To Subsidize or Not to Subsidize — Highlights from the MCFE Annual Meeting

Over 120 members and distinguished guests attended our 87th Annual Meeting of Members at the St. Paul River Centre on October 2 – but the first such meeting as the Minnesota Center for Fiscal Excellence. Our policy session this year focused on the complicated intersection of good tax policy, tax incentives, and economic development; a topic in the news and one likely to be a mainstay of legislative debate for years to come.

Commissioner’s Update

Perhaps in recognition that this year’s legislative session may have left a bitter aftertaste in the mouths of some MCFE members, Commissioner Myron Frans led off the policy session with a presentation designed for persuasion – heavily focused on discussing the rationale and justification behind the controversial tax and fiscal policies enacted this year. He reiterated the two themes driving this policy agenda – a “gim-mick free” structurally balanced budget and investment in public goods that Governor Dayton believes have needed attention and are critical to long term economic growth.

Commissioner Frans provided an overview of the chronic budget challenges the state has faced over the past decade and discussed the policy concerns prompting the spending increases in E-12 education, higher education, and economic development. With respect to the Revenue Department itself, the Commissioner highlighted the new upgraded web presence and discussed ongoing efforts to improve agency responsiveness and information dissemination. Business e-filing, education and outreach to newly formed businesses, and stakeholder conference calls to discuss and clarify tax law changes have been three priorities.

He concluded his presentation with a synopsis of the tax changes enacted this year placing, not surprisingly, a strong emphasis on the resulting tax fairness and progressivity improvements. Although, he noted, Minnesota’s recent economic performance relative to the rest of the nation has been quite stellar, the focus on economic development must continue and job creation remains the number one priority of the administration.

The challenge of meeting those jobs expectations provided a good segue into the featured panel on business incentives, tax policy, and economic development realities. A distinguished group of government and business leaders moderated by MPR’s economic correspondent Chris Farrell engaged in a wide-ranging discussion of the practice, politics, and policy issues surrounding the use of tax and other forms of business incentives. Panel participants were Representative Ann Lenczewski, DEED Commissioner Katie Clark Sieben, Greater MSP executive David Griggs, Minnesota Chamber of Commerce senior vice president Bill Blazar, and former state economist Tom Stinson.

The Proponents

Two panelists argued strongly that, like it or not, subsidies and targeted tax incentives are a necessity of today’s economic development realities. Commissioner Sieben and David Griggs both noted that good economic fundamentals – workforce quality, public infrastructure, etc. – remain as necessary as ever but are often insufficient in today’s intensely competitive economic development environment.

Mr. Griggs emphasized the idea that site selection is a process of exclusion. Great fundamentals are, without question, necessary to keep you in play – a quality workforce, good transportation systems, and all the other basics are a requirement. But the process of actually “winning” new companies increasingly requires at least some type of financial incentive and having these available is “needed and necessary to compete.”

Both argued that Minnesota’s high quality fundamentals help reduce the need for and reliance on incentives. Both cited examples where Minnesota was chosen over another state offering incentive packages many times larger because of the advantage Minnesota offered with respect to workforce and related issues. And both asserted that Minnesota has embarked both modestly and pragmatically into these waters with respect to the size of the incentives offered, and how they are used. Commissioner Sieben noted Min...
nnesota's programs are a very small fraction of the scale and cost of programs found in many other states. Mr. Griggs emphasized the strategic nature Minnesota uses when employing these programs. Unlike other states, he argued, “we don’t play the zero sum game, we are smarter than that.” Minnesota focuses its incentive spending on foreign direct investment, new companies, expanding companies, and firms with skills complementary to Minnesota’s economic base. Other states, he said, use their financial incentives to chase anything that may move.

With respect to accountability issues, both noted that their respective organizations emphasize performance measures and tracking returns on investment. According to Commissioner Sieben, each dollar invested through Minnesota Investment Fund leverages $33 in private investment. Similarly, Greater MSP’s board has established a minimum 10:1 return on dollars invested and according to Mr. Griggs current performance is tracking more like 40:1. Commissioner Sieben also noted many of the DEED incentive programs are designed to include both clawback and pay for performance provisions.

Some critics of business incentives and subsidies have argued they should only be offered if various social and equity outcomes are an additional condition of their provision – such as living wage requirements, physical sitting in economically depressed areas, or minority hiring provisions. Mr. Griggs adamantly dismissed such policy ideas noting he has never dealt with a business seeking more regulations on how to access money.

