FISCAL FOCUS

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In This Issue:

The Tax Lessons in the 2013 Tax Bill

Legislators might have wrapped up their annual session back in May, but their actions continue to reverberate in the political echo chamber. In late June, the Department of Revenue released a white paper prepared by the Research division that projects the impact the omnibus bill will have on the incidence of state and local taxes in 2015. The results provided talking point fodder across the political spectrum. DFLers were quick to herald the additional progressivity introduced into Minnesota's tax system; while Republicans were quick to note no one escaped the economic impact of the majority's tax policies.

But beyond feeding the political spin cycle, the Revenue white paper provides some instructive and important lessons on what state tax policy is simply unable to do well. Recognizing and appreciating these limitations offers the prospects of better tax and fiscal policy going forward.

Lesson 1: Exporting state tax burdens is difficult to do

In the spirit of "don't tax you, don't tax me, tax that fellow behind the tree" it's enticing to try to figure out a way make nonresidents help pay for Minnesota's public services. The increase in the tax on car rentals to 9.2% (from 6.2%) may represent such thinking. But as the incidence analysis of the tax bill points out, most of the omnibus bill's new taxes land on Minnesotans and attempts to use business taxation to export burdens are not particularly successful.

As **Table 1** highlights, of the $923 million in additional state and local tax collections forecast for calendar year 2015, almost $800 million (roughly 85%) will come from the pockets of Minnesota residents – either through direct payments to government or indirectly as business taxes result in lower wages, reduced return to capital, or higher prices. Business taxes generally, and the corporate income tax specifically, are often marketed as a way to export more tax liability. But according to the incidence analysis, 90% of the new sales taxes on business purchases and nearly 2/3rds of the expected increase in corporate income tax collections will ultimately be paid by Minnesotans.

Tax scholars argue the economic rationale for tax exporting is to pay for the benefits nonresidents receive and the costs nonresidents impose, not political expediency or subsidizing services. But regardless of whether attempts are driven by good policy or instead by opportunism and political gain, the incidence analysis shows that exporting is a lot more difficult than most people believe.

Lesson 2: Improving tax fairness is tough to do – and even more difficult when you also want a lot more money

Making the tax system more progressive was the stated rationale for tax changes this session, and the incidence analysis certainly demonstrates the result. According to the Department, 76% of the additional $798 million in tax burden projected for 2015 will fall on the top 10% of earners – households with more than $146,400 of income. Even this somewhat understates the focus on wealthy taxpayers; $492 million –

Table 1: Impact of Law Changes of Minnesota State and Local Tax Burdens by Tax Type, CY 2015 as Enacted ($000)

Tax Type	Change in Collections ($ millions)	Amount Paid By Minnesotans
Income Tax – Rate Increase	$542	$492
Income Tax – Alternative Minimum Tax	$3	$3
Corporate Tax	$171	$107
State Sales Tax – Consumer Purchases	$18	$17
State Sales Tax – Business Purchases	$209	$188
Local Sales Taxes	$15	$13
Cigarette and Tobacco Taxes	$215	$203
Estate Tax	$55	$47
Property Taxes	($176)	($143)
Property Tax Refunds	($129)	($129)
Impact, All Taxes	**$923**	**$798**

Source: Minnesota Department of Revenue; tabulation by MCFE.

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nearly 62% of the additional burden – will come from the top 1% of earners. Progressivity elements of the omnibus bill include the second highest statutory rate in the nation at the $250,000 of taxable income threshold for joint filers, a new gift tax (which only one other state in the nation – Connecticut – has), and an increase in the alternative minimum tax. At the other end of the taxpayer continuum, lawmakers also enacted a significant expansion of the state's property tax refund program to further reduce the regressivity of homeowners' and renters' taxes.

With all this considerable "fairness ammunition" fired at Minnesota's tax system, it's striking how relatively little these changes have actually moved the progressivity needle. According to the Department, this year's omnibus bill moves the Suits Index (a measure of tax system progressivity) projected for 2015 from -0.049 to -0.033. That change is only 1/3rd of the way to a proportional tax system (a Suits Index of 0.0) in which everyone pays the same amount of their income in taxes.

