



Jim Schowalter, MN Commissioner of Management & Budget

Civic Caucus, 8301 Creekside Circle, Bloomington, MN 55437

March 4, 2011

Notes of the Discussion

Present: Dan Loritz (chair); David Broden, Paul Gilje, Sallie Kemper, Tim McDonald, Clarence Schallbetter

Phone : Janis Clay, Jim Hetland, Wayne Popham

Summary of meeting: *Schowalter describes challenges facing Minnesota, and opportunities arising from them. He explains the variability of state revenue and cautions that the state's control in certain areas, such as higher education, is decentralized and rarely direct. He sees presently a greater opportunity for change than at most any other time in his career.*

A. Welcome and introductions - Jim Schowalter was appointed Commissioner of Minnesota Management & Budget (MMB) by Governor Dayton at the beginning of this year. He served previously as deputy commissioner, assistant commissioner, and state budget director under Governor Pawlenty and has led the budget process for Minnesota for the past six years.

Schowalter served on the Board of the National Association of State Budget Officers and frequently testified before the state Legislature. He has also served as executive budget coordinator for Health and Human Services and Local Government, as well as executive budget officer.

Before coming to Minnesota, Jim worked as regional economist at the Boston regional office of the U. S. Department of Housing and Urban Development, and as budget officer at the U.S. Office of Management and Budget. He is a graduate of Macalester College and the Harvard Kennedy School.

B. Comments and discussion -

Commissioner Schowalter noted that he got into public policy early and then never left. He was honored to be asked by Governor Dayton to stay on at the agency. "If a Democrat were elected, I'd rather work for a Democrat," he had said at the time, "but politics as they are-being appointed by a Republican and serving during his time, I was prepared to accept my fate." Instead of being succeeded by a new appointee, he was promoted to his current position.

Opportunities with the challenges facing Minnesota

After the election he had gone out with a friend for coffee. The friend told him, 'Jim, this is the time to deal with the problems of recent years. One way or another, they will be resolved in the next couple of years. Do you want to be part of that or not?'

The conflicts that need to be resolved are not just about money, Schowalter told the group. There are conflicts about values and governmental process as well. The challenge is to resolve these conflicts constructively so that this state continues to be a place where people want to live, with a government that delivers quality services, and where you can make public decisions on an orderly basis.

The commissioner outlined a few of the major challenges he sees facing Minnesota through this budget process:

- 1. Transitioning to a new federal medical framework.** Health care costs continue to grow year in and year out. That growth is the primary factor driving state budget problems. We need to do something to contain this growth. The governor is taking the early option into Medicaid as a first step; more market reforms and the development of health exchanges are to follow.
- 2. Settling on how much revenue to collect and who pays.** There is not agreement on how much revenue the state should operate with. In the end what is the right level of revenue for Minnesota, and how is it generated? The state also has to restore the financial tools to manage the volatility that goes with these revenues.
- 3. Reforming government even when the state has little direct control.** Changing government is an indirect process. "We talk about state government as if it were a single, private organization," Schowalter said. Rather, it is a loose collection of systems that indeed get some funding from the state, but have independent governance and leadership. A participant likened it to a university whose various departments are "connected" solely by a heating plant. "And then some departments start building their own steam generators."
- 4. Adapting state agencies for an aging public work force nearing retirement.** Demographics affect the public sector, too, Schowalter pointed out. Many agencies will have 40 percent of their workforce eligible for retirement in next few years.

Resolve the budget now

In the end the budget will be resolved, Schowalter said. And he likes the governor's approach, stating definitely that the budget will be settled by May 23rd. We sometimes liken the legislative session to a three-act play. The question is, does the play get any better with more drama?

"We need to deal with the budget, and go through it thoughtfully, faithfully, now." Then we get to work to implement it, deal with the substantial impacts that result and look for ways to deliver services better.

Redesign for the future-but big ideas are not implemented quickly

A participant asked about groups that are putting together ideas for innovations in state government. Are they bringing any good ideas?

Yes, certainly, Schowalter said-and they will continue to do so. There are major areas of state government that can benefit from (and need) continual innovation. But big ideas don't get implemented quickly. They are usually so conceptual that they need a lot of work to be brought to fruition.

