FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

How Do You Spell "Relief?"

"Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, imposes large compliance costs and can lead to an inefficient use of resources. A rational system would favor a broad tax base providing special tax treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion or credit justifies higher taxes paid by all taxpayers."

— 2005 Report of the President's Advisory Panel on Federal Tax Reform

As the details of this year's tax proposals emerge, it's evident that although strong disagreements exist between the parties on appropriate levels on taxation, there is an important shared belief among all the players which may help getting a tax bill signed this year: guidance like that of the 2005 President's Advisory Panel may be great theory but it's political and practical hooey.

With an updated forecasted biennial surplus of over $1.65 billion and nearly $2 billion more in the bank, tax relief of some form was practically guaranteed to be part of everyone's tax proposals. The questions are how much and which taxpayers get it. "Targeted relief" is the dominant theme, and the subspecies of Minnesota taxpayers in play as possible beneficiaries of any new tax relief is impressive including, but not limited to, the following (subject to a wide variety of conditions and eligibility restrictions of course):

- People with kids in day care
- People with kids in Pre-K
- People with kids in K-12
- People saving for college
- Taxpayers who give to foundations which support public or private K-12 education
- College graduates with debt
- Teachers who get a masters degree
- People who purchase tools, equipment, or supplies needed to obtain a degree or certification
- Farmers
- People who sell assets to new farmers
- Homeowners
- First time home buyers
- Builders of low income housing
- Seniors
- Military veterans
- People with estates
- Low income working childless singles between the ages of 21 and 24
- Cigar and cigarette smokers
- People who want to invest in businesses owned by minorities, veterans, women, or veterans
- Businesses buying capital equipment
- Businesses engaged in research and development
- Businesses which own land and buildings worth less than $200,000
- Attendees of high school athletic events
- People who buy stuff from non-profit organizations
- Governments and government contractors that buy construction materials
- People who buy herbicides to fight invasive species
- People who buy tickets to 2017 Super Bowl events
- The NFL

Such targeted relief efforts may be sand in the gears of simple, efficient tax administra-

Anatomy of House Tax Relief (HF 4)

Area	Primary Feature(s)	Total (in millions)
Individual Income Tax	Subtraction for some Social Security benefits New refundable credit for student loan payments Enhancements of refundable credits for education, pre-K, and child care	$586
Corporate Franchise Tax	Modification of R&D credit (first $100,000 of credit made refundable, 2nd tier rate increased to 4%, and credit against AMT)	$97 (corporate tax effects only)
Sales and Use Tax	Exemptions for construction materials purchased by local governments and their contractors Telecommunication equipment exemption	$93
Estate Tax	Match federal exclusion	$162
State Property Tax	Eliminate inflator, exempt first $200,000 of property and reduce levy accordingly to avoid shifting	$205
Cigarette and Tobacco	Repeal tax rate indexing on cigarettes and moist snuff	$12
Property Tax Refunds, Aids, and Credits	One time homeowner and renter property tax refund supplement School building bond agricultural credit	$129
Miscellaneous		$7
TOTAL		**$1,291**

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tion but it's lubricant for a productive conclusion to the 2017 session. If policymakers and the governor can agree on a relief number (admittedly a rather big if), this smorgasbord of potential tax relief offers an opportunity for everyone to claim success when going home to their constituencies.

Here is an overview of the tax bills entering the home stretch (as of this writing).

House: The first legislative body to release its omnibus tax bill, the House has unsurprisingly placed a strong emphasis on tax relief. Individual income taxation is the largest area of tax relief with a subtraction for some Social Security benefits ($269 million) and a new refundable credit for student loan payments ($101 million) comprising the largest two items. Two of the business community's long sought initiatives – enhancements to the state's R&D credit and restraint of/relief from the state general tax together comprise about a quarter of the revenue reductions. Property tax aids and credits spending focuses on the farming community although interestingly there are no increases in County Program Aid or LGA despite the rural Republicans' role in securing a majority in the House. The budget for aids and credits does include a one-time $58 million supplement to the homestead refund for FY 2019. Renters would also receive a one-time refund boost for that year but the budgetary impacts are largely offset by a change in of the level of rent deemed to constitute property taxes.

