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MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

- What Makes a State Tax System Competitive?
- Redesigning the Minnesota Price of Government
- The Politics in Tax Education

What Makes a State Tax System Competitive?

Highlights from the presentations and discussions at our 88th Annual Meeting of Members

A record crowd of nearly 200 members and guests attended the MCFE's 88th Annual Meeting at the St. Paul River Centre on October 8th. Following our early morning business session, this year's policy forum focused on what makes a state tax system competitive. A distinguished group of national and state experts engaged in a wide-ranging discussion on how to take this influential but rather abstract concept and turn it into policy reality.

Commissioner's Update

As is our custom, the policy forum began with a presentation by Department of Revenue Commissioner Myron Frans who offered some perspective on the topic of the day while also highlighting several departmental initiatives. He argued that the competitiveness of a tax system shouldn't be simply defined by tax levels but rather should be defined and viewed in the broader context of the economic trends and issues facing a state; or in his words, "where have you been, where are you going, and what are you buying."

Where the state has been and where it is going was the primary focus of his message to attendees, and it was clear that the Dayton administration believes that getting the fiscal affairs of the state in order should be recognized as an important consideration in the broader competitiveness debate. He highlighted the improvements achieved over the last few years including balanced budgets absent special shifts, a budget surplus for the first time since 2007 and only the third since 2002, and elimination of the state's payment obligation to schools. He noted that other tax policy achievements, specifically highlighting the improvements that have been made in the "fairness" or progressivity of the tax system in recent years, should not be overlooked.

Based on his significant travel around the state, Commissioner Frans suggested that the third dimension – "what are you buying" – resonates most strongly with citizens and small business owners with respect to taxes and competitiveness. Businesses he met with, he said, seldom suggested major structural reforms to the tax system. Any tax-related recommendations they offered typically centered on incremental changes of more tangible and immediate benefit such as the upfront sales tax exemption on capital equipment purchases. Instead, he said, the importance of obtaining good value and results from tax revenues was the predominant theme in discussions of taxes, job creation, and economic growth.

He concluded by noting that tax competitiveness is also influenced by simplicity. He noted that the Department continues to make strides in this area, citing Revenue's "plain language" initiative as well as other administrative efficiency improvements such as requiring submissions of certificates of real estate value in electronic form.

How and When Do Taxes Matter?

Are taxes becoming more or less of a competitiveness concern for states? How much of a state's competitive position and economic performance can be linked to tax policy? And given all this, what improvements should Minnesota pursue? These and related questions were the focus of the subsequent policy roundtable featuring a distinguished group of tax and policy experts moderated by MCFE board member and former revenue commissioner Ward Einess. Panel participants were House Tax Chair Ann Lenczewski, Tax Foundation Vice President Joseph Henchman, Council on State Taxation President Doug Lindholm, Texas Taxpayers and Research Association President Dale Craymer, and economist and author Edward Lotterman.

The consensus among all participants was that state and local taxation absolutely continues to matter, but how much it matters is a much more complicated issue heavily influenced by context. Aside from the straightforward issue of comparative tax burden, critical contextual issues affecting taxes' influence on competitiveness include the type of firm one considers, the structure of the tax system, and how productively tax dollars get used.

Taxes matter in the first place, Joe Henchman argued, because they are fundamentally an incentive, and incentives affect behaviors in both planned and unplanned ways. While acknowledging that a plethora of public goods and other factors influence expansion and siting choices (noting one study finding that the residential preferences of the wives of CEOs was an influential factor in establishing corporate headquarters) he categorically rejected the notion that taxes "don't matter"; there is ample academic and anecdotal evidence to the contrary.

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He continued that taxes matter in another way. How Minnesota chooses to collect revenues to finance its "high service" competitiveness model, he argued, is also important. As a principal investigator in the Tax Foundation's widely cited business climate study which focuses specifically on tax structure, Henchman noted Minnesota's historically poor ranking. "Different taxes matter in different ways" he said. Moreover, there will always be disagreement about which taxes matter most because the perfect tax system doesn't exist. "Every state has strengths, every state has weaknesses and the tax system should reflect that."

Doug Lindholm offered a perspective from discussions with his membership by describing a two-stage process used for siting and investment decisions and the role of taxation within that framework. The first stage includes evaluating 20-30 candidate locations on key factors and their costs. Taxes are included in this review. He noted that once upon a time, the tax review was largely limited to an examination of rates but today's reviews have become much more sophisticated and detailed. Out of this review companies develop a finalist pool of perhaps 3 or 4 locations whose overall cost structures are essentially competitive with each other. At this point tax incentive programs become a political reality, which is another real but controversial way that "taxes matter."

Texas' Dale Craymer offered three primary policy areas where state decisions can have a major impact on competitiveness and economic performance: regulatory, tax, and education. Reiterating the importance of context, Craymer argued the policy area that matters most will depend on the type of business. Based on his experience, tax considerations are most important for capital-intensive industries.

