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Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

Three Questions Surrounding a New Biennial Budget

As the session kicks into high gear and the DFL's budget vision takes shape, we look at questions regarding inflation's impact on budget development, meeting new staffing needs, and how sustainable the tax agenda is paired with big spending increases.

The February forecast is out prompting little change to the budget numbers nor likely lawmaker plans on how to deploy them. With DFL controlling all branches of government, we have better visibility than in recent history on what the biennial budget will embody. The Senate and the House will inevitably need to work out some differences on priorities. Governor Walz will have his own ideas. But even with different variations on the themes, we are getting a pretty good sense of what the final composition is likely to look like. A look at some questions surrounding the implementation and fiscal implications of what we can expect.

What Impact Will Adding Inflation to the February Forecast Have on Budget Development?

Just in time for the February forecast, the Governor signed into law the inclusion of inflation into the forecasted expenditure line item. Although approximately $1.42 billion of available resources for the FY24-25 budget vanished, we will still have $17.5 billion in available resources to serve as the official starting point for biennial budgeting because collections continue to exceed forecast. The near-term answer to the question is "not much."

The forecast has now been transformed from "only a planning tool" into a useful budgeting tool. According to the Governor's budget proposal, $664 million is needed to maintain current service levels across all executive branch operations. With February's inflation estimate, that leaves about $760 million in "prebooked" inflation spending to accommodate new or expanded current law programming, increase aids, make "pseudo-cuts" to this prebooked spending to provide tax relief, or otherwise assist in the mathematics and compromise of interests in developing a balanced budget. For this reason, arguments about "government spending on autopilot" are overstated; technically it just changes the decision-making starting point.

The new law's real and influential impact will be in how budget debates are framed and perceived going forward. First, having an official budget starting point be base budgets + current law + "billions in adjustments we could do but don't have to" will complicate and distort tracking, reporting, and interpreting general fund budget trends and spending growth rates. Taxpayers can expect to hear a lot of conflicting statements and numbers creating confusion about how fast government is or isn't growing and how spending increases are really cuts.

Second, questioning the adequacy of tax revenues will become a much more frequent talking point. Any new spending enacted this year will show magnified out-biennium impacts in future forecasts while at the same time billions of available resources cease to exist. Reported structural deficits will become much more common. This may happen much sooner than one might expect. If the impact of the Governor's proposed budget is added to the February forecast, the forecasted structural balance including inflation for FY26-27 is a $3.35 billion deficit.

That number excludes whatever expenditure inflation adjustment will need to be added from new spending this year heading into FY 26-27. For all the admonitions from advocates to be responsible and recognize the reality of inflation, it's curious there has been no acknowledgement or comment on the potential out-biennium fiscal implications of the Governor's proposed budget with expenditure inflation formally included.

Based on discussions and e-mails with sister organizations around the country, the claim that Minnesota was the only state that did not formally build expenditure inflation into its budget starting point is a myth. Most states don't have this budgeting feature because they budget annually and expenditure "planning" is part of the annual budgeting process itself. In such states, a detailed revenue forecast is assembled and executive branches and lawmakers act on that information (obviously in different ways according to state statutes and constitutional provisions regarding budget development and policy.) For example, in Michigan, "costs due to changes in department policy, economic factors (inflation), and new department programs are not included in the current services baseline request." [1] Any needed inflationary adjustments get included with current law adjustments and change items in an agency final operating budget request which gets reviewed and incorporated into annual appropriations processes.

Biennial budgeting does make the recognition and accommodation of inflation more complicated. The solution, in states like ours, would be to take the concept of even-year supplemental budgeting seriously and identify and prioritize actions on where inflation in various government-purchased goods and services was affecting current service delivery. However, while inflation rates were rampag-

[1] *A Guide to the State of Michigan Budget Process*, Citizens Research Council of Michigan, Report #320

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

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

ing at 40-year highs, last year's budget debate was primarily centered on big new tax and spending proposals, not tackling mid-course appropriation adjustments where needed.

Put everything together, a skeptical observer might conclude the push for this change has always been much more about cosmetology than substance — obtaining "home field advantage" in establishing the budget playing field and influencing public perceptions about budget conditions and the adequacy of tax revenues, rather than responsible fiscal management.

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Will the State Be Able to Staff Up to Deliver on Proposed New Programming?

With existing workforce shortages, labor force participation rates stuck in the mud, and demographics pointing to sluggish labor force growth well into the future, Minnesota employers find themselves in what the business press has called a "war for workers."

State government is hardly a disinterested observer on this war. According to *Governing*, government human resource departments are fighting employee burnout, rapidly rising retirement, and stiff competition from the private sector to fill open positions, let alone staff new ones. By our count based on agency change item submissions, the human resource requirements contained in the Governor's budget amounts to over 3,000 new full time equivalent (FTE) employees. That number is likely understated as it appears to not fully account for estimated staffing requirements of the proposed new state family and medical leave insurance program as well as some other emerging issues coming out of the session so far.