The Skeptics

In contrast, Representative Lenczewski, Bill Blazar, and Dr. Tom Stinson expressed considerably greater reservations and concerns regarding the use of tax incentives and targeted subsidies. Their objections arose out of both principle and practice.

Commenting that such policies may be good politics but poor policy and economics, Representative Lenczewski criticized both the distortion of markets and the major political problems of expectation and dependency these policies create over time. Both Representative Lenczewski and Blazar spoke to the implicit fairness problems such policies embody, noting that while the vast majority of Minnesota’s businesses do not benefit from these policies, they still bear much of the price tag associated with them. Mr. Blazar extended his critique to include the business taxation which made up a significant share of the $2.3 billion raised last session, commenting that “98% feel all the pain but get nothing from the benefit.”

Dr. Stinson commented on the timeless nature of this debate and provided an historical perspective, noting that in colonial days Alexander Hamilton's business was wooed to New Jersey by such incentives. He reiterated the concerns of principle expressed by other panelists, but said absent federal intervention to rein in the use of incentives – an approach advocated by most economists – they will continue to be used. As a result he offered a seven-point plan to keep their proliferation under some semblance of control:

- Make sure benefits exceed costs
- Apply a “but for” test to all proposals
- Indentify the market failure the incentive/subsidy is intended to address
- Put a sunset provision on all programs
- Provide for full public disclosure of subsidies and impacts
- Create legally binding contracts with clawback provisions based on performance
- Only award incentives if other firms are not put at a disadvantage

The panelists also expressed concerns over design issues. Representative Lenczewski emphasized legislators are simply not equipped to make these deals or be in a position to provide the best protection for taxpayer interests. Noting how easy it is for legislators “to get rolled,” Representative Lenczewski cited the Mayo Destination Medical Center project as one example of the very lengthy process of proposal and counterproposal that was needed to arrive at a truly acceptable result. There are also intangible costs. Arriving at an acceptable final agreement requires extraordinary amounts of legislative staff time and effort (who, according to the House Tax chair, are the unsung heroes of these things) which creates a major opportunity cost for the legislative process and other important matters on policymakers’ agenda.

What should be the focus of our economic development efforts? All three skeptics expressed concern about the ability of tax and incentive programs to distract us from the things that really matter – the foundational strengths of Minnesota’s economy, such as a highly skilled and educated workforce. Dr. Stinson emphasized that demographic challenges are creating the need for world class adult education. Rep. Lenczewski highlighted the Governor’s significant investments in E-12 and higher education. Mr. Blazar concurred with the need to focus on matters of true long-term strategic interest, but also expressed deep concerns about the increasing false equivalency of government spending and results. For example, at the same time more money was pumped into the E-12 education system, education standards required for graduation were repealed. Mr. Blazar argued that investments in ways to get better results and more for the money is just as important, if not more so, than the spending itself.

The Agnostic

In his luncheon address former National Tax Association and Federation of Tax Administrators president Billy Hamilton claimed agnosticism on this issue, joking that he has had to alter his perspective on this topic many times through the course of his long career in public finance depending on the organizational hat he was wearing. But his agnosticism is really rooted in a sense of political pragmatism.

He asserted that there are two fundamental truths regarding targeted subsidies and business tax incentives. The first is that over fifty years of study, no one has proved any lasting economic benefit from their use. Small project successes may be realized but often at considerable expense to state coffers. More importantly, their economic consequence means absolutely nothing relative to the scale of state economies. Meanwhile, attracting footloose firms means higher tax spending itself.

The second fundamental truth is that the above point simply doesn’t matter and never will. He said “angels could descend from on high” proclaiming them wasteful, shortsighted and mistaken policy and it wouldn’t matter – elected officials will continue to pursue them. Visible, high profile, and tangible results are absolutely irresistible to elected officials. Plus, “it makes them feel good.”

Complimenting the state based on the content of the panel discussion, Hamilton reflected that said Minnesota probably does a good a job as any state in achieving a balance.
He argued it would likely "shock Minnesotans to the core" to witness the practices occurring in other states. He affirmed both Dr. Stinson's policy recommendations and the need to focus on public spending critical to long-term economic growth. He noted that while the economic success and performance of his home state of Texas has received considerable attention, health, transportation, education, and water issues are presenting long term risks to his state's economy.

