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What Does Washington, DC Have in Store for Minnesota?

Find out by attending our 2017 Policy Forum

From all indications, the political and policy turmoil in Washington DC marking the first half of 2017 may even be exceeded by what is coming down the pike later this year. According to reports, federal tax reform is next in the queue – a topic likely to be no less contentious than the recent health care debate. At the same time, a highly controversial

federal budget (or more likely) a continuing resolution will need to be passed before the federal fiscal year ends on September 30th.

Here's some good news – our 91st Annual Meeting and Policy Forum on October 11 is bringing together some of the nation's foremost experts to help us make sense of what is happening, what isn't happening, what might happen, and above all what Minnesota policymakers should be thinking about as a result.

Our tax panel includes distinguished DC-based tax policy authorities who have their finger on the pulse of reform discussions and the potential implications for state tax policy and state revenue systems. Our fiscal policy panel features some of the nation's preeminent scholars and professionals to examine how the federal/state relationship is evolving and the implications for a variety of critical government services such as health care, infrastructure, and education. In addition to discussing state policy responses, both panels will explore potential implica-

tions for state economies and budgets in both the near and long term.

We are especially pleased to have Kim Rueben of the Urban Institute – Brookings Tax Policy Center, one the nation's leading experts on state and local finance, as our featured luncheon speaker. In addition to her extensive work in tax and fiscal policy reform efforts across the country, she also serves on a National Academy of Sciences panel on the economic and fiscal consequences of immigration – yet another federal policy topic of great interest to Minnesota and relevance to the state's economy.

As always, individuals who are not MCFE members are more than welcome – please register and join us for this event! Members – please consider hosting a friend or colleague and introducing them to the MCFE. Registration information is available on our website at <https://www.fiscalexcellence.org/annual-meeting.html>.

We hope to see you on October 11! ■

MCFE 2017 Policy Forum

Wednesday, October 11, 2017

8:30 am – 1:30 pm

St. Paul River Centre

2017 Tax Policy Panel

MODERATOR: Ward Einess, Former Commissioner, MN Department of Revenue

PANELISTS:

Cynthia Bauerly, Commissioner, Minnesota Department of Revenue

Max Behlke, Director, Budget and Tax, State-Federal Relations, National Conference of State Legislatures

Joe Crosby, Principal, MultiState Associates, Inc.

Doug Lindholm, President and Executive Director, Council on State Taxation

2017 Fiscal Policy Panel

MODERATOR:

Chris Farrell, Senior Economics Contributor, American Public Media

PANELISTS:

Donald Boyd, Director, Fiscal Studies, Rockefeller Institute of Government

Natalie Cohen, Managing Director and Head of Municipal Research, Wells Fargo

Myron Frans, Commissioner, Minnesota Management and Budget

Robert Zahradnik, Principal, State Fiscal Health and Economic Growth, Pew Charitable Trusts

ANNUAL MEETING LUNCHEON

Luncheon Speaker: Kim Rueben

Senior Fellow, Urban-Brookings Tax Policy Center and

Project Director, State and Local Finance Initiative

Minnesota Center for Fiscal Excellence

Tom Gottwalt <i>President</i>	Aaron Twain <i>Research Director</i>
Mark Haveman <i>Executive Director</i>	Linda Edstrom <i>Executive Secretary</i>

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Minnesota's Fiscally Healthiest City Is....

It's not a beauty pageant. Ratio analysis offers a way to extract more understanding out of government transparency efforts.

Mix a teaspoon of Great Recession hangover, a quart of stiff general fund competition for LGA dollars, a dash of unfunded legacy costs, and the usual gallons of levy reluctance, and you have some of the primary ingredients going into the preparation of city budgets for 2018. The good news is that the majority of city officials currently appear to find the state of municipal finance relatively stable, and cities are now somewhat better able to meet their needs compared to years past. According to the League of Minnesota Cities' 2017 "State of the Cities" survey, two-thirds of respondents said their city was better able to meet its needs in 2016 than in 2015. However, as the report is quick to note, "better able" is a relative measure. It does not necessarily suggest that a city's fiscal health is good; it may mean simply that meeting service needs and balancing the budget is a bit easier now than before.

Evaluating the fiscal condition of governments has been a growing area of interest and study over the last couple of decades. In the same way business financial statements yield many types of ratios to evaluate business performance and facilitate cross-business comparisons, scholars and government finance professionals have similarly mined governments' comprehensive annual financial reports (CAFR) to derive metrics to evaluate and compare their fiscal conditions.

