FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

January – February 2016 Volume XXXVII No. 1

In This Issue:

Is the Minnesota Miracle Dead?

Contrary to popular belief, the transformation of the state/local relationship and policy outcomes originating out of the Minnesota Miracle remain intact today. But to satisfy the continuing calls and insatiable expectations for lower property taxes, a new and different miracle is necessary.

The moniker itself originated in a long-forgotten report from a now defunct federal agency, but has lived on to become an enduring part of Minnesota's fiscal and political history. Enacted after a marathon special session in 1971, the legislative package known as the "Minnesota Miracle" fundamentally transformed the state/local fiscal system. It helped propel the state to national attention on the cover of Time magazine while becoming a powerful political rallying theme for decades

Forty-five years later the phrase is still routinely invoked in legislative hearings and on editorial pages, often with a wistful tone. The Miracle era coincides with the state's rise to economic prominence, and many believe that relationship is no accident. With property taxes on the rise again and the state/local relationship primed to be a focus for the shortened 2016 legislative session, it is worth looking at how "miraculous" we still are and whether the premises and promises linked to the Miracle can continue.

Miracle 101

The Miracle centered on two high profile, interconnected, and very legitimate policy concerns – extraordinarily high levels of property taxation and inequity in school funding. Through the early and mid 1960's Minnesota local property tax collections were consistently 30%-40% above national averages. Public outcry prompted the creation of the state's first ever general sales tax (3%) in 1967 specifically to provide property tax relief. The effort delivered $143.9 million in property tax relief, paid for by $175.7 million in additional (mostly sales) taxes.[1] But this relief was short-lived. From 1969-1971 levies increased by an average of 17% per year, again triggering strident public demands for more, and lasting, property tax relief.

Meanwhile, major problems in school finance equity were evident.[2] In 1971, state aid for K-12 education constituted only 43% of school operating costs. School districts had to raise the rest through property taxes, resulting in significant disparities in school spending and property tax effort between poorer districts and their wealthier counterparts. Heading into the famed 1971 session, both political parties' platforms recommended a goal of 50% state support for schools.

In January 1971, Governor Wendell Anderson unveiled his Fair School Financing Plan calling for a massive increase in state taxes to boost school aid much higher than what the parties were calling for – to 70% of school operating costs. The $762 million price tag of this proposal represented a whopping 37% increase in the state's operating budget from the previous biennium. This set the stage for what turned out to be a 157-day special session, the longest in state history.

In the end, the final legislative compromise tackled both the school finance and property tax relief objectives in a way that completely altered Minnesota's fiscal landscape. As **Table 1** summarizes, the Miracle's accomplishments were noteworthy but also came with a big price tag. The $580 million in new "Miracle" taxes enacted in 1971 is equivalent to about $3.4 billion in today's dollars. A 1972 report by the federal government's Advisory Commission on Intergovernmental Relations bestowed the description "miracle" to this monumental effort, but most legislators who participated in the process argued that the real miracle was getting reelected (which, in fact, most did).

Checking for a Pulse

So has the Miracle been abandoned? A check of key measures indicates that contrary to public perception, the two primary goals of this legislation – property tax relief and improvements in school finance equity – remain very much intact. Several measures suggest Minnesota is actually more "miraculous" now than we were during the supposed Miracle heyday of the 70s, 80s and 90s.

To begin with, we are no more reliant on property taxation than we were following the adoption of the Miracle. As **Figure 1** shows, the property tax relief efforts of 1967 and the subsequent Miracle legislation dramatically reduced property taxes' share

1 "Property Tax Relief Fund Ends Year With $32,000,000 Balance" Minnesota Taxpayers Association, July 25, 1968.

2 Many of the details of the Miracle contained here are taken from Steve Dornfeld's interview with its key legislative players in "Miracle: A Roundtable Discussion" which appeared in *Minnesota History*, Winter 2007-2008.

Minnesota Center for Fiscal Excellence

Susan Haffield, *President*
Aaron Twait, *Research Director*
Mark Haveman, *Executive Director*
Linda Edstrom, *Executive Secretary*

The Minnesota Center for Fiscal Excellence is a non-partisan, non-profit corporation founded in 1926 to advance economy and efficiency in government.

Fiscal Focus is published bimonthly for $150 per year by the Minnesota Center for Fiscal Excellence, 85 East Seventh Place, Suite 250, St. Paul, Minnesota 55101. ISSN # 1042-847X. UPS #519130. Periodical paid at St. Paul, MN 55101.

Postmaster, send address changes to:

Fiscal Focus
c/o Minnesota Center for Fiscal Excellence
85 East Seventh Place, Suite 250
St. Paul, Minnesota 55101

Phone: (651) 224-7477 or (800) 322-8297
Fax: (651) 224-1209

E-mail: question@fiscalexcellence.org
Web Site: www.fiscalexcellence.org

of all taxes from over 50% to the low 30% range by around 1980. But over the years – including periods when the Miracle was being "abandoned" – property taxes' share of all state and local taxes stayed at about the same level. The exception is a brief spike during the Great Recession due to year-on-year declines in actual sales and income tax collections – temporarily giving property taxes a greater relative tax share. But as the figure shows, property tax share was returning to normal historical patterns even before enactment of the 2013 income tax increase. Importantly, these shares are calculated ***before*** factoring in the property tax refunds the state annually delivers to homeowners and renters – which reduced property taxes by $650 million in 2015.