"Transformative spending" on the scale being proposed also requires some new human resource investments in government accountability and oversight. For example, the OLA's recent report on state grants management contained a series of recommendations to address existing concerns in grants oversight and administration. Many of these recommendations pertain to the Office of Grants Management (OGM) which responds to over 550 inquiries from state agencies and entities each year including requests for technical assistance and training on state grant requirements. Hundreds of millions in new competitive and noncompetitive grants in education, economic development, and many other government areas are a major feature of the DFL's budget proposals. The OGM currently employs three full time staff.

The OLA itself already suffers from a severe demand and supply imbalance pertaining to its services. Since 2003, total state spending per year from all government operating funds has increased 147%, or more than $33 billion. Over that same period, OLA's staffing has declined from 80 to 56 full time equivalent employees. In a General Fund budget likely to approach $60 billion, the Office spends about $2 million a year to "determine the degree to which the activities and programs entered into or funded by the state are accomplishing their goals and objectives." – the statutory purpose of its Program Evaluation Division.

Government employment does offer some competitive advantages. A new survey by the Center for State and Local Government Excellence[2] found two of the top three factors attracting individuals to their current public sector employment were job security (92%) and retirement benefits (86%). However, intangibles are also an important decision-making influence. A sense of purpose and making a difference in society, and the job satisfaction arising out of this was cited by 87% of respondents. According to the report, "rebranding" government employment to emphasize purpose, mission, and government employment outcomes in the real world resonates with millennial job seekers.

The last state employee contract cycle included some pilot programs to address the employment challenges the state faces:

- a recruiting incentive of up to $5,000 to new employees who accept hard-to-fill positions
- a referral incentive of up to $1,000 to current employees who successfully refer a new employee who accepts a hard-to-fill position.
- student loan reimbursement payments not to exceed five thousand dollars ($5,000) per calendar year per employee, up to twenty-five thousand dollars ($25,000) in total payments if this pilot is continued in future years, subject to several employment conditions.
- "equity adjustments" which would include advancing employees more quickly in their salary range schedule and/or provide a lump sum of no more than $2,500 to an individual at the top of their salary range to "maintain internal equity." (We're not clear how the function of a compensation system that is designed and managed specifically to create compensation equity across disparate jobs in government could "lose" internal equity. However, if this pilot program can be leveraged as a way to retain high performers whose position on the compensation grid does not match their worth to government operations, we see the value.)

It will be interesting to hear information on how well these incentives worked and see how amenable unions are to continuing these types of initiatives. Guaranteed to be addressed in this year's union negotiations is remote workforce capability — an increasingly attractive employment feature.

Despite these efforts, competing against the private sector in chronically tight labor conditions will not be easy especially with its flexibility and responsiveness to labor market conditions which government does not have. Finding and obtaining the necessary management, skills, and technical talent to implement and oversee new government programs will be more challenging than appropriating money for them.

Is the DFL's Workforce-Oriented Tax Agenda Sustainable When Paired With Large Spending Increases?

The Tax Foundation reports in the wake of post covid recovery and the avalanche of revenues most states have experienced, half of the states with an individual income tax have cut their

[2] *State and Local Government Employees: Morale, Public Service Motivation, Financial Concerns, and Retention 2022 Survey Results*, March 2023

tax rates since 2021. In these states, rate reductions are seen as the best way to marry tax relief with tax policy that fosters economic growth. Economic theory would concur with that.

The DFL tax agenda reflects a different approach and perspective: pro-growth tax policy is best served by targeting relief in ways that also address one of the state's biggest economic concerns – the "war for workers." Roughly $6.9 billion of new and expanded income tax credits and subtractions have been heard in committee and laid over for possible inclusion in future omnibus tax bills. Most target families with children and young workers (exemption of Social Security income being the big exception). They include a new child tax credit (which only 6 other states have), a new and much more generous child care credit, and making the state's student loan credit significantly more generous and accessible, Some are refundable having a larger dollar-for-dollar impact on general fund resources. All have out-biennium impacts, most grow going forward, some significantly.

There are some good reasons to think about the intersection of tax policy with workforce participation, attraction, and retainment issues and to think about it strategically. Demographic trends are not in anybody's favor, and the competition for workers among states is taking on some characteristics of a zero-sum game. According to the Pew State Fiscal Health Project, fertility across the country fell to a record low in 2020 representing "a key source of fiscal uncertainty for states as smaller working-age populations may eventually threaten tax bases." [3] Minnesota's births per 1000 women has fallen 11.8% from its 2001-2010 annual averages which actually ranks 21st *best* in the nation.