Several approaches have been developed over the years. They include the seminal "10 Point Test" proposed by a government finance scholar and revisited through the years;¹ a methodology based on 14 "fiscal solvency" metrics published by George Mason University researchers that annually evaluate and rank states' fiscal conditions;² the Government Accounting Standards Board's own *Analyst's Guide to Government Financial Statements*; and independent initiatives such as the City and County of Denver's Finan-

cial Sustainability and Benchmarking Project. Unsurprisingly, there are strong similarities across these approaches but all feature their own tweaks and unique points of emphasis.

We examined these different methods and assembled a hybrid approach selecting what we believed to be the most meaningful indicators in order to identify Minnesota's fiscally healthiest city. Given the time and effort required, our analysis is limited exclusively to Minnesota's 30 largest cities. In addition, our findings are based on 2015 financial reports since the 2016 CAFRs were not available for each of these cities at the time we conducted this investigation.

A Mercifully Brief (But Necessary) Introduction to the Methodology

In reviewing the metrics government finance professionals and academics have developed, the common theme defining fiscal health is risk management and financial sustainability. Governments are exposed to several types of risk involving their operations including:

- The risk that a period of financial adversity would negatively impact service delivery
- The risk that short-term or long-term obligations will become unmanageable
- The risk associated with consistently financing operating costs using savings
- The risk associated with having operating expenses funded by revenue sources over which the city exercises little or no control
- The risk associated with financial difficulties arising out of business-type operations managed by the city
- The risk associated with inadequate attention to maintenance and replacement of physical assets

Governments' fiscal health and security depends heavily on understanding the risks they face and managing them appropriately. The metrics government finance professionals and academics who work with governments have developed offer insights into how well governments are accomplishing that.

We selected ten ratios covering four differ-

ent areas that provide a broad picture of the overall financial health and security of our pool of cities. As part of our analysis, we created a "z-score" for each city on each of the 10 metrics. A z-score simply measures how many standard deviations a city's result for any single metric is from the overall (unweighted) average for that metric. Z-scores provide a much better sense of scale than simple ordinal rankings because they capture both clustering and outlier effects.

Unlike some of the efforts we reviewed, our final rankings do not weight metrics differently according to their relative importance. In consulting with public finance officials to gain their professional thoughts and perspectives on this issue, it was clear that some metrics are more important than others. But it was also clear that opinions on which metrics to weight and how much to weight them will differ. Any weighting decisions inevitably add an element of subjectivity to the title of "fiscally healthiest city". Given that our effort is a preliminary exercise, we have left any potential weighting schemes for the future.

There are a couple of additional things to keep in mind when reviewing our results:

- This is a benchmarking exercise. Z-scores offer a relative perspective – how financially secure these 30 Minnesota cities are compared with one another. Objectively, "best in class" performance on any individual metric may still be wanting. Conversely, "worst in class" performance on any individual metric may not necessarily be a major cause for concern. It is possible that efforts have been made to set general standards for what constitutes "good" financial ratios for government similar to the way generally accepted standards have been established for what constitutes "good" financial ratios in business. However, in our investigation we did not come across any such efforts.
- Our methodology strives to be agnostic with regard to the overall size of a city and its government. Cities are not explicitly penalized or rewarded for being large or small. We have standardized each metric using a control variable to minimize differences in city size.
- The methodology is also agnostic with respect to total amounts of spending or revenues. Our focus is instead on a city's

¹ "The Ten Point Test of Financial Condition: Toward an Easy-to-Use Assessment Tool for Smaller Cities" Government Finance Review, December 1993; and "Revisiting Kenneth Brown's 'Ten-Point Test'" Government Finance Review, October 2009

² "Ranking the States by Fiscal Conditions", Mercatus Center at George Mason University, various years.