So are business incentives and sound tax policy friends, enemies, or a difficult marriage? The answer appears to be all three. At their very best, carefully designed programs adhering to the principles espoused in the panel can complement economic development efforts while keeping distortions and cost to a minimum. At their very worst, they can be expensive, transitory, wasteful giveaways yielding nothing with respect to lasting economic gain. In reality and practice, they will have elements of the best and the worst, creating underlying tension and remaining a difficult political marriage for many years to come.

Business Session

At the morning MCFE business session, the following individuals were elected to serve on the MCFE Board of Directors. Our membership thanks you for your service to the organization.

Mike Engelmeier - Moneygram
Malcolm McDonald - Individual
Ken Levinson - Faegre Baker Daniels
Tom Gottwalt - TCF
Jerry Morris - General Mills
Dan Peterson - CliftonLarsonAllen
Justin McGough - 3M
Sandy Navin - Individual
Kevin Lewis - Minneapolis BOMA
Brett Boutwell - Pentair
Brian Pietsch - Ameriprise
Andrew Bosl - Ecolab

A copy of the Executive Directors Report (slide presentation) highlighting the organization efforts and accomplishments over the past year is available on the annual meeting page of our website.

Members also formally voted to change the name of our supporting research and education arm from the Center for Public Finance Research, to the Minnesota Foundation for Fiscal Excellence. The Foundation supports the broader public education and fiscal policy research studies of the organization. Members elected Susan Haffield as President of the Foundation.

At the meeting we were also extremely pleased to announce a generous new challenge grant made possible by one of our long term supporters. Any individual charitable contribution made to the Foundation will be matched dollar for dollar up to $25,000 through 2014. We are extremely grateful to this benefactor for his generosity, and we cannot emphasize enough how critically important Foundation support is to this organization. Your support provides the resources and the flexibility needed to undertake our important and timely investigations on state spending and related fiscal policy issues.

As the year end approaches and United Way campaigns are in full swing, we would again remind all members to consider making the Foundation the benefactor of your campaign donations.

MCFE Accountability Index 2013

Slaying the evil property tax dragon prompted policymakers to spend hundreds of millions of dollars last session to provide property tax relief. With this metaphor in mind, we present the MCFE 2013 Accountability Index – our annual journey into the fantasyland known as the uniform market value-based property tax system.

A quick reminder about how the Accountability Index works. It compares each property class's share of total tax burden to its share of total market value. For instance, they fail to capture the very different and distinctive patterns of property tax subsidization that are actually occurring around Minnesota. After all, local governments create and distribute these property tax burdens. Looking at Accountability Index data on a county-by-county basis illustrates these regional trends.

However, aggregate statewide totals only tell you so much, and can often be misleading – for instance, they fail to capture the very different and distinctive patterns of property tax subsidization that are actually occurring around Minnesota. After all, local governments create and distribute these property tax burdens. Looking at Accountability Index data on a county-by-county basis illustrates these regional trends.

For 25 counties, including the state's largest metro areas plus counties with significant seasonal and resort properties, the Accountability Index findings mirror the conventional wisdom associated with Minnesota’s property tax classification system. For a sense of perspective, this group of counties contains 75% of the state’s residents, 78% of the local property tax base, and 66% of total statewide property value. For this majority of Minnesotans, the classification system...
largely functions as it always has: homeowners remain a preferred class subsidized by the business community (commercial/industrial, utilities, railroads) and apartment owners. (See Table 2)

Table 2: Payable 2013 Accountability Index Values, Aggregate by Property Type for 25 Counties Where Residential Accountability Index Value is < 1.00

<table>
<thead>
<tr>
<th>Accountability Index Value</th>
<th>Residential</th>
<th>Apartment</th>
<th>Commercial/Industrial</th>
<th>Farm</th>
<th>Cabin</th>
<th>Utility</th>
<th>Railroad</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable 2013</td>
<td>0.86</td>
<td>1.15</td>
<td>1.81</td>
<td>0.43</td>
<td>0.55</td>
<td>1.36</td>
<td>1.70</td>
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</table>

But for the remaining 62 counties, largely rural or associated with smaller regional centers, the story is very different. For a start, the Accountability Index scores for each type of property are higher than in the first group of counties. As Table 3 indicates, residential properties here are substantially non-preferred, paying 41% more in property taxes than their relative share of total market value. Moreover, the spread between the lowest and highest index scores is much greater, meaning higher levels of subsidization are taking place between the different property types. Mainly, an exceptionally potent combination of very high values and very low classification ratios for farmland is driving this pattern.