Different Paths, Similar Results

Both Texas and Minnesota are known for their economic performance and both are routinely cited as among the best places for business by national media. Yet tax regimes and cultural attitudes toward government could hardly be more different. What does the juxtaposition of these two states tell us about tax competitiveness and state competitiveness generally?

Dale Craymer began by suggesting one of the most beneficial competitiveness actions Minnesota could take would be to find a giant pool of hydrocarbons under the state. But he did note that after stripping out the effects of the oil and gas boom, Texas's economic experience was largely a mirror image of Minnesota's. Craymer believed his state's more friendly regulatory structures have been a bigger contributing factor to Texas's economic success in attracting and expanding businesses than its tax policy.

Representative Lenczewski reflected on the fact that while most everyone would agree that Minnesota is a high tax, high service state, it's not clear to her "that this is negative." Minnesota's economic success, she believed, is partially attributable to smart tax policy ideas that we have incorporated into the tax code such as single sales apportionment, exemption of business personal property from the property tax, and avoiding overreliance on any one tax. Above all, she said, "we use our revenues to buy great public services and make our mark on our people."

Ed Lotterman echoed this notion that how government uses tax revenues primarily influences Minnesota's competitiveness. "Taxes are a means to an end," he said – the end being the provision of public goods needed for a market economy to function and be efficient. Lotterman also questioned whether the pursuit of ambitious major restructurings of tax policy in pursuit of competitiveness objectives is worth the effort because such a pursuit will inevitably crash head on with important political, cultural, and historical realities. He argued that these realities are no less a part of a state's tax system than the rates and other tax code features themselves. He argued for an incrementalist course – seeking to make marginal changes around the edges in support of desirable outcomes.

While recognizing that incrementalism can and has worked for some states, Joe Henchman cautioned against reflexively being too timid. Sometimes major overhauls of the tax code are needed. He cited several examples of tax systems around the country that are so sclerotic with special provisions that they calcify growth and do major harm to the state economy. Under these circumstances, big ambition is an asset – not a liability.

All panelists agreed that the primary challenge states have in improving their tax competitiveness is not a lack of ideas but in the politics of change. Representative Lenczewski said she believed there are ample opportunities for improvement in all areas of the tax code; but the real problem is not conceptual but practical. The three issues policymakers face when considering any change are 1) can they sell it, 2) who is going to pay for it and 3) who is not going to be happy about it.

Doug Lindholm concurred, adding "if the public had greater understanding of tax system we'd be better off." He noted several examples of how public misunderstanding and misperceptions about business taxation – often fueled by various advocacy groups – prevents policymakers from making progress. Much of COST's work, he said, centers around educating citizens and legislators on important issues such as how much businesses across the country actually pay in taxes, the ratio of taxes businesses pay to the benefits they receive from those tax dollars, and the tax rates on new business investment. Representative Lenczewski agreed that public perception of how taxes work is often inaccurate and that educating legislators is very important. This is especially true in the area of tax expenditures. She noted that educating these groups is absolutely essential to bringing them on board with the changes you want to make, because without them change is impossible.

A Look at Specific Taxes

With respect to the competitiveness of specific Minnesota taxes, panelists offered several interesting and some surprising perspectives. Unsurprisingly, the new fourth tier of the Minnesota income tax received considerable discussion. Lotterman expressed disappointment with the degree to which politicians, both nationally and here in the state, have focused on only taxing the rich. Even though literature is often ambivalent on the mobility issue, there is always competition between states and there can be repercussions if something becomes too great of an outlier. How big those repercussions are and to what extent they occur is a challenging empirical issue.

It might seem that Texans would consider the state's lack of an individual income tax as a cornerstone of their competitive advantage. However, Dale Craymer believed Texas' lack of such a tax is not particularly beneficial to business and is frankly "overrated" as a competitiveness factor. He saw two ways in which a lack of an individual income tax clearly benefits Texas: siting of corporate headquarters (since high end executive talent likes not having to pay state income taxes) and small business formation. However, he noted in all his discussions with members and prospective members that are looking to build a manufacturing plant in Texas, "the fact that their workers would not have to pay personal income tax has never been a factor." For these reasons he thought the Tax Foundation's weighting of the personal income tax in their tax climate study (about 1/3 of total) is too high and the individual income tax is "not a big driver of most business investment decisions."

Joe Henchman countered by noting that the OECD has studied which taxes affect location decisions the most, and the corporate income tax and the individual income tax rank first and second respectively. While property taxes draw the ire of many businesses, studies have not shown that they have a statistical effect on business location decisions. He also emphasized that the vast majority of new businesses formed in the United States today are structured as pass through entities. This is unique to the U.S. and there is a lot of speculation – much of it centering on regulation – as to why this is. Nevertheless, most new business income is subject to the individual income tax and to the extent a state has very high marginal rates, it will impact the success of those businesses.