Some other policy features worth noting include the establishment of a new federal conformity account ($35 million) to allow the state to conform its individual and corporate income tax laws to federal extenders. The proposal identifies a list of 14 eligible tax preferences – extender provisions which expire under federal law and to which prior legislatures have conformed in the past. The $35 million in the account would be automatically replenished annually as money in the account is used to offset revenue losses from this administrative conformity. Most any kind of revenue directly or indirectly related to the use of an automobile would be dedicated to a new transportation priorities fund including sales taxes from vehicle repair and replacement parts, leases, and rental taxes and fees. And in the property tax area, citizens could express their frustration with local decision making (and create budget chaos) through a new reverse referendum authority which could reduce the maximum allowed levy in cities and counties to that which existed two years earlier. A petition signed by only 10% of the voters is necessary to trigger a vote.

Advocates could rightfully argue the proposal offers about 20 times more relative tax relief to lower income households than higher income households

In the area of tax administration a number of provisions have been included that address process and procedural problems and annoyances some taxpayers have expressed. These include:

- Establishment of a private letter ruling program
- Authority for certain taxpayers to request income and sales tax audits at the same time
- Limitations on retroactive sales tax assessments and creation of a new "reasonable cause" standard for reducing or eliminating an assessment of a tax that the taxpayer is required to collect or withhold from another taxpaying entity. Reasonable cause grounds would include lack of clarity in the law and reliance on prior written advice from the Department of Revenue that has not been superseded or preempted.
- Enhanced discretion of the Commissioner to decline or abate penalties
- Extension of the statute of limitations for refund claims from one to two years after payment of tax
- Fixes for a number of tax court-related procedural annoyances (e.g. proof of timely mailing, enabling electronic filing, extension of deadlines for filing motions, and extension of small claims court jurisdiction -- from $5,000 to $15,000).

Senate: Senate Republicans have countered the House's plan with a slightly less ambitious tax relief package of $900 million for the coming biennium. In a departure from micromanaged relief, the Senate's centerpiece is a permanent cut in the state's first tier income tax rate, which will be reduced from 5.35% to 5.15% for tax year 2017 and then to 5.0% for tax year 2018 and beyond. Such a proposal would provide relief to any individual income tax filer with a tax liability; those at lower incomes would see the largest percentage reductions in their income tax burdens but higher earners may still see slightly larger absolute reductions. For example, in our most recent multi-state individual income tax study, for the 2013 tax year, a two-earner family with $50,000 of income paid $1,257 in state income taxes

Anatomy of Senate Tax Relief (SF 2255)

Area	Primary Feature(s)	Total (in millions)
Individual Income Tax	First bracket rate reduction Subtraction for some Social Security benefits New refundable credit for student loan payments Federal conformity for Section 179 expensing	$634
Corporate Franchise Tax	Federal conformity for Section 179 expensing Credit for Equity and Opportunity Scholarships	$47
Sales and Use Tax	Collection and remittance requirements for marketplace providers Sales tax exemption for DigiKey distribution center expansion	$16
Estate Tax	Match federal exclusion – phased in by FY 2023	$30
State Property Tax	Eliminate inflator, exempt first $100,000 of property	$96
Property Tax Refunds, Aids, and Credits	One time additional LGA and County Program Aid appropriations School building bond agricultural credit	$77
Alcoholic Beverages		<$1
TOTAL		$899

Note: numbers may not add due to rounding.

while the same family at $500,000 of income paid $36,243. A 5.0% first tier would have reduced the tax burden on the lower income family by 6.5% ($82) and by 0.3% ($124) for the family with the higher income. Advocates could rightfully argue the proposal offers about 20 times more relative tax relief to lower income households than higher income households while opponents will undoubtedly draw attention to the dollars of tax relief actually provided for different filer types. Needless to say, it will be very interesting to watch how this idea is marketed to the public and discussed.

The Senate includes many of the provisions found in the House bill, albeit with some differences. For example, both bills provide relief from the statewide property tax by eliminating the automatic inflator and exempting a portion of value. However, the House's exemption threshold is $200,000 compared to the Senate's $100,000. Both bills would also conform Minnesota's estate tax exclusion to federal levels; but the House would do so immediately while the Senate phases the change in over a 6-year period.

The Senate's approach does differ from the House's in a variety of ways. With regard to property tax aids and credits, the Senate is appropriating $18 million on a one-time basis for LGA and County Program Aid – contrasting with the House's decision to provide additional tax relief to homeowners and to a lesser extent, renters. The Senate's proposal to move toward federal conformity for Section 179 expensing would provide the business community with something it has sought after since Minnesota decoupled from federal rules well over a decade ago. The Senate bill also lacks a number of the administrative or policy-oriented provisions in the House bill, such as the private letter ruling program, the automatic federal conformity provisions; the reverse referendum on property tax levy increases, the requirement that local government referenda on spending take place only at the November general election, and the payment scheme to local governments for public lands purchased with outdoor heritage fund or environment and natural resources fund money.

