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MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

Going Big and Going Home

If nothing else, the 2013 legislative session breathed a lot of life into the old bromide "elections have consequences." Two years ago, a Republican-led legislature and a DFL governor engaged in a budget standoff that would result in a three-week state government shutdown that tarnished Minnesota's reputation for good governance. This spring, new DFL majorities in both houses of the legislature teamed up with the governor to erase all vestiges of the budget-balancing turmoil of sessions past with a revenue and spending package of stunning ambition.

Legislators needed to address a budget deficit of $627 million for fiscal years 2014-15. When all was said and done, policymakers adjourned for the year having turned that deficit into a $68.5 million surplus. But the path to that destination was anything but ordinary. In the end the legislature authorized an additional $2.3 billion (6.4%) in revenues to not only cover the projected deficit but also to finance roughly $1.6 billion in new spending initiatives – 4.3% more than the February forecast anticipated (see Table 1).

Legislators allocated new money to every area of the general fund except for debt service, although the big winners were K-12 education, higher education, economic development and local aids and credits. (See accompanying article for our take on Minnesota's most recent efforts at property tax relief.) Very little of the new revenue will go toward the budget gorilla known as health and human services. However, it is important to note that the $11.4 billion appropriation is nearly $800 million more than the state plans to spend for the current (FY 2012-13) biennium – a tribute to the power of demographics.

As we noted, it's a budget that makes every level of education a winner. K-12 schools will find nearly $240 million more allocated to the basic school funding formula – roughly 1.5% more in each of the two fiscal years.

Table 1: FY 2014-15 General Fund Budget, February Forecast and as Enacted ($000)

	Feb 2013 Forecast	May 2013 As Enacted	Change From Forecast	
			Amount	Percent
Balance Forward	1,007,778	1,007,778	0	–
Current Revenues	36,115,665	38,421,966	2,306,301	6.4%
Total Resources Available	**37,123,443**	**39,429,744**	**2,306,301**	**6.2%**
K-12 Education	15,177,280	15,662,096	484,816	3.2%
Higher Education	2,565,262	2,815,261	249,999	9.7%
Tax Committee Appropriations (Aids and Credits)	2,710,851	3,121,672	410,821	15.2%
Health and Human Services	11,362,473	11,438,794	76,321	0.7%
Environment & Agriculture	287,731	312,604	24,873	8.6%
Transportation	180,050	238,990	58,940	32.7%
Public Safety and Judiciary	1,825,379	1,930,542	105,163	5.8%
Jobs and Economic Development/Commerce/Housing	238,484	368,767	130,283	54.6%
State Government	895,368	914,588	19,220	2.1%
Debt Service	1,287,517	1,280,165	(7,352)	-0.6%
Capital Projects	233,073	233,073	0	–
Cancellation Adjustment	(20,000)	(20,000)	0	–
Dedicated/Other Expenditures	190	30,406	30,216	NA
Total Expenditures	**36,743,658**	**38,326,958**	**1,583,300**	**4.3%**
General Fund Balance Before Reserves	**379,785**	**1,102,786**	**723,001**	**190.4%**
Cash Flow Account	350,000	350,000	0	–
Budget Reserve	656,471	656,471	0	–
Stadium Reserve	0	27,807	27,807	NA
General Fund Balance	**(626,686)**	**68,508**	**695,194**	**NA**

Note: Dollars in thousands, parenthesis signify reductions or negative balances.
Note: Spending and revenue data by conference committee structure.
Source: Senate Counsel, Research, and Fiscal Analysis Office; calculations by MCFE.

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Legislators allocated nearly $135 million to fully fund optional all-day kindergarten – a long-time objective for many policymakers. Conferees on the K-12 bill also allotted an additional $40 million for special education funding – although this still leaves school districts to pick up a considerable portion of the tab – and another $40 million for early childhood scholarships. The University of Minnesota and the MNSCU system also stand to benefit – about $75 million more for the former and $100 million more for the latter. Students aren't being left out, either – the state has appropriated an additional $65 million for financial aid.

