FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

2016 Session: "Everything Just Got a Little Harder"

A shrinking surplus, tax and transportation gridlock, and a new – if slightly disingenuous – reason for increasing public pension contributions provides some of the context for the highly-compressed 2016 legislative session.

Like a television drama returning from a summer hiatus, Minnesota lawmakers will begin the 2016 legislative session with budgetary and political plot lines intact. Last session, with the tax bill and transportation finance tied up in knots, $865 million was left on the bottom line after accounting for reserves. By the November forecast, that projected surplus had swelled to just $1.2 billion (not counting an approximately $600 million increase in the budget reserve). But the recently-released February economic forecast downgraded economic growth projections and the resulting surplus now sits at $900 million – almost identical to where we were as this biennium began.

Similarly, legislative leaders are sticking to their scripts. DFLers are emphasizing interest in various spending initiatives like an expanded Working Family Credit, LGA enhancement, and rural broadband; Republicans are emphasizing tax relief for businesses and individuals; and everyone is seeking a transportation funding solution. Yet the revised forecast and downgraded economic growth projections throw a little cold water on everyone's agendas. Or in the words of Senate Majority Leader Tom Bakk, "Everything just got a little harder."

Forecast Summary

The accompanying table (page 2) presents how the perspective on this biennium has changed since the legislature adjourned last year. The resources carried forward from the prior biennium grew by nearly $700 million, largely because revenues during FY 2015 came in higher than expected. However, projected tax revenues for FY 2016-17 are now down $363 million from the July 2015 estimates. Reductions in individual income tax and general sales tax projections (down $205 million and $220 million respectively) are partially offset by $62 million of projected increases in all other tax revenues. This decline in projected taxes is largely mitigated by a $310 million decline in projected expenditures and transfers. Health and human service spending is the big driver in this change – with a projected half-billion-dollar plus decline more than offsetting anticipated spending increases in most other areas of state government.

The ratcheting back of expectations of economic growth over the last three months similarly impacts the FY 2018-19 out-biennium. The planning estimate for those years now shows a structural balance (forecast biennial revenues minus projected biennial spending) of $1.18 billion, down $861 million from the November forecast. That estimate does not include the effects of inflation on state spending, which is either foolish, responsible, or something in between depending on who is offering the commentary.[1] The (very) unofficial MMB estimate of $1.7 billion for inflation during FY 18-19 is derived simply by applying projected changes in the Consumer Price Index onto to the entire general fund, something all legislative leaders seem to agree significantly overstates inflationary impacts. Nevertheless, potential impact of inflation is another factor to weigh – especially for any proposals that would impact the FY 18-19 budget.

Taxes

The good news: all the raw material for the "conference committee bill that wasn't" remains on the table ready for action. The conference committee has been reconstituted (with Rep. Gene Pelowski replacing the now-departed Rep. Lenczewski) and the discussion will start from there. The bad news: legislative rules restrict the discussions to items that went through the process in either the House or Senate in 2015. New provisions from 2016 will be considered only if there is nexus with something already in either the House or Senate's 2015 omnibus bill. And with such differences in the House and Senate omnibus bills it's difficult to see how the process benefits at all from starting at the beginning of session rather than near the end of it.

As is always the case, whatever each side deems essential cargo will determine the fate of the conference committee's final product. News reports have suggested optimism about progress on state property tax relief, a prominent feature of the House's tax bill, but the new forecast presents cloudier skies. That same overcast also hovers over other tax-related priorities – notably the Senate's

[1] See our extensive examination of this topic, "The Debate Over Acknowledging Reality," in the November/December 2014 issue of Fiscal Focus.

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FY 2016-17 General Fund Forecast and Comparison to End of 2015 Legislative Session Projections

Item	July 2015 End of Session	February 2016 Forecast	$ Change	% Change
Balance Forward	1,421,221	2,103,017	681,796	48.0%
Tax Revenues	40,802,662	40,439,203	(363,459)	(0.9%)
Non Tax Revenues	1,425,825	1,461,669	35,844	2.5%
Dedicated Revenue	1,000	1,000	–	–
Transfers from Other Funds	329,338	316,942	(12,396)	(3.8%)
Prior Year Adjustments	70,000	70,053	53	0.1%
Total Resources Available	**44,050,046**	**44,391,884**	**341,838**	**0.8%**
K-12 Education	17,236,186	17,320,117	83,931	0.5%
Higher Education	3,066,924	3,066,924	–	–
Property Tax Aids and Credits	3,352,501	3,351,415	(1,086)	(<0.1%)
Health and Human Services	12,480,644	11,933,778	(546,866)	(4.4%)
Public Safety & Judiciary	2,121,924	2,145,944	24,020	1.1%
Transportation	275,139	277,639	2,500	0.9%
Environment & Agriculture	376,570	460,701	84,131	22.3%
Jobs, Economic Development, Housing & Commerce	402,079	439,491	37,412	9.3%
State Government & Veterans	987,073	1,023,683	36,610	3.7%
Debt Service	1,267,459	1,239,580	(27,879)	(2.2%)
Capital Projects	287,232	284,643	(2,589)	(0.9%)
Cancellation Adjustment	(20,000)	(20,000)	–	–
Total Expenditures & Transfers	**41,833,731**	**41,523,914**	**(309,817)**	**(0.7%)**
Balance Before Reserves	2,216,315	2,867,970	651,655	29.4%
Cash Flow Account	350,000	350,000	–	–
Budget Reserve	994,339	1,596,522	602,183	60.6%
Stadium Reserve	6,840	21,196	14,356	209.9%
General Fund Budgetary Balance	**865,136**	**900,252**	**35,116**	**4.1%**

