FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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A Special Session Hail Mary?

The Governor's enhanced rebate proposal raised the possibility of a special session focused on expanded tax relief. The numbers are accommodating but high inflation presents an economic and budget forecasting environment just as challenging as was experienced during the heart of the pandemic.

When talks collapsed earlier this month and Governor Walz met with reporters appearing to administer the last rites on the prospects of a special session, it was an outcome that was both a bit surprising and yet at the same time entirely predictable. Ample money was available to make a lot of constituents and causes happy, but the politics and realities of Minnesota divided government triumphed. Chalk it up to unbridgeable disagreements on priorities, a phobia of agreeing to anything before primary season, the lure of implementing a winner-take-all budget agenda in 2023, or some combination of all of the above – the way the session concluded has been experienced many times before. The only difference was the missing ingredient of actually needing to come to an agreement.

Now Governor Walz has indicated interest in a special session Hail Mary, apparently taking spending bills off the table and doubling his tax rebate proposal to $2,000 per family, $1,000 per single filer. One of the chief policy criticisms of a rebate proposal has been the exposure of the rebate to federal income taxation next year. This is already less of an issue than it was in pre-TCJA days since the potential taxability arises out of state tax deductions yielding a federal tax benefit, and the vast majority of Minnesotans now take the standard deduction and no longer itemize. The rebate would be designed as a refundable tax credit of either $1,000 or $2,000 against the state taxes owed on 2021 returns. The Department of Revenue would go back and automatically adjust returns since most taxpayers have already paid their 2021 taxes.

Republican leadership and candidates continued to dismiss the idea as a sign of political desperation and nothing more than an election year gimmick. With regards to the former charge, November may be part of the motivation, but doesn't change the reality that a lot of Minnesotans would welcome and benefit from the sweet smell of such desperation. As for being a gimmick, the definition is "something that is not serious that is used to attract people's attention and increase appeal." A similar claim might be leveled at the quarter point reduction in the first income tax tier agreed to in the Tax Conference Committee providing a statewide average of $75 of annual tax relief — or $1.44 a week. It checked the political box of providing permanent relief to all income taxpayers "week after week, month after month, year after year," with a Snickers bar every Friday to show for the effort. The point is, tax policy gimmickry will always be in the eye of the beholder.

It seems unlikely that Republicans would simply acquiesce to the rebate proposal without advancing their tax agenda as well. Some cut to the first-tier rate and/or full exemption of Social Security income (which both legislative bodies agreed to) are at the top of the list. But the Tax Conference Committee also agreed to a number of credit enhancements and related measures that were popular in both parties. Then there's federal conformity — which shouldn't be leverage in an omnibus tax bill in the first place — still needing to be addressed.

Add it all up, and a special session agreement offering a bigger rebate and permanent tax relief (perhaps along with content from other omnibus spending bills on which agreements were reached but didn't get through bodies) could quickly get expensive from a General Fund perspective.The Governor's enhanced rebate proposal alone would consume all of the $4 billion allocated for three years of tax relief under the now defunct agreement and over half of the approximately $7.1 billion in remaining current biennium surplus. Any permanent relief on top of that reduces carryover surplus and results in greater reliance on Minnesota's large structural balance currently forecasted for FY 24-25 materializing. Aside from the question of what tax relief would emerge from a special session, how much relief can be provided in these uncertain economic times without jeopardizing fiscal responsibility deserves a closer look.

Shades of 1991 or 1973?

If budget winds are shifting, it's not showing up yet. Minnesota's revenue beat continues largely unabated. According to the latest revenue update from MMB, general fund revenues in May were 40 percent more than forecast. For fiscal year 2022, year-to-date receipts are now $2.32 billion (9.4 percent) more than the upgraded forecast issued just 4 months ago. For the past several months MMB has cautioned a lot of this positive variance — currently estimated at about $1 billion — reflects the timing of pass-through entity (PTE) tax payments and refunds. The Department has stated it expects to see a reversion to forecast in these numbers as refunds from TY 2021 tax returns are filed and as estimated payments for TY 2022 are reduced. Although TY 2021 return pro-

Minnesota Center for Fiscal Excellence

Sarah Gette, *President*
Bob DeBoer, *Research Director*
Mark Haveman, *Executive Director*
Charisse Tester, *Office Manager*

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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

cessing is likely to continue for another 8 months or so, it's a bit curious that now in June the MMB's estimated "timing effect" is still nearly as large as it was in January. Regardless of when and how this shakes out, tax revenue collections are still robustly above forecast.