A Word From Our Sponsors

As expansive as the scope of new spending/investments were, the revenue options to pay for them were exceptionally constrained. Acceptable tax increases effectively had to meet one of three tests: 1) progressive; 2) regressive but appearing very progressive; or 3) tobacco.

The bulk of the new money will come via the income tax – about $1.1 billion alone from a new fourth tier of 9.85% at $250,000 of taxable income for married-joint filers, $200,000 for head of household filers and $150,000 for single filers. New taxes on cigarettes and tobacco products will total about $400 million; as will elimination/modification of several corporate income tax expenditures. Two chunks of the expected new tobacco and corporate income tax revenues were pledged as Plan B to backfill financing for the Vikings stadium and the disappointing but predictable e-pull tab shortfalls. If economic truth and justice prevailed, the new stadium would be named Marlboro-Finnigan Field.

Another noteworthy and last minute development centered around the reintroduction of a handful of business-to-business sales taxes – electronic and commercial equipment repair and maintenance, warehousing and storage services, and sales of telecommunications equipment. Their inclusion in the final tax bill offsets the cost of exempting city and county purchases from the sales tax, converting the sales tax exemption of capital equipment purchases to an upfront exemption, and then some. The result is a trade-off of one form of tax pyramiding for another.

The Impacts – On Rankings

Although only time will tell how these changes will impact Minnesota's national tax rankings, we have projected how an additional $1 billion in new revenues[1] from these tax increases would have impacted our most recent edition of How Does Minnesota Compare (which compares state revenues and spending using financial data gathered by the U.S. Census Bureau). Table 2 shows how Minnesota's rankings for FY 2010 would have changed if tax increases of the magnitude just enacted had been in effect then. The biggest impact clearly falls on corporate taxes – both in terms of the magnitude of the increase and in the change in rank. The changes also have a noticeable impact on income taxes – taking our ranking from high (8th per capita and 9th when measured against personal income) to really high (6th and 4th, respectively). Overall, Minnesotans' tax burden climbs two places from 13th to 11th when measured per capita and four spots from 15th to 11th when measured relative to personal income.

[1] $550 million in additional income taxes; $210 million in additional corporate franchise taxes; $30 million in additional sales taxes; $39 million in additional estate/gift taxes; and $200,000 in additional tobacco/cigarette excise taxes.

The Impacts – On Future Budgets

Throughout the legislative session, members of the DFL majority spoke often of crafting a "structurally balanced" budget – by which they meant a budget that not only balanced for the upcoming FY 2014-15 biennium that begins on July 1, but also for the subsequent FY 2016-17 biennium. Legislators and the governor certainly delivered on that goal – the expected revenues in FY 2016-17 of $41.45 billion are 14.8% higher ($5.3 billion) than the 2013 February forecast estimate. With those numbers, structural balance in the out biennium should be a lay up.

But as Table 3 shows the budget also adds $2.2 billion in new spending tails on top of the existing projected spending growth for FY 2016-17 – likely a lowball total since that excludes inflation (long an issue of concern for many regarding economic forecasts). Moreover, the new sources of revenue to support this spending are highly volatile. Tobacco taxes are known for their ability to disappoint revenue expectations; corporate income taxes are notorious for their cyclicality; and the top 2% of taxable individual income is almost certainly chock full of capital gains. It wouldn't be too surprising