Note: Dollars in thousands, parentheses signify reductions or negative balances.
Sources: *General Fund - Fund Balance Analysis*, February 2016 Economic Forecast and End of 2015 Legislative Session; Minnesota Management and Budget

interest in providing additional aid to cities and counties and the House's interest in exempting Social Security benefits from income taxes. It will be interesting to see if and to what extent state initiatives in this shortened session are subordinated to local interests.

There is also the question what new tax proposals legislators will consider and whether they can find their way onto a 2016 tax bill. As usual, a time-sensitive slate of federal conformity issues stare legislators in the face from day one. Aside from the bigger ticket "wish list" items like Section 179 expensing, there are many smaller investment provisions of potential interest to the business community plus a number of conformity concerns of interest to individual filers, such as deductions for educator expenses, mortgage insurance premiums, and some specific types of charitable contributions. However, House Tax Chair Greg Davids has already stated his preference that any "second" tax bill this year be one that all parties can agree to – meaning that if one even appears, it will be about as controversial as motherhood and apple pie. Federal conformity could move through the process as a stand-alone bill, but given discussion in the House Tax Committee it appears that the players involved would prefer to wait until May to adopt it. This would ensure that all taxpayers file using the same federal laws, and allow DOR the opportunity to adjust tax returns after-the-fact.

The House's list of "pre-filed" bills offers a window of insight into other tax initiatives on legislators' minds heading into the shortened session. Notable proposals include the elimination of the scheduled 2019 repeal of the Minnesota Care provider taxes; a reduction in the percentage of C/I growth metro-area cities under 15,000 contribute to the Fiscal Disparities program (with the state backfilling lost revenues); and, oddly, a DFL-authored bill to have the Department of Revenue study replacing the state's current individual income tax with a flat tax on income or consumed income. From the "this was predictable" file, another bill seeks to "reamend" the state Constitution to redirect the constitutionally dedicated 3/8th cent sales tax to roads, bridges, and clean water infrastructure. Most of the pre-filed bills, however, are the ubiquitous, low profile, targeted tax expenditures introduced every session providing some form of favorable treatment to some preferred behavior, activity, or type of taxpayer.

That said, one introduction from the first day particularly worth following is HF 2681 – a multi-faceted piece of legislation that looks a bit like a miniature omnibus tax bill. It conforms Minnesota's income tax law to 2015 federal tax law changes and establishes a process for prospective federal conformity going forward. It includes a number of small business tax relief and assistance measures. And it also addresses a few of the procedural protections for taxpayers highlighted in our November/December 2015 issue of *Fiscal Focus* – most notably the establishment of a program for private letter rulings.

Related to the issue of improving consistency and predictability in tax enforcement and administration, one final tax issue practically guaranteed to make a very visible return this year is residency determination for income taxation. "Factor testing" in determining Minnesota "intent" or "domicile" residency – especially as it relates to the impact of employing Minnesota-based lawyers, financial planners, and accountants – has received considerable attention with the passage of the fourth income tax tier.

Two recent developments guarantee that residency issues are not going away anytime soon. In mid-February, the Minnesota Supreme Court reversed a Tax Court ruling and now allows the Department of Revenue to consider ***all*** days spent in Minnesota in a year in determining physical presence residency (over 182 days + an abode in MN). This means that both days spent in the state as a non-resident as well as days spent as a resident are totaled when determining physical residency for income tax purposes. Two weeks earlier, the Department issued its long anticipated "*Revenue Notice #16-01: Income Tax – Domicile Consideration – Location of Attorneys, Certified Public Accountants, and Bank Accounts*", which was greeted with a giant raspberry by business practitioners. Frustration and aggravation has not abated, perhaps best captured by practitioners' expressions of disagreement over what was more amazing – publishing something with no explicative or decision-making value, or that it took well over a year to do it. With language in both the House and Senate tax bills addressing this concern, expect a redoubled effort to push for a legislative solution.

Bonding

Bonding is always a keenly-watched topic in even-numbered years. Passage of a bonding bill requires a 60% supermajority which almost always means the minority caucus needs to put up votes for the bill. Negotiations involve two contentious dimensions: the overall size of the bill and the specific projects within it. Governor Dayton has proposed a $1.4 billion package with a strong clean water focus. Republican leaders have suggested something around $1 billion would be more amenable (which is more or less in the historical range of past bonding years) centered on roads and bridges. DFL legislative leaders envision something closer to the Governor with Greater Minnesota projects being one theme of emphasis. Whatever number is finally agreed to, it will require a substantial winnowing of the estimated $3 - $4 billion in bonding requests.

