year.

Put succinctly, a root cause of our educational shortcomings is too much control from above and too little freedom below, as has been the case and basic frame of Minnesota and American schooling for a long time. For just one example, think here of how many schools—entwined in the quicksand of school bureaucracies and *systems*—are slower than broken abacuses in taking robust advantage of what digital learning has to offer students, be they the strongest or weakest in class.

Talking of root causes, another is what John Bacal, one of the most successful educational entrepreneurs I know, calls a "fundamental public lack of urgency around the education crisis in Minnesota. We've had it pretty good for the last fifty years. It's a 'Lake Wobegon Effect.' To most people it doesn't matter how much data you throw at them, because we're still above average."[2]

Then again, might Minnesota really reflect, or come to profitably reflect, the findings of a recent national survey which strongly suggested that "information about local district rankings increases public support for school choice programs, including charter schools, parent trigger mechanisms, and, especially, vouchers for all students"?[3]

We can and must do better.

Exactly what to do? The rest of this chapter proposes a number of ideas, all of which are thematically tied together by prosperity-generating principles of competition and choice. In other words again, freedom.

Also basic is recognition that on those occasions when poorly performing institutions change demonstrably for the better, impetus for doing so almost always comes from without, rarely from within. Think, for example, of how the increased importation of Japanese and German cars a few decades ago had much more to do with forcing American carmakers to significantly improve their vehicles than any grand plans they had previously developed on their un-pressured own.

The only way elementary and secondary schools in Minnesota will adequately improve is if smart policies make it possible for real competition to overcome entrenched interests—including but not limited to Education

Minnesota—in determining what schools do and how they serve.

If money, or its lack, were at the root of all troubles in Minnesota and American education, we would have run out of problems to overcome a long time ago, as spending per student, in constant dollars, has doubled, tripled, quadrupled and more, depending on what decade since World War II is chosen as a baseline.[4] The United States currently spends more money per student than almost every other nation in the world—and doesn't even approach having the academic results to show for it.[5]

It's also essential to note here that while competition and choice are necessary, they won't be sufficient unless they are potent and expansive enough to inspire not only strong teaching and rigorous curricula but also disciplined students and demanding parents.

In turn, it's likewise understood that robust competition and choice are impossible unless parents are afforded sufficient information—hard, transparent, and current data—about how area schools and school districts are performing. The same demanding requirement applies, of course, to providing parents with clear and timely information about how their children are progressing academically. Minus such information, parents will be less equipped to choose wisely for their children.

Minnesota suffers not just one achievement gap but three.

As commonly used in Minnesota, the term "achievement gap" refers to uncommonly large gulfs between the academic performances of white students and non-white students. This is accurate as far as it goes, but it is not the only academic separation that threatens our state and nation.

There is also the gap between *all* Minnesota students (as well as all American students) and *all* students in much of the industrialized world. Young people in many other advanced countries routinely learn substantially more.

And then there is the gap between Minnesota and America's *strongest* students and the *strongest* students in much of the rest of world, with young people elsewhere, once again, routinely learning more.

This report focuses on all three gaps and ways of addressing them.

LIKELY CONSEQUENCES OF NOT ACTING

What are the likely consequences if these gaps are not appreciably reduced? As framed most frequently, many men and women—especially those of color—will suffer economically because of their lack of requisite job skills. Likewise, Minnesota will come to be economically less competitive both domestically and internationally. While this is all true, it doesn't adequately describe additional statewide and national dangers, of which the following three clusters are certainties.

- Enormous numbers of citizens won't merely have hard times finding and keeping good first jobs, but the entirety of their work lives will be abridged.
- This, in turn, will constrain mobility, spur inequality, and deepen class divisions.
- And while the United States will remain economically powerful, it will become comparatively less innovative and skilled and, therefore, less prosperous.

How and why, more specifically, will these results be the case if students continue to be shortchanged, whether by the failure of their schools or by their own refusal to work conscientiously at school? Most elementarily, as long as four-year high school graduation rates for African American, Native American, and Hispanic students in Minneapolis public schools *remain under 40 percent* (or anything close to it),[6] it is impossible to imagine men and women of color in the Twin Cities having anything but disproportionate and dispiriting difficulty competing economically, be it early or late in their careers and non-careers. This is especially true of men (of all races), as boys and young men are being outpaced by girls and young women in most educational realms.

This is how Anthony P. Carnevale and a colleague at Georgetown put it from the perspective of potential employers: "Most employers today cannot compete successfully without a workforce that can use solid academic skills in applied settings. Increased interaction with sophisticated computerized machinery requires good technical and reading skills, and writing is frequently the first step in communicating with customers, documenting competitive transactions, or successfully moving new ideas into the workplace."[7]

Economist Isabel Sawhill of the Brookings Institution makes three self-evident points: (1) income in the United States is less equally distributed than it was several decades ago; (2) income is more correlated with education than it was several decades ago; and (3) income is also more correlated with family structure than it was in the past. Which is further to say, as long as large numbers of students leave school with insufficient reading, writing, computing and other skills, their chances of vocational and marital success, as well as satisfaction and happiness in other parts of their lives, will be depressed.

By no stretch, by the way, does this last stricture apply exclusively to high school dropouts and minorities but instead to great swaths of all kinds of Americans. Consider, for instance, what Paul Peterson of Harvard's Kennedy School, Eric Hanushek of Stanford University, and Ludger Woessmman of the University of Munich found when they compared the math performance of U.S. high school students with *at least one* parent holding a college degree, to the math performance of *all* high school students, regardless of their parents' education, in a sample of nations. The three researchers had expected this fortunate group of American kids, in the class of 2011, to be world leaders, but "students in sixteen countries, no matter their parents' educational attainment, outrank[ed] this more-advantaged segment of the U.S. population."[8]

Let's stick with math but add some science. Professor Hanushek, again, as much as anyone in the field, has demonstrated the vital importance of a nation's competence in math and science in determining its economic success. "There is now considerable evidence," he has written, "that cognitive skills measured by test scores are directly related to individual earnings, productivity, and economic growth." But if the relationship between cognitive skills and *individual* productivity (as well as individual incomes) is strong, the relationship, he has found, between "labor force quality" and economic growth for *nations* is likely even stronger. This is the case as a "more skilled society" leads to higher rates of invention, enables companies to introduce improved production methods, and results in faster introduction of new technologies.[9]

WHAT NEEDS TO BE DONE?

To suggest that the best antidote to the problems we face is for young and older Minnesotans to learn a lot more may sound like a cliché, but I would only ask: What better routes are there? I can't think of any.

At the risk of too many vehicular metaphors in a tight space, in the search for pothole-free routes so that Minnesota schools get up to speed, the main rule of the road must be replacing bureaucratically pitted streets with freeways. This will lead to more effective methods as well as stronger incentives for reducing gaps by giving teachers greater opportunities to be great as well as better compensated. All this in the service of tailoring specific approaches to the varied talents and needs of specific students. To this end, let me suggest three broad proposals.

1. Adopt Vouchers

When it comes to elementary and secondary education in Minnesota and especially the Twin Cities, vouchers represent the single most promising approach for reducing huge achievement gaps between white and non-white students. Solid research clearly suggests that many low-income and minority students would do better if allowed a chance to attend a private rather than government school. As for what is meant by the often politically charged term "vouchers," it's nothing more complicated than giving parents the freedom to choose a private school for their children by using all or part of the public funding set aside for their boy or girl's education. Simple enough.

Here are some acutely discomforting and dangerous National Assessment for Education Progress (NAEP) results.

NAEP reported these results for eighth grade students who were *reading* at either proficient or at advanced levels in Minnesota in 2013:

- White students 51 percent
- Black students 17 percent
- Hispanic students 21 percent
- Asian students 37 percent

And NAEP reported these results for Minnesota eighth graders who were either proficient or advanced in *math* in 2013:

- White students 71 percent
- Black students 17 percent
- Hispanic students 26 percent
- Asian students 58 percent

What does solid research say about the ways in which vouchers can help low-income minority students in particular?[10]

- Twelve empirical studies have examined academic outcomes for voucher participants using random assignment, the "gold standard" of social science. Of these, eleven find that vouchers improve student outcomes—six in which all students benefit and five in which some benefit and some are not affected. One study finds no visible impact. No empirical study has found a negative impact.
- Eight empirical studies have examined vouchers and racial concentrations in schools. Of these, seven find that vouchers move students from more racially concentrated to less racially concentrated schools. One finds no net effect on racial concentration. No empirical study has found that vouchers increase racial concentration.
- A 2012 study jointly released by the Kennedy School at Harvard and the Brookings Institution found that college enrollments for low-income African American students who, years earlier, had won vouchers to attend private elementary schools, were 24 percent higher than a socioeconomically identical group of students who had not won vouchers.[11]

What's the main reason why Minnesota, in contrast to a growing number of other states and cities, doesn't have K-12 vouchers for low-income children?

The easy answer has been the unyielding and well-financed opposition of teacher unions in particular and the educational establishment more broadly, resulting in ceaseless pressure on legislators to perpetually vote NO. This is not just the easiest answer, it's the most accurate. But there is a second reinforcing factor.

The drive for vouchers in Minnesota also has been blocked by the success of other efforts on behalf of educational freedom: cross-district open-enrollments, Post-Secondary Enrollment Options (PSEO), home schooling, and most importantly charter schools. Charters, in fact, originated in Minnesota, as did open-enrollments and PSEO. Minnesota families, consequently, already have had more choices than many families in other states. Under these ironic circumstances, it's not surprising that voucher campaigns in this state have never gained the same public support they have elsewhere.

Nevertheless, two basic facts remain: (1) large numbers of low-income and minority students in Minnesota are doing terribly; and (2) vouchers *unquestionably* could help many of them. At last count, vouchers of one kind or another are the law in Arizona, Florida, Georgia, Indiana, Louisiana, Mississippi, North Carolina, Ohio, Oklahoma, Utah, Wisconsin, and the District of Columbia. Minnesota should join them.

2. Significantly Expand Charter Schools

It's easy to get carried away by the very idea and possibilities of charter schools—roughly akin to Mickey Rooney and Judy Garland taking backyard shows to Broadway—until one sits back and thinks about the 101 very hard things it takes to get one started. Never mind subsequently running a truly excellent school.

I had a conversation a number of years ago with an education official in St. Paul, an old friend from graduate school days, who helped oversee charter schools in Minnesota and who wanted to know why American Experiment had never started one. Beyond not having the dollars and staff to devote to such a project, I said that most people simply don't know how difficult it is to start and run anything as complex as a school. At which point she gave me a grateful hug, as I got the distinct impression she had been working with various applicants who hadn't recognized that fact. Even so, charter schools have been one of the most important educational reforms over the last several decades, and it's essential for Minnesota to take greater advantage of them, as they offer real hope.

While chartering originated in Minnesota in the early 1990s, we are now far from leading the nation in terms of either the number of charter schools or the reasonableness of their regulatory environment—which, thankfully, doesn't mean we don't have some truly outstanding ones. Consider, for example, Hiawatha Academies in South Minneapolis, the Harvest Network in North Minneapolis, and St. Croix Prep in Woodbury, to pick three and unfairly bypass many others.

Specific improvements regarding chartering in Minnesota are suggested in the Recommendations below, but suffice it to say they focus on easing overly restrictive teacher licensing rules. Similar recommendations about licensing are included regarding digital learning—with charter schools, of course, taking greater advantage of digital instruction all the time.

In thinking about charter schools, many people associate them mainly with low-income and educationally struggling students. This is understandable, given the weight of media attention. But students of all kinds profitably attend charters. According to the Minnesota Association of Charter Schools, there were 150 of them in the state in September 2013, enrolling over 41,000 students, or about 5 percent of all K-12 boys and girls.[12] By comparison, Arizona, which has taken especially great advantage of chartering, has over 600 charter schools, enrolling almost 190,000 students, or about 17 percent of all public elementary and secondary school students in the state.[13]

It needs to be noted, of course, that many regular "district" schools are excellent places, and if parents choose to keep their children in them for sound educational reasons, wonderful. But if innovation and expanded choice matter, then there should be more charter schools, as they were conceived explicitly in those spirits.

3. Significantly Expand Digital Education

While vouchers will best serve many struggling students, an expansion of digital education has the potential of helping all Minnesota students, as ongoing technological advances make it possible to customize education as never before. Digital learning has been usefully defined as "learning facilitated by technology that offers students an element of control over the time, place, path, or pace of their learning and includes blended or online learning."[14] I use "digital learning" and "online learning" interchangeably.

Suffice it to say, no level of government, in or out of Minnesota, can point to many successes in improving the quality of education, no matter what amount of money is spent. Yet without indulging in the kind of exaggerated expectations and claims frequently voiced in K-12 circles, taking greater advantage of digital learning does, in fact, promise to help children learn measurably more without demanding that taxpayers spend more.

Political scientists Terry Moe and John Chubb have persuasively made the case that, as opposed to the nature of other education *reforms* which can be stopped by numerous interests at multiple chokepoints, technology is a *force*; one which opponents may slow down if they're determined but never halt no matter how they might try. Technology's most pertinent virtue for our purposes is the way in which it can "differentiate learning" (in Moe and Chubb's words), better enabling students at "vastly different achievement levels to master broad and demanding curricula." Or as another political scientist, Frederick Hess, has put it, digital learning "creates the opportunity to reconsider what's feasible."

This all sounds terrific, but it's not to say Minnesota is taking as much advantage of such brilliant and new possibilities as are many other states. It's as if we insufficiently grasp the lessons of this perfect metaphor as told by Minnesota's Ted Kolderie, who, among other things, is rightfully known as the intellectual godfather of charter schools.[15]

Thirty kids climb into a bus in St. Paul and head south on I-35, with a teacher on a mic pointing to various things out the windows as they roll along. Some kid says, "I missed that. I was looking at something else. Can we go back over it again?" "No," the teacher says, "we can't stop and do that again." Another student says, "Gee, this is interesting. Can I explore it a little bit?" "No, we can't do that," the teacher answers again. And then a third student says, "I've been down this road before. Can't we go any faster?" "No, we can't do that either."

Minnesota's biggest failure when it comes to taking better advantage of digital learning has to do with two licensing issues. The first pertains to the prohibited use of educational assistants or paraprofessionals—men and women who, while qualified for certain assignments, are not licensed teachers and, therefore, not allowed to "instruct" students. The second pertains to the requirement that for men and women who are, in fact, effective teachers, Minnesota-issued credentials are the *only* ones that count. As regulatory obstacles go, these are significant.

As for the first issue, overly tight rules around the use of personnel in Minnesota schools make it economically improbable to replicate the kinds of promising, digitally based programs elsewhere in the country which make effective use of paraprofessionals, tutors, and other non-licensed instructors, including parents. Two such schools showing very impressive results are Rocketship Education, which started in California, and Carpe Diem Schools in Arizona. The former, which has described itself as the "leading hybrid charter network dedicated to eliminating the achievement gap," has been described by John Merrow of the "PBS NewsHour" as having seven of the "top-performing low-income schools in California."[16] Neither network would be allowed to operate in Minnesota.[17]

As for the second regulatory issue, just as Minnesota districts and schools can buy textbooks from anyplace in the country or world, they can also contract with online providers anywhere on the planet, as long as courses are ultimately "taught" by a teacher with an up-to-date Minnesota teacher's license—and *only* an up-to-date *Minnesota* teacher's license. This is a very big problem as it precludes taking full advantage of the online teaching talents of the nation and world's most brilliant men and women, both scholars and others. For instance, while an astronaut with a doctorate in physics—albeit minus a Minnesota teacher's license—generally would not be allowed to teach Minnesota kids online,[18] there would be no problem for her doing so and inspiring thousands of girls and boys in a majority of other states across the country.[19]

None of this is to suggest that the State of Minnesota should be oblivious when it comes to who teaches or otherwise comes in contact with students. Careful background checks are called for, of course. However, it is to suggest that greater weight should be given to whether students are progressing than to whether various checklists get filled out as they have for generations. Focus, for example, should be on what students actually learn, not how long they're glued to assigned seats. Likewise, focus should be on what teachers know, not how many administrative hoops they've jumped through.

An epilogue regarding digital education and costs.

Harvard's Paul Peterson, a Montevideo, Minnesota native, has insightfully argued, "Elementary and secondary education cannot turn the excellence corner, so long as the industry remains labor intensive. The monies that can be reasonably anticipated in the next decade or two will hardly be enough to keep the quality of the system, as currently designed, from eroding further." "If," however, Peterson critically continues, "education could become a more capital-intensive industry, one where technological innovation progresses as rapidly as in other sectors of the economy, fewer teachers and other employees would be needed, and each employee could be better compensated."[20]

In similar spirit, digital learning makes it possible to weave the efforts of teachers and needs of students as never before. This is a very big deal, given how children have different types of intelligence and learning styles, as well as different starting points and pace. Think of it as true and consistent student-centered education in an age of mass schooling.

SPECIFIC RECOMMENDATIONS

For the sake of focus, the number of broad proposals above has been kept small. More exact ideas for following up on them follow. Please keep in mind that essential in many instances is affording parents unvarnished and up-to-date information about how area schools and school districts—and their own children, needless to say—are performing.

Vouchers

Voucher plans come in many shapes and sizes, especially in regards to what kinds of students and families are eligible to participate, what kinds of private schools are eligible to participate, and the size of vouchers. Over the last generation, neighboring Wisconsin has had more experience than any other state, and Milwaukee has had more practice than any other city, in designing and re-designing voucher programs.

Given Wisconsin and Milwaukee's experience, it makes sense to design our system based on things they have learned. More precisely:

- Students in Milwaukee qualify for vouchers if their family's income does not exceed 300 percent of the federal poverty level.
- Voucher students in Milwaukee can attend any participating private school in Wisconsin. This includes participating religious schools.
- A voucher may not exceed the per-student costs of a private school (including operating expenses and debt service).
- More specifically, the maximum voucher of $6,442 per pupil, based on scales of family income, is a little more than half of what public school students in Milwaukee are allotted.

Recommendation 1: Implement a strong voucher program.

The Minnesota legislature should pass, and the governor should sign, a strong voucher bill, based on the successful Wisconsin and Milwaukee model described above.

Recommendation 2: Start the new voucher program in Hennepin and Ramsey counties.

The plan should initially include both Hennepin and Ramsey counties (not just Minneapolis and St. Paul), with expectations of expanding the program to other parts of Minnesota once its potential has been demonstrated.

Recommendation 3: Adjust the value of a voucher for kids with special needs.

Since it's more expensive to educate students with special needs, the size of vouchers for such children should be increased accordingly.

Recommendation 4: Provide a tax credit for contributing to nonprofit scholarship programs.

Minnesota should also adopt, as other states have over the years, a statewide tax credit scholarship program in which individuals and/or businesses receive tax credits for contributing to nonprofit organizations which, in turn, provide private school scholarships.

Recommendation 5: Expand the current educational expenses tax credit to include private school tuition.

If a voucher bill does not pass, legislators and the governor should expand the tax-credit program for (limited) educational expenses, passed in 1997, to include private school tuition as an eligible expense.

Charter Schools

The Minnesota Legislature passed, and Gov. Arne Carlson signed, the nation's first charter school law in 1991, with most states eventually following suit. To the extent the number of Minnesota charter schools has been constrained by state and local policies which favor district schools over charter schools, they need to be fixed. For example:

Recommendation 6: Eliminate the funding imbalance between district schools and charter schools.

Charter schools in Minneapolis currently receive 34 percent fewer dollars per student than do district schools, even though charter schools in the city serve needier students. That funding imbalance should be eliminated.

Recommendation 7: Empower voters to turn all public schools into charter schools.

Voters in each school district should have the option of turning all public schools into charter schools.

Recommendation 8: Give parents the right to convert low-performing schools to charter schools.

Similarly, as is the law in California and other states, parents should have the right to convert a low-performing district school to a charter school if a majority of them so vote. Such options are commonly known as "Parent Trigger" laws.

Recommendation 9: Provide reciprocity to teachers who earned licenses in different states.

Reciprocity for teachers who have earned licenses in other states should be expanded. This is important, in part, because a growing number of charter schools are having trouble finding, recruiting, and hiring the kinds of teachers best equipped to help disadvantaged students make significant academic gains.

Recommendation 10: Allow charter schools to hire talented teachers who don't have a license.

Charter schools should be allowed to hire talented educators even if they don't have a teacher's license, as is the case in states with high-quality charter schools such as Massachusetts and Colorado.

Recommendation 11: Don't stifle innovation in charter schools with new rules and regulations.

More generally, the basic "deal" undergirding charter schools was straightforward: Government would regulate charters less, while charters, in turn, would be held more accountable for academic performance. It was a new and welcomed way of apportioning autonomy and accountability in public education. Not surprisingly, however, pressures to increase governmental intervention over the last two decades have been stronger than were earlier hopes of keeping government at bay. Given the inevitable creation across the country of bad charter schools among terrific ones, chartering institutions must have the authority to step in to protect children. But that authority must not be permitted to become a backdoor to imposing rules and regulations that have stifled innovation in district public schools.

Digital Learning

Center of the American Experiment already has played a role in strengthening digital education in Minnesota, as two recommendations in a paper we published in January 2012—*Online Learning: A Literal New World of Possibilities for Minnesota K-12 Education*—were subsequently made law. The first had to do with reviewing all pertinent state laws and rules to determine whether they inhibit the growth of digital education. That legislation was passed in 2012. That paper of mine also recommended rescinding the state prohibition against colleges and universities actively informing high school students and their families of the academic and economic benefits of taking advantage of Post-Secondary Enrollment Options.[21] That prohibition was partially lifted—covering portions of the state comprising a majority of students—by the 2014 Legislature and then signed into law by Gov. Mark Dayton.

The next two recommendations are pulled directly from a draft report by the K-12 Online Learning Advisory Council, which had been charged by the Legislature to review which Minnesota statutes and rules limit the expansion of digital learning.[22] The first recommendation deals with licensing reciprocity and the second with program-specific licensing.

Recommendation 12: Fully implement the National Association of State

Directors of Teacher Education and Certification Interstate Agreement.
Thirty-eight states participate in the National Association of State Directors of Teacher Education and Certification Interstate Agreement. This allows teachers to receive a teaching license if they have completed a state-approved teacher preparation program from a regionally accredited institution (not just from an institution in the state in question), or have a minimum of twenty-seven months of successful, fulltime teaching experience under a NASDTEC member state's valid Level II educator certificate. Minnesota is a signatory to this agreement but does not take advantage of what it has to offer. *Minnesota should fully implement this teacher reciprocity agreement, as our state (in the words of the Advisory Council), "has an opportunity to expand its teaching force by qualifying the best prepared and most experienced online teachers, regardless of location of licensure or teacher residence."*

Recommendation 13: Permit content specialist to be licensed without a school of education degree.
Content specialists should be permitted to become licensed teachers without completing a degree at a school of education. High Tech High in California, for example, has been granted authority by the State of California to train and license teachers so they might effectively teach in the distinctive school. *Minnesota should allow similar routes to classrooms.*

Recommendation 14: Eliminate the restriction on advertising Post-Secondary Enrollment Options.
Limitations on colleges and universities advertising their PSEO opportunities should be eliminated.

Recommendation 15: Get out of the way of education entrepreneurs.
Given that digital education is a force, there is no need for state government to spend much, if any, money or energy inventing novel ways of exploiting it. There are plenty of education entrepreneurs doing precisely that. The most important contribution the Minnesota Department of Education and the rest of state government can make in expanding digital education is to get out of the way.

Likely Results
What are the likely results if recommendations like those outlined in this chapter are adopted either in full or substantial part? It would be wonderfully satisfying to see educational performance of all Minnesota students rise across the board. But that's just not the way education works. If one thing has been learned in decades of perpetual efforts to improve schooling in America, it's

that moving achievement "needles" is just about as hard as finding them in haystacks.

What can be said with confidence about the proposals here is that, if adopted, they would afford young Minnesotans—be they strong students, weak students, or somewhere between—larger opportunities to be all they can be. Expanded choices will increase their chances of achieving closer to their potential, for both their sake and our state and nation's sake. This is the case because when it comes to intricate organizations—very much including schools and school systems—barnacled obstacles are best cleared, and new paths best discovered, by competition.

STRENGTHENING FAMILIES AND RESCUING MARRIAGE

Reducing Very High Fragmentation Rates and Strengthening All Families

Mitch Pearlstein, Ph.D.

EXECUTIVE SUMMARY

The Problem

Very high rates of family fragmentation in the United States are subtracting from what very large numbers of young people are learning in school and holding them back in other ways. This, in turn, is damaging our country economically by making us less hospitable to innovation while also making millions of Americans less competitive in an increasingly demanding worldwide marketplace. All of which is leading, and can only lead, to deepening class divisions in a nation which has never viewed itself or operated in such splintered ways. The same dynamic is destined play out in Minnesota unless attitudes, behaviors, and numbers change.

Consequences of Not Acting

One of the final questions I asked almost all interviewees for a new book of mine released last summer, *Broken Bonds: What Family Fragmentation Means for America's Future*, went like this: "In sum, considering all we've been talking about as well as at the risk of melodrama, what do you think the United States might look like in the days of your last breath? A radically reduced composite answer might read something like this:

On the more optimistic, albeit much slimmer side of the ledger, a few respondents placed their faith in the overcoming power of free markets. Or they speculated about a possible religious reawakening or simply cited the hope they already derive from religious belief. But such comments were decidedly in the minority, as much more numerous were worries and worse about our nation's future.

No respondents predicted anything apocalyptic with certainty; no one saw very high rates of family fragmentation necessarily doing us in completely or nearly so. To the extent they viewed such as rates as an ailment, they used terms such as a "wasting disease" rather than a "heart attack." They talked about slow declines, not fast ones. They saw a future America suffering the kinds of troubles we currently have, only more so. A place where have-nots have a harder times becoming haves. They imagined the United States as still the world's leader, but perhaps not. Still an economically successful nation, but a less innovative one. They assumed a less unified America with whiffs or stronger scents of unraveling.

For Minnesota families to prosper, the above is what we must reverse.

Recommendations

There is no magic bullet or simple set of ideas when it comes to restoring marriage in America or dramatically reducing out-of-wedlock births. This is the case as marriage and its improvements have more to do with elusive culture than manageable policy. Still, the following significantly abbreviated list of suggestions under each of the nine headings would help.

1. **Retrieve our voice about marriage.** One of the very first things we need is for leaders and key institutions to retrieve their voice when it comes to the centrality of marriage. This very much includes religious leaders and institutions.
2. **More effectively serve healthy marriages.** Writers Ross Douthat and Rehan Salam recommend a "family-friendly tax reform" which "keeps taxes lowest for young families making investments in their offspring." Might it work at the state level? In Minnesota?

3. **More effectively help troubled and potentially troubled marriages.** Prof. William H. Doherty of the University of Minnesota has developed a grassroots project called "Marital First Responders." As he says in *Broken Bonds*: "What I want to do is develop grassroots ways for people who are already confidantes to up their game in terms of how to respond helpfully to people who come to them." His creative initiative deserves support.
4. **Make marriage more likely in the first place.** The unintended consequences of no-fault divorce fall heaviest on couples with fewer emotional and financial resources. We should take advantage of research showing that "at least 10 percent of couples going through a divorce are open to efforts to reconcile."
5. **More effectively reduce nonmarital births.** What should Minnesota do to reduce teenage births in particular? Consider Milwaukee, which started a city-wide campaign in 2006 led by a broad coalition, which in turn was led by the United Way of Greater Milwaukee. They have had remarkable success. The Greater Twin Cities United Way should do the same.
6. **More effectively help girls and boys in fragmented families.** We all need help at times, often a lot. But at the end of days and lifetimes, only individuals—first as young people and then as adults—strengthened by the love and generosity of others, can break self-destructive cycles. Or if you will, "programs" don't overcome; people do. And while urging individuals in harsh situations to pull up their moral socks can be a simplistic suggestion, by no means is it always.
7. **Help boys, more specifically, become marriageable men**. If millions of boys (as well as girls) have holes in their hearts where their fathers (and sometimes their mothers) should be, what type of education might work best at filling such gaps, eventually enabling them to financially support children of their own? One word that comes to mind is "nurturing" suggesting schools in which religious belief, to one degree or another, animates. Meaning vouchers.
8. **More effectively help men in the criminal justice system**. If there is any hope whatsoever of re-institutionalizing marriage in inner cities we must find safe ways for ex-offenders to cleanse their names, get decent jobs, and support their families so they might become marriageable in the reasonably discerning eyes of women.
9. **Better allow our religious traditions and institutions to help**. In interviewing National Public Radio's Krista Tippett for *Broken Bonds*, I asked how we might take greater advantages of our religious institutions for various purposes, not just fortifying marriage. "We can have robust discussions," she said, "without in any way questioning the wall of

> separation. The wall between church and state should not be a wall through the integrity of our citizens. . . . I fault the culture. But I fault the traditions, too."

PROLOGUE

Ideas about how to reinforce healthy marriages and families are to be found not only in the pages that follow but also in several other chapters of Center of the American Experiment's new *Minnesota Policy Blueprint*. Policy changes that help build a Culture of Prosperity and help strengthen families. The particular emphasis of this chapter, however, is on what might be done to strengthen *less-healthy* and *less-secure* marriages, as well as what might be done to reduce very high rates of nonmarital births which are severely hurting not only children and adults but also our state and nation.

Much of what follows likewise draws on a new book of mine, *Broken Bonds: What Family Fragmentation Means for America's Future*. Based largely on interviews with forty sage men and women from Minnesota and across the country, the book seeks to rigorously speculate about what our country might come to look like given that the United States has more family fragmentation and "churning" than any other place in the industrialized world. The book's ultimate aim is forewarning and reducing the chances that interviewees' fears come to fruition nationwide. The more localized aim of this chapter is forewarning and reducing the chances of such fears coming to fruition in Minnesota.

THE PROBLEM

Very high rates of family fragmentation in the United States are subtracting from what very large numbers of young people are learning in school and harming them in other ways. This, in turn, is damaging our country economically by making millions of Americans less competitive in an increasingly demanding worldwide marketplace and, as a result, creating a culture that is less open to innovation. All of which is leading, and can only lead, to deepening class divisions in a nation which has never viewed itself as having a fixed class structure.[1]

The same dynamic, on a smaller but similarly destructive scale, is destined to play out in Minnesota unless attitudes, behaviors, and numbers change.

As for national numbers,[2] about 40 percent of American babies are currently born outside of marriage. This breaks down to almost 30 percent of non-Hispanic white girls and boys, somewhat more than 50 percent of Hispanic children, and somewhat more than 70 percent of African American children. All these numbers are substantially higher in inner cities and other low-income communities, as well as among women and men with less than four-year college degrees.

In regard to divorce, calculating rates is harder than most people assume, if many people assume anything about it at all. Nevertheless we do know that divorce rates have been reasonably stable since the 1980s after having exploded in the two preceding decades. Even better, divorce rates have been decreasing among well-educated couples. But even with this good news, it's still estimated that between 40 percent and 50 percent of first-time married couples in the United States divorce. This is still a terribly high number.

Moreover, there has been a stunning increase in cohabitation in recent decades, with these relationships typically, especially in our country compared to many other places, shorter-lived than marriages.

What is all this leading to?

In a report by the Educational Testing Service, two veteran researchers write: "If we are looking for a 'shock' that roughly coincides with the end of the long-term relative economic and educational gain for Black children . . . [the] steep rise in children being raised without fathers, and mostly without the benefit of earnings, coincides with the … curtailed progress in narrowing the achievement gap."[3]

There is also the frequently cited three-part sequencing about how people who finish high school, work fulltime, and marry before having children are "virtually guaranteed a place in the middle class" and that only about two percent of them end up in poverty.[4]

And there is this fascinating finding about men who marry and those who don't. In a study of 500 chronic juvenile delinquents aimed at determining why some young men stopped their criminal behavior while others continued into their early thirties, researchers found that a good marriage made more than a little difference. Statistically controlling for everything needing controlling, the men "who entered a good marriage reduced their criminal activity sharply." More specifically, they did so by about two-thirds compared to men who did not establish good marriages or had not married at all.[5]

CONSEQUENCES OF NOT ACTING

With data and matters like these in mind, one of the final questions I asked almost all of *Broken Bond's* forty eclectic interviewees, from Massachusetts to California, went something like this: "In sum, considering all we've been talking about as well as at the risk of melodrama, what do you think the United States might look like in the days of your last breath? A radically reduced composite answer—which is not necessarily an "on-average" answer, would read something like this:

On the more optimistic, albeit much slimmer side of the ledger, some respondents were confident their own middle-class and comparatively affluent children and grandchildren, along with their similarly situated friends, likely would have good lives and that their generation likely would well-serve the nation. A few respondents placed their faith in the problem-solving power of free markets. Or in the generative power of immigration. Or in the ability of low-income neighborhoods to turn themselves around. Or in the emergence of new and better-suited family forms. Or they speculated about a possible religious reawakening or simply cited the hope they already derive from religious belief. But such comments and spirit—and not just in response to the question above—were decidedly in the minority. Much more numerous were worries and worse about our nation's future.

No respondents predicted anything apocalyptic with certainty; no one saw very high rates of family fragmentation necessarily doing us in completely or nearly so. To the extent they viewed such as rates as an ailment, they used terms such as a "wasting disease" rather than a "heart attack." They talked about slow declines, not fast ones. They saw a future America suffering the kinds of troubles we currently have, only more so. A place where problems caused and exacerbated by family fragmentation are managed, not fixed, and where have-nots have a harder times becoming haves.

They imagined the United States as still the world's leader, but perhaps not. Still an economically successful nation, but a less innovative one. They assumed a less unified America with whiffs or stronger scents of unraveling. When talking about disparities and divisions, several respondents spoke unusually starkly about matters of culture, values, behavior, and race. Some spoke of a commonweal with further eroding trust, especially between men and women, with nonmarital birthrates and divorce rates perhaps even higher than are those today. A place where millions of boys and girls are no better educated than they currently are, and consequently no better prepared for marriage-hospitable careers.

For Minnesota families to prosper, and without being the least melodramatic this time, the above is what we must reverse.

RECOMMENDATIONS

At the risk of an extreme cliché, there is no magic bullet, no simple set of ideas or programs, when it comes to restoring marriage in America, dramatically reducing out-of-wedlock births, or anything of the sort. As a result, the recommendations filling the rest of this chapter are broader and less concrete than others in the *Blueprint*, as the problems of family fragmentation have more to do with elusive culture than manageable policy. For additional ideas and suggestions, you might want to take a look at both *Broken Bonds* and its 2011 predecessor, *From Family Collapse to America's Decline: The Educational, Economic, and Social Costs of Family Fragmentation*.[6]

Recommendation 1: Retrieve Our Voice about Marriage

One of the very first things we need is for leaders and key institutions to retrieve their voices when it comes to the critical importance of marriage. This very much includes religious leaders and institutions. (See, for instance, what NPR's Krista

Tippett says below.)

While the importance of fathers is now more widely recognized than was the case for several strange decades starting in the 1960s, many people persist in stopping short before getting to marriage and its distinctive and essential contributions. A perfect example of this was an otherwise superb Father's Day message that then-presidential candidate Barack Obama brought in June 2008, in which he said things such as:

> Of all the rocks upon which we build our lives, we are reminded today that family is the most important. And we are called to recognize and honor how critical every father is to that foundation. They are teachers and coaches. They are mentors and role models. . . . But if we are honest with ourselves, we'll admit that too many fathers are also missing—missing from too many lives and too many homes. They have abandoned their responsibilities, acting like boys instead of men. And the foundations of our families are weaker because of it.

Beautiful and necessary words, but nowhere in his combination sermon/ campaign speech was there a single mention of marriage. This is not to single out the president, as I could have selected from a long list of politicians, scholars, and others across the political and ideological spectrum. But he was uniquely positioned that morning to talk about the importance of marriage, and the fact that he and his wife have a wonderful one made him even better primed as a teacher. A great opportunity missed.

Social service bureaucracies and offices at state and county levels (the latter being where services are actually delivered) are also largely voiceless when it comes to speaking up for marriage. This has long been the case throughout the welfare establishment across the nation, which is particularly unfortunate given that increasing marriage rates among welfare recipients was one of the two main goals of federal welfare reform in 1996. The other was significantly reducing the number of people on welfare.

The replacement of AFDC (Aid to Families with Dependent Children) by TANF (Temporary Assistance to Needy Families) led to extraordinary success nationally regarding the latter aim but none to speak of regarding the former. As for Minnesota, caseloads have trended downward over time, with a slight uptick during the recession and then continuing downward. But state and county governments are uniformly uneager to make the case for marriage, develop policies which could encourage it, or get rid of policies which undermine it.

With the elevation of same-sex marriage to the top of the political agenda, one of *Broken Bonds*' respondents talked about how it has become increasingly difficult to "valorize the biologically two-parent family." And when Utah Senator Mike Lee talks about America's "other marriage debate," he's not referring to the one about same-sex unions. This chapter, and Center of American Experiment, have nothing to say about same-sex marriage except the following: Encouraging couples to get married before they have children and stay married afterward will have a far larger impact on the future of our society than anything we do or don't do about same-sex unions.

Recommendation 2: More Effectively Serve Healthy Marriages

In speaking about "healthy" marriages, this is a propitious moment to emphasize that healthy, "equal regard" marriages (to use the jargon) are the only kind we are advocating. While a couple of programs aimed at rescuing troubled marriages are described below, "troubled" in this usage does not come close to subsuming "violent." Domestically abusive unions need to be escaped, abused partners need protection, and abusive partners need cops called.

It's also important to note that millions of kids growing up in single-parent situations are doing well while millions of kids growing up in two-parent homes are not. Family life is "so personal, so complex, so angular and many-sided" as actually lived (in Michael Novak's beautiful phrasing), generalizations are necessarily incomplete. Nevertheless, the bottom line is a straight line: statistically, children who grow up in homes headed by married parents fare better, often much better, than those who don't. Rampant family fragmentation in the United States undercuts personal well-being and societal success. This is not to chastise single parents, especially single moms, as millions are raising their children heroically and successfully. But sobering findings about the effects of fragmentation need to be made clear to men and women who are contemplating having children so as to give them the best possible odds of success.

Writers such as Ross Douthat, Reihan Salam, and Ramesh Ponnuru have argued in recent years that many conservatives, for all their essential advocacy of keeping taxes low, have failed to adequately address the anxieties of many working-class and middle-class families. For instance, Douthat and Salam have persuasively argued that conservatives have confused "being pro-market with being pro-business, by failing to distinguish between spending that fosters dependency and spending that fosters independence and upward mobility, and by shrinking from the admittedly difficult task of reforming the welfare state so that it serves the interests of the working class rather than the affluent."[7]

In a chapter titled "Putting Families First," Douthat and Salam highlight four areas in which conservatives need to offer more: making parenthood less burdensome, and not just in terms of taxes; recognizing the benefits of sprawl; allaying anxieties about health care; and reforming taxes so they better enable young families to handle the costs of raising children. Ponnuru's threesome in 2012 were health care, higher education, and energy. Conservatives, he argued, need to better acknowledge and respond to the increased degree to which many middle-class families are viewing themselves as economically marginalized, with these three areas being sources of economic stress.[8]

As to how to do this, Douthat and Salam borrow from something Ponnuru had proposed earlier. They call for a "family-friendly tax reform"—one that keeps taxes lowest for young families making investments in their offspring as such a plan would "treat children as a species of investment, one that is currently overtaxed." Might such an approach work at the state level? In Minnesota? Lowering overall tax burdens on couples who are struggling with the many expenses and other challenges of raising young children would reduce stress on their marriages.

At the same time and in complementary spirit, we would argue that conservatives, in the drive to reduce the size and scope of government, need to recognize how family formation and stability, not just capital formation and returns, must animate policy.

Other chapters of this *Blueprint* address many of the other policy areas these and other writers have identified: The benefits of sprawl (Transportation and the Met Council); Education (although we do not address higher education or the debts many young people are carrying); plus Health Care and Energy. Policies advocated in this Blueprint are aimed at bringing more and better jobs to Minnesota, which is the best cure for economic anxieties of all kinds. In shaping all of these policies we need to keep in mind the effect they will have on families, particularly young families that have or are contemplating children, and try to minimize the stresses that contribute to family fragmentation.

Recommendation 3: More Effectively Help Troubled and Potentially Troubled Marriages

Let's start with two intriguing programs, each owing to the work of Prof. William J. Doherty, a family social scientist at the University of Minnesota.[9]

For several years now, Bill has been building on an Australian program which provides basic mental health first-aid training for lay people. His particular contribution has been to create a grassroots project in Minnesota and the United States called "Marital First Responders."[10] As he says in *Broken Bonds*:

"I want to do something similar around marriage and romantic relationships. We're not going to professionalize our way out of our problems. We could quintuple the number of professional marriage counselors and it won't be sufficient. What I want to do is develop grassroots ways for people who are already confidantes to up their game in terms of how to respond helpfully to people who come to them. That's the group I want to reach."

Doherty notes that we know from a large body of research that people in "relationship struggles" turn to their family and friends long before they turn to any professional, including their clergy. As for the project's prospects, a number of faith communities, he says, are "*very* interested," and he allows that some people have been using the term "game-changer."

A second, seminal project is "Back from the Brink," which takes advantage of research by Bill and others, including Hennepin County District Judge Bruce Peterson, showing that more couples going through divorce are open to reconciliation than had previously been thought. This insight, if pursued wisely, should give therapists, mediators, lawyers, judges and others professionally involved greater cause and confidence in urging some couples to slow down and reconsider. Bill's shorthand is "discernment counseling."

A third idea, also suggested by Doherty, has to do with stepfamilies, which routinely are difficult to make work well for all concerned. This is illustrated by the fact that substantial research shows that children in stepfamilies often actually do less well than those in single-parent homes. For that matter, such households are more than occasionally tough on stepparents, too.

Should "stepfamily training" be mandated, as has been suggested, when two families come together by way of marriage? I have no interest mandating much of anything. But it would be smart if soon-to-be stepparents had more opportunities to participate, along with their new combinations of children, in programs, perhaps on-line, regarding the difficulties they may face.

Recommendation 4: Make Marriage More Likely in the First Place

W. Bradford Wilcox is director of the National Marriage Project at the University of Virginia. Andrew J. Cherlin is a professor of sociology and public policy at Johns Hopkins University. Wilcox is self-identified as a conservative and Cherlin as a liberal.[11] In a paper titled "The Marginalization of Marriage in Middle America," they focus on the damaging ways in which moderately educated Americans increasingly resemble lower-income citizens when it comes to very high out-of-wedlock birth rates and divorce rates.

"We come to this brief," they write, "with somewhat different perspectives." Wilcox emphasizes the primacy of promoting and supporting marriage. Cherlin argues that stable care arrangements for children, whether achieved through marriage or not, are what matter most. Both of them agree that "children are more likely to thrive when they reside in stable, two-parent homes." Out of this mix of views they jointly propose several efforts to either strengthen marriages, or make them more likely in the first place, among Americans who have high school degrees but not four-year college degrees. Here is one of them.

The unintended consequences of no-fault divorce, Wilcox and Cherlin write, "seem to have been most powerful for couples with fewer emotional and financial resources." One thing to do, they continue, is take advantage of aforementioned research by family scholar William J. Doherty and others showing that "at least 10 percent of couples going through a divorce are open to efforts to reconcile."

Making efforts at reconciliation mandatory, at least when children are involved and violence is not, is something we ought to consider.

Of interest here is a recent report by the U.S. House Budget Committee Majority Staff, officially known as *Expanding Opportunity in America*, but forever to be better known as the *Ryan Report*, after Rep. Paul Ryan of Wisconsin, chairman of the Committee. The "Discussion Draft" recommends that community groups be allowed to test different ways of reweaving safety nets so as to more effectively help people "not just to avoid hardship—but build a successful career." And hence, for our purposes, better enable people to get and stay married. That's Ryan and the Committee's very large hope, even though all concerned recognize, in the specific matter of federally funded job-related programs, success rates over the decades frequently have been dismal.

We need to be realistic about how much government can do, as evidenced by the limited success of the programs originating in the Healthy Marriage Initiative during George W. Bush's administration.[12] I spent two days in Oklahoma City in late 2013 visiting the Oklahoma Marriage Initiative, often considered the most effective such program in the country, only to find that it had come to focus less on ways of increasing marriage rates and decreasing divorce rates and focus, instead, more on bringing greater stability to romantic relationships generally. Which, as a practical matter, means dwelling on cohabitation to a much greater extent than envisioned by the White House and Congress a decade ago.

This is a cautionary tale. The main reason for OMI's broader emphasis on "relationships" is that the relative absence of marriages affords relatively few opportunities for rescuing faltering ones. Reviving marriage in lower-income communities is a very tough business. But the fact remains that cohabiting relationships in the United States (as opposed to many other places) are routinely short-lived, meaning that children once again are ill-served.

Recommendation 5: More Effectively Reduce Nonmarital Births

Continuing with non-married men and women, particularly non-married teenagers, let's take a look at out-of-wedlock births—starting, actually, with some good news. Birthrates for girls and young women aged fifteen to nineteen across the country have been going down for most of the last two decades, with the drop between 2007 and 2011 an amazing 25 percent. Overall, the teen birthrate nationally in 2011 was at an all-time low of 31.1 per 1,000 teenagers.[13] Still, these encouraging numbers can't erase the fact that since marriage is close to absent in these situations, an enormously high proportion of children will try to grow up minus one of their parents, usually their father. And these data can't erase the fact that it's women in their 20s and 30s, not teenagers, who give birth to the overwhelming majority of American babies who come into this life outside of marriage.

As for Minnesota, we compare relatively well to other states, with the sixth lowest rate of teen births in 2011: 18.5 per 1,000 females between 15 and 19 years old. This is a dramatic drop of 50 percent since the peak year of 1991.[14] (Regardless of the age of mothers, data in recent years show that approximately 84 percent of all births to non-Hispanic black women in Hennepin County were outside of marriage.[15])

What should Minnesota do?

As with educational vouchers, we should once against look to Milwaukee, which started a city-wide campaign in 2006 led by the United Way of Greater Milwaukee. The group's statistical goal was to reduce the birthrate of fifteen-to-seventeen-year-olds in the city by 46 percent by 2015. That audacious number was actually exceeded—hitting 50 percent—two years early in 2013.[16] As a former member of the board of directors of the Greater Twin Cities United Way, a terrifically led organization, I've informally suggested once or twice over the last year that the GTCUW lead a similar campaign. I hereby do so again.

Recommendation 6: More Effectively Help Girls and Boys in Fragmented Families

Rigorous social science research has left no doubt that children growing up in fragmented families, on average, do less well than boys and girls growing up in families headed by stable married couples by every conceivable measure. The list includes educational performance, mental illness, drug use, criminal behavior, early sexual initiation, and new generations of nonmarital pregnancies, with government at all levels spending extraordinary sums in order to compensate. But what about the obligations of young people themselves for moving ahead?

Ron Haskins, a *Broken Bonds* respondent, was staff director of the House Ways and Means Human Resources Subcommittee when comprehensive welfare reform was passed in 1996. In other words, he was the lead staffer in getting the most successful social welfare reform of the last generation turned into law. He recently blogged this:

> A typical child from a poor family enjoys income and housing support for their family, health care, preschool education, public school education, college loans or scholarships, and employment and training programs. But unless adolescents and young adults make wise decisions about their schooling, about marriage before childbearing, and about work . . . all this programmatic spending will do little to boost their chances of moving into the middle class. Federal and state policymakers, program operators and teachers, and parents need to constantly remind themselves and their children that personal responsibility is the key to success and insist that children and adolescents demonstrate more of it.[17]

We all need help at times, often a lot. But at the end of days and lifetimes, only individuals—first as young people and then as adults—strengthened by the love and generosity of others, can break the kinds of cycles we've been talking about. Or if you will, "programs" don't overcome; people do. And while urging individuals in harsh situations to pull up their moral socks can be a simplistic suggestion it is by no means always the wrong thing to do.

It's impossible, both at this point of the paper as well as at this moment in educational and political time, not to say something about early childhood education. Yes, it can help. Yes, we need it. Yes, momentum behind its expansion is irresistible. Yes, it is encouraging that Minnesota is affording low-income parents choices, in effect using vouchers, in where to enroll their young children. But expectations for early childhood education are often unrealistically high given that large numbers of children still will wind up attending weak schools and living in disorganized homes (to use gentle terms both times). We've been trying a variety of government programs to address these problems for half a century, without success. We should set our expectations accordingly.

Recommendation 7: Help Boys, More Specifically, Become Marriageable Men

In a Twin Cites visit a long time ago, the late Pulitzer Prize-winning columnist Bill Raspberry was asked something like, "How to fix poverty?" Simple enough. He said the problem was big enough so that a person could jump in anyplace and make a contribution, but his preference was to start with the boys. This is sound advice, as boys often become the men who women don't want to marry, and for good reasons. This is not to ignore helping girls become marriageable women. But increasingly girls and young women are faring much better than boys and young men. That is a fact we should not be afraid to face.

So it's off to school, most vitally.

If millions of boys (as well as girls) have holes in their hearts where their fathers (and sometimes their mothers) should be, what type of education might work best at filling such gaps, eventually enabling them to financially support children of their own? Other than *rigorous*, adjectives coming quickest to mind are *paternalistic* and *nurturing*. With "paternalistic" suggesting tough loving charter schools in the "sweat-the-small-stuff" spirit of KIPP academies. And with "nurturing" suggesting places in which religious belief, to one degree or another, animates.

This is how Harvard's Paul Peterson, who has done extensive work evaluating voucher programs across the country, put it during our *Broken Bonds* conversation in regards to both religious and secular private schools:

"Most of the students in our studies are living in single-parent families. I think a private school, especially when talking about urban settings, is a quieter place. A more closed space. Students are protected from hostile elements in the larger environment. The street culture is a good example of what's out there especially for boys, but also girls living in single-parent families. This peer group culture is very pernicious to learning and achievement, and it could be beneficial if we could protect kids from that, to some extent, by enabling them to attend private schools. It's not a cure-all. It's not a silver bullet. But it's a positive step."

Recommendation 8: More Effectively Help Men in the Criminal Justice System

If there is any hope whatsoever of re-institutionalizing marriage in inner cities, we must find ways for ex-offenders to cleanse their names, get decent jobs, and support their families so they might become (in sociologist William Julius Wilson's already noted famous description) "marriageable" in the reasonably discerning eyes of women.

Infinitely better yet, it goes without saying, would be for men not to offend in the first place. But in addition to their own deep and demanding obligations when it comes to redemption, political scientist Lawrence Mead argues in *Broken Bonds* that "we have to make it quite clear to any man who comes out of prison, whatever his previous life, we're going to make it possible for him to lead a civilized life going forward." Mead, who teaches at NYU, has written as influentially as anyone on the right about ways of truly reforming welfare and getting people back to work. In the matter at hand he has argued elsewhere:

"Much of my approach is modeled on welfare reform. Poor fathers, like poor mothers, need both help and hassle. That is, they need more help from government than they are getting. But they must also be expected to help themselves. We need to demand work—and, if necessary, to enforce it." He has proposed doing this by building on the fact that governments already demand child support from absent fathers and they expect that men leaving prison to work as a condition of parole.[18]

Questioning and rethinking the immense extent to which we incarcerate in the United States is increasingly occurring on both the Right and Left, as witness for instance the reformist, Texas-based group Right on Crime,[19] and comments like this one by Sen. Mike Lee again, a Republican from Utah, at a Heritage Foundation anti-poverty conference in November 2013:

"The simple fact," he said, "is that in America today, we put too many people in prison for too long with too little benefit to our society. If inmates are violent and threats to our communities then we have a moral responsibility to keep them locked up." But if they are not violent, pose no such threat, and are ready to return to their communities and families, then "we have just as much moral duty to get them reintegrated into our nation's networks of social and economic mobility."[20] Suffice it to say these are welcomed developments as long as protecting public safety remains Job One.

(As I prepared to write a first draft of this section, a Mendota Heights police officer was murdered in West St. Paul by a habitual criminal. One of the biggest difficulties in making progress in imprisoning fewer people is that most citizens, very much including legislators, are ill-disposed to doing so when someone who should have been imprisoned was not and then does something hideous.)

Recommendation 9: Better Allow Our Religious Traditions and Institutions to Help

Finally, sociologist Brad Wilcox, who we heard from before, has written how "Churches are bulwarks of marriage in urban America." Drawing on data from the Fragile Families and Child Wellbeing Study headquartered at Princeton and Columbia universities, he said indications were that "urban parents who attend church frequently are significantly more likely to marry before the arrival of children or to marry in the wake of a nonmarital pregnancy, and they are more likely to experience higher levels of relationship quality." And that, "Religious attendance appears to foster behavior among urban fathers that makes them more attractive mates and better partners."[21]

A religiously rooted private school is not the best option for everyone. But they work well, sometimes wonderfully, for a large number of children. The research on the question is clear. Which is another way of saying the case for vouchers is a strong one, especially for low-income kids whose family lives are most likely to be complicated and diminished by fragmentation. These institutions cannot only help students get a better education, but help them to lead a better life.