Table 2: Projected Impact of Enacted Budget on National Tax Rankings

State and Local Taxes	Current Minnesota Ranking		Minnesota Ranking With Enacted Budget		Effects of Proposal on Burdens and Ranks	
	Burden	Rank	Burden	Rank	Burden (%)	Rank (#)
Income tax per capita	$1,216.07	8th	$1,319.63	6th	+8.5%	+2
Income tax per $1,000 income	$29.25	9th	$31.75	4th	+8.5%	+5
Corporate tax per capita	$135.90	13th	$175.45	7th	+29.1%	+6
Corporate tax per $1,000 income	$3.27	16th	$4.22	7th	+29.1%	+9
General sales tax per capita*	$853.90	28th	$859.55	27th	+0.7%	+1
General sales tax per $1,000 income*	$20.54	33rd	$20.68	33rd	+0.7%	–
Excise tax per capita*	$650.82	2nd	$688.48	2nd	+5.8%	–
Excise tax per $1,000 income*	$15.66	5th	$16.56	4th	+5.8%	+1
Overall Proposal						
Total taxes per capita	$4,587.44	13th	$4,781.21	11th	+4.2%	+2
Total taxes per $1000 income	$110.36	15th	$115.02	11th	+4.2%	+4

* Most states include motor vehicle sales taxes as sales taxes. Since Minnesota and five other states define them as separate excise taxes for purposes of the Census, Minnesota's sales tax rankings are artificially low and Minnesota's excise tax rankings are artificially high since they are not an apples-to-apples comparisons.

Table 3: FY 2016-17 Projected General Fund Budget Current and Compared to February Forecast (000)

	FY 2016-17 Current	Difference between FY 2016-17 Feb Forecast and 2016-17 Current	
		Amount	Percent
Balance Forward	1,102,786	723,001	190.4%
Current Revenues	41,454,245	2,159,199	5.5%
Total Resources Available	**42,557,031**	**2,882,200**	**7.3%**
K-12 Education	16,531,669	802,904	5.1%
Higher Education	2,850,830	285,568	11.1%
Tax Committee Appropriations (Aids and Credits)	3,558,004	772,204	27.7%
Health and Human Services	12,352,861	39,994	0.3%
Environment & Agriculture	332,456	32,022	10.7%
Transportation	207,022	26,972	15.0%
Public Safety and Judiciary	1,958,885	123,904	6.8%
Jobs and Economic Development/Commerce/Housing	344,417	106,683	44.9%
State Government	909,165	9,874	1.1%
Debt Service	1,412,476	(12,966)	(0.9%)
Capital Projects	261,859	0	0.0%
Cancellation Adjustment	(20,000)	0	0.0%
Dedicated/Other Expenditures	3,482	3,480	> 500.0%
Total Expenditures	**40,703,126**	**2,190,639**	**5.7%**
General Fund Balance Before Reserves	**1,853,905**	**691,561**	**59.5%**
Cash Flow Account	350,000	0	0.0%
Budget Reserve	656,471	0	0.0%
Stadium Reserve	27,807	27,807	NA
General Fund Balance	**819,627**	**663,754**	**425.8%**

Note: Dollars in thousands, parenthesis signify reductions or negative balances.
Note: Spending and revenue data by conference committee structure.
Source: Senate Counsel, Research, and Fiscal Analysis Office; calculations by MCFE.

if the projection of structural balance is in jeopardy by the beginning of the next budget cycle.

The Impacts – On Minnesota's Economy

What makes the decisions made this session all the more interesting – and the Monday morning quarterbacking all the more irresistible – is that Minnesota's performance coming out of the recession has been quite strong. According to a recent State Policy Reports study, Minnesota was among the top states in economic performance during the first quarter of this year. The state ranked sixth in economic momentum, third in personal income growth and seventh in employment growth – a very positive change after a decade of relative underperformance. Additionally, the state is on its best financial footing in years. Minnesota Management and Budget reports that in February and March, tax collections beat projections in all four major categories, coming in $300 million over forecasted amounts.

Republicans have been quick to claim credit for the turnaround, asserting that the philosophy of fiscal restraint they exercised when crafting the FY 2012-13 budget was justified and is now bearing fruit. Even if this implied causality is an overstatement, it does the raise the question of how this economic outperformance and momentum is occurring if the cuts and revenue restraint over the past decade has inflicted such significant damage to the public goods and services needed for economic growth, as many claim.

One answer lies in the competitiveness study we released in February – the damage never really occurred. We found little evidence to date of any "slippage" over time in our relative performance in what is called "foundational competitiveness" – areas like education, public infrastructure, workforce quality, quality of life, and other related issues many of which have a strong public goods orientation. Had Minnesota's relative performance been appreciably deteriorating in these areas, arguments for raising taxes for more spending would have been a lot more powerful.

