# FISCAL FOCUS

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*Sound tax policy. Efficient spending. Accountable government.*

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## In This Issue:



## Finish Line

*Resistance to the continuation of the governor's emergency powers was a formidable obstacle but rejecting over $2 billion in economic benefits spread across the state entailed its own political risk.*

Music may "hath charms to soothe the savage breast," [1] but music can't hold a candle to what capital equipment expensing and $1.9 billion in capital projects spread across the state can do to mollify lawmakers. After months of increasingly antagonistic rhetoric about the continuation of the governor's emergency powers, accusations of bad faith negotiations, and internecine party squabbles, the Legislature passed a combo bonding/tax/supplemental budget bill in its fifth Special Session. Seldom has a bill been a target of so much disparagement during its legislative journey and ultimately pass with such bipartisan support.

To be sure, its passage was far from a kumbaya moment as both House and Senate members on their respective floors leveled some strident criticism of both legislative process and bill substance. Criticism of process centered on backroom negotiations, legislative maneuvering (the House adjourned sine die after passing it creating a "take it or leave it" proposition for the Senate), and perhaps the mother of all violations of the state constitution's single subject rule. It's fair to say this constitutional provision now functions like the 55 mile-per-hour speed limit on I-94 in the Twin Cities: regularly ignored, never enforced, and adhered to only out of a sense of civic obedience — in which the practical result is needing more time to arrive at the destination.

Yet in the end, the elusive three-fifths majority in the House was achieved with plenty of votes to spare. And even though the bill on the Senate floor was likened to, among other things, rancid milk, garbage, and Mr. Potato Head (some metaphors aren't quite as intuitive as others), those sentiments didn't stop it from passing on an overwhelming 64-3 vote.

Interestingly, it turned out relatively little tweaking was needed to transform a bill declared "dead on arrival" earlier this summer into something signed by the governor. According to House Fiscal Analysis, the general obligation portion of the $1.89 billion bonding bill increased only by about $17 million from the July version. As might be expected, much of that modest increase went to House Republican districts. Supplemental budget appropriations went from $58 million in July down to $31 million at the beginning of the Special Session #5 before rebounding to $44.8 million at the end after salary increases for state troopers and personal care attendants were added in final negotiations. The biggest change from July lay in the tax article as the agreement permitted only one "cost" item from the Senate Republicans' tax want-list to be included. Unsurprisingly, that item was Section 179 expensing. It has a conspicuous budget impact, and its inclusion was immediately brought up by Democrats whenever Republicans questioned the fiscal responsibility of the overall package. Yet 179 conformity had considerable bipartisan support, was clearly a condition of the Senate's buy-in, and had long been recognized as something which ought to be done. **Table 1** summarizes the General Fund impact of the bill.

**Table 1: SS5HF1 General Fund Impact – Spending and Revenue Changes (in thousands )**

| | FY 20-21 | FY 22-23 |
|---|---|---|
| Capital Investment (debt service and general fund appropriations) * | $52,480 | $89,418 |
| Supplemental Appropriations | 44,828 | 10,723 |
| Taxes (decline in revenue collections) | 90,000 | 117,940 |
| **Subtotal – General Fund Impact** | $187,308 | $218,081 |
| **Less: Spending Offsets** | | |
| Bond Refinancing | ($41,666) | ($5,785) |
| FMAP Increase 4th Quarter (October- December) | (59,456) | 34,400 |
| Premium Security Plan Account Transfer | (105,000) | 0 |
| COVID Relief Fund Transfer (for eligible general fund support spending) | (10,000) | 0 |
| **Subtotal – Offsets** | ($216,122) | $28,615 |
| **NET GENERAL FUND IMPACT** | **($28,814)** | **$246,696** |

* Capital Budget – Provisions include:
$1.38 billion of general fund supported general obligation bonds,
$300.3 million of trunk highway bonds,
$147.7 million of appropriation bonds
$14.8 million user financed general obligation bonds.
$38.8 million of capital projects financed directly by the general fund

Source: House Fiscal Analysis Department

[1] We learn something new putting together every issue — it really is "breast."