In interviewing National Public Radio's Krista Tippett for *Broken Bonds*, I asked how we might take greater advantages of our religious institutions for various purposes—not just fortifying marriage—while also fully respecting the Constitution and American variety. (We agreed that we both preferred "variety" to "diversity.") "We can have robust discussions," she said, "without in any way questioning the wall of separation. The wall between church and state should not be a wall through the integrity of our citizens. It shouldn't be something that decouples how we are in our work places, in our families, and in civil society from the sources of our deepest values. I fault the culture. But I fault the traditions, too."

Of the "traditions," and with marriage in mind, she added: "I really want the traditions to begin fully articulating what they know, what they've known for generations and centuries about what it means to lead a worthy life, about what matters in life, and about who we are to be for each other. They are incredible repositories. We need them. We need them more than we ever have before."

ALIGNING TAXES WITH ECONOMIC GROWTH

John Spry, Ph.D.

EXECUTIVE SUMMARY

The Problem

Understanding the problems with Minnesota's tax code first requires an understanding of the principles that should guide the state's tax policy. Sound tax policy should promote three core principles: economic efficiency and growth, equal taxation of equally situated people, and simplicity. These principles generally favor *low tax rates* levied on a *broad tax base*.

The basic problem with Minnesota's tax code is that it fails to follow these principles. Instead of low tax rates, Minnesota's personal income, sales, and corporate tax rates are among the highest in the nation. The state boasts the 2nd highest state personal income tax rate on the bottom bracket, 4th highest personal income tax rate on the top bracket, 7th highest sales tax rate, and 3rd highest corporate income tax rate. These high tax rates are levied on a narrow base, certainly a narrower base than if Minnesota followed sound tax policy principles.

High tax rates coupled with a narrow tax base damage Minnesota's economy as taxpayers change their behavior. The state's high tax rates discourage work, discourage investment in education and on the job training, discourage entrepreneurial risk-taking, encourage rearranging the timing of financial transactions, encourage politically favored and less productive investments, and increase the cost of raising revenue.

A tax system with low tax rates and a broad tax base minimizes these economic distortions. With minimal distortions, economic decisions allocate resources to their most productive use. Economists agree this increases the total size of the economic pie. In the simplest terms, the obvious damage then from Minnesota's high tax rates is a smaller economic pie for the entire economy.

Corporate income taxes are particularly harmful to economic growth because they create a high amount of economic damage for each dollar of revenue collected. Thus, the problems with the corporate income tax are more than just high rates on a narrow base. As one economist recently put it, the corporate income tax is "self-defeating."

High tax rates negatively impact Minnesotans across the income spectrum. The "effective marginal tax rate" is a technical term for "the percentage of an additional dollar of earnings that is unavailable to a worker because it is paid in taxes or offset by reductions in benefits from government programs." A single parent with two children making around $20,000 can be subject to an effective marginal tax rate of 87 percent. A Minnesota C-Corp can be subject to a 60 percent marginal effective tax rate.

What Needs to be Done

In the near term, Minnesota will likely continue to be a state that collects more revenue than average. Though not optimal, this does not mean Minnesota can't dramatically improve its tax system to better promote economic growth and prosperity. Minnesota can offer below average tax rates to families and businesses by the end of the decade by adopting the following recommendations structured around three important themes: Lowering rates and broadening bases, increasing transparency, and reducing complexity.

Lower Rates and Broaden Base to Reward Work and Investment

1. Set long-term goals to reduce tax rates and aim to reach them by the end of the decade.
2. Create an optional, lower income tax rate based on federal Adjusted Gross Income in 2015.
3. Eliminate the corporate income tax in 2016.
4. Eliminate the statewide general tax on business and seasonal property after the corporate income tax is fully eliminated.
5. Eliminate the estate tax, phased over six years.

6. Review and sunset all tax preferences for their effectiveness versus lower tax rates.

Increase the Transparency of Minnesota's Tax System

7. Include federal taxes in the Minnesota Tax Incidence Study.
8. Analyze the complex interactions between Minnesota and federal tax and public welfare programs.

Reduce the Complexity of Minnesota's Tax System

9. Replace the Capital Equipment Sales Tax Refund with an upfront exemption.
10. Reduce the number of property tax classifications and tiers from 51 to 4.
11. Eliminate Minnesota's high "advertised" property tax rates.

THE PROBLEM

Sound tax policy should promote economic efficiency and growth, equal taxation of equally situated people, and simplicity. These principles generally favor low tax rates levied on a broad tax base. Minnesota's tax code falls woefully short of this ideal. The tax code's many credits, deductions, exemptions and exclusions substantially narrow the tax base. As a result of this narrow base and high expenditures, tax rates in Minnesota are among the highest in the nation. These high rates unnecessarily distort and damage Minnesota's economy.

This report focuses mainly on structural problems with Minnesota's tax system. To the extent Minnesota's damaging high tax rates are caused by high spending, the level of government expenditures is addressed by recommendations offered in the companion *Minnesota Policy Blueprint* report, *Smart Budgeting for an Era of Limits*.

Principles of Sound Tax Policy

Understanding the problems with Minnesota's tax code first requires an understanding of the principles that should guide the state's tax policy. The basic problem with Minnesota's tax code is that it fails to follow these principles.

While there is often strong disagreement over specific tax policies, there is generally broad agreement on certain principles that should guide tax policy. A recent Minnesota Department of Revenue report, authored by an ideologically diverse group of economists (including this author), identified three guiding principles of sound tax policy: "efficiency, equal treatment of equals, and simplicity." Here is how the report describes each principle.

> **Economic efficiency.** "Allocating economic resources toward their most productive use is perhaps the chief advantage of free markets. This allocative

efficiency is, in effect, a way of making the economic pie as large as possible. One goal of a successful tax system is to interfere as little as possible with this process. A mark of effective tax policy, therefore, is the preservation of incentives for individuals and businesses to make decisions on the basis of productivity rather than for pure tax benefit."

Equal treatment of equals. "Under this principle, those with equal incomes should pay equal income taxes regardless of the source of their income, for example. Similarly, taxpayers with equal consumption should pay equal consumption tax no matter what items they buy. Violating this standard gives taxpayers incentives to seek low-taxed sources of income (or buy untaxed products) for tax rather than economic reasons."

Simplicity. "The simpler the system, the more easily taxpayers can comply with it. A simple tax system is also easy to administer and enforce, thus preserving public resources. A simpler tax system is also likely to be more transparent to voters and their elected representatives."[1]

These principles recognize the negative impact taxes can have on economic growth and economic decision making. Taxes first damage the economy by adding a cost, or financial burden to whatever activity is being taxed. Taxes also damage the economy by distorting economic decisions. "Essentially all taxes distort decisions," according to University of Minnesota Economist V.V. Chari.[2] And basing economic decisions on taxes versus productivity damages the economy. Economists call this damage the excess burden of taxation.

As economists Alex Brill and Alan Viard explain, the excess burden "measures the extent to which a tax interferes with the taxpayer's freedom to choose his or her preferred behavior. Popular discussions of tax policy often focus on the obvious burden of taxation: the amount of taxes people pay. But excess burden arises when behavior changes in a way that causes taxes to not be paid."[3]

Based on these principles, it is clear that an effective tax system will minimize distortions to maximize economic growth.

Guiding Principles Favor Low Tax Rates Levied on a Broad Tax Base

What does an effective tax system look like?

The three guiding principles strongly favor a tax system with *low tax rates* levied on a *broad tax base*. That's the conclusion of the report published by the Minnesota Department of Revenue and the "canonical goal" of sound tax policy.[4] It's easy to understand why.

Low tax rates and a broad tax base offer few avenues for taxpayers to avoid the tax by changing behavior. Lower rates promote economic efficiency by minimizing decisions to reduce or forgo the taxed activity. A broad base promotes both efficiency and equal treatment of equals by minimizing opportunities to opt for lower- or non-taxed alternatives. A broad base also promotes simplicity by minimizing the complex assortment of loopholes inherent in a narrow base.

Minnesota's Tax System Fails to Follow Sound Tax Policy Principles

Minnesota's tax system falls woefully short of being ideal or effective. While the three guiding principles favor low tax rates and a broad tax base, Minnesota's tax system generally imposes high tax rates on unnecessarily narrow tax bases. In fact, Minnesota's personal income, sales, and corporate tax rates are among the highest in the nation. The following state tax rate rankings for Minnesota tell the story.

- 2nd highest personal income tax rate on the bottom bracket of earners.[5]
- 4th highest personal income tax rate on top bracket of earners.[6]
- 2nd highest personal income tax rate on a household earning $250,000 in taxable income.[7]
- 7th highest state sales tax rate.[8]
- 3rd highest corporate income tax rate.[9]
- 2nd highest estate tax rate, though Minnesota shares this rank with nine other states.[10]

Minnesota's 9.85 percent top personal income tax rate is 85 percent higher than the national average.[11] The combined state and federal corporate income tax rate is 41.4 percent in Minnesota. Because the federal income tax rate is already the highest in the industrialized world, this combined rate would be the third-highest in the industrialized world if states were considered as countries. Also, consider that a C-corporation doing business only in Minnesota has a 60 percent marginal tax rate taking into account the double taxation of dividends after entity level taxes are paid first (see Figure 4).

These high tax rates are levied on a narrow base, certainly a narrower base than if Minnesota were to follow sound tax policy principles. The most recent tax expenditure analysis identified $1.85 billion in sales to Minnesota consumers that are exempt from the Minnesota sales and use tax in FY 2014.[12] Compared to actual collections of $5.04 billion in FY 2014, these exemptions narrow the sales tax base.[13] Personal income tax exclusions, deductions, subtractions, and credits add up to $5.57 billion for FY 2014, compared to $9.65 billion in actual collections.[14]

Defenders of the state's current tax rates argue Minnesota fares a little better when you compare actual tax collections. However, the fact that Minnesota's state rankings on actual tax collections are not quite as high as its rankings on tax rates actually reflects Minnesota's narrow statutory tax base and the negative effects of high tax rates on the economy and Minnesota's tax base.

While Minnesota's general sales tax rate ranks 7th, general state sales tax collections as a percent of personal income rank 20th and general sales tax collections per capita rank 18th. A part of this difference is explained by Minnesota exempting motor vehicle sales from the general sales tax and, instead, taxing motor vehicle sales under the motor vehicle sales tax. But much of the explanation for this difference is that Minnesota's 7th highest state sales tax rate applies to a relatively narrower base of goods and services.[15] A high rate on a smaller base simply doesn't collect as much revenue.

Recent research by economist John Mikesell confirms Minnesota's sales tax is levied on a narrower base than most states. Using newly available state-level personal consumption data, Mikesell compares state sales tax "C-efficiency"—the "collection gap" between actual state sales tax collections and what would be collected if states uniformly taxed all consumption.[16] In 2007, Minnesota's sales tax C-efficiency ranked 32nd of the 45 states with a general sales taxes. Furthermore, this research shows Minnesota's sales tax base narrowed more than most states from 1998 to 2007. During this decade, the C-efficiency of Minnesota's sales tax dropped 17 percent, which was the seventh largest percentage loss.

Though not as dramatic, corporate income and personal income tax collections also rank a touch lower than their corresponding tax rate rankings.[17]

Minnesota's combination of high rates and narrow bases is consistent with what occurs in states with similarly high rates. Economists at George Mason University find high state sales tax rates are linked to the number of tax base narrowing sales tax exemptions available in a state.[18] The authors conclude, "High tax rates increase the incentive to lobby for special exemptions."

High Tax Rates Coupled with a Narrow Tax Base Damage Minnesota's Economy

As explained above, a tax system with low tax rates and a broad tax base minimizes economic distortions. With minimal distortions, economic decisions allocate resources to their most productive uses. Economists agree this increases the total size of the economic pie. Thus, in the simplest terms, the obvious damage from Minnesota's high tax rates is a smaller economic pie for the entire economy.

More technically, as the tax rate increases there are two interrelated negative effects on the economy. First, the amount of taxed economic activity is reduced as the tax rate increases. People decide to work less, consume less, and invest less. Second, the average value of each unit of the lost economic activity increases as the tax rate increases. As MIT economist James Poterba explains, these two negative effects combine so that the economic damage from each incremental increase in the tax rate tends "to rise with the square of the tax rate, so that as the tax rate gets into higher and higher territory, the marginal dead-weight losses tend to grow rapidly."[19] A 60 percent marginal tax rate is not three times more damaging to the economy than a 20 percent tax rate, but about nine times more harmful at the margin.

The economic damage from taxes is also higher when there are more alternatives for taxpayers to reduce their tax liabilities. The excess burden of taxation is larger when the behavioral response to taxes is greater. Opportunities to engage in the same economic activity outside of Minnesota make the Minnesota tax base more responsive to tax rates than the federal tax base.

Center of the American Experiment's report, *Minnesotans on the Move*, suggests people are responding to Minnesota's high tax rates by either leaving or avoiding the state. The income and migration data analyzed in the report shows Minnesota tends to "receive people and income from higher tax states and contribute people and income to lower tax states."[20]

In addition to decisions on where to live, economists have documented many ways that high tax rates create distortions that damage our economy.[21]

- **Discourage work.** The *Journal of Economic Literature* documents the economically important negative effect of tax rates on labor supply.[22] Moreover, women's labor supply generally is more responsive to taxes than men's labor supply.
- **Discourage investment in education and on-the-job training.** The tax code punishes successful education and training by lowering the returns to investments in human capital. When you tax something you get less of it. Our tax code provides a deterrent to investments in education and training by taxing the returns to successful education and training that push taxpayers into higher tax brackets.
- **Encourage rearranging the timing of financial transactions.** High income tax rates provide a strong incentive to time taxable transactions to occur in years with lower tax rates and to rearrange financial and accounting transactions to engage in the maximum legal tax avoidance. Income taxes also provide a strong incentive to take compensation in tax preferred forms such as perks, exotic business trips, and tax-exempt benefits.
- **Encourage politically favored and less productive investments.** High tax rates distort investment decisions away from the most productive investments for growth toward politically favored, tax-preferred, investments that are less productive. The Minnesota tax code provides a strong incentive to invest in lower-risk, tax free investments, such as tax exempt municipal bonds or Treasury bills, instead of taxable equity in high-risk startups.
- **Reduce the rewards to entrepreneurial risk-taking.** Entrepreneurs work less and invest less in job creating ventures under high tax rates. In

a study of the effect of the federal 1986 tax reform on sole proprietors' hiring and wage-setting decisions published in the *Journal of Labor Economics*, economists found that "individual income taxes exert a substantial influence on the probability that an entrepreneur hires workers."[23] Moreover, the same economists find that "lower taxes also raise the total wage payments to those workers."

- **Increase the cost of raising revenue.** There is a cost to the private sector economy of raising another dollar of tax revenue. This cost is higher when tax rates are higher and when the tax base is more responsive to tax rates. The federal Office of Management and Budget (OMB) has stated during the Clinton, Bush, and Obama administrations that, "because taxes generally distort relative prices, they impose a burden in excess of the revenues they raise. Recent studies of the U.S. tax system suggest a range of values for the marginal excess burden, of which a reasonable estimate is 25 cents per dollar of revenue." This means that each dollar of revenue collected for the federal government costs the private sector $1.25. This is the sum of the dollar transferred from the private sector to the public sector and the 25 cents of lost economic activity created by distorting decisions to make people less productive. At the current combined federal plus Minnesota income-tax rates, each extra dollar of government spending is likely to cost the private sector around $1.25 to $3.00.[24]

The Economic Damage from Corporate Income Tax Rates

Minnesota's combined state and federal statutory rate (41.1 percent) is the 3rd-highest corporate tax rate in the industrialized world. It is 62 percent higher than the average tax rate among Organisation for Economic Co-operation and Development (OECD) members of 25.3 percent.[25]

Corporate income taxes are particularly harmful to economic growth because they create a high amount of economic damage for each dollar of revenue collected.[26] The 2009 Minnesota Governor's 21st Century Tax Reform Commission concluded Minnesota's corporate income tax penalizes "success and stifles capital formation while discouraging savings, investment, new jobs and economic growth. Competitive, growth and policy problems are endemic to the inefficient, regressive and economically harmful corporate income tax."[27]

The Congressional Budget Office (CBO) notes, "The domestic distortions that the corporate income tax induces are large compared with the revenues that the tax generates."[28]

Boston College economist Laurence Kotlikoff recently offered a similar perspective in the *New York Times*: "I, like many economists, suspect that our corporate income tax is economically self-defeating — hurting workers, not capitalists, and collecting precious little revenue to boot."[29] Note the emphasis on workers. Kotlikoff points out how corporations can move their operations and jobs to avoid taxation. Workers do not have the same flexibility.

Thus, the problems with the corporate income tax are more than just high rates on a narrow base. The corporate income tax is inherently a bad and economically damaging tax. The cost of what is given up in economic growth is just too high compared to the relatively small tax revenue collected.

Economists Robert Chirinko and Daniel Wilson estimate the damage Minnesota's corporate income tax inflicts on the economy. Specifically, they estimate the change in investment and state product for each state in the long-run in response to changes in state business tax policy in their 2010 article published in the *Federal Reserve Bank of San Francisco Economic Review*.[30] Chirinko and Wilson's model estimates that repealing the Minnesota corporate income tax would result in a long-run increase in real Minnesota State Output (GDP) of about 5 percent and an increase in equipment and structures capital stock in Minnesota of around 10 percent. The net long-run effect would be an increase in Minnesota output (GDP) of over three percent after netting out the reduction in the growth of state spending or the economic effects of base broadening to finance the repeal of the economically harmful Minnesota corporate income tax.

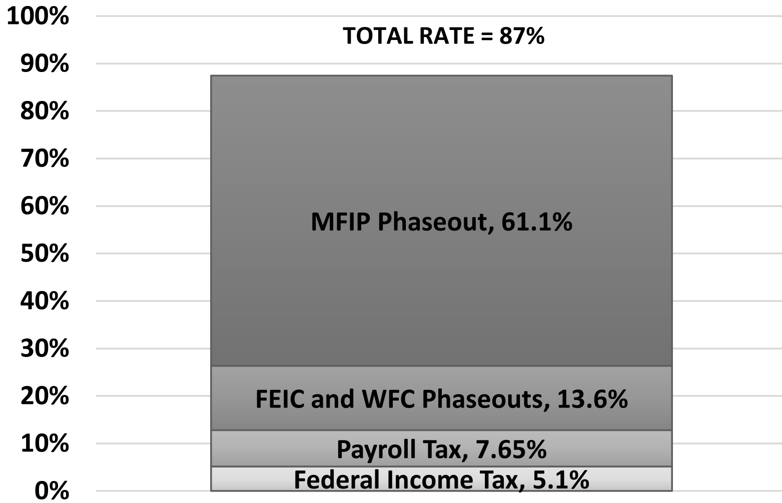
High Tax Rates Negatively Affect Minnesotans Across the Income Spectrum

The "effective marginal tax rate" is a technical term for "the percentage of an additional dollar of earnings that is unavailable to a worker because it is paid in taxes or offset by reductions in benefits from government programs."[31] It is a measure of the bite that both taxes and benefit losses take out of one's paycheck when one works a little more.

The rich are not the only people who can face high effective marginal tax rate. Figures 1 to 4 present four examples of how current laws create high effective marginal tax rates on Minnesotans.

- First, consider a single parent with two children making $18,720, whose hourly income rises from $9 per hour to $10. Figure 1 shows this family would have an effective marginal tax rate of 87 percent on this additional income. Of the $2,080 in additional income, this family would get to keep only $263. The government effectively takes $1,817 that was produced by the hard work of this single parent. Most of this loss is due to the phase-outs of the MFIP program that "claws back" benefits as the family's pretax income rises. [32] The rest of the effective marginal tax is due to income and payroll taxes. This high rate reveals the need to consider the structure of the tax code in

Figure 1: Marginal Effective Tax Rate on Single Parent with Two Children Whose Hourly Wage Increases from $9.00 to $10.00

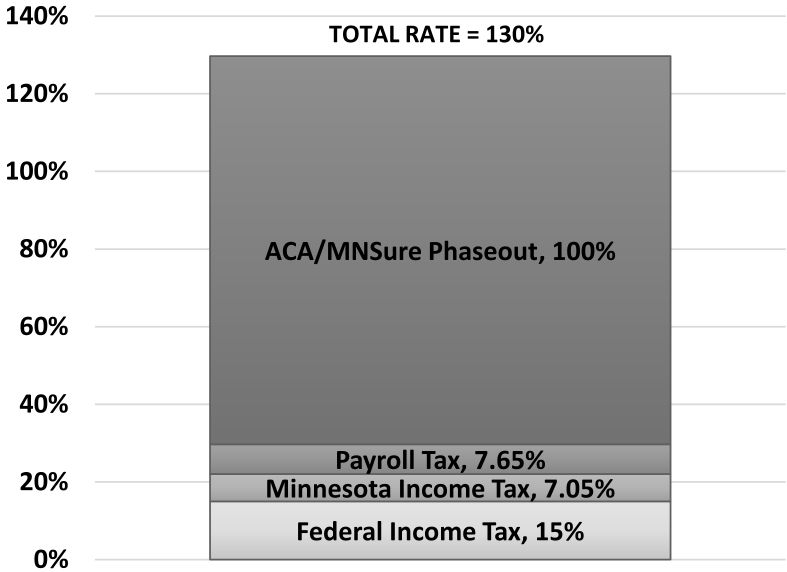


Source: Nina Manzi and Joel Michael, The Federal Earned Income Tax Credit and The Minnesota Working Family Credit, Minnesota House of Representatives (March 2013), available at http://www.house.leg.state.mn.us/hrd/pubs/feicwfc.pdf; and National Bureau of Economic Research, Internet TAXSIM Version 9.2 With ATRA, at http://users.nber.org/~taxsim/taxsim-calc9/index.html.

combination with the structure of the state's public benefits.

- Second, consider a family of four earning $93,000 that is enrolled in MNsure (Figure 2). When this family earns another $2000 in pre-tax income, the family's take-home income actually falls by $600 because of the combined effect of the family's 7.05 percent Minnesota income tax bracket, 15 percent federal income tax bracket, 7.65 percent federal FICA payroll tax and the phase-out of the MNsure tax credits set by the Affordable Care Act (ACA). This family faces an effective marginal tax rate of 130 percent.
- Third, consider a small business owner, such as a small day care provider, married to a high income earning spouse, such as a doctor (Figure 3). This taxpayer faces a 57 percent marginal income tax rate from the combination of the 9.85 percent Minnesota income tax, 35 percent federal income tax, and 15.3 percent federal FICA payroll tax.[33]

Figure 2: Marginal Tax Rate on a Family of Four Whose Income Rises from $93K to $95K



Source: Kaiser Family Foundation, Subsidy Calculator, at http://kff.org/interactive/subsidy-calculator/.

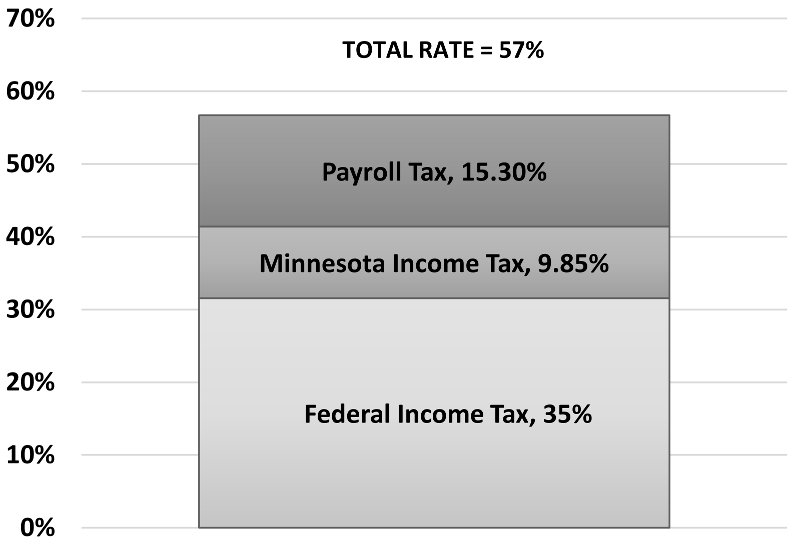
- Finally, there is a 60 percent effective tax rate on the income earned by the Minnesota owners of a C-corporation doing business entirely within Minnesota and paying annual dividends (Figure 4). This is the result of the double taxation of C-corporation income. Minnesota imposes a 9.8 percent corporate income tax on top of the federal corporate income tax of 35 percent. Then dividends are subject to a 9.85 percent Minnesota and 23.8 percent federal dividend tax.[34]

Whenever a taxpayer faces an effective marginal tax rate over 50 percent there is a greater benefit to the taxpayer to shelter another dollar from taxation than to be more productive to earn another dollar. High marginal tax rates create a disincentive to earn by reducing the rewards for work. Over time, these high effective tax rates harm our culture by undermining the virtue of hard work.

WHAT NEEDS TO BE DONE

In the near term, Minnesota will likely continue to be a state that collects more than average revenue. Though not optimal, this does not mean Minnesota can't

Figure 3: Marginal Tax Rate on Small Business Owner/Second Earner in Household in Top Tier



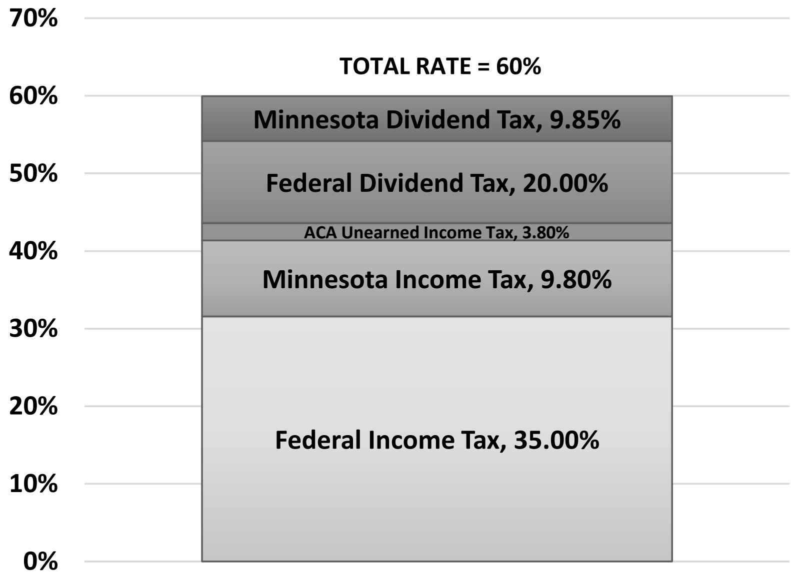
Note: Rates reported in the bar graph are statutory rates and do not add up to the total marginal effective tax rate due to the interaction of the federal deductibility of state taxes.

dramatically improve its tax system to better promote economic growth and prosperity. As detailed above, economists agree levying low tax rates on a broad tax base represents the ideal tax system. It minimizes economic distortions, which maximizes economic growth. Minnesota can make a strong move toward this ideal while continuing to collect above average tax revenue.

By itself, a broader base can bring in the revenue necessary to pay for lower rates. However, the economic growth spurred by minimizing distortions will also increase the tax base, allowing for even lower rates. Further helping matters, a growing economy and rising incomes will create space for lower spending and, therefore, lower tax rates by reducing the number of people who rely on the social safety net.

Center of the American Experiment also proposed spending restraint and budget reforms in a companion set of *Blueprint* recommendations on the state budget. Combining this spending restraint with sound tax reforms focused on growing the economy will allow Minnesota's above average tax collections to migrate closer to average and allow for even lower, more competitive tax rates.

Figure 4: Top Marginal Effective Tax Rate on Distributed Income from Minnesota C-Corporations



Note: Rates reported in the bar graph are statutory rates and do not add up to the total marginal effective tax rate due to the interaction of the federal deductibility of state taxes and the fact that dividend taxes apply only to the profits remaining after corporate income taxes are collected.

Minnesota can offer below average tax rates to families and businesses by the end of the decade by adopting the following recommendations structured around three important themes: Lowering rates and broadening bases, reducing complexity and increasing transparency.

Lower Rates and Broaden Base to Reward Work and Investment

Recommendation 1: Set long-term goals.

Minnesota cannot lower tax rates and broaden tax bases to ideal levels over night. The immediate loss in revenue to the state from lowering tax rates to the ideal level would be too great. Also, certain changes to the tax base will create winners and losers. Broadening the base will deliver lower rates to people already paying the tax, but will increase taxes on people subject to the expanded base. Any movement to broaden the base will likely need to be gradual or include strategic offsets to minimize immediate and painful losses.

Because a move to lower rates and a broader base must be gradual, the state should start by setting long-term goals for the rate reductions the state intends to achieve. Setting goals will create the framework for identifying and implementing strategies to achieve lower rates and broader base. This will give the state the best chance to figure out how to bring along all the special interests who understandably don't prioritize the overall health of the state's economy above all else. It will also give the state the motivation to stay the course when barriers seem insurmountable.

Specifically, Minnesota should set the following long-term goals and aim to reach them by the end of the decade:

- 5 percent income tax rate
- 5 percent sales tax rate
- Eliminate the corporate income tax
- Eliminate the statewide general tax on business and seasonal property
- Eliminate the estate tax rate

Recommendation 2: Create an optional, lower income tax rate based on federal Adjusted Gross Income in 2015.

To begin the gradual move toward lower tax rates and a broader tax base, the state should create an optional, lower income tax rate based on federal adjusted gross income (AGI) in 2015. One reason Minnesota income tax rates are so high (2nd highest bottom bracket rate and 4th highest top bracket rate) is because the state uses federal taxable income as the starting point for determining personal income tax liabilities, a narrower income tax base than most states start from. Federal taxable income equals a person's AGI minus personal exemptions and itemized deductions. Only eight states start from federal taxable income.[35] Most states—29 to be exact—start from AGI and thus start by treating federal personal exemptions and itemized deductions as income.

By starting from federal AGI, certain federal itemized deductions, like the home mortgage deduction, might still be allowed as a deduction on state taxes, but would not be automatic. State lawmakers would consciously need to set and justify each deduction in statute. Going through this process would almost certainly reduce the number of itemized deductions and broaden the income tax base. The state would also have the opportunity to reduce or eliminate the personal exemption, which would also broaden the base.

If the base were broadened by starting with AGI, the state could provide the option to take a lower tax rate and continue collecting similar revenues. At the very least, this would introduce Minnesotans to what a more sound tax structure would look like.

This idea is modeled after Rhode Island's alternative flat tax. Between 2006 and 2010, those subject to the top rate were given the option to choose a lower flat rate based on AGI, without any personal exemptions or itemized deductions. By 2010, state lawmakers decided to reduce rates permanently on all earners and start everyone from AGI. In the process the top rate dropped from 9.9 percent to a less distortionary and more competitive rate of 5.99 percent.

In 2009, former Minnesota state Rep. Laura Brod introduced this basic idea and called it the alternative even rate tax. Instead of gradually reducing the rate, she proposed an immediate change to an alternative even rate tax of 6 percent. It is time to reintroduce this idea in 2015 and introduce Minnesota to how applying sound tax policy principles to the income tax can enhance economic growth.

Recommendation 3: Eliminate the corporate income tax in 2016.

Corporate income tax rates should not just be lowered, they should be eliminated. Combined with the federal corporate income tax rate, Minnesota corporations pay stunningly high tax rates. When so many economists agree the tax is self-defeating, it's time to eliminate it.

This is not a giveaway to the rich. As the Minnesota Department Revenue readily acknowledges in its periodic tax incidence study, the Minnesota corporate income tax is regressive. Of the gain to Minnesota taxpayers, over 90 percent is passed to Minnesota consumers, in the form of higher prices, and workers, in the form of lower wages.[36]

This is by no means a radical idea. Ideally, business tax revenues should be reduced to match the government benefits businesses receive. The Council On State Taxation (COST) estimates Minnesota businesses received $1 in government benefits for every $3.20 in state and local taxes they paid in FY 2013. Of that $3.20 in state and local business taxes, the corporate income tax and statewide general tax accounted for only $0.55, or 17 percent. Thus, eliminating both taxes would still mean Minnesota businesses would pay far more in taxes than the benefits they receive.

The revenue loss from eliminating the corporate income tax would likely require spending cuts too politically painful to implement immediately. Thus, some phase in would likely be needed.

Recommendation 4: Eliminate the statewide general tax on business and seasonal property after the corporate income tax is fully eliminated.

Minnesota applies a statewide general property tax to business and seasonal recreational property. By law 95 percent of this tax is collected from businesses. This tax violates several principles of sound tax policy. First, it's a hidden tax because much of the burden falls on consumers and workers who never see a tax bill. The tax therefore violates transparency. Second, it violates equal treatment of equals by subjecting similarly situated property—property with the same value receiving the same public services—to this additional tax. Third, this additional tax reduces economy efficiency by discouraging investment in Minnesota business properties.

Recommendation 5: Eliminate the estate tax, phased in over six years.

Minnesota's estate tax should be eliminated because it imposes higher economic costs on Minnesota workers and families than can be justified by the small net increase in Minnesota tax revenue. The Minnesota estate tax is a very high tax ($146,000 paid on average in 2012) levied on a very narrow base (1,141 residents in 2012).[37] As such, it poses enormous incentives to distort decisions in economically damaging ways. It discourages savings and investment while promoting tax avoidance.[38] It provides strong incentives for estate planning, lifetime transfers, and moving out of Minnesota physically or via the creation of trusts in other states.

Furthermore, on net the estate tax may collect much less revenue than the state reports. Economist Douglas Bernheim writing in the NBER publication *Tax Policy and the Economy* has noted that the reduction in federal income tax revenue from estate planning transfers may offset gross federal estate tax revenue.[39] Bernheim's work suggests Minnesota's gross estate tax collections overestimate the net increase in Minnesota total tax revenue by not including the effect of the estate tax in eroding the personal income tax base.

Recommendation 6: Review and sunset all tax preferences for their effectiveness versus lower tax rates.

It's easy to understand the benefit of lowering tax rates by broadening the state's sales and income tax bases. Nonetheless, it is politically very hard to do. Changes to the tax base tend to create both winners and losers, and the losers usually put up a strong fight against any change. In order to create an environment more welcome to change, the state needs to institutionalize mechanisms that provide better information on tax preferences and motivate lawmakers to periodically review tax preferences.

Minnesota should fully integrate all tax credits, exemptions, exclusions, and deductions into the biennial budget process, requiring the governor and Legislature to make explicit decisions about whether to extend, repeal, modify or replace them. Each tax preference should be evaluated by a Tax Expenditure Sunset Commission along the lines of the recommendations of the *Tax Expenditure Review Report*. This commission should examine whether lower tax rates would be better for economic growth than continuing each tax credit, exemption, exclusion, or deduction.

State budget summaries should include total tax expenditures for each tax to show their fiscal impact on gross tax revenue. Tax expenditures should be included as a separate category in the Legislature's joint budget resolution. Each tax preference should have a revenue-neutral sunset following its evaluation and recommendation from the Tax Expenditure Sunset Commission to the Governor and the Legislature. Unless the tax expenditure is extended by the sunset date, it would expire and the rate for the tax would be adjusted downward to hold revenue constant.

Applying a sunset to all tax preferences can help motivate lawmakers to eliminate these tax preferences. A sunset would force a conversation on the legitimacy of a tax preference compared to lower tax rates and compels lawmakers to take action to reauthorize the preference.

Increase the Transparency of Minnesota's Tax System

Recommendation 7: Include federal taxes in the Minnesota Tax Incidence Study.

The biennial Tax Incidence Study currently includes taxes paid to state and local governments in Minnesota while excluding all federal taxes. Excluding the large, progressive federal slice of Minnesotans' tax payments confuses policymakers and the public. This omission is the source of the erroneous claim that higher income households pay a lower percentage of their income in taxes than lower income households. The Minnesota Department of Revenue has testified that higher income households pay a greater percentage of their income in total taxes than lower income households.[40]

Because taxpayers pay federal, state, and local taxes they deserve to see transparently the total tax burden from all levels of taxation. Minnesota should include federal taxes along with state and local taxes in the Tax Incidence Study.[41]

Recommendation 8: Analyze the complex interactions between Minnesota and federal tax and public welfare programs.

The interaction between Minnesota's tax code, the federal tax code, Minnesota public programs, and federal public programs creates high effective marginal tax rates for too many Minnesotans. A solution that would increase the percentage of the paycheck these Minnesotans brought home starts with measuring the effective marginal income tax rates that create barriers to upward mobility. Once the welfare walls and cliffs from multiple benefit phase-outs and taxes were measured, the programs should be redesigned to accomplish the following:

- Remove the highest cliffs that punish hard work;
- Expand the programs and/or tax credits that are most effective at providing a path to upward mobility;
- Eliminate the programs and/or tax credits that are not effective; and
- Reduce the overall number of programs to reduce complexity.

This analysis should be reported periodically in a study that calculates the effective marginal tax rates on Minnesotans with a variety of incomes, income types, household sizes, and participation in public programs. The study should also describe each of the tax distortions created by Minnesota taxes.

Reduce the Complexity of Minnesota's Tax System

Recommendation 9: Replace the capital equipment sales tax refund with an upfront exemption.

Minnesota businesses must currently collect sales tax from their employees, customers, and investors every time they buy or lease equipment used for manufacturing, fabricating, mining or refining. Then they have to apply for a refund of this business-to-business (B2B) sales tax. The state refunds about $220 million each year, but the process is cumbersome, and businesses fail to claim about 5 percent of eligible refunds. As the 21st Century Tax Reform Commission points out, "This delay is particularly harmful to small or startup businesses, where cash-flow is a crucial concern. Some businesses hire consultants to track and file for the refund on their behalf, which represents an additional business cost."[42] Furthermore, the state has to administer and audit both the initial collection of this B2B sales tax and the eventual refund of these payments.

This refund process was changed to an upfront exemption in 2013 law. However, 2014 law delayed the effective date for this change from September 1, 2014 to July 1, 2015, which reveals lawmakers are not fully committed to implementing the upfront exemption.

Changing to an up-front sales tax exemption on capital equipment purchases as scheduled in July 2015 would simplify compliance and regulation. An up-front sales tax exemption on capital equipment purchases would also be good tax policy. The *Tax Expenditure Review Report* says, "Economists and public policy analysts generally think of the sales tax as a consumption tax. As such, it should be levied only on sales to consumers, and not on sales between businesses. Taxing intermediate purchases—including capital equipment, office supplies, and building materials—will cause tax pyramiding as one business passes the tax cost along to the next. Ultimately, this creates an additional (and hidden) tax burden on consumers who purchase the final goods and products."

Recommendation 10: Reduce the number of property tax classifications and tiers from 51 to 4.

Minnesota currently categorizes property into 51 different classes and tiers for taxation. This introduces an astounding amount of needless complexity for both taxpayers and government officials. Minnesota should adopt the recommendation of the 21st Century Tax Reform Commission to consolidate classes with similar uses and rates under four broad classes.

- Agricultural;
- Residential (including residential rental property);
- Low-value commercial and industrial; and
- High-value commercial and industrial.

Consolidating classes will inevitably lead to some property paying higher taxes and others paying less. To minimize the size of these changes in tax liabilities, the 21st Century Tax Reform Commission recommends making sure "no class has a significant change in class rate. For example, the various residential classes currently have class rates that range from 0.75 percent to 1.25 percent; they could all be combined into a single residential class rate of 1 percent."[43]

Recommendation 11: Eliminate Minnesota's high "advertised" property tax rates.

Another 21st Century Tax Reform Commission recommendation the state should adopt is to eliminate Minnesota's high advertised property tax rates. Minnesota local property taxing jurisdictions report incredibly high "total local tax rates." For instance, St. Paul reports local property tax rates exceeding 160 percent.[44] Here's how the Commission explains the problem.

> Since 1988, Minnesota's property tax system has been unique among the states in that the taxable portion of property valuations is calculated using relatively low "classification rates" (1 percent or 2 percent, for example). These low classification rates effectively shrink local property tax bases (by 98 percent or 99 percent, for example).
>
> These dramatic base reductions drive local property tax rates to the uncommonly high levels needed to meet local revenue goals. The current statewide average local property tax rate (or "tax capacity rate," in the current system) is 94.7 percent.
>
> To potential investors in other parts of the nation or world, our

> unique system is likely to appear unnecessarily complex, and our tax rates confiscatory. On paper, Minnesota's rates are many times higher than those of other states even though actual property tax burdens may be comparable.[45]

Minnesota should abandon the current tax capacity system and convert to lower mill rates based on the actual value of the property.

RETHINKING ENERGY

Supplying Competitive Electricity Rates

Bill Glahn

EXECUTIVE SUMMARY

The Problem

Not long ago, Minnesota's energy policy focused on providing "adequate and reliable services at reasonable rates." As a result, Minnesota benefited from low and competitive electricity prices. This gave Minnesota businesses an important advantage, spurred job growth and provided relief for strained family budgets. Over the past decade, however, Minnesota electricity prices rose faster than other states. Minnesota is now among the twenty states with the highest electricity prices.

It is no coincidence that Minnesota electricity prices started rising faster after state energy policy shifted its focus to subsidizing and mandating green energy. Green energy policies clearly contribute to Minnesota's rising prices. Xcel residential customers now pay about 5 percent of their bill for its energy efficiency program. Utilities regularly cite the state's renewable energy mandate as one reason why they need to raise rates.

Most Minnesotans are willing to pay a little more for electricity if it means more green-sector jobs and a cleaner environment. Unfortunately, green policies are not producing the new jobs and environmental benefits promised to Minnesotans.

Instead, higher electricity prices are eliminating jobs. In just the manufacturing sector, a penny per kilowatt hour increase in electricity prices by one estimate eliminates 15,700 Minnesota jobs. Inflation adjusted electricity prices did, in fact, rise by more than a penny since 2005. The number of jobs at risk far outweigh the 14,000 clean energy jobs said to exist in Minnesota.

Higher electricity prices also hit low-income households the hardest. Home energy costs account for 32 percent of income for Minnesota households below 50 percent of the federal poverty guideline. If our society truly cares about reducing the impact of income inequality, then energy affordability should be a high priority.

The driving force behind current green energy policy is the reduction of carbon emissions in an effort to address global climate change. Minnesota, however, is simply too small to make a difference. Eliminate all Minnesota emissions tomorrow and the growth in global emissions would replace the state's emissions in about a month. Without global action, the cumulative actions of Minnesota and the United States are meaningless. Even if there were meaningful global reductions in carbon emissions, any benefits remain far too speculative to justify the cost.

What Needs to Be Done

As the proverb says, when you find yourself in a hole, stop digging. Accordingly, the state's first step must be to stop adding new green energy mandates. Next, policy makers need to review existing policies and eliminate those that are not producing tangible benefits for electricity consumers.

Here are seven specific recommendations to move Minnesota toward more affordable and competitive electricity rates:

1. Set a state goal to reduce consumer electricity prices by 10 percent relative to U.S. prices within ten years and direct the PUC to meet the goal.
2. Start to move toward the goal of more affordable, competitive rates by repealing certain green energy policies.
3. Give the PUC the power to suspend current mandates to meet the affordability/competitiveness goal.
4. Cap the cost of Minnesota's green energy policies.
5. Hire a nationally recognized accounting firm to audit the costs associated with Minnesota's green energy policies.
6. Annually report on the total cost of Minnesota's green energy policies and programs.

7. The Minnesota Legislature should estimate the cost to consumers of all new energy legislation before passage.

THE PROBLEM

It began with the best of intentions. In 1974, when the Minnesota state legislature decided to bring electric utilities under state regulation, it gave regulators responsibility for providing energy consumers "with adequate and reliable services at reasonable rates."[1]

In the last forty years, the need for affordable, reasonable rates has not changed. Affordable energy rates remain vital to Minnesota's ability to compete and create high quality jobs. For most Minnesota families, energy represents the largest household expense after food, housing, and transportation.

Twenty years after the state started regulating electricity, Minnesota began drifting away from the goal of affordable, reasonable rates. In 1994, when Minnesota still ranked among the twenty states with the lowest electricity rates, the Minnesota state legislature approved the "Prairie Island" settlement. This deal allows the state's largest utility—Xcel Energy—to store radioactive waste at its nuclear power plants. In exchange, Xcel began making large, and unprecedented, expenditures on wind power and energy efficiency programs. Xcel's consumers paid for both sides of the transaction—funding new investments for storage at the state's two nuclear power plants and covering the costs of the wind power and conservation programs.

Another twenty years later, after experimenting with every fashionable green energy policy to come along, Minnesota today finds itself among the twenty states with the highest electricity prices. For all of the negative impact on affordability, these green energy policies have not produced any significant countervailing benefits for Minnesota ratepayers or citizens. Not in jobs created or environmental benefits. These policies enable Minnesotans who favor green mandates to feel good. However, these feel good policies come with the price tag of fewer jobs and significantly higher electricity bills for Minnesotans.

Electricity Prices in Minnesota are High and Rising

During the two decades since the State Legislature began layering on green energy mandates in 1994, the average cost of electricity to Minnesota consumers has risen from 7.17 cents per kilowatt hour (kWh) in 1995 to 11.94 cents per kWh in 2013, or by 67 percent. Electricity prices have also been rising across the country and across the West North Central Region[2], but Minnesota prices have been rising faster. Figure 1 shows that over the same period in which Minnesota's residential electricity prices increased by 67 percent, the West North Central region's average residential prices rose by 48 percent and the U.S. as a whole rose by only 44 percent. In 1995, Minnesota's residential energy prices were

Figure 1: Residential Electricity Prices (Cents/kWh)

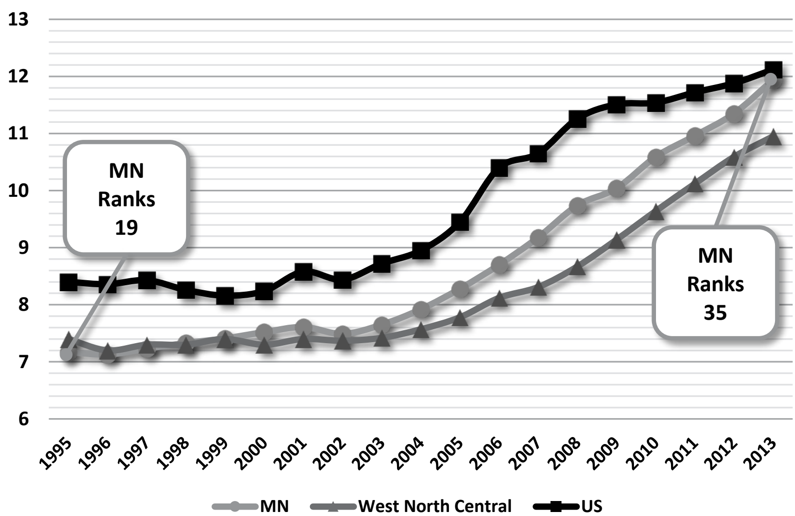


Figure 2: Commercial Electricity Prices (Cents/kWh)

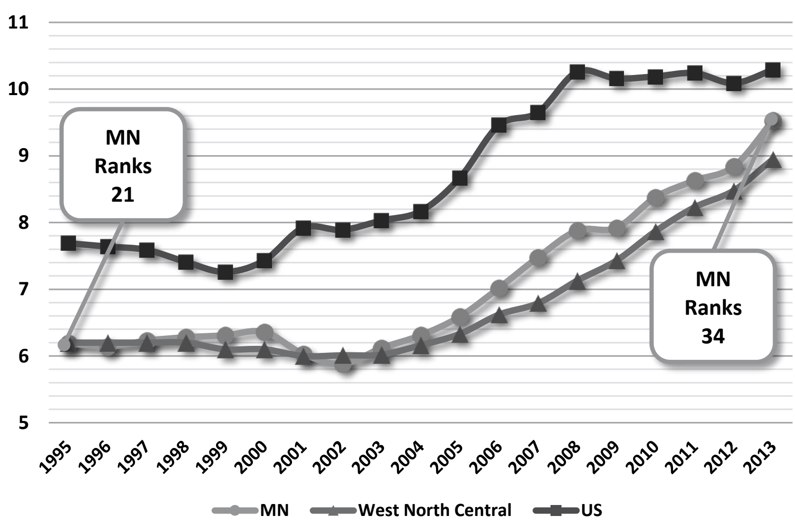
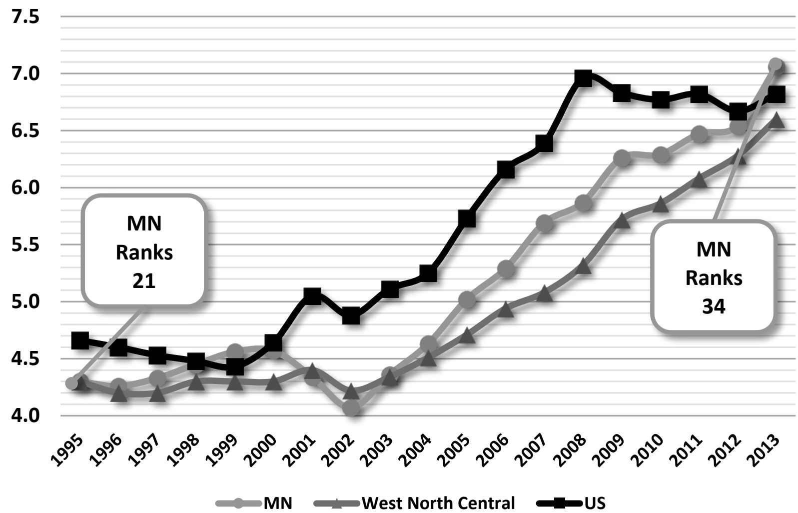


Figure 3: Industrial Electricity Prices (Cents/kWh)



Sources for Figures 1 through 3: Energy Information Administration, Electric Power Annual, Average retail price of electricity to ultimate customers, By state, by provider, annual back to 1990 (Dec. 12, 2013), available at http://www.eia.gov/electricity/data.cfm; and Energy Information Administration, Electric Power Monthly, Average Retail Price of Electricity to Ultimate Customers, Year-to-Date through December (various years), available at http://www.eia.gov/electricity/monthly/.

lower than the average residential electricity prices in the West North Central Region, lower than Iowa, Missouri and Kansas, but higher than the Dakotas and Nebraska. By 2013, Minnesota's residential electricity prices were the highest in the region.

Looking at commercial and industrial electricity rates, Figures 2 and 3 show a similar history of rising electricity rates relative to the region and the nation. Commercial rates in Minnesota rose 54 percent between 1995 and 2013, compared to a 44 percent increase in the West North Central region and 34 percent increase nationally. Industrial rates rose 64 percent in Minnesota between 1995 and 2013, which was again substantially higher than the increase experienced in the West North Central region (53 percent) and nationally (46 percent).

Notably, Minnesota's industrial rates leapt above the national average in 2013 after experiencing a 20 percent increase in just five years, all while U.S. rates declined by 2 percent. Moreover, ranking state electricity rates from most affordable to least, 2013 is also the first year Minnesota electricity rates rank in the bottom twenty states across all sectors. The state ranks 35th for residential rates and 34th for both commercial and industrial rates. This represents a huge change from 1990, when Minnesota ranked 16th for residential rates and 15th for both commercial and industrial rates.

Minnesota's Green Energy Policies Significantly Contribute to Rising Electricity Prices

As noted above, green energy policies became a priority in 1994 when the Minnesota state legislature approved the "Prairie Island" settlement, which required Xcel to make large expenditures on wind power and energy efficiency programs. Later, these renewable energy and conservation mandates were extended to the rest of the state's electric utilities. In fact, in each year from 2005 to 2013, the state legislature enacted additional mandates on the state's utilities; requirements to fund everything ranging from community energy projects, to global warming initiatives, to solar "gardens."[3] For the most part, other states have not added as many mandates. The debate in many states has in fact turned to rolling back green energy policies.[4] This year Ohio became the first state to freeze its renewable and energy efficiency mandates.[5]

While electricity prices are influenced by a number of factors, it is no coincidence that Minnesota's rates began rising faster than other states' rates at the same time state energy policy began focusing on subsidizing and mandating green energy.