Table 1: Financial Health Metrics

Category	Name	Description	Funds Included	Equal To
Financial Position	Cash Ratio	Indicates ability to meet short term obligations	Governmental ³	Sum of Cash and Cash Equivalents ÷ Total Liabilities
	Debt-to Assets Ratio	Indicates exposure from dependence on debt finance	Governmental Activities ⁴	Sum of Total Liabilities minus Total Deferred Outflows ÷ Sum of Total Assets minus Total Deferred Inflows
	Operating Reserves Ratio	Indicates ability to maintain day-to-day operations in the event of a revenue shortfall or spending emergency	Operating ⁵	Sum of Committed, Assigned, and Unassigned Fund Balances ÷ Total Expenditures
	Operating Surplus/Deficit Ratio	Indicates whether savings is being used over multiple years to finance ongoing operations	Operating	Sum of Current and Prior Years' Change in Fund Balance ÷ Total Fund Balance at Beginning of Prior Year
	Debt Coverage Ratio	Indicates ability to finance debt load over short term	Operating	Total Debt Service Expenditures ÷ Total Revenues
Revenues	Profitability Ratio	Indicates whether city's for-profit business operations are profitable	Non-Utility Enterprise	Total Revenues ÷ Total Expenditures
	External Exposure Ratio	Indicates risk operating budget reliance on external revenue streams poses to property tax levy	Operating (numerator); Governmental (denominator)	Sum of Operating Fund Intergovernmental Revenues, Operating Fund Interest/Investment Income, and Non-Utility Enterprise Fund Transfers to Operating Funds ÷ Total Property Tax Levy
	Own-Source Revenue Control Ratio	Indicates how controllable/predictable operating revenues are	Operating	Sum of Property Tax Levy plus Special Assessments ÷ Total Operating Revenues Minus Intergovernmental Revenues
Capital Assets	Capital Asset Replacement Ratio	Indicates whether capital assets are being maintained	Governmental Activities	Total Capital Assets at End of Year ÷ Total Capital Assets at Beginning of Year
Retirement	Change in OPEB Liabilities Ratio	Indicates potential for OPEB costs to either compete with direct service delivery costs or require higher property tax levies	Operating	Change in OPEB Liabilities ÷ Total Revenues

ability to finance the levels of services it provides to residents and businesses.

Table 1 provides an overview and description of the measures employed. Following is a discussion of each category and our results.

City Financial Position

Two of our five financial position metrics are balance sheet-oriented measures providing different perspectives on the risks associated with cities' ability to meet their financial obligations. **Table 2** shows the top five performers in each of the five metrics. The most basic measure is the cash ratio, which indicates whether there is adequate cash and easily convertible to cash assets to cover short-term liabilities. A broader perspective is offered by the debt-to-assets ratio that reflects the amount of financial leverage the city employs. This perspective is important because, unlike other liabilities debt covenants offer very little flexibility. Not only will a city employing a higher degree of financial leverage find funding ongoing operations more difficult during a recession

than one with low leverage, higher interest rates typically accompany these higher levels of repayment risk.

The remaining three financial position measures mostly use information from the statement of revenues, expenditures, and changes in fund balances (a.k.a. the "income/expense statement") to address other forms of exposure. The operating reserves ratio

compares the fund balances a city can spend at its discretion⁷ in relation to its annual spending – a measure of ability to withstand unanticipated revenue shortfalls and address emergency needs. The operating surplus/deficit ratio examines changes in reserves over a two-year period instead of at a single point in time, to see if they are growing or being used to finance current operations. The debt coverage ratio provides perspective on a government's capacity to finance debt payments by comparing them to its overall operating revenues.⁸ Importantly, the debt coverage ratio looks only at the debt a city accounts for in its governmental funds – mostly "general obligation" debt, or debt backed by a government's power to tax.⁹

³ Includes fund balances that the city has designated as "committed", "assigned", and "unassigned". Balances in the "committed" and "assigned" categories can be repurposed at the city's discretion.

⁴ Lower debt coverage ratios are reflected in higher z scores.

⁵ This excludes debt associated with enterprises because they typically raise cash through "revenue bonds", which aren't backed by a government's taxing power but instead by the revenues generated by the activity which is being financed (for instance, water and sewer charge revenues will be used to pay for bonds for a water or sewer enterprise)

⁶ "Operating" funds include a city's general fund, any debt service funds, any capital funds (money used to purchase or construct land and buildings, equipment, or infrastructure), and any special revenue funds (money that is dedicated for specific uses).

⁷ "Governmental Activities" comes from the Statement of Net Position (SNP). The SNP is a government-wide financial statement that accounts for the same activities as "governmental funds" do, but with one major difference. Governmental Funds are reported on a modified accrual basis, which provides a short-run financial perspective – effectively looking only at assets that are expected to be used within the current year or liabilities that are expected to be paid with current resources. Governmental Activities are reported on a full accrual basis, meaning that – unlike the Governmental Funds – the numbers include long-term liabilities and long-lived assets.