We would certainly expect some lag time between "disinvestment" and associated outcomes, and it is possible that the full impact of the fiscal restraint of the last decade has not yet been fully realized. It's also possible that the decision this session to push the envelope on the tax and cost climate in Minnesota will more than offset marginal gains in foundational competitiveness resulting from this new spending. As important as these services are, their tax prices also matter.

It will be interesting to see what this major experiment holds for Minnesota's economy. But in one important way we will never know the real impacts. Minnesota has now invested more heavily in the "deal model" of economic development policy: a less friendly general tax climate pockmarked by the provision of special tax advantages granted on assurances of construction activity and job creation. The fruits of that strategy will be visible, and its benefits touted, in future ribbon cutting ceremonies. What we won't know and can never know, is the amount of entrepreneurial activity, in-migration of talent, expansion interest, and business siting that never materialized because our new tax and cost environment disqualified us from further consideration. ■

Third Time is Not a Charm

This session's property tax provisions might be described as a low-cal version of the Minnesota Miracle. It lacks the transformative impacts on the state/local financial relationship its famous predecessor had, but with a price tag exceeding $400 million, the effort and impact is certainly not inconsequential.

Heading into the tax conference committee, the House and Senate positions were aligned on some important areas – including additional LGA and County Program Aid, an expansion of the renter's refund program, and changes to the LGA distribution formula. However, there were also some important strategic and philosophical differences. Most notably, the House sought a significant expansion of the homeowner's property tax refund program while the Senate prioritized a state takeover of a portion of school referendum levies. In the end, leaders negotiated a $400 million increase in aids and credits spending and allocated $130 million each to the House and Senate to spend on their chosen priorities.

As a result, legislators and Governor Dayton delivered on their promise of property tax relief but in the process also delivered on additional distortion of local tax prices and the prospect of further eroding accountability at the local government level. What implications might this session's actions have going forward? A trip down memory lane of major state-funded property tax relief efforts offers some hints.

"Minnesota Miracle" In 1973, the year following the Miracle's enactment, state taxpayers realized $11 per capita of property tax relief – made possible by $72 per capita in new state taxes. As the years progressed, state aid to cities increased three times faster than the national average and by 1986 total city spending had risen by 74% after adjusting for inflation. Concerns began to arise over the stimulative effect aids seemed to be having on local government spending, which led in part to a 1990 investigation by the Office of the Legislative Auditor (OLA) on local government spending.[2] Among the report's notable findings and statements:

- Cities used 82 percent of the additional aid to finance increased spending and 18 percent to reduce property taxes.

- By 1987, the fastest growing and largest expenditure category was not fire, or police, or parks, or streets, but the category labeled "Other."

- "Property tax relief programs succeeded in keeping taxes low only ***as long as major new revenues were pumped into the system***. They were not controlled by large but stable aid programs." (emphasis ours)

- "We recommend the state not increase general purpose aid to cities or take on the job of preventing future city tax increases."

2 *Local Government Spending*, Office of the Legislative Auditor, Program Evaluation Division, March, 1990

The investigation led the OLA to conclude "responsibility for spending ought to be lined up to responsibility for raising revenue," while recognizing that "since important state programs now compete for scarce dollars, it seems appropriate that state policymakers be assured that city services are what local residents really want and are willing to pay for."

The "Big Plan" In 2001 the state engaged in another major buydown of local property taxes by taking over the general education levy which reduced school property taxes by over $1 billion or 55.4% in payable 2002. The accompanying table highlights city levy activity prior to and immediately following the takeover with accompanying aid changes as reference.

In the booming late 90's, prior to the state takeover, LGA increased an average of 3.3% per year. But during this same period city levies grew at a robust 5% - 7% per year. Such juxtaposition raises major doubts about claims regarding the relationship between LGA and property tax restraint.