If renewable electricity and other green energy policies were cost competitive, mandates would be unnecessary. Utilities would jump at the chance to implement green energy strategies to both save customers money and pump up their public image. But they aren't doing that.[6] Instead, in 2012, Xcel attempted to end its Solar Rewards program due to the high cost.[7]

Most of the recent requests for rate increases from Minnesota utilities cite green energy mandates as one reason for the need to raise rates.[8] As membership organizations with a duty to protect member interests, Minnesota's cooperative utilities have been the most forthcoming on the link between green energy policies and higher rates. Great River Energy reports that Minnesota's renewable energy standard (RES) cost $32 million in 2013, and they "are concerned additional mandates will burden our members with even more costs."[9]

The most recent evidence emerged from a settlement agreement between Xcel and utility regulators in North Dakota, in which Xcel admitted that it spread the cost of Minnesota's green energy policies across five states. North Dakota estimates Minnesota's policies cost North Dakota Xcel customers over $5 million a year. Mike Diller, the Director of Economic Regulation of the North Dakota Public Service Commission, provided this testimony on Minnesota's higher costs:

> It is no secret that Minnesota rules, laws and policies are highly influenced by various environmental groups and ideas. North Dakota

> has a renewable energy objective of 10 percent while Xcel Energy has a renewable portfolio standard (RPS) of 30 percent in Minnesota plus a recently added solar energy requirement of 1.5 percent. The environmental concerns of North Dakota are different than those of Minnesota and the cost of compliance with the environmental and energy policies in Minnesota is becoming a burden to North Dakota ratepayers.[10]

With a number of Minnesota based utilities operating across state lines, other states may well seek to follow North Dakota's example. If so, Minnesota ratepayers will soon bear the full cost of these green energy policies.

The costs of the Conservation Improvement Program (CIP)—Minnesota's energy efficiency mandate—are the easiest to track. Every year utilities must report how much they spend on CIP and estimate how much energy the program saved. Xcel, for example, claims that their energy conservation programs save the equivalent of 1.71 percent of the electric utility's retail sales.[11] To achieve these savings, Xcel spent about $80 million in 2013.[12] Adding the cost of its performance bonus ($54 million) and interest ($298,021)[13] brings the total cost to ratepayers to something closer to $135 million a year.

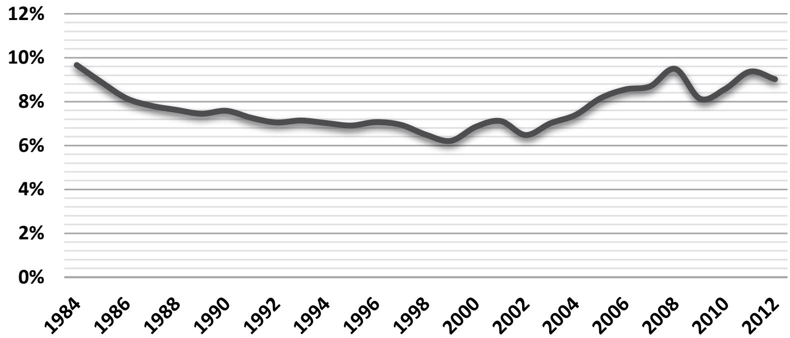
Based on Xcel's electricity rates, the cost per kWh of its CIP program works out to 5 percent of the cost of a typical retail residential consumer's bill.[14] Consumers are, therefore, paying 5 percent of their total bill for programs which reduce electricity needs by 1.71 percent.

Expensive Electricity Eliminates Jobs

The price of electricity is a critical factor in economic development. For many businesses, electricity is one of their top costs. Combined, Minnesota manufacturers spend over $1 billion a year on electricity. Lower energy costs would directly translate to lower costs of goods and services, making Minnesota businesses more competitive.

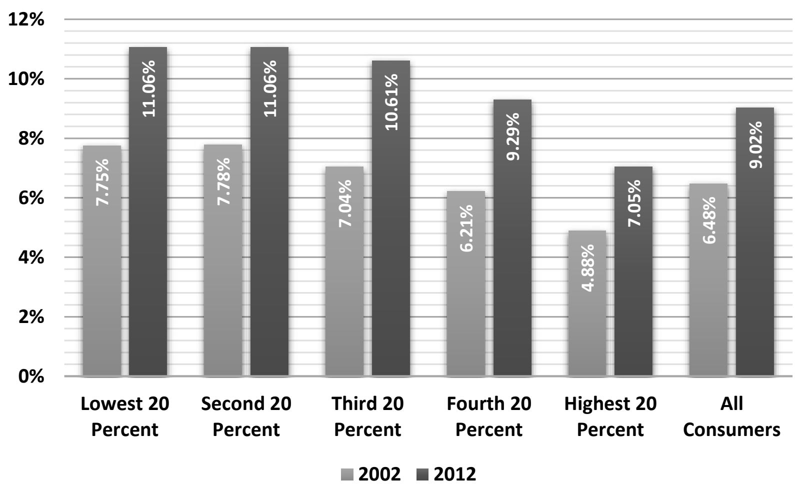
Unfortunately, with Minnesota's energy costs rising faster than elsewhere, Minnesota's businesses are now less competitive and good jobs are disappearing as a result. Drawing from a national study released by the Kentucky Energy and Environmental Cabinet, Center of the American Experiment's Peter J. Nelson estimated job losses due to rising electricity prices for various sectors of Minnesota's economy in a 2013 study. Each penny per kilowatt hour in increased electricity prices translates to a loss of 15,700 jobs in the Minnesota manufacturing sector alone.[15] And over the past ten years, inflation adjusted electricity rates for the industrial sector did, in fact, rise by more than a penny. These manufacturing job losses alone exceed the 14,000 jobs said to exist in Minnesota's clean energy sector.[16]

Figure 4: Energy as a Percent of Average Annual Expenditures, 1984-2012



Source: Bureau of Labor Statistics, Consumer Expenditure Survey, available at http://www.bls.gov/cex/.

Figure 5: Share of Consumer Spending on Energy in the U.S. by Income Quintile, 2002 and 2012



Source: Bureau of Labor Statistics, Consumer Expenditure Survey, available at http://www.bls.gov/cex/.

Expensive Electricity Hits Minnesota's Low-Income Households Hardest

High electricity prices tend to harm the poorest families the most because they spend a larger share of their income on energy. For most families, energy is the largest expenditure next to food, shelter, and transportation. U.S. families at all points on the income scale are spending a larger portion of their budgets on energy than they were a decade ago, as shown in Figures 4 and 5.

Fisher Sheehan and Colton—a law and economics research and consulting firm that advocates for affordable energy—calculates an "affordability gap" for Minnesota and other U.S. states. The firm reported in May of 2014:

> Home energy is a crippling financial burden for low-income Minnesota households. Minnesota households with incomes below 50 percent of the Federal Poverty Level pay 32 percent of their annual income simply for their home energy bills.[17]

If our society truly cares about reducing the impact of income inequality, then energy affordability should be a high priority.

Benefits Do Not Justify Higher Prices

So what value do Minnesotans get from higher energy rates? Not much.

After twenty years of expanding green energy mandates and subsidies, the clean energy sector employs less than one half of one percent of the state's workforce. Remember, Minnesota loses more *manufacturing* jobs to a penny increase in electricity prices than the *entire* green energy workforce.

The driving force behind current green energy policy is the reduction of carbon emissions in an effort to address global climate change. However, nothing the state of Minnesota can do will have any measurable impact on global carbon emissions.

Minnesota is simply too small to make a difference. The state's energy-related carbon emissions (93.4 million metric tons) represent 1.66 percent of U.S emissions (5,631.3 million metric tons) and 0.3 percent of global emissions (31,502.4 million metric tons).[18] Our emissions are less than those of the Central Asian country of Uzbekistan. For additional context, consider that it took just 32 days in 2011 for the growth of global carbon emissions to equal Minnesota's total emissions.[19] If Minnesota were to completely eliminate its carbon emissions, it would take about a month for growth elsewhere to add those emissions back.

Because Minnesota's emissions are miniscule on a global scale, any reduction will not impact Minnesota's climate. Indeed, local actions to reduce carbon dioxide emissions will not produce local benefits. There are types of emissions, such as sulfur dioxide or mercury, where local action has a local effect. Carbon dioxide is not one of them.

Furthermore, Minnesota's efforts to reduce carbon emissions may actually

The distinction between green energy laws and environmental protection laws

While Minnesota's economy needs affordable energy to remain robust and competitive, Minnesotans also value and demand a clean environment. Setting the right balance between affordable and environmentally responsible energy is no easy task. The task, however, is not so hard in regard to policies that promote green energy to reduce carbon emissions.

Reducing carbon emissions produces zero local benefit because the reductions are miniscule and irrelevant on a global scale. This is still true if you believe reducing global carbon emissions will produce some benefit, considering there is no concerted and coordinated global action to reduce carbon emissions. Without global action, the cumulative actions of Minnesota and the United States are meaningless. But even if there were global action, any benefits remain far too speculative to justify the cost.

This report makes a distinction between green energy laws and environmental protection laws. Generally speaking, green energy laws aim to mitigate climate change by reducing carbon emissions, while environmental protections laws aim to reduce specific pollutants, such as mercury, that are proven to harm the environment. Understanding this distinction is essential to setting an appropriate balance between environmental responsibility and affordability. While there is usually a sound or at least measurable cost-benefit justification for environmental protection laws, the same cannot be said for green energy laws.

be backfiring. There is some evidence that substituting renewable generation for coal results in more coal being shipped to China where power plants have a higher carbon emissions intensity.[20] At the very least, this adds emissions from transporting Wyoming and Montana coal a much longer distance. But coal demand also drops when Minnesota stops buying it. As Kellogg School of Management professor Bård Harstad explains, if a country participating in carbon reductions "reduces its demand for fossil fuel, the world price declines and nonparticipating countries find it optimal to purchase more oil or fossil fuels."[21]

Ultimately, it's difficult to justify any green energy policy that imposes a measurable economic cost because there's so much uncertainty in establishing the benefits, if there are any, from curbing carbon emissions. A 2010 National Research

Council study, commissioned by the Energy Policy Act of 2005, acknowledges that attempts to measure the benefits of reducing carbon dioxide remain speculative.

> Given the uncertainties and the still preliminary nature of the climate-damage literature, the committee finds that only rough order-of-magnitude estimates of marginal climate damages are possible at this time. Depending on the extent of future damages and the discount rate used for weighting future damages, the range of estimates of marginal global damages can vary by two orders of magnitude, from a negligible value of about $1 per ton to $100 per ton of CO2-[equivalent].[22]

As one analyst summarized, "In other words, you can get any number you want."[23] Without a reliable method for demonstrating a benefit, there is no reasonable cost-benefit justification for Minnesota to devote resources to force a transition to green energy.

To the extent the state of Minnesota is interested in doing something to help its citizens deal with climate change, a better policy would involve steps to adapt to actual climate change as it appears, regardless of why the climate is changing.

It turns out that many of the benefits claimed for this suite of green energy policies are at best oversold (e.g., green jobs and energy efficiency) and at worst non-existent (e.g., effect on climate change). We need to reorient state energy policy toward outcomes with measurable benefits for all Minnesotans rather than emotional benefits for a few.

LIKELY CONSEQUENCES OF NOT ACTING

This report documents the increase in electricity prices in Minnesota and demonstrates the link between state energy policy and those price increases. Unfortunately for Minnesota's electricity consumers, more price increases are on the way based on current policy.

It will be some time before Minnesota ratepayers feel the full impact of mandates enacted in the middle of the last decade. Though Minnesota's green energy policy shift began in 1994, it was not until 2002 that Minnesota electricity prices turned upward. This likely reflects normal implementation delay between the policy goals set forth in the Prairie Island Settlement and the impact of those policies. Similarly, Minnesota has yet to experience the full cost of the green energy policies implemented in the latter half of the last decade.

As of 2013, Xcel reports generating 18 percent of electricity from renewables and every other utility reports generating 12 percent, which means Xcel still has 13.5 percentage points to go by 2020 and other utilities have 14.5 percentage points to go by 2025.[24] Additional renewables to meet the remaining mandate will almost certainly be more expensive.

- New wind developments will likely be less productive because the most productive wind sites are already developed, although improved technology will offset this factor at least in part.
- Opposition and, therefore, the cost to siting new wind and transmission is growing as wind projects enter areas with higher population density.
- Generous federal subsidies for wind, which benefited Minnesota ratepayers (although they also cost them as federal taxpayers), lapsed at the end of 2013 and are unlikely to be renewed in the near future. Without such subsidies, Minnesota energy consumers will bear a much higher cost to fulfill the remainder of the existing Renewable Energy Standard.
- Finally, the 2013 solar power mandate is just now starting to phase in, and will result in a far higher costs than previous wind mandates.

While much of the cost associated with green energy mandates may already be "baked in" in terms of contracts signed and projects under construction, current policy is directing Minnesota to bake even higher costs into future rates. It is also directing utilities to spend more and more money on ineffective energy efficiency programs. If current policy persists, Minnesota will undoubtedly experience even higher electricity rates relative to the rest of the country. This will make Minnesota businesses less competitive and further strain the finances of low- and middle-income families. By reversing course now we can still avoid *future* price increases associated with past energy policies.

WHAT NEEDS TO BE DONE

As the proverb says, when you find yourself in a hole, stop digging. Accordingly, the state's first step must be to stop adding new green energy mandates. Next, policy makers need to review existing policies and eliminate those that are not producing tangible benefits for state electricity consumers.

Here are seven specific recommendations to move Minnesota toward more affordable and competitive electricity rates:

Recommendation 1: Set a state goal to reduce consumer electricity prices by 10 percent relative to U.S. prices within ten years and direct the PUC to meet the goal.

Minnesota's energy policy is familiar with goals. Utilities must aim to meet certain energy saving goals annually and must meet renewable energy goals by as early as 2020. As implemented by state regulators, these goals override the original purpose of state regulation—"reasonable" electricity rates. It's time to rebalance the goal of Minnesota energy policy and reintroduce affordability and competitiveness as goals for electric utility companies in Minnesota. To that end, the state should set a goal to reduce retail electricity prices by 10 percent relative to U.S. prices within ten years.[25] For instance, Minnesota industrial prices are now 104 percent of the U.S. price. We should aim to bring rates down to 94 percent of the U.S. within a decade.

Ten percent is not a random number. A 10 percent reduction would bring Minnesota close to its historically competitive position across all sectors. And competitiveness is key. If Minnesota were to reduce rates by 10 percent while the rest of the country reduced rates by 10 percent or more, then Minnesota businesses will not be in a more competitive position.

Recommendation 2: Start to move toward the goal of more affordable, competitive rates by repealing certain green energy policies.

To help utilities start moving toward the goal of more affordable, competitive electricity rates, the state should immediately repeal the green energy policies and programs outlined below. These policies were passed either with no economic analysis or with faulty "broken windows" thinking and should be repealed.[26]

> *Conservation Improvement Programs (CIP):* For nearly two decades, Minnesota law has required utilities to spend, at a minimum, a fixed percentage of their revenue on energy conservation through the CIP. By its very nature, the minimum spending requirement (MSR) is arbitrary. In addition to the MSR, the Next Generation Energy Act of 2007 requires utilities to work toward energy saving goals. These energy saving goals are even more arbitrary than the MSR. It's one thing to require utilities to spend the same amount of revenue; it's quite another to expect the same energy-saving results. While utilities annually report substantial energy savings under this program, these savings likely overstate the effectiveness of the program. Much of the energy savings would have occurred without the program as businesses and families already have a powerful financial incentive to save on the cost of energy. Indeed, other states have achieved similar and even greater energy savings without a similarly generous program. Thus, CIP likely socializes energy efficiency costs among all ratepayers that would have occurred anyway. This is simply not fair to those who pay and yet receive no direct benefit, especially low-income families. As noted above, Xcel's CIP amounts to 5 percent of a typical residential consumer's bill. Eliminating CIP would, therefore, immediately cut rates by about 5 percent, which would be a strong step toward meeting the goal to reduce electricity prices by 10 percent.
>
> *Renewable Energy Standards (RES):* The State of Minnesota mandates

that electric utilities obtain a significant amount of their energy needs from renewable sources. Depending on the utility, a requirement exists stating that 25 to 31.5 percent of all energy must come from qualifying types of renewable power. As a practical matter, it turns out that the vast majority of renewable energy acquired by state utilities has come from wind power. As explained above, this mandate has played a strong role in raising electricity rates. Investor-owned utilities regularly cite the mandate as a reason for needing to raise rates and many of the state's cooperative electric utilities report that the mandate has cost their customers tens-of-millions of dollars. With Minnesota utilities already supplying 14.8 percent of electricity from renewables, it's time to declare "Mission Accomplished" and move to other goals.

Solar Mandate: In 2013, the state legislature passed an additional requirement that utilities obtain a further 1.5 percent of their total energy requirements from solar power. The mandate continues to work its way through the regulatory system, but will impose significant costs on utility ratepayers. If solar power were cost competitive, such a mandate would not be needed. It should be repealed.

Community-Based Energy Development: In 2005 the legislature passed a Community-Based Energy Development (C-BED) Tariff. Utilities are required to consider community-based renewable energy projects to help satisfy their renewable energy requirements when they need to construct or purchase a new generation facility. The legislature has revised the mandate time and again in the years since its original passage, in order to make the mandate workable. It should be scrapped entirely. Xcel's settlement with North Dakota revealed this policy may be costing much more than expected. C-BED, according to estimates by North Dakota regulators, accounted for $2 million of the more than $5 million in additional costs due to Minnesota energy policies.[27]

Recommendation 3: Give the PUC the power to suspend current mandates to meet the affordability/competitiveness goal.

Politically, it will be difficult to fully repeal the green energy policies and programs described above. Short of repeal, the PUC should be given the power to suspend current green energy policies in order to achieve the goals for affordable and competitive electricity rates. Suspensions could be statewide or specific to certain utilities based on their unique position. Green energy policies pose different burdens on utilities based on their generation mix, consumer demand projections and customer base.

Recommendation 4: Cap the cost of Minnesota's green energy policies.

Unlike many other states that capped the cost exposures of their ratepayers, Minnesota does not limit the cost of its renewable energy mandates or energy efficiency programs. The legislature should enact a "ratepayer safety valve." This would require that each utility, when seeking PUC approval of a power purchase agreement for renewable energy or a proposal to construct or purchase a renewable energy project, certify that the contract or project (including any infrastructure required to support the project) will not cause rates to increase. In addition, it should require the PUC to waive the application of any energy mandate if a utility certifies to the PUC that it is unable to meet the mandate without requesting a rate increase.

If, as the proponents of such mandates often argue, the mandates do not increase electricity prices, then such a safety valve would have little effect. But if, as we argue, these mandates are a source of the substantial change in Minnesota's electricity prices, then such a safety valve would protect ratepayers and at least help to limit the seemingly endless rise in Minnesota electricity rates.

Recommendation 5: Hire a nationally recognized accounting firm to audit the costs associated with Minnesota's green energy policies.

As initial efforts to estimate the rate impact of the RES show, various methodologies deliver widely divergent results. Xcel reports virtually no rate impact at the same time it agrees to settle a complaint arguing that Minnesota policies cost Xcel ratepayers in North Dakota millions. Minnesota's energy efficiency programs also report dubious savings considering Minnesota hasn't become any more energy efficient relative to other states. Moreover, the process of developing any methodology to measure costs is heavily influenced by special interests that repeatedly understate the costs of the policies they promote. Cost estimates developed through an essentially political process are highly suspect. To get credible cost estimates, the state should hire a major accounting firm with appropriate experience to audit how Minnesota reports the costs attributable to green energy policies and to standardize the methods used to calculate those costs.

Recommendation 6: Annually report on the total cost of Minnesota's green energy policies and programs.

In spite of the expectation that energy costs will rise due to green energy policies and the evidence that costs are indeed rising as a result of Minnesota's energy mandates and regulations, no one is measuring the overall cost and its impact on ratepayers. Utilities have begun reporting on the cost of the RES and, though probably the largest cost driver, it is just one of many state policies with the potential to increase electricity rates. Unfortunately, information on how green energy policies affect consumer rates is fragmented across a number of different regulatory proceedings, and there is no established framework to bring this information together in a way that's useful to policy makers, consumers, and regulators. Obviously this information would be useful. Policymakers will need this information to make sound decisions in the future. Consumers deserve this information to understand why their energy bills are increasing. Finally, and most importantly, regulators need this information to know whether to modify or delay green energy regulations as this report recommends.

Recommendation 7: The Minnesota Legislature should estimate the cost to consumers of all new energy legislation before passage.

Any legislation that impacts the state's pocket book requires a revenue note from the Department of Revenue or a fiscal note from a state agency in order to give lawmakers the data they need to make an informed decision. However, the impact of proposed legislation on the pocketbooks of families or businesses is not always considered. To better inform decision making, the Minnesota Legislature should estimate the cost to consumers of all proposed energy legislation.

LIKELY RESULTS

If Minnesota repeals, or at least suspends, the mandates identified in this paper, we can expect electricity prices to continue rising for the next few years as the pipeline of projects contracted or committed to under current policies come online. But then the cost curve will start to level out, eventually declining as older projects come off contract and are replaced by cost competitive sources, whether renewable or otherwise. Because a major part of electricity prices are driven by large capital investments, recovering from bad policy decisions takes time, but the sooner we start, the sooner recovery will begin.

Eliminating CIP, currently at 5 percent of Xcel's residential rates, would be a solid start. There are still capital costs associated with CIP and so an immediate 5 percent rate reduction isn't likely, but a 2 to 4 percent reduction is certainly possible. On other fronts, there's no telling what regulators and utilities will propose to lower rates when directed and empowered to make low rates a priority. Ten percent is doable, given the authority to do so.

Most importantly, legally shifting Minnesota's energy priority to more competitive rates will send a strong message that Minnesota is open for business expansion. Minnesota's green energy policies have sent a clear signal to businesses: Expect higher electricity rates in the future. Resetting Minnesota's priorities will give businesses confidence that Minnesota intends to take full advantage of the lower-cost energy resources available in the region. That confidence is necessary for business, and especially energy intensive business, to expand and create high quality jobs for Minnesota.

SMART BUDGETING FOR AN ERA OF LIMITS

King Banaian, Ph.D. and Peter J. Nelson, J.D.

EXECUTIVE SUMMARY

The Problem

Minnesota's state budget continues to grow and grow, even after adjusting for inflation and population. Total spending in Minnesota's current FY 2014-15 budget grew by 9.8 percent over the previous budget, which translates to a hefty $1,130 per Minnesotan. As spending grows, the state budget continues to face long-term challenges from an aging population, rising health care costs, unfunded pensions and uncertainty over federal spending.

Minnesota's competitiveness will suffer if we do not gain control of state spending. Because the state constitution requires a balanced budget, increased spending in one area must be offset either by higher taxes or lower spending in other areas. The spending required by an aging population and past promises threaten to crowd out spending in other, more economically productive areas such as education and transportation. Future budget challenges will almost certainly require higher, economically damaging taxes if nothing is done soon to control spending.

How we got here

Minnesota follows a *baseline budgeting* process. The process starts with the prior year's budget as a baseline and then adds or subtracts from the prior budget depending on available revenues. Thus, there is very little effort spent evaluating the rest of the budget and whether past spending decisions effectively deliver outcomes citizens value. Without a budget process that forces policymakers to evaluate the effectiveness of current programs, inertia carries current spending programs forward and allows programs to be expanded and new programs added when revenue permits. In effect, the baseline budget process sets the budget to grow on autopilot, which allows budgets to grow consistently faster than inflation plus population.

The Solution

Proposals to correct the pro-spending, pro-status-quo biases in government budgeting should be based on a single principle: Spending should be evaluated based on the value of what it buys for the public.

Specific Recommendations

1. **Replace the baseline budget process with *budgeting for outcomes*.** The state budget should be determined by public priorities and evaluated based on results. In outcome budgeting, Legislators start by setting the price of government—the money available to be spent on public programs—and then establish priorities to guide spending decisions.
2. **Create a Legislative Budget Office.** An effective legislature requires a neutral arbiter of budget proposals. We propose that the Legislature create and fully fund a ***Legislative Budget Office*** (LBO) to estimate the spending and revenue impacts of proposed legislation, to prepare forecasts of budgets for upcoming sessions, and to evaluate public program performance or at least audit evaluations.
3. **Charge the Legislative Commission on Planning and Fiscal Policy (LCPFP) with taking a stronger leadership role in creating the state budget.** The executive branch has been given too much control over the budget process. It is the Legislature that provides the best forum to set priorities based on the diversity of views and values held by the citizens of Minnesota. To guarantee that future budgets best represent citizens' values and priorities, the Legislature through the LCPFP should take a stronger leadership role in setting the budget.
4. **Revive the Sunset Commission.** In 2011, Minnesota lawmakers created

a Sunset Commission to review the performance of state agencies and make recommendations for policy, organization, and structural changes. Unfortunately, the Legislature repealed the Sunset Commission in 2013. The Sunset Commission should be reinstated.

5. **Require public value impact statements**. New bills introduced to the legislature that increase spending, create new financial obligations, or impose new regulatory burdens on the private sector should be accompanied by a ***public value impact statement*** that states the chief author's intended outcomes and a means of measuring or evaluating those outcomes.
6. **Impose spending limits through statute or constitutional amendment.** To provide an anchor for the outcome budgeting process, the state should require that budgeted spending rise no faster than the average of inflation and population growth in the prior biennium. Overriding this limitation should require supermajority support from the legislature.

How these recommendations can improve Medicaid

Nowhere is containing costs more important than in the health and human services budget and, in particular, Medicaid. Budgets for public health spending have consistently outstripped the growth of state income. How would the above recommendations apply to Medicaid, and what could be done to improve Medicaid within this framework?

1. **Start by setting the price of government and agreeing to fit Medicaid spending within that overall price.**
2. **Stop autopilot growth in the Medicaid budget.** With outcome budgeting, the Medicaid budget would not increase automatically simply because enrollment or health care costs went up. Eligibility criteria and the benefits purchased with increased per-beneficiary spending would be consciously considered against other priorities.
3. **Require Medicaid programs to accomplish specific outcomes and demonstrate progress.**
4. **Prioritize Medicaid spending based on the effectiveness of proposed programs.** With evaluations of the Medicaid program in hand, lawmakers and citizens could have a serious discussion about prioritizing funding.
5. **Gain control of the data necessary to measure Medicaid program performance.** These health plans consider certain Medicaid data to be proprietary information. As long as the information remains proprietary, policymakers cannot effectively evaluate performance.

6. **Work to gain greater freedom to prioritize and reallocate resources within Medicaid.** Medicaid is funded by both the state and federal governments, and federal funding comes with very stringent rules on how those funds are spent. Minnesota should pursue greater control over Medicaid spending to take maximum advantage of outcome budgeting.

THE PROBLEM

Minnesota's state budget continues to grow and grow, even after adjusting for inflation and population. To fund this continued growth, the legislature adopted substantial, economically damaging tax increases in 2013. Despite this tax increase, Minnesota's budget still faces future challenges from health care cost increases, baby boomer retirements, unfunded pensions, and uncertainty over federal funding. The current budget process allows state spending to escalate on autopilot and fails to assess whether all this spending delivers good results. Minnesota can no longer afford to spend on autopilot.

Spending Continues to Grow Unabated

As shown in Figure 1, state spending took an aggressive turn upward in the current budget as total spending from all funds grew by 9.8 percent, which translates to a hefty $1,130 per Minnesotan.[1] This is the largest percentage increase in total spending since the 1984-85 budget.

The main takeaway from Figure 1 is that state spending since 1960 (adjusted for both inflation and population growth) basically only goes up and up and up. The recession of the early 1980s is the only exception. There are times when growth stalls, but the long-term trend clearly points up.

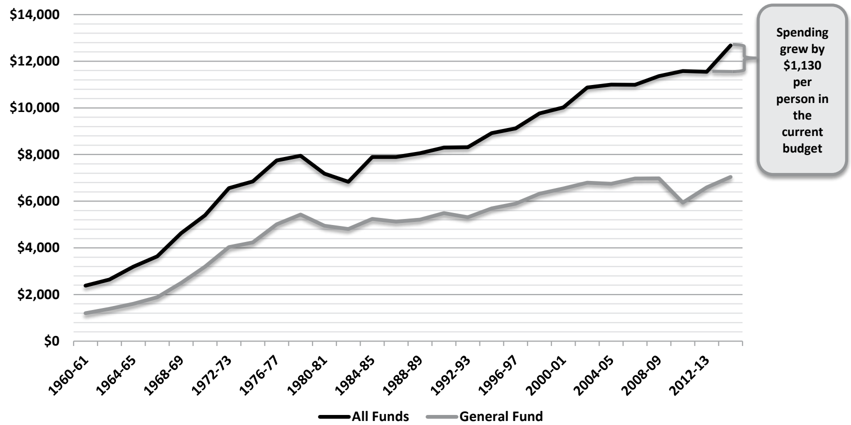
State spending as a portion of the state's economy is projected to set a new record in 2014. Between 1980 and 2013, state spending averaged 9.9 percent of the state's gross domestic product (GDP). Based on GDP projections in the February economic forecast, state spending will hit 11.2 percent in 2014. Because the state's GDP represents such a huge number, this small percentage difference represents a big change in the budget. Minnesota would be spending $6.8 billion less in the current budget if spending as a percent of GDP were 9.9 percent.

The Budget Still Faces Long-term Challenges

Currently, the budget is balanced and projected to remain balanced into the 2016-17 budget cycle. Nonetheless, there are long-term challenges to future budgets that will be much more difficult to address if spending continues on its current trajectory.

- **Aging population.** Retiring boomers pose the most serious challenge

Figure 1: State Expenditures per Capita, Minnesota, 1960-61 to 2014-15 biennial budgets (FY 2013 dollars)



Source: Author calculations based on Minnesota Management and Budget, Spending History, 1960 to Present (May 2014), available at http://mn.gov/mmb/images/Spending_history_May2014.pdf; Minnesota Management and Budget, Minnesota Annual Forecast Data (February 2014), available at http://mn.gov/mmb/forecast/forecast/economic/; Massachusetts Institute of Technology, "Cost Indices," at http://web.mit.edu/ir/cost_indices/index.html; and U.S. Census Bureau, "Population Estimates," available at https://www.census.gov/popest/.

because they have an impact on both the tax and spend sides of the ledger. On the tax side, the state will collect less revenue from boomers as their incomes decline during retirement. On the spending side, boomers will eventually increase demand for Medicaid long-term care services. Speeches by former state economist Tom Stinson and former state demographer Tom Gillaspy have warned repeatedly that rising health care costs are the natural outcome of the aging of the boomers.[2]

- **Health care costs.** Annual growth in health care costs has slowed since the start of the recent recession. However, growth is projected to accelerate as the economy improves. The most recent projections estimate public health care spending in Minnesota will increase 7.5 percent annually, on average, from 2012 to 2022 and private spending will increase 6.1 percent annually, on average.[3] These costs are driving the growth in health and human services spending. The financing for those costs has been made more uncertain by the recent, wrenching changes to federal programs for health care under the Affordable Care Act.
- **Pension liabilities.** The state's reported unfunded pension liabilities

are estimated to be $17.3 billion.[4] If this liability is not managed properly, the state will need to fund costly pension bailouts. Accounting practices, though legal, permit the state to delay recognition of these liabilities. When finally recognized, they will either require massive tax increases or crowd out other budget items.
- **Uncertainty over federal funding.** Much of the state budget depends on federal matching funds and these funds—especially transportation and Medicaid—are increasingly at risk as pressure to cut the federal deficit grows.

The current budget substantially increased taxes to fund new spending. To fund spending increases, the Minnesota Legislature passed and governor Dayton signed $2.1 billion in new taxes in 2013. At the time, the economic forecast projected a deficit of only $627 million. Thus, these new taxes went to support $1.5 billion in new spending. Since that time, revenues came in higher than projected; therefore, lawmakers were able to repeal about $500 million of taxes passed in 2013, including business-to-business taxes and the gift tax. Nonetheless, most of the 2013 tax increase was left in place, and the budget includes at least $1.5 billion in new spending.

Maintaining Minnesota's high tax rates is increasingly difficult as Minnesota businesses compete in a global market. Globalization puts pressure on government at all levels to reduce taxes on mobile resources, including labor and capital. One measure of the cost of our tax environment is when Minnesota businesses move or expand elsewhere. These costs are visible. It may be more damaging for the state to have businesses start elsewhere or not consider moving here. We cannot know how many there are, but it does long-term harm to the economic health of the state. Other states in our region have recognized this and have started to take substantial steps to control spending to remain competitive. Minnesota and Illinois, alone among Midwestern states, have failed to respond.

Minnesota's competitiveness will suffer if we do not gain control of state spending. Because the state constitution requires a balanced budget, increased spending in one area must be offset either by higher taxes or lower spending in other areas. The spending required by an aging population and past promises threaten to crowd out spending in other, more economically productive areas such as education and transportation. The budget challenges outlined above will almost certainly require higher taxes if nothing is done soon to control spending. And there certainly won't be room to lower taxes to make Minnesota more competitive with other states and countries. The resulting decline in economic growth will reduce revenue, creating a vicious cycle.

HOW WE GOT HERE

Why does the Minnesota state budget have an inflationary bias?

Baseline Budget Process Fails to Evaluate Performance and Value

Minnesota follows a *baseline budgeting* process. The process starts with the prior year's budget as a baseline and then adds or subtracts from the prior budget depending on available revenues. The process focuses on the margins of the budget—only the items subject to being cut or added. Thus, there is very little effort spent evaluating the rest of the budget and whether past spending decisions effectively deliver outcomes citizens value.

Baseline Budget Sets the Budget to Grow on Autopilot

Without a budget process that forces policymakers to evaluate the effectiveness of current programs, inertia carries current spending programs forward and allows programs to be expanded and new programs added when revenue permits. In effect, the baseline budget process sets the budget to grow on autopilot, which allows budgets to grow consistently faster than inflation plus population. On autopilot, dysfunctional programs rarely go away, and mediocre programs never go away. New ideas also struggle for fair consideration in this process because the inertia of current spending programs shoves them aside.

No Strong Institutional Barrier to Spending Growth

The only institutional barrier to autopilot spending growth is the state constitution's requirement of a balanced budget. State government cannot borrow money long term to finance current spending. While this keeps Minnesota's public debt low, it does not effectively contain spending. Instead, it produces "accounting ingenuity" when revenues fail to keep pace with spending. Whether by school shifts, tobacco bonds (which pull forward a stream of dedicated revenue to the moment of crisis), or promises of revenue from unreliable sources, the state manages to squirm, wiggle, shift, and slide around periods when revenues fall short of spending, without actually cutting spending.

State Agencies Lead the Process

Another issue with the budget process is that state agencies—the agencies asking for money—lead the budget process. The process starts with Minnesota Management and Budget (MMB)—the state's finance agency—preparing and providing budget instructions to state agencies in July. As a courtesy, MMB sends the instructions to legislative finance committees, but the committees are not charged with responding at this point in the process. State agencies work through October to prepare budget documents based on the governor's goals and priorities and then work with MMB to refine their budgets into December—again, all without input from the Legislature.

When the Legislature does become involved in the budget, it does not have great information. It must wait to receive the November economic forecast (usually released in December) and then receive the budget from the governor in January. Only then, with five and a half months to the end of the biennium, does the Legislature become actively involved in the process. And it still must depend on the agencies for the information to make budget decisions.

Fiscal notes present a particular information problem. State agencies develop fiscal notes to estimate the costs attached to bills, which is vital to understanding how a bill will affect future spending. Executive branch agencies under threat of reform have significant incentives to overstate the costs of reform and are not required to state the benefit envisioned. This has led to what is known in the Legislature as bills suffering "death by fiscal note."

Past Efforts at Performance Budgeting Have Failed

Because the baseline budget process fails to evaluate the performance of state programs in any meaningful way, Minnesota has tried to use some variation of performance budgeting since the mid-1970s.[5] Budget instructions to the agencies from the executive branch, however, have consistently changed how outcomes would be measured, how those measurements would be placed in budget documents, and how budgeting decisions would be affected by these measurements. In 1991, Governor Arne Carlson attempted to improve those efforts by creating Minnesota Milestones. The Milestones initiative had five themes, 20 goals, and 79 performance measures with 30-year targets for each. There were public hearings, and a citizen panel to create those themes, goals, and measures. However, a 1994 legislative audit report indicated that the agencies and the legislature found the Milestones "had a limited impact on the 1994-95 budget."[6] It was too difficult, they concluded, for committees and agencies to use the Milestones. The effort foundered and was abandoned.

For the current FY 2014-15 budget, state agencies were instructed to "focus on performance measures and how agency's strategies contribute toward high level outcomes for the state."[7] This is a positive development, but it remains to be seen whether these are serious efforts to evaluate performance or if they will be ignored and abandoned like past efforts. Furthermore, there is no requirement to prioritize spending items.

The high level of information necessary for performance evaluation remains the biggest impediment to implementing a budget process that regularly and systematically evaluates programs and then prioritizes spending based on value provided to citizens.

However, the executive branch poses another impediment. Because the agencies currently lead the budget process, and because the process provides the agencies with steadily increasing revenue regardless of performance, the agencies are largely satisfied with the status quo. Any change would likely mean giving up some control to the Legislature.

THE SOLUTION

Proposals to correct the pro-spending, pro-status-quo biases in government budgeting should be based on a single principle: Spending should be evaluated based on the value of what it buys for the public. Bringing that about will require a number of institutional changes.

> **1. Objectively evaluate spending proposals.** There should be a neutral evaluator of the cost and effectiveness of programs. Using the agencies that will bear the reductions to evaluate potential savings leads to a systematic bias against spending reduction.
> **2. Categorize spending by what we buy, not what we spend.** Many activities and programs in different agencies aim at the same goal, but their budgets remain in separate departments, with budgets determined by separate legislative committees. Silos abound in state budgeting. To evaluate what we spend on transportation, for instance, requires going through state, county, and local budgets with money coming from special funds as well as general revenues. A mechanism must be developed to evaluate these different programs and revenue sources together.
> **3. State what an increase in taxes buys in very clear terms**. In 2011, we had a debate over the size of the state budget without a clear statement by those favoring higher spending of what it would buy for the public. In 2013, a new legislature enacted tax increases without specifying the public benefits to the state. There was no list of "if we have extra revenue, this is what we will do with it," or "if there is less revenue, here's what we would reduce." As a result, the public was under-informed about the costs and benefits of the higher spending and taxes.

Our proposal addresses these three institutional shortcomings.

Specific Recommendations

Recommendation 1: Replace the baseline budget process with *budgeting for outcomes.*

The state budget should be determined by public priorities and evaluated based on results. Yet as discussed above, Minnesota uses prior budgets as a baseline and never intentionally or systematically reviews priorities. Rather than have a budget start with the amounts spent in the previous budget and propose changes, the state should change to an outcome-based budget process.

In outcome budgeting, Legislators start by setting the price of government—the money available to be spent on public programs—and then establish priorities to guide spending decisions. When requesting funding, agencies must develop proposals linked to public priorities and demonstrate that the requests produce the best results for the money. Reducing cost and increasing effectiveness would make it more likely an agency's activity will be included in the budget. This would work only if managers of programs and activities—middle-level state employees—were convinced that leaders would not simply use their savings to reallocate money to pet projects. There must be commitment by a governor and legislative leaders to a rigorous, objective evaluation of the effectiveness of particular spending in meeting stated public priorities.[8]

Outcome budgeting removes the concept of a "base" level of spending, which means prior spending programs are no longer presumed to have an entitlement for future spending. As a result, outcome budgeting turns off a key driver of autopilot spending growth. More importantly, removing the concept of base spending subjects public programs to regular assessments of whether they are actually achieving the results the public and policymakers expect.

There are a variety of outcome budgeting models available, such as public service agreements in the UK or the "priorities of government" program in Washington State.[9] As outlined by Marc Robinson and Duncan Last in a report for the International Monetary Fund, at a minimum the budgeting system should require these elements:

- A "strategic" priority-setting phase early in the budget cycle
- An expenditure review process
- Systematic scrutiny of new spending proposals
- Information on efficiency and effectiveness to support budget submissions
- Introduction of a program budget structure
- Increased managerial flexibility to meet priorities[10]

While, to be sure, linking performance to the budget is much more difficult than this list above, as Robinson and Last indicate, it should still be a goal to find links where feasible.

In addition to this list, it is also crucial that the process start with setting the price of government up front.[11] The budget is then set and prioritized to live within those means.

Why would this work, while Milestones failed? The model has worked in Washington in no small part by having themes or goals prioritized. Where the Milestones failed, in our view, is in its lack of agreement on priorities. Prioritization is necessary to inform budget decision-makers of which purchases are in and which are out.

Outcome budgeting offers tremendous advantages over the current budget process. The process would force leaders to state their priorities and periodically rethink the outcomes that matter most to the public. More importantly, this process would make public programs truly accountable for results because they would have to meet clear and objective performance measures. Finally, outcome budgeting would improve the public conversation. By starting with a focus on results that citizens value, the conversation would focus on what's working and on satisfying a stated set of public priorities.

Recommendation 2: Create a Legislative Budget Office to manage and prepare the information necessary to create budgets.

An effective legislature requires a neutral arbiter of budget proposals. We propose that the Legislature create and fully fund a ***Legislative Budget Office*** (LBO) to estimate the spending and revenue impacts of proposed legislation, to prepare forecasts of budgets for upcoming sessions, and to evaluate public program performance or at least audit evaluations.

The LBO should be run entirely by nonpartisan staff. Within government, it is our view that nonpartisan staff in the Legislature have proven to be the most reliable resource for fair and unbiased information. Therefore, it seems wise to take greater advantage of this valuable resource.

Moving in this direction would align Minnesota with the 31 states that rely primarily on the Legislature to estimate the budget impacts of proposed legislation.[12] This supplements rather than replaces MMB and other state agencies. The law must require state agencies to provide information to the Legislature in a timely fashion. The LBO would work in concert with the existing Legislative Commission on Planning and Fiscal Policy, which would conduct work in much the same way the federal Joint Committee on Taxation operates.

Recommendation 3: Charge the Legislative Commission on Planning and Fiscal Policy (LCPFP) with taking a stronger leadership role in creating the state budget.

The executive branch has been given too much control over the budget process. Executive agencies are the "first mover" in setting budget targets and control the information. It is the Legislature that provides the best forum to set priorities based on the diversity of views and values held by the citizens of Minnesota. And that is why the state constitution gives the Legislature the exclusive power to enact laws, including taxing and spending policy. To guarantee that future budgets best represent citizens' values and priorities, the Legislature should take a stronger leadership role in setting the budget. Five state legislatures create budgets independently of their governors, and four of those five states depend on a joint budgeting committee much like the LCPFP.[13] For the LCPFP to create budgets independently of the governor, the resources of a Legislative Budget Office or something similar would be necessary. The Legislature should move in this direction.

More immediately, the Legislature should charge the LCPFP with taking a stronger role in coordinating with the governor's office throughout the budget process. In fact, the LCPFP should lead the process by holding budget hearings during non-budget sessions. These hearings could be used to start the outcome budgeting process and to develop budget instructions based on outcomes for agencies to follow. In this way, the non-budget session would become the program-evaluation session, and the LCPFP would gain a far more elevated and constructive role in the budget-setting process. After the session concluded, LCPFP should continue meeting to provide ongoing input and oversight.

State law already empowers the LCPFP to take a stronger leadership role. According to current law:

> All departments, agencies, and education institutions of the executive and judicial branches must comply with a request of the [LCPFP] for information, data, estimates, and statistics on the funding revenue operations and other affairs of the department, agency, or education institution. The commissioner of management and budget and the commissioner of revenue shall provide the commission with full and free access to information, data, estimates, and statistics in the possession of the Management and Budget and Revenue Departments on the state budget, revenue, expenditures, and tax expenditures.[14]

Thus, the LCPFP basically has the power to subpoena the information necessary to begin setting a new budget, either alongside or ahead of the governor. Moreover, state law specifically directs the LCPFP to provide the Legislature with budget information and oversee the governor's budget proposals. The major obstacle is funding. The LCPFP would work best in coordination with a fully funded Legislative Budget Office.

Recommendation 4: Revive the Sunset Commission.

In 2011, Minnesota lawmakers created a Sunset Commission to review the performance of state agencies and make recommendations for policy, organization, and structural changes. Instead of reviewing agencies all at once, it evaluated agencies one at a time on a schedule. This was the first time agencies were required to present anything looking like a priority/outcome-based budget.[15] Unfortunately, the Legislature repealed the Sunset Commission in 2013. The Sunset Commission should be reinstated. Any money saved could be freed to support higher priorities, which would certainly include lower taxes. If outcome budgeting were adopted, the Sunset Commission would be an important part of this process.

Recommendation 5: Require public value impact statements.

New bills introduced to the legislature that increase spending, create new financial obligations, or impose new regulatory burdens on the private sector should be accompanied by a ***public value impact statement*** that states the chief author's intended outcomes and a means of measuring or evaluating those outcomes. Those would be used by the Sunset Commission, the Legislative Budget Office, and the Legislative Commission on Planning and Fiscal Policy (LCPFP), which collectively are charged with increasing legislative oversight and visioning of public spending in Minnesota.

Recommendation 6: Impose spending limits through statute or constitutional amendment.

Thirty states operate under some type of tax or expenditure limitation. Minnesota does not. Decades of expenditure growth that consistently and substantially exceeded inflation and population growth suggest that Minnesota lawmakers need help reining in spending. To provide an anchor for the outcome budgeting process, the state should require that budgeted spending rise no faster than the average of inflation and population growth in the prior biennium. Overriding this limitation should require supermajority support from the legislature. Such expenditure limits have been used successfully in Alaska, Nevada, Ohio, Utah, and Washington. In Washington's case, we believe the spending cap has been vital in the success of the state's Priorities of Government program.

HOW THESE RECOMMENDATIONS CAN IMPROVE MEDICAID

Nowhere is containing costs more important than in the health and human services budget and, in particular, Medicaid. Budgets for public health spending have consistently outstripped the growth of state income and consumed a larger and larger share of the state budget. Looking to the FY 2016-17 biennial budget, health and human services spending is projected to grow $1.202 billion—10.6 percent more than current spending.[16] This represents 72 percent of the total projected growth in spending.

It bears repeating that the recommendations offered here are not only about saving money. All of these recommendations are aimed at providing better results for the people served by government programs and the taxpayers who fund them.

How would the above recommendations apply to Medicaid, and what could be done to improve Medicaid within this framework?

1. **Start by setting the price of government and agreeing to fit Medicaid spending within that overall price.** Instead of starting from the prior budget's baseline plus natural cost increases, future budgets should start by deciding how much money there is to spend, just as any family or business would do. The revenue forecast offers an ideal starting point, but lawmakers could decide to adjust the price of government up or down by increasing or reducing taxes. The amount of Medicaid spending would then have to fit within this aggregate price and compete with other government priorities.
2. **Stop autopilot growth in the Medicaid budget.** Baseline budgets assume current spending and planned increases will carry forward. In Medicaid, that means the budget assumes eligibility levels and benefit levels set in law carry forward into the new budget. It also assumes any increase in the cost of delivering services is a given. As discussed above, this baseline approach almost always leads to higher spending. For instance, current projections for the Medicaid Medical Assistance program estimate costs to the state's general fund will increase by $1.053 billion in the FY 2016-17 budget. Some of the factors driving this change include an estimated 254,673 more people who would be eligible on an average monthly basis.[17] In addition, average payments per person are projected to increase by $67 per month, or $804 per year. With outcome budgeting, the Medicaid budget would not increase automatically simply because enrollment or health care costs went up. Eligibility criteria and the benefits purchased with increased per-beneficiary spending would be consciously considered against other priorities.
3. **Require Medicaid programs to accomplish specific outcomes and demonstrate progress.** Outcome budgeting generally requires lawmakers to define five to ten high-level strategic outcomes and indicators to measure progress toward meeting those outcomes. The Medicaid program probably would focus on achieving outcomes based on the health of Minnesotans in the program. To that end, Medicaid would need to demonstrate whether the many programs and benefits actually improve the health of beneficiaries, and at what cost, and whether there were alternatives that could do a better job. This would give lawmakers and citizens information necessary to judge the effectiveness of various components of the Medicaid program
4. **Prioritize Medicaid spending based on the effectiveness of proposed programs.** With evaluations of the Medicaid program in hand, lawmakers and citizens could have a serious discussion about

prioritizing funding. Importantly, this conversation could be about what the state can do to get the most from the money lawmakers decide to spend. The conversation should focus less on what is to be cut and more on whether the benefit of certain spending is a higher priority than the alternatives.

5. **Gain control of the data necessary to measure Medicaid program performance.** One of the main obstacles to adapting outcome budgeting to the state's Medicaid program would be collecting the data necessary to measure performance. Currently, much of the data necessary to measure performance is controlled by the managed care health plans that run Medicaid. These health plans consider this to be proprietary information and have fought hard in recent years not to give it up despite a congressional investigation into their practices. As long as the information remains proprietary, policymakers cannot evaluate performance. The state should require health plans to provide access to the data the state needs to judge the effectiveness of public health care programs. One way to get the data would be simply to stop contracting with managed care health plans and move to a self-insured model used by large corporations like Target and General Mills. These corporations know exactly what is happening with their health plans and can assess in great detail how various managed care tools save money or improve health. The state of Connecticut made this move in 2012, and it expected to save \$80 million in 2013.[18]
6. **Work to gain greater freedom to prioritize and reallocate resources within Medicaid.** The benefit of outcome budgeting is that it would require lawmakers to assess what programs deliver the most value for each dollar spent. This process assumes the state is free to redirect dollars to higher-value uses. Unfortunately, the state is not entirely free to redirect Medicaid spending. Medicaid is funded by both the state and federal governments, and federal funding comes with very stringent rules on how those funds are spent. To gain more control over Medicaid spending, states can apply for waivers from federal rules. These waivers are usually very narrow in scope and take years to get approved. The state of Rhode Island, however, received a global waiver, which gives it greater freedom over administering Medicaid. Even greater control could be achieved if federal Medicaid funding were converted to block grants. Through a block grant, a state would receive the entire block of Medicaid funding, free from the federal government's severe restrictions on how the program must be administered. Whether

through a global waiver or a block grant, Minnesota should pursue greater control over Medicaid spending to take maximum advantage of outcome budgeting.

TRANSPORTATION

Moving People and Commerce Where They Want and Need to Go

Fritz Knaak, J.D. and Amy Roberts, J.D.

EXECUTIVE SUMMARY

The Problem

Minnesota can and must support and build a world class transportation system that provides a foundation for economic prosperity and personal fulfillment for all Minnesotans. Doing so is mostly a matter of making transportation a higher priority.

Transportation should embrace the philosophy that Minnesotans and Minnesota employers know where they want to go and how they want to get there. Instead of trying to impose other policy objectives on our transportation dollars, such as encouraging people to drive less, transportation policy should focus on supporting this demand as efficiently and cost-effectively as possible.

The Minnesota Department of Transportation (MnDOT) projects a five to twelve billion dollar funding gap for Minnesota's main roads and highways. These are the very highways that move people and freight—the raw materials and goods that make the economy run. Minnesota workers and freight are fighting ever increasing amounts of congestion, losing time and money sitting in traffic and doing so on even poorer quality roads. While our roads and mobility deteriorate, policy makers have taken their eye off the road and steered more and more scarce public dollars to an expensive and slow light rail system that moves too few people and no freight.

Lack of funding is the main reason for increased congestion and declining pavement and bridge conditions. The main source of federal funding for highways, the Federal Highway Trust Fund, is declining. This could force the Federal Department of Transportation to begin delaying payments to states. Minnesota's fuel- and vehicle-related tax revenue streams face similar challenges due to increasing fuel efficiency, people driving less and slower new vehicle sales.

The Solution

Addressing questions of transportation funding, as well as proper maintenance and expansion will require a significant shift in public policy priorities. Reducing congestion and re-aligning priorities toward mobility and commerce reinforces the essential role of the state's transportation system—moving people and commerce where they want and need to go. Moving forward, Minnesota must pursue options that result in a greater return on investment, promote statewide economic development and prioritize spending in order to live and thrive within its means.

The following recommendations restore roads as a top priority and return the state's transportation system to one that promotes economic prosperity for all Minnesotans.

Focus transit spending on cost effective approaches to connect people to jobs

1. Place a moratorium on future light rail projects, focus resources on road expansion and repair, and divert constitutionally mandated and other transit dollars to more cost effective modes of transit.
2. Focus new transit spending on more flexible and less costly transit options, such as bus rapid transit.

Invest the funding necessary to maintain and improve Minnesota's transportation system

3. Dedicate a portion of the existing statewide sales and use tax proceeds to road and bridge maintenance and expansion.
4. Direct the Legislative Auditor to review the Transportation Finance Advisory Committee 20-year transportation funding and financing projections.
5. Set aside a larger portion of state bonding for maintenance and congestion relief projects for local roads and bridges.
6. Convert the Counties Transit Improvement Board to the Counties Transportation Improvement Board.

7. Revise Minnesota law to enable implementation of a public-private partnership (3P) pilot program and determine which state transportation projects and programs could be more efficiently and affordably delivered using the 3P model.

Reduce traffic congestion for commuters and commerce

8. Set a goal to reduce the miles of congested roadway by 20 percent in 10 years.
9. Require MnDOT to create a congestion relief action plan to meet the goal.