⁸ "Operating" funds include a city's general fund, any debt service funds, and any special revenue funds.

⁹ Lower debt to asset ratios are reflected in higher z scores

Table 2: Top Five Cities: Financial Position Metrics

Rank	Cash Ratio		Debt-to-Assets Ratio		Operating Reserves Ratio		Operating Surplus/Deficit Ratio		Debt Coverage Ratio	
	City	Z-Score	City	Z-Score	City	Z-Score	City	Z-Score	City	Z-Score
1	Brooklyn Park	4.61	Plymouth	1.34	Cottage Grove	2.09	St. Cloud	2.01	Minnetonka	1.14
2	Andover	2.01	Shakopee	1.33	Apple Valley	1.92	Eagan	2.01	Rochester	0.99
3	Maple Grove	0.58	Minnetonka	1.19	Minnetonka	1.83	Brooklyn Park	0.88	Plymouth	0.98
4	Woodbury	0.49	Woodbury	1.13	Coon Rapids	1.34	Richfield	0.87	Eagan	0.92
5	Coon Rapids	0.10	Andover	1.05	Eagan	1.27	Blaine	0.87	Brooklyn Park	0.82

The financial position metrics demonstrate one of the significant advantages of using a z-score approach to benchmarking – mitigating issues the timing of the CAFR financial snapshot can create. While cities' operating expenditures are regular, the timing of many major revenue sources is not. Cities in Minnesota receive large lump sum payments four times a year – including one-half of their property tax dollars in November and one-half of their LGA payments in December. Because the CAFR measures a government's financial status as of December 31 in any year, cities tend to be at a high point with regard to assets – for example, the average cash ratio of the 30 cities in our pool was 11 times current liabilities – skewing perceptions about financial position. Since z-scores offer the perspective of relative position, all cities are skewed in a similar fashion and the effect gets largely washed out.

As the table indicates, there is some overlap among the top performing cities in these five metrics. Three cities – Brooklyn Park, Eagan, and Minnetonka – are in the top five in three metrics, while four other cities – Andover, Coon Rapids, Plymouth and Woodbury – are in the top five in two metrics. The remaining eight spots are filled with eight different cities. Cities ranking high in these four metrics tend to be very large suburbs located in the seven-county metro, with medium growth and high commercial activity.¹⁰

Revenues

The three revenue metrics all address the influence and reliability of city revenue sources. The profitability ratio simply examines whether city business-like enterprises¹¹ (golf courses, ice arenas, liquor stores, etc)

Table 3: Top Five Cities: Revenue Metrics

Rank	Profitability Ratio		External Exposure Ratio		Own-Source Revenue Control Ratio	
	City	Z-Score	City	Z-Score	City	Z-Score
1	Rochester	2.93	Eden Prairie	0.55	Brooklyn Center	1.43
2	Roseville	1.72	Edina	0.54	Eagan	1.02
3	St. Louis Park	1.59	Minnetonka	0.53	Brooklyn Park	0.96
4	Duluth	1.31	Roseville	0.52	Inver Grove Heights	0.84
5	St. Paul	0.73	Andover	0.52	Maplewood	0.84

are run at a profit – since unprofitable operations can require a subsidy, which could create a significant drag on city finances. The external exposure ratio measures the potential risk that revenue streams completely outside a city's control present.¹² This ratio compares the amount of outside financing used to support general operating expenses – including aid payments from other governments, interest and investment earnings, and dollars generated by business-like enterprises – with the total property tax levy. The risks associated with outside decisions or economic conditions increases as the ratio increases – cities with higher ratios need proportionately larger property tax increases to make up any shortfalls in these revenues.

The final revenue measure also addresses revenue exposure but focuses specifically on the reliability and predictability of a city's own-source revenues. Compared to property taxes and special assessments, collections from other sources such as fines, fees for services and permits are more variable and are often heavily influenced by economic conditions and circumstances. The own source revenue control ratio provides a measure of this exposure.

Table 3 presents the top performers on the revenue metrics. With respect to business-like operations the average city in this group collected 5.7% more in revenues than it spent, but Rochester stands out as having a level of "profitability" with respect to these operations that is nearly three standard deviations above the 30 city average. Perhaps not surprisingly, higher wealth metro-area suburbs that tend to receive little, if any, Local Government Aid score best on external exposure while Brooklyn Center and Eagan lead the way with respect to the predictability and reliability of their own-source revenues.