A similar story emerges when looking at Minnesota property tax collections in a national context – significant decline immediately following the Miracle's adoption with a leveling off thereafter. In some ways, the transformation of the state/local fiscal system culminated in 2001 with the state takeover of the general education levy, cutting local property taxes by $1.3 billion. Even though other units of local government took advantage of this opportunity by backfilling some of this cut with sizable levy increases beyond their loss in state aid, this most recent major buy-down effort still propelled Minnesota property tax collections to all-time lows relative to national averages. (Perhaps unsurprisingly, this unique moment in time also conveniently became the benchmark moment for political assessments of property tax trends and changes going forward.) Although both national rankings and collections relative to the national average have increased since the Ventura Big Plan, we remain right where we have been through most of the Miracle's lifespan. In fact, with aggregate property taxes only 0.6% above the national average in 2013, property tax burdens are lower relative to other states than at almost any other time since the enactment of the Miracle.

Table 1: What the Miracle Wrought – The Highlights

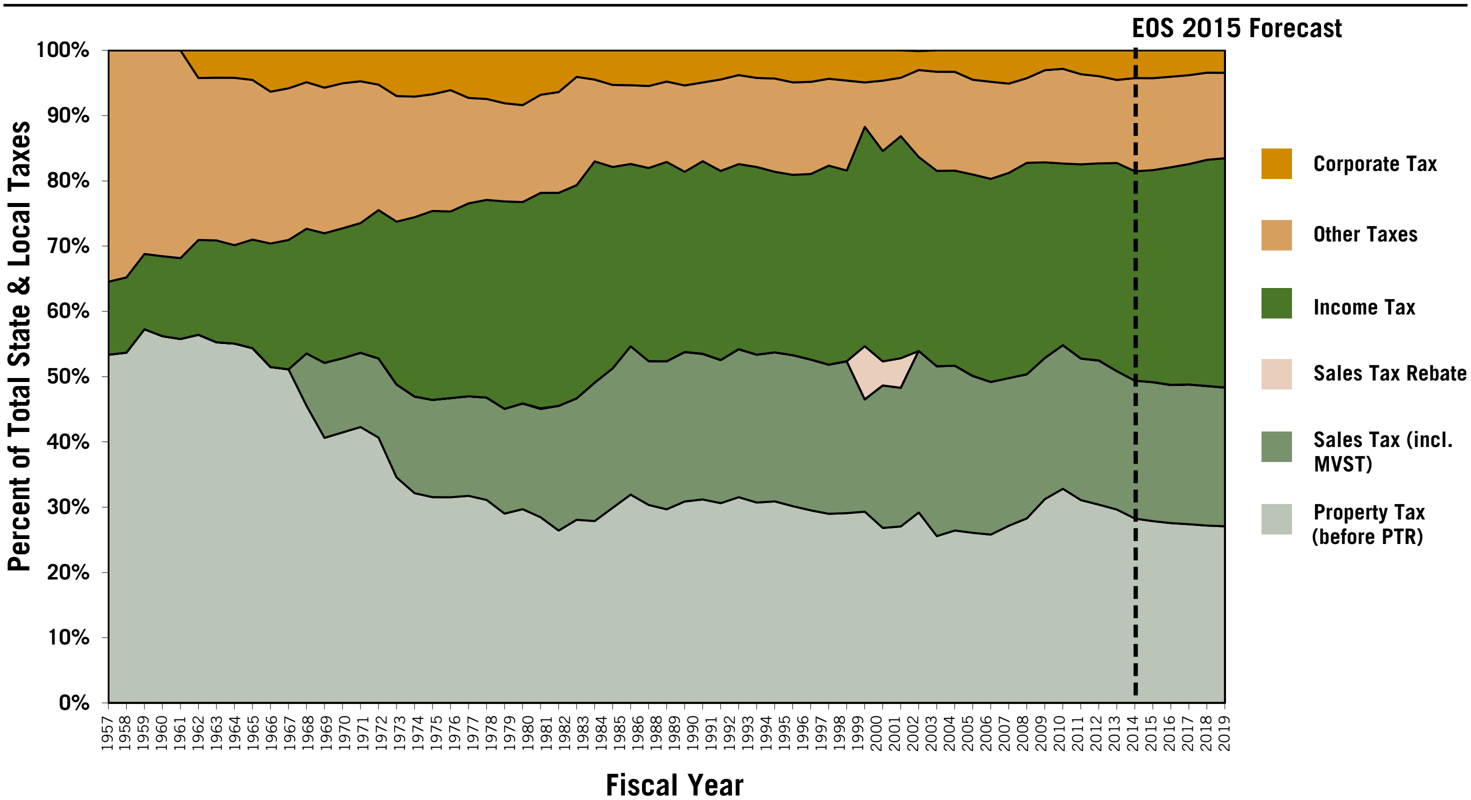
For Schools	For General Property Tax Relief	All Paid for by…
Increased state aid to 65% of school operating costs	Expanded homestead property tax credit and exemption of business inventories and machinery	Increase in income taxes by an average of 22%
Established a uniform and equalized local property tax levy for schools	Established Local Government Aid (LGA)	Increased corporate income, bank excise, and taconite taxes
Additional aid to districts based on disadvantaged students served	Increased categorical aid to counties for welfare costs	Increased liquor and beer taxes by 25% and cigarette taxes by 5 cents a pack
	Established levy limits	Increase in state sales tax rate from 3% to 4%
	Regional tax base sharing (Fiscal Disparities)	