Executive Office: Governor Dayton's tax plan generally and tax relief ideas specifically are markedly different from the legislative bodies'. For starters, tax relief is substantially smaller, approximately $265 million for the coming biennium. It's much more concentrated with nearly all of it focused on two tax areas, individual income taxes and property tax aids and credits. It's targeted differently – nearly all of the $165 million in individual income tax relief results from enhancements and expansion of the state's child care and working family credits. And perhaps most importantly, the relief that is provided to some comes at the expense of some higher taxes for others. About $85 million in new biennial revenue is projected from "closing corporate loopholes" while another $12 million comes from an increase in the state general tax levy accompanying proposed changes to railroad property valuations. The proposed levy increase ensures business does not receive even an incidental reduction in state property tax bills from having a now broader tax base on which to distribute the levy.

Even though the House tax chair has expressed some sympathy toward the idea of needing to tighten up the corporate income tax structure, these provisions – which are essential to the Governor's tax relief math – are not included in the House's omnibus bill. And while both the House and likely the Senate demonstrate an interest in taking a bite out of the state general levy, the Governor's proposal heads in the opposite direction. Thus the fiscal difference between majority legislators and the governor is even larger than the gross numbers suggest.

Combined with Governor Dayton's commonly expressed reticence to jeopardize future budget stability, all this suggests major tax relief would seem to face a major uphill challenge. Yet the 2016 session came within a whisker of delivering on many of the tax relief ideas being included in this year's bills – spoiled by the use of an incorrectly employed two-letter word. We don't how this year will turn out, but if a tax bill gets derailed again, interjections rather than conjunctions will take center stage. ■

A Senior Moment

Is a tax break specifically for seniors good policy? A look at the issues and evidence.

Their numbers are growing rapidly. They like to vote. They are by and large more mobile than any other age demographic and are generally the wealthiest. With respect to their net fiscal impact, some are (in the words of one researcher) "pure gold" to have around while others are disproportionately large users of state government services. And over a longer period of time some may fall under both these categorizations.

As this year's House and Senate omnibus tax bills demonstrate, as far as priority audiences for tax relief go, seniors are near the top. As highlighted above, senior tax relief does give lawmakers some interesting political and policy implications to think about. But its inclusion also fundamentally changes the calculus of tax relief available to other taxpayers which were prime tax relief targets in the "almost" tax bill of 2016 and remain so today – like farmers, households with kids, college graduates with student loans, and rural businesses.

Republican legislators have been the most vocal proponents, introducing several bills putting state taxation of Social Security

Table 1: Minnesota Results from Tax Year 2013 Multistate Individual Income Tax Comparison Study

Senior Filer Type/ Income	MN Income Tax Burden	MN Income Tax Burden Above U.S. Average	As % of U.S. Average	Rank
Married $20,000	$0	NA	NA	**
Married $35,000	$0	NA	NA	**
Married $50,000	$157	$42	136.5%	12
Married $75,000	$2,316	$1,319	232.2%	1
Married $100,000	$4,345	$2,302	212.7%	1
Married $150,000	$7,117	$2,802	164.9%	1
Married $250,000	$13,749	$3,743	137.4%	1
Single $20,000	0	NA	NA	**
Single $30,000	$328	$126	162.7%	10
Single $50,000	$1,791	$984	222.0%	1
Single $75,000	$3,543	$1,597	182.1%	1
Single $100,000	$4,132	$1,670	167.8%	1
Single $150,000	$7,478	$2,299	144.4%	1

** Rank not shown because 2/3rds of states tied with $0 liability benefits directly in the crosshairs. Four bills were introduced calling for 100% exemption of Social Security benefits – the only difference being the timelines involved. Unsurprisingly, these are not cheap proposals. Even the most gradual phase in – exempting an additional 10% of currently-taxable benefits each year for the next decade – has a $135 million price tag for the coming FY 18-19 biennium, which ramps up to $365 million for FY 20-21. DFL interest centered around a less expensive and not surprisingly more progressive approach which reduces the tax relief for higher earners.