Equally interesting is the levy behavior following the adoption of the Big Plan. As part of the reform, the state eliminated $200 million in HACA aid to cities which was partially offset by a $157 million increase in LGA (explaining the large percentage jump in 2002). The need to backfill a net loss of $43 million in state aid explains some of the 17.4% increase in city levies in 2002. Nevertheless, the year on year change in levy plus aid in 2002 – a measure of the change in city revenue base – was still 78% higher than the average of the six previous years (7.6% vs 4.25%).

This strongly suggests that cities were both able and very willing to take advantage of the "spare capacity" on homeowner property tax bills created by the elimination of the general education levy – even after years of robust levy growth. Importantly, the sense of opportunism does not seem to be limited to city governments. In 2003, school levies rebounded by $200 million – 18.5% of the $1.3 billion the state bought down the year before. The imposition of a one-year levy limit on local governments in this year's tax bill suggests these lessons from Minnesota's long history of providing property tax relief are not totally lost on legislators.

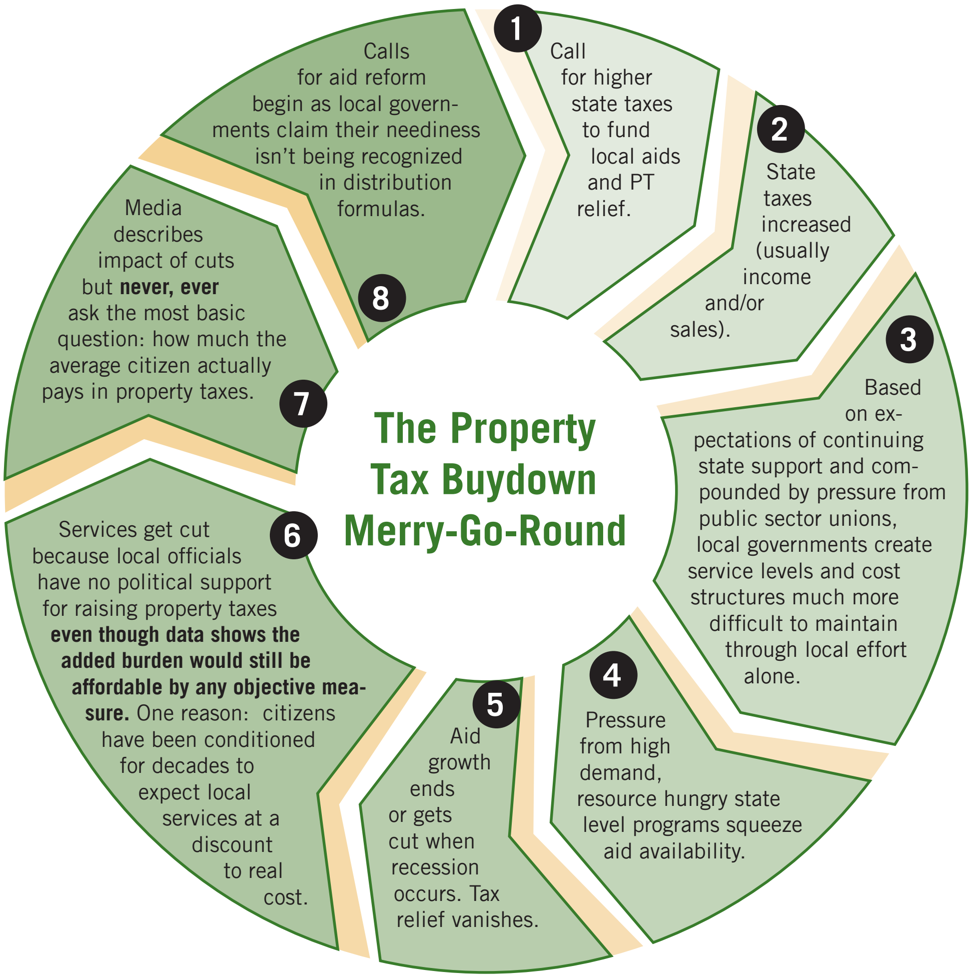
The "Great Stool Balance of 2013" – as this year's effort might be known by future students of Minnesota political history – lacks the scope and scale of its predecessors. It also operates in a different environment. Local governments would argue, undoubtedly with some merit, that the condition of operating budgets today after a tough decade of recessions and alleged state neglect is very different from the spending largesse captured in the 1990 OLA report. And the much more modest and diffuse state buyoff of local school referenda levies makes any attempt by other local governments to "fill the void" with their own new levies more challenging.