Why? Part of the reason is due to a critical and under recognized point that the *Incidence Study* itself makes: changes in the economy that affect the distribution of income can have a much greater effect on changes in the overall level of progressivity or regressivity in the tax system than do tax law changes themselves:

> "Although the historical changes in the degree of regressivity are due partly to changes in tax laws, the role of the business cycle may be even more important. During the past two decades, income inequality has generally risen during times of rapid growth and fallen during economic contractions. This concentration of income by itself, with no change in tax law, will increase the measured regressivity of the tax system....
>
> Tax policy can certainly affect the degree of regressivity, but it is difficult to identify tax changes that are large enough to move the Suits index by as much as it has moved over the last 20 years. Trends in income inequality are certainly responsible for much of the pattern shown above." [1]

In other words, in the pursuit of greater progressivity, the state tax system is often swimming against larger and much more powerful economic forces and income trends. The changes enacted this year were destined to fail to make a bigger dent in the pursuit of a tax fairness ideal.

But another reason for the lack of progress on progressivity revolves around the incidence of the newly enacted increases in tobacco and business taxes to pay for additional desired spending. While the new income and estate taxes fall almost entirely on Minnesota's highest earners, the other tax increases – corporate, cigarette and tobacco, and business sales – land hard on lower income households. In fact, according to the incidence analysis, change in tax burden as a percent of income for households earning $35,000 or less are higher than any group except for the top 5% of earners – i.e. those making $200,000 or more. The impact on the second and third decile of earners is proportionately larger than any group except the top 1% – undoubtedly an awkward finding for many who supported the overall thrust of the bill. What taxes on the wealthy giveth in the pursuit of fairness, taxes on businesses and tobacco taketh away.

[1] 2013 Minnesota Tax Incidence Study, pp. 21-22.

Table 2: Projected Impact of Omnibus Tax Bill on Tax Burdens by Population Decile, CY 2015

2015 Population Decile	Income Range	Change in Tax Burden	
		($000)	As % of Income
1	$10,937 and under	$28,065	1.56%
2	$10,938 – $19,316	$28,545	0.70%
3	$19,317 – $26,397	$27,271	0.44%
4	$26,398 – $35,600	$23,581	0.27%
5	$35,601 – $46,507	$12,900	0.11%
6	$46,508 – $59,998	$7,385	0.05%
7	$59,999 – $77,704	$6,836	0.04%
8	$77,705 – $101,618	$13,420	0.05%
9	$101,617 – $146,600	$42,557	0.13%
Detail for 10th Decile			
(lower half of decile)	$146,101 – $202,407	$29,232	0.12%
Next 4%	$202,408 – $510,005	$85,929	0.27%
Top 1%	$510,006 and above	$492,128	1.41%
10 - Total	$146,601 and above	$607,290	0.67%
All Households' income	**Impact, All Taxes**	**$797,850**	**0.37%**

Source: Minnesota Department of Revenue

Lesson 3: State tax structures are a largely ineffective way to try to address income inequality concerns.

For many tax fairness proponents, "ability to pay" is not their only concern. Mitigating growing income inequality through the tax code and redistributing income is another key dimension of tax fairness. The ability of state and local taxes to actually accomplish this objective has been a topic of study, and controversy, for some time.

On the one hand, noted economist Martin Feldstein found that state and local governments cannot redistribute income because of migration effects combined with the finding that gross wages rapidly adjust to more progressive taxation.[2] "Attempts at using state taxes to redistribute income," he concluded, "are based on fiscal illusion." Such a finding also raises an interesting issue of cause and effect: to what extent do states adopt progressive income taxes to address significant wage inequality and to what extent do states exacerbate wage inequality with highly progressive income taxes?