Transportation Finance

Despite the encouraging comments from transportation finance chairs, and the insistence of all legislative leaders that transportation is unequivocally a top priority for the session, all indications are that last year's complications are alive and well. Republicans are adamantly against gas tax increases and want to tap the general fund for transportation – both using one-time money as budget conditions permit and structurally by dedicating general sales tax revenues from auto repair parts. They are also cool to big ticket transit spending and new transit financing options. DFLers are much more amenable to gas tax increases, but ice cold to any lasting dedication of existing general fund resources for roads and bridges. And it's clear DFLers expect transit to have a significant presence in any transportation finance package looking beyond the current biennium. Combine this with the fact that these positions continue to be intertwined with unresolved tax matters and any compromise will have some political fallout ahead of the November elections, it's difficult to see a breakthrough forthcoming this session. Our accompanying article in this issue takes a closer look at the transportation finance stalemate.

Pensions

Largely ignored in all the biennial budget squabbles are some very significant developments in public pensions. In 2010, with pension funds reeling from the Great Recession, the legislature enacted a major package of sustainability fixes including both contribution increases and reductions/freezes in cost of living benefit adjustments (COLA) to restore fund health. Just six years later, with the S&P 500 now up over 165% from its Great Recession lows, another round of sustainability fixes looms.

The focus this time is on the plans for teachers statewide (TRA) and for state employees (MSRS).[2] MSRS will be proposing to increase both employee and employer contributions and to reduce the annual COLA to 1.75% going forward. TRA is proposing to boost employer contributions (for the third time in ten years) and also lower the annual COLA to 1.75% but keep employee contributions unchanged. TRA is also asking for a fresh 30-year amortization period to pay off its $6.7 billion in unfunded liabilities.

The long anticipated Revenue Notice was greeted with a giant raspberry by business practitioners

Together, the proposed changes in employer contributions represent an opportunity cost of $84 million in FY 2017 – resources that would be directed toward additional pension support and away from the delivery of services that the state and school districts provide. Testimony from school district representatives made it abundantly clear that they have no capacity to absorb their share of these costs without impacting their operating budgets, and they want the state to appropriate general fund money to cover this additional expense. For anyone who still may believe that pension costs are not significant in the grand scheme of governmental budgets, school representatives also testified that if they had to assume this additional expense, it would consume 25-50% of the increase in basic education formula aid appropriated with such effort and drama last session.

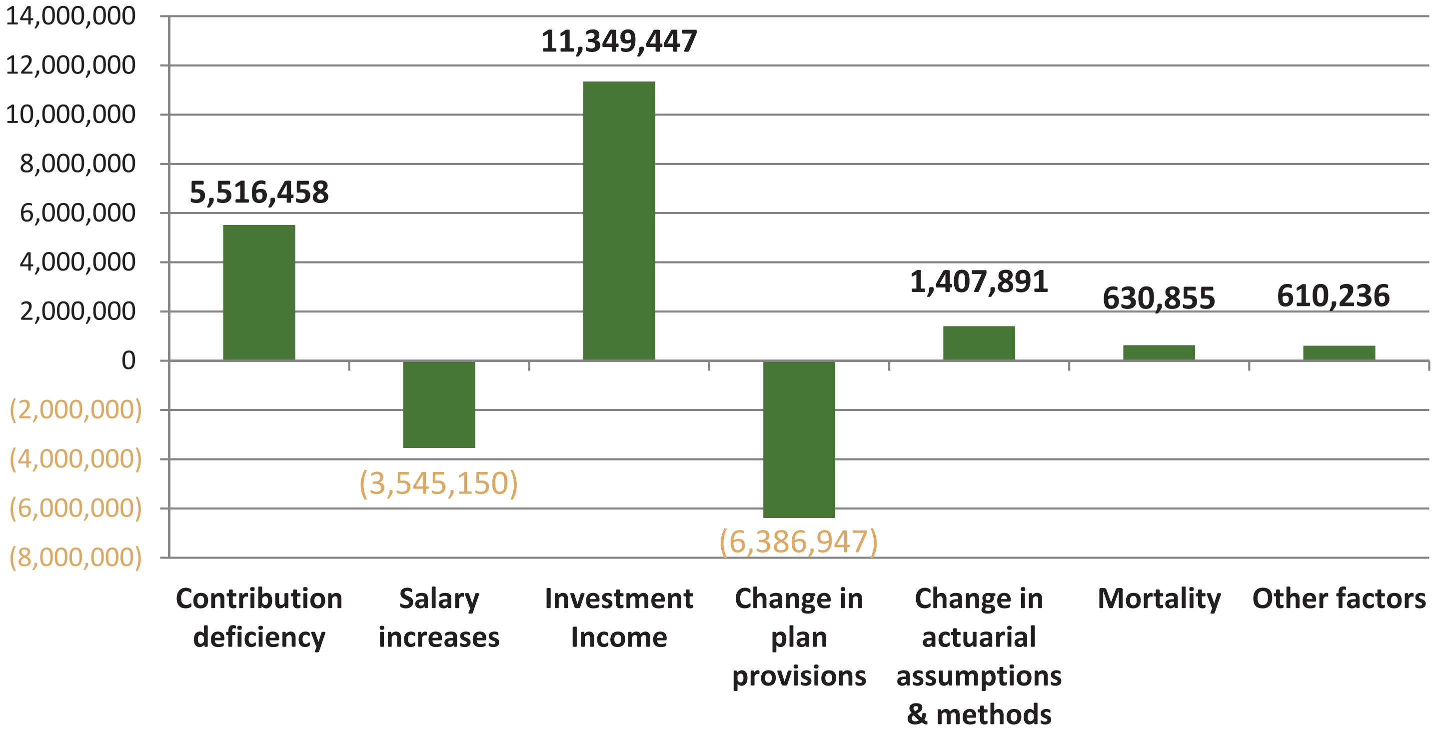
What's prompting the need for more fixes? The message being related to beneficiaries, legislators, and the media is that longer life expectancies are driving up costs. The plans' experience studies are showing that public employees are living longer than expected– two years longer on average – which must be factored into pension financing. Collecting an additional two years of monthly benefits is certainly a significant cost issue. When the MSRS actuaries calculated the impact on the General Employees Retirement Plan, the longer life expectancies increased total liabilities by approximately $700 million. State pension plans deserve to be commended for pursuing prompt action on this issue.