With respect to sales taxation, significant discussion centered around the challenges of following good tax policy principles by expanding sales taxes on end-users' consumption to reduce more harmful taxes on income and capital formation. According to Doug Lindholm, one reason why progress in this pursuit is so rare is that after you exclude business-to-business services from the expansion – as one absolutely should – the money "is just not there." Plus, this is exceptionally difficult to do from a political standpoint because lobbyists representing the interests which a sales tax base expansion would affect immediately mobilize.

Representative Lenczewski agreed that sales tax base expansion is politically difficult, noting that this idea has been floated during DFL, Republican, and Independence Party control of the Governor's office and failed every time. For legislators, she said, "taking one bad vote is hard enough; this is like getting stabbed with a toothpick a thousand times." States are unlikely to expand their sales tax bases until faced with a huge fiscal crisis. Even then, she continued, the public education issues discussed earlier will raise their heads making the task all the more difficult. The public simply doesn't distinguish the difference between B2B and personal consumption taxes. Perhaps the best thing we can do is to expand our efforts to exempt business inputs from sales taxes.

Dale Craymer said the sales tax expansion debate reflects "the disconnect between academia and reality". Consumption taxes don't work well for taxing services because so many are B2B or interstate commerce. Administration and enforcement, he noted, is no picnic either. Until the federal "Main Street Fairness Act" passes, he suggested, the

From The Director: The Politics in Tax Education

One of the more interesting and entertaining discussions at our Annual Meeting concerned the tension between what good tax policy says we *should* do and what the political realities of state and local taxation say we *can* do. It's been a frequent topic at annual meetings over the years including last year's event that focused on tax incentives. All our panelists agreed that efforts to better connect sound tax principles with policy outcomes must begin with improving public understanding of taxes and our tax system. For an organization like this, that's music to our ears.


Mark Haveman

What doesn't get enough recognition, however, is how politics also influences these educational efforts. The politics of taxation doesn't just make tax policy improvements hard, it makes public education difficult too. For starters, important tax policy ideas are too often used and then disposed of as political circumstances dictate. As our last biennial budget session demonstrated, business tax incidence is the Dixie Cup of tax concepts — embraced in arguments over tax system fairness to consume every drop of regressivity that business taxes offer, but tossed into the trash when the discussion turns to the amount of revenue that needs to be collected.

Nowhere is this problem more evident than in policy debates surrounding property taxation. If the property tax was sentient, it would sue policymakers for libel and assault. Few understand how our ridiculously complex system works, but that's not necessarily a bad thing because that complexity can be a political asset. The fact that complexity and confusion exacerbate citizens' inherent dislike of the tax is a bonus. If you beat property taxation like a piñata, election certificates and elected majorities fall out.

So should we accept property tax loathing as an important part of the political, cultural, and historical heritage of our tax system and accommodate it in our tax policies? Or should we embark on the excellent but dormant recommendations of the bipartisan 2012 Property Tax Working Group by first trying to improve public understanding and respect for the tax? We obviously recommend the latter, but like the adoption of tax reform itself, we have to temper our expectations. Politics makes slow, protracted incrementalism the reality of tax education as well as tax reform.

Our thanks again to all our members and guests who joined us at our annual meeting. A reminder: the 2015 dues statements will be coming out in the near future for calendar year members. Thanks to a generous member, **all new memberships and membership level upgrades will be matched dollar for dollar up to $25,000**. Please consider help us take advantage of this extraordinary opportunity to better make your voice heard. Contact us for more details.

— M. H.

distortions consumption taxes create in the marketplace make it dangerous for states to over rely on them. He said a "tone of reality" needs to temper these discussions. Ed Lotterman concurred again noting that tax systems also have a strong political component and it's important to have a tax system that matches the political culture of the state.

Henchman argued against too easily dismissing the findings and conclusions of academia. He noted that most people wouldn't second guess the opinion of an airline pilot or surgeon, yet find it easy to completely dismiss the conclusions of tax experts and scholars – even when there is essentially complete consensus like the inadvisability of taxing business to business inputs. There is no escaping the fact that public opinion will frequently push for the exact opposite of good tax policy but policymakers should pursue it anyway.

What to Do?

What's the best idea Minnesota can pursue to create a more competitive tax system? Henchman argued that policymakers should simply "listen to the good people in the room." Choosing to be a high tax, high service state, he said, does not mean that there aren't ways to improve Minnesota's competitiveness by improving how that revenue is collected. Harkening to the discussion at last year's annual meeting, Lindholm encouraged continued careful, prudent, and thoughtful tax incentive policy noting that – like it or not – incentives are an economic development reality that companies will continue to use to separate equals in the final stages of siting decisions.