Ultimately, both the House and Senate omnibus bills embraced this more targeted approach allowing a subtraction of Social Security benefits from taxable income, subject to limitations. The maximum value of the subtraction differs between the bodies – the House bill provides for a complete subtraction of benefits up to a phase-out threshold, while the Senate bill allows a maximum of $2,500 in benefits (for married-joint filers; scaled for other filing types) to be subtracted. In both bills the subtraction is phased out for filers with "provisional income" (i.e. the income used to calculate the federally taxable portion of Social Security benefits) greater than certain threshold amounts. However, these threshold amounts and the associated phase-out rates differ between the bills. Notably, the "thresholds" above which Social Security benefits are taxed have never been adjusted for inflation since they were first put in place in the mid 1980's. Going forward, the Senate version corrects for this de facto "bracket creep" by adjusting all thresholds for inflation. Projected budget impacts for the House and Senate versions for FY 18-19 are $269.1 million and $74.9 million respectively.

Meanwhile, Governor Dayton has been circumspect on senior tax relief, occasionally expressing caution about the long-term revenue implications of such proposals. The only senior-targeted tax initiative in his budget is enhancements to the senior citizen property tax deferral program to make it more accessible and easier to use.

No Country for Old Men

Unlike nearly all other states Minnesota offers little in the way of preferential income tax treatment for seniors. Minnesota offers no special deduction, exemption or tax credit based solely on age, no general exemptions for pension income, and no favorable treatment of Social Security benefits above and beyond that offered under federal law. The results of these policy choices can be seen in the results of our own Multistate Individual Income Tax Comparison Study. As the accompanying table shows, Minnesota consistently ranks as the highest senior income tax state in the nation at middle and upper income levels. The "burden above U.S. average" column only includes states with personal income taxes; the differential for the nine states without a personal income tax is, of course, the Minnesota income tax burden itself.

For higher income seniors, might favorable treatment in other Minnesota tax areas offset whatever comparative disadvantages exist in state income taxation? Perhaps, but not likely to any significant degree. Our 50 State Property Tax Comparison Study finds urban and rural homestead taxes are near national averages.[1] Minnesota does have a far more generous and accessible general property tax refund program than other states, but most other states do offer some type of exemption or refund program specifically for senior households. Moreover, the Minnesota property tax refund program is income-tested so fewer refund benefits accrue to those households paying comparatively more in senior income taxes than they would in other states. For example, according to the *2015 Tax Incidence Study*, the average property tax refund of the top 30% of Minnesota senior income households is only $66 – which represents a small savings relative to the higher income tax burden they pay.

For Minnesota to match the senior tax treatment offered by a typical state, the estimated decline in income tax revenues would more than double.

Similarly, sales tax treatment of seniors is unlikely to materially offset disadvantages in income taxation. Generally speaking, the portfolio of goods and services comprising Minnesota's sales tax base is not significantly different from most other states – including the non-taxation of senior consumables like prescription and over the counter drugs. The high profile exception – clothing – may be an iconic and popular feature of Minnesota taxation but clothing only constitutes 3-5% of total senior expenditures.[2] Our more limited use of local sales taxes could be considered an advantage, but that is offset by our comparatively higher general sales tax rate.

In short, Minnesota's ranking as the third least friendly tax state for retirement by Kiplinger's personal finance magazine appears justified. The primary policy questions for legislators are 1) does that even matter, and 2) if so, what are the potential fiscal impacts on the state in addressing it?

Fall Migration Patterns

From the purest tax policy perspective, there is no theory of taxation justifying favorable income tax treatment simply on the basis of age. Evaluated on principle, such efforts would routinely violate tax fairness – albeit the less appreciated and recognized "horizontal equity" version. But the elderly do face greater limitations on obtaining more income, unlike younger but income-equivalent counterparts. Ensuring senior health and enhancing protections against senior poverty is why one reason why legislators have expressed interest in senior income tax preferences.

Evidence suggests, however, that state senior income taxation does not appear to have a major influence on senior income security. According to the *2015 Tax Incidence Study*, the bottom half of all Minnesota senior households (which reflects incomes below $46,408) have an average state income tax burden of only $126. Since most of the tax-related benefits of exempting larger amounts of Social Security income would

[1] Of course money has to come from somewhere and states with no individual income tax often will feature higher property taxes. For example, a $150,000 home in Houston pays $682 more in property taxes than an equivalently valued home in Minneapolis and a $300,000 home pays $1,068 more.