But everything is relative, including the impact of longer lifespans. To put this issue into better perspective, the accompanying chart uses data from the pension plans' actuaries to isolate and quantify how specific factors have affected the unfunded liabilities of the state's major pension plans from 2006 through 2015. Positive numbers mean that the factor has generated increases in unfunded liabilities during this period; negative numbers mean the factors have reduced unfunded liabilities. For example, lower-than-expected salary growth and changes in plan provisions (most of which reflects the sustainability fixes of 2010) together had a positive effect on plan health by lowering unfunded liabilities by nearly $10 billion dollars. The sum of all the bars equals the net increase in unfunded liabilities over this period: $9.6 billion.[3]

[2] The local government employee plan – PERA – currently has less than 80 cents in assets for every dollar of already earned retirement obligations. But contributions have been determined to be sufficient to achieve full funding 30 years from now if all assumptions work out as expected. PERA officials have declared the plan "sufficiently stable" with no immediate need for corrective action.

[3] Adding this $9.6 billion to the $6.4 billion in total unfunded liabilities going into FY 2006 equals the $16 billion in unfunded liabilities being reported as of June 30, 2015.

Contributing Factors to Changes in Unfunded Accrued Actuarial Liability: FY 2006 - FY 2015 (Total Increase: $9.6 Billion)



The specific impact on fund health of public employees living longer than expected over the last decade can be seen in the bar labeled "mortality." $631 million is a lot of money and hardly a rounding error. But it pales in comparison to other factors. For starters, the state has set contribution levels into these pension funds at woefully inadequate levels – they have been $5.5 billion inadequate, to be precise. Although both employer and employee contribution rates have gone up, FY 2015 marks the 12th consecutive year contributions to the pension plans – on an aggregate basis – failed to meet the required amounts. It is especially interesting to compare the impact of "changes in plan provisions" (generally, the highly-praised and relentlessly-referenced sustainability fixes of 2010) with the impact of contribution policy. 90% of the roughly $6 billion in one-time benefit the 2010 sustainability fixes provided has been undercut by failing to make necessary contributions. What plan and benefit changes giveth to sustainability, state contribution policy essentially taketh away.

Then there is the Sears Tower – investment income. This time period obviously captures the devastating effects of the Great Recession, but it also captures the decent to excellent market years before and after. Interestingly, the State Board of Investment reported a respectable annualized return of 7.8% for the ten years that ended on June 30, 2015. This makes the $11.3 billion increase in unfunded liabilities over this same period just from missing investment expectations very much worth contemplating. Part of the disconnect is attributable to "smoothing" practices – some of the recent gains have not been realized yet. But it also vividly demonstrates the extraordinary impacts even small deviations from investment expectations can have on pension health.

Going forward those deviations may not be so small. At least the plan's own actuaries think so. In their GASB compliance memo to plan officials, they note "according to our most recent experience study, the probability of achieving the 8% assumption is only 37%. The study further indicates that to have a 50% chance of achieving the assumed earnings rate, the rate would have to be lowered to 6.97%."

In short, the "living longer" repercussions for pension fund health are undoubtedly real. But it is also proving to be a bit of a scapegoat and convenient distraction from the far more influential policies and historical practices that are triggering the need for contribution increases – and creating significant risk and exposure for beneficiaries, taxpayers and government services alike.