Enhance the existing freight network across Minnesota

10. Update the boundaries of the Minnesota Department of Transportation's regional districts and empower those districts to select project and funding priorities on regional road and bridge projects essential to statewide economic development.

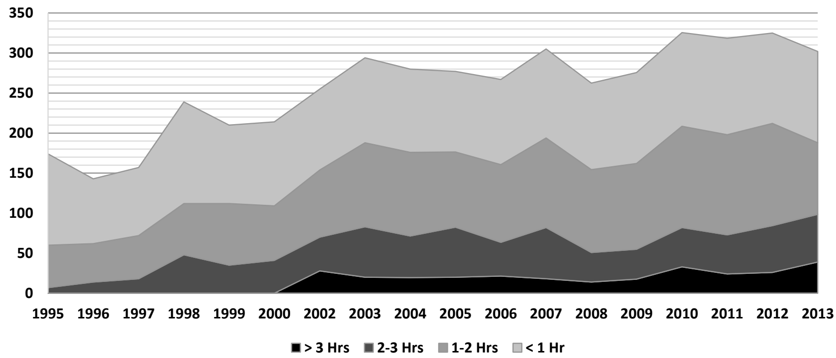
THE PROBLEM

Efficient road traffic fuels Minnesota's economic engine and is essential to job creation and improving the quality of life for all Minnesotans. Trucks carry the majority of the freight traveling to and from Minnesota destinations—66 percent of total tonnage (386 million tons) and 60 percent of total value ($297 billion).[1] Safe, efficient movement of freight is critical for Minnesota's manufacturers, retailers, wholesalers, and farmers. Together, these businesses account for 32 percent of Minnesota workers.[2] Of course, Minnesotans also need to get to work and they primarily depend on roads, too. Over 87 percent of workers in the Twin Cities commute to work by car, and nearly everyone else gets to work on roads by way of a transit bus.[3]

Despite enthusiasm surrounding trains and other transportation alternatives, the reality is Minnesota's businesses and workers use roads and bridges to make the economy run. Minnesota's road system, however, is facing challenges.

Congestion is the most visible challenge facing Minnesota drivers. The Minnesota Department of Transportation (MnDOT) measures congestion based on the number of freeway miles with traffic moving less than 45 miles per hour. Congestion is assessed in October to help avoid non-recurring causes of congestion, like construction and weather-related delays. As shown in Figure 1, total morning and evening congestion in the Twin Cities grew from 174 miles in 1995 to 326 miles in 2010 and appears to have leveled off after 2010. However, more severe congestion lasting more than 2 hours continues to grow and reached nearly 100 miles of highway in 2013, which represents around one-third of congested miles.

Figure 1: AM plus PM Miles and Duration of Congestion (speeds less than 45 MPH) in the Twin Cities



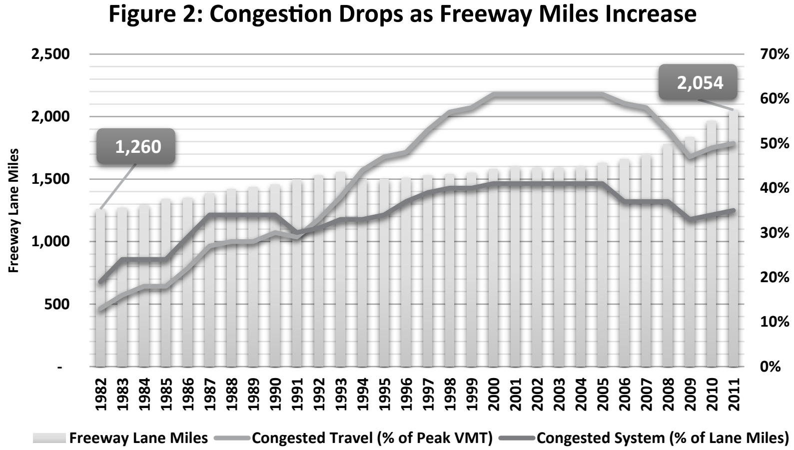
Source: Minnesota Department of Transportation, Metropolitan Freeway System Congestion Report, various years. Note: MnDot did not report data for 2001.

Data from the Texas A&M Transportation Institute offer a more positive view on recent congestion trends. These data assess year round traffic on both freeways and streets. Figure 2 shows congested travel in the Twin Cities, both as a percentage of the road system and as a percentage of peak period vehicle miles traveled, plateaued between 2000 and 2005 and then dropped after 2005. Figure 2 also shows this drop in congestion occurred at the same time lane miles were added, which strongly suggests adding lane miles reduced congestion.[4] However, these benefits are now built into the system and congestion is again on the rise.

Congestion issues are not limited to the Twin Cities. In 2009, the Minnesota Statewide Transportation Policy Plan reported: "Traffic volumes on interregional corridors have risen by 50 percent in the last 10 years causing congestion and safety concerns especially near large regional trade centers."[5] In particular, mobility along interregional corridors in central Minnesota is expected to decline.

Not only is congestion increasing, it is happening on even poorer quality roads. In 2002, 310 miles (2 percent) of state highway were in poor condition.[6] By 2011, the miles of poor roads rose to 940 (7 percent) and MnDOT expects the mileage to rise to 1,300 (9 percent) by 2016. In the National Highway System, the pavement condition of Minnesota's rural highways ranks 43rd.[7] The pavement condition of Minnesota's urban highways ranks much higher at 16th. However, comparing only urban interstates, the state ranks 41st.[8] Poor pavement conditions, according to MnDOT, "result in slower traffic times, higher vehicle operating costs, additional safety hazards, and reduced economic development."[9]

Bridge conditions in Minnesota have improved but are aging. Currently, 87 percent of bridges are in *Good* or *Satisfactory* condition, 11 percent *Fair* and



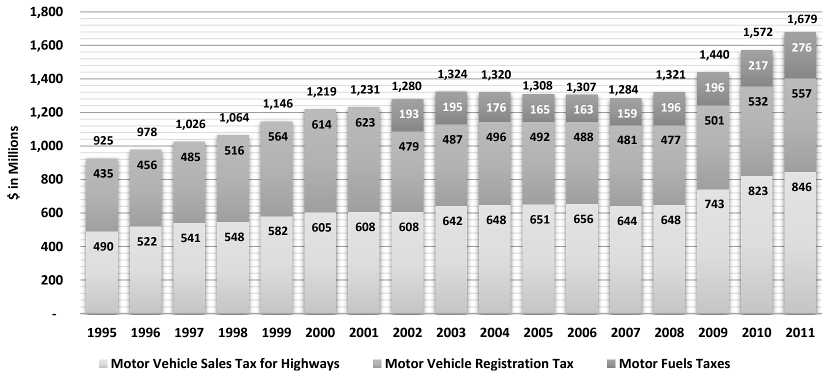
Source: Texas A&M Transportation Institute, 2012 Annual Urban Mobility Report, Congestion Data for Your City spreadsheet (December 2012), available at http://mobility.tamu.edu/ums/.

2 percent *Poor* but it took a major catastrophe, the collapse of the 35W Bridge and the death of 13 people to provide the political willpower to devote the attention and resources necessary to adequately address the problem.[10] The infusion of federal and state dollars to focus attention on bridge repair has made a very significant and positive impact. MnDOT's project funding will remain sufficient to meet structural goals for the next 10 years. But, Minnesota bridges are aging and they are doing so at a steady rate. Currently, 2,900 Minnesota bridges are older than 50 years but by 2030, that number could more than double to over 7,200.[11]

Safety is always a top priority and here Minnesota excels. After establishing the *Toward Zero Deaths Program* in 2003, Minnesota experienced the third largest drop in the fatality rate in the country, dropping from 1.19 deaths per million miles traveled in 2003 to .69 deaths in 2012, moving Minnesota to the second lowest fatality rate in the nation.[12] Minnesota reports that serious injuries also declined dramatically after 2003.[13] Minnesota is clearly on the right track, therefore, there are no specific recommendations here other than to say the state should not let up on its commitment to make roads even safer.

Finally, many Minnesotans depend on transit (buses mostly) to get to jobs and other destinations. Unfortunately, today's transit system is not well suited to connect people to jobs. Though 67 percent of working-age Twin Cities residents live near a transit stop, only 30 percent of jobs are reachable via transit in 90 minutes or less, according to the Brookings Institute.[14] The percentage of jobs reachable via transit drops to 7 percent for people who want to reach their jobs in less than 45 minutes.[15]

Figure 3: Trends in Minnesota's Primary State Transportation Revenue Sources



Source: Minnesota Department of Transportation, 20-Year Minnesota State Highway Investment Plan 2014-2023, Appendix E. Revenue Forecast (December 2013), available at http://www.dot.state.mn.us/planning/mnship/pdf/finalplan/revenue-forecast.pdf.

HOW WE GOT HERE

Lack of funding is the main reason for increased congestion and declining pavement and bridge conditions. The main source of federal funding for highways, the Federal Highway Trust Fund, is declining. This could force the Federal Department of Transportation to begin delaying payments to states as early as this fall.[16]

Minnesota's revenue stream faces similar challenges. As shown in Figure 3, the state's primary state transportation revenue sources remained flat between 2000 and 2008, which, when accounting for inflation, represents a decline in revenues. During that period, bonding was used to help compensate for this decline in revenue. Revenues began ticking up in 2009 when the motor fuels and motor vehicle registration tax increases passed in 2008 began to phase in.

Looking forward, MnDOT's project funding from the State Highway Trunk Fund will increase by only 2 percent per year for the next 20 years, which is much slower revenue growth than in previous decades.[17] Growth is expected to slow due to increasing fuel efficiency, people driving less and slower new vehicle sales. Compounding the revenue growth issues, construction costs are projected to increase at an annual rate of 5 percent. Thus, future tax dollars will buy fewer construction projects in coming years.

Combine slow revenue growth with rising construction costs and, according to the Minnesota Transportation Finance Advisory Committee, the state's highway system alone faces a $5 billion gap ($250 million annually) in funding over the next 20 years to just maintain the existing system and a $12 billion gap ($600 million annually) if the state wants to expand the transportation system to become more economically competitive.[18]

Addressing these funding issues has not been a high enough priority in recent years. Minnesota is collecting plenty of tax revenue. Taxes were increased by $2.1 billion in 2013, but none of that went to transportation. Bonding in 2014 went to other misplaced priorities as well, such as $80 million for housing infrastructure bonds. Or consider the $90 million going toward the new Senate office building and parking ramp. That money could have reconstructed 40 miles of principal arterials in Southwestern Minnesota or relieved a choke point along MN 23 near Paynesville.

In their most recent performance report, MnDOT clearly admits congestion relief is no longer a priority.

> Going forward, MnDOT expects congestion to remain the same or increase as the region continues to grow. Since 2010, MnDOT's strategy has shifted away from reducing congestion and toward providing alternatives to congested travel.

Based on the Minnesota State Highway Investment Plan, MnDOT plans to direct nearly 70 percent of transportation investments over the next ten years toward maintaining the current infrastructure of roads and bridges.[19] Congestion relief in the Twin Cities gets just 7 percent ($520 million), while congestion relief in greater Minnesota gets nothing. As a result, "the number and scope of system capacity improvements decrease." Bicycle infrastructure, however, receives $100 million. In years 11 through 20, the plan directs nearly 90 percent of funding to maintain current infrastructure and nothing toward congestion relief. Bikes continue to receive $100 million.

Priorities have also been misplaced on transit. The Met Council and many DFL lawmakers remain stubbornly committed to rail transit, despite the fact that rail transit is extraordinarily expensive, time consuming to ride, and set on a fixed track that cannot flexibly connect people to jobs. Instead of connecting transit to where people live and work, the Met Council appears focused on steering people into higher density housing along light rail corridors. The $1.7 billion price tag for the Southwest LRT would be better spent on improving the bus system. This would more effectively connect people to jobs and other important destinations. And by the way, $1.7 billion is three times more than what MnDOT plans to spend on congestion relief over the next 10 years

CONSEQUENCES

Allowing congestion to grow and failing to maintain good road conditions will undermine Minnesota's future competitiveness. The Texas A&M Transportation Institute determined that every American wasted an average of $818 sitting in traffic in 2011.[20] That same study found Americans spent an additional 5.5 billion hours on the road for a total cost of $121 billion, with $27 billion of that in wasted time and fuel for commercial truck drivers alone.[21] The Twin Cities ranks 19th for total congestion costs at $1.26 billion and 24th for commercial truck costs at $232 million.[22]

The State of Washington recently assessed the potential economic impact if its truck freight encountered a 20 percent increase in traffic congestion. While some jobs would be gained due to the need to hire more drivers to combat congestion, far more jobs are "lost due to lessening demand from consumers, who must devote more resources to purchasing goods, and are therefore required to cut back in other spending categories."[23] They determined that when all of the direct, indirect, and induced impacts are accounted for, Washington State would experience a net loss of nearly 30,000 jobs and $3.3 billion in economic output. Assuming Minnesota experienced proportional losses based on the size of its economy—about three quarters the size of Washington—Minnesota would lose about 23,000 jobs and $2.5 billion in economic output.[24]

RECOMMENDATIONS

Rather than waiting for the next tragedy and watching Minnesota's opportunities for economic growth and prosperity travel to neighboring states or countries, it is time for Minnesota's decision makers to transcend traditional political tethers, work together and pursue genuine solutions that address the very real problems Minnesota faces today. Moving forward, Minnesota must pursue options that result in a greater return on investment, promote statewide economic development and prioritize spending in order to live and thrive within its means.

Focus transit spending on cost effective approaches to connect people to jobs

Recommendation 1: Place a moratorium on future light rail projects, focus resources on road expansion and repair, and divert constitutionally mandated and other transit dollars to more cost effective modes of transit.

In 2006, a Constitutional amendment passed dedicating at least 40 percent of the revenue from a tax on new and used motor vehicle sales to public transit assistance and not more than 60 percent for highway purposes. What that amendment did not do is mandate a disproportionate amount of transit resources to be spent on a light rail system. The development of light rail is coming with a very expensive price tag but without sufficiently proven results. Each of the three major light rail projects (Green Line, Blue Line, Metro Green Line) completed or in progress, costs significantly more per mile than road expansion or other transit options such as Bus Rapid Transit (BRT.) If light rail ridership reflected a significant change in how Minnesotans traveled, perhaps such a heavy investment in this one option would be justified. Without sufficient evidence to demonstrate a shift, Minnesota's limited transportation resources should be directed to those places where the state will experience a greater return on its investments.

A moratorium on new light rail projects will provide time for more evidence regarding light rail's impact to be gathered and assessed. Is ridership increasing in numbers that justify such a significant investment of public dollars? Is Minnesota's economy growing and are quality jobs being created as a result of this transit option? With such significant and scarce public resources at stake, and with claims from many parties declaring light rail as the answer to Minnesota's transportation woes and just as many claims declaring it a bottomless pit of wasted public dollars, it is time to hit pause. By allowing evidence to develop, Minnesota will be in a better position to make informed decisions regarding current transit and future transportation needs and how to best address the growing congestion and road quality concerns the state currently faces.

Recommendation 2: Focus new transit spending on more flexible and less costly transit options, such as bus rapid transit.

At a length of 11 miles, the Metro Green Line's $957 million price tag equates to approximately $87 million per mile. By comparison, the proposed I-35W South BRT line or "Metro Orange Line" is projected to cost $208 million, which comes to $13 million per mile.[25] The initial investment required to plan and build a new light rail line is only one aspect of total light rail costs. The $957 million cost to plan and build the new metro Green Line does not include the on-going annual operating costs.[26] In 2019, the Metro Green Line's net annual operating cost is projected to be $24.2 million, while operating costs for the Metro Orange line are approximately $4.6 million.[27] Assuming the Metro Green Line carries 40,000 passengers per day and the Metro Orange Line carries 10,000, the operational costs are still about 30 percent more for LRT per rider. The comparison is striking. Not only does Minnesota pay significantly more per mile for light rail, the on-going costs to operate the system are also more expensive. These costs represent transit dollars that could potentially be invested in other transit options that cost less per mile.

Invest the funding necessary to maintain and improve Minnesota's transportation system

Recommendation 3: Dedicate a portion of the existing statewide sales and use tax proceeds to fund road and bridge maintenance and expansion.

Providing for the state's transportation infrastructure is an essential function of government and should be a priority reflected in the public policy decisions made by its leaders. The voting public seems to agree that the transportation infrastructure should be a higher priority for the state. 59 percent of voters in Minnesota believe that government has a duty to make sure that roads and bridges are safe and reliable and 51 percent believe it is THE top priority of government.[28] With the state predicting that over the next 20 years it will be $5 billion short ($250 million annually) of funding for maintaining the current performance of the transportation system or $12 billion short ($600 million annually) of making economically competitive improvements and with the risk of less federal funding, a new source of transportation funding is warranted.

As a first step, the state should dedicate .25 percentage points (a quarter cent of the tax on each dollar spent) of the existing statewide sales and use tax toward road and bridge maintenance and expansion. That would shift about $182 million of the $5 billion currently generated by the sales and use tax to transportation, which would go a long way to cover the $250 million annual shortfall.[29] **To be clear, this is not a recommendation to increase taxes**. It is a recommendation to dedicate existing tax collections toward transportation, which may require spending cuts elsewhere, depending on revenue collections. Dedicating this funding elevates the priority of transportation funding in the state budget, a priority most Minnesotans demand. The additional revenue would also allow for additional bonding. Currently, annual debt service is nearing MnDOT's limit set at 20 percent of annual state revenues to the trunk highway fund. Importantly, the funding source will not be undercut by increasing fuel efficiency and declining auto sales. The dedication should sunset after ten years in order to force the Legislature to revisit the issue.

Recommendation 4: Direct the Legislative Auditor to review the Transportation Finance Advisory Committee 20-year transportation funding and financing projections.

The previous recommendation relies on projections made by the Minnesota Transportation Finance Advisory Committee, which was supported by MnDOT. While these projections were no doubt made in good faith, it is entirely possible they have overestimated the funding requirements. Because the projections form the basis for substantial policy changes, they should be audited by the Legislative Auditor before making more dramatic policy changes to bridge the $12 billion gap identified in the report. The report should basically be an update to the Legislative Auditor's 2008 evaluation of state highways and bridges.[30]

Recommendation 5: Set aside a larger portion of state bonding for maintenance and congestion relief projects for local roads and bridges.

At least every other year, Minnesota lawmakers enact a substantial bonding bill to fund hundreds of millions of dollars in capital improvements across the state. Transportation received $140 million in bonds in 2010, $50 million in 2012, and $100 million in 2014. After the Legislative Auditor reviews transportation funding requirements as recommended above and until a long-term solution is implemented to sustain adequate transportation funding, a larger portion of each bonding bill should be prioritized toward relieving congestion on Minnesota's local roads and bridges. This is not to suggest bonding bills should be larger to accommodate more transportation bonding. Rather, congestion relief should be prioritized ahead of things like a Senate Office Building.

Recommendation 6: Convert the Counties Transit Improvement Board to the Counties Transportation Improvement Board.

As a result of legislation passed in 2008, seven metro counties were given the authority to increase the sales tax by 0.25-percent within the county and dedicate the proceeds to transit projects.[31] While different forms of transit can help address traffic congestion by drawing riders to these other forms of transportation, nearly 90 percent of Minnesota workers and 66 percent of freight traffic depend on Minnesota roads. Transit projects alone will not alleviate the congestion issues these regions face. Converting the CTIB to the Counties Transportation Improvement Board (CTIB) and expanding its authority to fund road projects will provide another pathway for Minnesota to address congestion issues that hamper economic development. It will also give less dense areas outside the core cities more opportunities to use the funding. Currently, some counties, such as Dakota, are questioning whether they are receiving a fair share of the funding.[32]

In addition to expanding the function of the CTIB, the law addressing the on-going operating costs of projects that receive funding through the CTIB should be strengthened. Currently, the law requires a grant applicant seeking transit capital funding to identify the source of money necessary to operate the transit improvement. This language should be clarified to require that those projects where the CTIB funds 20 percent or more of the capital costs, should also fund 100 percent of the on-going operating costs.

Recommendation 7: Revise Minnesota law to enable implementation of a public-private partnership (3P) pilot program and determine which state transportation projects and programs could be more efficiently and affordably delivered using the 3P model.

Minnesota has long "discussed," "studied," and debated the feasibility of utilizing public-private partnerships for various transportation projects. MnDOT previously identified projects at various stages of preparedness as potential 3P candidates, including projects that could be completed in the near term. They also convened a policy task force in 2011 to study the issue and recommend steps for moving forward. In a review of eight 3P projects, the Federal Transit Administration found they were completed between 1 and 6 years earlier than planned and saved between $1 million and $32 million.[33] In Minnesota, various attempts have been made legislatively to move the approach forward but thus far a comprehensive initiative has not advanced to a state of implementation. There is little left to study and much more to be gained by moving forward with a pilot project.

The use of 3Ps would also expand economic development opportunities. In addition to the job creation connected to the specific 3P transportation projects, improving and expanding Minnesota's transportation infrastructure will positively impact the businesses relying on those roads to transport materials, goods, and people necessary to operate and conduct transactions. Once the MnDOT regional districts are redrawn according to the statewide routes essential to economic development, these districts should also be empowered to pursue 3P solutions and economic development opportunities essential to growth in their regions. The existing regional partnerships will provide a strong foundation for developing specific 3P projects.

Reduce traffic congestion for commuters and commerce

Recommendation 8: Set a goal to reduce the miles of congested roadway by 20 percent in 10 years.

The state should prioritize congestion relief by setting a congestion relief goal and focusing resources on these efforts. Similar to the zero death goal and approaches taken to reduce traffic fatalities, the state should set a congestion relief goal and focus resources to achieve a 20 percent reduction in traffic congestion in 10 years. Prioritizing and goal setting works. As already discussed, since setting the goal of achieving zero deaths on Minnesota's roads, the state experienced the 3rd largest drop in fatality rate.[34] With a clearly defined goal, MnDOT and other agencies were empowered to focus resources and work toward reducing fatality rates. MnDOT and Minnesota succeeded. Similarly, by drawing attention to reducing traffic congestion, MnDOT can again use its experience and know-how to improve Minnesota's performance.

Recommendation 9: Require MnDOT to create a congestion relief action plan to meet the goal.

To reach the congestion relief goal, MnDOT will need to carefully craft an action plan. MnDOT already identifies high impact congestion relief projects in other planning documents. The action plan should prioritize these projects and clearly identify the return on investment expected from each project. Congestion is not just a Twin Cities problem and any plan must address issues in greater Minnesota.

Enhance the existing freight network across Minnesota

Recommendation 10: Update the boundaries of the Minnesota Department of Transportation's regional districts and empower those districts to select project and funding priorities on regional road and bridge projects essential to statewide economic development.

The boundaries of the eight regional districts that manage the majority of day to day functions of MnDOT—including evaluating, recommending, and determining project and funding priorities within those specific regions—were originally based primarily on regional population centers. This may have served an important function at one time but the state's $12 billion funding gap for its highway system demands updated priorities. Minnesota cannot afford to make siloed decisions regarding transportation infrastructure independent of overall economic development needs. The regional districts should be updated and defined according to major transportation routes vital to statewide economic development. The revised regional districts will then have at their center the major routes that move raw materials to manufacturers, goods and products to stores and then to homes. Reframing MnDOT and Minnesota's transportation infrastructure through the lens of economic development will refocus limited resources on the main purpose of transportation infrastructure; moving people and goods where they want to go, when they want to get there, and doing so safely.

The already established Corridors of Commerce Program targets transportation routes essential to state and regional economic growth. Updating not only the boundaries, but also the priorities of MnDOT districts, to reflect the goals outlined by the Corridors of Commerce—a bonding program established to fund freight improvements and additional highway capacity—will help ensure already limited resources are directed to those projects that will have the greatest impact on statewide development needs. The newly drawn commerce-oriented districts should also then have greater discretion and authority to direct resources to economic corridors with the greatest needs. The local voices and partnerships that form the foundation of each current district's decision-making capabilities are critical to statewide and regional decision-making. These local partners are essential and should also be updated to include regional voices of economic development.

MET COUNCIL POWER GRAB

How the Dayton Administration Intends to Transform the Twin Cities Region for Decades to Come

Katherine Kersten, J.D. and Kim Crockett, J.D.

EXECUTIVE SUMMARY

The Metropolitan Council ("Met Council") is an appointed body created by the Minnesota legislature to plan for the growth and delivery of regional services in the seven-county Twin Cities metro area. It has many of the broad powers normally entrusted to elected officials, but none of the Council members are elected by the people they govern. The governor appoints all 16 commissioners and the chair; they serve at his pleasure and direction.

The Met Council has rejected the mission the legislature assigned it—to *accommodate growth* in the region by planning for and delivering regional services—and flipped the mission to *directing growth* by leveraging its power over planning, transportation, and sewers.

Thrive MSP 2040 is the Dayton administration's 30-year plan for development in the Twin Cities seven-county region. The plan entrenches a model of regional administration that neuters the power of local elected officials and centralizes decision-making authority in the unelected, unaccountable bureaucrats of the Met Council.

The Council's ambitions in the *Thrive* plan—unauthorized by statute—range

from solving income inequality and the racial learning gap to mitigating climate change.

Thrive MSP 2040 seeks to commit future administrations to reshape the region to reflect an urban-centric vision of an "ideal society" that is planned and administered by people who have not been elected by the region's residents. It threatens to:

- **Impose "transit-oriented development"** designed to remake the region around transit; move many of us into high-density, "stack and pack" housing along fixed-rail lines; deplete road funding and increase congestion; and wean us out of our cars so we walk, bike, or take public transit to work and leisure activities, even in Minnesota's harsh winters.
- **Empower unelected bureaucrats to funnel jobs and economic growth** into the central cities and areas within a half-mile of transit stations, distorting market forces and sapping development in the rest of the region.
- **Calculate "Housing Performance Scores" to allocate poverty** across the metro area, apportioning people on the basis of race, ethnicity, and income and pressuring cities to pay for low-income housing. As one observer put it, "The Council has embraced dilution as the solution to poverty."
- **Redistribute wealth from the suburbs to the urban core** to pay for all this. Under "regional government," suburban residents will pay more in taxes but receive less in infrastructure and services.

Regional administrators dictate to local officials. The Met Council already wields major control over our region's 186 municipalities. Cities must submit for approval a "comprehensive plan" over which the Council exercises arbitrary and unchecked power—the Council sets the agenda, and cities have no right of appeal.

The Council holds the ultimate trump card—the power of the checkbook—allocating millions of dollars in funding for road improvements, sewer-related projects, and low-income housing. Local officials must cower and bow, unable to object on behalf of their constituents for fear of retaliation.

The Council's new plan, wrapped in vague and noble-sounding goals, imposes a host of new, ideologically driven criteria for municipal development that will give it the raw power, unchecked by elected representatives, to remake our region dramatically.

The *Thrive* Housing Policy Plan will vastly expand the Council's *de facto* power over housing and local land-use decisions.

- The plan's crusade to "densify" our region's housing will impose "development patterns that support high transit demand" to "improve residents' ability to live without a personal vehicle." *Thrive* calls for herding people into dense urban enclaves to build ridership for fixed-rail transit and buses.
- The plan threatens to push so much land into high-density zoning that it will create an artificial shortage of single-family-zoned land—causing higher prices for all new homes in the region.
- The Council aims to engineer "socioeconomic integration" across the seven-county metro area but lacks the statutory authority to do so. As a result, its housing plan aims to strong-arm cities into meeting its goals by tying their receipt of vital, Council-controlled funds for roads (and other benefits) to how much their housing and zoning policies disperse regional poverty.

The *Thrive* Transportation Policy Plan misallocates scarce public resources by funding Council planners' priorities rather than the needs and preferences of the people.

- The plan will lavish funds on fixed-rail transit, while virtually ignoring funding for expanding roads—which are vital to regional prosperity and on which the vast majority of people rely to get around**.**
- In *Thrive*, the Council declares that "expanding the roadway system is not a sustainable way to address congestion, climate change, equity, and livability."
- The transportation plan endorses other policies designed to make driving more expensive and inconvenient, such as narrowing streets and "limited, managed parking," and elevates biking and walking over driving.
- The plan greatly favors the urban core over suburbs and exurbs and uses limited transportation funds as a tool to promote its social agenda.

The county boards of the five "ring" counties—Anoka, Carver, Dakota, Scott, and Washington—have unanimously denounced the Council's transportation plan.[1]

- At an unprecedented joint meeting on September 29, 2014, the county commissioners declared that the plan "represents a bleak future for the regional highway system."

- They charged that the plan will provoke a "radical shift" in how the transportation system is built and operated, causing "severe congestion and safety issues" and "reduc[ing] the economic vitality of the region."

The people of the Twin Cities have a right to govern their own communities. Social planning by unelected regional bureaucrats who use government power to tell us where to live and how to get around undermines democracy and is hostile to our cherished American traditions of freedom and local self-government.

Summary of Recommendations:

1. Governor Dayton should immediately rein in Chair Susan Haigh and his appointed Met Council.
2. The governor in January 2015 should appoint a new Council that includes elected officials.
3. The governor and legislature in January of 2015 should reject *Thrive MSP 2040* in its entirety and call for a moratorium on all light rail projects.
4. The legislature and Council should not commit capital funds to transitway development projects without ensuring that operating revenues for the first five to ten years have been identified.
5. The Legislative Commission on Metropolitan Government (LCMC) should be given authority over the Council's operating and capital budgets to introduce real legislative oversight.
6. Any redesign that retains a regional body must match the mission and powers with appropriate measures to hold that body in check and accountable.
7. Any redesign should include staggered terms to promote stability while favoring local control.
8. Cities should reject the Livable Communities Program.
9. The legislature should repeal the 1995 Livable Communities Act and transfer housing programs to the state HFA and local housing programs.
10. The Metropolitan Council should cease performing tasks carried out by other government agencies.

THE PROBLEM

Twin Cities' Model of Regional Government is Broken

The seven-county Twin Cities region is governed by an unelected, unaccountable body with broad, vague policy-making and funding powers and no meaningful oversight. Under Governor Mark Dayton, the Met Council is aggressively seeking to expand its reach. It is planning social transformation of the region and issuing dictates to elected local officials in policy matters far beyond its statutory authority. The resulting overreach threatens both local self-government and the economic well-being of the region.

The Council's credibility problem began almost at its inception in 1967. The Minnesota legislature narrowly rejected elective council members and instead embraced a regional governance model that put planning in the hands of 17 commissioners appointed by the governor.[2]

That decision, and the legislature's subsequent actions, created a perfect storm for egregious mission creep. Over the decades, the legislature expanded the Council's power to control planning and allocate funds through a patchwork of laws and amendments.

It gave the Council power over regional comprehensive planning[3] and the power to tax. It made the Council both planner and operator of the region's sewer and transit systems—transforming it overnight into one of the state's largest agencies, with an annual operating budget of $830 million.[4] It gave the Council control over certain affordable housing and transit-oriented development grants, though, significantly, it did not add authority over housing or affordable housing as a regional system.

As it piled on these powers, the legislature—along with past governors—failed to provide meaningful oversight of the unelected, unaccountable Council, and that travesty continues today.

The Met Council's escalating overreach raises two vital sets of questions:

1. Will the people of the Twin Cities region continue to govern their own communities through their elected representatives? Or will the Met Council increasingly usurp the authority to decide how we live and what the character of our communities will be?
2. Is urban planning for people or the other way around? Do people exist to serve transit and sewers or does infrastructure exist to serve people?

Sources of the Met Council's Inordinate Power over Local Communities

The Council's power over the destiny of the region's 186 municipalities has three primary foundations:

1. As owner and operator of the regional wastewater treatment system, it controls the location of sewer interceptors and lines and therefore can dictate where new development will occur.
2. As the planning body for the seven-county area, it unilaterally develops a comprehensive framework for regional development, including four statutory systems: transportation, wastewater, parks and open space, and aviation. Local government units' comprehensive plans must conform

to this framework, and municipalities cannot change or develop in significant ways without the Council's approval.

3. As a funding gatekeeper, it allocates federal, state, and regional funds among local governments for a host of important projects. In its role as the region's "MPO" or Metropolitan Planning Organization, the Council distributes competitive federal grants for transportation projects such as highway improvements, bikeways, and transit improvements.[5] It also distributes Livable Communities grants for redevelopment, brown fields clean-up, and low-income housing.

Our Right to Self-Governance is at Risk: Balancing Efficiency and Local Control

The idea behind the Met Council was that communities in the metro area would give up certain controls over local planning in exchange for the efficiencies of high-quality, low-cost planning and services. The equilibrium of that exchange, while always a source of conflict, is now completely out of balance.

Today, the Council is using its dual role as planning czar and funding gatekeeper to pick winners and losers among the region's municipalities and to impose its own sweeping priorities on local communities as a condition for receipt of funds and planning approval.

It is a waste of time, however, to direct critiques and complaints about the Met Council to the Met Council. Only the governor and legislature can fix this problem.

Regional planning should facilitate citizens' choices about how and where they want to live, not impose the Council's preferences and penalize people for their choices. Towns and cities should be free to shape their own character, as long as they pay the costs of those choices.

A Brazen Assault on Local Control: *Thrive MSP 2040*

The Met Council's mission creep has escalated markedly under Governor Dayton, who appointed all the Council's current members. The Council is now on the cusp of a significant new power grab, driven by an ideologically charged "social justice" agenda that goes far beyond its statutory planning powers.

The assault on local control has reached a watershed with the release of *Thrive MSP 2040*, the Council's new 30-year comprehensive development framework for the seven-county metro area. The plan delineates a blueprint to reshape the region to conform to the Dayton administration's vision of an ideal society.

The plan's central premise is that urban planners (inspired by lofty and noble ideals) know best what the future holds and are thus best equipped to determine how the region's residents should live.

The Council has a two-pronged vision of how to transform the region:

- First, it will promote compact, high-density living and "transit-oriented development" (TOD).[6] TOD seeks to pivot from an "auto-friendly" to a "transit-friendly" transportation system by discouraging driving and pushing people to walk, bike, or take public transit.
- Second, it will attempt to engineer "socioeconomic equality" among demographic groups by dispersing people across the region in a government-approved mix of race, ethnicity, and income.

The *Thrive* Vision: The Council Knows Best

The *Thrive* plan includes an overarching themes document, adopted in May 2014, and detailed policy plans on housing, transportation, water resources, and regional parks. The housing and transportation plans were released in July 2014, with adoption scheduled for December 2014 and January 2105, respectively. The other plans are scheduled for approval in 2015.

In *Thrive*, the Council lays out five sweeping "outcomes" (equity, sustainability, livability, prosperity, and stewardship) and three "principles" (integration, collaboration, and accountability) that serve as the basis for all its plans and policies. None of these highly subjective terms is clearly defined.

The Council acknowledges that it lacks statutory authority to reframe its regional planning function in such a vague and open-ended way. However, it seems to view its goals as so noble as to need no clear basis in law:

> The *Thrive* outcomes...are lofty ideals that *defy simple categorization into the Council's authorities*. Instead, progress toward these outcomes *demands* that the Council use its full range of authorities and activities in a new, coordinated way . . . .[7] (emphasis added)

In other words, the Council intends to "weave" its authorities together in unprecedented ways in an attempt to justify its overreach, as its Housing Policy Plan openly admits.[8]

The Council does not mean to let lack of statutory authority stand in the way of achieving its goals. Its strategies to expand its regional influence include:

- Issuing a highly prescriptive "policy plan" on housing, an issue over which it has no "system" authority.
- Using broad policy areas over which it has no authority—such as "economic competitiveness" and "climate change"—as "lenses" to evaluate all future development policies.[9]
- Employing its so-called "convening authority" to lead regional "conversations"[10] on a host of topics outside its statutory authority—

> including the racial achievement gap and housing discrimination. Its goals in this respect include creating a high-profile forum for special interest groups that share its ideological objectives.[11]

Question: The legislature has created very few checks on the Council's power. Why, then, is it doing so little to watchdog the Council's escalating overreach?

***Thrive* Claims More Future Growth in Urban Core and Inner Ring**

A central claim of the *Thrive* plan is that more of the metro area's population growth will be in the urban core and inner ring—a reversal of the last 60 years. The Council's forecasts are inconsistent with demographic trends between 1950 and 2010, when virtually all our nation's population growth occurred in the suburbs, not the core cities. In the Twin Cities region, between 1950 and 2010, 110 percent of population growth was in the suburbs outside Minneapolis and St. Paul. During those 60 years, the share of regional growth in the two core cities' population was *negative 10 percent*.[12]

In its projections for 2040, the Council is now forecasting a major turnaround, with 16 percent of regional growth occurring in Minneapolis and St. Paul.[13] Even so, it projects that the overwhelming share of growth—84 percent—will take place in the suburbs. (Officials in the metro area's five "ring" counties believe the share of growth in those counties will be even higher.)[14] According to the Council's data, even by 2040, the population of Minneapolis and St. Paul will not have recovered to 1950 levels.

In short, in the next 25 years, the vast majority of the metro area's population growth will occur in the suburbs. Even the Met Council knows that. Yet the Council's *Thrive* plan fails reflect this reality and focuses regional resources on urban center over suburban areas in myriad ways.

Council Claims Shifting Living Preferences

The Council claims that the metro area population's living preferences—led by Baby-Boomers and Millennials—are shifting. Like most "smart-growth" advocates nationally, the Council maintains that over the next 25 years, retiring Baby-Boomers and Millennials (ages 20-29) will flood into the region's urban area, choosing high-density neighborhoods and preferring walking, biking, or transit to travel by car.

The *Star Tribune* characterized the Council's vision for the future as a "return to the tighter live/work/shop neighborhoods that *dominated the streetcar era of the early 20th century*" (emphasis added).[15]

The Council relies on this claim about people's changing "live/work/shop" preferences to justify three of its primary planning objectives:

- To lavish transportation funds on enormously expensive fixed-rail transit, while virtually ignoring the roads the vast majority of the region's people use.
- To redesign areas within a half-mile radius of major transit stops around "mixed-use" developments, with apartments on top and commercial realty on the bottom. Forbes.com columnist Joel Kotkin has labeled these "adult Disneylands" for hipsters and older, sophisticated urban dwellers: "city as entertainment machine, chock-a-block with chic restaurants, shops, and festivals."[16]
- To funnel as much population growth and economic development as possible into the urban core and inner ring suburbs. Outer-ring residents will disproportionately shoulder the burden and pay more in taxes but get less in infrastructure and services.

Question: If people's preferences about where to live and how to get around are changing as dramatically as the Council claims, why are Thrive's prescriptions and mandates necessary? If market demand really supports these changes, why are public subsidies necessary?

Boomers and Millennials Are Not Flocking to Urban Core

Baby-Boomers and Millennials do not appear to be flocking to high-density housing in the core cities, as the Council maintains. Today, Baby-Boomers—as a group—are not abandoning their single-family homes for apartments and condos, as the Council maintains. In fact, the proportion of all Boomers residing in a single-family detached home actually *increased* between 2006 and 2012, according to a June 2014 study by the Federal National Mortgage Association (Fannie Mae).[17] A 2010 survey by AARP found that almost nine in ten Boomers prefer to remain in their current residences as long as possible.[18]

Nationally, the percentage of Millennials residing in urban core areas is declining. About 80 percent live in suburbs or exurbs, and Millennial population growth is fastest there.[19] This is true in the Twin Cities as well. In the Minneapolis-St. Paul metropolitan area, 22.2 percent of Millennials lived in the urban core in 2000. By 2010, the number had declined to 21.1 percent.[20]

***Thrive* Lays Out Top-down Controls to Reshape Region**

Thrive's Housing and Transportation Policy Plans lay out top-down controls to reshape our region in line with an urban-core vision. The Council claims its drive for housing densification and transit-oriented development is merely intended to increase people's "choices." But in the words of "smart-growth" critic Kotkin, "The people designing your city don't care what you want." If Twin Cities-area residents don't actually wish to live the way planners believe they should, *Thrive*'s intrusive policies are designed to see they do.

The Council's housing[21] and transportation policy plans[22] divide policy-making and implementation responsibilities into two categories: "Council roles" and "local roles." A quick survey of the documents reveals that the Council intends to dominate on almost every front, while local governments are generally relegated to merely carrying out the Council's dictates.

Question: Why do we need local governments if their role is increasingly just to carry out the policies set by the unelected Council and its permanent staff?

The Housing Policy Plan

Socioeconomic Integration

"If you care about the economy, you should care about the employment gap and the poverty it creates," declared Met Council chair Susan Haigh in the *Star Tribune* in December 2013. Haigh decried the "disparities and inequities that manifest themselves in employment and education gaps and concentrated areas of poverty" and promised that the Council's "Fair Housing and Equity Assessment"—completed in June 2013—would "help us dig deeper into the data and plan to address shortcomings."[23]

The Council's Fair Housing and Equity Assessment

The Fair Housing and Equity Assessment mapped every census tract in the Twin Cities' seven-county area by race, ethnicity, and income. Its purposes were two-fold:

1. To identify "Racially Concentrated Areas of Poverty" and "high opportunity clusters"—essentially those areas with high-performing schools and low crime rates, and
2. To identify suburban land use and zoning practices that allegedly deny opportunity and create "barriers" for low-income and minority people.

As Haigh indicated, the Council intends to use the assessment to achieve "socioeconomic integration" and disperse poverty across the seven-county metro area.

Housing is not a "system" over which the legislature has given the Met Council statutory authority. Yet the Council has issued an unprecedented Housing Policy Plan to carry out the Fair Housing Assessment's prescriptions and to impose a government-sanctioned demographic mix over local land use decisions, including housing development.[24]

Significantly, the highly prescriptive 106-page housing plan includes no summary. Readers must wade through all its dense verbiage to discover its contents. "Transparency" was clearly not the Council's objective.

Because the Council lacks the power to regulate local land use directly, it has concocted a scheme to compel municipalities to take the necessary steps to achieve "socioeconomic integration" themselves.[25] The Council will dictate to every city how much regional poverty it must plan to absorb through low-income housing, for people at 30 percent, 50 percent and 80 percent of area median income (thus expanding the categories of "income-burdened" people whose needs cities must meet.) Details of how this will work and what it will mean for individual cities are still being determined.

For example, the Council is considering a requirement that "50 percent of all housing units (existing and new)" in every municipality should be affordable to low or moderate-income people.[26] If it adopts this policy, high-density, multi-family units will be the only kind of housing that can be built in many municipalities for years to come.

The housing plan pressures cities and their taxpayers to finance subsidized housing themselves, since federal funds for this purpose have largely dried up. Many cities cannot afford the tab. The plan also instructs cities to locate low-income housing in "higher income areas"[27] and proposes a "mobility counseling program" to "help ensure access to opportunity-rich communities and neighborhoods."[28]

The Council will measure cities' compliance with its affordable housing dictates with an arbitrary "housing performance" point system.[29] Under the law, the Council has no authority to enforce its affordable housing directives. It can comment on a city's affordable housing plans in reviewing its comprehensive plan, but cannot turn down a plan on this basis.[30]

But in the *Thrive* plan, the Council announces a two-pronged strategy to pressure and intimidate cities into compliance:

- First, it implies to cities that it will, in fact, condition approval of their updated comprehensive plans on their compliance with its affordable housing directives.[31] The Council lacks statutory authority for this.
- Second, it proposes to tie a city's receipt of vital transportation grants (and other Council-controlled benefits) to the city's "Housing Performance Score"—that is, to how much that city's housing policies disperse regional poverty.[32]

In other words, the Council is attempting to tie its housing and transportation plans together in an unprecedented way to strong-arm cities into meeting its goals. It intends to use its power over transportation—and probably parks and sewer-related funds and other benefits—as a bludgeon to compel cities to carry out a social agenda beyond its statutory authority.

The Council's unprecedented use of transportation funds as a tool to enforce its housing goals is a raw power grab, and cities should investigate a legal challenge. The Council's enabling legislation, the Minnesota Land Planning Act, has not changed since the last round of comprehensive planning. On what grounds, then, does the Council now claim that updates to local plans must meet arbitrary new criteria to be approved, and that it is entitled to withhold transportation funds if they do not?

But time for a challenge is short. The Council will issue new "system statements"—which describe how the Council's "updated forecasts, system and policy plans apply to each individual community"—in September 2015.[33] (Cities have 60 days to request "reconciliation" of differences they may have with the Council.)[34] Cities must incorporate the data included in their system plan into their updated comprehensive plans (due in December 2018). The *Thrive* plan will essentially go into effect in October 2015, since local amendments to comprehensive plans proposed after that time must reflect its provisions.

Affirmatively Furthering Fair Housing

The final draft of the Housing Policy Plan—scheduled to be adopted in December 2014—will likely include much more aggressive "fair housing" provisions than the current draft does. The Council is considering the addition of new requirements that dovetail with the Obama administration's proposed "Affirmatively Furthering Fair Housing" (AFFH) rule, which will radically transform the meaning of housing discrimination.[35] A Met Council staff person laid out recommendations in this respect in PowerPoint presentations to the Council in September 2014.[36]

Under current federal law, a city's housing policies must intentionally discriminate against racial and ethnic minorities to be in violation of federal civil rights laws. However, under the proposed AFFH rule's "disparate impact" analysis, a city may be found in violation merely if its population does not reflect a vaguely defined, government-approved ratio of races and ethnicities. The city's zoning laws and other land-use policies would be presumed to deny opportunity and create "barriers" for minorities.[37]

In Minnesota, local communities are empowered to make zoning decisions. However, the new federal AFFH rule—in conjunction with the "fair housing" policies the Council may add to its Housing Policy Plan—is likely to greatly undermine local control. In the future, many metro-area cities may be prevented from adopting common zoning practices that, for example, place limits on the size, type, height, and density of buildings, as the Council may claim these create "barriers" to low-income housing.[38]

The federal Department of Housing and Urban Development (HUD) is advancing a "disparate impact" analysis in Westchester County, New York. As

Rob Astorino, Westchester's county executive, told the *Wall Street Journal*, "If HUD can define what constitutes exclusionary practices, then local zoning as it is known today disappears. Apartments, high rises, or whatever else the federal government or a developer wants can be built on any block in America."[39]

The proposed "Affirmatively Furthering Fair Housing" rule is of dubious constitutionality.[40] The AFFH-related provisions the Council is considering for its Housing Policy Plan would help lay the groundwork for the rule's imposition in Minnesota.

Racism Not a Primary Cause of Housing Patterns

The Twin Cities' rapid diversification suggests that racism is not the primary cause of the region's housing patterns. The Council seems to view racism as a primary cause of the metro area's housing patterns. Yet the Twin Cities region is rapidly diversifying, and minority residents have been flooding into the suburbs for the last 20 years.

In 2000, for example, only 16 percent of Hmong residents lived outside the core cities; in 2010, 41 percent did. Only 35 percent of blacks lived outside core cities in 2000; in 2010, 51 percent did.

Our region has strong laws against housing discrimination, and we should vigorously enforce them if violations are occurring. But the Council ignores the fact that housing patterns often reflect people's choice to live near family, friends, and cultural support systems.

The Council is proposing to expend funds to investigate alleged "mortgage lending discrimination" and "real estate steering" in the metro area,[41] although it lacks statutory authority to carry out these activities for which other agencies are responsible.

The Met Council assumes that for very troubled households, just dropping people into the suburbs will end the causes of entrenched poverty that are unrelated to zip codes. This hope is unfounded, as "Moving to Opportunity," a federal Department of Housing and Urban Development program begun in 1994, has demonstrated. The program used housing vouchers to move tenants in five cities from poor areas to more prosperous suburbs. In 2004, the National Bureau of Economic Research found "no significant overall effects on adult employment, earnings, or public assistance receipt." Another study, in 2006, "did not find evidence of improvements in reading scores, math scores, behavior or social problems, or school engagement, overall for any age group."[42]

The Met Council seems to believe that "the solution to poverty is dilution," as one observer put it. It's impractical to move most or all low-income people to higher-income areas. And *Thrive*'s plan to move low-income people to far-flung suburbs with little or no transit and a high cost of living is likely to harm, not benefit, them.

The best way to aid low-income residents is to improve education and increase jobs through a business-friendly environment—not to move them around like pieces on a chess board to achieve a metro-wide, government-approved mix of income and skin color.

Thrive to Require Compact Development

The *Thrive* housing plan will require "compact" development in both developing and mature suburbs, with a special focus on cramming people into tiny areas around train stations. The Council maintains that to be "sustainable," the Twin Cities must become a "denser, more compact region." Density is legitimately related to wastewater treatment. However, a primary motive for the Council's densification crusade is that the region can't support enormously expensive new transit projects—both planned and underway—at its current density.[43]

According to *Thrive*, sustainability requires "development patterns that support high transit demand" to "improve residents' ability to live without a personal vehicle."[44] As a result, the housing plan calls for herding people into dense urban enclaves to build ridership for fixed-rail transit and buses.

In the housing plan, the Council significantly revised the descriptions and density criteria for the geographical planning areas used in the *2030 Regional Development Framework* adopted in 2004. Communities have been reclassified into new categories, many with new and higher "minimum average net density" standards, to match the social engineering agenda of *Thrive.*[45]

For example, the communities of Columbia Heights, Fort Snelling, Hilltop, Hopkins, Richfield, Robbinsdale, South St. Paul, St. Louis Park, and West St. Paul, despite their location and suburban character, are now classified with Minneapolis and St. Paul in the "Urban Center" with its "overall density expectation" of 20 units per acre. Some suburbs, such as Minnetonka and Wayzata, must plan to increase density by about 30 percent, through infill, redevelopment and high-density housing.[46]

Forced densification of this kind can cause problems for municipalities whose roads, sewers, schools and parks were not designed for high densities. And if *Thrive* pushes too much land in developing suburbs into high-density zoning, it will create an artificial shortage of single family-zoned land, creating higher prices for all new homes.

The Met Council, despite its illusions, can't change residents' housing preferences. If people can't get what they want here, they will leapfrog outside the seven-county metro area or move to another region with the housing they want and can afford.

The Transportation Policy Plan

The Council's new Transportation Policy Plan (TPP) ignores our highway system's pressing needs and seeks to remake the metro area around fixed-rail transit and buses. The massive, 500-page plan—like the Housing Policy Plan—includes no summary. Again, transparency was not the Council's objective.

A top-quality road system is vital to the Twin Cities region's prosperity and quality of life. In our spread-out area, about 90 percent of jobs are outside the downtown areas of Minneapolis and St. Paul.[47] Eighty-four percent of area trips are by car, with only three percent by transit, including less than one percent by fixed-rail.[48]

For most residents, transit is not time-competitive with auto travel. The average employee can reach only seven percent of jobs by transit within 45 minutes, while drivers get to their jobs in about 25 minutes.[49] The Green Line LRT requires nearly an hour to traverse the 11 miles between Minneapolis and St. Paul. (Travel time by car is less than half that.) "In an end-to-end race with a good long-distance runner a Green Line train would come in second," in the words of the *Star Tribune.*[50]

In our increasingly congested region, transportation planning should aim at expanding highway capacity and improving travel times and road conditions. But a Met Council staff member made clear at a forum on August 6, 2014, that there will be no new roads except for the completion of Highway 610.[51]

Why? The Council's new Transportation Policy Plan declares that "*expanding the roadway system is not a sustainable way to address congestion, climate change, equity, and livability*" (emphasis added).[52] The plan instructs municipalities to consider "travel modes other than the car at all levels of development."[53]

Council Cites Lack of Funds to Justify Ignoring the Road System

"Demand for highway capacity projects to relieve congestion and to serve [outer-ring suburbs is] well beyond the available resources to pay for transportation improvements," according to the TPP. The plan continues:

> *Thus, the focal point for accommodating growth around transportation investments will be having local governments focus their planned growth in areas that support multimodal travel and support this growth with land use and design that integrates transit, walking, and biking*" (emphasis added).[54]

TPP Directs Scarce Funds Toward Fixed Rail

Yet while the new transportation plan virtually ignores road expansion funding, it lavishes increasingly scarce funds on fixed-rail transit, an inflexible, 19th century technology. Our region is projected to have just $52 million available annually from 2014 to 2022 for highway congestion relief. After 2022, federal funding is projected to dry up. Fixed-rail transit costs $100 million a mile to construct, while adding a highway lane in each direction costs just $10 million a mile.

Despite this massive cost differential, the Met Council intends to spend $2.7 billion on the Southwest and Bottineau light rail projects, which will serve a tiny fraction of commuters. That's five times more than will be spent in ten years on highway congestion and bottleneck relief for the entire seven-county region, though 99 percent of area trips use roads in some manner,[55] while less than one percent use fixed-rail.

The Council's obsession with fixed-rail is particularly indefensible in light of its projection that 73 percent of the region's population growth and 59 percent of employment growth by 2040 will take place outside the urban and urban center communities. This growth—and the Council's drive for densification across the metro area—will actually put more cars on our already-burdened roads. The reason is that as density goes up, driving per capita goes down only slightly.[56] The Council's refusal to expand road capacity to meet this increased demand will greatly add to congestion.