Others argue that child-oriented tax credits have more pro-growth benefits than is typically realized. As James Pethokoukis, Senior Fellow at the American Enterprise Institute has noted, "in addition to raising take-home pay, expanding child credits serve as a sort of human-capital gains tax cut for worker creators (also known as families). It might just be nudge enough for financially-stressed families to have another kid since surveys suggest parents don't have as many as they would otherwise prefer due to money concerns. Modern pro-growth policymakers should fret as much about the nation's birthrate as productivity and labor-force participation rates. Lower birthrates and older populations are associated with less economic growth. A younger American society with a higher birth rate, helped by a tax code that offsets anti-family government policy, would be more dynamic, creative, and entrepreneurial." [4]

Finally, these issues do matter for business expansion and siting decisions. At our 2019 Annual Meeting of Members, keynote speaker Phil Schneider shared his lessons from 30 years of experience in site selection consulting consisting of nearly 400 projects around the world. Decision factors, he noted will vary from industry to industry and function to function, but a number of key issues are always looked at to some extent. At the top of this list is the workforce and talent pool. Schneider emphasized that ability to sustain a high-quality workforce over time is just as important a consideration as developing and attracting that workforce in the first place. Noting that "turnover rates eat a company alive," Schneider pointed out sustaining the workforce requires finding places where talent is and wants to stay and reducing dependence on in-migrating populations.

The problem for the DFL is that these targeted credits all need to be financed, along with their no less ambitious spending agenda. About $135 million in proposed new sales tax exclusions and a plethora of bills seeking automatic inflation adjustments resulting in de facto dedication of general fund resources adds to the challenge. For this reason, it is not surprising to see tax increase bills being introduced despite having $17.5 billion in hand (or $19 billion depending on the glasses you wear.)

The one bill currently in play is the Governor's proposed 1.5 percent surcharge on capital gains and dividend income between $500,000 and $1 million and 4 percent surcharge on capital gains and dividend income over $1 million. It's being marketed as a fairness fix but that claim objectively fails a couple of tests. For starters, unlike some other states, Minnesota already includes all net capital gains income in taxable income and subjects it to the same tax rates as apply to other income. As a result, Minnesota's progressive income tax structure already taxes this income at higher rates. In addition, as the accompanying table shows, over the past twenty years Minnesota's highest income earners have been steadily assuming an increasing share of the state's individual income tax burden accompanied by smaller changes in — or in the case of the top 1% declining — shares of state household income.

Fairness matters aside, relying on these income streams to finance permanent credit relief and large spending increases is precarious for a few reasons:

- Volatility – Capital gains and dividend income tends to fluctuate with economic cycles declining when demand for government services are rising. According to an analysis done by MMB in 2015, tax income from net capital gains revenue is over 12 times more cyclically volatile than revenue from salary and wage taxation.

- Timing issues – Taxpayers are in control of when capital gains taxation is recognized. Such surcharges would be a powerful motivator to defer realizing gains until they die or move to another state.

- Migration Effects – It's a perpetual debate in Minnesota, pitting business, accountants, and financial planners against progressive interests each backed by their experiences and scholarly research. But under the new tax credit regime, the fiscal impact of the departure of any high-income earner will be magnified significantly. That's because the use of credits and combinations

Table 1: History of Household Income Share and Share of Income Taxes Paid by Minnesota Top Earners

	Share of Household Income Top 1%	Share of State Income Taxes Paid Top 1%	Share of Household Income Top 5%	Share of State Income Taxes Paid Top 5%
2021 Incidence Study	16.5%	27.0%	31.9%	47.1%
2011 Incidence Study	16.2%	24.6%	31.2%	43.2%
2001 Incidence Study	17.3%	23.4%	31.4%	40.9%

Source: MN DOR Tax Incidence Study for selected years, shares based on population deciles

3 "The Long-Term Decline in Fertility—and What It Means for State Budgets" Pew State Fiscal Health Project, December 5, 2022

4 "Supply-Side Economics Needs a 21st Century Update: Responding to Cato's Dan Mitchell on Middle-class Tax Cuts" AEI Blog, August 21, 2014

of credits will be reducing or zeroing out a lot of household tax liability elsewhere. How much is unknown but it will build on the 25% of adults in this state that the Department of Revenue reports already pay no income tax.[5] For example, based on our most recent individual income tax comparison study, if a single $1 million married filing jointly household would leave the state, 32 new families with two dependents at the $75,000 income level would be needed to make up for the lost income tax revenue. With the new tax credits this "high earner dependency ratio" would be many multiples larger because much or all of that household's $2,296 of income tax liability would be eliminated.