But the motivations, dynamics, and incentives inherent to any state buydown of property taxes are no less real in this year's effort. There is more than enough to embark on another trip on the property tax buy down merry go round.

- $120 million of additional base general purpose aids to city and county governments (with small increases for cities through calendar year 2016) combined with $125 million in annual savings for cities and counties from a new sales tax exemption on their purchases creates a

	Certified City Levies	Annual Change	Paid LGA	Annual Change	City HACA	Annual Change	Annual Change in Aid Plus Levy
1995	$ 651,518,401	—	$336,108,543	—	$197,070,502	—	
1996	$ 685,536,122	5.2%	$345,889,967	2.9%	$189,897,211	(3.6%)	3.1%
1997	$ 734,189,979	7.1%	$356,832,779	3.2%	$195,710,902	3.1%	5.4%
1998	$ 769,189,979	4.8%	$365,814,605	2.5%	$195,829,633	< 0.1%	3.4%
1999	$ 807,671,828	5.0%	$378,061,347	3.3%	$195,709,227	(< 0.1%)	3.8%
2000	$ 851,162,554	5.4%	$391,429,593	3.5%	$199,911,348	2.1%	4.4%
2001	$ 912,030,602	7.2%	$408,086,711	4.3%	$199,739,369	(< 0.1%)	5.4%
2002	$ 1,070,975,531	17.4%	$564,990,952	38.4%	$0	(100.0%)	7.6%

Source: MN Department of Revenue Property Tax Research Unit



very rich environment for spending increases with little, if any, short term property tax repercussions.

- Public sector unions, keenly aware of the dramatically improving fortunes of local governments, will integrate these developments into their negotiating positions and look to make significant amends for what they consider to have been a very difficult period for their members. Local officials feel pressure to acquiesce since labor peace in the present has far greater currency for decision-makers than the impact of spending tails out in the indefinite future.

- Meanwhile, the most generous and broadly accessible property tax refund programs in the nation became even more generous and more accessible insulating more citizens from more of the cost of operating local governments.

- Finally, recovering real estate markets and ubiquitous taxpayer confusion about how property taxes work (primarily a belief that there's a direct relationship between higher property values and higher property taxes) provides some temporary cover for whatever property tax increases do occur.

Each trip on the merry-go-round just reinforces taxpayers' expectations that local government services should be delivered at discount tax prices – the conditioning that led to the calls for property tax relief in the first place. The added irony is that any truly objective, apolitical analysis of the data would conclude that local property tax burdens are likely the least of our fiscal worries.

For anyone still truly interested in the quaint notion of local accountability, the history of riding this carousel offers one final invaluable lesson. Contrary to perception, times of economic difficulty and distress are not the times demanding greatest property taxpayer attention to local government finances. As our recent experiences through the Great Recession have demonstrated, local governments do an excellent job of restraining levy growth when taxpayers are on high alert. Rather, the time for maximum taxpayer vigilance is after the temporary relief has been provided, local taxpayers are placated, the economy is improving, and citizens are most oblivious to the cost structures and trends affecting local government services. That's when the seeds of the next period of property tax outrage are sown. And that time is now here. ■

From the Director – The Progressives' Tax Policy Paradox


Mark Haveman

According to the International Organization for Economic Co-operation and Development (OECD), the United States has the 4th highest income inequality among all developed countries – superseded only by Turkey, Chile, and Portugal. Yet, also according to the OECD, the United States has the most progressive tax system, far exceeding the wealthier, highly egalitarian social democracies of northern Europe.[3] How is this reconciled?