Significant structural changes, or goals for structural changes, need a champion to promote them for multiple years. When it comes to resolving the structural nature of the budget deficit, we all need to keep at it, year after year.

Revenue sources are volatile and unpredictable

Anyone that invests knows that higher risk means higher return, Schowalter said. It's the same for the volatility of the state's revenue sources. So long as our revenue is tied to the economy we'll have a degree of volatility. Volatility is not bad, so long as we have the tools to manage it. If you wanted to lessen volatility, you'd have to substantially trim back corporate taxes while expanding the sales tax.

Our volatility is already managed to some extent by having multiple tax types. Some states put it all in one form of taxation. That puts them far out on the volatility or instability range. We could go 'all in' to property tax, which would be more stable, but then we'd have revenues that grow more slowly and that are not closely tied to economic activity or growth.

Another source of stable revenue source is fees. But fees are not a good tool for balancing the budget, and there are not many increased fees in the governor's proposed budget, Schowalter said. A few dedicated fees have gone up to cover added services that members of a particular group wanted- such as fees on hunting licenses, etc., and its best to keep that revenue tied to the services offered.

Explaining the state's structural budget deficit

"I was interested in seeing a \$2 billion structural deficit next year," a participant said. That's current law, Schowalter replied-forecast spending is expected to be that much more than revenues every year. The governor's recommendations in his budget bring the deficit down substantially, to about a billion dollars for the entire fiscal 2014-15 biennium.

In describing the different kinds of proposals being considered to address the budget, Schowalter emphasized that a democracy "doesn't skip to the end." The budget process is one in which we start with ideas and then they get tested. That is a healthy process, and that is what the legislature will be doing in the coming weeks and months. In the end, everyone won't like the compromises but we should be able to say that we all understand the proposals and their consequences.

Post-secondary education costs are driven federally; institutions have a responsibility

As the discussion touched on post-secondary education, one participant asked whether rising education costs are fundamentally a federal issue-that is, driven (enabled) by federally subsidized education loans.

"Calling out federal loans, or student loan capacity is a great point and one that's under-appreciated," Schowalter said. One example is law school. It is hard to make an economic case for anyone going to law school in the next three years-there is such a backlog of lawyers-yet it's a process that is being facilitated by federal loans and the questionable perception that there is money to be made on the other end, following graduation from law school.

Fundamentally, he said, the problems are lack of information and easy credit. There's a lot of responsibility for the president and leadership level of universities to manage their students and curriculum in a responsible way, so graduates have real opportunities in the future.

Within the state, higher education funding is hands-off. "We give the U of M a lump sum and say, 'here you are, go forth.'" That could change as some states try and succeed with other arrangements. But then education in general needs to change. "People in college can acquire information more quickly than ever, yet we have brick-and-mortar campuses all over. There's a need to talk about it."

The role of MMB in controlling budgets and promoting changes

One participant observed that the role of MMB is to be the economic voice of reason with the other agencies. My understanding, the participant said, is the number of people running to the capitol asking for more, for new spending, is growing rapidly. There are not enough creative, low-cost ways to help people who are disabled; to take the child in K-12 who is seriously limited and bring him up to 'significantly limited'; to provide mass transit at a public subsidy. We can take \$150,000 and use it to improve a person's situation a little bit. But, there's no limit, in other words, to legitimate and important needs. Advocates not only solicit the legislature, but they hit the departments as well. Your agency must look at what's coming out of the departments and then say: This is an interesting idea, but it's going to cost so much money.

Schowalter responded that he asks himself, and the agency asks itself-what is the problem we're trying to fix? The default is always the numbers, because that's the urgent issue. But the answer lies beyond the budget, to processes. A focus on budgets has lead to greater dependence on the federal government, when that may or may not be the right thing.

C. Closing -

"This has been very interesting," Schowalter said, to close. "In addition to what you're doing at the Civic Caucus to promote redesign, I'd just encourage you to investigate the processes of government and the processes of change."

"It is possible to change processes. For example, in only a few months Minnesota went from one of worst states in terms of transparency to one of the best. You orient yourself, you decide, you act, and then you go back to step one and repeat."

Thank you to the Commissioner for his time and insights.