**Minnesota Center for Fiscal Excellence**

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The direct general fund impact is $187.3 million in the current biennium and $218.1 million in the next biennium. However, the current biennium impact is mitigated by three spending offsets:

- State bond refinancing this August has yielded an estimated $41.7 million in current biennium debt service savings.
- The federal government has again extended (now through December) the temporary 6.2 percentage point increase in the federal match for the state's Medical Assistance program saving the state $59.5 million.[2]
- A $105 million transfer to the General Fund from the State's Premium Security Plan account which provides reinsurance payments to health insurers to cover the cost of high claims in the individual market. (Even with the transfer the plan is still projected to have sufficient resources to meet demand through the current scheduled ending date.)

Additional current biennial savings may materialize if local governments are unable to commit all of their federal CARES appropriation in the few weeks and these funds revert back to the state. It is a mortal lock that the state will do everything in its power to find ways to spend all unused state and local CARES dollars to mitigate general fund spending within the relatively broad confines and constraints of federal guidance. In addition, at the end of this calendar year, any unobligated funds from the COVID-19 Minnesota Fund created earlier this year must be transferred back to the General Fund. However, any savings from these potential offsets is not likely to be large. Local governments also have every incentive to spend all their state appropriation to mitigate the health and economic impacts of COVID. And as of mid-October, only $18.8 million of the COVID-19 Minnesota Fund remains unauthorized.

Even with the tax relief, bonding, and supplemental spending, HF 1 still reduces the current biennium deficit by $28.8 million thanks to these offsets. The same can't be said for FY 22-23 as the Governor's signature tacked on about a quarter billion dollars of fiscal impact onto whatever deficit materializes in the November forecast.

There is some good news on the budget front from MMB. October revenue and economic update show Minnesota revenue collections solidly exceeding the May 2020 interim budget projections. Net general fund receipts for the first quarter of FY 2021 are $593 million, or 12.7% more than projected in May. Collections from nearly every tax supporting the general fund is exceeding its forecast. Yet MMB notes that estimated income tax payments are still 2% lower than the same period one year ago and general sales tax receipts are about 3.8% lower than the same period a year ago. That's not necessarily a Great Recession-like collapse, but any year-on-year declines in the state's two tax revenue workhorses foreshadow problems. And the challenge is compounded with a counter-cyclical increase in demand for government services. For example, Minnesota has already been identified as one of three states whose Medicaid rolls have grown by over 13.5%. [3]

The evolution of the virus and the November elections will have a considerable influence on how the 2021 biennial budget debate plays out. But our budget destiny really resides in Washington. Another big package of relief that this time includes aid to compensate for lost state and local tax revenues would be the welcome music needed to soothe lawmakers' temperaments. Without it, the unpleasantness marking this year's regular and special sessions will almost assuredly crescendo. ■

# COVID's Fiscal Footprint

*What is COVID's impact on state and local finances and family financial security? A National Tax Association publication offers some analysis as well as perspective on what it may mean for any new round of federal support.*

When Covid-19 hit earlier this year, governments acted quickly and spent a lot of money to deal with an unfamiliar health and economic foe. Speed was of utmost importance requiring state and federal governments to take a lot of action based on incomplete information on the virus itself and the economic consequences of its presence.

To foster a better understanding of what we are facing, the venerable National Tax Association invited a number of scholars to assemble a "first look" at the fiscal impacts of the COVID-19 crisis and a snapshot-in-time assessment of what the policies accomplished. The fall quarter issue of its National Tax Journal is devoted entirely to the topic. We take a look at a couple of papers of particular interest and their potential relevance to future state budget discussions.

## Implications for State Government Tax Revenues

One of the major limitations of the federal government's COVID response is that the avalanche of cash delivered to states was only for COVID-related expenses. The federal government's guidance on what types of spending would qualify for COVID-related reimbursement was quite accommodating. However, no money could be used to make up for lost tax revenue from a decline in economic activity stemming from the pandemic.