Representative Lenczewski argued that after a tumultuous few years, it is time to "take a breath" on tax policy and work on marginal improvements such as further business input exemptions, focus on spending improvements, and if possible reduce the "sticker shock" of our higher statutory rates. She reiterated that how we spend tax revenues heavily influences Minnesota's competitive strength. Craymer encouraged Minnesotans to rethink how we evaluate our tax system. He argued that there is a tendency to place too much emphasis on evaluating tax systems through the lens of revenue collection – where it comes from, how much, whether revenue sources appropriately "balanced" etc. Instead, he argued, it's important to really understand how taxes affect businesses. That will tell you much more about how your tax system affects the economy and allow you to build a strategy accordingly. Administrative and compliance costs, he also noted, are often-overlooked dimensions of a tax system's impacts on the "real economy". Lotterman stated it was more important than ever to find political consensus on manageable, incremental improvements. Tax expenditures and funding for transportation infrastructure, he argued, are the two areas likely offering the greatest potential for improvement.

Richard Davis: The Bigger Competitiveness Picture

As the nation's 5th largest commercial bank, headquartered in Minnesota (and which pays a significant amount of Minnesota taxes), U.S. Bancorp has a major stake in Minnesota competitiveness. As the leader of U.S. Bancorp, and also being engaged in a myriad of philanthropic endeavors touching nearly every dimension of the Minnesota economy, Chairman, President, and Chief Executive Officer Richard Davis offered attendees a unique and highly engaging perspective on Minnesota's competitive situation and the opportunities and challenges before us.

Richard Davis
CEO U.S. Bancorp

At its core, he began, competitiveness is essential to the continuation and fulfillment of the American Dream. Recent polling has found only 39% of the population thinks their children will have a better life than they have had. Such numbers are a troublesome commentary on citizens' economic perspectives and expectations, and competitiveness is an essential ingredient in erasing this pessimism. Davis made it clear that he thinks our state's and nation's best days are in front of us.

What are Minnesota's strengths? Davis highlighted several, starting with the extraordinary concentration of Fortune 500 companies in this state. Such an incredible asset is the envy of the nation and deserves our "love and respect" in developing policy. Our philanthropic activity is second to none. Finally, as countless media reports and think tank analyses have found, we are in the top ten in most every dimension of foundational competitiveness – health, workforce, quality of life – the lists are seemingly endless.

What are our challenges? Davis identified several policy concerns and one very large attitudinal problem. Our educational achievement gap, he began, is a problem that should upset all Minnesotans. Our high taxes, he noted, are recognized across the nation and internationally, and the wage effects of individual income taxation in locating and compensating business talent is real. The propensity for Minnesota spending growth to exceed economic growth rates raises questions of sustainability. And transportation infrastructure is now a critical issue. Paying for infrastructure, he commented, is just part of the challenge. Businesses are increasingly demanding concrete evidence that transportation spending is both efficient and nimble enough to prioritize and allocate on the basis of need.

According to Davis, the overarching attitudinal problem is that we do not have a "burning platform" – a sense of urgency that causes us to continually investigate ways to improve and protect our position of economic leadership. Pride and confidence based on our economic past and present might be becoming a liability. As an example, he cited the business-to-business tax debate from the 2013 legislative session. Despite repeated statements from business leaders across Minnesota about the exceptionally damaging effects this broad scale expansion of sales to business inputs would cause, the seriousness of the concerns did not resonate with elected officials. It took significant effort to get the attention of policy makers on the importance of the issue; including direct involvement of CEO's of several large Minnesota based companies. All parties need to be engaged in the policy debates and advocate for a positive environment in the State.

Davis argued that Minnesota needs a role reversal between business and government in the fiscal policy area. Instead of business having to continually justify the legitimacy of competitiveness concerns, government instead should have to prove to citizens that current tax structures are not, in fact, outdated, that tax revenues are in fact going to the right places, that its spending priorities are proper, and that the state has the ability to adjust to circumstances as needed. It should be incumbent upon government, he said, to "profile the competition" and demonstrate that Minnesota is indeed engaging in best tax and fiscal policy practices and is embodying an ethic of continuous improvement.

Turning more specifically to the issue of the day – tax competitiveness – Davis identified several tests of a competitive state tax system. It needs to align not just with other state tax systems and the federal system, but also with the realities of the global economy. It needs to reduce revenue volatility. It should reduce inequality. It should facilitate the economic expansion and job creation that generate additional revenue. It should be aligned with spending that improves the economic climate, most notably education, infrastructure, and the environment. And, perhaps above all, it should demonstrate a potent return on investment.

"The intersection of taxes and benefits is value," he said, "and our challenge is to make sure the tax burden is balanced with the benefit." This concept, he argued, will become increasingly important as pressure builds over the coming years to use tax dollars for equity and redistributive programs in light of demographic changes. Davis predicted the next generation of taxpayers will be even more demanding of the value proposition of government spending.