Table 2: MN Property Tax Collections per $1,000 of Personal Income, Selected Fiscal Years

	1968	1971	1973	1983	1993	2004**	2013
MN Property Tax Rank	9th	15th	19th	21st	19th	37th	19th
Above (Below) National Ave.	27.4%	18.4%	6.3%	6.8%	11.8%	(17.9%)	0.6%

** Census Bureau did not publish state-specific data for FY 2003

Figure 1: Selected Taxes as Share of Total State and Local Taxes, FY 1957-2019



Minnesota Department of Revenue, Tax Research Division, October 15, 2015

Are geographic equity improvements intact? We eagerly await the Department of Revenue's next Voss Report on effective homestead burdens across the state to see how things have (or haven't) changed. In the meantime, the accompanying map (Figure 2) offers some perspective by examining total net local effort property taxes paid within a county[3] divided by all the cash income available to pay those property taxes within a county.[4] As the map on page 4 illustrates, the cause of property tax fairness seems rather well served. Sixty of Minnesota's 87 counties are within 15% of the state average. Large swathes of average and below average tax burdens running border to border in any direction suggests that common concerns about equity are a lot more complicated than editorial pages generally communicate.

With respect to school finance, the story is similar. Whether the state is providing adequate support is debatable, but no one can say that the Miracle's goal of far greater reliance on the state for school funding hasn't come to fruition. According to the Department of Education the state paid for 77% of district general operating costs in 2013 – higher than Governor Anderson's original ambitious target.[5] To improve inter-district equity in school finance – another Miracle objective – over the years the state has added various compensatory aid programs to pay for geographic and other cost factors outside of a district's control.

Major Headwinds

All this suggests the problem isn't that we have dismantled the state/local fiscal relationship; rather, the problem is finding enough money to pay for the continuing twin demands of low property taxes and high quality local government services. That challenge has been emblematic of the Miracle's 45-year history. (See the sidebar on page 5 on Minnesota's 45-year-long struggle to fuel the Miracle.) Going forward, Minnesota faces two major problems in delivering on such expectations.

In 2015 the state distributed over $720 million of general purpose aid to subsidize local government operations as they currently exist, but nothing to directly support cooperation, shared service, and consolidation efforts.

The first problem is simply demographic. According to the House's Fiscal Analysis Department, in FY 2000 health and human service spending comprised 22.1% of all spending out of the state's general fund. By FY 2015 that share had climbed to 30.7%. To put this trend in another way, since FY 2000, the health and human service area has consumed 42% of all additional state general fund spending. Moreover, as the 2009 Budget Trends Study Commission pointed out, we are only at the cusp of the demographic changes that will increase pressure on health and human service spending going forward.

This budget reality translates into a mammoth uphill struggle for reliable, state-subsidized property tax restraint and relief over the long-term. The aforementioned change in health and human services share of the general fund budget represents $1.75 billion of 2015 resources unavailable to support other spending priorities – including aids to local governments and funding for schools. As former state Finance commissioner Jay Kiedrowski has stated, "If I was a betting man I'd bet that there would be reduced local government aid for cities and counties into the future as human services costs go up."[6]

The second problem is the absence today of any notion of "shared sacrifice" —a belief that was so essential to the ambitions of the original Miracle. In the rhapsodizing over how much better the state functioned when the local aid spigots were opened wide, one crucial element gets ignored – every citizen paid for it. Lower- and middle-income households clearly felt the increases in sales, excise, and income taxes that supported these new initiatives. As just one example, the effective state income tax rate for a household with income at 150% of the federal poverty guidelines immediately after the Miracle was adopted was 4.2% (compared to -2.3% today thanks to the state's Working Family Credit). The $272 income tax bill in 1973 for this filer would be equivalent to about $1,450 in 2015 dollars. By the early 80's recession, the effective rate for a filer at this income had risen to 4.9%, thanks in part to a surtax added to tax liability in 1981-1983 as policy makers frantically attempted to keep property tax relief going at the same time as the state budget was imploding.