On the other hand, other studies have concluded that state tax codes can and do mitigate income inequality by compressing before and after tax incomes – albeit far less than the federal tax code is able to do. A Federal Reserve Bank of Boston paper found by far the most income compression from taxation is derived from the federal system.[3] On average, income compression achieved

[2] Feldstein and Vaillant, "Can State Taxes Redistribute Income?" NBER Working paper No. 4785, June 1994

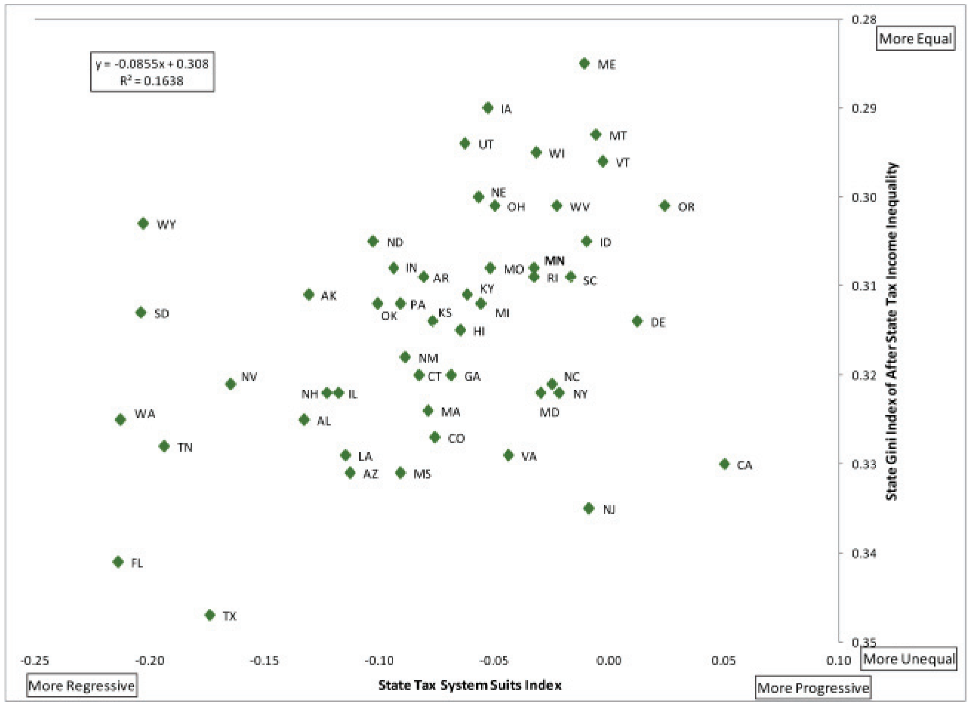
[3] Cooper, Lutz and Palumbo, "Quantifying the Role of Federal and State Taxes in Mitigating Income Equality" Public Policy Discussion Paper No. 11-7, Federal Reserve Bank of Boston, September 2011

by state taxes is equal to only around 12% of the compression achieved by the federal tax code. Any attempts by a state to match federal performance in this area would certainly result in massive tax outlier status. Hence, economists recognize redistributive goals are best left to the federal system.

Interestingly, this study also found Minnesota is first in the nation at reducing income inequality through the state tax code, achieving about 33.7% of the compression brought about by federal taxes – or nearly three times the national average. And this finding is based on the tax policies that existed prior to this legislative session which were resoundingly decried for their lack of fairness.

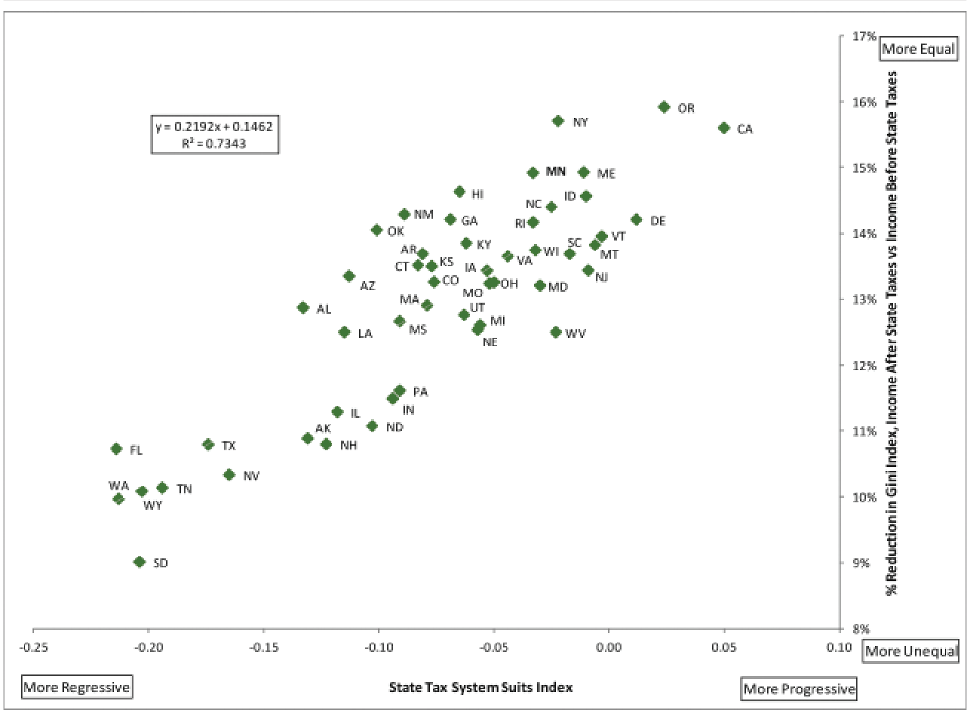
Do state taxes have an impact on income equality? The evidence suggests a resounding "sort of." **Figure 1** plots state tax system progressivity[4] against the percent change in state income equality specifically due to state taxes. The upward sloping line confirms the relationship between income equality gains and more progressive taxation. The "R squared" value communicates a quite strong correlation between the two measures.