Capital Assets and Retirement

The final set of metrics focus on two distinct areas that complement metrics emphasizing current operating budgets and take a longer term perspective on fiscal health. The capital asset replacement ratio looks at the extent to which governments are maintaining their asset base. Note that this metric looks only at the capital assets that support governmental functions – and not those that support business-type operations (such as a golf course clubhouse).

Last, but certainly not least, is the financing of long term retirement obligations. City budgets finance two retirement-related costs. One is retirement income, which cities support through contributions to Social Security and the state's public pension systems. The other is retirement health care, which they finance through contributions to Medicare and for what's known as "other

¹⁰ i.e., they belong to the "metro large cities" city cluster in a typology the Minnesota House of Representatives' nonpartisan Research Department developed in conjunction with their work on the Local Government Aid program. House Research provides more information on the 15 "clusters" of cities they have developed at <http://www.house.leg.state.mn.us/hrd/lghist.aspx#noaction>

¹¹ Lower external exposure ratios are reflected in higher z scores.

Table 4: Top Five Cities: Capital Asset and Retirement Cost Metrics

Rank	Capital Asset Replacement Ratio		Change in OPEB Liabilities Ratio	
	City	Z-Score	City	Z-Score
1	Brooklyn Center	3.14	Eagan	2.54
2	Moorhead	1.80	Duluth	2.54
3	Lakeville	1.72	Blaine	0.87
4	Rochester	1.18	Cottage Grove	0.80
5	Edina	0.99	Brooklyn Park	0.69

post-employment benefits”, or “OPEB” – a catch-all phrase for retirement benefits other than pensions.

On a relative basis, differences between cities in pension, Social Security, and Medicare costs aren’t particularly meaningful. These programs are financed by assessing cities based on some percentage of their payroll. Because cities participate in all these programs, and because the rates don’t vary, any differences in costs are largely a function of differences in payroll. More importantly, none of the choices about what kind of benefits to offer or how much to spend for them are being made by local elected officials. While these retirement obligations can have a major impact on government financial health these decisions are made further up the food chain, by the federal or state government.

Where cities do have considerable control over their retirement costs is in the OPEB area. OPEB costs are almost always related to health insurance, and subsidize retirees’ healthcare costs. Unlike retirement income programs or Medicare, cities have wide latitude to negotiate these benefits with their retirees as part of their collective bargaining process.

Cities have options about how to pay for these costs. One way is to pay for them as the bills come – known as a “pay-as-you-go” basis. The other payment method is based on the idea that since the city is essentially creating future costs now by making these promises, it should set aside money now that can be used to pay for the costs as they come due in the future. Pre-funding these benefits is considered a best practice, because it pays for the costs of these benefits as employees earn them – matching the cost of the benefit with the taxpayers and businesses that benefit from the services they provide. Alternately, the pay as you go system pushes the costs of the benefits being earned now onto future taxpayers.

Government finance standards now require that cities work with actuaries to determine the current value of all the OPEB liabilities they owe to their workforce – both past and present – even if they only finance these costs on a pay-as-you-go basis. This allows governments to understand what their “unfunded liabilities” are – essentially how much these benefits can be expected to cost in future years.

The change in OPEB liabilities ratio takes this information to determine the risks associated with a city’s decisions regarding both the level of OPEB benefits it offers (value of benefits) and the share of those benefits it pays for during the year (annual cost). The main risk is that increasing OPEB liabilities will generate increasing costs – and because these are also fixed costs, additional OPEB costs essentially mean a choice between more revenues, redirecting money away from providing services, or some combination of the two. Our ratio measures the annual change in unfunded OPEB liabilities relative to the city’s operating budget.¹³

Table 4 presents the top performers on the revenue metrics. Brooklyn Center’s score in the capital asset replacement ratio is worth noting because its outlier status flags the need for an explanation for such a large relative change. Major changes in this ratio will generally be the result of the purchase or sale of a major asset, and taxpayers will want to understand why the purpose behind such decision-making. With regard to OPEB, on average these cities’ unfunded liabilities grew by about 0.5% of their operating revenues – not surprising considering that most of the cities we analyzed finance their OPEB costs on a pay-as-you-go basis. Table 4 highlights the cities with the best practices, with Duluth and Eagan standing out. Duluth is the

only city in this group whose OPEB liabilities declined during the course of 2015, giving it a z-score of roughly 2.5. Eagan is the only city in this group that has fully pre-funded its OPEB liabilities, and so we have set its score equal to the best-performing city that has unfunded liabilities (Duluth) to provide a better sense of the low risks associated with a fully funded OPEB plan. Other high performers included the city of Blaine, which reported no additional OPEB liabilities in 2015, and Cottage Grove and Brooklyn Park where their growth was minimal.