Table 3: Payable 2013 Accountability Index Values, Aggregate by Property Type for 62 Counties Where Residential Accountability Index Value is < 1.00

<table>
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<th>Accountability Index Value</th>
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<th>Cabin</th>
<th>Utility</th>
<th>Railroad</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable 2013</td>
<td>1.41</td>
<td>2.00</td>
<td>2.72</td>
<td>0.58</td>
<td>0.93</td>
<td>2.31</td>
<td>2.77</td>
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At the extreme, the magnitude of subsidization approaches the pre-Big Plan reform days. In 19 of these 62 counties where residential property is non-preferred, farmland accounts for at least 80% of the total countywide property value. (Overall, Traverse County has the highest proportion of countywide value – 91.9% – in farmland). Table 4 shows the aggregate Accountability Index results for this group of counties. Notably, now even cabins are non-preferred properties. Homeowners in the aggregate pay over two times their “fair share” in taxes as determined by assessed values while commercial-industrial properties in the aggregate pay over 4.5 times their share of market value in taxes.

Table 4: Payable 2013 Accountability Index Values, Aggregate by Property Type for 19 Counties Where Farmland Accounts for 80% or More of Total Market Value

<table>
<thead>
<tr>
<th>Accountability Index Value</th>
<th>Residential</th>
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<th>Cabin</th>
<th>Utility</th>
<th>Railroad</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable 2013</td>
<td>2.27</td>
<td>3.59</td>
<td>4.62</td>
<td>0.74</td>
<td>1.07</td>
<td>3.16</td>
<td>3.95</td>
</tr>
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</table>

We see a few takeaways from these findings. First, for all the fuss over aid cuts and redistributive impacts of the legislative actions like the conversion of the market value credit for homesteads to a value exclusion, it is important that citizens and their elected officials recognize the potentially potent effects Minnesota’s class rate system continues to have on local property tax burdens and local tax fairness. Preferential computation from property tax classification is also a tax expenditure as duly noted in the Department of Revenue’s biennial Tax Expenditure Report. (Although as Colonel Nathan Jessup might say, “it’s a tax expenditure you don’t talk about at parties.”)

Second, is there an untold and unappreciated “favoring big business over the little guys” story in Greater Minnesota? The rapid increase in farmland value relative to other properties has certainly resulted in much higher property taxes for farmers. However, as our analysis shows, favorable classification still provides extraordinary benefits compared to property tax distribution under a uniform system of property assessment. Modern farming is a highly sophisticated business enterprise far from any “Little House on the Prairie”-inspired imagery. Moreover, as we discussed last year (“Accountability Index is Down on the Farm” Fiscal Focus July/August 2012), the magnitude of favorable property tax treatment farmland receives must also be called into question in light of the more diffuse, collective benefit, less parcel-specific services supported by county and school property taxes. It’s difficult to derive an economic justification for requiring a small retailer or manufacturing shop in Greater Minnesota to pay 4+ times the property taxes on equivalent dollars of market value than farms do to finance various health, human service, and income support programs, among others. It’s also worth noting the capitalization of property taxes into farmland values may have a helpful dampening effect on any speculative bubbles that might be occurring in the state.

Finally, we again highlight one of our favorite and important findings from our 50 State Property Tax Comparison Study— the link between low levels of homeowner subsidies and lower growth in property taxes. In the 10 states which dare to exist in the political fantasyland where no assessment limitation provisions and little/no favorable homeowner treatment in the property tax system exists, property taxes grew 11% slower on a per capita basis over the last decade and 48% slower when measured against personal income than property taxes in the remaining states.

Accurate tax pricing is an asset, not a liability, with respect to promoting efficient, accountable government. The sooner Minnesota appreciates this, the better off we will all be.

Economists Weigh In — Do High Quality Teachers Make A Difference?

No two words are guaranteed to trigger a more passionate debate in education policy circles faster than “teacher quality.” Debates about teacher quality have taken on new life with the advent of large scale standardized testing, which offers researchers entirely new data sets to investigate and interpret. Recently, teacher quality debates in Minnesota again have arisen with the Minneapolis and St. Paul school districts pondering participation in the state’s Q-Comp plan designed to incentivize higher teacher quality.

Two new National Bureau of Economic Research working papers report the results of one of the most ambitious efforts yet to evaluate the effectiveness of teacher value-added ratings and impacts of high value-added teachers on student outcomes in adulthood. The study covers nearly two decades and

2 Chetty, Friedman, Rockoff “Measuring the Impacts of Teachers I: Evaluating Bias in Teacher Value-Added Estimates” and “Measuring the Impacts of Teachers II:
tracked over one million students in grades 3-8 from a large urban school district.