How much money do states need to make up for this revenue loss? To answer that question researchers examined the pandemic's effects on state government sales and individual income tax revenue collections.[4] Together these two critical revenue streams comprise 85.5% of states' total own source general tax revenues.[5]

The revenue impact is a function of two components: 1) the change in the tax base due to the decline in economic activity; and 2) how sensitive individual state tax revenue collections are to the changes in tax base. Using the Congressional Budget Office's revised macroeconomic forecast to identify tax base effects, researchers translated the size and composition of the economic shock into changes in state government revenues. This was accomplished by gathering information on individual state government tax

[2] The continuation of the 6.2 percentage point increase in the federal match for the state's Medical Assistance program through the end of year requires the state to meet certain requirements. One of those is that recipients cannot be removed from Medical Assistance for a certain period of time even after they lose eligibility including the time higher rate is in effect. As a result, the $59 million in FY 21 savings is offset by the $34.4 million more the state is expected to spend on the program in FY22-23.

[3] "Medicaid rolls swell amid the pandemic's historic job losses, straining state budgets" Washington Post, September 14, 2020

[4] "Implications of the COVID-19 Pandemic for State Government Tax Revenues" Clemens and Veuger, National Tax Journal September 2020, pp 619-644

[5] Based on 2017 U.S. Census data. General sales and Individual income taxes comprise 61.4.% of all state general revenue from own sources, the difference being the inclusion of "charges and miscellaneous revenue."

bases and mining the considerable research history that exists on the sensitivity of tax revenues to economic shocks.

For the current fiscal year researchers projected the mean state revenue shortfall would be $303 per capita, split almost equally between individual income and sales taxes. Unsurprisingly, there is considerable variation among states due to differences in tax bases and tax reliance. Minnesota's exposure was determined to be about 15% above the national average. That translates into a projected FY21 revenue shortfall in the neighborhood of $1.9 billion compared to what we would otherwise collect if the pandemic did not exist. For comparison purposes, MMB's forecasted individual income and sales tax collections for FY21 prior to COVID was $19.7 billion last November and $17.1 billion this May, meaning a COVID-induced revenue shortfall of around $2.6 billion.

These figures offer perspective on the amount of aid the federal government would need to provide states to offset pandemic-created income and sales tax shortfalls. The $303 average per capita figure translates into $106 billion in federal aid to make up for lost state income and sales tax revenues in FY 21. That's substantially less than the $500 billion the National Governors Association requested earlier this year for revenue replacement purposes and less than half of what the last iteration of the House of Representative's HEROES ACT would have provided to states for this purpose ($238 billion).

However, a lot of general state revenues are derived from miscellaneous charges, fees, and other taxes also likely to be impacted by COVID-19. These declines are not factored into the NTA author calculations. A separate analysis conducted by the Cleveland Federal Reserve Bank estimates what Minnesota's "all in" FY 21 revenue loss / replacement income need would be.[6] As might be expected it all depends on the nature of the economic recovery. The estimate of lost revenue in a V-shaped recovery is a "relatively" modest $800 million. The "slow recovery" estimate is $2.5 billion – a figure that appears to largely track with the estimates generated by the NTA researchers if an additional $500-$600 million on top of individual income and sales tax shortfalls seems reasonable. A major "second wave" scenario is projected to result in a $4.6 billion revenue shortfall this fiscal year. Regardless of how accurate the estimates are, the message is clear: the evolution of the virus in the state in the next 2-3 months is going to have a huge say about our budget destiny.

## The Impact on Cities

A similar investigation was done to estimate the impact of the pandemic on city finances.[7] Like the previous state-focused study, researchers assembled a counterfactual of what city revenues would look like absent the pandemic, then generated estimates of own-source revenue declines and state aid reductions to estimate city revenue shortfalls. Researchers generated estimates under both a "less severe" and a "more severe" pandemic scenario.