[2] "Expenditure Patterns of Older Americans" Employment Benefit Research Institute, 2012

accrue to higher income senior households, the primary policy outcome is likely to be the enhanced protection of retirement lifestyles rather than enhanced income security.

Another more frequently heard argument concerns taxpayer mobility: the need to attract –or perhaps in Minnesota's case simply retain –an economically important demographic: the higher income retiree. Several studies have documented the importance of seniors to an economy – especially the prime "young –old," amenity-seeking retirees possessing above average incomes, wealth, and work experience. They spend money that generates jobs within their local economies; they place fewer demands on community services like schools; they frequently continue to work in some capacity, which adds to state revenues; and they meet important volunteer needs in the non-profit sector. One economist has concluded that a senior citizen with retirement income has an economic multiplier of 3.1 compared to 1.7 to 1.8 for the average consumer.[3] Another study estimated it takes 3.7 manufacturing jobs to equal the economic impact of one new retiree household.[4] The proliferation of special tax breaks for seniors across the country over the past couple of decades suggest this has not gone unnoticed by legislators.

One important question is whether higher income seniors respond to these incentives. Unsurprisingly, academic research findings are mixed with "do they or don't they" conclusions dependent on the methodological approaches employed and their incomprehensible econometric details. One noteworthy study that examined changes in state tax breaks over time and migration trends covering four U.S. census periods adamantly concluded, "our results are overwhelming in their failure to reveal any consistent effect of state income tax breaks on elderly interstate migration.[5] However, the authors also note that their analysis ends with migration that took place before 2000 – long before the large, wealthier, more active cohort of baby boomer retirements commenced – and acknowledge, "current elderly could be behaviorally different from their predecessors."

3 "Do Senior Citizen Tax Breaks Pay For Themselves?" *Governing*, April 25, 2013

4 "Manufacturing or Retirement: A Comparison of the Direct Economic Effects of Two Growth Options" Green and Schneider, Arkansas Business and Economic Review, 1989

5 "No Country for Old Men (Or Women): Do State Tax Policies Drive Away the Elderly?" Conway and Reed, *National Tax Journal*; June 2012

To gain some additional perspective on the migration patterns of higher income seniors we examined the Public Use Microdata Sample from the Census Bureau's American Community Survey for each year between 2011 and 2015. We focused specifically on wealthier senior households (age 65 and with at least $75,000 of income[6]) who reported living in a different state in the previous year, and their in-migration to Minnesota or out-migration from Minnesota with respect to neighboring states (the Dakotas, Iowa, Wisconsin, and Illinois) and classic sunbelt retirement states (Arizona, California, Florida, and Texas). Based on the data, we estimate about 6,000 of these individuals left Minnesota for these states while about 3,000 migrated into Minnesota from these places, for a net loss of about 3,000 of these individuals over the 5-year period, or about 600 per year.

Using the revenue estimates associated with the Social Security exclusion bills offers some insight into the cost effectiveness of using Social Security tax policy to retain retirees. Even just exempting 10% of the current Social Security income base would cost $42.4 million in the first year – or $71,000 for each of the 600 net seniors with higher incomes who leave each year. Clearly, those amounts go up if more Social Security income is exempt. A full national analysis of this cohort's migration in and out of Minnesota might show a larger net migration and thus lower "cost per senior to retain." Still, it seems reasonable to conclude that an across-the-board Social Security tax break is a rather expensive way to try to stem the net loss of higher income seniors for the simple reason that so much of the benefit would be directed to individuals who would stay in Minnesota anyway.

6 In constant 2015 dollars.

Putting State Budgets at Risk?

At the same time Minnesota is exploring new tax relief to seniors, other states are investigating ways to roll back the favorable treatment they currently provide. Both Georgia and Michigan have frozen or rolled back income tax exemptions on seniors' income while a 2013 blue ribbon commission on tax reform in Kentucky concluded the state could bring in nearly a half a billion dollars annually in needed revenue by reducing income tax exemptions on pension benefits. The fact that policymakers have pursued these rollback efforts in spite of their unpopularity and political risk suggests a growing recognition that these tax system features are setting states up for potentially big budget problems in the future – budget problems influenced by the same demographic group Minnesota is targeting for relief.