For Davis (and likely many other Minnesotans), if Minnesota needs higher taxes because the benefits are that good and the returns on that marginal dollar are better, "he's in." But for Davis (and again many other Minnesotans) policymakers in turn need to be ready to prove that they are extracting the maximum returns from their existing revenues first.

Business Session

At the morning business meeting the following individuals were elected to serve on the MCFE board of directors and as officers. Our membership thanks you for your service to the organization.

Name	Affiliation
Jerry Geis	Briggs and Morgan
Jim Girard	Cook Girard
Jim Duevel	XCEL Energy
Jim Peterson	Carlson Companies
Patrick Shrake	Cargill
David Uphaus	BNSF
William Kusterman	Ernst & Young
Andrew Bosl	Ecolab
Jodie Scott	KPMG
Richard Forschler	Faegre Baker Daniels
Phil Albert	Medtronic
Mark Faulkner	Deloitte
Tom Hanson	Winthrop & Weinstine
Todd Rapp	Himle Rapp & Company
Chad Bailey	Target Corporation
Ward Einess	Einess Strategies
Beth Kadoun	MN Chamber
Jill Larson	MN Business Partnership
Jamie Jago	Allete
Katina Peterson	Dorsey & Whitney
Denise Bergevin	Blue Cross and Blue Shield of Minnesota

MCFE Officers:	**2014-2016**
President	Susan Haffield
Vice President	Tom Gottwald
Treasurer	Mike Nelson
Vice Treasurer	Jerry Geis
Secretary	Jim Girard

A copy of the Executive Director's report (slide presentation) highlighting the organization's efforts and accomplishments over the past year is available on our annual meeting webpage: http://www.fiscalexcellence.org/annual-meeting.html. ■

Indicator or Dashboard: Redesigning the Minnesota Price of Government

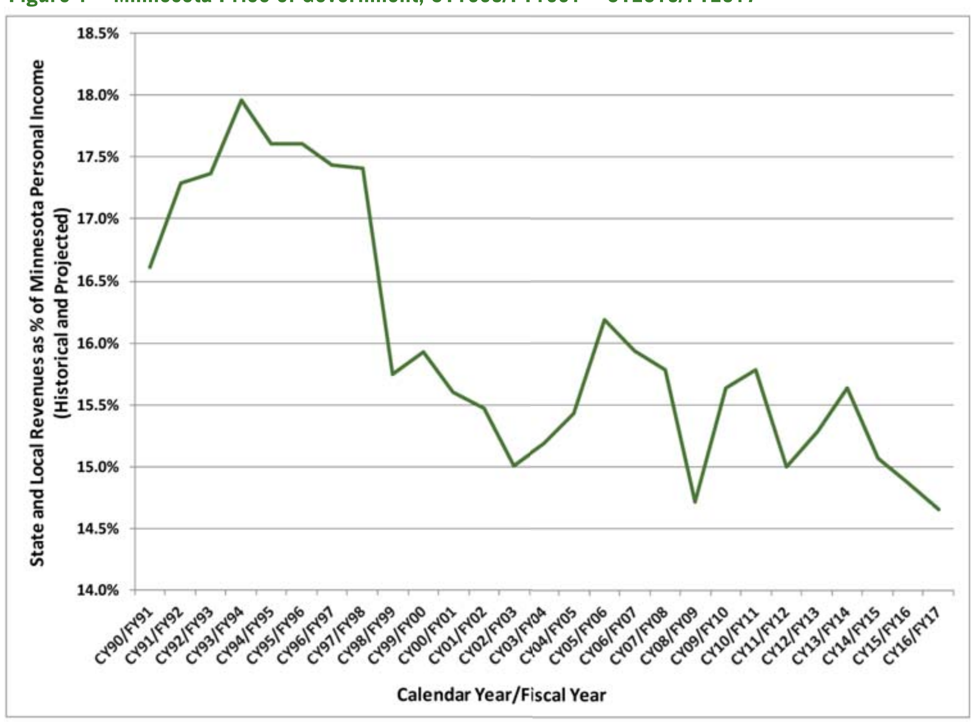
Minnesota's "Price of Government" report needs an upgrade. A look at why and how.

The history of politics is filled with quotes that became highly regrettable. Most of the time the only aftermath is some temporary embarrassment that fades quickly. But occasionally a statement lives on for years, becoming a long-term political liability that is difficult to shake.

Minnesota has a vivid example of the latter. In 1994, with bipartisan support and the hearty endorsement of business groups, Minnesota established the "Price of Government" (POG) report. Prepared by Minnesota Management and Budget (MMB), the POG report summarizes the "who, what, and how much" of revenue collection by all governments in Minnesota. The POG metric itself is conceptually simple – it equals the sum of all revenues directly raised by Minnesota's state and local governments (i.e. "own source revenue") divided by total state personal income. Policymakers designed it to measure the relative cost of state and local government by tracking their claim on Minnesota's economic activity. Or, in the fateful words of the Coalition of Minnesota Businesses, it would serve as "an index of what taxpayers can afford."