The Harvard and Columbia University economists concluded that existing achievement gaps are largely driven by factors other than teacher quality. Nevertheless, a sequence of good teachers can significantly raise test scores, and thus primary school is not too late to close achievement gaps. In addition:

- When controlling for several factors including a student’s prior year test scores, higher teacher value-added scores were associated to some extent with higher normalized test scores
- Students assigned to high-value added teachers in these grades have somewhat better outcomes in adulthood – they are more likely to attend college, earn higher salaries, live in neighborhoods with higher socioeconomic status scores, have higher savings rates, and are less likely have children as teenagers.
- On average, improving teacher value-added scores in a single grade by one standard deviation raises earnings by 1.3% at age 28.
- Replacing a teacher whose value added is in the bottom 5% with an average teacher would increase the present value of students’ lifetime income by around $250,000 per classroom.
- More than 85% of the variation in teacher value-added scores are within schools; only 15% of the variation is between schools

Unsurprisingly, this work has generated considerable debate in the blogosphere and elsewhere. As some critics have pointed out, the “$250,000 per classroom” perspective changes when you consider that the numbers are 1) for an entire classroom and 2) for each of those student’s entire careers. That math works out to about $5 per week per student. Others note that replacing lower value added teachers with higher value added teachers works only if there’s a supply of higher value-added teachers that are available and willing to take the job highlighting the crucial need for professional development.

Perhaps the most intriguing finding concerns the distribution of high value added teachers. Attracting great teaching talent to the places and circumstances needing that talent is considered essential to improvements in closing the achievement gap. But the finding that 85% of the variation of teacher quality is within schools and only 15% is between schools does not convey a major problem of high value added teachers gravitating toward more favorable teaching environments. Instead, most schools simply have pools of more and less effective teachers. Recognizing this basic truism and having the ability to respond accordingly would seem to be an essential part of any effort to improve educational outcomes and closing achievement gaps.

From The Director: Our Non-Identical Twin

A few weeks ago, Forbes magazine released their annual “Best States for Business” scorecard. Minnesota jumped up a rather remarkable 12 spots to 8th best in the nation prompting victory laps across the political spectrum. Whether this is a validation of the policies of the last few years or a vindication of the fiscal restraint prior to that will be debated for some time to come.

What was most interesting to us wasn’t our shiny top ten ranking, but the state ranked one spot above us at 7th – Texas. It was interesting to us not because Texas “beat” us out, but because of the supremely odd juxtaposition. It is difficult to imagine any state being more of a polar opposite to Minnesota than Texas. Not only are our tax and fiscal policy structures extremely different, but the underlying political cultures and general attitudes toward government suggest these states might exist on different planets. Yet there they are, side by side, both excelling in their own way in providing a very positive climate for business according to an esteemed publication that should know a few things about the topic.

This suggests there are different paths to economic success. Texas places a very strong premium on economic freedom, with minimal government intrusion into the economy. Minnesota places a premium on strong public goods and quality of life considerations featuring a strong government role and presence. Different industries – and different companies within industries – will always emphasize various competitive issues and factors in different ways. Each strategy can be (and is) successful in its own way.

But each of these strategies has a vulnerability that threatens its success. Our annual meeting luncheon speaker and Texas native, Billy Hamilton, spoke of Texas’ vulnerability in the context of complimenting Minnesota’s commitment to its public goods. In his opinion, overlooked in all the bouquets currently being tossed at Texas for its economic successes, are the state’s major challenges with respect to health, transportation, education, and water infrastructure needs which he sees as a threat to their long term economic performance.

So what is our vulnerability? Getting caught up in debates about the adequacy of spending increases while paying insufficient attention to how productive that spending is and whether it produces the desired results. This last legislative session demonstrated how easy it is to focus on how much we tax and spend while essentially ignoring the far more important and influential issue of how we tax and spend.

Minnesota’s competitiveness strategy – emphasizing high quality public services in significant quantity – has clearly served us well, and can continue to do so. But sustaining this strategy requires government systems and a political culture that encourages, supports, and rewards public sector innovation combined with an aggressive and relentless pursuit of efficiency and productivity improvements. Otherwise, as sure as the aquifers of Texas deplete, the costs of these public services will explode, taxes will increase, and our state business climate will deteriorate.

— M. H.