With income and sales tax rates already among the nation's highest, Minnesota tax policy doesn't have the headroom it once had to allow policymakers to move further along this path. Base broadening might be an avenue for "revenue enhancement" but there appears to be zero public appetite or support today for such thinking. Ironically, part of that resistance is likely a function of the highly successful effort to portray Minnesota's tax system as chronically and perpetually unfair. As a result, Minnesotans may still express strong support for egalitarian ideals like "One Minnesota" but are also adamant that a very tiny fraction of the state's population pay for it.

Miracle 2.0

There is no evidence of a return to anything resembling the reliance on property taxation that predated the Miracle nor the equity problems such reliance created. With respect to property taxation we essentially

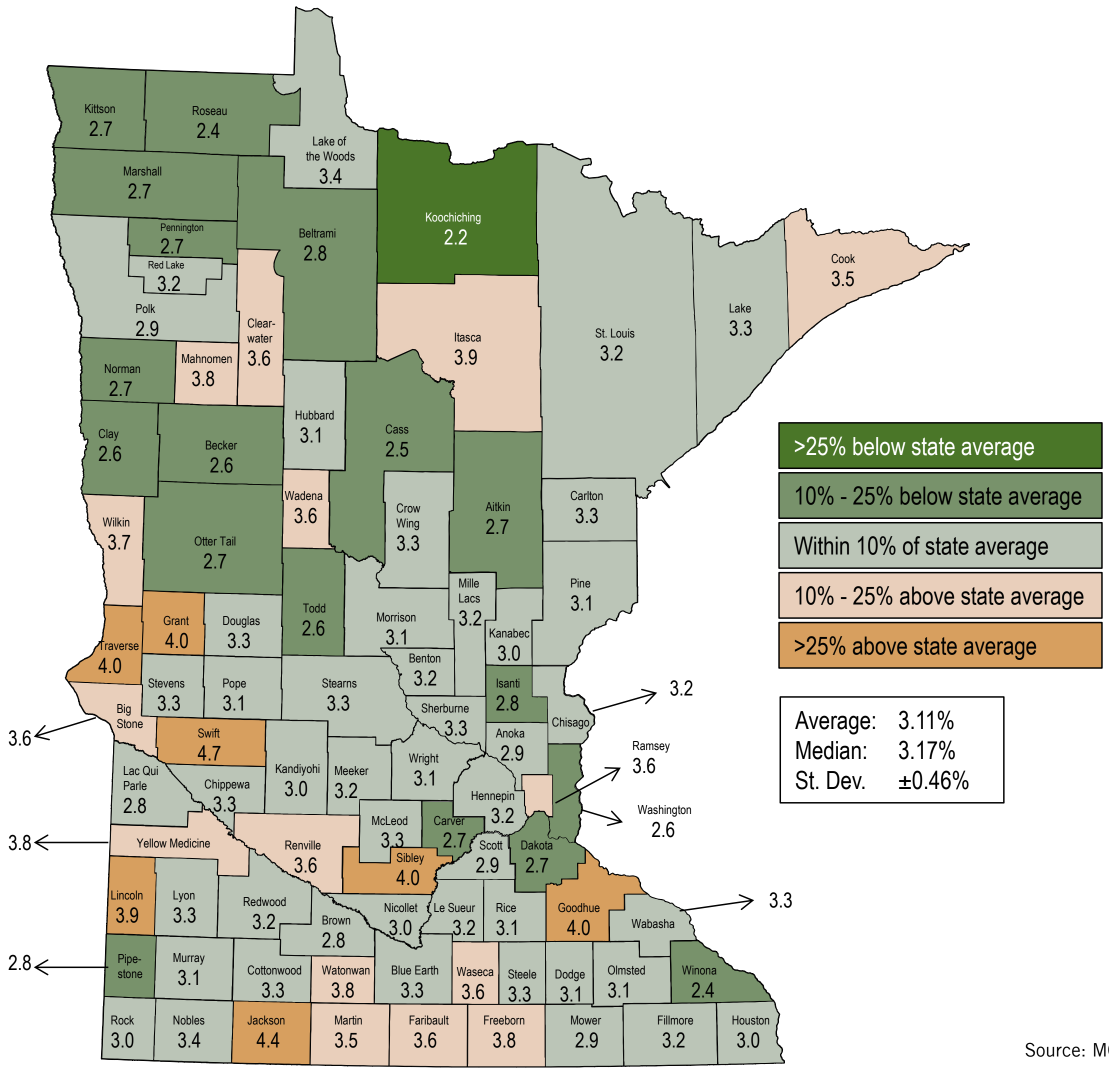
3 Equal to all local property taxes levied within a county, less property taxes exported to non-county residents. Exported taxes assumed to equal 30% of local sales taxes, 80% of local cabin property taxes, 90% of local lodging taxes, and 100% of property tax refunds (which essentially exports the local property tax burden to the state).

4 Cash income is equal to personal income less readily available non-cash components (employers' FICA, pension, and insurance costs, one-half of the FICA taxes paid by the self-employed, imputed rental income, imputed interest income, the cash value of government medical benefits, SNAP benefits, education and training assistance benefits, and government transfer payments to nonprofit institutions) plus cash available for spending that is not included in personal income (employees' FICA taxes, pension and annuity income, IRA distributions, and capital gains).