Funding Allocated to Planners' Priorities, Not Citizens' Priorities

The plan misallocates public resources by funding Council planners' priorities rather than the needs and preferences of the region's citizens. The TPP endorses other policies designed to make driving more difficult. They include narrowing streets; use by cities of "Complete Streets" principles (which often take out car capacity to favor walking, biking and transit),[57] and "limited, managed parking," which the Council intends to reduce the demand for driving.[58] Biking and walking—while worthy forms of exercise and sometimes commuting—are not practical year-round alternatives for most people in our frigid climate, which saw more than 50 below-zero days in 2013-14.

The Council justifies its focus on fixed-rail transit by claiming it stimulates economic development, but such "transit-oriented development" (TOD)—which frequently fails to materialize as planned—often requires large public subsidies.

Former World Bank principal planner Alain Bertaud has described why in *Cities as Labor Markets*, where he points out the flaws of the "urban village model" at the heart of the TOD concept.[59] (This model is what the *Star Tribune* has called the Met Council's vision of a "return to the tighter live/work/shop neighborhoods that dominated the streetcar era of the early 20th century.")

According to Bertaud, "The urban village model exists only in the mind of urban planners." It "does not exist in the real world, because it contradicts the economic justification of large cities: the efficiency of large labor markets." A city's welfare, says Bertaud, depends on its labor market. "As long as a labor market does not fragment into adjacent, smaller ones as it grows, the larger the market, the more innovative and productive the city will be."

In contrast to the Met Council's claim that rail transit and urban villages stimulate economic development, Bertaud notes that the "urban village model implies a systematic fragmentation of labor markets within a large metropolis, which leads to less economic efficiency and thus to less economic growth."[60]

The TPP uses scarce transportation dollars as a tool to promote its social agenda, and overwhelmingly favors the urban core at the expense of suburban communities—especially in the outer ring. The Council plans to use municipalities' "housing performance scores," which measure their contribution to dispersing poverty, to determine their eligibility for federal transportation grants under its Regional Solicitation guidelines.

As a result, in the future, funds for congestion relief and road safety are likely to go almost exclusively to Minneapolis, St. Paul, and a handful of inner-ring municipalities. Suburbs and exurbs will find it very difficult to obtain funds to meet their pressing needs in this respect. Many suburban communities will also be at a disadvantage in obtaining transit funds, because the Council plans to condition grants for transit-oriented development on satisfactory provision of low-income housing.

Local Governments Object to Thrive Plan

Suburban Counties Raise Formal Objections to TPP

In a strongly worded resolution, the county boards of the region's five ring counties have raised numerous objections to the TPP. On September 29, 2014, the county boards of Anoka, Carver, Dakota, Scott, and Washington Counties met to call public attention to the Met Council's overreach in the TPP. The meeting was a historic event, where commissioners from the five ring counties—all elected officials—implored Met Council members—all appointed officials—to stop and listen to them.

In an extraordinary, unanimous statement, the commissioners charged that the Council had not partnered with the counties and called on the Council to halt the TPP and go back to the drawing board.[61] The plan, they declared, "represents a *bleak future for the regional highway system in most counties*" (emphasis added).[62]

The TPP's "goals and outcomes," said the statement, "do not align" with metro area citizens' actual travel behavior or with the Council's own growth projections, which forecast major population growth in the suburbs in coming years. The TPP's failure to reflect these realities will have dire consequences for the entire metro area, the statement added:

> *Without such alignment, there will be a radical shift in how transportation systems are built and operated, which will result in severe congestion and safety issues in certain areas of the region.* Local governments will

> be forced to use their resources on high-priority projects outside their jurisdiction which will impact their tax base and affect the quality of life in their communities which, in turn, *will reduce the economic vitality of the region* (emphasis added).[63]

The county commissioners also protested the Council's high-handed dictates to cities and counties on matters ranging from "transit focused investment" to "use of Complete Streets principles"—mandates for which the Council has no "clear authority," they said.[64]

The county commissioners plan to follow up on their analysis of the TPP with a detailed critique of the *Thrive* Housing Policy Plan.

Regional Park Plan Drawing Local Government Objections

The new *Thrive* plan for regional parks is also drawing the ire of suburban governing bodies. Like the housing and transportation plans, the Met Council's parks plan[65]—scheduled for adoption in early 2015—is encountering concerted push-back from bodies that administer regional parks.

Not surprisingly, the new plan calls for increasing the Council's power over how park funds are spent, among other things.[66] Citing the region's growing minority population, the Council claims it will use its enhanced control to "steer funds to strengthen equitable access to park amenities," in the words of the *Star Tribune*.[67]

Suburban park administration bodies counter that they already have programs and practices in place to ensure that parks are available to a wide range of users. Local authorities—not the Met Council—are in the best position to determine residents' needs, they say.

Suburban officials' objections to the *Thrive* parks plan echo their criticisms of the Council's intrusive housing and transportation plans. "It's a nonelected body trying to wrestle control," Daniel Freeman, vice chair of the Three Rivers Park District Board, told the *Star Tribune*. "It looks like a power grab."

Other elected officials used more colorful language, according to the paper:

> Three Rivers Commissioner Penny Steele said the Met Council's eagerness to expand its traditional scope reminds her of 'The Little Shop of Horrors,' the musical story of a tiny plant that morphs into a giant and voracious Venus flytrap. 'Who's gonna prune that plant?' she said.[68]

City Councils Are also Blasting the *Thrive* Plan

Burnsville City Council members have charged that *Thrive*'s details "reveal a set of overly prescriptive transportation and housing policies that sap local control, deprive the suburbs of highway dollars, and ignore market forces," according to the *Sun This Week* newspaper.[69]

One Burnsville Council member denounced the Met Council's actions as "government planning, overreach, dictation, whatever you want to call it, at its finest!" Another branded the Met Council's agenda as "out of control."

In a subsequent *Sun This Week* article, a Lakeville City Council member charged that the Met Council has "too much power" and is engaged in "dictation and control." "They're not advising at all," she added. "It's very scary."[70]

Lakeville Planning Commission member Karl Drotning emphasized that the Council's new scoring criteria for transportation spending are heavily slanted toward Hennepin and Ramsey counties. According to *Sun This Week*, Drotning emphasized that the Council is "pretty much ignoring the developing communities:"

"They're more or less adding another mandate or criteria and making the scoring tougher for the outer counties," he said, "so we start out basically with one hand tied behind us. What was the *Animal Farm* thing? All animals are created equal, but some are more equal than others."

The Council's Expanding Overreach into Economic Competitiveness and Climate Change

Thrive identifies planning for "economic competitiveness" as "an important new emphasis for our region." Details are not yet clear. However, the Council apparently intends to preside over creation of a "regional vision for economic competitiveness." It will then "localize"[71] a "strategy" to implement that vision through cities' and counties' updated comprehensive plans. [72]

The Council insists that participation in its new initiative—which will rely in part on "increased information and technical assistance"—will be voluntary.[73] However, local governments have expressed "skepticism" and concern about "mandates," according to a staff presentation at a meeting of the Council's Community Development committee on November 3, 2014.[74]

Top-down controls and mandates seem likely as the unelected Council—with limited business expertise—attempts to instruct local officials and business people how they must use their resources to further its vision for "regional economic competitiveness."[75]

For example, the Council plans to compile and prioritize a "regional inventory" of sites for potential development and redevelopment. It will then analyze the market readiness of these sites and will work with its local and regional partners to develop investment and redevelopment strategies customized to the needs of different types of hot and cold markets, including racially-concentrated areas of poverty and advancing the priority of regional balance.[76]

The Council's "economic planning" power grab will enhance its ability to pick winners and losers among the region's 186 municipalities. This move threatens to significantly increase the Council's capacity to reward jurisdictions it favors—including inner ring communities, where it wishes to increase jobs and population growth—and to penalize outer ring communities and local officials who resist its "regional vision."

The Council has no legal authority in the area of climate change. Its intention to use climate change as a "lens" to evaluate all local and regional plans virtually guarantees increased, open-ended government intrusion into local and even state-level affairs. For example, in the future, a municipality that needs road funds may have to conform to onerous "clean energy" or "carbon footprint" requirements.

The Consequences of Failing to Check the Power of the Met Council

For decades, the Twin Cities region has been one of the nation's most thriving metro areas. Our prosperity is the result, not of government planning, but of the hard work and innovative vision of the area's people. Given our region's remarkable success, on what grounds does the Council now claim that, going forward, we must implement the massive, top-down changes that *Thrive* calls for to remain successful?

The Met Council claims that *Thrive*'s intrusive prescriptions for land use and transportation are necessary to ensure our region remains economically competitive. But people move to a metro area, not for transit, but for jobs.

The Council's plans threaten our region's standard of living and economic competitiveness. *Thrive* will make long-term commitments for scarce transportation dollars and spending on other activities that will be difficult, if not impossible, to undo. It's not just the Twin Cities that is at risk. The entire state's economy, and even neighboring states, which benefit from the robust and diverse economy of the greater metro area, will be adversely affected.

Top-down planning by unaccountable bureaucrats that distorts market forces is likely to constrict overall prosperity and stymie development. The nation's fastest growing areas—virtually all in the South and West—are characterized by less government regulation and business-friendly environments. These factors are strongly correlated with greater economic growth.

Thrive's prescriptive micromanagement will prevent our region's people and local governments from responding quickly and effectively to change. Thirty years ago, the Internet hadn't even been invented. Today, telecommuting is increasing rapidly, and driverless cars may be around the corner, yet the Met Council is investing billions in fixed-rail, a 19th century technology.

Most importantly, the Met Council's escalating overreach, if left unchecked, will undermine our freedom and ability to live as we choose. Its imposition of "rule by planners" is inconsistent with local self-government: our birthright as Americans.

WHAT IS TO BE DONE?

To summarize, the problem is not *Thrive* per se. The problem is regionalism as a governance structure. *Thrive* is an extreme example of the problems inherent in regionalism and an advanced symptom of the Met Council's lack of accountability. Tackling the Met Council problem is an urgent matter. There are certain actions that Governor Dayton should take immediately and other actions that the governor and legislature should take in 2015 and beyond.

Center of the American Experiment noted in a 2003 *Minnesota Policy Blueprint* "Task Force on Metropolitan Governance"[77] that campaigns have been waged against the Met Council from its inception, yet "it has survived every attempt on its life, often emerging at the end of the battle with an expanded mandate and ever-increasing budget." That observation should cause anyone with a mind to redesign the Met Council—or to spin off its useful functions and jettison the rest—to pause in trepidation and then push on as the threat to self-governance, fiscal soundness, and prosperity is too serious to ignore.

In 2011, the Office of the Legislative Auditor issued *Evaluation Report: Governance of Transit in the Twin Cities Region*.[78] Legislative Auditor James Nobles pointed to the Council's lack of credibility among elected officials and other regional stakeholders. He called for reform of the governance structure as a first step in addressing his office's finding that the transit decision-making process for the region was fraught with distrust and lacked an agreed-upon set of priorities.[79] While he focused on transit, he made broad recommendations that would bring elected officials into the Council.

A consensus may be building around a new governance structure that keeps the Met Council but replaces the current appointees with a mix of elected officials and appointees from the region.[80]

The drawback with most of the ideas under consideration is that many keep the broad statutory powers currently given to the Council but do not check those powers with effective oversight and recourse by the legislature or hit the right balance between regional efficiency and local control.

Put simply, no matter how clever the design, there can be no appointed body—even one with local elected officials—that retains the Council's current mission and powers. No *appointed* body should be able to exercise the kind of power wielded by the Met Council.[81] No *appointed* body should be able to adopt and then implement a plan on the scale of *Thrive MSP 2040*. To date, the legislature and a long string of governors have failed to exercise the kind of oversight citizens should expect of a powerful, enigmatic governing body like the Met Council. For decades, citizens have demanded reform without satisfaction.

Instead of fixing the problem, the legislature has exacerbated the problem by adding to the Council's power and, when frustrated, worked around the Council by adding, for example, other transit entities.[82] This leaves Minnesota without a credible, widely accepted vision for the region.[83]

If past is prologue, this dereliction of duty can be expected to continue, and yet the answer must come from the legislature. Perhaps the grand arrogance of *Thrive MSP 2040* will finally bring legislative and regional factions together to solve or at least improve the Met Council problem.

To act regionally or not to act regionally?

Before concluding that the Met Council merely needs to be tweaked by adding local elected officials, let's briefly examine whether the state requires a regional regime. Much has changed since the 1960s, and much has been accomplished.

Set aside for the moment the desirability of regional services for sewage treatment and transit;[84] the initial goal was to require local units of government to have comprehensive plans to handle the development generated by the "baby boom" and our rapidly expanding Twin Cities region.

The goal of comprehensive planning by cities was largely accomplished by the 1980s—the mission was a success. But instead of sunsetting the Council, the planners' next question was, "Who is going to ensure that local units follow their plans and ensure that the infrastructure is compatible?" The desire for "efficiency" and a misplaced confidence in an appointed body over local officials, has exacerbated the Met Council problem.

The addition of sewer and transit operations to the Council in the mid-1990s cemented the Council as one of the largest "state agencies" with a projected budget of $927 million for 2015 and large amounts of state and federal dollars running through it. Yet the legislature exercises no authority over the Council's budget and little authority over its policies.

We are so accustomed to the Met Council that we forget that 80 counties in the state manage their development and secure funding without a regional plan or body. You might argue that the region around the Twin Cities is unique and vital as the economic engine of the Upper Midwest, requiring more controls and long-term planning. Yet other major metropolitan areas across the United States have managed growth without a regional council that the current chair Susan Haigh and others tout as a model for the nation.[85]

If you conclude that the region does not need a regional planning body and that our state government, counties, and municipalities are fully capable of planning for and coordinating local and regional needs, the solution is to eliminate the Met Council and delegate important regional services like sewage treatment and transit to separate entities. This solution, however, has failed to pass the legislature many times and is rejected almost universally as politically impossible. After five decades, there are many interests invested in keeping some kind of regional body.

If you conclude that the region still benefits from regional planning and certain regional services, or that as a political matter we are simply stuck with some version of the Met Council, then to get credible policies, you still have to design a governance structure to properly match what you want that body to do.[86] This conclusion, moreover, does not preclude separating planning, implementation, and operations of regional services. In fact, a strong argument can be made that there is an insurmountable conflict of interest, for example, between the Council operating Metro Transit and approving how federal transportation dollars are spent. *Thrive MSP 2040, for* example, aggressively shifts highway dollars to light rail in the core cities, and starves the suburbs and outlying areas of funds for roads and bus transit, and the funds are controlled by the Council.

The mistake we have made over and over with the Met Council is thinking that we can vest significant authority in a body that is not elected by, and therefore accountable to, the people who must live with its decisions. The mistake proponents of direct elections make is thinking that elections will overcome the problems posed by the broad mission and powers of the Council, which are often in direct conflict with local and county officials. Why do we need a regional body when we already have local, county, and state officials—and more ballot decisions than even involved, conscientious citizens can reasonably make? While attractive at first glance, direct elections pose just as many problems as the status quo.

Conclusion

Though it may not be politically feasible, as a matter of sound public policy, the Met Council should be eliminated and its various functions, if needed, delegated to local, state, and even private entities. Valuable regional services, such as transit and waste water treatment, could still be run on a regional basis but managed by state and local agencies (or a private company, if that model delivers the best value). The original planning mission was accomplished long ago. The region is developed and mature enough to handle the coordination of future growth without a regional regime imposed on the state, counties, and municipalities. If the state decides to develop master plans for the region, the legislature should narrow the mission of any agency strictly to planning so that cities can determine their own character, as long as they accept the financial price of their decisions (e.g., expensive trains or lower density).

The Met Council is making long-term and massive financial and legal commitments that exceed its statutory authority; these commitments will affect the rights of citizens and the economic health of the region for decades. Given the Council's lack of credibility and accountability, the power of the Met Council should be interrupted and checked to prevent further damage to the economic health of our state.

SPECIFIC RECOMMENDATIONS:

Recommendation 1: Rein in the Council.

Governor Dayton should immediately rein in Chair Susan Haigh and his appointed Met Council by issuing an executive order that directs the Council to limit its planning to areas of statutory authority and to cease its attempt to extend its authority to housing by leveraging its control of transit and sewers. The Council should be directed to cease all programs related to non-statutory areas (e.g., achievement gap, income inequality, global warming, and/or climate change).

Recommendation 2: Appoint elected officials to the Council.

As a temporary solution, the governor in January 2015 should appoint a new Council made up of elected officials selected by the seven counties and municipalities and appoint a new chair (or allow the new body to select a chair) who can advise the governor and legislature on how to move forward with transit in particular. Merely adding elected officials, however, will not remedy the Council's many defects.

Recommendation 3: Reject *Thrive MSP 2040*.

The governor and legislature in January 2015 should reject *Thrive MSP 2040* in its entirety and call for a moratorium on all light rail projects so the legislature can get a handle on the capital and operating costs and start anew without the burden of a plan enacted by unaccountable appointees.

Recommendation 4: Identify operating revenues before committing capital funds.

Per the Office of Legislative Auditor, the legislature and Council should not commit capital funds to transitway development projects without ensuring that operating revenues for the first five to ten years have been identified.

Recommendation 5: Give the legislature authority over the Council's budgets.

While the legislature debates the Met Council's governance problem, the Legislative Commission on Metropolitan Government (LCMC) should be given authority over the Council's operating budget and capital budgets to introduce real legislative oversight.[87]

Recommendation 6: Provide measures to appropriately check the power of any redesigned regional body.

Any redesign that retains a regional body must match up the mission and powers with appropriate measures to hold that body in check and accountable. For example, if the body has levy and eminent domain powers, it must be directly elected and held to a narrow mission. If it merely plans for regional systems, it can be run, for example, by a mix of elected and appointed officials, but its budgets should be overseen by the legislature. To avoid conflicts of interest, it should not be empowered to plan for, implement, and operate any system.

Recommendation 7: Subject the Council to staggered terms and greater local control.

We recognize that any redesign that retains some kind of regional body could take many forms to balance the interests of cities and counties with the interests of the governor and the state.[88] Any redesign should include staggered terms to promote stability while favoring local control by the cities and counties.[89] This would greatly increase the Council's credibility.

Recommendation 8: Cities should avoid the Livable Communities Program.

Cities should reject the Livable Communities Program, withdraw from the program or avoid it altogether, and consider suing for injunctive relief against the Council's Housing Policy Plan under *Thrive MSP 2040*.

Recommendation 9: Repeal the Livable Communities Act.

The legislature should repeal the 1995 Livable Communities Act and transfer housing programs to the state HFA and local housing programs. Revolving loan funds for reinvestment could replace the Metropolitan Council's Livable Communities program.

Recommendation 10: End redundant tasks carried out by other government agencies.

The Metropolitan Council should cease performing tasks carried out by other government agencies. Housing programs and environmental review are duplicative and should be left to other entities.

PENSIONS

Keeping the Promise: Securing Retirement Benefits for Current and Future Public Employees

Kim Crockett, J.D.

EXECUTIVE SUMMARY

Summary of the problem: Minnesota's public employee pension system is broken. The state's reported unfunded liabilities for 2013 are estimated by the state to be **$17.3 billion**. If reasonable economic assumptions are used, the amount is far larger. This is a ticking fiscal time bomb for Minnesota. Escalating costs will force us to choose between reducing spending on core services that are essential to our quality of life, raising taxes by a far larger amount than the Legislature did in 2013, or breaking our promises to retirees. These choices can be avoided if we redesign the system now.

Summary of our solution: First, maintain and fully fund the defined benefit plan for retirees and current employees, honoring all earned benefits. Second, accurately state and fully disclose the true cost of pensions. Third, create a defined contribution plan for all new public employees that puts them on a path to a secure retirement without creating future unfunded liabilities. Fourth, take immediate steps to preserve and prudently grow pension assets while paying down the unfunded liability.

Summary of why this works: This solution keeps our promise to retirees and current employees while updating the retirement system to meet the needs of today's public workforce. More importantly, it avoids a predictable fiscal crisis that will put school districts, and local and state government in the untenable position of choosing between funding past pension promises and delivering core services. It also takes backroom politics out of retirement savings and investments. These reforms would position Minnesota as a leader among states; we will be rewarded with more cost effective government and a stronger economy that will provide more good paying jobs.

Why you should care: Ignoring the problem puts everybody at risk—current and future retirees, taxpayers and consumers of public goods and services.

A Note on Public Pension Data

The pension data for this report are based on the actuarial reports dated January 2014. So, for example, the $17.3 billion unfunded liability reported here is the *actuarial* value, not the *market* value, of the 2013 unfunded liability. The actuarial value accounts for volatility in the market value and provides an estimate for what the pension funds must set aside to meet long-term obligations. Using the market value in a down year might overstate the amount the pension must set aside, while the market value in an up year might understate what must be set aside.

When we first published this report in July of 2014, the pension funds responded with a three-page press release calling our numbers "very outdated" and claiming that the unfunded liability had dropped from $17.3 billion to $10 billion due to legislative reforms and an 18.6 percent return on investments. While we welcome that good news, it is important to note that the $10 billion dollar figure was the *market* value of the unfunded liability—and based on "preliminary numbers" not available to the public. Because this market valuation comes at a time of strong positive returns and in the context of a large unfunded liability, it likely understates what must be set aside to meet long-term obligations. And while an 18.6 percent return is impressive, we worry about how the funds are achieving this high return with employee retirement dollars. As noted below, the risk profile for pension investments has increased steadily and Minnesota has a more aggressive, and therefore volatile, mix than private pension funds and even most public funds. Minnesota pension funds lost over 18 percent of their value in 2009. Another market downturn could have devastating consequences.

INTRODUCTION TO THE NATIONAL CONVERSATION ABOUT PUBLIC PENSIONS.

A recent *Report of the State Budget Crisis Task Force* detailed the fiscal problems that are plaguing most states—and public pensions are front and center.[1] The task force reports state and local pension funds are "underfunded by approximately a trillion dollars according to their actuaries and by as much as $3 trillion or more if more conservative investment assumptions are used." This underfunding poses a serious risk for future budgets. Independent experts across the political spectrum agree that pension funding is a problem that needs our immediate attention.[2]

What does this have to do with Minnesota? The vast majority of Minnesota's public employees are in one of three defined benefit plans managed by the state: PERA (local employees including police and fire), TRA (K-12 school teachers) and MSRS (state employees). There are 307,600 active public employees counting on the state to manage their defined benefit retirement funds and 194,256 retirees, survivors and disabled people who are relying on a pension check. That means over 11 percent of Minnesota's population (586,897 people) is counting on these plans for retirement security.[3] Like many states, Minnesota has fallen behind in payments, putting pension promises and taxpayers at risk.

THE SIZE OF THE PENSION PROBLEM.

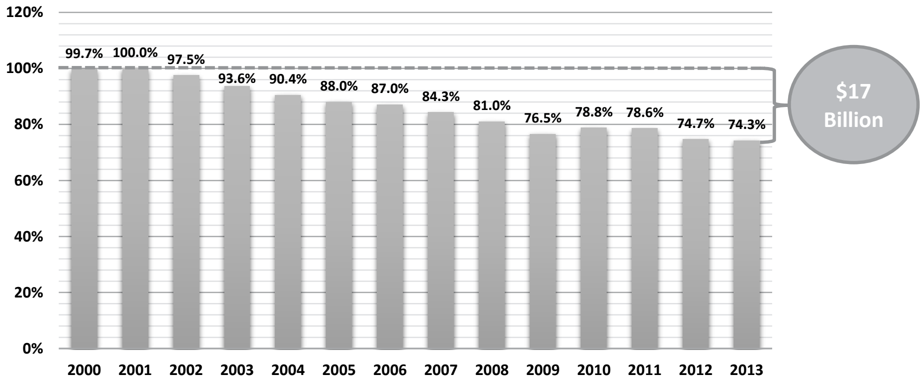
Minnesota's public pension plans have a large and growing unfunded liability. The combined funds[4] have dropped from 100% funding in 2001 to about 74 percent in 2013 (**Figure 1).** As of 2013, the state calculated the unfunded liability at **$17.3 billion**. This calculation was based on an assumed rate of return and a discount rate for liabilities that were excessive. As a result, the actual unfunded liability is probably larger.

Minnesota State Economist Laura Kalambokidis recently outlined alternative assumptions for calculating the unfunded liability in testimony before the Legislative Commission on Pensions and Retirement (LCPR).[5] These alternative assumptions put the unfunded liability between **$21.8 billion** and **$30.6 billion** and drops the funding ratio from 74 percent to as low as 62 percent (**Figure 2).**

The unfunded liability is already burdening state and local budgets. While some underfunding (and overfunding) is expected in a defined benefit pension system, the amount and pace of growth of Minnesota's unfunded liability is extreme and dangerous. It has already led to higher spending by state and local governments. **Figure 3** shows how direct state aid and additional local government contributions grew in step with the growth of the unfunded liability.

In 2013, additional employer contributions and cash aid from state and local government totaled **$114 million.** These additional payments are only a portion of the total price paid in 2013 to cover the unfunded liability. Actuarial

Figure 1: Funding Ratio Drops, Leading to $17 Billion Unfunded Liability



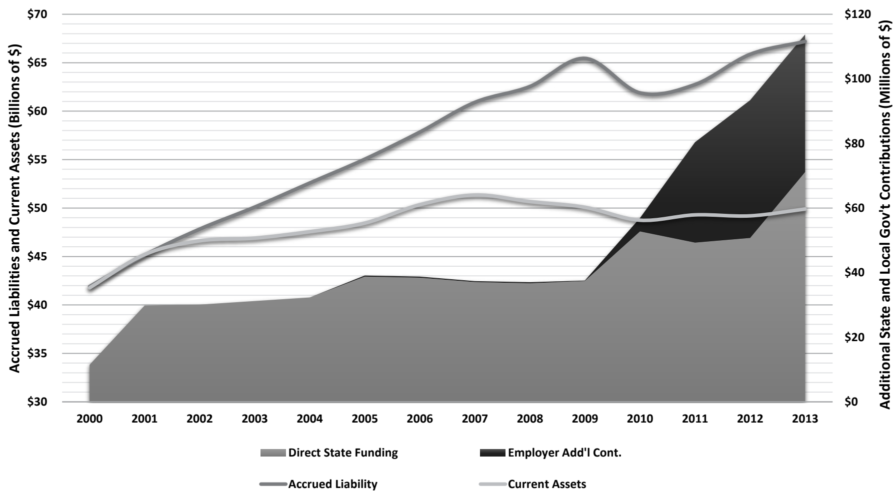
* 2012 and 2013 do not include Volunteer Fire Plans and 2013 does not include Bloomington Fire because data was unavailable.

Source: Minnesota Legislative Commission on Pensions and Retirement, Minnesota Pension Plan Actuarial Reporting, Historical Data by Plan (January 16, 2014), available at http://www.commissions.leg.state.mn.us/lcpr/valuations.htm.

Figure 2: Unfunded Liability is Billions More When Using Standard Pension Assumptions (billions of $)

Sources: Calculations are based on the following formula: Present Value = Future Value / (1 + Discount Rate)^15. See Wake Forest University Law School, Law & Valuation, Chapter 1.3.2, at https://users.wfu.edu/palmitar/Law&Valuation/toc.htm. Alternative discount rate assumptions are drawn from a presentation by Laura Kalambokidis, Minnesota's state economist. See Laura Kalambokidis, Rate of Return Assumptions for Minnesota's Public Pension Plans (August 29th, 2013), available at http://www.commissions.leg.state.mn.us/lcpr/documents/mtgmaterials/2013/Kalambokidis_LCPR_08292013_final.pdf.

Figure 3: Unfunded Liability is Already Crowding Out Other Spending Priorities



Source: Minnesota Legislative Commission on Pensions and Retirement, Minnesota Pension Plan Actuarial Reporting, Historical Data by Plan (January 16, 2014). Direct state funding excludes Volunteer Fire Plans funded through insurance premium taxes.

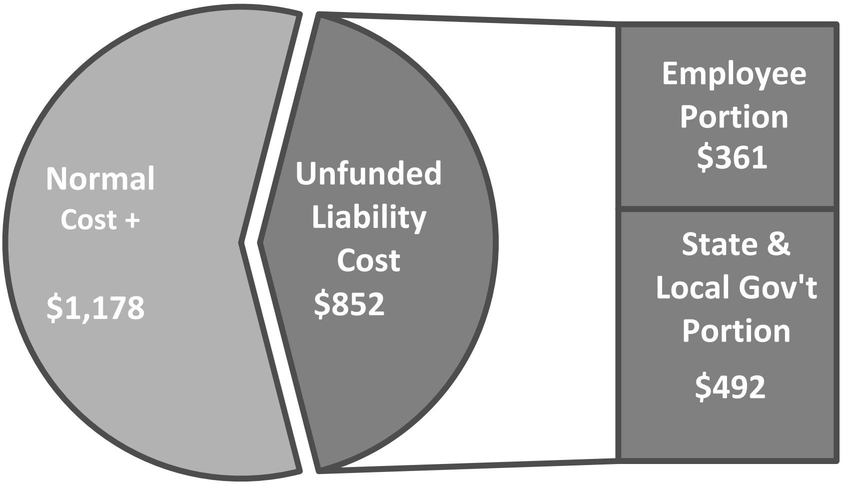
valuation reports reveal Minnesota pension funds paid a total of **$852 million** in "supplementary contributions" to amortize the cost of the unfunded liability in 2013.[6]

These payments are funded by employee and employer payroll contributions, plus the additional payments **($114 million**) shown in **Figure 3**. The **$852 million** total "supplementary contributions" is on top of the **$1.178 billion** paid to fund the current, or "normal cost" plus administrative expenses of the pensions. (The "normal cost" is the cost of projected future benefits allocated to the current plan year.)

Assuming employees and employers pay proportional shares based on their annual contributions, then the **$852 million** in unfunded liability payments was split between employees (**$361 million)** and state and local governments (**$492 million**) as shown in **Figure 4**.

The **$852 million** in supplemental contributions paid in 2013, however, fell far short of the **$1.231 billion** supplemental contribution needed to cover the actuarial required contribution (ARC)—the contribution that should be made to both cover the normal costs and pay down the unfunded liability.[7] The annual payment Minnesota needs to make to actually pay down the unfunded liability was, therefore, over 100 percent of the normal cost of the pension plans.

Figure 4: Substantial Portion of 2013 Pension Contributions Pay Unfunded Liability Cost (millions of dollars)



Source: Minnesota Legislative Commission on Pensions and Retirement, 2013 Valuation Reports, available at http://www.commissions.leg.state.mn.us/lcpr/valuations.htm. Calculations include all open pension plans with 2013 data available, which excludes Elective State Officers Retirement Plan and Legislators Retirement Plan.

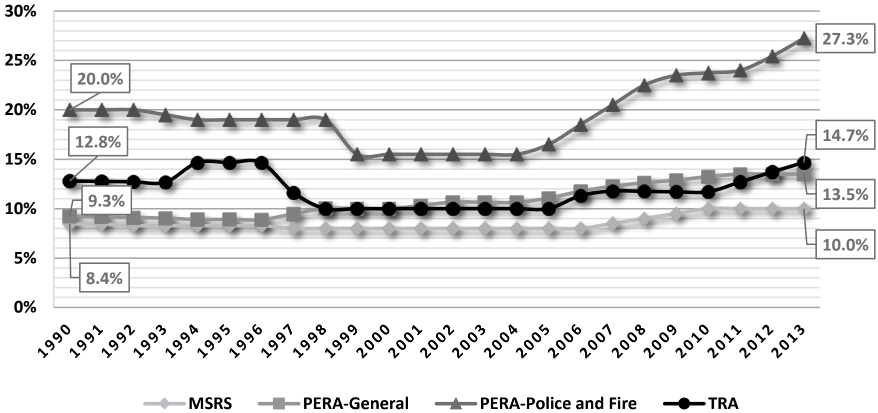
Each day, Minnesota's defined benefit plans take on new unfunded liabilities but fail to make the full required contributions. In 2013, this deficiency totaled $378 million.[8] At the same time, the state is paying earned benefits to retirees (plus a COLA to protect against inflation).

In other words, the state is in a hole and it just keeps digging. The 2013 Valuation Report for MSRS (Minnesota State Retirement System), which has one of the better funding ratios, puts the problem in stark terms. The report said that under current assumptions, *"an infinite number of years would be required to eliminate the unfunded liability (the unfunded liability will never be eliminated)... the unfunded liability as a percent of pay will increase without limit to an infinite amount."*[9]

THE CROWDING OUT EFFECT.

Extra pension costs are already "crowding out" other spending priorities. As noted above, the total state and local government portion of the **$852 million** "supplemental contribution" toward the unfunded liability was **$492 million** in 2013. **(Figure 4).** Of that, **$114 million** comes from additional state aid **($71**

Figure 5: Contributions are Rising as a Percent of Payroll for the Four Major Pension Funds



Source: Minnesota Legislative Commission on Pensions and Retirement, Minnesota Pension Plan Actuarial Reporting, Historical Data by Plan (January 16, 2014).

million) and local aid **($43 million**).[10] These backward looking "extra" payments toward the unfunded liability are crowding out funding for other priorities like tax relief or other spending priorities. What else does that buy?

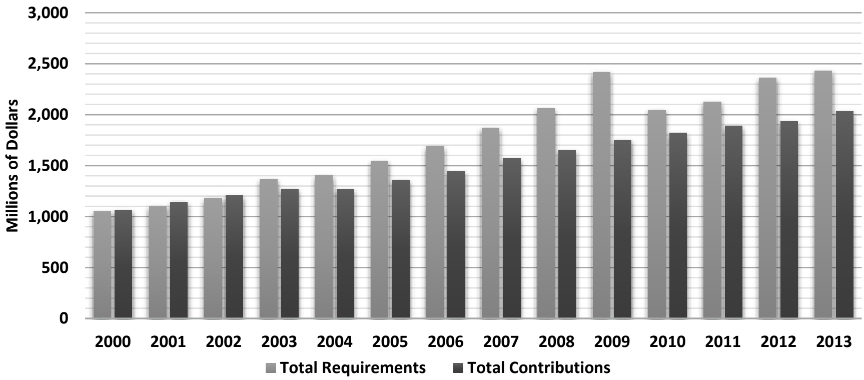
- State taxpayers and City of Minneapolis taxpayers are going to pay a combined $498 million for the Viking Stadium—a touch more than the **$492 million** dollar unfunded liability payment made by state and local governments for one year.[11]
- **$71 million** in state aid is almost enough to fund the state's pre-K education program for a year, or
- Minnesota's business and workforce development programs for a year.[12]

The two largest shares of the **$852 million** unfunded liability payment went to TRA **($133 million**) and PERA-General (**$183 million**). Again, what else does that buy?

- **$133 million** could pay salaries for an additional 2,400 teachers.[13]
- **$183 million** could double the 2014 renters property tax refund, buy 732 snowplows, add 18 miles of new lanes to an existing highway,[14] or maintain 12,000 miles of local roads.[15]

We are paying more but getting less. Figure 5 shows that contributions as a

Figure 6: Actual Contributions Continually Fail to Make the Required Contributions Necessary to Fully Fund Minnesota Pensions (All Plans)



Source: Minnesota Legislative Commission on Pensions and Retirement, Minnesota Pension Plan Actuarial Reporting, Historical Data by Plan (January 16, 2014), available at http://www.commissions.leg.state.mn.us/lcpr/valuations.htm.

percent of payroll decreased in the 1990s (perhaps sowing the seeds for today's underfunding) and then increased steadily in the 2000s. Employees, state government, school districts and local governments are all being hit by higher contributions to the existing system, yet the problem continues to grow.

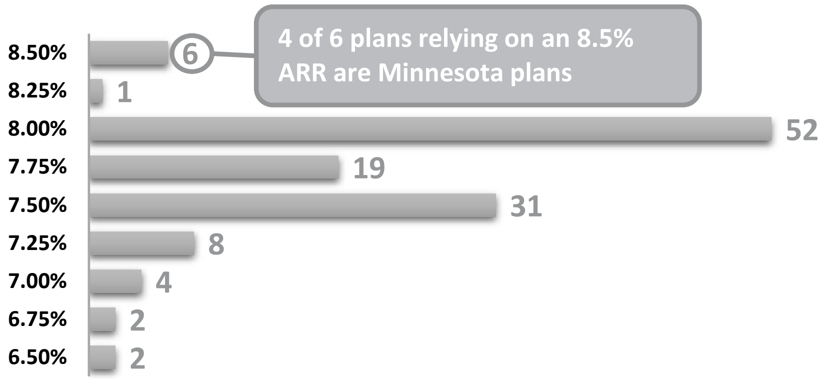
And even with increased payments, the state has not created a fully funded, secure retirement system.

HOW DID MINNESOTA GET INTO THIS MESS?

Skipping full payments. The state is not making the necessary annual required contributions to keep the pension system actuarially sound. Minnesota started shorting payments in 2003 (**Figure 6).** This means the state is pushing off some of today's costs onto future employees and taxpayers and significantly raising the total costs of that obligation.[16]

Unrealistic assumptions. The state is underestimating what it actually costs to fund the promised benefits.[17] For example, most U.S. public pension funds—not just Minnesota's—use unrealistic assumptions about what they will earn on assets. But Minnesota is an outlier even among U.S. public pension funds. Since 1989, the state has used the highest assumed rate of return (ARR) in the nation (8.5 percent). This optimistic assumption recently got the attention of legislators. In 2012, the state dropped the rate to 8.0 percent for one year, adding a point (0.1%) each year until it reaches 8.5 percent again after five years. Despite this brief acknowledgement of real returns, Minnesota has not

Figure 7: Minnesota Pension Plans Use the Highest Possible Assumed Rate of Return on Investments



Distribution of Investment Return Assumptions Among Public Pensions in the U.S., NASRA Survey Results

Source: National Association of State Retirement Administrators, Public Pension Plan Investment Return Assumptions (April 2014). Note that NASRA identifies Minnesota pensions as using an 8.00% ARR in 2013, but practically speaking Minnesota continues to rely on an 8.50% ARR. Minnesota plans are using an 8.00% ARR for five years until 2016 and after that the ARR wil return to 8.50%. Considering investment returns on a 20 to 30 year basis, dropping the ARR for five years does not change the average annual ARR over a longer time frame all that much. Thus, over this longer time frame, an 8.50% ARR remains the basic investment assumption.

joined other public pension funds in *permanently* lowering the ARR to a more realistic number (**Figure 7)** because this would likely cause contribution rates to increase even more than they already have.[18]

Further compounding the problem, Minnesota uses this rate of return to discount future liabilities. Because pension benefits are a binding legal obligation, state and local governments have to pay them even if investment earnings fall short.[19] This is why the cost of future benefits (liabilities) should be calculated using a discount rate that reflects this lower risk, rather than assumed investment returns. This is the approach taken by private sector pension plans and public plans in Canada and Europe.[20] A lower discount rate would require that *more, not less* money is set aside to cover guaranteed benefits. As noted above, if you calculate Minnesota's unfunded liability using the more realistic discount rates suggested by Minnesota's state economist, the unfunded liability ranges from **$21.8 billion** to **$30.6 billion** (**Figure 2).**

Opaque, hard to understand techniques. Minnesota uses a variety of management techniques (e.g. long amortization periods, level percent of pay rather than level dollar payments toward the unfunded liability) to postpone dealing with the problem. These opaque techniques, which are hard to understand, delay the pain of paying for promised benefits. But as the Rockefeller Institute recently warned, "The future does arrive."[21]

Not so benign neglect and backroom political mischief. Politicians are not good managers of other people's pensions. And defined benefit plans require a lot of managing. In theory, a defined benefit plan is the most cost-effective vehicle for public pensions. In practice, it has not turned out well. No matter how dedicated and honorable, politicians operate on two-year budget and election cycles. The temptation to ignore pension funding problems is great. State lawmakers are very busy and pensions are very complex; most lawmakers do not understand pensions and rely on their colleagues on the pension commission to determine policy.[22] The pension commission members in turn are greatly influenced by and dependent on public union lawyers/lobbyists, pension administrators, pension staff and representatives of the defined benefit industry.[23] Each pension plan also has a board of trustees. A quick glance, for example, at the trustees of TRA (Teachers Retirement Association) demonstrates the intimate relationship between TRA and Education Minnesota, the teachers union.[24]

MINNESOTA'S LEGISLATURE HAS TRIED TO FIX THE PENSION PROBLEM.

The legislature has attempted to manage the pension problem. For example, in 2007 it corrected an egregious practice it had previously enacted that was draining pension assets and creating major inequities among retirees. Specifically, they eliminated increases to base pensions for retirees paid when the State Board of Investment (SBI) made more than the targeted 8.5 percent on investments.[25]

Following the 2008 financial crisis, the state passed politically difficult "sustainability measures." The 2010 omnibus legislation attempted to put the pension plans on a sound footing. The pain was spread around to taxpayers and employees (higher contributions) and retirees (who have had their COLAs reduced until the plans return to 90 percent funding).[26] These legislative efforts may have prevented the kind of financial meltdown we see in states like Illinois or cities like San Bernardino, California. If full and current funding was the objective, however, the 2010 measure has fallen seriously short. The reason is that the 2010 legislation did nothing to address the fundamental problems in the defined benefit system.

Since then, additional refinements have been signed into law, yet the gap between the assets and liabilities continues to grow.[27] The 2013 pension bill included a "contribution stabilization" measure that automatically lowers or raises contributions in response to funding levels (if the gap between assets and liabilities, for example, increases over a certain amount, contributions will increase again). It remains to be seen how it will impact funding levels.[28]

Market Crash Did Not Cause Unfunded Liability. Though the market crash following the 2008 financial crisis did contribute to the unfunded liability problem, it gets way too much blame. It is a convenient narrative for pension administrators and politicians trying to explain dropping funding ratios. The truth is the state was already propping up certain funds in 2000 when the assets and liabilities (all funds) began to move apart at a steady pace (**Figure 3).**[29] The pension funds dropped from 100 percent to 81 percent funded in 2008 after 6 years of failing to pay the full ARC. Then in 2009, the pension funds lost 18.8% of their asset value, dropping the funding ratio to 76.5 percent (**Figures 1 and 6).**

Solid long term returns have not closed the gap. Despite significant volatility, the State Board of Investment has earned annualized returns of 8.2 percent over the last 10 years and 10 percent since 1980. SBI reported a return of 14.2% in 2013. But these returns have not been enough to *improve* the funding ratio, let alone cover the unfunded liabilities. These market returns cannot make up missed ARC payments, underestimated benefit costs and inevitable market losses. Guaranteed benefits must be paid regardless.[30]

An unfunded pension system is entirely predictable. The 2008 financial crisis did accelerate the impact of fundamental management errors and political mischief. The complexity of managing a defined benefit system (long term horizons that require a solid grasp of actuarial science) and the mischief of backroom politics (short term horizons that require a solid grasp of political science) destine defined benefit plans to regular and severe underfunding.[31]

CONSEQUENCES IF THE PENSION PROBLEM IS NOT FIXED.

- **"Crowding Out" effect.** Operating budgets will be increasingly constrained by requirements to pay for past pension promises rather than current services or future infrastructure.
- **Increased borrowing costs and scrutiny.** The rating agency Moody's recently recalculated pension debt using a corporate bond discount rate. As a result, Moody's lowered the bond rating of municipalities and states to better reflect their ability to pay unfunded pension liabilities. A lower rating results in higher borrowing costs, which in turn squeezes the public purse with *absolutely no added value.* Dozens of Minnesota cities have already been downgraded.[32]
- **Putting pension assets at risk.** The legislature directs the SBI to aim for an 8.5 percent rate of return on pension assets. By contrast, the S&P

500 10-year annualized return through 2013 was about 7.4 percent (the highest 10-year annualized return since 2006).[33] SBI's investment returns are supposed to supply a good chunk of pension benefits ($.69-$.73 out of every dollar);[34] this keeps the contribution rates down. The optimistic assumed rate of return (ARR), missed ARC payments and recent investment losses place enormous pressure on SBI to not just meet but to exceed the target of 8.5 percent. It is no surprise then that the risk profile for investments has increased steadily over time. Minnesota's asset mix is more aggressive than private pension funds and even most public funds.[35] Another market downturn could have devastating consequences for the pension funds.[36]

- **The pension problem will hurt job creation both in the public and private sector.** The public sector will face constraints in hiring as it devotes an increasing share of revenue to pension costs. This means fewer teachers in the classroom and police officers on the street. It also puts upward pressure on taxes without delivering any extra value. This will discourage investment and hurt job creation in the private sector.

DESIGNING A SOLUTION THAT IS TRANSPARENT, PREDICTABLE, AFFORDABLE AND FULLY FUNDED

The solution must address all stakeholders: retirees, current and future employees, taxpayers and state and local governments. And the solution should be transparent (understandable to employees, taxpayers and legislators). The costs should be predictable, affordable and fully funded as benefits are earned.

Summary of the solution. We should honor our promises to retirees and current employees. In the near future, however, we should move from a partially funded defined benefit system to a fully funded defined contribution system that takes control of retirement decisions away from politicians and bureaucrats and gives control to public employees.

Recommendation 1: Maintain and *fully fund* the defined benefit plans for retirees and current employees, honoring all earned benefits.

Pensions are an important ethical and legal obligation that must be honored. That means fully funding, on a current basis, retirement benefits as they are earned.[37] This keeps the promise to public employees but also stops the practice of shifting the cost to future employees and taxpayers. It also means realistically addressing today's unfunded liability. **To be clear, this is not a recommendation to increase taxes.** It is a recommendation to fully fund pensions from existing revenue, which may require spending cuts elsewhere.

Recommendation 2: Accurately state and fully disclose the true cost of pensions *for reporting purposes.*

Reporting policy is distinct from funding policy. Accurate reporting will start a much needed state-wide conversation that will better inform the debate and lead to the best benefit and funding policies.

- **Use realistic assumptions.** Use a more realistic assumed rate of return (affects contribution rates and investment policies) and a more defensible discount rate to value liabilities (future benefits).[38] New accounting standards from GASB will be in effect for 2014, so we should see the impact on *reporting (as distinct from funding)* next year.
- **Make public pension data transparent and accessible.** Pension funding data should be published in an accessible format and place by MMB (Minnesota Management and Budget) and on municipal websites. Require the state auditor and legislative auditor to report annually on unfunded liabilities for pensions.[39]
- **Encourage new talent and oversight for pension administration.** Revise laws that require the state to hire executives from a limited pool of retirement system administrators. We should explicitly allow private sector talent to be tapped.[40] We should review the makeup of pension boards and add taxpayer and young employee representatives to balance the influence of union representatives and retirees.
- **No more cash bailouts**. Stop cash bailouts from state taxpayers.[41] If a fund is in distress, that fund should make adjustments (e.g. raise contributions, lower benefits) to close the gap.[42] Taxpayers already pay the employer contribution. They should not cover the employee contribution, as well. After all, they do not get the pension benefit and need to save for their own retirement.

Recommendation 3: Create a defined contribution plan for all new public employees that puts them on a path to a secure retirement and give current employees the option to join.

To stop adding new liabilities to the current system, the defined contribution plan needs to be required for all new employees. There should also be an option for employees in the current defined benefit plan to move to the defined contribution plan.[43]

- **A flexible defined contribution plan should offer employees a wide range of options.** Some employees will want full control and responsibility over their investments while others will prefer to leave the management of investments to others (much like the current defined benefit plan). Similarly, some employees will want an account they draw on as needed (like 401a/403b) while others will want a fixed income (annuities). Employees should have the flexibility to change their plans to reflect their individual needs.[44]

- **The Legislative Auditor should hire an outside consultant to prepare a report for the governor and Legislature on how to implement a defined contribution system.** The consultant should not be hired by the pension plans or the Legislative Commission on Pensions and Retirement because of the inherent conflict of interest (closing the plans that they administer to new members).[45]

> **Note: Minnesota already offers defined contribution plans.** Many Minnesota State Colleges and Universities (MNSCU) employees already take advantage of defined contribution options through an asset manager called TIAA CREF.[46] This successful plan could serve as a model for Minnesota's new defined contribution plan. In theory, the State Board of Investment could manage a defined contribution plan—or the state could choose outside asset managers. These plans are popular because the assets are portable: employees can choose without penalty to change employers and when to retire. And unlike a defined benefit, they feature assets that can be inherited by an employee's spouse, children or other heirs.[47]

Recommendation 4: The state should take immediate steps to preserve and prudently grow pension assets while paying down the unfunded liability.

- **Assets should be preserved**. The funding ratio for payment of COLAs to retirees should be increased from 90% to 100% over a period of years.[48] COLAs should be further reduced on base pensions that received *gratuitous* investment-based post-retirement increases; this will address the drain on assets created by this unique class of benefits and the large inequities among retirees and employees whose contributions help to cover these benefits.[49]
- **Don't chase unrealistic returns.** The SBI asset allocation and investment policies should be reviewed for risk with an eye toward lowering the assumed rate of return to a more reasonable target. The time when returns fall short is usually the worst time to increase contributions.
- **Fix the debt payment.** The current unfunded liability amortization schedule should be changed to a fixed payment ("level dollar" instead of the current "level percent of pay"). This will pay off the debt sooner

and maximize savings.[50]

- **Limit borrowing to pay for benefits.** Municipalities are allowed to issue bonds to pay retirement benefits (pensions or OPEB) *without a referendum*. Review the statutes that allow this borrowing. At a minimum, require a referendum.[51]

The pension problem is one of the most difficult fiscal and political challenges facing the State of Minnesota. Moving new employees into a defined contribution system is achievable in the near future. The more difficult task will be paying down the unfunded liabilities for the existing defined benefit plans. Finding the money from existing revenue will take uncommon courage and talent from our state leaders. But it must be done. We must keep our promises.

HEALTH CARE

State Solutions in an Era of federal control

Peter J. Nelson, J.D.

EXECUTIVE SUMMARY

Minnesota's health care system struggles with many of the same problems as the rest of the country. In particular, high and rising health care costs have long been a top challenge facing Minnesota and the nation. Though it faces similar challenges, the state consistently leads the country in delivering broader access to higher quality care.

The primary explanation for rising health care costs lies in how health care is financed. As third party payers, private insurers and public health care programs insulate patients from the true cost of care. And because employers and the government fund the large majority of health insurance premiums, most people are also insulated from the cost of health insurance. As such, people do not weigh medical treatment costs or health insurance premium costs against their benefits or other spending priorities. Thus, there's very little consumer pressure to reduce health care costs.

In 2010, Congress passed the Affordable Care Act (ACA), also known as Obamacare. Unfortunately, the ACA puts Minnesota's health care system at serious risk. The federal law tends to double down on everything that's currently driving dysfunction in our health care system. It continues insulating people from health care costs by expanding the broken, expensive Medicaid program and mandating traditional employer-sponsored insurance. It also greatly expands costly regulatory burdens on insurers and providers. Thus, the ACA tends to aggravate problems, not solve them.

Beyond cost, the ACA, in combination with other health care trends, is diminishing patient control over their own health care, including their relationship with their doctor, their health records, and their privacy.

All the while, the federal law took problem-solving flexibility away from states—states like Minnesota that were doing many things right—by transferring control over the most important health care regulation from state governments to the federal government.

Looking forward, the passage of the ACA makes the future of health care in Minnesota much more uncertain and challenging. Still, despite entering a new age of federal control over health care, states are not entirely powerless. The following recommendations offer state solutions to address risks posed by the ACA and to improve health care in Minnesota.

Increase competition and affordability in the health insurance market

1. Reduce barriers to employer-based defined contribution health plans.
2. Convert MinnesotaCare into a premium subsidy program that empowers enrollees to afford individual health insurance.
3. Offer state employees a defined contribution health plan option.
4. Expand the insurance market from a state market to a regional market through an interstate health insurance compact.

Promote the next great innovations in health care

5. Apply for an ACA Section 1332 waiver to redesign insurance regulation and insurance premium subsidies to free insurance companies to innovate.
6. Establish a task force to develop strategies to work toward market-based pricing of provider services.
7. Pursue innovative strategies to redesign Medicaid long-term care to control spending growth through a broad waiver.

Enhance patient control over their own health care

8. Empower and engage consumers to manage and control their health care and health data better through personal health records.

THE PROBLEM

Minnesota's health care system struggles with many of the same problems as the rest of the country. In particular, high and rising health care costs have long been a top challenge facing Minnesota and the nation. Though it faces similar challenges, the state consistently leads the country in delivering broader access to higher quality care.

In 2010, Congress passed the Affordable Care Act (ACA), also known as Obamacare. Unfortunately, the ACA puts Minnesota's health care system at serious risk. The federal law tends to double down on everything that's currently driving dysfunction in our health care system. Thus, the ACA tends to aggravate problems, not solve them. All the while, the federal law took problem-solving flexibility away from states like Minnesota that were doing many things right. The ACA in combination with other health care trends is diminishing patient control over their own health care, including their relationship with their doctor, their health records, and their privacy.