The answer is that in most countries, progressivity and income equality gains are achieved through government programs, not the tax code. According to the author of the OECD study, the United States is the only OECD country which reduces inequality more through the direct tax system rather than through transfer spending. Or as described in the Washington Post, "America's taxes are the most progressive in the world. Its government is among the least."

In most of the world equality gains come through progressive income support, child care, education, health, and related spending programs. But crucially all this is financed by far more regressive tax systems than we have in the United States. These countries learned that to support strong redistributionist policies, they needed tax systems that could collect a lot of tax revenue without harming economic growth. Among other features, regressive, broad-based consumption taxes are especially important. The value added tax - a revenue staple in most of the world – fits that bill.

— Continued on Page 6.

[3] *Growing Unequal? Income Distribution and Poverty in OECD Countries*, OECD, 2008

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What does any of this have to do with Minnesota? We have just emerged from a session where a lot of progressive policy cuisine was made from distinctly American tax ingredients. "Tax the rich," "tax fairness," and "more progressivity" were the only words on the recipe card. Any tax proposal affecting the middle class was *revenue non grata*.

The end of session demonstrated that under these tight philosophical and political constraints, securing enough revenue to support progressive policy ambitions isn't easy. For example, the tax conference committee briefly noodled on whether the world of excise and gross receipts taxes on alcohol could be manipulated to build progressivity into the taxation of alcohol consumption. Is it possible to protect the average Minnesotan's six-pack while sticking it to the *Wine Spectator* crowd? (Alas, it isn't, but not for lack of trying.)

In the end taxes on high income earners, estate taxes, and corporate income taxes – regressive, but having the considerable benefit of appearing to tax the wealthy – did most of the heavy lifting. Highly regressive tobacco taxes were also essential, but proponents argued these taxes were only meant to induce people to stop smoking. $400 million was simply the price society had to be willing to pay – rather, make that receive – to support good public policy.

The call for new revenue may not be over. Many in Minnesota's progressive community may not be completely satisfied with the results of the 2013 session. When first introduced, Gov. Dayton's budget featuring $2 billion in new taxes was described only as "a good start." [4] Concerns have already been expressed about addressing the treatment some health and human services programs received this session.

Funding future program ambitions will remain no less of a challenge than they were this session. For both practical and political reasons, progressivity advocates will have to embrace more regressive forms of taxation going forward.

Practically, we have now essentially spent all our "fairness ammunition" with respect to taxing income, especially if one gives any credence at all to the competitiveness principle of taxation. Minnesota can now claim the second highest income tax rate in the nation at the 4th tier threshold of $250,000 for married joint filers – second only to Oregon, a state without a sales tax. Plus we continue to have one of the highest corporate income tax rates in the nation but now stripped of some provisions which may have helped make the tax palatable enough to locate here. What little comparative headroom we may have had in the past with respect to taxing income has now evaporated.

[4] "A legislative session to rebuild the middle class", Duluth News Tribune, 2/23/2013

Politically, further pursuit of even more progressive taxation in Minnesota may do significant damage to progressives' own agenda. Author and scholar Monica Prasad of Northwestern University has built a distinguished academic career around investigating the sociology of taxation. In exploring why decreases in social spending took root in some countries but not others, she has concluded tax codes and tax progressivity have a major effect. Countries with stronger progressive tax codes and more punitive business taxation triggered much stronger and more aggressive conservative responses against social welfare policies and related spending. The net effect in these countries is that progressive agendas actually lost ground over time. In short: the progressivity of tax codes is negatively correlated with the amount of redistribution they do. The less progressive the tax code, the more overall progressive the fiscal system.

Selling the average Minnesotan on the idea that regressive taxes are needed to support important social outcomes is a lot more difficult than selling the idea "some people aren't paying their fair share." But sooner rather than later, Minnesota's progressives will have to recognize that to achieve their vision for Minnesota, some regressive forms of taxation will need to be considered an ally, not an enemy.

— MH