5 Data from Consolidated Financial Report for all districts statewide for the 2012-13 school year. Data for 2013-14 is available, but the payback of certain accounting shifts distorts the results and so does not provide a representative measure.

6 "Minnesota Scrutinizes 40-year-old 'Miracle' " MPR 12/23/2011

Figure 2: Locally-Paid Property Taxes Relative to Cash Income, by County: 2013



Source: MCFE calculations

are where we always have been ever since adopting the Miracle.

None of this matters. Minnesotans want greater services but expect low property taxes, making local governments reluctant to raise levies. Policy makers want to fulfill both wishes. The difference today is that our ammunition is spent, competition for general fund resources is more intense than ever, and the flawed tax policy which helped sustain it through challenging times (see sidebar) is unlikely to return.

Meeting this expectation without resorting to clumsy and heavy handed levy limits will require a new miracle – only focused this time on the other side of the ledger. "Miracle 2.0" will need to be based on three building blocks:

1. **Major Investment in the Scale Up of Local Government Service Redesign**

For many years, and largely under the radar, local governments across the state have made significant strides in redesigning the ways they deliver services. This redesign comes in many forms. Despite the general recognition that the number and organization of local governments in Minnesota often reflects a bygone era, actual consolidation of local government entities – apart from schools – remains relatively rare. But shared service arrangements and other intergovernmental cooperative agreements are much more common and have yielded many success stories.

However, none of this happens without incurring real costs. Structural, administrative, and technical transition issues – such as the disposition of existing employees, professional service contracts and the need for coordinated technology platforms – have cost implications. According to a 2012 OLA report on local government consolidation, though there are opportunities to increase collaboration and consolidation, the path can be a "costly, controversial, and complicated undertaking with no guarantee of savings."

But the state's budgetary indifference to these pursuits doesn't help. Consider that in 2015 the state distributed over $720 million of general purpose aid to subsidize local government operations as they currently exist, but nothing to directly support cooperation, shared service, and consolidation efforts. One path forward would be to create a pool of resources to help pay for the costs associated with these opportunities for collaboration – including early retirement incentives to leverage the impending public sector retirement boom.

Some repurpose of state aid would also help correct for the disincentives existing state aid creates. The Legislative Auditor's report also concluded local governments and citizens are in the best position to determine

The Dubious Relationship Between the "Miracle" and State Tax Policy

Ask policy observers when the Miracle derailed and many would point to the across-the-board income tax rate cuts of the Ventura Administration. The rate cuts reduced the revenue raising capacity of Minnesota's individual income tax by about 10% and certainly affected the state's ability to support local governments and commit to property tax buy-downs going forward. But ever since the Miracle was established, the state has struggled mightily with securing enough general fund revenue to keep the Miracle's engine running – and employing a lot of questionable tax policy in the process.

When the Miracle was enacted, the state income tax featured 11 income brackets, some of which were $500 wide. In 1977, to further prime the Miracle pump, policymakers created two additional top brackets, bringing the total to 13. No less crucially, throughout the 1970s income brackets were not indexed to inflation resulting in bracket creep on steroids. During the early Miracle years (1971-1983), consumer inflation averaged 7.8% per year, hitting double digits in three of those years. As wages and income grew to keep up with inflation, taxpayers could jump two tax brackets – with major tax implications – with average increases in income.

The adoption of tax bracket indexing in 1979 fulfilled a campaign promise by Governor Al Quie, who objected to cost of living increases pushing families into higher tax brackets. But to illustrate the political grip the Miracle had on Minnesota, Governor Quie was forced to agree to big increases in state aid to local governments and another bump in the homestead property tax credit just to achieve this most basic and simple improvement in tax fairness.

What was the result? To quote Red from *The Shawshank Redemption*, "oh my Lord how the money rolled in." From 1973-1984, individual income tax collections per capita increased from $150 to $557 – nearly tripling in just over a decade. A new political problem emerged: these policies propelled even average Minnesotans to the top of the nation in income tax burdens. Public grumbling now shifted to income taxation. Noting that having the top national income tax ranking for married couples with one wage earner at so many income levels was simply not competitive or acceptable, Governor Rudy Perpich successfully pushed for lowering income tax rates, reducing the number of brackets, and making other structural modifications. However, these policy changes disrupted the major fuel line for the Miracle.

By the late 80s, with income taxes reformed and inflation largely in check, the continuation of state property tax buy-downs became much more difficult. How then could policymakers continue to deliver on the Miracle's promises? The answer was to shift the burden to business by jiggering the state's property tax classification system.

From 1985 to 1990, effective residential property tax rates increased 3.5% while effective commercial/industrial rates increased 26.7%. By 1993, business property owners were paying well over 4 times the property tax per dollar of value than homeowners were. Unsurprisingly, it was now business property taxation's turn to assume the mantle of being number one in the nation with a bullet. But just with income taxes a decade earlier, concerns over competitiveness implications and the lack of local accountability resulted in calls for reform.