An investigation several years ago offers some interesting insight on the revenue related implications of an aging population and on providing more favorable tax treatment to this demographic. The study explored the revenue impact of an aging Minnesota population by simulating what Minnesota tax revenues in 2007 would have

Estimated Changes from Enacting Selected Senior Tax Preferences to 2007 Minnesota Income Tax Revenues (Adjusted for 2035 Characteristics)

Baseline (collections using 2035 assumptions; no law changes)	-7.5%
Social Security thresholds indexed to 2007	-9.0%
A. $10k pension subtraction, not indexed	-10.1%
B. $10k pension subtraction, indexed	-11.4%
C. Full pension subtraction	-18.0%
D. No tax on social security income	-13.0%
E. Option B plus Option D (typical state)	-16.2%
F. Option C plus Option D (most generous states)	-21.3%

Source: B. Jajko and P. Wilson "The Aging Population and State Income Tax Revenue: 2007 and 2015," Presentation to the Federation of Tax Administrator's Revenue Estimation & Tax Research Conference, Sun Valley, Idaho, September, 2010.

looked like by superimposing projected 2035 demographics, income sources and labor force participation onto the then-current (2007) tax law. Importantly, the investigation examined only the direct impact on income taxation – it ignored indirect impacts like age induced lower rates of economic growth and increased pressures on government spending. Researchers found retirement income receipts (pension and Social Security) would be 34.4% higher but would be more than offset by declines in both earned and capital income. The result was a hypothetical 7.5% decline ($535 million) in 2007 individual income tax receipts relative to what was actually collected.

Of course, Minnesota offers nothing in the way of senior preferences, so any effort to start doing so would result in projected greater losses going forward. The accompanying table highlights how enacting several types and combinations of senior preferential tax treatments would affect the scenario the researchers modeled (i.e., 2007 revenues under 2035 characteristics). As the table notes, for Minnesota to match the senior tax treatment offered by a typical state (Option E), the estimated decline in income tax revenues would more than double.

Researchers concluded that even without new senior preferences, states face declines in income tax revenue due to an aging population, and states like Minnesota with limited senior preferences face an even greater potential loss should they choose to mimic the preferences other states provide.

Meanwhile, spending pressures on government programs serving this demographic are growing. Many younger retirees will become over time part of a senior population requiring some form of long-term services and supports (LTSS). A 2013 Congressional Budget Office study on growing demand and rising costs of LTSS offers some perspective on the looming challenge:

- Two-thirds of 65 year olds will need assistance to deal with a loss of functioning at some point during the remaining years of their life
- By 2050, one-fifth of the total U.S. population will be over 65
- From 2013 to 2023, Medicaid spending on LTSS is expected to grow by an average of about 5.5% per year
- LTSS spending as a share of national GDP will grow from 1.3% in 2010 to 3.0% by 2050

Anticipated federal health care reforms only further complicate the calculus of senior tax relief. As we noted in our last issue of *Fiscal Focus*, personal income-adjusted Medicaid block grants alone could cost the state $1 billion or more in annual federal revenue. The Congressional Budget Office estimated enactment of the American Health Care Act would increase the number of uninsured individuals by 24 million and raise the out-of-pocket health care premiums for a typical low-income 64-year-old senior from $1,700 to $14,600 a year. Although the AHCA ultimately failed to pass the U.S. House, any health care reform seems likely to create some level of financial challenge for seniors. This creates a dilemma. Facing these types of outcomes and financing responsibilities, states will be compelled to hang on to every tax dollar they can get. At the same time, such reforms will put even more pressure on seniors to retain every dollar of income they can.

Greater levels of redistributive spending gets to be used as evidence for the governments' ability to raise additional revenues that can be spent on, among other things, more government redistribution.

Health care is just the most visible example of policy proposals that are primed to delegate far more responsibilities to states for the financing and delivery of essential public goods and services. A recent report described how Minnesota could lose $80 million in federal support for childhood immunization programs and infectious disease monitoring requiring more state backfilling. From public health to infrastructure to tax administration to environmental protection, nearly every area of government is directly or indirectly exposed to budget uncertainty.