Another important consideration in the fiscal responsibility calculus is that Minnesota is now more dependent on individual income taxation that at any other time in state history. In such a weird and strange moment in state budget history, it seems fitting that protecting Minnesota highest earners is one strategy to help ensure the fiscal responsibility and viability of the DFL tax agenda. ■

How Does Minnesota's "Brain Waste" Compare?

A look at the extent of Minnesota "underemployment" in a time of full employment.

The state's February forecast revealed once again what employers around the state know only too well: Minnesota has a major workforce shortage problem. MMB reports state labor market remains one of the tightest in the nation, featuring the fourth lowest unemployment rate but the sixth highest labor force participation rate among states resulting in little workforce slack. There are two open positions for each unemployed individual. Employment growth going forward is further constrained by an aging workforce, and lower levels of net immigration into the state.

However, behind these numbers is another potential issue for concern: worker underemployment, or failing to tap the full potential of human capital. Providing information and analysis of this issue is one focus of the Migration Policy Institute (MPI), a Washington DC-based, non-partisan research organization which "seeks to improve immigration and integration policies through authoritative research and analysis and the development of new ideas to address complex policy questions." While their primary interest is rooted in underemployment and skill underutilization among foreign born college educated individuals who have immigrated to the United States, their data analysis also offers insights into domestic born underemployment and the differential rates of underemployment among foreign born and domestic workers.

The MPI tracks what it calls "brain waste" – four-year, college-educated persons 25 years or older who are either unemployed or employed in unskilled jobs, i.e., jobs that require only moderate on-the-job training or less, such as construction laborers, taxi drivers, file clerks, or nannies. ("Brain waste" does not include employment in associate and technical degree employment) The MPI has issued several reports on brain waste trends, contributing factors, economic effects, and policy implications. In 2016, the MPI estimated federal, state, and local governments combined were losing $10 billion in taxes as a result of forgone earnings from underemployment.

In calendar year 2019, Minnesota had approximately 176,800 college educated individuals unemployed or underemployed in low skilled jobs representing 17.6% of the state's total civilian college-educated workforce.

State estimates of brain waste are based on information obtained from the U.S. Bureau of Census American Community Survey (ACS) as well as ACS microdata provided by the Institute for Social Research and Data Innovation located here at the University of Minnesota. As the accompanying table shows, Minnesota is a better performer than the national average with respect to both domestic-born and foreign-born workers and in the difference between foreign and domestic performance placing the state in the bottom 15 nationally in all categories. In calendar year 2019, Minnesota had approximately 176,800 college educated individuals unemployed or underemployed in low skilled jobs representing 17.6% of the state's total civilian college-educated workforce. An important caveat is that the latest information is for calendar year 2019 so table figures do not reflect post Covid labor market realities. However, MMB was already reporting "robust demand for workers and low unemployment define Minnesota's current, tight labor market" in the November 2019 economic forecast.

The reported rates of brain waste in combination with Minnesota's extremely tight labor market is both bit confusing and disconcerting. It suggests that not only do we face chronic workforce challenges but we are also not able to maximize the potential of the workforce we have. It also suggests some of the workforce shortages in especially hard-hit sectors like food and hospitality may be even worse than they appear now because they are being staffed by overqualified workers.

Some, perhaps much, of the explanation can be linked to mismatches between supply of college majors and market demand for those majors. Nationally, law and public policy, fine arts, and communications/journalism majors

Table 2: Percentage of College-Educated Workforce Underemployed*

	Domestic %	Rank	Foreign %	Rank	Domestic/ Foreign Differential	Rank
MN	15.6%	35	18.6%	39	3.0%	35
US Ave.	15.8%	NA	20.7%	NA	4.9%	NA

* Total civilian, college-educated labor force, age 25 +
Source: MPI State Workforce Datatable. Calculations by MCFE

5 "How Many Minnesotans Pay No State Income Tax?" MN Department of Revenue Tax Research Division, December 16, 2022

represented some of the highest shares of underemployed workers while, unsurprisingly, STEM and health majors represented the lowest levels. Job transitions, family developments, and related unique household circumstances may be other contributing factors.

There are other possible explanations that are policy oriented. At the top of the list are licensing and regulatory barriers to entry that limit opportunities for gainful employment for college-educated immigrant and U.S.-born workers alike. MPI reports the number of occupations that require licenses or certifications has increased from 5 percent in 1950 to more than 25 percent in 2015. Moreover, the process of obtaining licenses has become more complex and difficult to navigate. On a macro level it could also suggest that the current Minnesota business climate is failing to provide sufficient employment opportunities to utilize the supply that is available.

Minnesota lawmakers are preparing to invest hundreds of millions of dollars in a wide variety of workforce training and economic development related initiatives and public private partnerships to address workforce constraints and needs across industries. Such initiatives are invaluable but shouldn't distract the state from also looking at policies which create a regulatory and economic environment for new and existing firms to grow and thrive. ■