Over the next decade the state compressed classification rates – assisted hugely by the booming general fund revenues of the dot com era. These unique economic circumstances made both class rate compression and the continuation of the Miracle-based buy-down of local property taxes politically possible.

So while the tax cuts of 1999 and 2000 didn't do the Miracle any favors, finding enough money to keep homeowners happy has really been a 45-year challenge. Over that period, the practice of the Miracle vividly demonstrates perhaps the most fundamental and important economic lesson of all: there is no such thing as a free lunch.

when and how service reform would make sense for them. But such determinations need more accurate local tax pricing of existing services to signal that investigations into service delivery reform and redesign are necessary. Hiding the true cost of local government from taxpayers through substantial state subsidies doesn't do the cause of innovation in local government service delivery any favors.

2. Transformation of Local Government Cost Structures

Unfunded state mandates and maintenance of effort requirements have long been the bane of city and county governments – interfering with local decision-making and budget prioritization while increasing local property taxes. As a general rule, in a next generation Miracle environment, state government would resist temptations to micromanage local governments. Instead, it would identify measurable service performance expectations while giving local governments the freedom to organize and design processes to achieve those outcomes in whatever ways make sense for them. Towards this end, one "Miracle 2.0" initiative would be the creation of a mandate review and sunset commission to systematically and regularly evaluate the efficacy and cost of local government mandates, eliminate those that fail the benefits test, and ensure adequate state financial support for those that are retained.

Since local service delivery is a labor intensive process with compensation constituting the majority of local governments' general operating budgets, compensation design and flexibility is no less a necessary focus for cost structure reform. As our recent education finance report concluded, moving away from the traditional collective bargaining constructs and towards alternative strategies can be challenging to design responsibly without creating other unintended consequences. But moving to an alternative compensation design that offers the opportunity to repurpose existing compensation resources for greater effect is rapidly evolving from a debatable policy discussion to an undebatable fiscal necessity.

3. **Citizen Reengagement in Local Government Decision-Making and Budget Priorities**

The next Miracle must focus on a different relationship – the relationship between local governments and citizens. Improving this relationship may be the greatest challenge of all. Empty seats at Truth in Taxation hearings may represent apathy and disengagement of citizens but they also likely reflect a belief that the average citizen has no way to meaningfully deconstruct and responsibly question the narrative of the budget that local officials are presenting.

Service performance measurement and benchmarking, which many local governments have pursued, should include cost information as well as outcome measures so citizens can evaluate government's efficiency as well as its effectiveness. Transparency initiatives should be pursued to allow citizens to make informed judgments about the use of their tax dollars. Local governments should present their final levy in a "tax of last resort" format so citizens can clearly see how spending decisions and changes in other revenue sources resulted in the final determination of the levy.

Nothing is easy about any of the ideas behind Miracle 2.0. Reaching consensus on tax levels and state appropriations is child's play compared to the challenges and obstacles embedded in this agenda. It collides head on with powerful and entrenched special interests of all types, inside and outside of government, while often requiring state policy makers to relinquish their most valued commodities: power and control. If any of this takes root, one thing can be said with certainty: the new Minnesota Miracle will be a lot more miraculous than the first. ■

Federal Conformity: The "Other" Business Tax Relief

Two new studies suggest full conformity with federal treatment of new capital investments merits consideration in the forthcoming 2016 business tax relief debates.

If sports books offered betting lines on what business tax relief might materialize next legislative session, smart money would be going into reducing the statewide property tax. It's scalable to fit any budget negotiation, interest in it has been bipartisan, it conforms to good tax policy, and contrary to some suggestions otherwise, all business benefits to some extent. (Even tiny, space-leasing nonprofits like ours since business tax incidence does not magically vanish once tax fairness battles recede into the background.)

But most every December, another potential avenue arises as the federal government passes legislation to prevent various tax benefits from expiring at the end of the year. True to form, Congress enacted the "Protecting Americans from Tax Hikes Act of 2015" on December 18, which extends and modifies a wide range of tax provisions giving longer leases on life to what are theoretically "temporary" tax cuts. To reduce tax filing headaches, Minnesota policy makers work hard and as expeditiously as possible to conform to these federal provisions. Occasionally, however, the price tag of full federal conformity conflicts with budget realities and revenue demands.

Such is the case with Minnesota's relationship to "Section 179 expensing" and "bonus depreciation" – two federal provisions designed to reduce business' cost of capital. Each allows businesses to deduct a larger portion of new investment purchases as a current business expense than the regular depreciation schedules provide for. This both "speeds up" cost recovery of new business investment and increases the present value of the cost recovered because a dollar today is worth more than a dollar tomorrow.