It's in this context that senior tax relief – and for that matter any tax relief or new program spending being considered in 2017 – also needs to be evaluated. That is especially true for a high tax, high service state like Minnesota which has historically struggled with embracing government redesign ideas and thinking about government spending in terms of priorities as a way to address uncertainty, risk, and exposure. As a result, building a state budget in this environment is akin to playing Texas hold 'em with the federal government. The state might be prudent to check and see the flop before going all in with very large and ambitious new tax or spending policies. ■

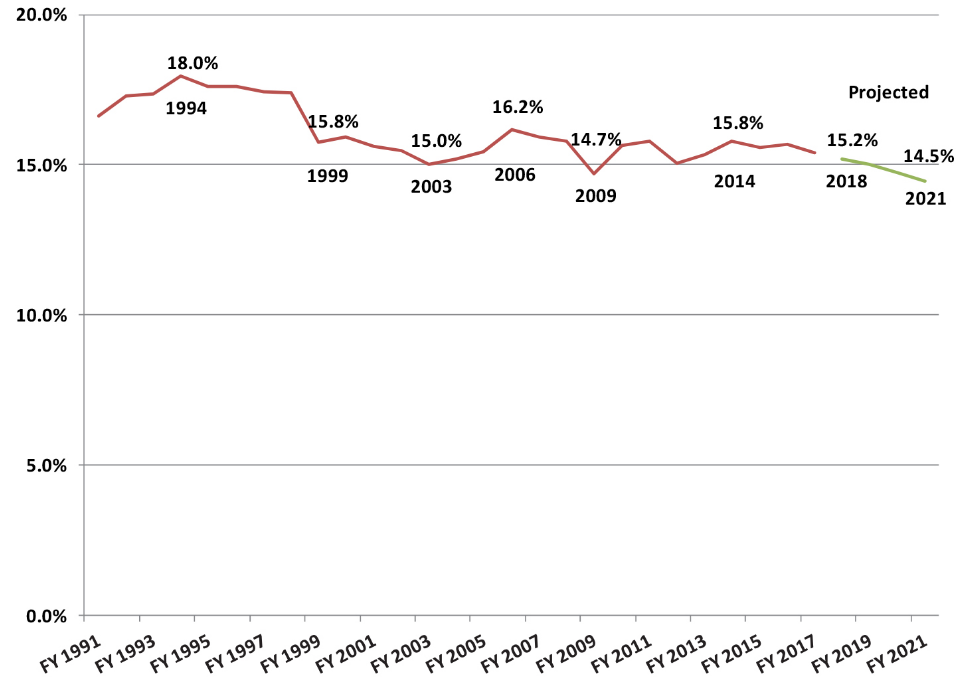
Price of Government Declining ... Thanks to More Government Spending

The growth in government transfer payments is making Minnesota's Price of Government appear cheaper

Legislators brought the Minnesota Price of Government (POG) report to life in the early 90s to answer the question, how much do Minnesotans pay to state and local governments in total? It's a seemingly simple and straightforward metric: take all the own source revenues the state and local units of government collect directly from citizens (taxes, fees, charges, assessments, and basically everything except for payments from one government to another) and divide it by total state personal income. The result serves as a kind of financial index for the cost of public services in Minnesota.

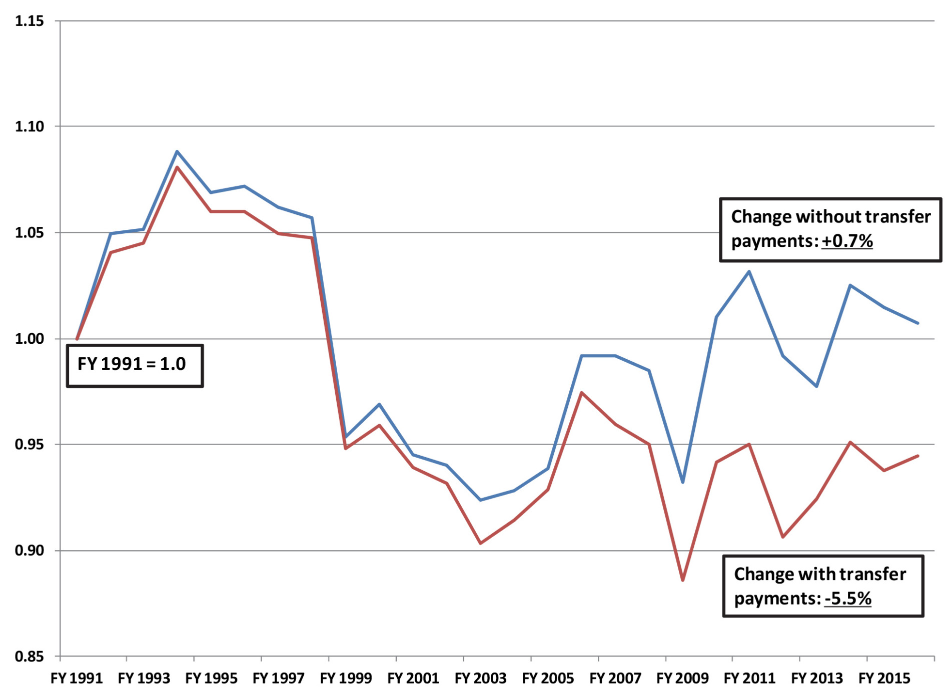
The November 2016 Price of Government report, the most recent available from Minnesota Management and Budget, has some interesting results. Even though governments' total own-source revenues across the state have grown by 43% since FY 2006 and are at an all-time high, the POG declined over that period and is projected to continue to decline. It seems like there can be only one explanation: Minnesotans'