Given all this, and other tax relief and spending ambitions, it's easy to understand why legislators might be so disappointed to see $300 million disappear in smoke. Many different Capitol veterans have uttered the phrase "all or nothing" to describe the 2016 session. It reflects a sense that either all the pieces of the puzzle will come together expeditiously or will quickly dissolve leaving the November elections to chart the future path. By all accounts, the prognosis for putting these pieces together – reaching meaningful agreement on these issues (and others) – is not good. If that's the case, voters tired of reruns may head to the polls in November in search of a different channel. ■

Funding a Bridge Over Troubled Waters

The alleged growing impotence of the gas tax is exaggerated, and alternative user fees may help at some point in the future. But the real key to transportation funding adequacy and sustainability likely demands a return to an old fashioned public finance ideal.

Depending on the news report – and how much effort is put into parsing quotes coming from the players involved – a gas tax increase this session to fund transportation will remain dead or might be reanimated (with the potential to create session mayhem much like the reanimated "walkers" on television.)

What is clear is that Republican legislators and many business advocacy groups are staunchly opposed to a gas tax increase. The primary objection is philosophical – based on the belief that some of the revenue being generated by the large tax increases of a couple years ago should go toward this quintessential public good. It's an argument buoyed by the $900 million surplus that is seemingly tailor made to support "no-tails" spending like road construction.

A majority of the state's voters seem to share this objection. Polling consistently has shown majority opposition to a gas tax increase – even though 100% of the money would be dedicated for what most acknowledge is a legitimate need. Not too long ago, Minnesotans overwhelmingly approved increasing the general sales tax by 3/8ths of a cent for 25 years and dedicating the revenues to support arts and natural resource spending, regardless of merit or need. Whatever enthusiasm for dedication washed over the populace back then does not seem to penetrate concrete and asphalt.

From the perspective of tax principle, most public finance economists would likely argue the gas tax remains an important and excellent way to fund transportation.[4] It's a simple-to-implement tax with low administrative and compliance costs. Plus, its user fee-like qualities conform well to the benefit principle of taxation, and as a general rule we should try to retain a relationship between road funding and road use.

However, there is growing criticism of the tax based on substance – rooted in its increasing inability to keep up with growth in transportation needs (and costs). That alone shouldn't disqualify the state from continuing to rely on the tax any more than the increasing challenge of paying for a college education disqualifies putting more money into a college savings fund. But the decline of the gas tax's purchasing power is real and linked to two well documented issues: a shrinking tax base (the amount of gasoline sold) and the impact of construction cost growth.

A Gas Tax Low on Fuel?

How big are these problems? Can the gas tax overcome them? To examine these questions we explored what Minnesota's gas tax rate would be in 2016 if we had adjusted it over the short-term for both fuel efficiency and construction cost inflation.

Minnesota Gas Tax Rate: Adjusted for Vehicle Efficiency and Highway Cost Inflation
Adjustments based on trends from January 2008 through January 2015

	Adjusted Rate: January 2015			
Gas Tax Rate: January 2015 (Actual)	Efficiency Only	Efficiency plus Federal Inflation	Efficiency plus State Inflation	Efficiency plus State/Federal Average Inflation
$0.285	**$0.251**	**$0.226**	**$0.334**	**$0.277**

The first step incorporates the effects of increases in vehicle fuel efficiency. Since 2007, the University of Michigan Transportation Research Institute (UMTRI) has tracked the average sales-weighted fuel economy rating of new purchased vehicles. Using this data set offers two advantages. First, focusing on new purchases captures the greatest gains in car and truck fuel efficiency. Because the fuel efficiency improvement of the total fleet of cars and trucks on the road will be less than this, the methodological bias is to overstate the "efficiency challenge" the gas tax faces. Second, by sales-weighting the data, we are capturing the fuel efficiency gains resulting from vehicles actually being put into use on the nation's highways. Leapfrog fuel efficiency gains such as that provided by hybrids only impact the results to the extent these vehicles are actually purchased.

The second step is to adjust the tax rate to accommodate historical inflation in road construction and maintenance costs. As we have discussed in *Fiscal Focus* before, what might seem like a simple, straightforward adjustment turns out to be mysterious, controversial, and worthy of a much better understanding.[5] From 2003 to 2014, highway cost inflation as reported by the state has been over six times that of the Federal Highway Administration's (FHA) Highway Cost Construction Index. This large discrepancy has serious implications for adjusting gas tax rates for cost inflation. Our analysis presents three findings: one based on the federal cost index, one based on the Minnesota cost index and one based on an average of the two.

To calculate how efficiency and cost inflation might change the gas tax rate, we assumed that Minnesota's actual gas tax rate was recalculated each January 1 based on the average increase in sales weighted efficiency and construction cost inflation in the previous year, without regard to any actual changes in the rate. We set January 2008 as the base from which to measure growth because the UMTRI data set begins during 2007, prohibiting analysis to an earlier date. The accompanying table presents the results.

Since 2008, sales-weighted new vehicle fuel efficiency has increased by about 25%. Over that time Minnesota's gas tax increased 8.5 cents/gallon, which has more than accommodated that increase in fuel efficiency.