That quote is now a political millstone around the necks of those members of the business community seeking tax restraint and relief for a simple reason: not only is Minnesota's POG bouncing around all-time lows, MMB also projects the metric to con-

Figure 1 – Minnesota Price of Government, CY1990/FY1991 – CY2016/FY2017



Source: Minnesota Management and Budget

tinue to decline over the near future – in spite of the substantial tax increases enacted in 2013. (Figure 1).

It's a trend that advocacy groups have certainly noticed. In the battle for public attitudes about the level of government spending taxpayers can afford and its adequacy, the POG has gone from a topic for wonks to headline material in social media and editorial pages. It has metamorphosed from a "transparency tool" (as described by MMB) into focal point for tax and spending debates. Its ascendance is best captured in a recent editorial that declared the POG as "the state's truest bottom line." [1] And the strong historical endorsement of the business community is never rhetorically far away. Like naming rights for a football stadium, the phrase "business-backed" is permanently affixed to Minnesota's Price of Government metric.

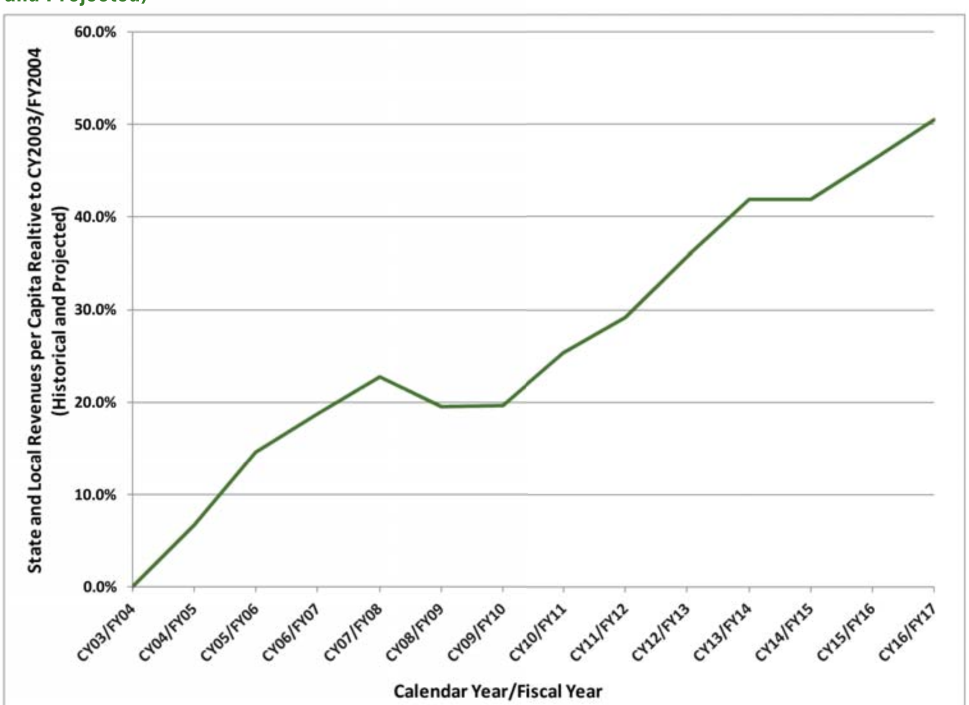
Per Capita vs. Personal Income?

On a political level, the POG provides an invaluable lesson: always understand exactly what you are asking for. According to the most recent POG report from this July, own source government revenues in Minnesota have grown by 3.9% per year on average since FY 2003, while state personal income growth has increased over that time at a 4.0% per year clip. Clearly, that math will yield a declining POG. But the logic embedded in the POG implicitly communicates an idea that government revenues (and therefore spending) ought to grow at the same rate as economic activity. That alone should have given long ago business supporters a lot of pause about the wisdom of championing this tool as a guide for developing state tax and fiscal policy.

On a more fundamental level, the question of what this measure does – and does not – tell you deserves closer examination. For example, calculating the POG on a per capita basis tells a very different story and communicates a very different trend. Spreading state and local government revenues across the state's population offers perspective on the burden government imposes on taxpayers to deliver public services to those same citizens. Over the past decade, own source revenue collected per capita increased 50.5%, or over $2,200 for every man, woman, and child using state and local services. Equally important, the projections going forward show the per capita Price of Government growing by 2.0% per year over the next three years, not declining as in Figure 1 when it is measured against personal income.

1 "Public policy in Minnesota: It's a 'we' thing," Star Tribune, August 18, 2014

Figure 2 – Growth in Per Capita Minnesota Price of Government Since CY2003/FY2004 (Historical and Projected)



Note: revenue data from Minnesota Management and Budget; population data from Minnesota State Demographer's Office; calculations by MCFE.