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High costs and access limitations pose long-running challenges to the health care system

The basic health care challenges America faces today are not new. Here's how Arnold Rosoff, a business law professor at the University of Pennsylvania Wharton School, described the health care "crisis" in 1975.

> That the health care system in the United States is in a state of crisis is an observation so frequently made that it rarely generates debate any more. The high cost of care is the most dramatic problem, with health care expenditures now totaling approximately eight percent of our gross national product and expected by some to exceed 10 percent in the next few years. No less serious is the problem of availability and accessibility of care.[1]

Nearly the exact statement could be made today, except for the fact that the numbers reveal a much deeper crisis: National health care expenditures now top 17 percent of gross domestic product (GDP).[2]

In terms of access, the uninsured rate provides the main gauge of the problem. The national uninsured rate for people under 65 years old hit a historical low of 12 percent in 1978 and has hovered between 16 and 18 percent since 1990.[3] Beyond the general problem of people lacking coverage, another major concern with access to care has been the fact that many people with preexisting health conditions cannot purchase health insurance.[4]

The main cause of rising costs hasn't been addressed

In 1982, Harvard professor Paul Starr published the seminal history of health care in America, *The Social Transformation of American Medicine*. Though many people at the time attributed rising health care costs to the implementation of Medicare and Medicaid or medical technology advancements, Starr explained the "more fundamental explanation lay in the basic incentives in the health care system, especially its financing arrangements, which Medicare and Medicaid had only reinforced." He went on to explain the problem this way:

> The tolerance of the market for higher prices allowed costs to increase. Higher incomes and higher expectations were partly responsible for that increased tolerance, but the key was the structure of financing.
>
> As third parties, both private insurers and government programs effectively insulate patients and providers from the true cost of treatment decisions and so reduce the incentive to weigh costs carefully against benefits.

The same holds true today. In his 2012 book, *Priceless: Curing the Health Care Crisis*, economist John Goodman describes the problem in similar terms.

> [W]e have completely suppressed normal market processes in healthcare—in this country and all over the developed world. As a result, in healthcare few people ever see a real price for anything. Employees never see a premium reflecting the real cost of their health insurance. Patients almost never see a real price for their medical care. Even at the family doctor's office, it's hard to discover what anything costs. For something complicated, like a hip replacement, the information is virtually impossible to obtain.
>
> On the supply side, doctors and hospitals are rarely paid real prices for the services they render.

While stating basically the same cause of the problem as Starr, Goodman helpfully emphasizes two points. First, insurance consumers are insulated from rising costs because employers pay the lion's share of private insurance premiums. As such, people do not weigh medical treatment costs or weigh health insurance premium costs against their benefits or other spending priorities.

Second, there is no normal, free market for health care. The power of a market is its ability to organize complex systems. No top-down approach can ever match a market's ability to allocate resources to their highest and best use, to identify consumer demand for high quality and low prices, and ultimately to meet those demands. It's the suppression of market forces that has permitted health care costs to rise faster than inflation for a half century. Though some say markets can't work in health care, the evidence points in one direction, according to Goodman, and shows "markets can work much better than our current system, if they are allowed to do so."

Unfortunately, since the health care crisis emerged in the 1970s, America has primarily tried top-down "solutions," not market-based solutions. These top down solutions generally aim at regulating the health care system to expand access and control prices and nearly always stir up unintended consequences and fail to tackle the underlying problem. The government simply can't organize something as complex as the health care system any better than the Soviet Union could organize the delivery of basic consumer goods. Yet that hasn't stopped the government from attempting to set health care prices and dictate the type of health care people must buy. The ACA is simply the most recent and comprehensive attempt at central planning of our health care system. Predictably, none of this has "bent the cost curve."

Minnesota does not escape high and rising health care costs

How does Minnesota's health care system fare?

There is a perception health care costs substantially less in Minnesota—a perception that Minnesota mitigates, at least in part, the perverse financial incentives driving up costs.[5] However, high and rising health care costs pose just as serious a problem for Minnesota as elsewhere.

To establish a pre-ACA baseline, the Centers for Medicare & Medicaid Services (CMS) created state-level estimates of health spending per capita for the years 1991 to 2009. [6] During this period health spending per person in Minnesota grew at an average annual rate of 5.9 percent, faster than the national average of 5.3 percent. By 2009, health care spending per person in Minnesota reached $7,409, which was nearly $600 (nine percent) more than the national average.[7]

The U.S. Department of Health & Human Services Medical Expenditure Panel Survey (MEPS) shows private health insurance in Minnesota costs about the same as the national average. Between 2009 and 2012, the average family coverage premium for private sector employees cost $14,513 in Minnesota compared to $14,348 nationally.[8] Single coverage premiums in Minnesota cost $5,082 compared to $5,054 nationally.[9]

Looking forward, projected growth in Minnesota health care costs mirrors the high growth projections for the nation. Annual growth in health care spending for both Minnesota and the nation is projected to average six percent or more. [10]

This is faster than the economy is projected to grow, which means health care spending will continue to consume a larger share of GDP.[11] As a result, an increasing portion of workers' wages will go to pay for health insurance and leave families with less income to improve the house, send kids to camp, and save for retirement. State and federal governments will either have to raise taxes—again leaving less income for families—or reduce spending on other priorities like education and transportation. Most likely, they will do some of both.

Minnesota performs better on quality and access

Though Minnesota might not deliver lower-cost care, it does deliver higher quality and broader access than nearly every other state. Among the states, the Commonwealth Fund 2014 Scorecard on State Health System Performance ranks Minnesota number 1 overall.[12] The United Health Foundation ranks Minnesota as the third healthiest state.[13] Digging deeper into the United Health quality rankings, Minnesota has fewer low birth weight babies, fewer preventable hospitalizations, and fewer people with diabetes. Additionally, the state boasts the lowest percentage of people reporting poor physical health, the lowest cardiovascular death rate, and the lowest premature death rate.

The uninsured rate in Minnesota is also among the lowest in the nation. In 2013, according to the most recent Census Bureau data, the state had the sixth lowest uninsured rate.[14] As recently as 2005, Minnesota had the lowest uninsured rate.[15]

People with preexisting conditions also had better access to affordable health coverage in Minnesota. Since 1976, any Minnesotan denied coverage in the regular insurance market has been able to gain coverage through the state's high risk pool. Premiums for this coverage were capped by law at 125 percent of comparable private coverage. Though 35 states also ran high risk pools, Minnesota's pool offered the best protection. No state had more covered lives in their pool than Minnesota.[16]

A number of factors contribute to these better outcomes. To start, the people of Minnesota tend to make healthier choices. A very large portion of Minnesota workers receive coverage through their employer. Minnesota's hospitals and clinics hold a well-deserved reputation for excellence. And Minnesota health insurance companies always seem to be on the leading edge of innovating new health plan designs.

Even state regulation deserves some credit. As already noted, people with a preexisting condition have long been able to access affordable insurance through the state's high risk pool, which appears to have contributed to a more stable insurance market.

That said, state regulations often go too far. For instance, Minnesota subjects insurers to 49 coverage mandates, the sixth most in the country.[17] The results of a recent study published in the *Eastern Economic Journal* found "that mandates seem to account for 9.3 percent to 23.6 percent of all premium increases from 1996 to 2011."[18] Part of the state's success may be tied to the fact that Minnesota leads the country in the proportion of people who manage to avoid state insurance regulations altogether. Around 70 percent of Minnesotans with employer-sponsored coverage are in self-insured health plans—plans where the employer assumes the financial risk—which are exempt from state regulation.[19]

The ACA will aggravate problems

The Affordable Care Act (ACA) was enacted in 2010, purportedly to address many of the problems discussed above. Indeed, after signing the ACA, President Obama claimed the law would expand coverage and lower costs.[20] The ACA will indeed expand coverage, but only by increasing costs and aggravating other problems. As mentioned above, health care inflation is not projected to "start slowing down" as the President said it would.

Health care costs will continue inflating because the ACA expands coverage by doubling down on the dysfunctions and perverse financial incentives that have long been the source of higher costs. First, it relies on expanding Medicaid—a state and federal public health care program long beset with cost and quality problems. Second, it relies on mandating traditional employer-sponsored coverage. Employers play an important financing and administrative role, but traditional employer-sponsored health plans continue shielding employees from the true costs of insurance. Third, it relies on substantially increasing the regulatory burden on insurers and providers. Each new regulation adds new costs, and most will have unintended consequences.

The ACA diminishes individual patient control over health care

Beyond cost, the implementation of the ACA diminishes the individual patient's control over their health care. Here are some of the key ways the ACA reduces patient control:

- The ACA reduces the types of insurance options available to people. Mandates force people to pay for benefits they don't need.
- The ACA limits innovations that might improve the customer experience and the quality of care. Health plans must spend a specific portion of a premium on health care. This limits what they can spend to improve the customer experience in other ways, such as spending to provide consumers with more transparent information on provider prices and to integrate the health plan with personal health records.
- The ACA reduces the time doctors can spend with patients by increasing the time they must spend satisfying new administrative burdens, especially requirements related to implementing Electronic Medical Records.
- The ACA reduces the pool of doctors available to Medicaid and Medicare patients. Many doctors don't accept Medicaid patients because the program's reimbursement rates are too low. Expanding Medicaid expands

doctors' incentive not to see Medicaid patients. The ACA also cuts Medicare reimbursements, which increases a doctor's incentive to opt out of Medicare.

- The ACA encourages doctors to deliver care based on the health of the population versus the health of the individual patient. A common criticism of the health care system is that it pays for volume, not value. The ACA, through Medicare demonstration projects, encourages movement toward value-based purchasing. Value-based purchasing, however, tends to require someone other than the patient, such as the government or an insurer, to define value. If the value equation isn't driven by the patient, it will likely be driven by what is generally best for the health of the population.

ACA limits Minnesota's ability and flexibility to solve health care problems

On top of aggravating the primary existing problems in the health care system, the ACA limits what states can do to help solve these problems. There's truth behind the charge that the ACA is a government takeover of the health care system. More precisely, the ACA is a *federal* takeover, an unprecedented transfer of control over health care regulation from state governments to the federal government.

While the supporters of the law claim that states remain in control of health insurance regulation, the federal government took over the most important aspects of insurance regulation. The federal government defines the following:

- when insurers must sell insurance to individuals;
- the base level of benefits insurers must provide;
- how much of an insurance premium must go toward health care expenses;
- the preventive services health plans must cover at no charge;
- how much young adults must subsidize older adults;
- the limits on the size of a deductible;
- which employers must provide health insurance; and
- the features that must be included in the new health insurance marketplaces.

With all the new federal insurance regulations, there's very little left for states to control. Thus, there's very little flexibility left to Minnesota to develop and promote state-based solutions to improve health insurance coverage.

The ACA puts Minnesota's health care system at risk

Recall how Minnesota's health care system delivers higher quality and broader access. The ACA puts Minnesota's health care system at risk because it touches every player driving Minnesota's better health care outcomes—patients, providers, employers and the state. Some risks are obvious. Patients may start having more trouble accessing their preferred doctor if health plans move to narrower networks. Providers may further consolidate and reduce what value-enhancing competition exists. State health care spending may crowd out education spending or other state priorities. Individuals and employers, especially small employers, may see dramatic rate increases. Health care quality may decline if doctors are distracted by unnecessary administrative burdens. Other consequences, because they're unintended, are not as obvious and the state will have to wait to see how the law plays out.

Still, despite entering a new age of federal control over health care, states are not entirely powerless to address these risks and to work toward real health care solutions. The rest of this report outlines steps Minnesota can and should take to improve health care.

WHAT MUST BE DONE

Moving forward, states can continue to lead. Specifically, Minnesota should focus on increasing competition and affordability in the health insurance market, maintaining an environment that promotes the next great innovations in health care, and enhancing patients' control over their own health care.

Increase competition and affordability in the health insurance market

Though health insurance markets are now primarily regulated at the federal level, there are certain strategies the state can implement to increase competition and thereby increase affordability. One of the main factors driving higher health care costs discussed above is that people with employment-based health insurance are rarely exposed to the cost of health insurance and, therefore, never need to weigh the cost of insurance against other priorities in their lives. The state should focus on advancing the individuals' roles in shopping for and ultimately owning their own health insurance. In addition, there are steps the state can take to encourage more insurers to compete in the market.

Recommendation 1: Reduce barriers to employer-based defined contribution health plans

Employers play an important role in providing access to affordable, high quality health insurance and will continue to do so. The federal tax code's preference for employer-sponsored coverage, however, creates a strong incentive for one type of employer-based health plan model. Under this model, the employer makes all the decisions and the individual employee is insulated from the consequences of those decisions. Employers should be allowed to rebalance their health plans to give individuals more choice and ownership over their health plans, while still maintaining the tax preferences available to traditional health plans. This more balanced approach is called a defined contribution (DC) health plan.

In a DC plan, the employer provides the employee with a defined (fixed) dollar amount each month, which the employee can then use to shop for a health plan on the individual market. Private retirement plans long ago successfully shifted to this model. Most people are familiar with 401(k) retirement plans; a DC health plan would be structured similarly.

Both the employer contribution and any employee contribution, if necessary, should be made pre-tax. Because the health plan is purchased on the individual market, employees own their health plans and do not lose them when they switch or leave jobs.

Unfortunately, there are both state and federal barriers to DC health plans. To reduce these, the state should take the following two steps:

1. *Allow insurance brokers to advise employers to switch to a DC health plan.*

At the state level, an outdated law—according to some interpretations— restricts insurance brokers from advising lawmaker to switch from a traditional group health plan to a DC health plan to fund individual health insurance premiums. This law should be repealed.

2. *Create a new type of group insurance coverage to accept pre-tax contributions from employers that easily converts group coverage to individual coverage (and individual coverage to group coverage) with changes in job status.*

The federal barrier to a DC health plan is more serious. Federal agencies issued guidance last year which generally prohibits employers from making contributions to fund *individual insurance coverage* through a DC health plan.[21] The reason for the prohibition is largely to protect against employers dropping group coverage, either because they have sicker, more expensive employees or because they want to double dip on tax advantages available to employer contributions and tax subsidies available to individuals in the exchange.[22] The guidance basically states that an employer health plan can be integrated with *group* insurance coverage, but cannot be integrated with *individual* insurance coverage.

The state should create a new type of group insurance coverage that employers can fund with pre-tax contributions under a DC health plan. To gain the benefits of individual choice and individual ownership over health insurance coverage, this new group coverage should easily convert to individual coverage and then back to group coverage. To do so, people covered by the new group coverage should be in the same risk pool as people with individual coverage, and benefits and cost sharing should be identical. In effect, this would be a merger of the individual and group markets.

Helpfully, the ACA specifically allows for at least the individual and small group markets to be fully merged together.[23] A partial merger where small and even large employer groups could choose to pool with either the individual market in a DC health plan arrangement or remain with the traditional group markets may also be possible.[24] A partial merger would not upset current group insurance arrangements and would allow large groups to participate. However, giving employers a choice could lead to an adverse selection problem where healthier groups tend to pick one pool and less healthy groups pick the other. These benefits and risks would need to be weighed carefully.

Furthermore, the Minnesota Department of Commerce will need to provide a clear regulatory framework to establish that this new type of group coverage satisfies the ACA's health plan requirements at issue. In doing so, the state should be sensitive to the federal concerns behind the prohibition on employers making pre-tax contributions to individual health plans. To the extent the federal government has reason to worry about employers "abusing" the tax code, the state can fix the problem when politicians at the federal level cannot by banning employers from contributing to health plans sold through the state insurance exchange. This sensitivity should help avoid any push back from the federal government.

Recommendation 2: Convert MinnesotaCare into a premium subsidy program that empowers enrollees to afford individual health insurance.

MinnesotaCare is administered through private managed care health plans. However, MinnesotaCare is not a traditional insurance product, and like every government health plan, it reinforces the perverse financial incentives that increase health care costs. Providing a premium subsidy would empower people to own true individual insurance coverage that they could continue owning as their income rose above MinnesotaCare's income thresholds.

Recommendation 3: Offer state employees a defined contribution health plan option.

The state should offer a DC health plan option for state employees. The advantages to empowering individuals to choose and own their health plan is no different for state employees. Currently, the average premium for a state employee with single coverage is $503 and the average premium for an employee with family coverage is $1,480.[25] The state covers the full amount for single coverage and $1,333 for family coverage, on average. These amounts are more than enough to provide meaningful coverage options through a DC health plan.

Recommendation 4: Expand the insurance market from a state market to a regional market through an interstate health insurance compact.

The state should allow Minnesotans to buy health insurance across state lines with our Midwestern neighbors through a regional insurance market, such as but not limited to a "Health Care Choice Compact" under Sec. 1333 of the ACA. An interstate health insurance compact would create uniform regulatory standards across member states that allow individuals to purchase health insurance products from these other states. This compact would operate much the same way as the Interstate Insurance Product Regulation Commission, an organization that "serves as a central point of electronic filing for certain insurance products, including life insurance, annuities, disability income, and long-term care insurance to develop uniform product standards, affording a high level of protection to purchasers of asset protection insurance products."[26] A similar compact would provide consumers with access to more competitive health insurance products without sacrificing consumer protection standards.[27]

Promote the next great innovations in health care

Too often, state and federal regulations stymie innovations in health care. Health benefit mandates, limits on cost sharing, and other health insurance regulations on health benefits restrict health insurers from innovating new insurance products. Physicians, clinics, and hospitals also must be freed from stifling regulation and bureaucracy to use their intelligence and creativity to develop and adopt new strategies to deliver higher quality care at a lower cost.

Recommendation 5: Apply for an ACA Section 1332 waiver to redesign insurance regulation and insurance premium subsidies to free insurance companies to innovate.

The ACA's federal takeover of insurance regulation leaves little left to states to regulate and little room for insurers to innovate. However, the ACA does give states the opportunity to apply for a "Waiver for State Innovation," otherwise known as a Section 1332 waiver. Under a 1332 waiver, Minnesota may request to waive the ACA's requirements related to qualified health plans, essential health benefits, limits on cost sharing and deductibles, metal level categories, actuarial value, and insurance exchanges. In addition, states can request to waive IRS regulations on premium tax credits, the employer mandate, and the individual mandate. The law encourages states to combine this waiver request with other requests to waive Medicaid and Medicare regulations. Altogether, this waiver provides an opportunity to redesign both insurance regulation and insurance premium subsidies.

Of course, there are strings attached to receive a waiver. The state plan must provide coverage that is at least as comprehensive as the essential health benefits now required, coverage and cost sharing that is at least as affordable as ACA coverage, coverage to a comparable number of residents, and must not increase the federal deficit.

Vermont officials plan to use this waiver to move toward a single-payer system, but there is no reason the same waiver could not be used to move toward market-based health care. Here are some important improvements a state could make through a 1332 waiver:

- Limit MNsure, the state insurance exchange, to qualifying people for public programs and subsidies, which would protect the insurance market from any duplicative and distortionary behavior on the part of MNsure.
- Reduce disincentives to work found in the current structure of premium subsidies.
- Redesign premium subsidies to focus on the truly needy by, for instance, imposing an asset test to qualify.
- Give insurers more freedom to set minimum health benefits.
- Empower employers to design their own health plans.
- Eliminate the mandate on individuals to buy insurance.

Recommendation 6: Establish a task force to develop strategies to work toward market-based pricing of provider services.

A common criticism of the health care system is that providers tend to be paid a fee for each service they deliver, which perversely rewards them for delivering higher volume, not higher value. There's some truth to this, but fee-for-service payment is not the problem. The problem is that the prices (fees) set for each service are usually cost-based prices, not market-based prices. The price of each service tends to be set by Medicare which bases the price on the cost of delivering the service. Medicare pricing tends to guide pricing in the rest of the market.[28] When services are priced on their cost, the price fails to reflect the consumer demand for the service or any additional value the service might deliver. Cost-based pricing also fails to put pressure on reducing the price because the price and the cost of the service are one in the same. As a result, cost-based pricing fails to reward innovations that deliver lower costs and higher value.

Prices for provider services should be set by the market, not by the government. A market sets prices based on cost, demand, and value. This pricing rewards entrepreneurs who innovate ways to lower costs or provide services that better align with what consumers want. Moving toward market-based pricing is easier said than done. Health care pricing and provider payment systems are incredibly complicated. Furthermore, Medicare presents a powerful influence over prices and, therefore, a powerful obstacle to market-based pricing. To wade through the complexity, the state should establish a task force to develop a strategy to work toward market-based pricing.[29]

Recommendation 7: Pursue innovative strategies to redesign Medicaid long-term care to control spending growth through a broad waiver.

According to the report of the Minnesota Budget Trends Study Commission, "The aging of the population means that a larger share of the population will become eligible for and begin using expensive long-term care services under the Medical Assistance program." [30] Due to this rising demand and the substantial portion of state spending already devoted to long-term care, the state should renew its focus on innovating new ways to finance and deliver long-term care.

In a bipartisan effort, the state recently sought to redesign Medicaid long-term care through the Reform 2020 initiative. Despite only modest savings projected from the initiative, it represented a positive step forward. Unfortunately, the federal government approved only two of twelve Reform 2020 elements.[31] While the federal government's waiver rejection is a substantial setback, Minnesota should redouble efforts to innovate and redesign Medicaid long-term care. The status quo is simply not sustainable. These efforts should focus on developing waiver proposals for the next presidential administration.

Enhance consumer control over health care management

Recommendation 8: Empower and engage consumers to manage and control their health care and health data better through personal health records (PHRs)

As our society moves to more management of our personal lives through sophisticated mobile devices, most health care data has been pulled in a different direction, stored in mega-data banks under the control of entities which either process payment or in Electronic Health Record (EHR) banks controlled by the EHR vendor and its hospital system contractor. These records are often incomplete for many reasons, including the mobility of Americans. This data management by outside entities does little to empower or engage the consumer in his or her management of both wellness and health care.

Personal health records (PHRs) can be a powerful tool for patients to control and manage their health care and wellness. Most progress has been made recently on "wellness apps" which track everything from sleep patterns to calories burned. While some of these products may not serve clinical value, most do encourage engagement by consumers in their own health and wellness. This interest should be expanded and empowered through further development of robust, interoperable PHRs. A PHR gains even more importance in light of all the ways the ACA diminishes patient control outlined previously. A PHR is distinct from an electronic health record EHR: While a PHR is managed by the patient, an EHR is managed by health care providers or payers.

EHRs pose a number of problems. First, despite a state law requiring providers to adopt EHRs that are interoperable "for sharing and synchronizing patient data across systems," this does not appear to be taking shape.[32] Thus, an Allina doctor cannot easily access a patient's data housed in a HealthPartners' EHR. Second, EHR data are generally not easily shared and synchronized with PHRs. Thus, patients can be dependent on multiple providers' EHR systems to access and manage information. Third, EHRs are not controlled by the patient. Though most patients probably want some of their data stored by their provider and shared across provider systems, patients often have legitimate privacy concerns over some or all of their health data.

So, on one hand EHRs are not yet equipped to share enough data across provider systems and PHRs. On the other hand EHRs risk compromising patient privacy if they do store and share data the patient wants private. EHRs present at least one additional problem: government efforts to push providers to adopt EHRs create excessive and expensive administrative burdens, especially because of the lack of national standards for interoperability.

The state should establish a new statewide policy on PHRs and EHRs to help address some of these problems and empower patients to manage their health care and control their health data better. A new policy should encourage the following changes:

- Extend the functionality of EHRs to share and synchronize data with a patient's choice of PHR. This includes a standard for the PHR that limits alteration of data in the PHR but also allows the patient control over what data can be held private and not loaded into an EHR. Integrated EHR and PHR arrangements exist, but the integration is proprietary and so patients are locked into one EHR/PHR package;
- Enable patients to control the privacy of their EHR data better, preferably through their PHR. This empowers the patient as it requires the EHR provider to seek specific, rather than blanket, permission to share the patient's personal health information; [33]
- Share and synchronize insurance claims data with PHRs. Through MyMedicare.gov's Blue Button, Medicare already provides an easy way to download personal health information and import it into a PHR;[34]
- Reduce EHR (and PHR) reporting burdens on providers. Ideally, these burdens would be eliminated for small and independent providers; and

- Identify and remove barriers to adopting industry standards for interoperability. To share and synchronize data, an industry standard for connectivity is necessary to facilitate the secure movement of data across the Internet just like there is an industry standard to guarantee leak-free movement of water across plumbing fixtures or to transfer money through ATM machines. To date, specific industry vendors have blocked progress on an industry standard for competitive reasons, despite the billions of dollars invested in EHRs.[35]

UNLEASHING MINNESOTA'S JOB CREATING POTENTIAL

Ron Eibensteiner, Ted Risdall and John Gaylord

EXECUTIVE SUMMARY

The Problem

Minnesota has long been a fertile state for growing successful businesses. The roster of Fortune 500 companies headquartered in Minnesota in the 1970s testifies to the vital role the state's agricultural, forestry, and mining resources played in setting the foundation for a strong economy. Minnesota's history of successful business enterprises now extends well beyond the companies that sprouted from the state's prairies and forests, proving that the people of Minnesota are the state's most valuable resource. The diversity and success of Minnesota's businesses now form the foundation of an enviable economy.

The biggest risk facing Minnesota's economy: Complacency. Minnesota's past performance does not guarantee future results. Data on the state's workforce and economy demonstrate Minnesota cannot afford to be complacent.

Despite Minnesota's low unemployment rate, there are weak spots in the labor market. Though Minnesota regained jobs lost during the recession more quickly than many states, job growth has fallen behind the national average in the past two years. The state's low unemployment rate masks the number of discouraged workers who have left the workforce and people working part time because they can't find full-time jobs. In addition, Minnesota's labor force participation rate is declining among young people and people in the prime of their working lives. Long-term economic trends also reveal cause for concern. Since the 1970s, Minnesota's ten-year employment growth rates regularly beat the U.S. and Midwest averages. Yet beginning in 2005, Minnesota dropped below the U.S. average. GDP growth since 2000 has been just average. In addition, startup activity is down, IRS data show income leaving the state, and Minnesota's workforce productivity is showing signs of weakness.

The troubling economic trends outlined above show the state must pay close attention to anything that might be undermining Minnesota's job-creating capacity. These factors include high taxes, burdensome regulations, weak business clusters, declining capital investment, ongoing skills gaps in education, and inefficient distribution of economic development funds.

Globalization also presents a challenge. In a general sense, globalization heightens the importance of every factor just listed. In particular, having competitive tax and regulatory environments and making sound investments in the state's labor force and infrastructure gain increasingly more importance as Minnesota tries to compete globally.

The Solution

The trends and challenges outlined above demonstrate that Minnesotans should not be satisfied with the performance of the state's economy and job market. Many policies must be changed and new policies adopted for the state to reach its full potential. To improve Minnesota's jobs environment, the state should focus on two strategies. First, reduce regulatory burdens on Minnesota businesses. Second, provide broad-based support for economic development that avoids picking winners and losers.

Reduce Regulatory Burdens

1. Establish an Office of Regulatory Oversight in the legislature to evaluate state and local regulations.
2. Require state agencies to evaluate all regulations for adverse effects on small businesses.

3. Sunset state occupational regulations.
4. Create an Office of Regulatory Assistance.
5. Guarantee workers the freedom to choose whether to join a union.

Provide broad-based support to businesses; stop picking winners and losers

6. Reduce corporate taxes.
7. Create an advisory council to recommend ways to expand and improve Minnesota's incentives for business investments.
8. Change DEED's focus from investment to support.
9. Provide a tax credit to businesses for preparing workers in an apprenticeship program.
10. Create an Internet-based databank to provide more detailed and objective economic and demographic analysis for Minnesota policymakers and businesses.
11. Narrow the information gap between youth and employers.

THE PROBLEM

Minnesota has long been a fertile state for growing successful businesses. The roster of Fortune 500 companies headquartered in Minnesota in the 1970s—including Green Giant, General Mills, Pillsbury, Hormel, International Multifoods, Hoerner Waldorf, and 3M—testifies to the vital role the state's natural resources played in setting the foundation for a strong economy. Still, these businesses did not succeed spectacularly by simply extracting the state's resources. They grew by turning these raw materials into higher-value products for American consumers. This took entrepreneurial vision and a capable workforce.

Minnesota's history of successful business enterprise now extends well beyond the companies that sprouted from the state's prairies and forests, proving that the people of Minnesota are the state's most valuable resource. Minnesotans' innovative spirit and work ethic have led to remarkable business successes across nearly every sector of the economy, from food processing to financial services to retail to manufacturing to transportation. The diversity and success of Minnesota's businesses now form the foundation of an enviable economy. As a result, economic growth in Minnesota has historically outpaced other states and served both to drive higher standards of living and to position Minnesota as a desirable place to locate a business. Currently, Minnesota's 4.3 percent unemployment rate is the sixth lowest in the nation. Per-capita personal income is the thirteenth highest in the nation and—excluding North Dakota, which is in the midst of an energy boom—the highest in the Midwest. Minnesota also regularly appears at the top of national lists of best states for business.

The biggest risk facing Minnesota's economy is complacency. Successful companies always pay close attention to competitors and adjust their business strategies to new realities. To thrive, the state of Minnesota must do the same. Yet many people seem too satisfied with the direction of the state. The fact is, Minnesota's past performance does not guarantee future results. Despite Minnesota's low unemployment rate, there are a number of weak spots in the labor market. Furthermore, several economic indicators point to long-term problems for the state's workforce. A number of factors are converging to lessen or even eliminate many of the advantages that have long supported Minnesota's economy. The state is slipping under current policy, but the full impact will not be felt for years. The solutions offered in this report aim to address this.

Past Performance Does Not Guarantee Future Results

Minnesota is home to many great companies that have been a driving force behind the state's success. However, that strength was established years ago, and Minnesota cannot rely on those companies for tomorrow's jobs. The state's future economic performance depends on new companies. Recent research demonstrates the job-creating prowess of small businesses is generally limited to young startups.[1] Economists Edward Prescott (a Nobel laureate who formerly taught at the University of Minnesota) and Lee Ohanian explained the importance of startups in a *Wall Street Journal* editorial last June:

> New businesses are critical for the U.S. economy to grow because a small fraction of today's startups will become tomorrow's economic heavyweights. Most of today's workers are employed at older, established businesses, but the country cannot rely on existing companies to boost the economy. Businesses have a life cycle in which even the largest and most successful reach a stage at which they stop expanding.[2]

Many Fortune 500 companies in Minnesota appear to have hit this stage, at least in terms of expansion in the state. **Table 1** shows the number of Minnesotans employed by the largest Fortune 500 firms with substantial business operations in Minnesota. Target, 3M, Delta Airlines, and Supervalu all report fewer Minnesota employees in 2012 compared to 2000. Most other companies report only modest gains. The state rightly takes pride in these companies, but this pride risks making Minnesotans complacent about what new businesses need to succeed. The following data on the state's workforce and economy demonstrate Minnesota cannot afford to be complacent.

Table 1: Number of Minnesotans Employed by Selected Fortune 500 Companies									
	Target Corporation	UnitedHealth Group, Inc.	3M Company	Delta Airlines	U.S. Bancorp	Supervalu, Inc.	Medtronic, Inc.	Hormel Foods Corporation	Best Buy Company Inc.
1995	22,600	3,145	23,127	16,770	10,938	5,000	4,600		3,192
2000	35,047	4,694	18,179	21,303	10,834	8,600	5,696	7,167	6,500
2010	28,381	11,500	14,275	13,000	10,482	9,052	8,000	7,848	6,982
2011	30,525	12,000	15,000	13,000	10,655	8,646	8,000	7,885	7,459
2012	30,773	18,000	15,000	9,000	10,883	8,300	7,898	7,976	7,555

Source: Corporate Report and Twin Cities Business Corporate Lists, various years.

Table 2: Private Employment Growth						
	10 yr (2004 to 2013)		5 yr (2008 to 2013)		1 yr (2012 to 2013)	
	Growth	State Rank	Growth	State Rank	Growth	State Rank
Minnesota	4.12%	22	0.78%	10	2.02%	18
United States	4.12%		-0.20%		2.09%	

Source: Bureau of Labor Statistics, Quarterly Census of Employment and Wages.

Minnesota's Economy Is Leaving Many Workers Behind

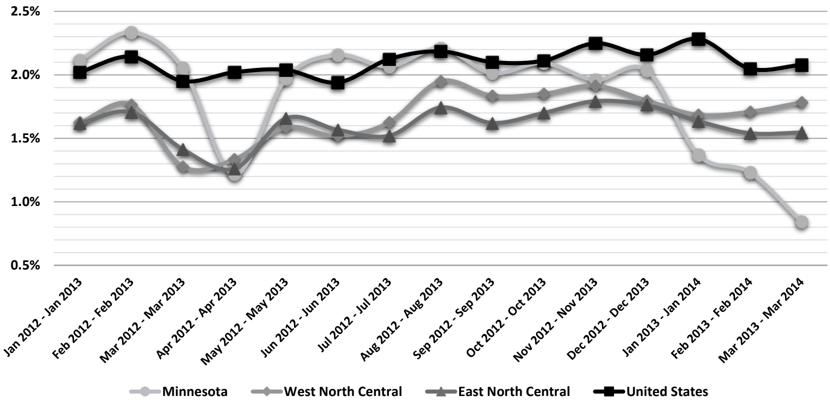
Reporters on Minnesota's relatively low unemployment rate generally acknowledge that "the signs of strength in the job market mask a lot of economic pain that remains."[3] The fact is, today's 4.3 percent unemployment rate exists in a much weaker job market than in November 2006, the last time the rate was as low. Lower employment growth, continued under-employment, and declines in labor force participation all point to a job market that leaves much to be desired.

Recent Job Growth Is Low

During the past ten years, employment growth in Minnesota has been just average. As shown in **Table 2**, Minnesota's 4.12 percent employment growth between 2004 and 2013 exactly matched the U.S. growth rate and underperformed 21 other states. Although Minnesota's job market pulled out of the Great Recession faster than most states, annual job growth in the state has been below the national average for the past two years.

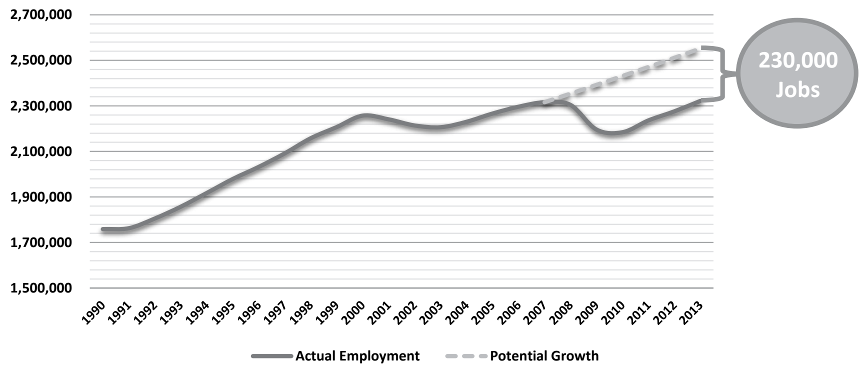
Newly released employment data suggest employment growth in Minnesota is slowing well below the national average. Annual employment growth in Minnesota, measured on a monthly basis by the Bureau of Labor Statistics Quarterly Census of Employment and Wages, began dropping below the national average in January 2014. **Figure 1** shows the annual employment growth preceding each month between January 2013 and March 2014. Between March 2013 and March 2014, Minnesota dropped well below the U.S. average and ranked last among Midwestern states. Data show that less hiring is the primary issue in

Figure 1: Annual Employment Growth by Month



Source: Bureau of Labor Statistics, Quarterly Census of Employment and Wages.

Figure 2: Potential Job Growth since 2007 if Minnesota Matched the Average Annual Growth Experienced from 1990 to 2007



Source: Bureau of Labor Statistics, Quarterly Census of Employment and Wages.

flagging job numbers today, not layoffs or firings.[4]

Employment Gains Have Not Made Up for Lost Growth

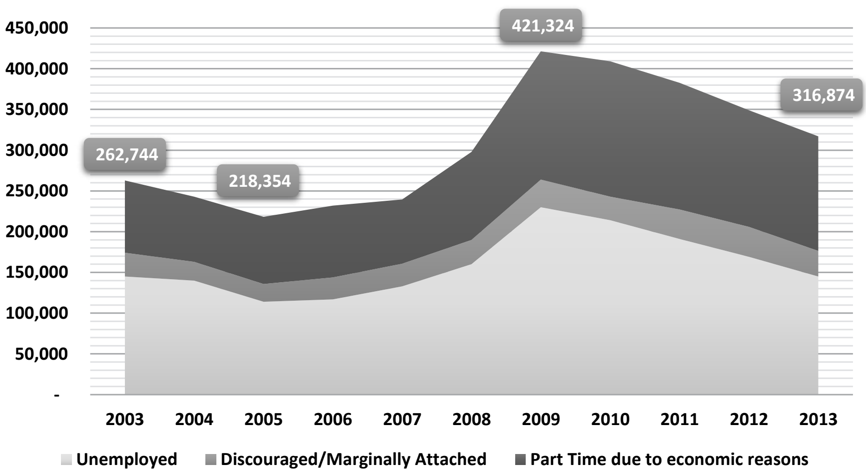
Minnesota has now recovered the jobs "lost" in the recession, but this does not account for the job growth missed during those years. If job growth had continued after 2007 at the 1.6 percent average annual rate experienced between 1990 and 2007, **Figure 2** shows Minnesota would have 230,000 more jobs in 2013. This is not to say that the job losses were avoidable or even that another 230,000 jobs represents an ideal size for the job market. The point is that substantially more growth is needed for the job market to recover fully.

Unemployment Rate Undercounts the Number of Unemployed and Under-Employed

Though Minnesota's unemployment rate is relatively low, digging a little deeper reveals a large number of people still left behind. The nominal unemployment rate does not include discouraged and marginally attached workers who have stopped looking for work, nor does it include people working part time because they can't find full-time work. If included, these people would represent more than a doubling of the standard unemployment rate.[5] **Figure 3** shows there were still nearly 100,000 more people not fully employed in 2013 compared to 2005.

More hallmarks of today's job market are individuals who can't find work for six months or more, degree-holders working at jobs where no degree is required, a dramatic upswing in part-time work, disproportionate numbers of government hires,[6] and a boom in temporary labor with no benefits.[7] Because the unemployment rate doesn't account for these factors, it overstates the health of the job market. These are not "questionable and tangential factoid[s]," as Minnesota's current governor recently argued.[8] Concerns about the value of using the standard unemployment rate to describe the health of the state's economy are shared broadly among economists.[9]

Figure 3: Number of Minnesotans Underemployed



Source: Bureau of Labor Statistics, Local Area Unemployment Statistics.

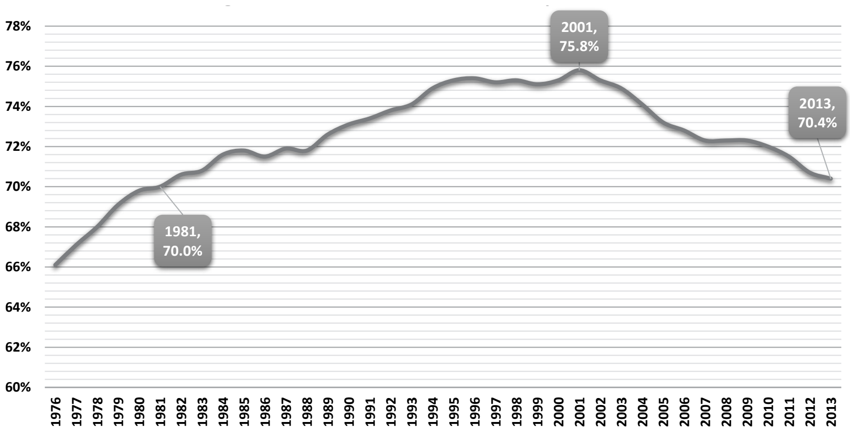
The Labor Force Participation Rate Continues to Decline

Minnesota's falling labor force participation rate offers further evidence of weakness in the job market. In fact, workforce departure is a big factor behind the state's declining unemployment rate. When an unemployed person leaves the market, there is one less person in the numerator of the unemployment rate, which leads to a lower rate. The state economic forecast confirms that Minnesota's favorable unemployment rate benefits from a "sharp decline in labor force participation."[10]

Labor force participation, defined as the population either working or actively seeking work, is at its lowest level since 1980 in Minnesota, as shown in **Figure 4**. Minnesota labor force participation has declined from a high of 75.8 percent in 2001 to 70.4 percent in 2013. If today's workforce matched the participation rate in 2000, there would be another 176,000 Minnesotans in the labor market. That's not too far from the 230,000 jobs Minnesota would have had if the job market had maintained average annual growth through the recession.

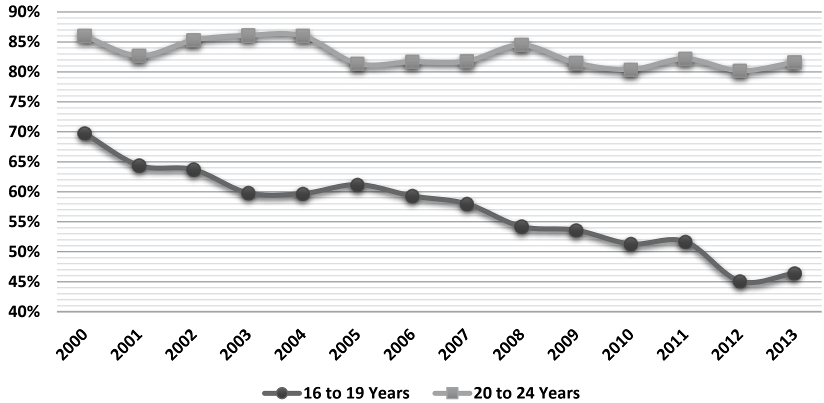
State officials blame retiring baby boomers for the much of the decline, suggesting there's not much the state can do about it.[11] Retirements account for part of the decline, but **Figure 5** reveals a dramatic drop in the rate of young people participating in the labor force, and **Figure 6** shows a worrisome drop among people in the prime of their working lives. The weight of evidence in the economic literature confirms economic weakness is the primary factor behind declining labor force participation rates since the start of the Great Recession.[12]

Figure 4: Minnesota Labor Force Participation Rate



Source: Bureau of Labor Statistics, Local Area Unemployment Statistics.

Figure 5: Minnesota Labor Force Participation Rate, Teenagers and Young Adults



Source: Bureau of Labor Statistics, Local Area Unemployment Statistics.

Economic trends reveal cause for long-term concern

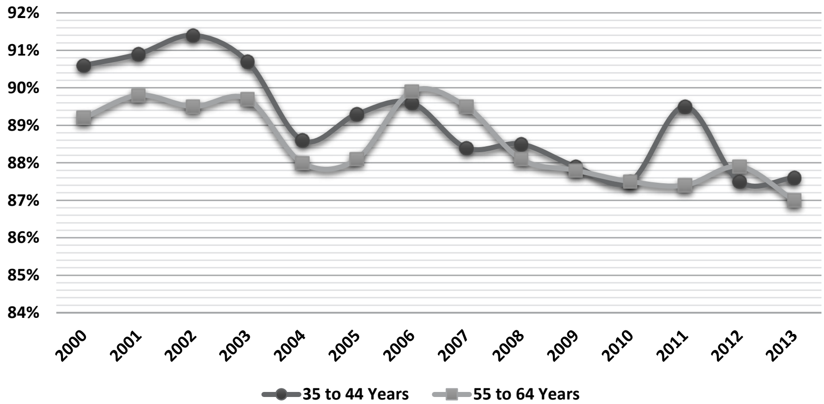
A number of additional economic trends are perhaps more worrisome than the current job situation.

Long-Term Employment Growth Waning

To understand long-term trends in the stock market, analysts often look to ten-year "rolling returns," which track the ten-year stock growth preceding each year. The same can be done for employment growth. **Figure 7** charts the difference between Minnesota's ten-year rolling employment growth rates and rates for the United States and the Midwest. It specifically shows whether Minnesota's employment growth rate was higher or lower over any ten-year period ending in 1970 to 2013.

Until 2005, Minnesota growth rates were consistently higher than both the United States and the Midwest, save for a five-year period between 1986 and 1990. The state's higher than average growth in the 1990s began declining in 2000. Since 2005, Minnesota ten-year employment growth has been slightly lower than the national average. Minnesota employment growth dipped below its West North Central neighbors beginning in 2009. It would be tempting to assume the North Dakota gas and oil boom accounts for this change. However, with North Dakota removed from the region, Minnesota employment growth still would fall short in 2010, 2011, and 2013.

Figure 6: Minnesota Labor Force Participation Rate, Prime-Age Workers



Source: Bureau of Labor Statistics, Local Area Unemployment Statistics.

GDP Growth Revised Down

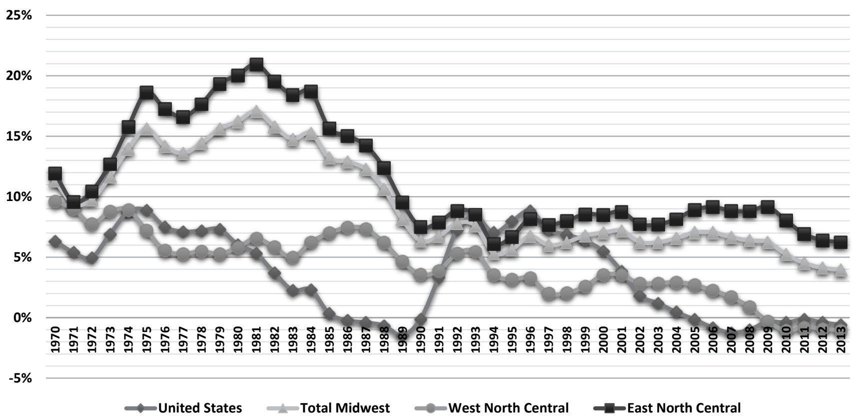
A little more than a year ago, local media reported Minnesota had the fifth-fastest-growing economy in the nation in 2012, according to the Bureau of Economic Analysis (BEA). Minnesota politicians understandably trumpeted this news. In June 2014, however, the BEA revised its GDP estimates, which dropped Minnesota's 2012 GDP growth below the national average and dropped the state's rank to 25.[13] This change did not make headlines.

The state's GDP growth did accelerate in 2013, moving the state to the 13th-fastest-growing economy for the year. Still, the past two years actually reflect a longer trend of Minnesota growth swinging above and below the national average. Since 2000, Minnesota has posted seven years of GDP growth above the national average and seven years below the national average. The long-term trend shows Minnesota's economy growing at just an average rate.

New Startup Activity Is Down

Much of Minnesota's economic strength draws from major Fortune 500 companies that are maturing. As noted previously, while they still contribute significantly to the state's economic health, future job growth depends on new startups. Unfortunately, national data show the startup of new firms has declined from highs around 12 to 13 percent in the early 1980s to eight percent in 2010.[14] The nonprofit Center for Enterprise Development rates Minnesota exactly average

Figure 7: Difference Between Minnesota and U.S. and Regional Private Employment Growth Rates, Percentage Point Differnce Between 10-year Rolling Employment Growth Rates, 1970 to 2013



Source: Bureau of Labor Statistics, Current Employment Statistics. West North Central includes IA, KS, MN, MO, NE, ND, and SD. East North Central includes IL, IN, MI, OH, and WI.

among the states in per-capita business creation.[15] Also, Minnesota ranked 48th of all 50 states plus D.C. for entrepreneurial activity in the Kauffman Foundation's Index of Entrepreneurial Activity for 2013, down from a rank of 10th in 1998.

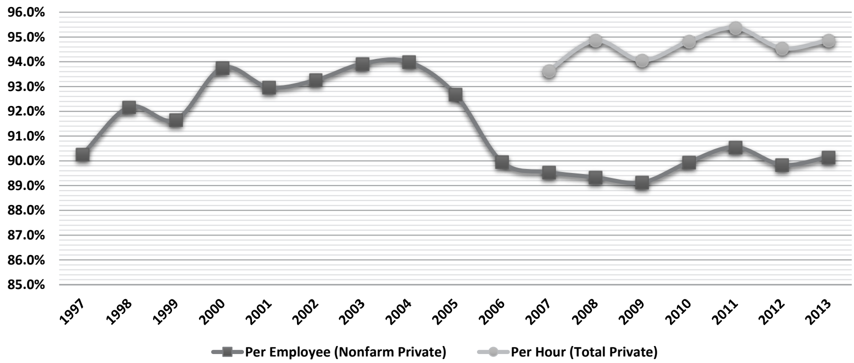
Wealth is Flowing Out of the State

According to Internal Revenue Service data, over $5 billion in income moved from Minnesota to other states between 1995 and 2010.[16] This has reduced the funds available for business investment, for tax collection, and for wages. Much of this is income moved to more tax-friendly states like Texas, Colorado, and Washington. For many retirees, especially wealthy ones who maintain homes in two states, the decision about where to declare "tax residency" is driven by tax policy. Given the right policy, "snowbirds" could leave wealth in Minnesota as they retire to Florida for part of the year. Populist sentiment against "the rich" notwithstanding, this wealth is needed to fund business investments, and, in turn, jobs.

Workforce Productivity Concerns

Most people assume Minnesota workers are more productive than the average U.S. worker. After all, Minnesota's per-capita GDP and per-capita personal income are substantially higher than the national average. Yet looking at GDP per worker,

Figure 8: Minnesota Workforce Productivity as a Percent of U.S. Productivity



Sources: Author calculations based on data from the Bureau of Economic Analysis, Regional Economic Accounts and Bureau of Labor Statistics, Current Employment Statistics.

Minnesotans appear to be less productive than average U.S. workers. In 2013, GDP per Minnesota employee equaled $113,096 compared to $125,457 for the nation—about ten percent less.[17]

Figure 8 tracks Minnesota's labor productivity as a percent of U.S. productivity. It shows a relative bump in Minnesota productivity between 1998 and 2005, but since 2006 productivity has held close to 90 percent of the national average. Federal data became available in 2007 to create a more accurate state-level measure of productivity based on economic output per hour worked. Minnesota's productivity is 95 percent of the national measure. There is one bright spot. Minnesota made strong gains in manufacturing productivity between 2007 and 2013, which is what accounts for the uptick seen in Figure 8. Nonetheless, the relative decline in per-employee productivity after 2004 is still a concern.

Factors undermining Minnesota's workforce

Faster growth is needed to offer Minnesotans opportunities similar to decades past. The troubling economic trends outlined above show the state must pay close attention to anything that might be undermining Minnesota's job-creating capacity. Here is a short list of factors undermining the future growth of Minnesota's workforce.

High Taxes

Minnesota is a high-tax state, and in the last two years, taxes have become considerably higher. In 2013, the Minnesota Legislature approved and the governor signed $2.1 billion in tax increases. They raised the top personal income tax rate from 7.85 percent to 9.85 percent—the third highest in the United States. A large proportion of Minnesota corporations are S-corporations that pay their taxes through the personal income tax. Minnesota is in the top ten for individual capital gains taxes and, at 9.8 percent, the state's corporate tax rate is also third highest in the country. Adding in the federal corporate tax rate of 35 percent—the third highest in the industrialized world—makes Minnesota one of the least attractive places for business investment.

Governor Dayton and other proponents of high taxes argue that taxes are just one of many factors businesses evaluate.[18] While that is true, for many businesses taxes are a substantial factor. The Dayton administration's promotion of tax incentives to lure new businesses to Minnesota underscores the fact that taxes do matter. It is widely accepted (and covered in the *Blueprint* report on taxation) that higher taxes reduce the amount of taxed activity; therefore taxes are clearly a barrier to creating more jobs.

Former state economist Tom Stinson recently suggested high taxes are "not a problem" as long as Minnesota has a competitive advantage in worker productivity.[19] Yet Minnesota may not have this advantage. The labor productivity data reported above place Minnesota's productivity below the national average. Minnesota still does well on most education outcomes, but the gap between Minnesota and low-performing states is narrowing. If Minnesota is indeed losing its worker productivity advantage, then high taxes are a problem.