Perhaps surprisingly, since 2007 – at least based on federal measures – highway cost inflation has also worked to ensure that gas tax rates remain adequate. Federal statistics indicate the Great Recession was a period of considerable deflation in highway construction costs (down around 19%) and the subsequent rebound in the inflation rate has been quite modest – averaging only around 1.4%. The result is that the increases in Minnesota's gas tax rate since the beginning of 2008 have far outpaced the combined effects of efficiency and federal inflation over this time and the rate has basically grown at efficiency plus the average of state and federal inflation rates.

The story is very different if we use trends in MnDOT's composite construction cost index to adjust the tax rate. The Great Recession caused only a modest 3.8% temporary drop in 2009, followed immediately by a 9.2% rebound by the end of 2011. As we have previously discussed, because cost inflation trends are so crucial to estimates of future transportation spending needs – let alone any ambition to adjust the gas tax rate for purchasing power – an investigation into the causes of this extraordinary discrepancy is very warranted. Nevertheless, adjusting the tax rate using Minnesota's inflation measure yields a rate of 33.4 cents per gallon, among the nation's highest. Adjusting the

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4 It is worth noting that all four of our panel of economists at our 2015 Annual Meeting of Members endorsed the continued reliance on the gas tax to support future transportation needs.

5 "Why is Minnesota Highway Construction Inflation So Much Higher than the Nation's?" MCFE *Fiscal Focus*, January/February 2015

rate up by 4.9 cents (relative to the actual 28.5 cent rate) would bring in an estimated $157 million dollars annually – about two-thirds of the $234 million in the precedent-concerning proposal to dedicate sales tax revenues from auto-related purchases.

Can It Be Replaced With Something Better?

An estimate based on a recent eight-year snapshot does not fully capture the growing challenges of the gas tax. An analysis over a longer time period would likely find "adjusted" gas tax rates even higher. But nor do these findings seem to justify the increasingly pessimistic claims that gas taxes are anachronistic and hopelessly inadequate given the raging trends in construction cost inflation and fuel efficiency.

Some of the world's most admired surface transportation systems share a common characteristic: general fund financing that includes the deposits of transportation user fees and taxes into government general funds.

Considering the viability and adequacy of new user fee approaches suggests that continued reliance on the gas tax is merited. In recent years user fees based on vehicle miles traveled have received growing attention – not just as a supplement to the gas tax but as a replacement. A 2011 University of Minnesota Center for Transportation Studies (CTS) report[6] evaluated the replacement of the gas tax with a mileage based user fee system. It concluded mileage based user fees scored better on every transportation finance principle – except implementation and compliance costs (hardly minor issues). The authors concluded that "fuel taxes are not sustainable for funding surface transportation but a mileage based use fee would be."

Recognizing the real pragmatic implementation barriers to this switch, the authors offered a vision of a future "transitional" transportation funding structure. Under this approach, the gas tax rate would be lowered to the level needed to generate sufficient revenues for "baseline transportation needs" – essentially the maintenance and operating costs of the existing system plus "user system safety" and enforcement. Revenues from a mileage based user fee would fund road and bridge capital costs – reconstruction, expansion, and right of way.

What would the result look like in Minnesota? For starters, the premise that a lower gas tax rate could fund "baseline transportation needs" appears very questionable. According to the most recently available data, state and local government combined spent $1.82 billion on road operating and maintenance spending – far exceeding the $878 million brought in by fuel taxes. Every penny of the existing gas tax and then some is needed just to operate and maintain the existing system.

With respect to supporting construction costs with mileage-based user fees, evidence suggests such fees would need regular increases just to maintain the status quo in purchasing power – creating the same challenge the gas tax now faces. According to the FHWA, vehicle miles traveled in Minnesota have essentially flatlined over the recent decade (56.90 billion in 2005 to 56.97 billion in 2013). Minnesota gasoline consumption may have peaked in 2004, but vehicle miles traveled peaked only four years later in 2008.

A Public Good in Theory, Less So in Practice

Nearly 200 years ago Whigs and Jacksonian Democrats were engaged in bare knuckle brawls over whether the federal government should even be involved in developing transportation infrastructure. Today, the concept of transportation as a public good has been well established – at least in principle. With respect to the practice of actually funding transportation, that idea is on a much more fragile foundation.

The prescribed ideal from the early 20th century of allocating an equitable share of transportation funding responsibility among "users, beneficiaries, and the business man and citizen through general taxation" has given way to a popular expectation that users and beneficiaries must pick up most – if not all – of the tab. (At least where state government is concerned – local governments have been employing general fund dollars for transportation purposes since time immemorial.) That's true for both transit and roads resulting in debates about which receives the bigger subsidies and theories of transportation modes "paying for itself" – all without ever questioning if and how the concept of "government subsidy" should even apply to transportation infrastructure.