Which measure of government finances – on a population basis or a personal income basis – is "better?" It's a debate that has been around for ages, especially when discussing state rankings in taxes and spending. As our own national ranking publication, *How Does Minnesota Compare* routinely highlights, it's common for the rankings to vary when using different denominators. Advocacy groups, of course, will tend to report the metric that best supports a political message. Most public finance types would acknowledge that each measure communicates important information worthwhile to consider. A per capita measure communicates some sense of the actual burden on households while a personal income measure places that burden in the context of the state's economic health.

Some, however, insist that personal income measures are superior to per capita measures. The reason: states with high income-based rankings by definition will have high per capita tax rankings because they tend to receive less federal assistance, have higher labor costs, and have greater demands for public services because higher incomes can finance them. This rationale is an important consideration with respect to cross-state tax and spending comparisons but is irrelevant to the Minnesota Price of Government. The POG tracks change *within the state over time* rather than externally across governments at a single point in time. Minnesota's high-income status does not need to be normalized for comparative purposes.

In fact, any time-series data based on personal income needs to be interpreted with some degree of care. Why? Because the composition of personal income changes over time – and this has great potential to distort both trend assessments and common interpretations of the POG.

A Flawed Measure of Government Affordability

According to MMB, the POG "measures the relative cost of state and local government" and **"reflects how much of each dollar earned goes to support state and local government"** (emphasis ours). [2] Understandably, most citizens and legislators will interpret the POG as a "government affordability" measure based on these statements. But using the POG as a measure of

2 MMB Testimony to the Legislative Commission on Planning and Fiscal Policy, October 30, 2013

government affordability is problematic, for three reasons:

Taxpayers don't pay for government with "the broadest measure of Minnesota economic activity. As we reported in our 2013 issue brief *Minnesota's Troubled Price of Government*, twenty cents of every dollar of Minnesota personal income is non-cash income and can't be used to pay taxes. Such personal income elements include employers' pension and insurance contributions and the value of government sponsored medical benefits (principally Medicare and Medicaid). Moreover, the non-cash share of Minnesota's personal income has increased since the inception of the POG from 15% to 20%. While that may sound like a relatively small change, the practical result is that the actual amount of cash income that Minnesotans can use to finance state and local government services has grown $13 billion less than personal income overall – skewing the base considerably over time. As we also reported, using personal income to compute the POG means that it significantly understates state and local government's claim on cash income used to pay taxes. Substituting the household income measure used in the state's *Tax Incidence Study* yields a POG that is 20% to 35% higher, depending on the year.

If we want to convey a better macro-perspective on the trends in the affordability of state and local government, it would seem important to have a measure that evaluates governments' claims on the actual income people use to pay Minnesota taxes rather than the much more expansive federal definitions of personal income.

Tax and other cost exporting distorts the findings. The use of the word "price" introduces a consumer perspective: who is footing the tab for government services. Removing federal support and focusing only on Minnesota state and local government revenues collected certainly helps distinguish Minnesota's Price of Government from its much larger "Cost of Government." But even with this adjustment the solution to the question the report proposes to answer – "how much do Minnesotans pay to state and local governments in total?" – is complicated by the issue of tax and cost exporting.

Non Minnesota residents pay sales taxes while in the state. Out-of-state cabin owners pay property taxes to both local governments and the state. Excise taxes on motor fuels get passed along to people who "are on their way through". According to the latest *Tax Incidence Study*, Minnesota's state and local governments exported about $4.1 billion in taxes in 2010 and was expected to export $4.9 billion in taxes in 2015 – about 11% to 12% of total own-source revenues in those years. And of course, this doesn't take into consideration the non tax revenues – most notably out-of-state tuition paid to Minnesota's public colleges and universities – that also come from outside the state. Including all these exported revenues would actually lower the true "price" that Minnesotans themselves pay for state and local government services.