And Our Winner Is...Eagan

Adding the ten individual z-scores together provides a comprehensive perspective of these cities’ relative financial security. **Table 5** shows these results for the ten best-performing cities, with the city of Eagan coming out on top. We performed some basic statistical analysis to test whether scores correlated with certain characteristics. City type¹⁴ seems to have very little relationship to the overall results, with a simple regression analysis indicating a less than 1% correlation between changes in total z-score and type of city. Our testing suggests that changes in population explain about 8% of the change in scores – hardly a strong causative relationship.

Table 5: Top Ten Fiscally Healthiest Cities

Rank	City	Z-Score
1	Eagan	7.21
2	Brooklyn Park	6.73
3	Minnetonka	5.52
4	Blaine	4.45
5	Rochester	4.35
6	Brooklyn Center	4.21
7	Apple Valley	4.18
8	Cottage Grove	3.98
9	Andover	2.86
10	Inver Grove Heights	2.61

With all due respect and congratulations to the city of Eagan, the primary purpose of this exercise is to reveal another way to extract more value out of government transparency efforts. Thanks to major investments governments have made in their information systems, all sorts of financial data is now instantly available with the click of a mouse, and on line tools enable this data to be organized, sliced and diced in countless ways. But context and perspective – the two key ingredients needed to turn data

¹³ Lower OPEB liabilities ratios are reflected in higher z scores.

¹⁴ See footnote 10 for information on the city typology system we used.

into understanding and allow taxpayers to make informed judgments about the financial condition of governments – don't just appear with better access to numbers.

Ratios like the ones outlined in our effort use CAFR data to provide this context and perspective. Not only do such measures present a snapshot of the many dimensions of government fiscal health, the measures can be used to benchmark financial condition against other governments, establish trend lines, and flag signs of fiscal stress or weakness. In what area of finance is a government underperforming relative to others? Why? And most importantly, what is the plan to manage that stress or weakness? Even if some unique economic or institutional factors justify the reason for being an outlier, getting that explanation out into the public is an important part of government transparency.

The challenge, of course, is that choosing and reporting a consistent and best set of ratios to evaluate and benchmark local government financial health is far beyond the capacity of ordinary citizens. That is solidly a responsibility of governments and their finance professionals. History suggests mandating new reporting requirements would not be well received. It's up to governments to take the initiative to make an analysis like this available. Many have done excellent work in making tax and spending data much more accessible to the public. That commitment needs to carry forward to further that data's interpretation and use. ■

The Other Issue Surrounding a \$15 Minimum Wage

The interactive effects of increased wages and reduced eligibility for income support programs is chock full of under-recognized consequences.

To call Minneapolis' move to impose a \$15 minimum wage "controversial" is certainly a gross understatement. Republicans in the legislature tied policy provisions that would have pre-empted the city from taking such a step to the annual pensions bill, with the resulting veto telegraphed long beforehand. Concern about restaurant workers and tip credits kept the issue front and center in the media, along with dueling reports from economists studying the effect of a \$15 minimum wage in Seattle. Nevertheless, Minneapolis has now joined other cities across

the country – most notably Washington, D.C.; Seattle; and San Francisco – that have raised their minimum wage to this level.

Largely absent from the debate, however, has been an analysis of how these higher wages would interact with the considerable number of tax credits and income support programs the state and federal governments offer. Such programs generally have income thresholds above which households lose eligibility and program benefits. The result is that gains in earned income can be offset by a loss of cash and non-cash benefits creating a higher wage "penalty" in many cases.

To shed some light on this issue, we updated the model we created for our 2007 *Disincentives to Earn* report, which examined the interactive effects of changes in income with 16 different state and federal programs that provide cash and noncash benefits to households (**Table 6**). We have modeled the latest available period, which runs July 1 through September 30, 2016.¹⁵

There are a number of issues to keep in mind when considering our findings.