Burdensome State Regulations

A state's regulatory environment may be the most important factor contributing to job growth within the state's control. When asked what makes Texas such an attractive place for business, Dale Craymar, the president of the Texas Taxpayers and Research Association, highlighted the state's regulatory environment, not the state's low tax rates.[20] While government has an obligation to protect the public, over-regulation is costly and often places heavy burdens on job producers while providing little or no social benefit. Here's how Edward Glaeser and Cass Sunstein recently summarized the problem:

> Sensible regulatory requirements can reduce illnesses and accidents, protect the environment, and maintain quality of life. But when regulations are onerous and poorly designed, they can cause serious harm—overwhelming small businesses, reducing economic growth, eliminating jobs, squelching innovation, and causing serious hardship. Many studies have found that entrepreneurship is the lifeblood of urban regeneration, meaning that business regulations that stymie

> entrepreneurship… can have particularly large costs, especially during times of economic difficulty. While regulation is an important tool for governments, it is vital that the authors of such rules strike the right balance, giving careful consideration to the track records of old rules and the likely consequences of any new requirements.[21]

Minnesota has a mixed record on regulation. The latest Thumbtack.com/Kauffman Foundation Small Business Friendliness Survey gives Minnesota high marks for the ease of starting a small business; however, Minnesota receives C grades when it comes to the general regulatory environment, employment regulations, ease of hiring, and licensing.[22] By comparison, Texas garnered As and A-pluses across every indicator. Forbes ranks Minnesota's regulatory environment as average, at 22nd.[23]

These rankings suggest there are ample opportunities to improve Minnesota's regulatory climate. The processes for gaining approval to mine nonferrous metals in northern Minnesota and build the Sandpiper Pipeline from North Dakota to Superior, Wisconsin, provide concrete examples of the difficulties the state's regulatory process can impose on businesses that would create good-paying jobs.

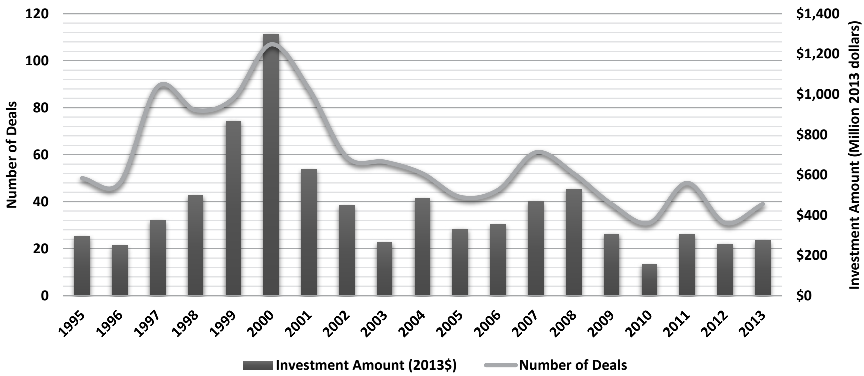
Weak Business Clusters

As the Minnesota Center for Fiscal Excellence noted in a recent report, "Minnesota may have a lower margin for error in being a significant outlier on business taxes and costs than other 'high tax, high service' peer states."[24] This is because Minnesota does not have the strong business "clusters" found in other high-tax, high-service states like New Jersey, New York, Maryland, Massachusetts, and Connecticut. Minnesota's traded cluster strength ranks 39th nationally; these other states rank 16th or better. According to Harvard Professor Michael Porter, clusters of concentrated business activity in related industries deliver tremendous advantages to a region. Porter recently visited the Twin Cities to launch a website highlighting their importance.[25]

Declining Capital Investment

One reason for a lower rate of startups is a lower rate of funding. Capital investment is fundamental to business startups, and a lack of adequate capital is one of the primary reasons for business failure. A study commissioned by the Department of Employment and Economic Development (DEED) in 2013 indicated that between 2008 and 2012 venture capital investments in total dollars in Minnesota decreased 45 percent, compared to a decrease of only 17 percent for the country as a whole.[26] The number and total value of venture capital deals in Minnesota since 1995 are shown in **Figure 9**. These data are not trending in the

Figure 9: Venture Capital Deals and Investment in Minnesota



Source: PricewaterhouseCoopers, The MoneyTree Report.

right direction. Investing capital in startups often involves a high degree of risk for the investor, especially for cutting-edge technologies or untried business models.[27] Minnesota needs those startups and therefore must be or become an attractive place to take those risks.

Skills Gap in Education

The so-called "skills gap" is another indicator of long-term economic weakness. Though another *Blueprint* report addresses the topic of education, the seriousness of the issue to the long-term prospects of job growth cannot be overstated. Even though Minnesota fares better than the nation on graduation rates as a whole, there are still serious problems in education. A significant portion of graduates from the nation's high schools lack the basic skills[28] to obtain work in advanced manufacturing,[29] to attend college, or to fill entry-level jobs.[30]

Future job growth and education are linked, and the data indicate problems in matching employees with employers. Many Minnesota firms struggle to fill positions, and students are leaving school unable to find meaningful work. The Governor's Workforce Development Council in 2011 found that nearly half of manufacturers had positions that were unfilled due to a lack of qualified applicants, and one in eight reported having at least ten percent of jobs unfilled.[31]

Inefficient Distribution of Economic Development Funds

The Department of Employment and Economic Development (DEED) is empowered to offer incentives selectively for business. This is a very inefficient way to achieve growth. The engines of prosperity have rarely been fueled by government management. DEED's economic development programs are classic examples of corporate welfare:

- They are discretionary, so they put government in the position of choosing winners and losers.
- They frequently discriminate against Minnesota businesses trying to grow organically in favor of outsiders coming with promises of jobs.
- They evaluate a small number of private sector business plans—a far larger number are never considered.
- They are the focus of endless debate and tinkering.

Government has a poor record of success in determining which businesses deserve capital; therefore, it does not make sense to put the government in the role of business investor.

Globalization

As the Minnesota Department of Revenue explains, "Minnesota must compete for new jobs, business investments, and economic growth in today's global economy, driven by rapid advances in technology, transportation, and communications."[32] To the extent other states and countries across the globe can offer higher returns on investments in capital and labor, economic growth and job growth in Minnesota will slow. In a general sense, globalization heightens the importance of every factor just listed. In particular, having competitive tax and regulatory environments and making sound investments in the state's labor force and infrastructure become increasingly important as Minnesota tries to compete globally.

THE SOLUTION

The trends and challenges outlined above demonstrate that Minnesotans should not be satisfied with the performance of the state's economy and job market. Many policies must be changed and new policies adopted for the state to reach its full potential. The entire *Minnesota Policy Blueprint* is in a real sense a blueprint of state policy reforms focused on maximizing the number and quality of jobs available to the people of Minnesota. From transportation to education to energy to taxes to families, every blueprint recommendation centers on promoting prosperity for all Minnesotans, which ultimately means connecting people to good jobs. The following recommendations provide more specific steps the state should take to maximize the job opportunities for the people of Minnesota.

To improve Minnesota's jobs environment, the state should focus on two strategies. First, reduce regulatory burdens on Minnesota businesses. Second, provide broad-based support for economic development that avoids picking winners and losers.

Reduce Regulatory Burdens

The best opportunities to improve the business climate and grow jobs center on strategies to streamline and reduce regulatory burdens. This offers the potential for high impact at relatively low cost. Furthermore, some of these strategies are attainable in a divided political environment. Efforts to streamline state regulations have received bipartisan support over the past few years and have most recently led to a new goal to issue environmental permits within 90 days.

Recommendation 1: Establish an Office of Regulatory Oversight in the legislature to evaluate state and local regulations.

The state should establish an Office of Regulatory Oversight modeled after the federal Office of Information and Regulatory Affairs (OIRA) with one important difference: The office should be housed in the legislative branch to provide credible and effective oversight of executive agency activities. As recommended by Glaeser and Sunstein, the office should focus on "finding creative ways to institutionalize regulatory simplification and freeing up the private sector without jeopardizing public safety, health, or the environment."[33] At a minimum, the office should provide the following services:

- Periodically review the impact of state and local regulations on businesses.
- Assess the cost and benefit of legislative proposals to add new regulations.

Like the OIRA, it would likely be necessary to limit reviews to regulations with substantial economic impact or raising novel questions of policy. The office could be combined or coordinated with the Legislative Budget Office proposed in a previous *Blueprint* report on the state budget.

Recommendation 2: Require state agencies to evaluate all regulations for adverse effects on small businesses.

State agencies should be required to evaluate every state regulation for its impact on small business. Rhode Island enacted a law in 2012 requiring each agency to review every state regulation within four years. The agencies accomplished this task in under 17 months and identified over 250 changes to improve the state's regulatory system.[34] Minnesota should follow Rhode Island's example.

Recommendation 3: Sunset state occupational regulations.

State law recognizes the harm state occupational regulations can impose on the workforce by requiring the proponents of any "bill proposing new or expanded regulation of an occupation" to provide a report documenting the need for the new regulation.[35] This is called a *sunrise* law, and it aims to protect people from unnecessary and possibly anticompetitive regulations. Occupational regulations often serve only to boost incomes and provide job security for people working in regulated occupations. It is not clear whether this law is actually followed or whether it has had meaningful effect. To protect people more effectively from anticompetitive occupational regulations, the state should also implement a *sunset* provision that periodically would repeal occupational regulations, unless the legislature acted to reinstate them.

Recommendation 4: Create an Office of Regulatory Assistance.

Businesses could benefit greatly from more support navigating state and local regulatory processes. Instead of being an adversary, the state should be a partner and work with businesses toward a shared goal of creating a safer and healthier state. In 2002, Washington state established the Governor's Office for Regulatory Innovation and Assistance to offer a more collaborative and supportive permitting process to businesses.[36] Minnesota should create a similar office within DEED or the Department of Administration. The office should collect and report feedback from businesses to inform lawmakers on whether regulations must be improved or repealed.

Recommendation 5: Guarantee workers the freedom to choose whether to join a union.

One of the most onerous regulations the state imposes on workers is the requirement to join a union under certain circumstances. There is tremendous merit to allowing citizens the freedom to choose whether to join a union. Evidence shows that right-to-work states have fared better in job growth. One of the most highly regarded studies related to this topic was done by University of Minnesota Economist Thomas Holmes. Holmes's study tested the effect of a state's business climate on industry location and employment growth. While the study centered on business climate, Holmes used the existence or absence of a right-to-work law as a proxy for a state being pro-business or anti-business. Holmes compared growth in manufacturing employment between border counties, including differences along Minnesota's border. The differences in the growth in manufacturing employment between Minnesota and its neighbors were among the most dramatic in the country. Between 1947 and 1992, border counties in North Dakota grew by 137 percent compared to 20 percent in Minnesota, in South Dakota by 138 percent compared to 27 percent in Minnesota, and in Iowa by 130 percent compared to 85 percent in Minnesota.

Provide broad-based support to businesses; stop picking winners and losers

Current state economic development policy relies heavily on tax credits, loans, and grants to specific businesses and industries. As a result, the state is heavily involved in picking winners and losers. The most notable programs include the Minnesota Investment Fund and the Minnesota Job Creation Fund. The following recommendations support shifting the state toward more broad-based approaches to economic development that would benefit all businesses equally. These recommendations focus on improving access to capital, information, and skilled workers.

Recommendation 6: Reduce corporate taxes.

Minnesota's decline in new business starts relative to the rest of the country strongly suggests the state would benefit by increasing access to capital for businesses. The most obvious and appropriate strategy to connect businesses with capital is to tax businesses less and thereby leave businesses with more of their own money to invest. In FY 2013, the state collected about $2.4 billion from Minnesota businesses through the corporate and individual income tax.[37] A portion of any reduction in these taxes should be reinvested in Minnesota businesses. Another Blueprint report, *Aligning Taxes with Economic Growth*, recommends eliminating the corporate income tax by 2016, lowering the income tax rate on top earners—which includes S-corporations—to five percent and eliminating the statewide general tax on business property. Repetition of these recommendations here underscores how these tax reductions would increase the capital available to Minnesota businesses to invest in future jobs. Furthermore, a trend of reducing taxes would show entrepreneurs they are valued in Minnesota and would encourage them to take the risk of starting or expanding businesses.

Recommendation 7: Create an advisory council to recommend ways to expand and improve Minnesota's incentives for business investments.

Ideally, the state would not need to be directly involved in making investments in businesses. All a state must do is offer businesses a set of general policies that provide a fair playing field to build any type of business. However, with every state in the country engaged at some level in offering tax credits, grants, and loans, it would be practically impossible for a state—especially a high-tax state like Minnesota—to avoid giving any businesses incentives. State incentives for business investments are in many ways a necessary evil.

Despite this, state incentives run a high risk of promoting inefficiency and economic cronyism. Businesses often receive incentives when they would have invested in the state anyway, the benefits of the incentives often leak out of state, incentives for one company can displace investment in another company, and incentives leave fewer public dollars for public investments.[38] Thus, any state incentive must be carefully administered to avoid these negatives.

Currently, Minnesota provides tax credits for research and development expenses and startup company investments. The tax credits provide a way to increase investment in Minnesota companies in a way that minimizes economic distortions because they are not targeted at any specific company or industry. They apply generally to research and startups. To the extent Minnesota provides investment incentives, these non-targeted incentives are the most appropriate avenues. The state may be able to improve and expand on these approaches. This includes the possibility of incentives to increase the capital available to community banks to invest in local businesses.[39] To do so, the state should create an advisory council to recommend appropriate ways to expand broad-based incentives and eliminate targeted incentives. The first action of the council should be to catalog the state and local incentives available to businesses across the country.

Recommendation 8: Change DEED's focus from investment to support.

DEED was created in 2003 by the merger of the Minnesota Department of Trade and Economic Development (DTED) and the Minnesota Department of Economic Security (MDES). DEED has a multi-billion dollar budget and has a multitude of programs aimed at administering benefits in addition to economic development. Because of the merger, only a minority of DEED's resources are focused on stimulating job growth. DEED currently offers targeted "economic development" incentives to businesses, which in 2014 resulted in a couple hundred businesses being selected out of thousands that applied (or that could have applied).[40] This puts the government in the place of betting on certain business plans and discriminating against current businesses, including those whose executives believe the effort of applying will not pay. The number of plans in play is constrained by government bureaucracy, limiting growth before it can start.

Business owners are willing to take risks if there is a reasonable chance of success, and the state should want them to take those risks, because success will bring jobs. The state should encourage every business to invest in its ideas by lowering the costs associated with starting or expanding. This would put thousands or tens of thousands of potential business plans in play, vastly increasing the chance of success and leaving the risk where it belongs, on the business owner and not on the state.

DEED should be focused on supporting businesses through access to information and access to external business opportunities—both domestic and international. Relative to education and in addition to supporting present STEM initiatives, DEED should expand and innovate to support engagement by business leaders with educational institutions and should be expand and enhance apprenticeships and other partnerships that lead youth to good careers.

Recommendation 9: Provide a tax credit to businesses for preparing workers in an apprenticeship program.

Apprenticeship programs could be an important tool to close the skills gap. Instead of requiring traditional coursework, apprenticeship programs provide students with opportunities to learn skills on the jobsite. These programs take on greater importance as traditional vocational training declines. The state should not discriminate between traditional coursework and training at a jobsite. To provide more opportunities for apprenticeships, the state should offer a tax credit to businesses to train workers through apprenticeship programs. DEED should survey apprenticeship tax credit programs in other states as well as successful apprenticeship programs in other countries.[41]

Recommendation 10: Create an Internet-based databank to provide more detailed and objective economic and demographic analysis for Minnesota policymakers and businesses.

Policymakers and businesses require economic information to make sound decisions. While large businesses can afford consultants, small businesses and policymakers are often left in the dark. To fill the information gap, the state economist's office, under the direction of the Minnesota Council of Economic Advisers, should create a databank to provide objective data and analysis on the state's economy and demographics. Too often, DEED reports statistics flattering its programs or showing progress toward political objectives. Similarly, business groups tend to highlight only the information that makes Minnesota look like an attractive place to locate and grow a business. Periodic objective analysis of the state's economy is provided by the Secretary of State in collaboration with the St. Cloud State University School of Public Affairs Research Institute.[42] This recommendation envisions a similar but more robust effort that takes a more detailed analysis of demographics, economic sectors, regions of the state, and peer states. The databank should coordinate data from multiple state and federal agencies, similar to the Federal Reserve Economic Data (FRED) online data tool provided by the St. Louis Federal Reserve.

Recommendation 11: Narrow the information gap between youth and employers.

Too many students leave the education system without skills to fill high quality jobs. Minnesota has a world-class system of public colleges and technical schools. Courses in needed skills are available, but that does not mean students will opt to take them.

The skills gap is in many ways an information gap. There are good, high-paying jobs that do not require a four-year college degree; for example, a skilled machinist makes about $60,000 a year.[43] The state should be working to narrow the information gap that exists between youth and businesses so students who elect not to pursue a traditional college education become aware of the alternatives available to them.[44]

The private sector should take the lead in closing the information gap. For instance, there is a broad move nationally to sponsor student tours of local manufacturing facilities, such as the Florida Advanced Technological Education Center "Made in Florida" student tours.[45] Kentucky recently began the Tech Ready Apprentices for Careers program to provide pre-apprenticeship opportunities to secondary students. Ford recently started a program of two-day externships to bring high school teachers into their facilities to provide real-world examples they can bring back to their classrooms to demonstrate how math and science are applied in the workplace.[46] Colleges are also collaborating with high schools to connect students to manufacturing careers.[47] Similar initiatives are underway in Minnesota, and these programs should be expanded.

ENDNOTES

EDUCATION

Student Achievement and Prosperity: The Indispensability of Competition and Choice in Minnesota K-12 Education

[1] Eric A. Hanushek, Paul E. Peterson and Ludger Woessmann, "Teaching Math to the Talented: Which Countries—and States—are Producing High-Achieving Students?" *Education Next* (Winter 2011), available at http://educationnext.org/teaching-math-to-the-talented/. They also find, "The only OECD countries producing a smaller percentage of advanced math students than the United States are Portugal, Greece, Turkey, and Mexico." For an unabridged version of this study, see Eric A. Hanushek, Paul E. Peterson and Ludger Woessmann, U.S. Math Performance in Global Perspective: How well does each state do at producing high-achieving students, Program on Education Policy and Governance Report No.: 10-19 (Harvard University, November 2010), available at http://www.hks.harvard.edu/pepg/PDF/Papers/PEPG10-19_HanushekPetersonWoessmann.pdf.

[2] Mitch Pearlstein, *Minnesota's Immense Achievement Gaps: The Untapped Promise of Vouchers* (Center of the American Experiment, May 2014): p. 8, available at http://www.americanexperiment.org/sites/default/files/article_pdf/Promise%20of%20Vouchers.pdf.

[3] Michael B. Henderson, William G. Howell, and Paul E. Peterson, "Information Fuels Support for School Reform," *Education Next* (Spring 2014), available at http://educationnext.org/information-fuels-support-for-school-reform/.

[4] Jay P. Greene, *Education Myths: What Special-Interest Groups Want You to Believe About Our Schools—and Why It Isn't So* (Lanham, MD: Rowman & Littlefield, 2005): p. 9.

[5] Over the years I've seen studies in which the United States spends anywhere from the most in the world per K-12 student to fifth most. Here are two such examples, with the first having the United States first worldwide. "'U.S. Spending and Performance vs. the World,' Average spending per school-aged child," *Inside USC [University of Southern California] Rossier Online Blog*, February 8, 2011, at http://rossieronline.usc.edu/u-s-education-versus-the-world-infographic/. The United States is fifth in this next citation. Julia Ryan, "American Schools vs. the World: Expensive, Unequal, and Bad at Math," *The Atlantic*, December 3, 2013, available at http://www.theatlantic.com/education/archive/2013/12/american-schools-vs-the-world-expensive-unequal-bad-at-math/281983/.

[6] News Release, Minneapolis Public Schools, "Graduation Rates up 7 percent over two years in MPS," February 19, 2014, available at http://www.mpls.k12.mn.us/uploads/mps_grad_rates_press_release_2-19-14.pdf.

[7] Anthony P. Carnevale and Nicole Smith, "Workplace Basics: The Skills Employees Need and Employers Want," *Human Resource Development International*, Vol. 16, No. 5 (November 2013).

[8] Eric A. Hanushek, Paul E. Peterson, Ludger Woessmann, *Endangering Prosperity: A Global View of the American School* (Washington, DC: AEI, 2013): p. 52.

[9] Eric A. Hanushek, "The Economic Value of Education and Cognitive Skills," in *Handbook of Education Policy Research*, eds. Gary Sykes, Barbara Schneider, and David N. Plank (New York: Routledge, 2009): pp. 43-44, available at http://hanushek.stanford.edu/sites/default/files/publications/Hanushek%202009%20HndbEducPolicyResearch.pdf.

[10] Greg Forster, *A Win-Win Solution: The Empirical Evidence on School Choice* (The Friedman Foundation for Educational Choice, April 2013): p. 1, available at http://www.edchoice.org/Research/Reports/A-Win-Win-Solution--The-Empirical-Evidence-on-School-Choice.aspx. This reference applies to the first two bullets.

[11] Matthew M. Chingos and Paul E. Peterson, *The Effects of School Vouchers on College Enrollment: Experimental Evidence from New York City* (Brookings Institution, August 2012), available at http://www.brookings.edu/research/papers/2012/08/23-school-vouchers-harvard-chingos.

[12] Minnesota Association of Charter Schools, *A Primer on Minnesota Charter Schools* (September 2013), available at http://www.mncharterschools.org/_uls/resources/A_Primer_on_Minnesota_Charter_Schools.pdf.

[13] "About Charter Schools," Arizona Charter Schools Association, accessed November 10, 2014, https://azcharters.org/about-charter-schools.

[14] Minnesota K-12 Online Learning Advisory Council, *Removing the Barriers to Digital Learning in Minnesota: A Review of State Laws and Rules and Policy Recommendations* (June 30, 2013), available at http://education.state.mn.us/MDE/Welcome/AdvBCT/OnlineLearnAdvCoun/.

[15] Mitch Pearlstein, *Online Learning: A Literal New World of Possibilities for Minnesota K-12 Education* (Center of the American Experiment, January 2012): p. 19, available at http://www.americanexperiment.org/publications/reports/online-learning.

[16] John Merrow, "Can Rocketship Launch a Fleet of Successful, Mass-Produced Schools?" *PBS NewsHour*, December 28, 2012, available at http://www.pbs.org/newshour/bb/education-july-dec12-rocket_12-28/.

[17] Pearlstein, *Online Learning*: p. 13.

[18] Schools can get temporary community expert waivers, but only on a limited basis.

[19] Pearlstein, *Online Learning*: p. 14.

[20] Paul E. Peterson, *Saving Schools: From Horace Mann to Virtual Learning* (Cambridge, MA; Belknap, 2012): pp. 231-32.

[21] Simply put, school districts had pushed for the restriction not wanting to lose portions of student funding to colleges, universities, and other postsecondary institutions.

[22] Minnesota K-12 Online Learning Advisory Council, *Removing the Barriers to Digital Learning in Minnesota*: pp. 33, 36.

STRENGTHENING FAMILIES AND RESCUING MARRIAGE

Reducing Very High Fragmentation Rates and Strengthening All Families

[1] Mitch Pearlstein, *From Family Collapse to America's Decline: The Educational, Economic, and Social Costs of Family Fragmentation* (2011): p. xiii.

[2] Mitch Pearlstein, *Broken Bonds: What Family Fragmentation Means for America's Future* (2014): pp. xviii-xix.

[3] Paul E. Barton and Richard J. Coley, *The Black-White Achievement Gap: When Progress Stopped* (Educational Testing Service, July 2010): p. 16, available at http://www.ets.org/Media/Research/pdf/PICBWGAP.pdf.

[4] Ron Haskins and Isabel Sawhill, *Creating an Opportunity Society* (Washington, DC: Brookings Institution, 2009): p. 9.

[5] Linda J. Waite and Maggie Gallagher, *The Case for Marriage: Why Married People are Happier, Healthier, and Better Off Financially* (2000): pp. 157-58. The quotes are Waite and Gallagher's; not the original researchers.

[6] See Endnotes Nos. 1 and 2 above.

[7] Ross Douthat and Reihan Salam, *Grand New Party: How Republicans Can Win the Working Class and Save the American Dream* (2008; 2009): p. 11. I interpret Douthat and Reihan's use of "working class" as including a significant portion of the middle class. And as for the word "Republican" in their title, suffice it to say as 501(c)3 tax-exempt organization, American Experiment has everything to do with ideas and nothing to do with partisanship. This, in fact, is one of the few times in recent years I've typed the word "Republican."

[8] Ramesh Ponnuru, "Right to the Middle: Conservatives Need Not Surrender Voters of Moderate Income to the Democrats," *National Review*, December 17, 2012.

[9] Pearlstein, *Broken Bonds*: Chapter Seven.

[10] *See* Marital First Responders [Website], accessed November 12, 2014, http://maritalfirstresponders.com/.

[11] W. Bradford Wilcox and Andrew J. Cherlin, *The Marginalization of Marriage in Middle America*, Brookings Institution Center on Children and Families Brief No. 46 (August 2011), available at http://www.brookings.edu/research/papers/2011/08/10-strengthen-marriage-wilcox-cherlin.

[12] Pearlstein, *From Family Collapse to America's Decline*: pp. 19-21.

[13] Alexandra Sifferlin, "What's Behind the Drop in U.S. Teen Birth Rates," *Time Magazine,* May 24, 2013, available at http://healthland.time.com/2013/05/24/whats-behind-the-drop-in-u-s-teen-birth-rates/.

[14] The National Campaign to Prevent Teen and Unplanned Pregnancy [Website], accessed November 12, 2014, http://thenationalcampaign.org/.

[15] Response to a data request from Shel Swaney, Supervisor, Assessment & Epidemiology, Hennepin County Human Services & Public Health Department, August 3, 2011.

[16] "Teen Pregnancy Prevention," Greater Milwaukee United Way, accessed November 12, 2014, http://www.unitedwaymilwaukee.org/TeenPregnancyPrevention; and phone conversation with the Greater Milwaukee United Way's Lori Holly, December 5, 2013.

[17] Ron Haskins, "Mobility Is a Problem: Now What?" *Brookings Institution Up Front* (blog), December 23, 2011, at http://www.brookings.edu/blogs/up-front/posts/2011/12/23-mobility-opportunity-haskins.

[18] Lawrence M. Mead, *Expanding Work Programs for Poor Men* (Washington, DC: AEI Press, 2011): pp. 1-2.

[19] Right on Crime endorsers include leading conservatives such as Gary Bauer, Bill Bennett, Jeb Bush, Newt Gingrich, David Keene, Ed Meese, Grover Norquist, and J.C. Watts.

[20] Mike Lee, "Bring Them In," Heritage Foundation Anti-Poverty Forum, Washington, DC, November 13, 2013, transcript available at http://www.lee.senate.gov/public/index.cfm/2013/11/bring-them-in.

[21] W. Bradford Wilcox, *Religion, Race, and Relationships in Urban America*, Center for Marriage and Families Research Brief No. 5 (Institute for American Values, May 2007), available at http://www.americanvalues.org/search/item.php?id=29.

ALIGNING TAXES WITH ECONOMIC GROWTH

[1] Note these principles can contradict themselves and other policy goals. As the report notes, treating equals equally can require a more complex tax when business arrangements are complex. Thus, these are indeed guides and not hard and fast rules.

[2] V. V. Chari, *Tax Reform: Lesson from Economic Theory* [PowerPoint slides] (n.d.), available at http://hhei.umn.edu/assets/ppt/CHARI.ppt.

[3] Alex M. Brill and Alan D. Viard, *The Real Tax Burden: More than Dollars and Cents*, (Washington D.C.: AEI Press, 2011): p. 4. This section is influenced by Brill and Viard's excellent exposition of tax policy and excess burden.

[4] Jason Furman, *The Concept of Neutrality in Tax Policy*, U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform, April 15, 2008, available at http://www.brookings.edu/research/

testimony/2008/04/15-tax-neutrality-furman.

[5] Data is available from Federation of Tax Administrators, at http://www.taxadmin.org/fta/rate/xls/ind_inc.xls.

[6] Data is available from Federation of Tax Administrators, at http://www.taxadmin.org/fta/rate/xls/ind_inc.xls.

[7] *See* Editorial, "Minnesota: Reckoning with restraint," *Pioneer Press*, May 31, 2014, available at http://www.twincities.com/opinion/ci_25868817/minnesota-reckoning-restraint-pioneer-press-editorial; and Lyman Stone, "State Personal Income Tax Rates and Brackets 2014 Update," Tax Foundation Fiscal Fact No. 22, March 21, 2014, available at http://taxfoundation.org/article/state-personal-income-tax-rates-and-brackets-2014-update. This is because California and Hawaii's top income bracket starts at a higher income levels than Minnesota.

[8] Federation of Tax Administrators, *State Sales Tax Rates and Food & Drug Exemptions (As of January 1, 2014)* (January 2014), available at http://www.taxadmin.org/fta/rate/sales.pdf.

[9] Federation of Tax Administrators, *Range of State Corporate Income Tax Rates (For tax year 2014—as of January 1, 2014)* (February 2014), available at http://www.taxadmin.org/fta/rate/corp_inc.pdf.

[10] Joel Michael, *Survey of State Estate, Inheritance, and Gift Taxes* (Minnesota House of Representatives, December 2013), available at http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf; and Joel Michael, *The Minnesota Estate Tax* (Minnesota House of Representatives, July 2014), available at http://www.house.leg.state.mn.us/hrd/pubs/ss/ssesttx.pdf.

[11] Data is available from Federation of Tax Administrators, at http://www.taxadmin.org/fta/rate/xls/ind_inc.xls.

[12] Minnesota Department of Revenue, *2014 Tax Expenditure Summary List* (February 2014), available at http://www.revenue.state.mn.us/research_stats/Pages/Tax_Expenditure_Reports.aspx.

[13] Minnesota Management and Budget, *Revenue and Economic Update* (July 2014), available at http://mn.gov/mmb/images/Revenue%2526Economic_Update_July2014.pdf.

[14] *Id.*; and Minnesota Department of Revenue, *2014 Tax Expenditure Summary List* (February 2014), available at http://www.revenue.state.mn.us/research_stats/Pages/Tax_Expenditure_Reports.aspx.

[15] Buying fewer goods and services could also be part of the explanation, but Minnesotans do not appear to be stingier than the average American. Minnesotans spend about average based on personal consumption expenditures as a percent of personal income. In 2012, personal consumption expenditures in Minnesota was 80.8 percent of personal income, slightly higher than the national average of 79.1 percent. Author calculations based on Bureau of Economic Analysis, *Personal Consumption Expenditures by State, 1997-2012 (Prototype Estimates)* (August 7,

2014), available at http://www.bea.gov/newsreleases/regional/pce/pce_newsrelease.htm; and Bureau of Economic Analysis, Annual State Personal Income and Employment data, available at http://www.bea.gov/regional/index.htm.

[16] John Mikesell, "State retail sales tax productivity: identifying economic, legal, and administrative influences on c-efficiency ratios across the American States," in *Proceedings: Forum for Economists International, Conference held in Amsterdam, May 30-June 2, 2014*, ed. M. Peter van der Hoek (Papendrecht, Netherlands: Forum for Economists International, 2014). In comparing states, Mikesell adjusts for major variations in the structure of state sales taxes, such as whether or not motor vehicle sales are included in the general sales tax.

[17] Compared to the 3rd highest corporate tax rate, Minnesota collects the 6th most corporate income taxes as a percent of personal income and the 8th most per capita. Compared to personal income tax brackets that range from the 2nd to 4th highest, Minnesota collects the 5th most personal income taxes both as a percent of personal income and on a per capita basis.

[18] Andreea Militaru and Thomas Stratmann, "A Survey of Sales Tax Exemptions in the States: Understanding Sales Taxes and Sales Tax Exemptions," Mercatus Center Working Paper #14-01 (January 2014), available at http://mercatus.org/sites/default/files/Stratmann_SalesTaxExemptions_for-release.pdf.

[19] Douglas Clement, ed., "Interview with James Poterba," *The Region,* June 1, 2008, available at https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3478&.

[20] Peter J. Nelson, *Minnesotans on the Move to Lower Tax* States (Center of the American Experiment, April 2013), available at http://www.americanexperiment.org/sites/default/files/article_pdf/MN%20Income%20Migration.pdf.

[21] Martin Feldstein, "Effects of Taxes on Economic Behavior," *National Tax Journal*, Vol. LXI, No. 1 (March 2008), available at http://ntj.tax.org/wwtax%5Cntjrec.nsf/A6D34F3F901369588525742E006EA140/$FILE/Article%2006-Feldstein.pdf.

[22] Michael Keane and Richard Rogerson, "Micro and Macro Labor Supply Elasticities: A Reassessment of Conventional Wisdom," *Journal of Economic Literature*, Vol. 50, No. 2 (June 2012).

[23] Robert Carroll et al, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics*, Vol. 18, No. 2 (1999), available at http://www.nber.org/papers/w6578.

[24] This estimate is imprecise because the excess burden from standard economic formulas varies across taxpayers facing different effective marginal income tax rates and there is a range of estimated behavioral responses in the economic literature. Minnesota's tax rates bases are more responsive to taxes than federal tax bases. Minnesotans face higher tax rates than the tax rates used for the OMB's estimate of the excess burden of federal taxation.

[25] The Organization for Economic Co-operation and Development (OECD), *OECD Tax Database*, Table II.1 –Corporate income tax rates: basic/non-targeted, available at http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial.

[26] Asa Johansson et al, "Tax and Economic Growth," Economics Department Working Paper #620, (Organization for Economic Co-operation and Development, July 11, 2008): pp. 2, available at http://www.oecd.org/tax/tax-policy/41000592.pdf.

[27] Minnesota Governor's 21st Century Tax Reform Commission, *Minnesota's Millennium: Launching a New Generation of Competitive Leadership and Economic Growth* (February 2009): p. 16, available at http://archive.leg.state.mn.us/docs/2009/other/090277.pdf.

[28] The CBO goes on to identify at least six ways the corporate income tax rate "has the potential to distort economic incentives and generate inefficiency":

> First, because it is imposed on income from capital, it biases individuals' decisions about how much to save and can therefore influence overall capital investment and economic growth. Second, because the corporate income tax is imposed only on some kinds of business profits (in the United States, typically those of corporations that have many shareholders) and not on others (such as the profits of partnerships and sole proprietorships), it affects the ways in which businesses are organized and creates biases in investment and production toward those types of business structures that are not subject to the corporate income tax. Third, it creates a bias in corporate financing toward the use of debt—because the tax is imposed on income from equity-financed investment and not on the return to debt-financed investment. Fourth, because the law treats a corporation as a separate taxable entity from which shareholders subsequently realize income in the form of either dividends or capital gains, the relatively beneficial tax treatment of capital gains under the individual income tax creates a bias toward them and against the payment of dividends. Fifth, because the United States levies corporate income tax on the basis of schedules for depreciation that do not correspond to economic depreciation, it taxes different kinds of assets and industries at different effective rates, creating a bias in investment and production toward the more lightly taxed assets and sectors. Finally, the corporate income tax may distort the allocation of resources by making corporations' compliance with taxation costly and by creating additional opportunities for tax planning.

Congressional Budget Office, *Corporate Income Tax Rates: International*

Comparisons (November 2005): pp. ix, 1, and 2, available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/69xx/doc6902/11-28-corporatetax.pdf.

[29] Laurence J. Kotlikoff, "Abolish the Corporate Income Tax," *The New York Times*, January 5, 2014, available at http://www.nytimes.com/2014/01/06/opinion/abolish-the-corporate-income-tax.html.

[30] Chirinko, Robert S. and Daniel J. Wilson, "State Business Taxes and Investment: State-by-State Simulations," *Federal Reserve Bank of San Francisco Economic Review* (2010), available at http://www.frbsf.org/publications/economics/review/2010/er13-28.pdf. This paper has an internet modeling applet available at http://www.frbsf.org/csip/taxapp.php.

[31] Congressional Budget Office, *Effective Marginal Tax Rates for Low- and Moderate-Income Workers* (November 15, 2012), available at http://www.cbo.gov/publication/43709.

[32] This example is not the only case in which the combination of our tax code and phase-outs of government programs creates high effective marginal tax rates. A study by the non-partisan Minnesota Center for Fiscal Excellence (MCFE), *Disincentives to Earn*, available at http://www.fiscalexcellence.org/our-studies/disincentives-to-earn-final.pdf, provides another example. Consider a single parent of two children who works more to increase gross family income from $33,000 to $34,000. The effective marginal tax rate from the federal and state earned-income tax credit phase-outs are about 21 percent and 10.3 percent, respectively. These rates reduce the family's tax credits—in effect, its income—by about $210 and $103. In addition, benefits from the Basic Sliding Fee child-care program are reduced by $1,692 because of the sliding fee. Thus, the reward for earning an additional $1,000 in gross wages is a reduction in take-home family income of $1,005 because of the combined effects of these three programs. A Minnesota House Research study, summary available at http://www.taxadmin.org/fta/meet/06re_data/pres/Wilson_low-income.pdf, found that—given the intersection of our tax system with various social programs—the average effective marginal tax rate for a single parent with two children and income between $23,500 and $41,700 was 104 percent. On average, working overtime to earn an additional $1,000 in gross income reduces household after-tax income by $40.

[33] This 56.7 percent total effective marginal tax rate is less than the sum of all of these individual taxes because of federal deducibility of state taxes.

[34] This 60 percent total effective marginal tax rate is less than the sum of all of these individual taxes because of federal deducibility of state taxes and dividend taxes applying to only to C-corporation income after corporate level Minnesota and federal taxes are paid.

[35] Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points* (February 2014), available at http://www.taxadmin.org/fta/rate/stg_pts.pdf.

[36] Minnesota Department of Revenue, *2013 Minnesota Tax Incidence Study* (March 2013), available at http://www.revenue.state.mn.us/research_stats/research_reports/2013/2013_tax_incidence_study_links.pdf.

[37] Minnesota Department of Revenue, *Minnesota Estate Tax Study* (March 5, 2014), available at http://www.revenue.state.mn.us/research_stats/research_reports/2014/estate_tax_report_3_5_14.pdf.

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RETHINKING ENERGY

Supplying Competitive Electricity Rates

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[2] The West North Central Region includes Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska and Kansas. It is one of the regions used by the United States Energy Information Agency to analyze regional trends in energy use and prices.

[3] For a list of Minnesota's green energy policies, see Database of State Incentives for Renewables & Efficiency, "Minnesota: Incentives/Policies for Renewables and Efficiency," at http://www.dsireusa.org/incentives/index.cfm?re=0&ee=0&spv=0&st=0&srp=1&state=MN. *See also* Brian Bakst, "Xcel

Energy Plan to Steer 'Solar Gardens' Push," *Pioneer Press*, September 27, 2013, available at http://www.twincities.com/news/ci_24191383/xcel-energy-plan-steer-solar-gardens-push.

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[10] Mike Diller, "Direct Testimony on Behalf of the North Dakota Public Service Commission Advocacy Staff," *In the Matter of the Comprehensive Settlement Agreement*, North Dakota Public Service Commission Case No. PU-12-813 (January 2014), available at http://www.psc.nd.gov/database/documents/12-0813/168-030.pdf.

[11] Xcel Energy, *2013 Status Report & Associated Compliance Filings: Minnesota Electric and Natural Gas Conservation Improvement Program*, Minnesota Public Utilities Commission Docket No. E,G002/CIP-12-447, (April 1, 2014): p. 1.

[12] *Id.*, p. 2.

[13] *Id.*, p. 21, lines 3 and 14.

[14] As of December 2013 when new rates were established, the CIP tracker reports the program costs $0.005986 per kWh ($0.003051/kWh charged through the base rate and $0.002935/kWh charged through the CIP recovery adjustment rider). *Id.*, p. 21, lines 5 and 7. At $0.005986, the CIP accounts for 4.99 percent of the $0.12/kWh residential customers are paying. This assumes Xcel's current average rate is about the same as the state average rate of $0.1194 in 2013, as it was in 2012.

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[23] Chip Knappenberger, "Coal: 'Externalities' Can be Positive, Not Only Negative," *MasterResource*, March 7, 2011, at https://www.masterresource.org/externality-debate/coal-externalities-knappenberger/.

[24] Minnesota Department of Commerce, *Summary of 2013 Minnesota RES*

Compliance through Retirement of Renewable Energy Credits, Minnesota Public Utilities Commission Docket No. E999/PR-14-12 (June 6, 2014).

[25] The length of the period to accomplish this goal requires consideration of costs already incurred to satisfy green energy mandates and contracts in place. In took many years for Minnesota to lose its competitive position and it will take many years to gain it back. We estimate that it will take 10 years to bring about a 10 percent reduction. It may take fewer years considering the substantial and immediate savings available from eliminating the CIP.

[26] The parable of the broken window was first used by Frederic Bastiat in his famous 1848 essay, "What is Seen and What is Not Seen." Frederic Bastiat, *Selected Essays on Political Economy* (Irvington-on-Hudson, New York: The Foundation for Economic Education, 1995), available at http://www.econlib.org/library/Bastiat/basEss1.html.

[27] Mike Diller, Direct Testimony on Behalf of the North Dakota Public Service Commission Advocacy Staff, *In the Matter of the Comprehensive Settlement Agreement*, North Dakota Public Service Commission Case No. PU-12-813 (January 2014): p. 8, available at http://www.psc.nd.gov/database/documents/12-0813/168-030.pdf.

SMART BUDGETING FOR AN ERA OF LIMITS

[1] We acknowledge that some observers believe government spending should be deflated by a different price index than the consumer price index. But in a state where budgets must balance, the burden of government is based on its cost to taxpayers, not its imposition on government agencies. Much of the cost of government is under the agencies' control, but without incentives to control the cost of their inputs, the price of government is simply permitted to rise faster than the price of goods in the private sector.

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[3] Minnesota Department of Health, *Minnesota Health Care Spending and Projections, 2012* (June 2014), available at http://www.health.state.mn.us/divs/hpsc/hep/publications/costs/healthspending2014.pdf.

[4] This unfunded liability represents the most recent actuarial estimates reported in January 2014. After Center of the American Experiment cited this number in a previous report, the Retirement Systems of Minnesota claim "preliminary numbers indicate that unfunded liabilities have dropped below $10 billion." However, the Retirement Systems of Minnesota admitted they were using a market valuation to estimate the unfunded liability, not an actuarial valuation, which helps explain the dramatic difference. Officials have not come forward with preliminary numbers estimating the unfunded liability based on

actuarial values and so $17.3 billion remains the most recent data. *See* Retirement Systems of Minnesota, "CAE Response," (July 16, 2014), available at https://www.minnesotatra.org/images/pdf/CAE%20response.pdf.

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[6] For a description and evaluation of early efforts, see Minnesota Office of the Legislative Auditor, *Performance Budgeting* (February 1994): p. 66, available at http://www.auditor.leg.state.mn.us/ped/1994/perform.htm.

[7] Memorandum, Margaret Kelly to Chief Financial Officers and Budget Directors/Coordinators, "Subject: 2014-15 Biennial Budget, Part A: Narrative Instructions," July 11, 2012, available at http://www.mn.gov/mmb/images/Part%2520A%2520memo%2520July%252012.pdf.

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[9] Washington's priorities of government approach was directly supported by the St. Paul-based Public Strategies Group (PSG). Current and former PSG consultants have generously offered advice and support to the authors in their ongoing efforts to advance outcome budgeting in Minnesota.

[10] Marc Robinson and Duncan Last, *A Basic Model of Performance-Based Budgeting* (International Monetary Fund, September 2009), available at https://www.imf.org/external/pubs/cat/longres.aspx?sk=23247.0.

[11] Jim Chrisinger, "Budgeting that Really Works," *Governing*, May 17, 2010, available at http://www.governing.com/blogs/bfc/Budgeting-that-Really-Works.html.

[12] Minnesota Office of the Legislative Auditor, *Evaluation Report: Fiscal Notes*, Table A.1 (February 2012), available at http://www.auditor.leg.state.mn.us/ped/pedrep/fiscal.pdf.

[13] Ronald Snell, *The Power of the Purse: Legislatures that Write State Budgets Independently of the Governor* (National Conference of State Legislatures, March 2008), available at http://www.ncsl.org/research/fiscal-policy/the-power-of-the-purse-legislatures-that-write-st.aspx.

[14] Minn. Stat. § 3.3885, available at https://www.revisor.mn.gov/statutes/?id=3.885.

[15] Margaret Martin, "Requiem for the Sunset Commission," *Politics in Minnesota*, June 5, 2013, available at http://www.americanexperiment.org/publications/commentaries/requiem-for-the-sunset-commission.

[16] Minnesota Management and Budget, *Budget & Economic Forecast* (February 2014): p. 47, available at http://mn.gov/mmb/images/Budget%2526Economic_Forecast_Feb2014.pdf.

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2014 Forecast, available at http://www.dhs.state.mn.us/main/idcplg?IdcService=GET_DYNAMIC_CONVERSION&RevisionSelectionMethod=LatestReleased&dDocName=id_016358.

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TRANSPORTATION

Moving People and Commerce Where They Want and Need to Go

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[2] U.S. Census Bureau, *County Business Patterns* (2012), available at https://www.census.gov/econ/cbp/.

[3] U.S. Census Bureau, *2008-2012 American Community Survey 5-year Estimates*, Table B08141, Minneapolis-St. Paul-Bloomington, MN-WI Metro Area.

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Minnesota Department of Transportation, *Bond Accelerated Program Final Report to Legislature on Trunk Highway Bonding* (January 2008), available at http://archive.leg.state.mn.us/docs/2008/mandated/080098.pdf.

[5] Minnesota Department of Transportation, *MN Statewide Transportation Policy Plan 2009-2028*, Chapter 7 - Policy 5: Statewide Connections (August 2009), available at http://www.dot.state.mn.us/planning/stateplan/Final%20Plan%20Documents/Policy%20Plan/Entire/Minnesota%20Statewide%20Transportation%20Policy%20Plan_2009-2028.pdf.

[6] Minnesota Department of Transportation, *Minnesota State Highway Investment Plan: 2014-2033*, Appendix F (December 2013), available at http://www.dot.state.mn.us/planning/mnship/.

[7] Federal Highway Administration, U.S. Department of Transportation, *Highway Statistics 2012*, Table HM-47, available at http://www.fhwa.dot.gov/policyinformation/statistics.cfm

[8] *Id.*

[9] Minnesota Department of Transportation, *Assessing Return on Investment in Minnesota's State Highway Program* (November 2013), available at http://www.dot.state.mn.us/minnesotago/pdf/2013/MnDOTFinalReport.pdf.

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[11] "The Fix We're in For: The State of Our Bridges: Minnesota Data," Transportation for America, accessed November 10, 2014, http://t4america.org/maps-tools/bridges/states//?state=mn.

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[29] Minnesota Management and Budget, *Budget and Economic Forecast* (February 2014), available at http://www.mmb.state.mn.us/doc/fu/14/complete.pdf.

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MET COUNCIL POWER GRAB
How the Dayton Administration Intends to Transform the Twin Cities Region for Decades to Come

[1] Officials representing Anoka, Carver, Dakota, Scott, and Washington Counties met September 29, 2014, to endorse a resolution denouncing the Metropolitan Council's *2040 Transportation Policy Plan Draft* (July 2014). Carver County sent a letter summarizing these objections, which includes an attachment of their full objections. Gayle Degler, Carver County Board Chair to Susan Haigh, Metropolitan Council Chair, "RE: Draft 2040 Transportation Policy Plan (TPP) Input," September 16, 2014, available at http://www.co.carver.mn.us/docs/Draft_2040_Transportation_Policy_Plan__TPP__Input.pdf.

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[3] Metropolitan Land Planning Act of 1976, ch. 127, 1976 Minn. Laws.

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[9] *See* Metropolitan Council, *Economic Competitiveness and Prosperity: Proposed Policy Direction* (September 26, 2013), available at http://www.metrocouncil.org/METC/files/41/41bd3f21-9707-4375-998f-8739f82b9cb6.pdf; and Metropolitan Council, *Climate Change Mitigation, Adaptation and Resilience: Proposed Policy Direction* (August 2013), available at http://www.metrocouncil.org/METC/files/90/90165275-15ab-4bcd-9702-f5fdb40719c3.pdf.

[10] For example, the Council plans to "begin a sustained conversation that embeds the objectives of equity into the region's practices and investments extending across multiple jurisdictions and sectors." Metropolitan Council, *2040 Housing Policy Plan Draft Released for Public Comment* (July 2014): p. 72. The Council intends to "convene housing policy stakeholders with leaders from school districts and the Minnesota Department of Education to improve the alignment between housing planning and education." *Id*., p. 42.

[11] For example, the draft *2040 Housing Policy Plan* says the Council plans to "conduct, in coordination with the Equity in Place coalition, a series of public engagement sessions in specific communities where more prominent disparities exist in our region." *Id*., p. 73.

[12] Metropolitan Council, *Area Population Trend: 1950-2010 with Projection to 2040* (2014), available at http://metrocouncil.org/Data-and-Maps/Data/Census,-Forecasts-Estimates/Thrive-MSP-2040-Forecasts-(1).aspx .

[13] *See* Wendell Cox, "From Jurisdictional to Functional Analysis of Urban Cores and Suburbs," *NewGeography.com,* June 6, 2014, at http://www.newgeography.com/content/004349-from-jurisdictional-functional-analysis-urban-cores-suburbs. It is not valid for the Council to base its projections of housing demand until 2040 on short-term changes that occurred during the Great Recession of 2008 and the period of sluggish growth that followed it.

[14] Presentation on Sept. 29, 2014, by Carver County engineer Lyndon Robjent at a joint meeting of commissioners from Anoka, Carver, Dakota, Scott, and Washington Counties to critique Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), available at http://www.metrocouncil.org/Transportation/Planning/Transportation-Policy-Plan/2040-Transportation-Policy-Plan/2040-TPP-Public-Comment-Draft.aspx.

[15] Editorial, "Major Changes Ahead in Twin Cities Housing," *Star Tribune*. June 26, 2014, available at http://www.startribune.com/opinion/editorials/264822771.html. For a critique of the work of Arthur Nelson of the University of Arizona, who performed the Metropolitan Council-commissioned study in question, see Wendell Cox, "A Housing Preference Sea Change? Not in California," *New Geography* (blog), November 13, 2012, at http://www.newgeography.com/content/003224-a-housing-preference-sea-change-not-california. *See also* Randal O'Toole, "Housing Report Not Credible: The Met Council's Thrive Blueprint Calling for More Density by the Year 2040 Was Built on a Shaky Foundation," *Star Tribune,* July 4, 2014 available at http://www.americanexperiment.org/publications/commentaries/housing-report-not-credible.

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> Eighty-four percent of 18-34 year olds who are currently renting say that they intend to buy a home even if they can't currently afford to do so. …
>
> Glenn E. Crenlin from the Runstad Center for Real Estate Studies at the University of Washington believes that "what we're looking at in terms of the Millennial Generation is likely only a delay in homeownership of three to five years, not a long-term trend away from homeownership itself." He cites census data from the American Community Survey that shows a significant increase in homeownership among Millennials as compared to Baby Boomers when they were at the same age that Millennials are now. "While 900,000 households in the Millennial Generation [now] own their own home, only 500,000 Baby Boomer households owned their own homes at the same point in their lives."

See also Morley Winograd and Michael D. Hais, "The Millennial Metropolis," *NewGeography.com*, April 19, 2010, at http://www.newgeography.com/content/001511-the-millennial-metropolis, stating:

> According to the most recent generational survey research, done for Washington-based think tank, NDN, by Frank N. Magid Associates, 43 percent of Millennials describe suburbs as their 'ideal place to live,' compared to just 31 percent of older generations. In the same survey, a majority of older generations (56%) expressed a preference for either small town or rural living....

A majority (54%) of Millennials live in suburban America and most of those who do express a preference for raising their own families in similar settings. Even though big cities are often thought of as the place where young people prefer to live and work, only 17 percent of Millennials say they want to live in one, less than a third of those expressing a preference for suburban living.

[20] Figures calculated from Metropolitan Council, *Thrive MSP 2040 Forecasts* (May 2014), available at http://metrocouncil.org/Data-and-Maps/Data/Census,-Forecasts-Estimates/Thrive-MSP-2040-Forecasts-(1).aspx. The Minneapolis-St. Paul metropolitan area is larger than the seven-county metropolitan area, though the urban core for both areas is identical.

[21] Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014), available at http://www.metrocouncil.org/METC/files/34/34310c88-766b-406d-815b-bfbd1371fcc5.pdf.

[22] Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), available at http://www.metrocouncil.org/Transportation/Planning/Transportation-Policy-Plan/2040-Transportation-Policy-Plan/2040-TPP-Public-Comment-Draft.aspx.

[23] Susan Haigh, Maykow Hang, and Chris Ferguson, "Economic Equity Is Indeed a Group Effort," *Star Tribune*, December 1, 2014, available at http://www.startribune.com/opinion/commentaries/233878301.html.

[24] The following are examples of the Council's plan to expand its power over housing: "This *Housing Policy Plan* provides an integrated policy framework that unifies the Council's existing roles in housing and *opportunities for an expanded Council role* supporting housing across the region (emphasis added)," in Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014): p. 48. "Supporting local governments in their efforts to diversify their housing stock is a new opportunity for the Council," in Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014): p. 46. "Changes to the established Council roles in housing—including the Allocation of Affordable Housing Need, the Goals for Affordable and Life-cycle Housing, the Housing Performance Scores, and expanded roles in technical assistance—are examples of the Council's next steps to refine and implement this plan," in Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014): p. 73.