Figure 2: …But Overall State Tax Systems Don't Make Much of a Dent



But as **Figure 2** shows, state tax system structure appears to be a marginal player in the grand scheme of things. The correlation between state system progressivity and state after tax income equality is much weaker (R squared of 17%). For example, California – featuring one of the indisputably most progressive tax structures in the nation – nevertheless remains a national leader in income inequality.

Figure 1: More Progressive Tax Systems are Correlated with Larger Proportional Reductions in After Tax Income Inequality…



It is true that incremental revenues from more progressive taxation could be used to support various transfer payment programs to further reduce income equality. But such spending must compete with a wide variety of other critical state supported services mitigating that potential. Moreover, evidence from around the world has shown "post transfer" income equality is actually strongest in places featuring much more regressive tax structures than in the United States. The much larger amounts of tax revenue collected through these more regressive tax structures – especially consumption taxes – combined with attention to the structural progressivity of spending systems that redistribute this revenue is the key to their income equality gains.

All of these lessons encourage a sense of humility regarding what subnational tax systems can actually accomplish with respect to fairness, progressivity, and income equality agendas. With Minnesota now clearly pushing the envelope with the progressivity of its tax system, and with little apparent public appetite for entertaining additional, albeit more regressive, forms of taxation like a broader array of consumption taxes to support more social spending, spending systems and their own progressivity will have to take center stage. ■

[4] Reported State suits indexes are calculated by Minnesota 2020 using data from the Institute on Taxation and Economic Policy. (http://www.revenue.state.mn.us/research_stats/research_reports/2013/2013_tax_incidence_study_links.pdf), page 64.

The Case of the Mysterious Municipal Downgrades

Occasionally we come across a news story that makes us scratch our heads and prompts us to do a little more investigating, but we wind up no less confused. Such is the case of recent reports of a spate of municipal credit downgrades by ratings agencies, most of which affect small cities around Minnesota. Examining the explanations for the downgrades and the evidence behind them leaves us with a lot more questions than answers.

The facts are fairly straightforward. According to a report in the *Mankato Free Press*, about 40 Minnesota cities have seen their credit ratings lowered in the past 18 months, almost all by Moody's. The timing itself is a bit surprising, not only because the worst of the Great Recession appears to be over but also because the grand total of Minnesota cities similarly downgraded during 2011 was one. Watchdog.org, an investigative news site, identified many of the cities and they vary in size and location – suburban and exurban locations like Wayzata, North St. Paul, and Monticello and smaller rural cities including Spring Valley (Fillmore County), Ada (Norman County), and Little Falls (Morrison County). On the face of it, the group seems have little in common.

The timing may be curious, but the rationale is even more befuddling. From news reports and editorials, a primary factor appears to be concern over the condition and trends of local property tax bases. Part of this is market driven, but according to press reports another consideration was the impact of the 2011 Legislature's action that transformed the homestead market value credit into a market value exclusion. One result of that change: the reduction of taxable value base across the state.