Unappreciated Depreciation

Two recently released reports have shed additional light on these provisions – why they exist, and the policy issues surrounding them. The first is a report released last month by the Tax Foundation[7] examining the underlying economics and practice of corporate investment cost recovery. The report points out the growing economic criticism being directed at current income tax frameworks, which treat capital investment differently from other forms of business consumption. The current system prevents full cost recovery and thereby discourages businesses from making investments that would otherwise be profitable. The Tax Foundation concluded that U.S corporations will only be able to deduct 87.14% of the value of investments made in 2012. Therefore, absent a tax system allowing immediate and full expensing of capital costs, accelerated depreciation mechanisms like Section 179 expensing and bonus depreciation are important tools to correct for this problem. According to the report, bonus depreciation alone moves the U.S. tax system a quarter of the way toward full cost recovery.

The second report from the Congressional Research Service (CRS)[8] looks in more detail at the history and evolution of these provisions and their economic effects. Their assessment concludes that the macro effects of these policies are questionable as research findings indicate accelerated depreciation, "is a relatively ineffective tool for stimulating the overall economy during periods of weak growth," and "may have a minor effect at best on the level and composition of business investment." However, at the micro or firm level, such mechanisms can significantly lower a firm's cost of capital and improve the cash flow of investing firms in the short run "offering the potential to stimulate increased small business investment."

For many years Minnesota has "partially conformed" to both Section 179 expensing and bonus depreciation affecting the timing of when a business realizes the benefits of accelerated depreciation. With respect to Section 179 expensing, Minnesota's $25,000 maximum deduction is much lower than the federal government's $500,000 maximum and Minnesota's phase out threshold for eligibility is also a fraction of the federal government's ($200,000 vs $2,000,000). Minnesota does allow the entire federal Section 179 deduction for state taxes; but requires businesses to claim the difference between the Minnesota and federal benefit over a six-year period instead of just one year. The state stretches the bonus depreciation benefits from a one-year to a six-year period in the same way.

Although non-conformity ultimately is an issue of timing rather than substance, the near term impacts on state revenue collections are quite noticeable. According to a 2015 revenue analysis by the Department of Revenue, adopting full federal conformity for Section 179 expensing would have reduced general fund receipts by $78 million in FY 2016 (declining to $18 million by FY 2019). According to the Department, the

[7] *Cost Recovery in New Corporate Investments in 2012* Tax Foundation, January 2016

[8] "The Section 179 and Bonus Depreciation Allowances: Current Law and Issues for the 144th Congress" Congressional Research Service, August 2015.

From The Director: Minnesota's "Bizarro World" of Property Taxation

DC Comics (with a huge assist from the television show *Seinfeld*) introduced popular culture to the term "bizarro world" – a universe where reality is inverted and people and things have opposite or backwards qualities and characteristics. Round things are square, strong people are weak… you get the idea.

Mark Haveman

Having reviewed several decades of MCFE/MTA publications in putting this issue together, it struck me that a substantial part of this organization's history has been one long, protracted commentary on Minnesota's bizarro world of property taxation – where public finance principle, theory, and practice gets turned upside down and inside out. We have long argued that local reliance on property taxation is a good thing, that relative to other potential sources of local revenue it is a fair tax (especially after factoring in our very generous and accessible income-tested refund programs), and that a dollar used to pay local property taxes is mathematically equivalent to a dollar used to pay any other tax. In bizarro world, greater reliance on local property taxes and increases in property tax collections are bad, it is the least fair tax, and (for some reason never quite explained) it is better to have a dollar go to pay income or sales taxes than to pay property taxes.

The bizarro world of property taxation comes with bizarro political arguments. My personal favorite is the popular phrase invoked whenever the history of state aid cuts is referenced: "balancing the state budget on the backs of local government." What makes this phrase so through-the-looking-glass-strange is that the whole purpose of local aids is to balance ***local*** budgets on the back of ***state*** government. It's local governments' own self-determined budgets, their own decisions, their own local control, the cost structures they create driving the car; the state is an interested – and certainly invested – passenger.

There is a scientific explanation – highlighted in tax literature – for the existence of bizarro tax world. It's tax visibility. Some of the most entertaining tax research studies I come across address what the academic literature calls "tax salience." ("Salience" is the $20 word for "visibility." Academicians seem professionally obligated to use such words to make their research as inaccessible as possible to the general public and the real world of policy making.) These research findings point to a consistent theme: the visibility of a tax has a powerful effect on taxpayers' behavior and attitudes and consequently the government's ability to raise revenue. One study found toll rates are 20% to 40% higher following the adoption of electronic toll collection and the elimination of the need to use cash. Another study found that simply posting sales tax-inclusive prices reduced the demand of consumer goods by roughly 8%.