[25] *See* Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014): p. 48, for the Council's explanation of the "housing triumvirate: allocation, goals and housing performance scores."

[26] Libby Starling, "PowerPoint Presentation to Metropolitan Council Members," September 2014, p. 6.

[27] Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014), p. 76.

[28] *Id.*, p. 33.

[29] A "Housing Performance Score" has been used for some time, but the Council plans to revise it—along with its methods of determining affordable housing "need" and "goals." *See, e.g., id.*, pp. 42, 53, 76-7, and 86.

[30] *See, e.g.,* David Theisen "PowerPoint Presentation to the Metropolitan Council Committee of the Whole" (August 2014). The exception is that cities must comply if they want to participate in the Livable Communities program.

[31] *See, e.g.,* Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014), p. 29 ("Local role: Prepare a local comprehensive plan that addresses the housing planning requirements of the [MLPA], including guiding sufficient land to support a community's share of the regional affordable housing need, and housing element and implementation plan sections that identify the programs, fiscal devices and official controls to be employed to address a community's share of the regional need for affordable housing.").

[32] Metropolitan Council, *2040 Housing Policy Plan Draft,* pp. 54-56.

[33] The Council's system "statements describe how the [Council's] updated forecasts, system and policy plans apply to each individual community" and inform "the process of updating" communities' comprehensive plans. News Release, Metropolitan Council, "Council Outlines Next Steps in Planning Process for Communities," September 8, 2014, available at http://metrocouncil.org/News-Events/Planning/Newsletters/Council-outlines-next-steps-in-planning-process-fo.aspx. *See also* Metropolitan Council, *Comprehensive Plan Review through 2018* (undated), available at http://www.metrocouncil.org/Communities/Publications-And-Resources/Comp-Plan-Amendment-Review-Through-2018.aspx.

[34] Under Minn. Stat. § 473.857, a city that disagrees with the Met Council about the content of its system statement has 60 days to "request that a hearing be conducted by the [Council's] advisory committee or by the state Office of Administrative Hearings for the purpose of considering amendments to the system statement. If no request for a hearing is received by the council within 60 days, the statement shall be final."

[35] Housing and Urban Development Department, Proposed Rule, "Affirmatively Furthering Fair Housing," *Federal Register* 78, no. 5173-P-01 (July 19, 2013): pp. 43709-43743, available at, https://www.federalregister.gov/articles/2013/07/19/2013-16751/affirmatively-furthering-fair-housing.

[36] Libby Starling, "PowerPoint presentation to the Metropolitan Council with remarks by Erika Finkler, Acting Director, Fair Housing and Equal Opportunity Division, U.S. Department of Housing and Urban Development, Minneapolis" (September 2014).

[37] *See* Paul Sperry, "HUD Proposal Slammed as Fair Housing Overreach," *Investor's Business Daily,* December 30, 2013, available at http://news.investors.com/123013-684627-hud-proposal-called-fair-housing-overreach.htm. Terry

Eastland reports on an attorney's summary of the proposed rule:

> In an interview, Paul Compton, chair of the Affordable Housing and Community Development group at the law firm Bradley Arant Boult Cummings, summarized the change in policy this way: "It's a real shift in emphasis from ensuring that the private sector and participants in federal programs don't unlawfully discriminate to defining the existence of racially and ethnically 'segregated' neighborhoods to be in themselves a violation of fair housing." Likewise, "if a neighborhood is not integrated in some vaguely defined ratio, then that in itself is a fair housing issue."

Terry Eastland, "HUD's Power Grab," *Weekly Standard*, October 14, 2013, available at http://www.weeklystandard.com/articles/hud-s-power-grab_759151.html?page=3.

[38] Regarding land use and zoning, the rule affects "enacting or implementing land use rules, ordinances, policies or procedures that restrict or deny housing opportunities or otherwise make housing unavailable or deny dwellings because of [protected classes]." This includes zoning ordinances that limit multi-family housing. Michael Allen, *Disparate Impact Liability under the Fair Housing Act* [PowerPoint slides], Fair Housing Council of Oregon, January 29, 2014), available at http://www.fhco.org/pdfs/AFFHallen2.pdf (quoting proposed HUD Regulation).

[39] Robert Astorino, "Washington's 'Fair Housing Assault' on Local Zoning," *Wall Street Journal*, September 5, 2013, available at http://online.wsj.com/news/articles/SB10001424127887323623304579056721426092030.

[40] The proposed Affirmatively Furthering Fair Housing rule's "use of race likely violates the Fourteenth Amendment," according to a letter to HUD Secretary Shaun Donovan signed by three commissioners of the United States Commission on Civil Rights on Sept. 17, 2013. Abigail Thernstrom, Todd Gaziano and Peter Kirsanow, letter to Shaun Donovan, "Re: Docket No. FR-5173-P-01," September 17, 2013, available at http://www.newamericancivilrightsproject.org/wp-content/uploads/2014/04/HUD-Comment-Affirmatively-Furthering-Fair-Housing.pdf. The commissioners compared the rule's use of race to the race-based school assignment plans at issue in *Parents Involved in Community Schools v. Seattle School District No. 1*, 551 U.S. 701 (2007), where the Supreme Court ruled that racially-based school assignments violate the Constitution. According to the commissioners, "The proposed rule's justifications for discriminating on the basis of race are reminiscent of the school districts' justifications: 'reduc[ing] racial and ethnic origin concentrations', 'promot[ing] integration', 'reducing [the] concentration of tenants...by race', and 'reducing disparities in access to key community assets based on race'. These ends are no more compelling than those

offered by the school districts. Like the school districts, HUD is not attempting to desegregate housing areas that were legally segregated until very recently. HUD is not concerned about legal segregation, but about racial imbalance in residential areas. As Justice Thomas wrote, 'Racial imbalance is not segregation.... [It] can result from any number of innocent private decisions, including voluntary housing choices [citation omitted].'"

On November 3, 2014, Judge Richard Leon of the U.S. District Court for the District of Columbia threw out a 2013 HUD regulation imposing "disparate impact" racial policy on housing. The judge ruled that the 1968 Fair Housing Act allows only for direct discrimination claims, and not those based on "disparate impact." Leon wrote that the Obama administration's view that the act presumes disparate impact claims are allowed "appears to be nothing more than wishful thinking on steroids." Lawrence Hurley, "Court Rejects Obama Housing Bias Rule as 'Wishful Thinking,'" *Reuters*, November 3, 2014, available at http://www.reuters.com/article/2014/11/03/us-usa-court-discrimination-idUSKBN0IN24C20141103. In October 2014, the U.S. Supreme Court indicated that it would take up a related case. By the end of June 2015, the Court will likely determine whether the Fair Housing Act permits disparate impact lawsuits. *See also* Editorial, "Disparate Impact Rejected," *Wall Street Journal*, November 3, 2014, available at http://online.wsj.com/articles/disparate-impact-rejected-1415059893.

[41] Libby Starling, "PowerPoint presentation to the Metropolitan Council with remarks by Erika Finkler, Acting Director, Fair Housing and Equal Opportunity Division, U.S. Department of Housing and Urban Development, Minneapolis" (September 2014), pp. 5, 26.

[42] Howard Husock, "'Mixed Income' Housing Won't Spur Upward Mobility," *Wall Street Journal*, July 2, 2014, available at http://www.manhattan-institute.org/html/miarticle.htm?id=10493#.VCyfj-Z0xzk.

[43] *See* Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), p. 10: "All places—urban center, urban and suburban development—need a base of residential density need to support transit. The Council's growth forecasts will require that communities plan for minimum density targets so transit is successful."

[44] Metropolitan Council, *2040 Housing Policy Plan Draft* (July 2014), p. 26; and Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), pp. 23-27.

[45] *See* Metropolitan Council, *Thrive MSP 2040* (July 2014), p. 116.

[46] *See id.*, pp. 92-110.

[47] *See* Demographia, *Demographia: United States Central Business Districts, 3rd Edition* (March 2014), available at http://www.demographia.com/db-cbd2000.pdf.

[48] Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), p. 9.

[49] Adie Tomer, Elizabeth Kneebone, Robert Puentes, and Alan Berube, *Missed*

Opportunity: Transit and Jobs in Metropolitan America (Brookings Institution, May 2011), available at http://www.brookings.edu/~/media/research/files/reports/2011/5/12%20jobs%20and%20transit/0512_jobs_transit.pdf.

[50] Editorial, "Green Line Needs Green Lights in St. Paul," *Star Tribune*, August 20, 2014, available at http://www.startribune.com/opinion/editorials/272072551.html.

[51] This statement was made by Met Council spokeswoman Libby Starling in a presentation on August 6, 2014, at a forum sponsored by the Sensible Land Coalition. We cannot find a statement to this effect in the Transportation Policy Plan and have asked for clarification from the Met Council. The Council responded by referring us back to Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014).

[52] Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), p. 1.

[53] *Id.*, p. 5.

[54] Id., p. 2.

[55] These trips include cars, school buses, transit buses, bikes and pedestrians. (Sidewalks are included in road budgets).

[56] Wendell Cox, "The Transit-Density Disconnect," *NewGeography.com*, June 21, 2013, at http://www.newgeography.com/content/003781-the-transit-density-disconnect.

[57] Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), p. 7.

[58] *See id.*, pp. 2, 7, 13. The plan advises "manag[ing] the demand for driving" by "exploring parking policies such as parking pricing, on-street parking management, shared parking facilities, and parking maximums in zoning codes," according to Metropolitan Council, *2040 Transportation Policy Plan Draft* (July 2014), p. 7.

[59] *See* Alain Bertaud, "Cities as Labor Markets" New York University Marron Institute of Urban Management Working Paper #2 (February 2014), available at http://marroninstitute.nyu.edu/content/working-papers/cities-as-labor-markets. *See also* Wendell Cox, "Urban Planning 101," *NewGeography.com*, March 6, 2014, at http://www.newgeography.com/content/004203-urban-planning-101. For an analysis of how businesses along a transit route can suffer, see Frederick Melo, "For Light Rail-Related Street Work, University Avenue Businesses Billed," *Pioneer Press*, September 25, 2014, available at http://www.twincities.com/localnews/ci_26605290/university-ave-businesses-billed-rail-related-street-work.

[60] Alain Bertaud, *The Spatial Organization of Cities: Deliberate Outcome or Unforeseen Consequence?* (Institute for Urban and Regional Development, University of California at Berkeley, 2004), available at http://alain-bertaud.com/images/AB_The_spatial_organization_of_cities_Version_3.pdf.

[61] "Metropolitan Suburban Counties' 2040 Transportation Policy Plan Review" and related resolution, Counties of Anoka, Carver, Dakota, Scott and Washington, September 29, 2014.

[62] The commissioners charged that the Metropolitan Council's *2040 Transportation Policy Plan Draft* (July 2014), is "skewed to transit and non-motorized policy," while "statements related to improving the highway system are virtually non-existent."

[63] "Metropolitan Suburban Counties' 2040 Transportation Policy Plan Review" and related resolution, Counties of Anoka, Carver, Dakota, Scott and Washington, September 29, 2014, p. 5.

[64] *Id.*, p. 4

[65] Metropolitan Council, *2040 Regional Parks Policy Plan Draft Plan* (July 2014), available at http://www.metrocouncil.org/METC/files/3c/3cae8e61-aac1-43ac-a481-244614d150b6.pdf.

[66] For example, the plan inserts the Met Council into the process of prioritizing park projects and establishes a new competitive grant program to promote "equitable" use of the park system. *See* Cali Owings, "Met Council Parks Plan Under Scrutiny," *Finance and Commerce*, October 22, 2014, available at http://finance-commerce.com/2014/10/met-council-parks-plan-under-scrutiny/.

[67] Susan Feyder, "Met Council's Parks Plan Gets a Cool Reception in the Suburbs," *Star Tribune*, October 19, 2014, available at http://www.startribune.com/local/west/279681052.html. *See also* Metropolitan Council, "Council Engages People of Color to Discuss Regional Parks Usage," March 25, 2014, http://www.metrocouncil.org/News-Events/Parks/Newsletters/Council-engages-people-of-color-to-discuss-regiona.aspx.

[68] Susan Feyder, "Met Council's Parks Plan Gets a Cool Reception in the Suburbs," *Star Tribune*, October 19, 2014.

[69] John Gessner, "Burnsville Blasts Met Council Transportation, Housing Plans," *Sun This Week*, September 10, 2014, available at http://sunthisweek.com/2014/09/10/burnsville-blasts-met-council-transportation-housing-plans/.

[70] Laura Adelmann, "Met Council Transportation Plan Criticized," *Sun This Week*, September 18, 2014, available at http://sunthisweek.com/2014/09/18/met-councils-transportation-plan-criticized/.

[71] Mark VanderSchaaf, "PowerPoint presentation to Metropolitan Council's Community Development Committee" (November 2014), available at http://metrocouncil.granicus.com/MediaPlayer.php?view_id=2&clip_id=2050. For example, the Council intends to "assist" local governments to incorporate its "economic analysis" into their updated comprehensive plans and their "local economic development strategies."

[72] Mark VanderSchaaf and Janna King, "Economic Competitiveness Work Program," Metropolitan Council Community Development Committee

Information Item, August 4, 2014, available at http://www.metrocouncil.org/METC/files/01/010fb7ac-d3f6-48db-af42-78787a8ba931.pdf. *See also* "Economic competitiveness is new emphasis for Metropolitan Council," Civic Caucus Focus on Competitiveness Interview with Mark VanderSchaaf, September 13, 2013, available at http://civiccaucus.org/Interviews/2013/VanderSchaaf-Mark_09-13-13.htm.

[73] Mark VanderSchaaf, "Presentation to Metropolitan Council's Community Development Committee" (November 2014).

[74] *Id.*

[75] Metropolitan Council, *Economic Competitiveness and Prosperity: Proposed Policy Direction* (October 2013), available at http://www.metrocouncil.org/METC/files/41/41bd3f21-9707-4375-998f-8739f82b9cb6.pdf. For example, the Council's "shared economic competitiveness strategy" will "outline the roles and responsibilities of each partner [cities, counties, GREATER MSP, etc.]", along with "a process for identifying select development or redevelopment opportunities whose location, scale and complexity justify a regional focus."

[76] *Id.*

[77] Center of the American Experiment, *Minnesota Policy Blueprint Task Force on Metropolitan Governance* (2003), available at http://www.americanexperiment.org/publications/reports-books/task-force-on-metropolitan-governance.

[78] Minnesota Office of the Legislative Auditor, *Evaluation Report: Governance of Transit in the Twin Cities Region*, (January 2011), available at http://www.auditor.leg.state.mn.us/ped/pedrep/transit.pdf.

[79] *Id.* See letter dated January 2011 at front of the report and pp. 41-49.

[80] This observation is based on many interviews with elected officials and the Metro Cities, Metro County and other reports (listed in the Addendum hereto) written in response to the Office of the Legislative Auditor, *Evaluation Report: Governance of Transit in the Twin Cities Region* (January 2011).

[81] Although appealing at first glance, it is not at all clear that a directly elected Council would solve the problem—and many believe it would create new ones. It may be that our system of direct elections is simply not suited for a regionally based government with broad powers when we already have local, school board, county and state officials.

[82] More than 25 organizations are involved in transit, according to Office of the Legislative Auditor, *Evaluation Report: Governance of Transit in the Twin Cities Region* (January 2011), see letter dated January 2011 at front of the report and Table 1.3 (key organizations) and Table 1.5 (transit governance responsibilities).

[83] Office of the Legislative Auditor, *Evaluation Report: Governance of Transit in the Twin Cities Region* (January 2011), major findings and pp. 37-38.

[84] Most observers agree that a regional approach to waste water treatment makes sense, though transit is more complex. The suburban bus lines are

outstanding services that few customers would want to trade for transit run by the current Metropolitan Council.

[85] Susan Haigh, "The Metropolitan Council," *William Mitchell Law Review*, Vol. 40, No. 1 (2013): p. 161. Available at http://web.wmitchell.edu/law-review/wp-content/uploads/Volume40/documents/5.Haigh.pdf.

[86] Wendell Cox, "Regionalism: Spreading the Fiscal Irresponsibility," *NewGeography.com*, August 24, 2012, at http://www.newgeography.com/content/003044-regionalism-spreading-fiscal-irresponsibility. For a survey of different approaches and discussion about the Twin Cities, see Gerald E. Frug, "Beyond Regional Government," *Harvard Law Review,* Vol. 115, No. 1763 (2002), available at http://www.wjh.harvard.edu/urban/docs/FrugBeyondRegGovt.pdf.

[87] The Legislative Commission on Metropolitan Government was established to oversee the Metropolitan Council's operating and capital budgets, work program, and capital improvement program. The commission must monitor, review, and make recommendations to the Metropolitan Council and to the legislature for the following calendar year on: the tax rate and dollar amount of the Metropolitan Council's property tax levies and any proposed increases in the rate or dollar amount of tax; any request for an increase in the debt of the Metropolitan Council; the overall work and role of the Metropolitan Council; the Metropolitan Council's proposed operating and capital budgets, work program, and capital improvement program; and the Metropolitan Council's implementation of the operating and capital budgets, work program, and capital improvement program. Minn. Stat. § 3.8841.

[88] For example, counties could send seven county commissioners, cities could send seven elected officials, and the governor could appoint elected officials from the current districts or new districts (rural, suburban, urban) and perhaps the Council could even elect its own chair, rather than the governor appointing the chair.

[89] Furthermore, the Metropolitan Planning Organization (MPO) conduit problem must be resolved so that federal transportation funding can properly flow through a new regional body and/or new or existing state agencies (e.g., the Minnesota Department of Transportation—MnDOT).

PENSIONS

Keeping the Promise: Securing Retirement Benefits for Current and Future Public Employees

[1] Richard Ravitch and Paul Volker (Co-Chairs), *Report of the State Budget Crisis Task Force* (July 2012): p. 12, available at http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Summary.pdf. *See also*, Donald J. Boyd and Peter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans* (The Rockefeller Institute, January

2014), available at http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf; and Patten Priestley Mahler, Matthew M. Chingos, and Grover J. "Russ" Whitehurst, *Improving Public Pensions: Balancing the Competing Priorities, Brown Center on Education Policy* (Brookings Institute, February 2014), available at http://www.brookings.edu/~/media/research/files/papers/2014/02/26%20public%20pension%20reform/improving%20public%20pensions_final.pdf; Andrew Biggs, *The Multiplying Risks of Public Employee Pensions to State and Local Government Budgets* (American Enterprise Institute, December 2013), available at http://www.aei.org/files/2013/12/18/-the-multiplying-risks-of-public-employee-pensions-to-state-and-local-government-budgets_142010313690.pdf; and Andrew Biggs, "When it Comes to Public Pensions, There's Funding and Then There's 'Funding,'" American Enterprise Institute, January 15, 2014, available at http://www.aei.org/article/economics/when-it-comes-to-public-pensions-theres-funding-and-then-theres-funding/.

[2] Donald J. Boyd and Peter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans* (The Rockefeller Institute, January 2014), available at http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf; Patten Priestley Mahler, Matthew M. Chingos, and Grover J. "Russ" Whitehurst, *Improving Public Pensions: Balancing the Competing Priorities, Brown Center on Education Policy* (Brookings Institute, February 2014), available at http://www.brookings.edu/~/media/research/files/papers/2014/02/26%20public%20pension%20reform/improving%20public%20pensions_final.pdf; and Patrick McGuinn, *Pension Politics: Public Employee Retirement System Reform in Four States* (Brookings Institute, February 2014), available at http://www.brookings.edu/~/media/research/files/papers/2014/02/26%20public%20pension%20reform/pension%20politics_final_225.pdf.

[3] Another 159,392 people paid into the pension system at one time or another but did not "vest." Minnesota Legislative Commission on Pensions and Retirement, *2013 Actuarial Valuation Results, Summary of All Plans* (January 22, 2014): p. 2, available at http://www.commissions.leg.state.mn.us/lcpr/documents/valuations/2013/2013_valuation_summary_ava_2-yr.pdf; and U.S. Census data for Minnesota.

[4] For simplicity, we combine all funds (MSRS, PERA, TRA and others included under "All Plans" by the LCPR Valuation Report) and treat them as a whole ("combined funds"). We note that each fund has its own assumptions, funding ratio and other distinct features.

[5] Laura Kalambokidis, *Rate of Return Assumptions for Minnesota's Public Pension Plans* [PowerPoint slides], Minnesota Legislative Commission on Pensions and Retirement Meeting, August 29, 2013, available at http://www.commissions.leg.state.mn.us/lcpr/documents/mtgmaterials/2013/Kalambokidis_LCPR_08292013_final.pdf (suggested yields to consider are 10-year treasury/

riskless rate of 4.3%, Aaa corporate bonds/Moody's and FASB rate of 6.0%, Aaa municipal bond/CBO Fair Value approach rate of 6.7%).

[6] Plans in this calculation are all open funds with 2013 data available and include MSRS, MSRS-Correctional, State Patrol, Judges Retirement Plan, PERA-General, PERA-Correctional, PERA-Police and Fire, MERF, TRA, DTRFA, & SPTRFA.

[7] The full actuarially required contribution for these pension funds was $2.4 billion. Minnesota Legislative Commission on Pensions and Retirement, *2013 Actuarial Valuation Results, Summary of All Plans* (January 22, 2014): p. 2, available at http://www.commissions.leg.state.mn.us/lcpr/documents/valuations/2013/2013_valuation_summary_ava_2-yr.pdf.

[8] The actuarially required contribution (ARC), missed by $378 million for "All Funds" is what full funding looks like under current assumptions. Minnesota Legislative Commission on Pensions and Retirement, *2013 Actuarial Valuation Results, Summary of All Plans* (January 22, 2014): p. 2, available at http://www.commissions.leg.state.mn.us/lcpr/documents/valuations/2013/2013_valuation_summary_ava_2-yr.pdf.

[9] Gabriel Roeder Smith & Company, *Minnesota State Retirement System State Employees Retirement Fund: Actuarial Valuation Report as of July 1, 2013* (November 26, 2013): p. 1, available at http://www.commissions.leg.state.mn.us/lcpr/documents/valuations/2013/2013valuation.msrs.general.pdf.

[10] $71 million comes from state aid and $43 million from local governments. Minnesota Legislative Commission on Pensions and Retirement, *2013 Actuarial Valuation Results, Summary of All Plans* (January 22, 2014), available at http://www.commissions.leg.state.mn.us/lcpr/documents/valuations/2013/2013_valuation_summary_ava_2-yr.pdf.

[11] "New Stadium Q&A," Minnesota Vikings Football, accessed November 7, 2014, http://www.vikings.com/stadium/new-stadium/faq.html#nvs-construction.

[12] Minnesota Management and Budget, *Consolidated Funds Statement* (June 27, 2014), available at http://mn.gov/mmb/images/CFS_May2014.pdf.

[13] The average teacher salary in Minnesota is $54,945. Minnesota Department of Education, *Minnesota Report Card, 2013 Staffing Profile*, at http://rc.education.state.mn.us/.

[14] "Transportation FAQs," American Road &Transportation Builders Association, accessed November 7, 2014, http://www.artba.org/about/transportation-faqs/#20; or Rails to Trails, *What is the Cost of Constructing a Mile of Highway?* (n.d.), available at http://www.railstotrails.org/resources/documents/whatwedo/policy/07-29-2008%20Generic%20Response%20to%20Cost%20per%20Lane%20Mile%20for%20widening%20and%20new%20construction.pdf.

[15] Itasca County estimates it costs $15,500 per mile per year to maintain a bituminous road. Karen Grandia, *5-Year Plan for Highway Improvement Projects*

(Itasca County, April 8, 2014), available at https://www.co.itasca.mn.us/Home/Departments/Transportation/Documents/5%20year%20plan.pdf; and Bill Salisbury, "Road to Minnesota transportation funds is not a smooth one" *Pioneer Press*, July 6, 2013, available at http://www.twincities.com/ci_23607277/road-minnesota-transportation-funds-is-not-smooth-one.

[16] *See* pension debt schedules Figures 1 and 2 in Josh McGee, *The Transition Cost Mirage: False Arguments Distract from Real Pension Reform Debates* (Arnold Foundation, March 2013), available at http://www.arnoldfoundation.org/sites/default/files/pdf/LJAF_Transition_Cost_Policy_Brief.pdf. The unfunded liabilities are assets that are not available to SBI for investing (so the funds miss out on their earning power). In a very real sense, the state has "borrowed" from the pension assets at a high rate (the real rate of return or in theory the ARR of 8.5 percent).

[17] Minnesota also uses long amortization periods (25-30 years) to pay off unfunded liabilities, which pushes costs on to future employees and generations of taxpayers. GASB now recommends that the amortization period not extend beyond the average expected service years of active and inactive members (more like 15-17 years). For a discussion on GASB Rules 67 and 68, see News Release, Governmental Accounting and Standards Board, "GASB Improves Pension Accounting and Financial Reporting Standards," June 25, 2012, available at http://www.gasb.org/cs/ContentServer?pagename=GASB/GASBContent_C/GASBNewsPage&cid=1176160126951. The rules are explained in Bill Karbon, "GASB's New Rules on Uniformity and Disclosure," *Plan Consultant* (Winter 2014).

[18] For insights into the political compromise that gave us a "select and ultimate" rate, see Hazel Bradford, "Public DB plans follow corporate lead in using 'select and ultimate' rates," *Pensions & Investments*, August 8, 2012, available at http://www.pionline.com/article/20120808/ONLINE/120809942/public-db-plans-follow-corporate-lead-in-using-select-and-ultimate-rates. In 2012 Minnesota adopted a unique version of a "select and ultimate" rate. It lowered the ARR to 8.0% but only did so for five (5) years. Each year the rate goes up .01% until reaching 8.5% in 2017. While the "select and ultimate" approach is new, it is supposed to feature a longer time frame so that the change has an actuarial impact on the system. From an actuarial standpoint, which takes the long view, five years is not long enough to have any notable impact. It is not clear if Minnesota's reduced ARR improved the calculation of future liabilities or reduced any investment risks (all benefits of a lower ARR if used over a long time frame).

[19] The COLA, however, can be reduced for current retirees. *See Swanson v. State,* No. 62-CV-10-05285 (Minn. Dist. Ct., June 29, 2011). For a discussion on Minnesota case law, see Amy Monahan, *Understanding the Legal Limits on Public Pension Reform* (American Enterprise Institute, May 2103): p. 6, available at http://www.aei.org/wp-content/uploads/2013/05/-understanding-the-legal-limits-on-

public-pension-reform_104816268458.pdf.

[20] *See* Donald J. Boyd and Peter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans* (The Rockefeller Institute, January 2014): pg. viii, available at http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf (discussing the U.S. public pension system versus private funds and other countries). For a discussion on how to value pension liabilities, see Paul Angelo, *Understanding the Valuation of Public Pension Liabilities: Expected Cost Versus Market Price* (American Enterprise Institute, May 2013), available at http://www.aei.org/papers/economics/retirement/pensions/understanding-the-valuation-of-public-pension-liabilities-expected-cost-versus-market-price/.

[21] Donald J. Boyd and Peter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans* (The Rockefeller Institute, January 2014): p.viii, available at http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf.

[22] For a good primer for legislators and citizens, see Minnesota Center for Fiscal Excellence*, Fixing Minnesota's Public Pensions: What Every Citizen Should Know* (April 2014), available at http://www.fiscalexcellence.org/our-studies/pension-guide-2014-final.pdf.

[23] The National Institute on Retirement Security (NIRS) is a champion for public defined benefit systems and regularly testifies at the pension commission. The board of directors is dominated by public retirement systems. For more detail, see Robert Costrell, "*GASB Won't Let Me*"*—A False Objection to Public Pension Reform* (Arnold Foundation, May 2012): p. 13, fn. 16, available at http://arnoldfoundation.org/img/LJAF-Policy-Perspective-GASB-Wont-Let-Me.pdf.

[24] *See* "Board of Trustees," Minnesota Teachers Retirement Association, accessed November 7, 2014, https://www.minnesotatra.org/administration/bdtrustees.html.

[25] *See* Minnesota Office of the Legislative Auditor, *Postemployment Benefits for Public Employees* (January 2007), available at http://www.auditor.leg.state.mn.us/ped/pedrep/postemployment.pdf.

[26] Some members of the Legislature, rather than focusing on how to pay off the unfunded liability, have asked the state actuaries how to get to 90% funding so they can increase the COLA for retirees again. The dilemma: once you start paying an increased COLA, the funding ratio drops below 90% again. *See* William V. Hogan & Timothy J. Herman, *July 1, 2013 Actuarial Review of the Retirement Systems under the Minnesota Legislative Commission on Pensions and Retirement* (Milliman, January 31, 2014): p. 7, available at http://www.commissions.leg.state.mn.us/lcpr/documents/valuations/2013/2013_actuarial_review_milliman.pdf. The actuary notes that most of the pension funds "will not reach the 90% funding level within the next 15 years in order to pay the COLA….This implies that additional actions may be necessary if the goal is to achieve a 90% funding level." The report

goes on to suggest various ways for the fund assumptions to be changed so that the COLA can be paid. As of 2014, the fund has to be at 90% for two years before paying a COLA. See summary of Article 11 of the 2014 Omnibus Pension Bill in Edward Burek to Members of the Legislative Commission on Pensions and Retirement, "2014 Omnibus Retirement Bill (H.F. 1951, 4th Engr.), as Sent to the Governor," May 20, 2014, available at http://www.commissions.leg.state.mn.us/lcpr/documents/omnibus/2014/H1951-4_Summary_of_4th_Engr.pdf.

[27] Pension Omnibus bills are summarized by the Legislative Commission on Pensions and Retirement and available at http://www.commissions.leg.state.mn.us/lcpr/sessionsummaries.htm.

[28] See summary of Article 3, 2014 Omnibus Pension in Bill Edward Burek to Members of the Legislative Commission on Pensions and Retirement, "2014 Omnibus Retirement Bill (H.F. 1951, 4th Engr.), as Sent to the Governor," May 20, 2014, available at http://www.commissions.leg.state.mn.us/lcpr/documents/omnibus/2014/H1951-4_Summary_of_4th_Engr.pdf . This change may be in response to new GASB Rules 67 and 68 (contribution policies are expected to change to avoid asset depletion and due to pressure from new rules on the discount rate). *See* Bill Karbon, "GASB's New Rules on Uniformity and Disclosure," *Plan Consultant* (Winter 2014).

[29] There are three major pension systems (PERA, TRA and MSRS), plus several independent funds, all with individual funding ratios and valuations. For purposes of simplicity, we are combining them here.

[30] *See* Center for Public Finance Research, *Public Pensions in Minnesota: Re-Definable Benefits and Under-Reported Performance* (May 2006): p 46, 50-51, available at https://www.fiscalexcellence.org/our-studies/public-pensions-in-minnesota-final.pdf.

[31] The pension plans, individually and as a group, suffer from other unsound practices that reduce the assets available for investment and contribute to inequities among public employees (such as ever-changing contributions and formulas, spiking pension benefits through the use of over-time, or allowing employees to retire and take a pension while getting hired for another position that will also pay a pension benefit). We are not addressing those kinds of practices or proposing reforms to fix the defined benefit system in this paper. We have concluded that defined benefit plans are not consistent with today's demographic and market challenges,—and that defined benefit plans are too vulnerable to political mischief. Our focus, instead, is on funding the defined benefit plans, paying down the unfunded liability and introducing a secure alternative system. But these unsound practices should be addressed by the Legislature.

[32] Moody's uses a discount rate for calculating liabilities tied to the yield on Aaa corporate bonds (around 6%). Minnesota is paying off the pension debt via an amortization schedule that pushes off the cost far into the future, which

significantly raises the cost of that debt. *See* Kim Crockett, *Minnesota Taxpayers to Pay Higher Borrowing Costs Because of Pension Debt* (Center of the American Experiment, August 2, 2013), available at http://www.americanexperiment.org/sites/default/files/article_pdf/Borrowing%20cost%20and%20pension%20debt.pdf.

[33] "Historical Annual Returns of the S&P 500 Index-Updated Through 2013," *Jim's Finance and Investments Blog*, February 8, 2014, at http://financeandinvestments.blogspot.com/2014/02/historical-annual-returns-for-s-500.html. Perhaps the state considers the S&P's long term (more than 30 years) returns of over 10 percent when setting the ARR. After all, the pension obligations are long term. But when you look at the ARRs in the private pension sector, they dropped over the last decade. *See* Society of Actuaries, *Report of the Blue Ribbon Panel on Public Pension Plan Funding* (February 2014), available at https://www.soa.org/blueribbonpanel/.

[34] Retirement Systems of Minnesota, *Public Pensions: Myths and Facts* (n.d.), available at https://www.minnesotatra.org/images/pdf/MythsFacts-combined%20 2012-13.pdf.

[35] Gregory Zuckerman, "Big Investors Missed Stock Rally," *Wall Street Journal*, June 23, 2014, see graph showing *public funds* dropping to about 50% equities in 2013, available at http://online.wsj.com/articles/big-investors-missed-stock-rally-1403567478. The SBI asset allocation as of June 30, 2014 is about 61 percent equities, 23 percent fixed income and 13 percent "alternatives" with the rest in cash. (The goal is 20 percent "alternatives" though SBI has not met that goal presumably because not enough "alternative" vehicles have met SBI's criteria). *See* Minnesota State Board of Investment, *Combined Funds (Net of Fees)* (June 30, 2014), available at http://mn.gov/sbi/Combined%20Funds%20Performance.html. By contrast, the average asset mix for private pension funds, which use lower ARRs and discount rates, and must be fully funded under federal law, is 41 percent in equities, 40 percent in fixed income and 20 percent in "other' investments. *See* Milliman, "Corporate Pension Funding Study" (*Milliman,* 2013), available at http://us.milliman.com/Solutions/Products/Corporate-Pension-Funding-Study/; and Donald J. Boyd and Peter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans* (The Rockefeller Institute, January 2014): p. 23, available at http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf.

[36] For a general discussion of this risk, see Pew Charitable Trusts & the Laura and John Arnold Foundation, *State Public Pension Investments Shift Over Past 30 Years* (June 2014), available at http://www.pewtrusts.org/~/media/Assets/2014/06/PensionInvestments06032014.pdf. What happens when there is another market downturn? Current assets total about $57 billion. An 18 percent loss (2009 loss) would reduce assets by over $10 billion.

[37] Alaska offers a cautionary tale of pension reform and why it is critical to

fully fund the remaining defined benefit system, and to pay off the unfunded liability. A new defined contribution for new employees does not solve the defined benefit problem. *See* Victor Nava, "Did Pension Reform in Alaska Fail?", *Out of Control Policy Blog*, *Reason Foundation*, May 7, 2014), available at http://reason.org/blog/show/did-pension-reform-in-alaska-fail.

[38] This recommendation comes from the accounting standards boards (GASB/FASB) and across the political spectrum of pension experts in the academic and think tank world.

[39] This report could also include state and municipal unfunded liabilities for OPEB ("other post-retirement benefits") such as health care.

[40] For current law, see Minn. Stat. § 352.03 Subd. 5, available at https://www.revisor.mn.gov/statutes/?id=352.03 (governing MSRS); and Minn. Stat. § 354.06 Subd. 2a, available at https://www.revisor.mn.gov/statutes/?id=354.06 (governing TRA). "The director must have had at least five years' experience on the administrative staff of a major retirement system." PERA's statutory language is different: "The executive director must have had at least five years' experience in an executive level management position, which has included responsibility for pensions, deferred compensation, or employee benefits." Minn. Stat. § 353.03, available at https://www.revisor.mn.gov/statutes/?id=353.03.

[41] Two examples are the 2013 annual cash bailouts of the school districts of Duluth ($14.3 million) and Saint Paul ($7 million). Why should the state taxpayer pay (potentially in perpetuity) for the bad management practices of these school districts? The practices that lead to the unfunded liabilities remain in place and in both cases, and retirees are scheduled to receive an increase in benefits (COLA to match TRA). If the state taxpayer had to be called to the rescue, surely a more respectable deal could have been reached.

[42] If the municipality cannot afford to cover the gap, bankruptcy should be considered. While municipalities can declare bankruptcy, the state cannot under federal law. Amy Monahan, *Understanding the Legal Limits on Public Pension Reform* (American Enterprise Institute, May 2013): p.6, available at http://www.aei.org/wp-content/uploads/2013/05/-understanding-the-legal-limits-on-public-pension-reform_104816268458.pdf.

[43] Other options under consideration around the country include hybrids and cash balance plans. While these may be more politically attractive, they do not solve the problem and are, therefore, not sound policy. *See* Richard Dreyfuss, *Fixing the Public Sector Pension Problem: The (True) Path to Long-Term Reform* (Manhattan Institute, February 2013), available at http://www.manhattan-institute.org/html/cr_74.htm#.U7WjlPldW-g.

[44] Josh McGee from the Arnold Foundation testified before the LCPR on January 28, 2014 about retirement design. Josh McGee, *Retirement Design: Much of What You Think You Know is Wrong* [PowerPoint slides], Minnesota Legislative

Commission on Pensions and Retirement Meeting, January 28, 2014, available at http://www.commissions.leg.state.mn.us/lcpr/documents/mtgmaterials/2014/mcgee_presentation_012814.pdf.

[45] When the Legislature asked the pension plans in 2010 to study and report on a transition from the DB system to a DC or hybrid system, the pension plans issued a report that shut down the discussion by claiming that the transition costs were astronomical; the report has been criticized as confused and misleading. The critique reveals the conflict of interest. *See* Robert Costrell, "*GASB Won't Let Me*"*—A False Objection to Public Pension Reform* (Arnold Foundation, May 2012), available at http://arnoldfoundation.org/img/LJAF-Policy-Perspective-GASB-Wont-Let-Me.pdf. Minnesota's actuary and legislative study are called out by Costrell for being in error on pages 13-14; the NIRS, which Minnesota relies on for "expert" testimony is thoroughly discredited in a footnote on page 13, as it members are "virtually all public retirement systems." In other words, they are not an independent resource. Also the "Transition Cost" objection has been thoroughly debunked here (page 30) and elsewhere. *See* Andrew Biggs, Josh McGee and Michael Podgursky, "Transition Cost Not a Bar to Pension Reform," *Pension & Investments*, January 6, 2014, available at http://www.pionline.com/article/20140106/PRINT/301069999/transition-cost-not-a-bar-to-pension-reform; and Josh McGee, *The Transition Cost Mirage: False Arguments Distract from Real Pension Reform Debates* (Arnold Foundation, March 2013), available at http://www.arnoldfoundation.org/sites/default/files/pdf/LJAF_Transition_Cost_Policy_Brief.pdf. (argues that the state can and should pay off debt early).

[46] The state already offers a variety of supplemental defined contribution plans for employees as well. Here is the link to the MNSCU plan: http://www1.tiaa-cref.org/tcm/mnscu/plans/index.htm. TIAA is a lifetime benefit, so those wanting a steady stream of annuity income can buy it at any time. You can move all CREF accounts to TIAA when you want to lock in retirement income. *See also* Thomas Gais and Paul Yakoboski, *Public Sector Pension Reform: Addressing Pressing Fiscal Realities from a Long-Term Perspective* (TIAA-CREF Institute and Rockefeller Institute of Government, 2013), available at http://www.rockinst.org/pdf/government_finance/2013-06-13-TIAA-CREF_Pension_Reform.pdf.

[47] Michigan has the longest experience to offer. It moved new state employees to a DC plan in 1997. For an estimate of the savings and other benefits, see Richard Dreyfuss, *Estimated Savings from Michigan's 1997 State Employees Public Pension Reform* (Mackinac Center for Public Policy, June 23, 2011), available at http://www.mackinac.org/archives/2011/2011-03PensionFINALweb.pdf. *See also Pension Modernization for the 21st Century Workforce, United States Senate* (2012) (testimony of Andrew Biggs, American Enterprise Institute, Washington, D.C.), available at http://www.help.senate.gov/imo/media/doc/Biggs1.pdf.

[48] Private pensions generally do not pay COLAs.

[49] For background, see Minnesota Office of the Legislative Auditor, *Evaluation Report: Postemployment Benefits for Public Employees* (January 2007), available at http://www.auditor.leg.state.mn.us/ped/pedrep/postemployment.pdf .Would the reduction of the COLA for certain employees be constitutional? It is not clear but the 2010 Swanson decision held that the state, as the manager of the funds, had the discretionary power to change the COLA (not the base pension), *Swanson v. State,* Minn. District Court, June 29, 2011 No. 62-CV-10-05285.

[50] This is recommended by GASB. For a discussion on how this saves money, see Josh McGee, *The Transition Cost Mirage: False Arguments Distract from Real Pension Reform Debates* (Arnold Foundation, March 2013): p. 5, available at http://www.arnoldfoundation.org/sites/default/files/pdf/LJAF_Transition_Cost_Policy_Brief.pdf. Minnesota will have to strike a balance between paying down debt and maintaining a high credit rating. In 2012, a level dollar payment was adopted for the (closed) Legislators funds. Omnibus Pension Bill, ch. 286, Art. 5, Sec. 1, 2012 Minn. Laws, available at https://www.revisor.mn.gov/laws/?year=2012&type=0&doctype=Chapter&id=286.

[51] Minn. Stat. § 475.52 Subd.6, available at https://www.revisor.mn.gov/statutes/?id=475.52; and Minn. Stat. § 475.58 Subd. 1 (7) and (10), available at https://www.revisor.mn.gov/statutes/?id=475.58. Minneapolis appears to be the only city that has done this so far but school districts are issuing bonds. *See* Minnesota Office of the State Auditor*, Special Study: Other Postemployment Benefit Liabilities of School Districts in Minnesota* (March 31, 2009), available at http://www.osa.state.mn.us/reports/gid/2009/opeb/OPEB_liabilities_report.pdf; Liz Farmer, "The not-so-sunny side of pension obligation bonds," *Governing Magazine,* July 8, 2014, available at http://www.governing.com/topics/finance/gov-a-financial-tool-governments-should-use-with-caution.html; Alicia H. Munnell, Jean-Pierre Aubry, and Mark Carafelli, *An Update on Pension Obligation Bonds* (Center for State and Local Government Excellence, July 2013), available at http://slge.org/publications/an-update-on-pension-obligation-bonds.

HEALTH CARE

State Solutions in an Era of federal control

[1] Arnold J. Rosoff, "The Federal HMO Assistance Act: Helping Hand or Hurdle?", *American Business Law Journal*, Vol. 13, No. 2 (Fall 1975): p. 137.

[2] Centers for Medicare and Medicaid Services, National Health Expenditure Data (n.d.), available at http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/index.html.

[3] Robin A. Cohen, *Health Insurance Coverage Trends, 1959–2007: Estimates from the National Health Interview Survey*, National Health Statistics Report No. 17 (July 1, 2009), available at http://www.cdc.gov/nchs/data/nhsr/nhsr017.pdf; and Robin A. Cohen and Michael E. Martinez, *Health Insurance Coverage: Early*

Release of Estimates From the National Health Interview Survey, January–March 2013, (National Center for Health Statistics, September 2013), available at http://www.cdc.gov/nchs/data/nhis/earlyrelease/insur201309.pdf.

[4] Note insurance coverage or lack of coverage does not directly reflect a person's access to care. Some people without coverage can access care at free or low-cost clinics. Emergency rooms must also treat anyone who shows up. Furthermore, people who would qualify for Medicaid can basically wait to sign up until they need care because Medicaid allows retroactive payments.

[5] This perception largely stems from Dartmouth University researchers who regularly find Medicare spends less per person in Minnesota. Based on this research, President Obama specifically praised the Mayo Clinic in 2009 for its high quality, low cost care. No one disputes Mayo's quality, but there is a reason why most insurers don't include Mayo in their network and why people in the city of Rochester pay far higher insurance premiums than anyone else in the state. Mayo costs more. Peter J. Nelson, *The Mayo Clinic: High quality yes, but low cost?* (Center of the American Experiment, September 8, 2009).

Another factor driving this perception is the fact that Minnesota now has the lowest health insurance premiums in the individual market in the country. Yet these low rates are likely an aberration. Until the end of the year, many of the highest risk, most expensive people remain insured through the state's high risk pool. Moreover, the 2014 premiums offered by the lowest cost insurer in the individual market proved too low to sustain and so the insurer recently announced they will drop out of the state's insurance exchange in 2015. Paul Demko, "Reform Update: Exit of PreferredOne from MNsure raises practical and political questions," *Modern Healthcare*, September 19, 2014, available at http://www.modernhealthcare.com/article/20140919/NEWS/309199964. Furthermore, Minnesota insurers have substantial reserves, which would allow them to raise rates more conservatively and gradually. Jackie Crosby, "Minnesota health plans pile up big reserve," *Star Tribune*, July 15, 2013, available at http://www.startribune.com/business/215609981.html.

[6] Centers for Medicare and Medicaid Services, National Health Expenditure Data, available at http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/res-tables.pdf.

[7] Higher than average spending is due to Minnesota's very generous Medicaid program. In 2009, Minnesota spent $9,851 per Medicaid enrollee, far more than the national average of $6,826. By contrast, the CMS data show Minnesota spent less per enrollee on Medicare ($8,941 versus $10,365) and about the same per enrollee on private health insurance ($3,649 versus $3,766). Clearly, Medicaid pushed Minnesota over the top.

[8] Agency for Healthcare Research and Quality, *Medical Expenditure Panel*

Survey, Table X.D. Premium distributions (in dollars) for private-sector employees enrolled in family coverage at the 10th, 25th, 50th(median), 75th and 90th percentiles, private-sector by State; United States (various years), available at http://meps.ahrq.gov/mepsweb/. Survey data produced suspiciously high estimates for average family premiums in 2008 (Minnesota ranked 50th lowest) and suspiciously low estimates in 2013 (Minnesota ranked 10th lowest). Thus, these data were not used. AHIP surveys produce similar results.

[9] Agency for Healthcare Research and Quality, *Medical Expenditure Panel Survey*, Table X.C. Premium distributions (in dollars) for private-sector employees enrolled in single coverage at the 10th, 25th, 50th(median), 75th and 90th percentiles, by State; United States (various years), available at http://meps.ahrq.gov/mepsweb/. *See also* Center for Policy and Research, America's Health Insurance Plans, *Small Group Health Insurance in 2010: A Comprehensive Survey of Premiums, Product Choices, and Benefits* (July 2011), available at http://www.ahip.org/Small-Group-Report-2011.aspx; Center for Policy and Research, America's Health Insurance Plans, *Individual Health Insurance 2009: A Comprehensive Survey of Premiums, Availability, and Benefits* (October 2009), available at http://www.ahip.org/Individual-Health-Insurance-Survey-2009/.

[10] Minnesota Department of Health, *Minnesota Health Care Spending and Projections, 2012* (June 2014), available at http://www.health.state.mn.us/divs/hpsc/hep/publications/costs/healthspending2014.pdf. The latest projections published in Health Affairs estimates health spending will grow 5.6 percent in 2014 and average 6.0 percent annual growth from 2015 to 2023, increasing health care expenditures as a share of GDP to 19.2 percent. Andrea M. Sisko et al, "National Health Expenditure Projections, 2013–23: Faster Growth Expected With Expanded Coverage And Improving Economy," *Health Affairs* (September 2014), available at http://content.healthaffairs.org/content/early/2014/08/27/hlthaff.2014.0560. Similarly, PricewaterhouseCoopers projects 6.8 percent spending growth in the employer-sponsored market in 2015. PricewaterhouseCoopers, *Medical Cost Trend: Behind the Numbers 2015* (June 2014), available at http://www.pwc.com/us/en/health-industries/behind-the-numbers/.

[11] Between 2014 and 2024, the CBO projects GDP will grow at an average annual rate of 4.5 percent. Congressional Budget Office, *Economic Projections: August 2014 Baseline From An Update to the Budget and Economic Outlook: 2014 to 2024* (August 27, 2014), available at http://www.cbo.gov/publication/45066.

[12] David Radley et al., *Aiming Higher: Results from a Scorecard on State Health System Performance, 2014,* (The Commonwealth Fund, April 30, 2014), available at http://www.commonwealthfund.org/publications/fund-reports/2014/apr/2014-state-scorecard.

[13] UnitedHealth Foundation, America's Health Rankings, *2013 Annual Report*, available at http://www.americashealthrankings.org/reports/Annual.

[14] U.S. Census Bureau, *Health Insurance in the United States: 2013* (September 2014), available at http://www.census.gov/hhes/www/hlthins/data/index.html.

[15] U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage: 2005* (August 2006), available at http://www.census.gov/hhes/www/hlthins/data/incpovhlth/2005/index.html.

[16] This is in part due to the fact that most states allowed higher premiums. By law Minnesota capped premiums at 125 percent of comparable private coverage, whereas most other states capped premiums between 150 and 250 percent of private rates. Also, some states capped the number of people allowed to be in the high risk pool.

[17] James Bailey and Douglas Webber, "The Political Roots of Health Insurance Benefit Mandates," Mercatus Center Working Paper #14-14 (May 2014), available at http://sites.temple.edu/jamesbailey/files/2013/10/PoliticsOfMandates10-29.pdf, *citing* Susan Laudicina, Joan Gardner, and Kim Holland, *State legislative healthcare and insurance issues: Technical report* (Blue Cross and Blue Shield Association, 2011). *See also* News Release, Council on Affordable Health Insurance, "CAHI Identifies 2,271 State Health Insurance Mandates," (April 9, 2013), available at http://www.cahi.org/cahi_contents/newsroom/article.asp?id=1115 (finding Minnesota has the fourth most insurance mandates in 2012).

[18] James Bailey, "The Effects of Health Insurance Benefit Mandates on Premiums," *Eastern Economic Journal*, Vol. 40 (Winter 2013): pp. 119-127. *See also* Amanda E. Kowalski, William J. Congdon, and Mark H. Showalter, "State health insurance regulations and the price of high-deductible policies," *Forum for Health Economics & Policy*, Vol. 11, No. 2 (2008). *But see* Tracey A. LaPierre et al., "Estimating the impact of state health insurance mandates on premium costs in the individual market," *Journal of Insurance Regulation*, Vol. 27, No. 3 (2009).

[19] Agency for Healthcare Research and Quality, *Medical Expenditure Panel Survey*, Table II.B.2.b.(1): Percent of private-sector enrollees that are enrolled in self-insured plans at establishments that offer health insurance by firm size and State: United States, 2013, available at http://meps.ahrq.gov/mepsweb/data_stats/summ_tables/insr/state/series_2/2013/tiib2b1.pdf.

[20] Barack Obama, Remarks by the President on Health Insurance Reform (University of Iowa Field House, Iowa City, Iowa, March 25, 2010), available at http://www.whitehouse.gov/the-press-office/remarks-president-health-insurance-reform-university-iowa-field-house-iowa-city-iow.

[21] Internal Revenue Service, Application of Market Reform and other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain other Employer Healthcare Arrangements, Notice 2013-54, available at http://www.irs.gov/pub/irs-drop/n-13-54.pdf; and United States Department of Labor, "Application of Market Reform and other Provisions of the Affordable Care Act to HRAs, Health FSAs, and Certain other Employer Healthcare Arrangements,"

Technical Release No. 2013-03 (September 13, 2013), available at http://www.dol.gov/ebsa/newsroom/tr13-03.html. *See also* Internal Revenue Service, "Employer Health Care Arrangements" (May 13, 2014), at http://www.irs.gov/uac/Newsroom/Employer-Health-Care-Arrangements.

[22] A forthcoming paper by this author will outline why federal law does not give the Obama administration the power to restrict tax advantaged DC health plans. Nonetheless, states must work within the current federal interpretation of the ACA until it is successfully challenged.

[23] Pub. L. 111-148, Sec. 1312 (c)(3).

[24] The ACA clearly allows states to continue regulating insurance when regulations do not conflict with the ACA. Pub. L. 111-148, Sec. 1321 (d).

[25] The Pew Charitable Trusts, *State Employee Health Plan Spending: An examination of premiums, cost drivers, and policy approaches* (August 2014), available at http://www.pewtrusts.org/~/media/Assets/2014/08/StateEmployeeHealthCareReportSeptemberUpdate.pdf.

[26] Interstate Insurance Product Regulation Commission, *About the IIPRC*, at http://www.insurancecompact.org/about.htm.

[27] Note that this is no cure-all for the absence of competition. Recall that the primary obstacle to competition is the fact that employers, acting as third party payers, are the primary purchaser of health insurance. Furthermore, out-of-state insurers may find it difficult to compete with the reimbursement rates Minnesota health plans negotiate with providers.

[28] This is a major simplification of Medicare pricing. Medicare pricing problems go much deeper, but that is an issue for another report.

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