- We assume that households automatically participate in any program or tax credit for which they are eligible. Clearly this is not the case in reality. Some programs have waiting lists and in other cases households do not apply for benefits for a variety of

reasons including unfamiliarity with their availability.¹⁶ Switching certain programs "off" would affect the findings in material ways.

- Minneapolis' \$15 minimum wage is scheduled to fully phase in for large businesses on July 1, 2022. Since income thresholds for benefit eligibility change annually, assuming a \$15 minimum wage for 2016 purposes could inadvertently push households over income eligibility thresholds for programs. To adjust for this we have discounted the \$15 minimum wage from July 1, 2022 to July 1, 2016 using a 2.2% inflation rate (the average of the CPI from 1996-2016), which sets the rate at \$13.16 for 2016. Note also that we assume in each instance the adult works full-time (40 hours per week, 2080 hours per year).
- We assume that the parent places children in childcare centers (as opposed to an in-home setting), because of the flexibility that a center offers regarding hours of operation and because centers are more

¹⁵ The model covers this period because many of these programs update their income eligibility levels annually but do not operate with identical "years". Tax credits operate on a calendar year basis, while income support programs operate on the state fiscal year (July 1-June 30) or the federal fiscal year (October 1-September 30).

¹⁶ According to the IRS, 1 in 5 people eligible for one of the most visible programs, the federal earned income tax credit, do not claim it.

Table 6: Programs Included in Modeling

Federal Tax Credits	State Tax Credits	Income Support Programs
Earned income tax credit (EITC)	Working Family Credit (WFC)	Minnesota Family Investment Program (MFIP)
Child tax credit	Child and dependent care credit	Medical Assistance
Child and dependent care credit	Marriage credit	MinnesotaCare
	Renters' property tax refund	Child Care Assistance Programs (both MFIP and Basic Sliding Fee)
		Supplemental Nutrition Assistance Program (SNAP – formerly "Food Stamps")
		Housing Choice (Section 8) Voucher Program
		Low-Income Home Energy Assistance Program
		Women, Infants and Children
		National School Lunch and Breakfast Programs

Table 7: Interactive Effects of Higher Minimum Wage on Income Support Programs and Tax Credits, July-September 2016, Selected One-Adult Households

Age of Children			Min. Wage = \$9.50/hr				Min. Wage = \$13.16/hr**				Total Gain	METR*
			Wages	Benefits Value	Credits	Total	Wages	Benefits Value	Credits	Total		
1	2½	6	\$19,760	\$50,533	\$11,772	\$82,065	\$27,373	\$47,485	\$11,860	\$86,718	\$4,653	38.9%
3	6	9	17,760	39,015	11,772	70,547	27,373	35,967	11,860	75,200	4,653	38.9%
1	2½		19,760	41,086	11,109	71,955	27,373	37,585	10,598	75,556	3,601	52.7%
4	7		19,760	29,568	11,109	60,437	27,373	25,923	10,598	63,894	3,457	54.6%
10	12		19,760	12,644	11,109	43,513	27,373	9,687	10,598	47,658	4,145	45.6%
	1		19,760	25,071	6,948	51,779	27,373	20,383	5,937	53,685	1,906	75.0%
	4		19,760	19,388	6,948	46,096	27,373	14,700	5,929	48,002	1,906	75.0%
	10		19,760	9,153	6,948	35,861	27,373	4,893	5,929	38,195	2,334	69.3%
			19,670	4,668	398	24,826	27,373	1,544	647	29,564	4,738	37.8%

* In all instances METR = (Wage Gain - Total Gain) / Wage Gain where Wage Gain = \$7,613

** Reflects the fully phased in \$15/hour minimum wage discounted from 7/1/22 to 7/1/16 using a 2.2% inflation rate

Note: For purposes of sensitivity testing, we assume no childcare expenses or benefits for the households with children aged 10 and 12 and with one child aged 10.

likely to accept the hassles of dealing with child care assistance programs. We further assume the modeled family chooses a center that charges the reimbursable rate.