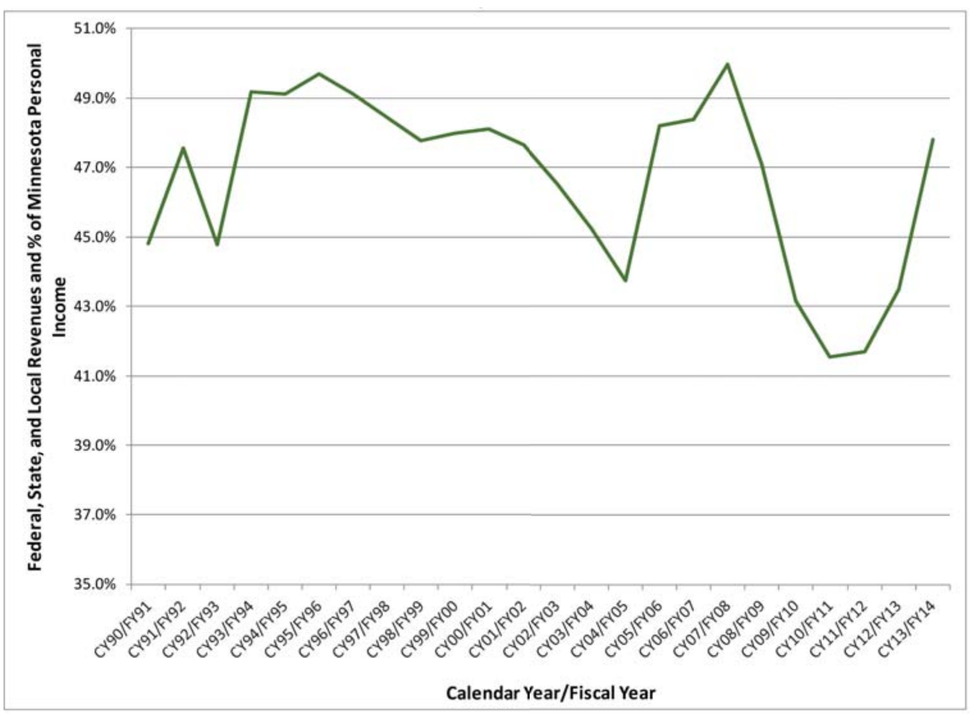
From a taxpayer's perspective, the analysis is incomplete. A commonly heard endorsement for the POG is that it's the only measure we have that provides a complete sense of the financial burden government places on Minnesotans. This is certainly true from a state and local perspective, but that sense of totality is limited by the exclusion of the biggest player of them all: the federal government.

Federal government revenues largely come from the individual income tax, but other notable sources include the Social Security/Medicare taxes, business income taxes, and excise taxes on alcohol, tobacco, and motor fuels. According to the IRS, in federal fiscal year 2013 net federal tax collections in Minnesota (i.e., gross collections less refunds issued) were $84.6 billion dollars – roughly twice the amount Minnesota's state and local government collected over a similar period. In total dollars, Minnesota's net collections that year ranked 9th nationally – federal taxes hit Minnesota relatively harder than many other states because our high-income status mean relatively higher individual income tax collections.

Bringing federal taxes into the analysis changes the picture dramatically, as Figure 3 demonstrates. Where the state and local-only POG generally ranges from between 15% to 18% of personal income, adding federal dollars brings the total government "take" up to 42% to 50% of the state's personal income. But bringing federal taxes into the equation doesn't just change the level of the POG, it also changes the trendlines. The state and local-only POG has declined about 15% from its highs in the early- to mid-1990s. After accounting for federal taxes, the POG for 2013 (we aren't able to project federal collections forward) is basically at the levels seen throughout the decade of the 1990s and above the average for 1990-2013.

If this topic sounds a bit familiar, it's because it's a mirror image of a criticism often directed at the *Tax Incidence Study* – that exclud-

Figure 3 – Minnesota Price of Government, Including Federal Collections, CY1990/FY1991 – CY2013/FY2014



Note: revenue data from Minnesota Management and Budget; population data from Minnesota State Demographer's Office; calculations by MCFE.

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ing federal taxes from the report presents an incomplete picture of the tax incidence on Minnesotans. It is frequently pointed out that state and local elected officials can only set policy on issues over which they have control. But such a perspective lacks a sense of realism with respect to evaluating the affordability of tax burdens. With the federal government taking a tax bite that may be multiple times that imposed by state and local government, it seems implausible to think that taxpayers do not notice this, don't care about this, and that it doesn't play a role in their assessment of the affordability of tax burdens.

Turning an Indicator into a Dashboard

Using our existing POG as "the state's truest bottom line" to help guide our discussion and our thinking on state tax and fiscal policy is akin to flying a plane by studying only the altitude gauge. In charting a responsible fiscal path (and ensuring a safe landing), looking at this gauge is important but it is also surely insufficient.

Rather, policymakers should expand and enhance the Minnesota Price of Government report to comprise a dashboard of metrics, each offering its unique and important insights to this important policy discussion. We suggest four complementary pieces: a per capita analysis to communicate trends in burden imposed for services delivered; a money income analysis to better determine the affordability of governments' claims on Minnesotans; an analysis net of tax and cost exporting; and an inclusion of federal taxation to offer a complete perspective of all governmental claims on the state's economic activity. Not only would this dashboard better meet the stated transparency goals underlying the Minnesota Price of Government report, it would offer a more complete perspective on governments' financial footprint.

In 2013, a hearing of the Legislative Commission on Planning and Fiscal Policy included testimony from MMB staff on the latest Price of Government findings. Following the presentation, a high-ranking senator was clearly struggling to understand the implications of these findings for decision-making. He asked some very basic questions of the testifier like "what should this tell me" and "how should I use this." The responses appeared to leave him unsatisfied. He felt some perspective still seemed to be missing. To the chuckles of the committee, the chair suggested he author a bill to change the POG.

That's a really good idea. ■