Perhaps that's why some of the world's most admired surface transportation systems share a common characteristic: general fund financing that includes the deposits of transportation user fees and taxes into government general funds. A recent report by the Eno Center for Transportation[7] concluded traditional dedicated trust fund approaches to transportation financing – and the highly divisive modal / distributional squabbles that inevitably result – can distract from a focus on overall transportation system performance and the strategic allocation of resources towards that objective. An argument can also be made that requiring transportation to compete for general fund resources would stimulate process redesign and efficiency improvements within transportation agency operations.

Such a radical transformation of transportation finance will never happen here, but this does point to a need to return to a fundamental public finance idea. If all the blue ribbon panels and MnDOT estimates are correct, an "all hands on deck" approach to transportation funding will be needed. The gas tax – and gas tax increases – will have to remain part of the portfolio. At the same time, spending interests will have to get used to the idea that not only will transportation start competing for general fund dollars; such competition is appropriate and beneficial. ■

6 "From Fuel Taxes to Mileage Based User Fees: Rationale, Technology, and Transitional Issues," Center for Transportation Studies, Humphrey School of Public Affairs, University of Minnesota, 2011

7 *The Life and Death of the Highway Trust Fund,* Eno Center for Transportation, December 2014

A Perspective on the "Local Price of All Government" in Minnesota

A look at government's "all in" fiscal footprint – local, state, and federal – at the county level.

Our recently released "Price of Local Government" issue brief – now an annual report – offers several perspectives on Minnesota's fiscal geography and the claim local governments have on their residents' income. But it made us wonder: if we tacked on support for state and federal government as well, what would each county's "Local Price of All Government" look like?

We offer perspective in the accompanying 'Local Price of All Government" map, constructed as follows:

- The baseline is our "Price of Local Government" which includes all county, city, township, school, and Met Council own-source revenues.
- To this we add state government revenues that can be tracked by county: total individual income tax liabilities, the state general property tax levy, and sales taxes (including the general sales and use tax, the liquor and car rental taxes, the sales and use tax on mobile homes, and the in-lieu tax on lottery tickets).
- Finally we add federal government revenues that can be tracked by county, including the FICA (Social Security and Medicare) payments employees make, total federal income tax liabilities, and other taxes reported on Form 1040.[8]
- Our denominator – county cash income – equals total county personal income less elements that can't be used to pay taxes and fees (such as the value of Medicaid benefits) plus income that is not included in personal income but can be and is used for this purpose (e.g. retirement benefits and capital gains). We prefer to use this measure since it better reflects income actually available to pay the taxes, fees, and other revenues that finance government.

8 Includes taxes from recapture of certain prior-year credits, tax applicable to individual retirement arrangements (IRA's), social security taxes on self-employment income and on certain tip income, advanced earned income payments, household employment taxes, and certain "other taxes" listed in the Form 1040 instructions.

Data limitations mean that some notable revenue streams are missing from this analysis. State corporate income taxes are not included (Minnesota House Research estimates collections on a county basis but data is not available for 2013.) Limitations also force us to exclude the state excise taxes, motor vehicle sales taxes, health care taxes, and all state fees and charges including tuition payments. With respect to federal taxation, we have no data on corporate income and excise taxes and any fees and charges.

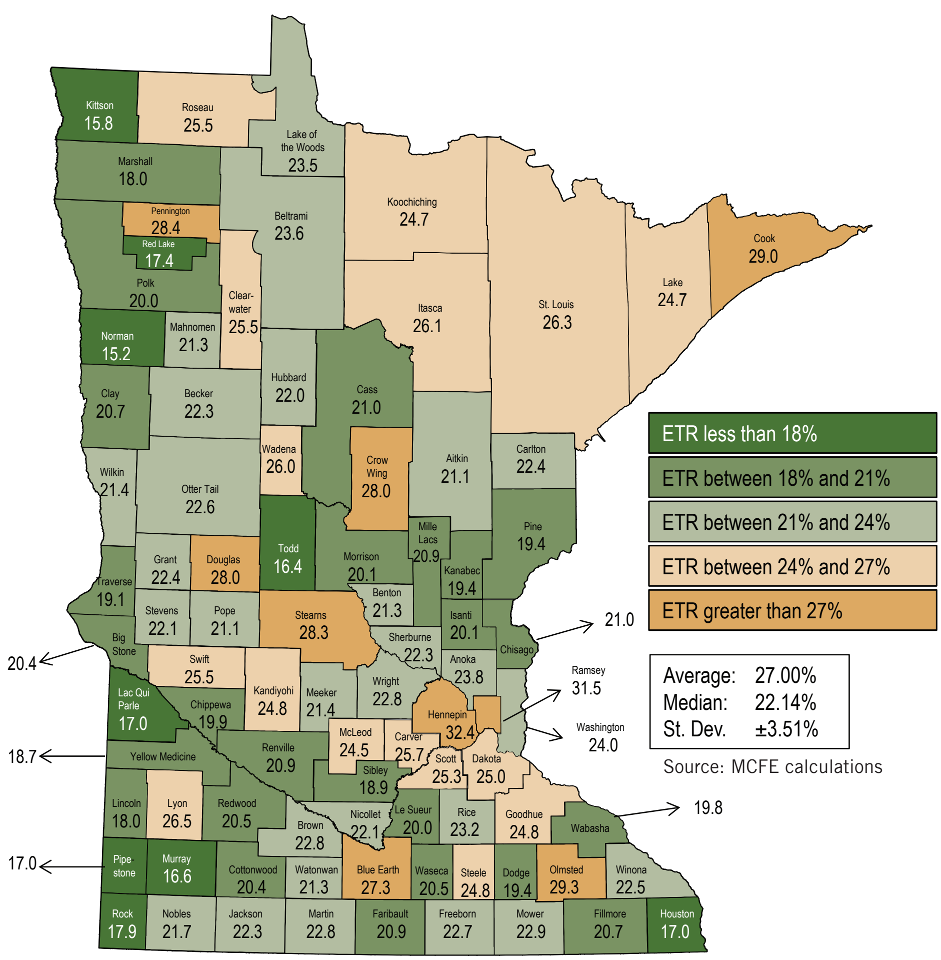
Our analysis does capture over 70% of all state taxes and over 60% of all state own source revenues