A challenge in investigating city finances is that the structure and organization of the services city residents receive from government varies widely across the country. For example, the revenue needed for a service obligation in one city may be a county function in another. To address this problem, researchers used a specialized database (created and managed by our *50-State Property Tax Comparsion Study* partner, the Lincoln Institute of Land Policy). It combines fiscal data from city governments with a prorated share of both expenditures and revenues from all overlying governments. The result is detailed revenue and expenditure data that reflect total revenues raised on behalf of city residents and businesses and public spending carried out on their behalf. The 150 "fiscally standardized cities" (or "FiSCs") included in this study account for almost 75% of the residents of the principal cities comprising U.S metropolitan areas and include at least two cities from each state.[8]

Table 2 presents the estimated average growth (decline) by revenue type in FY 21. As might be expected, researchers found big differences in the sizes of shortfalls among cities – a function of, among other things, tax dependency, employment base, and how the fiscal condition of states affects the ability to provide/maintain local aid. For the 150 FiSCs included in this investigation these declines translate into total revenue shortfalls of $34.2 billion in the less-severe scenario and $55.3 billion in the more severe scenario.

Cities' relative reliance on property taxation is the major reason why aggregate shortfalls differ so much among cities. The revenue stability that property tax reliance provides is an underappreciated quality of the tax. The ability of local governments to offset declines or increases in property values by changing nominal rates (but collect the same amount of levy) is the key to this stability, and a feature of the tax that is commonly misunderstood by taxpayers. Political messages to voters suggesting greater reliance on property taxation is something akin to contracting shingles has undoubtedly left some challenging municipal finance situations to deal with around the country.

Nevertheless, the pandemic's influence on property values, the resulting shifts of tax burden, and the implications for raising property tax revenue in the future is something to watch. Researchers flagged the uncertain future of urban commercial office space, noting a Stanford economist who was recently quoted as saying he could "easily

**Table 2: Estimated Growth (Decline) in Revenue for the Average "Fiscally Standardized City" in FY 21**

| Revenue Source | Less Severe Scenario | More Severe Scenario |
|---|---|---|
| Property tax | 1.5% | (0.5%) |
| General Sales Tax | (6.8%) | (11.7%) |
| Local income Tax | (9.4%) | (11.75%) |
| User fees and charges | (5.0%) | (10.0%) |
| Selective sales taxes, other taxes and miscellaneous | (15.0%) | (15.0%) |
| State Aid | (9.6%) | (13.8%) |
| **Aggregate Shortfalls** | **(5.5%)** | **(9.0%)** |

6 "How Much Help Do State and Local Governments Need? Updated Estimates of Revenue Losses from Pandemic Mitigation," Whitaker, Federal Reserve Bank of Cleveland, June 29, 2020

7 "The Fiscal Effects of the COVID-19 Pandemic on Cities: An Initial Assessment,"Chernick, Copeland and Reschovsky, National Tax Journal September 2020, pp 699-732

8 Minnesota cities included in the analysis were Minneapolis and St. Paul. Unfortunately, no city-specific results were presented for either city.

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**FUTURE DIRECTIONS IN FEDERAL TAX POLICY AND STATE IMPLICATIONS: A POST-ELECTION ASSESSMENT**

In light of the election results and in a time of extraordinary economic uncertainty and exploding deficits, our panel of DC tax experts will discuss what tax policies will be pursued, what should be done, and what it may mean for state tax policy decision-making.

**Doug Lindholm**, President and Executive Director, Council on State Taxation, Washington, DC

**Karl Frieden**, Vice President and General Counsel, Council on State Taxation, Washington, DC

**David Brunori**, Senior Director, RSM, Washington DC, and Research Professor of Public Policy, Trachtenberg School of Public Policy, George Washington University

**10:00 - 11:00: Presentations**

**THE 2021 SESSION LANDSCAPE: STATE ECONOMY, BUDGET, AND POLITICS**

**State of the State Economy:**
**Sean O'Neil**

Director, Economic Research, Minnesota Chamber of Commerce

**State of the State Budget:**
**Jim Schowalter**

Commissioner, Minnesota Management and Budget

**State of State Politics: Todd Rapp**
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see downtown skyscrapers in the center of some big cities falling in value by 60, 70 percent." [9] Meanwhile, unlike in the Great Recession, housing values remain robust and continue to grow. Any distributional shift from commercial value onto residential value will be compounded by the leverage that exists in Minnesota's classification system. Assessment/taxation lag times may dampen this effect for a while, but some very interesting Truth-in-Taxation hearings may lie in the state's future.