Figure 1: Minnesota Price of Government: State and Local Own-Source Revenues as % of Personal Income, FY 1991-FY 2021



Note: 2017-2021 projected
Note: Personal income for all years based on September 2016 BEA revision
Source: Data from Bureau of Economic Analysis personal income) and Minnesota Management and Budget (own-source revenues); calculations by MCFE.

Figure 2: Impact of Transfer Payments on Minnesota Price of Government: FY 1991 – FY 2006



personal income has grown even faster – at a 50% clip. But on closer examination it's the growth of a particular piece of personal income – government transfer payments – that has been responsible for the long term gradual decline in Minnesota's Price of Government.

Government transfers have been the fastest-growing piece of Minnesota's personal income since 1990 – growing about 25% faster per year than personal income overall and about 35% faster per year than salaries and wages. In calendar year 2015,[7] government transfer payments accounted for $44.2 billion of Minnesota's personal income – 19% of the overall total. These transfers include:

- Benefits that are paid to recipients in cash that are often taxed (e.g. Social Security benefits and unemployment compensation);
- Benefits that are not paid to recipients in cash and theoretically could be taxed but would likely result in someone being hung in effigy if they tried (e.g. the $20 billion worth of Medicare and Medicaid benefits Minnesotans received in 2015);
- Benefits that are not paid to recipients in cash and that can't be taxed under federal law (e.g. food stamps); and,
- Benefits that are paid to recipients in cash via a "negative tax" (e.g. the earned income tax credit and the child tax credit).

The accompanying chart shows the indexed change in the Minnesota Price of Government between its inception in FY 1991 (the first year it was measured) and FY 2016 – the most recent year for which we have data on the individual pieces of Minnesotans' personal income. If you measure the Price of Government using just wage and salary income, the POG is actually up 1.3% since its inception. As Figure 2 shows, when measuring the POG using all personal income except government transfer payments, government is essentially taking the same bite now as it was 25 years ago – up 0.7%. But when transfer payments are included, we get the perspective that government is asking 5.5% less from Minnesotans than it did in FY 1991.

Problems arise when this reality does not factor into the policy debates into which the POG gets woven. The POG has become synonymous with the affordability of government – because it purports to measure how much Minnesotans are paying to state and local governments – and so the conventional interpretation has been that when it declines we are demanding less from citizens. And if you think that Minnesotans' ability to pay for government services ought to factor in the value of Medicaid and Medicare benefits, then the conventional wisdom is correct. For those advocating for more government spending, the POG is a dream

[7] The Price of Government report uses calendar year 2015 personal income data to calculate the fiscal year 2016 POG.

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metric. It offers perfect circularity – greater levels of redistributive spending gets to be used as evidence for the governments' ability to raise additional revenues that can be spent on, among other things, more government redistribution. And as baby boomers age and safety net spending likely becomes an even bigger player, that trend will most certainly be their friend.

None of this delegitimizes the value and importance of government transfer programs. It is, however, an example of the problem that occurs when you use the wrong tool for the job – in this case, measuring state and local governments' claim on Minnesotans' pocketbooks. As Figure 2 illustrates, for a long time the influence of government transfers was a Minnesota personal income afterthought. But with the rapid growth in transfer payments, that is no longer the case. That is why we have now based our own published state tax and spending rankings and our annual Price of Local Government Report on a modified personal income basis – to capture what the Price of Government, we think, should be really trying to get at.

We would encourage lawmakers to rethink the Price of Government and update it to better capture what it purports to measure. Otherwise the POG is likely to perpetuate the appearance that government somehow manages to get cheaper the larger the role it plays in the state economy. ■