As a result of these multiple drivers that can severely impact the economy all coming together at the same time, discussion of a more protracted period 1970's-type "stagflation" (slow/no growth with high inflation) has reemerged from 50 years of hibernation.

To some degree that is not surprising in an inflationary environment. Income and sales tax receipts will generally increase if inflation occurs, so a state is likely to see their revenues keep pace with moderate inflation. The problem arises when inflation moves from "moderate" to what we have today, prompting Fed action to bring inflation down without triggering a recession.

Even though the nation's economy contracted for the first time since 2020 in the first quarter, it still appears to be in decent health. The Federal Reserve of Philadelphia's Coincident Index employs four state-level indicators (nonfarm payroll employment, average hours worked in manufacturing by production workers, the unemployment rate, and wage and salary disbursements deflated by the consumer price index) to gauge the current state of the economy and recessionary risk in a single statistic. In its most recent release (May), the coincident indices for all 50 states remained positive indicating no immediate signs of a recession.

However, many major banks have significantly raised probabilities of a recession occurring within two years. A Wall Street Journal survey of economists put the risk at 44% within the next 12 months (Interestingly, in December 2007, the month that the Great Recession began, this same survey found only a 38% probability of a recession). High inflation and the Fed's efforts to quell it are the chief concern.

A survey of CEOs by The Conference Board found business leaders even less sanguine about the ability of the Fed to engineer a soft landing with 58% expecting a recession this year. These and other more pessimistic assessments are driven by supply shock considerations in addition to monetary policy such as worker shortages, continuing supply chain bottlenecks, and the war's impact on global commodity prices — all making taming inflationary pressures more challenging. As a result of these multiple drivers that can severely impact the economy all coming together at the same time, discussion of a more protracted period 1970's-type "stagflation" (slow/no growth with high inflation) has reemerged from 50 years of hibernation. Already the Fed's tightening of its benchmark rate to an historically modest 1.75% has propelled stock, bond, and cash (3-month Treasury) returns into a bear market. The last time this happened to all three at the same time was in the 1970s.

If a recession does occur, several forecasters offer hope it will be short and mild. For example, Wells Fargo has forecasted a peak-to-trough contraction of 1.3% for just three quarters. This would be a substantially milder contraction than the short-term pandemic-induced contraction of 2020 (10%) and the Great Recession (3.8%). The best analog for what could lie ahead may be the 1990-1991 recession. It lasted three quarters and featured GDP contraction in line with the Wells Fargo forecast (1.4%), but the similarities between then and now don't stop there. A San Francisco Federal Reserve autopsy on that 1990-1991 recession identified three major contributing factors: pessimistic consumers, attempts by the Federal Reserve to lower the rate of inflation, and elevated oil prices linked to Iraq's invasion of Kuwait.[1] Fast forward to today and all three of these factors are in play. The University of Michigan Consumer Sentiment survey found consumer sentiment in the US fell to a record low in June with expectations plunging to its lowest level since May of 1980. The Fed's recent 75 basis point increase in its benchmark rate increase is projected to be part of a year-long journey to around 3.5% by the end of the year. And no comment on oil prices is necessary.

How did Minnesota's economy and revenue collections fare during that recession? All things considered, quite well likely due to the state's diverse economy. Total tax revenues in FY 1991 (which covered the 8-month official duration of the recession) still increased by 3.4%. The current forecasted tax revenue growth for the second year of the current biennium is 5.6%. If history would repeat itself and a similar recessionary revenue impact would materialize, it would put about a $600 million dent in expected FY 2023 tax collections. That's not pocket change, but it wouldn't trigger anything close to a 2023 budget balancing scramble, especially in light of carryover surplus, full reserves, and the fact that revenue for the first year of the biennium are already well above the February forecast.