The problem is that the relationship between changes in the local property tax base and a local government's ability to repay debt is rather dubious. In places like Minnesota, where values only distribute the overall burden, relating credit ratings to changes in property value doesn't seem to make much sense. Lower values don't inhibit governments' ability to collect property taxes, they only redistribute property tax burden among parcels. This is true both when declines are market driven and when declines are driven by legislative changes like the homestead market value exclusion, which artificially changed the base.

Of course, it is possible that declining property values are capturing real local economic malaise or decline (and not just real estate trends ubiquitous to the entire country). But if problems with the local economy were the rationale for these downgrades we would expect to see this malaise reflected in local business property values.

To the contrary, a closer look at these numbers generates cause for even more confusion. We found taxable market value data for 28 of the cities on Watchdog.org's list through the University of Minnesota's *Minnesota Land Economics* website (*www.landeconomics.umn.edu*). Between payable 2007 and payable 2012 – a period when the United States faced some of the most challenging economic circumstances since the 1930s – taxable commercial-industrial market values grew in 23 of these 28 cities, declined in 4 cities, and were essentially unchanged in the other. In fact, the growth was nothing short of remarkable in some instances. In 19 of these communities – again, places where ratings agencies deemed the city to be a greater credit risk – commercial-industrial growth was at least 10% through the guts of the Great Recession. In 12 cities the growth was at least 20%, and in 2 cities (Cologne and Albany) taxable commercial-industrial market value grew by over 60%.

For all the hue and cry about the effects of tax base changes on city credit ratings, this valuation data makes it difficult to ascertain either the rhyme of why these particular cities were singled out or the reason for their

Table 3: Percent Changes in Taxable Market Value by Property Tax for Selected Cities, Payable 2007 to Payable 2012

	Homes	C-I	Apts	Other	Total
Cologne	-20.5%	69.5%	4.8%	26.4%	**-15.9%**
Albany	-8.7%	63.7%	19.3%	50.5%	**5.8%**
Avon	-6.3%	48.9%	17.8%	-38.8%	**3.6%**
Sleepy Eye	-18.4%	45.1%	0.0%	5.8%	**-13.9%**
Circle Pines	-30.4%	29.4%	3.4%	6.9%	**-27.9%**
Ada	-18.7%	28.2%	-7.5%	7.1%	**-13.1%**
Le Center	-25.3%	25.2%	10.8%	39.3%	**-16.3%**
Granite Falls	-13.5%	25.0%	22.1%	34.0%	**-0.1%**
Wadena	-23.6%	22.2%	-7.0%	53.4%	**-11.5%**
Le Sueur	-13.2%	21.7%	5.5%	41.0%	**-6.0%**
Hayfield	-26.5%	20.9%	-2.7%	36.7%	**-17.2%**
Monticello	-23.7%	20.2%	-33.2%	23.1%	**-5.2%**
North Branch	-32.8%	18.6%	31.8%	-11.0%	**-22.2%**
Byron	7.5%	15.3%	8.9%	24.9%	**8.7%**
Delano	-3.9%	13.6%	1.8%	-21.0%	**-1.1%**
Dayton	-11.6%	13.4%	-96.5%	34.7%	**-5.6%**
Gaylord	-38.4%	13.3%	130.3%	18.2%	**-23.6%**
Madelia	-27.8%	11.3%	17.3%	44.6%	**-19.9%**
Virginia	-8.1%	10.3%	13.4%	95.8%	**0.7%**
Watertown	-21.6%	6.2%	-20.6%	2.7%	**-19.4%**
Spring Valley	-23.6%	5.9%	-12.3%	-30.8%	**-17.5%**
Vadnais Heights	-22.5%	1.5%	-3.2%	-2.1%	**-16.5%**
Rollingstone	-7.5%	1.0%	16.7%	-12.0%	**-6.6%**
Little Falls	-30.4%	0.0%	33.8%	38.1%	**-18.7%**
Buffalo	-24.3%	-1.6%	-24.1%	20.1%	**-20.1%**
Pine City	-25.0%	-2.6%	-14.7%	53.4%	**-15.6%**
North Saint Paul	-30.4%	-6.3%	-12.1%	64.1%	**-26.2%**
Wayzata	9.7%	-14.3%	-7.4%	17.6%	**3.5%**