With these limitations in mind here are some findings:

- Looking to visit a county with the lowest "all-in" government claim on county cash income? Put Norman County (15.2%) high on your list. Conversely, Hennepin County is the place where government's combined footprint is the greatest, claiming nearly one-third of county cash income (32.4%).
- Unsurprisingly, including progressive state income taxes and highly progressive federal income taxes has a much bigger impact on the "all in" price of government in some counties than others. For example, Olmsted County has a slightly below average Price of Local Government (4.7% of cash income). But when state and federal collections are included, the Local Price of All Government jumps to 29.3% – 6.2 times that of just local government. Contrast that with Lincoln County, where the relatively high Price of Local Government (6.0% of cash income) jumps only 3.0 times to 18.0% when adding state and federal taxes.
- One potential indicator of fiscal stress within a county is large amounts of personal income – which measures economic activity – coming from income support programs. That potential for fiscal stress is likely amplified in counties where progressive state and federal income tax collections are modest. Mahnomen, Wadena, and Aitkin Counties are examples where such conditions exist.

One theme clearly permeates this analysis: the impact that federal taxes have on the price of government felt by Minnesotans.

Figure 2: Local Price of All Government, Cash Income Basis, by County, 2013



Source: MCFE calculations

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When looking at all taxes Minnesotans pay to all levels of government (including the taxes that we can't allocate to the county level in this analysis), about half of those revenues go to the federal government in the form of income and FICA taxes. State discussions about tax policy generally create a firewall around state and local taxation – ignoring the interaction and combined effects with federal taxation. In some respects that is understandable – state legislators have no control over federal tax policy. But it's always worth remembering taxpayers themselves are unlikely to draw such a clear distinction in evaluating their tax burdens.

From The Director: The State Tax Research Institute Arrives with a Splash

A new research study from the State Tax Research Institute (STRI) provides plenty of grist for the mill regarding state efforts to expand the reach of state taxation to capture earned income of foreign subsidiaries. "State Tax Haven Legislation: A Misguided Approach to a Global Issue" finds such efforts are based on often absurdly inflated assertions, are administratively unmanageable, face significant constitutional challenges, and pose a major risk to foreign direct investment by departing from international consensus on how to appropriately address this issue. This study is notable not just for its grounded examination of this high profile topic, but also for being the first major report of the Council on State Taxation's (COST) new 501c3 research arm.


Mark Haveman

Founded in 1969, COST's mission is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. Globalization, technological advancement, and other factors have made this mission much more challenging. In an environment where officials and taxing authorities at every level of government around the globe pursue claims to the same pool of profits, a voice that provides new perspective and understanding – and often a healthy dose of reality – in the pursuit of equitable and nondiscriminatory tax treatment should be welcomed.

COST is already well known for its several existing research products including its highly regarded and often-referenced State Tax Business Burden Study and its Business Tax Competitiveness Study. Plans are for the STRI to assume these existing studies and expand its research portfolio. Examples of investigations being considered include an analysis of the differential impact the corporate income and the personal income taxes have on business income, cost/benefit analyses of various efforts to improve state tax administration, and an evaluation of collection and compliance burdens for both states and businesses with respect to specific state taxes – in essence, a look into which tax provides the biggest bang for the dollar.

Because of its strong practitioner basis and focus, STRI research investigations are also likely to connect principles of good tax policy to very specific tax administrative issues and circumstances that go far beyond the expertise of "think tank" type tax organizations – another contribution that is sorely needed. For example, another STRI brief has examined good tax policy considerations in private label credit card default.

Minnesota's much lauded economic performance is highly attributable to the impressive multinational headquarters presence in the state and the agglomeration economies they create. It would behoove state policy makers to be highly sensitive to the tax realities and administrative complexities these organizations face. As the STRI matures and grows, we can expect this organization to be a major source of information and education in Minnesota's pursuit of sound tax policy.

— M.H.