The Other Side of the Ledger

Fiscal responsibility is also a function of conditions and decisions made on the other side of the ledger, and today's inflation has direct and indirect ramifications for current and future operating budgets in the delivery of public services. Inflation has already taken a toll on state infrastructure projects of all types as the price of such essentials as piping, valves, steel, and asphalt have all exceeded CPI measures. According to the American Association of State Highway and Transportation Officials, the cost of projects has gone up by 20% - 30%, "wiping out the increase from the federal government that they were so excited about earlier in the year." [2]

State and local government operations are largely service organizations, so any inflationary repercussions primarily will be felt in payrolls – directly for state government employment and indirectly through state aids of all types (for example nearly 80% of all

[1] "The 1990 recession is a cautionary tale for today's economy" *Business Insider*, April 27, 2022

[2] "Inflation taking bite out of new infrastructure projects" *Associated Press*, June 19, 2022

K-12 education spending is compensation). Thanks to the compounding effect of annual cost of living adjustments (COLAs) with employee "step" (tenure) increases,[3] over half of the state's collectively bargained employee base received salary increases of 10.5% - 13% over the current two-year contract period which, when matched up with BLS data, has kept inflation-adjusted wages essentially flat. (For employees no longer eligible for step compensation, the story is different. COLAs alone have yielded salary increases slightly over 5% for the current biennium). The 2023 session can be expected to feature some challenging negotiations as unions seek to not just make many of their members whole but also provide some real wage growth. The current environment practically assures a notable response challenge with respect to wage-price inflation for government budgets next year.

A related issue, public pension health, has been out of spotlight for some time but has the potential to return to state fiscal debates with a vengeance. As noted earlier no asset class has been left unscathed from the start of the Fed's inflation fight. That's even true of private equity which has been the yield savior for many state pension funds including Minnesota (MN State Board of Investment private equity has averaged 15.9% over the past 20 years). As Bain and Company concluded in their 2022 global private equity report, "while most fund managers have never had to deal with inflation, they have certainly benefited from its absence."[4] Easy borrowing in a persistent low interest rate environment for two decades has been influential to private equity's run of success. Inflation now poses the dual threat of rising costs for portfolio companies and muted growth in "multiple expansion" — how much more buyers are willing to pay for a dollar of enterprise value when they are sold or IPOed (which has exceeded both business revenue growth and margin improvement combined as the primary source of returns in the industry). On the liability side, pension funds will once again be burdened by new actuarial shortfalls. Benign inflation assumptions will likely fall short of actual wage increases, creating new unfunded liabilities.

Without question, Minnesota is in as good a fiscal shape as it could possibly be in advance of any economic turndown. Nevertheless, the significant uncertainties surrounding the length and severity of such a downturn deserve to be considered in any decision-making this year should a special session materialize. Whether this was a conscious consideration in the now obsolete "4 billion for relief, 4 billion for spending, 4 billion for saving" agreement or not, it reflected this possibility and was a significant departure from the dramatic tax cuts and major new spending proposals offered earlier in the session.

There is no reason not to offer tax relief this year and some good reasons to do it. But the possibility of persistently high inflation, and a hard landing in efforts to control it, is real. And we shouldn't be shocked if future forecasts, much like the forecast volatility experienced throughout COVID, offers surprises — albeit this time in a different direction. ■

[3] Step increases are now routinely called "merit increases." We believe "step" or "tenure" still most accurately describes this compensation feature for two reasons: 1) step compensation is given for satisfactorily meeting job expectations and performance standards, not exhibiting outstanding performance or excellence as the word "merit" implies; and 2) the state's default action is to grant everyone their annual step increases. In other words, providing steps does not require an affirmative notification or action by management. Instead, refusing a step increase requires a manager to give the employee a written notice that the step increase is to be withheld because of less than satisfactory performance. If that notification is not given to the employee prior to the employee's anniversary date, the step increase is automatically granted. According to the latest information we have from MMB, 92% of step-eligible employees receive their step increases.

[4] *Private Equity's Inflation Challenge*, Bain and Company, March 2022

How Does Minnesota Government Employment Compare?

A look at the latest Census of Government findings and the type of questions they can prompt.

The 2022 legislative session exposed the strong political disagreements that exist on what government's spending priorities need to be. But it also revealed an undercurrent of frustration and doubt about how efficiently spending programs are being managed and administered. Aside from the merits of the spending proposals themselves, legislators frequently questioned the administrative appropriations accompanying them, questioning the justification of the need for more personnel to – for example – administer incrementally larger amounts of grants or take on expanded tasks.