The impact of property tax salience is especially relevant and significant. A Stanford study hypothesized the "in your face" nature of the property tax had much more to do with property tax hatred than actual tax burdens. To test this hypothesis they examined the relationship between tax levels/tax revolts and the use of property tax escrow which smoothes property tax bills out over 12 months. Researchers found that areas in which the property tax was less visible because of the higher use of escrow were also areas in which property taxes were actually ***higher*** and were also areas where property tax revolts ***were less likely to occur.*** Appropriately enough, the researchers reached a bizarro conclusion about property taxpayers:

> *"A primary implication of our results is that a non-benevolent government will wish to decrease the salience of taxes and that voters facing a non-benevolent government will wish to keep taxes' salience high – even if the forms of taxation that are highly salient cause inconvenience and animus such as that generated by the property tax."*

Using a trusty "Academic to English" translator, you get this:

> *"A primary implication of our results is that a government which tends to prioritize its own internal interests over the interests of citizens will want to reduce the visibility of taxation. Voters dealing with a government exhibiting this characteristic should want very visible taxes – even if it causes extreme annoyance and anger like the property tax does."*

For decades MCFE has argued that one of the greatest assets of the local property tax is its visibility. It ensures local accountability and does a great job of matching taxpayers' expectations of government with their willingness to pay for it. But given these findings it's easy to see why property tax visibility is often seen not as a tremendous asset but a major liability. So taxpayers, love your hatred of the property tax. And welcome to bizarro world!

— M.H.

short term price tag of conforming with bonus depreciation ($218 million in FY 2016) was substantially larger.

Undelayed Gratification?

Federal conformity may not have the visibility and sizzle of other business tax relief ideas but economics aside, there are a few other reasons why it deserves consideration. The first is tax administration. The reason why federal conformity bills typically receive such prompt attention and bipartisan support is the recognition that conforming reduces administrative and compliance costs for all stakeholders in the tax system, making life simpler for everyone. Partial conformity essentially requires businesses to keep and reconcile two sets of books for their fixed assets. Administrative costs are particularly relevant to the small business community, which is a prime target for these policies. According to a Brookings Institute publication, The Crisis in Tax Administration, tax administration costs are "regressive to firm size" imposing greater burdens on smaller companies. Adding to the administrative rationale: the federal government has now made its more generous Section 179 provisions permanent.

Another consideration is that concerns about budgetary "tails" are mitigated. Most of the costs are upfront, with very small effects on the state budget over the long-term.

MINNESOTA CENTER for
Fiscal Excellence
85 East Seventh Place
Suite 250
St. Paul, MN 55101
(651) 224-7477

Periodical
Postage
Paid
Twin Cities,
MN

Thirdly, it satisfies the common political demand that something be done to "earn" business tax relief. Minnesota's long history with business and individual tax expenditures demonstrates we are quick to criticize them in the abstract, but no less quick to embrace them if linked to some desirable and tangible behavior or policy outcome. The benefits of federal conformity directly flow to those making investments in the Minnesota economy.

One can make a strong argument that – based on efficient tax administration, economic principle, and the ability to improve both business cost recovery and cash flow -- full federal conformity on this issue is an important policy initiative to pursue. One might also make an argument that macroeconomic evidence does not support these initiatives and all the implications of federal non-conformity are worth it. But probably the weakest policy position is the one we embrace now: partial conformity based not on economic evidence and merit but on budgetary convenience. ■

MCFE News and Notes

New and Improved "How Does Minnesota Compare" (now with more illuminating power…)

As we foreshadowed a couple months ago, we have overhauled our venerable *How Does Minnesota Compare* report, which uses Census Bureau data to compare state and local government revenues and spending from state to state. We're pleased to announce that this product is now available on our website at http://www.fiscalexcellence.org/our-studies/how-does-mn-compare.html.

On the revenue side, the major change is that we now normalize revenues using "cash income" instead of population or personal income. We have designed "cash income" to more accurately measure the amount of money people have with which to pay taxes. We believe this creates a better indicator of governments' claims on society's ability to finance its operations. To calculate "cash income", we subtract several items out of personal income that can't be directly used to pay taxes (such as the cash value of government medical benefits) and add retirement- and capital gains-related income into the mix.

On the spending side, we improve cost and efficiency comparisons by 1) aligning spending areas with their target populations where possible; and 2) recognizing that different states have different costs for providing the same service. To adjust for price differences, we use the Regional Price Parity index created by the federal Bureau of Economic Analysis. For example, in K-12 spending, these changes mean that instead of simply comparing nominal dollars to total population or income, we instead adjust the spending totals to normalize for price differences and then make comparisons on a per-pupil basis. The result controls both for differences in the costs schools have in providing services but also in the different proportions of school-age children each state has.

Does this change Minnesota's rankings a lot? The answer is generally "no" – the big shifts tend to occur among both high and low outlier states with respect to regional price differentials and we're a fairly average state in that regard. The biggest difference is in highway spending, where our traditionally high spending has been the result of a highly developed highway system.

In Memoriam: Dick Brust

The MCFE board of directors and staff join in expressing our heartfelt sympathy to the family of Dick Brust, who passed away Sunday, January 3rd. Dick was a 40-year 3M employee who served as Corporate Vice President of the company's Tax Division. An icon of the Minnesota tax community, he maintained a keen interest in tax policy and research over the years, as evidenced by his long service and dedication to this organization as both an officer and board member as well as serving as president of the National Tax Association from 1986-87. We will miss him greatly.