Regarding state aids, researchers observe states are in much better shape to address budget shortfalls compared to entering the Great Recession. But they also observe most state governments close budget gaps by relying heavily on spending reductions in responding to a recession. (An interesting fact: from the start to the end of the Great Recession, the sum total of state government-enacted revenue increases was less than 1% of all state general fund revenues.) The state aid reduction estimates reflect this history.

How state aids fair in state budget-cutting circumstances is another critical factor. The historical answer is "not well." Minnesota local governments are certainly not alone in struggling with how state government treats them in difficult economic times. State aids to the average FiSC continued to decline for four years after the official end of the Great Recession and by 2017 was still 7% below its 2007 value. In Minnesota, general purpose aids to local governments have often been one of the first targets for reduction for the simple reason in stressed economic times the state has its own service delivery obligations to protect. It will be interesting to see if the nature of the pandemic and its impact on local government alters policymaker perceptions about state budget cutting priorities.

Expanding the estimates to all types of local governments in the U.S. yielded an estimated aggregate revenue shortfall of between \$102.9 and \$165.2 billion. The latest iteration of the HEROES act would commit \$178 billion to local governments.

### Impact on Family Financial Security

Congress targeted about \$560 billion of the \$2 trillion CARES Act to individuals to

9 "American Skyscrapers Face an Uncertain Future Amid Coronavirus" PBS Newshour June 4, 2020

## From The Director:
## Minnesota's "Must Do" Sits on a Department of Revenue Bookshelf

In a recent interview, Governor Walz declared every option needs to be on the table as legislators face the prospects of tackling two multi-billion dollar budget deficits simultaneously. In addition to the usual "go-to" items of tax increases, budget cuts, and program reforms, there is another plan of action that deserves priority attention. Best of all, we have an excellent blueprint already in hand on how to do it. It's bringing tax expenditures into the biennial budget process.

Mark Haveman

Tax expenditures are tax exclusions, deductions, and credits providing beneficial tax treatment to support favored activities or assist favored groups of taxpayers. They exist on the Venn diagram of tax policy in the increasingly shrinking area where the Republican and Democrat circles actually overlap. Republicans like them because, in spite of their commitment to lower taxes, their constituents still want government to do things. Indirect "spending" through the tax code is the way to accomplish these legislative goals while appearing true to tax cutting principles. Democrats like them because they can incentivize all sorts of societal outcomes and behaviors in a highly targeted, "non general fund threatening" way — and sell them to Republicans as tax cuts.

The evidence of their bipartisan appeal can be found in the number of new tax expenditure bills introduced every legislative session and their growing presence in our tax system. Readers of our member publication *Legislative Spotlight* know that counting tax expenditure bill introductions and commenting on their increasing creativity and complexity has become a bit of a hobby of ours. At least three dozen are practically guaranteed to be introduced every biennial budget session in all areas of state taxation. Most of these don't make it into law, but many do. The 2017 tax bill alone enacted 10 new income tax expenditures and expanded two existing ones.

Tax expenditures are not by definition bad policy. They can support important public policy goals. They also cause tax rates to be higher than they need to be, introduce significant amounts of administrative complexity and cost into the tax system, can create perverse incentives, and violate important tax principles like treating equals equally. Contrary to popular belief they do not shrink the size of government. Taxpayers who do not benefit pay higher rates for the same size of government. If forgone revenue would have been used for a rate cut, the size of government has gone up not down.

The biggest problem is that once put in place they continue to exist without any review and evaluation process to examine outcomes and the merits of keeping them. As legendary tax expert (and father of the term "tax expenditure") Stanley Surrey said long ago, "Unless attention is paid to tax expenditures, a country [state] does not have its tax policy or its budget policy under full control."

In 2010, the Department of Revenue brought together a distinguished group of economists and public policy experts from across the political spectrum to tackle this problem. Their 2011 report, "Bringing Tax Expenditures into the Budget Process" is a careful and comprehensive examination of how to establish such a review infrastructure. The report's 25 recommendations cover evaluating whether tax expenditures meet their purpose, folding them into the budgeting process, improving the state's acclaimed Tax Expenditure Budget Report, and making this information more accessible to the public.