- While most of the programs modeled provide a cash benefit, Medical Assistance and MinnesotaCare provide a service (health insurance) instead. To calculate a cash value for this benefit, we have used federal data to estimate the average employee health insurance premium costs for employer-sponsored single, single-plus-one, and family health care plans in Minnesota in 2015.¹⁷ We set the value of the state-sponsored benefit equal to the cost of the plan the household would need to purchase if Medical Assistance or MinnesotaCare were not available, less any health insurance premium costs the household actually incurred. Note that this methodology assumes that the household is able to obtain employer-sponsored health care in lieu of Medical Assistance or MinnesotaCare. If the household instead sought insurance on the private market or participated in an employer sponsored plan with above average employee costs, the value of the benefit would likely increase, and dramatically so in some cases.

Model Results

Our findings look at the marginal effective tax rate (METR) associated with the addi-

tional income generated by the higher minimum wage – calculated as the lost value of benefits as a share of the net increase in wages. For the single-parent household with children that we modeled, the METR exceeds 35% in every instance. However, the METR tends to increase as family sizes decline, since all things being equal larger families have higher income thresholds and so are less likely to lose eligibility for programs under a \$15 minimum wage.

For a single-parent household with three children, we modeled two family combinations: one where the children are aged 1, 2½, and 6; and another where the children are aged 3, 6, and 9. As Table 7 indicates, the marginal tax rate for both households is the same: 38.9%, or \$2,960 of foregone benefits relative to \$7,613 of additional wages. Although the value of the benefits is high in both circumstances, the overwhelming majority of those benefits are the result of childcare costs.¹⁸

The reduced benefits are attributable to a variety of factors. At the higher income levels, the family loses eligibility for MFIP and moves from MFIP childcare to the Basic Sliding Fee program, which comes with a

required premium payment that reduces the value of the benefit. The value of Section 8 housing vouchers decline because gross benefits are reduced by 30% of the higher income. Finally, the household realizes reduced EITC and WFC benefits, although those are offset by a higher federal tax credit and higher renter's property tax refund and federal child care credit payments – both of which are generated by the higher out-of-pocket costs associated with reduced benefits.

About half of the economic benefits of the minimum wage increase are lost for our two-child households and up to 3/4ths for the single child households.

Households with one and two children face the same issues that the three-child households do with regard to reduced benefits: new or greater premium payments associated with the Basic Sliding Fee childcare program, reduction in the value of Section 8 housing vouchers, and reduced EITC and WFC benefits. However, in both the single child and two-child households, the additional wages push the parent (but not any children) above the eligibility thresholds for Medical Assistance; bumping the parent onto MinnesotaCare where the premium

¹⁷ Data from Exhibits 3.8, 3.9, 3.10, 4.17, 4.18, and 4.19; *Medical Expenditure Panel Survey Insurance Component Chartbook 2015*. Rockville, MD: Agency for Healthcare Research and Quality; August 2016. AHRQ Publication No. 16-0045-EF. https://meps.ahrq.gov/mepsweb/survey_comp/MEPSICChartbook.pdf.

¹⁸ As an example, in Hennepin County the rate for infant childcare is \$268 per week, or nearly \$14,000 per year for just one child.

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co-pay requirements reduce the value of the benefit. The differential in the METR between the one- and two-child households is largely the result of the single child household's loss of SNAP benefits at the higher income level.

Our single adult-only household has the lowest marginal tax rate on the additional wage income (38%). This is a function of the fact that the adult is eligible for very few income support programs to begin with (only Section 8 housing and energy assistance), and that while Section 8 housing benefits are reduced by 30% of the higher income, the higher out-of-pocket rent payment generates a higher renter's property tax refund.

Complexity Underneath the Advocacy

While most of the debate has been focused on the business impacts and resulting business behaviors triggered by the new minimum wage law, it's important to recognize that the recipients of the wage increases themselves may also experience some unanticipated consequences, not just with respect to job access but also their economic well being.

The magnitude and extent of any effective tax rate concern the new minimum wage represents as reflected in actual METRs faced by real Minnesota households is essentially unknowable. The fragmented nature of work support and assistance programs, the influence of household demographics,

and the relative lack of information on programs and program combinations actually used by households makes such calculations practically impossible.

However, the interactive effects are real and are important to appreciate in both designing safety net supports and regulating private sector wages. One of the conceptual appeals among higher minimum wage advocates of increasing the minimum wage is to export the cost of low-income economic supports from the public sector onto the private sector. Our METR analysis shows that worker gains of minimum wage policy are likely to be smaller than advertised and the private sector will not be fully picking up where government leaves off. ■