Source: Minnesota Land Economics, calculations by MCFE.

downgrade, absent questionable financial decisions on the part of the city (like the expensive sports arena albatross hanging around the neck of Vadnais Heights prompting a default on their revenue bond payment). Instead of finding answers, we're left with several new questions:

- *Do rating agencies really understand how the local property tax works?* It may seem ridiculous to even suggest this (at least it does to us) but the property tax-related explanations hint at a fundamental misunderstanding about Minnesota's levy-driven property tax system. In states with rate-driven property tax systems – in which property values DO partly determine total tax collections instead of just distributing the burden – such downgrades would make a lot more sense. But Minnesota is not one of those states and it seems odd rating agencies wouldn't recognize this. (Then again, the phrase "triple A ratings on subprime mortgages" leaps to mind.)

- *Are new legacy cost analyses beginning to work their way into the ratings?* As we noted in our recent blog post ("Sifting Through Pension Rhetoric in Search of Pension Truth"), Moody's is changing the way it assesses pension liabilities and other legacy costs in its credit ratings. It's understandable that the new methodology would result in downgrades of local government credit ratings, but it's unclear what legacy cost sins this handful of cities might have committed that would single them out for this kind of treatment.

- *Are downgrades really capturing political will (or lack thereof)?* Occam's razor states the simplest explanation is usually the correct one. Overlooked in all the tax capacity hullabaloo regarding these downgrades is the statement from Moody's that "political unwillingness to increase levies in some cases has led to fiscal pressure," and further noting that some cities have not raised property taxes to increase revenue despite "having the ability to do so." If the fundamental reason is "cities can levy without creating undue burden but don't because it's unpopular," we seem to have even more evidence that our longstanding concern about fanning flames of resentment toward property taxation and conditioning taxpayers to expect local services at a discount is justified. Only now the concern is financial, not just a matter of principle.

This we can conclude: although this wave of credit downgrades is disturbing, the ratings agencies are still doing Minnesotans a favor if they prompt a serious discussion about the state of our property tax system. ■

MCFE Annual Meeting to Examine Business Tax Incentives

Plane trips shrouded in mystery to secret destinations. Whisperings of "Project Fern." Hundreds of millions of dollars at stake. You could be excused for confusing recent state economic development happenings with a Tom Clancy novel.

Mark Haveman

It's clear that competition between states for jobs and economic growth has intensified, especially coming out of the Great Recession. Willingly or begrudgingly, policy makers this session invested heavily in the incentive-based model of economic development authorizing $850 million in various subsidies in 2013, according to a recent article in *Politics in Minnesota*.

All this raises important questions going forward about the intersection of good tax policy; the popularity of conditional tax breaks based on private sector behaviors, promises, and outcomes; and today's economic development realities. Is the policy ideal of a highly competitive, level playing field for state and local business taxation an anachronism in today's economic development environment? Can tax incentives be complementary with good tax policy? Or are they fundamentally irreconcilable ideas that have to somehow get along for the sake of the children (the "kids" being Minnesota's economy)? And if so, what does that kind of "marriage" look like?

Our 87th Annual Meeting of Members, to be held Wednesday, October 2 at the St. Paul River Centre, will take a closer look these issues. A panel of distinguished government and business representatives will take on this topic in a discussion moderated by award winning journalist, popular radio host, and American Public Media's Senior Economics Contributor Chris Farrell. To provide a national perspective on this important topic, our luncheon speaker is Billy Hamilton, former president of the both the National Tax Association and the Federation of Tax Administrators, and author of the entertaining and informative feature State Tax Merry Go Round in *State Tax Notes*. We also will get an update on Department of Revenue developments and initiatives from Commissioner Myron Frans.

As always, individuals who are not members of the MCFE are more than welcome to join us and register for the policy portion of the conference. So bring a friend or colleague and introduce them to the MCFE. A complete agenda for the day and additional information can be found on our website, *www.fiscalexcellence.org*. To reserve your place simply call Linda Edstrom at 651-224 7477 x 101 (or e-mail her at *ledstrom@fiscalexcellence.org*)

I look forward to seeing you there.

— M. H.

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