These comments prompted us to take another look at what the latest data tells us about how Minnesota state and local government employment levels and compensation compare to the rest of the country. We examined preliminary estimates from the 2021 Annual Survey of Public Employment & Payroll (ASPEP) released in May. The ASPEP measures the number of state and local civilian government employees and their gross monthly payroll in March of each year by government function. Federal agencies, state and local

Comparison of 2021 Minnesota Total State and Local Government Employment Levels and Compensation by Selected Function*

Government Function	FTE per Capita Above (Below) U.S Average	MN Rank	Payroll per FTE Above (Below) U.S Average	MN Rank
Financial Administration	55.8%	5	20.7%	4
Other Administration	42.3%	8	5.6%	14
Corrections	(13.4%)	34	8.3%	15
Police Protection with Powers of Arrest	(23.1%)	44	3.5%	16
Total Police Protection	(21.4%)	43	3.6%	15
Judical and Legal	(2.6%)	28	11.7%	9
Highways	42.9%	16	14.0%	10
Natural Resources	44.1%	17	11.7%	8
Parks and Recreation	(0.1%)	24	21.0%	4
Public Welfare	72.9%	3	17.5%	9
Housing and Community Development	2.0%	16	9.7%	5

*U.S. weighted average (not simple 50 state average)
Source: 2021 Annual Survey of Public Employment & Payroll, United State Census Bureau

MINNESOTA CENTER for
Fiscal Excellence
85 East Seventh Place
Suite 250
St. Paul, MN 55101
(651) 224-7477

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Twin Cities,
MN

governments, and educational and research organizations use the data for a wide variety of purposes, including comparative studies of state and local government employment and wage and salary negotiations by state and local governments.

We examined full time equivalent (FTE) employee counts per capita and payroll per FTE in several functional areas of government (see table on previoius page). As we prefer to do with our annual total spending publication How Does Minnesota Compare (HDMC), this table reports combined state and local government totals, since states can differ significantly on how responsibilities for service delivery are allocated between the state and local levels – making "apple to apples" comparisons problematic. Unlike our HDMC publication, no adjustments were made to payroll to account for cost-of-living differences among the states.

Historical comparisons of total state and local government employment levels have long found that Minnesota tends to run somewhat "leaner" than other states but with higher levels of compensation. Although from a macro perspective that may continue to hold true, comparisons across specific functional areas of government offer some notable variances. Some are readily understandable, for example our higher levels of employment in natural resources and highways certainly reflect, at least in part, Minnesota's larger management and service responsibilities in these areas compared to other states. The significantly higher relative levels of employment in government administration are likely influenced by the fact that Minnesota ranks 9th in the nation in the number of general purpose local units of government per capita. Recent developments and Minneapolis' police staffing shortfalls notwithstanding, below average levels of state and local employment in the area of total police spending goes back several years.

The data itself is not sufficient to draw any conclusions on what the appropriate size of government workforce in these functional areas can or should be. Each state's demographics, geography, policy decisions, and residents' preferences for public services will have an impact on the demand for and composition of government employment across specific functional areas. However, such benchmarking can flag curiosities and relationships deserving of further investigation.

For example, Minnesota has long been among the national leaders in public welfare spending,[5] so a larger workforce than the average state in this area might be expected. However, Massachusetts ranks right behind Minnesota in total public welfare spending in national rankings, is also a high-income state, and serves a population about 1.2 million larger than Minnesota. Yet according to Census data, Massachusetts employs about one-third fewer employees across state and local governments in the delivery of these services. Assuming this is not a survey response coding/categorization difference or a data anomaly (which doesn't seem to be the case as previous survey findings show similar results), this begs for a closer benchmarking examination of how the delivery of these services are organized across governments, designed, administered, and staffed.

Yet this is precisely the type of understanding that is seemingly never at hand when such questions are asked, even when resources are available to truly consider system improvements. Without this understanding, we have seen how budget battles evolve: proposals for large indiscriminate cuts to base agency operations in an unfocused attempt to drive efficiencies into the system, and proposals for large spending increases based on an assumption that existing agency systems and programs are already organized and operating on their efficiency frontiers. Neither approach do taxpayers any favors. ■

5 "Employees engaged in all public welfare activities, including those involved in administration of public assistance programs as well as those providing direct assistance. Includes: Administration of medical and cash assistance, general relief, vendor, and other welfare programs. Maintenance of nursing homes or other institutions for the benefit of veterans or needy persons (contingent upon their financial or medical need). Provision of veterans services, senior citizen and handicapped transportation, services to the homeless, and child services (such as foster care, adoption, day care, nonresidential shelters, and the like). Social workers. Regulation of private welfare institutions and activities. For local governments, vocational rehabilitation for blind and other handicapped, in the form of commercial activity, is reported here rather than at Education." *U.S. Bureau of the Census Government Finance and Employment Classification Manual*