The final report and its recommendations never really got any traction. That's not particularly surprising since a thoughtful approach to addressing a complicated problem is a lot less sexy than a "hit list" for immediate action. The fact that creating such an evaluation infrastructure would require some resources certainly didn't help matters either.

Establishing such a process today may not be able to yield the instant gratification and immediate returns lawmakers will be looking for in grappling with the budget decisions they are facing. But these are precisely the times when otherwise politically difficult subjects can be —and need to be —brought forward. Putting this on the to-do list is a timely and critical investment in our state's fiscal future.

— M. H.

improve household financial security. Enhanced unemployment insurance (UI) benefits and direct cash (stimulus) payments comprised nearly all of this total. Another group of researchers examined to what extent and for how long these CARES benefits would help families cover their normal monthly expenses during unemployment.[10] Using federal Survey of Consumer Finance data, researchers examined this issue on several different dimensions including family type, income levels, ethnicity, and employment exposure. Researchers calculated a "baseline" coverage of monthly expenses consisting only of existing household savings plus normal unemployment insurance. The additional impact of CARES benefits on financial security was evaluated relative to this baseline.

Researchers concluded the bonus unemployment and stimulus payments have a major impact on improving the fragile financial security many working households face. Thanks to the magnitude and progressive nature of federal CARES benefits nearly all working families are able to cover normal, recurring monthly expenses for six months — with an important caveat. For many working families the CARES Act actually improves household financial security compared to normal times.

A few of the noteworthy findings:

- Among all working families, only 54% are able to cover normal monthly expenses for 6 months of job loss (through September, 2020) from household savings and

[10] COVID-19, the CARES Act, and Families' Financial Security," Bhutta, Blair, Dettling, and Moore, *National Tax Journal*, September 2020, pp 647-672

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regular unemployment insurance. The addition of CARES Act cash assistance enables 94% of working families to cover these expenses.

- The ability to cover normal monthly expenses begins to taper off and accelerate downward beyond the six-month period of CARES assistance. By December, only 85% of working families can cover these monthly expenses and less than 70% by March. Without the CARES Act less than half of working families are able to cover expenses through the end of this year.

- Within the lowest income quartile of working households, only 29% are able to cover monthly expenses for 6 months with savings and regular unemployment benefits. The inclusion of CARES Act benefits enable 97% of these families to cover monthly expenses. Within the highest income quartile (whose regular monthly expenses are almost 3 times that of the lowest income quartile) 73% of families would be able to cover 6 months of expenses with savings and regular unemployment benefits. Interestingly, with CARES Act benefits, 93% of these families can cover monthly expenses for 6 months. That's a notable improvement but a lower percentage than lower income households. Researchers observed "the progressivity of CARES benefits not only removes disparities by income in financial security, but actually leads to relatively higher levels of financial security in the bottom two income quartiles."

- Ten percent of working single parent families have savings to cover six months of household expenses. With the CARES act 91% of these families are able to do so.

The caveat to all this is the assumption that households are able and willing to save any benefits in excess of monthly expenses to cover future monthly expenses. Events like an unexpected health care expense, a needed durable good purchase, or some other unforeseen expense would affect these findings.

## What Comes Next?

This is hardly the extent of COVID's fiscal footprint. Another investigation concluded "coronavirus has created an enormous and expensive challenge for elementary and secondary schools while simultaneously depleting the revenue sources on which public schools depend." Still another found that each percentage point increase in the annual unemployment rate generates an additional $31 in per capita spending as demand for social insurance programs increases.

For all these reasons it should not be surprising that Federal Reserve Chair Jerome Powell has recently said failure to provide more federal support could have "tragic" economic consequences. "At this early stage," he said, "I would argue that the risks of policy intervention are still asymmetric. Too little support would lead to a weak recovery, creating unnecessary hardship." [11]

The prospects for further federal action are on hold at least until after the election and likely into 2021. In the meantime, it's important to learn the lessons from the experiences now playing out in our neighboring states. An ounce of prevention is now worth $2.6 trillion…and counting. ■

[11] Presentation to National Association for Business Economics, October 5, 2020