ness session, this year’s policy forum focused on a two issues making headlines – the push for greater “fairness” in business taxation and the disposition of the state budget surplus. A distinguished group of state and national experts engaged in wide ranging discussions of these important, and often politically contentious, issues.

Commissioners Update

The policy forum began, as is our custom, with a departmental update from Revenue Commissioner Cynthia Bauerly who provided an overview of some key departmental administrative initiatives as well as a look ahead to the forthcoming 2016 session.

Commissioner Bauerly began by highlighting the emphasis the Department has placed on taxpayer education and outreach over the past year – all with the intent to improve understanding of and compliance with the tax system and to ensure all taxpayers pay “no more and no less” than their obligations. She cited the over 1,000 outreach events the Department has conducted over the past year on issues such as sales tax withholding, business registration and tax filing. These outreach initiatives include the development of educational videos and further investments in their “plain language initiatives” which has won an award for state government innovation. Other noteworthy accomplishments include new e-subscription services that provide developments on tax topics of interest and the new electronic certificate of real estate value system – a major modernization and upgrade of what was once a labor and paper intensive process that offers significant value to real estate professionals of all types. The e-CRV system has also earned the Department an award for state government innovation.

Turning her attention to tax policy and legislation, Commissioner Bauerly noted that given the unusual way the 2015 session ended, 182 tax provisions remain open and are still on the table. Notably, the Department’s technical and policy bill, which contains a large number of important and vetted provisions, counts as only “one” of that total. More such provisions are likely to be added and combined with the $2.7 billion worth of proposals remaining open ($4.8 billion when fully phased in) plus the likely prospect of “last minute” federal extenders. Two economic forecasts before the start of the next session only adds to the uncertainty. There is considerable interest in figuring out ways to have the shortened 2016 session go as smoothly as possible. Rumors of early hearings may become reality as all indications suggest an exceptionally busy tax agenda.

Commissioner Bauerly concluded with a summary of the accomplishments of the past several years – among them being improvements in tax fairness, the payback of accounting shifts, and investments in the state’s rainy day fund. She noted Standard and Poor’s has issued an improved outlook which helps pave the way for the state to regain its triple-A credit rating. She also noted the twin goals of structural stability in state finances and necessary investments to secure our economic future will remain a focus for the Administration in the session to come.

Business Tax Fairness

How does the concept of “tax fairness” apply to business taxation? Does the pursuit of fairness require something more than compliance to existing law? If so, how can it be determined and what are the implications at the state, national and international level for business planning and operations? These and related questions were the focus of our 2015 tax panel featuring a distinguished group of state tax experts moderated by Council on State Taxation President Doug Lindholm. Panel participants were Gerald Morris, Vice President and Chief Tax Officer, General Mills; Scott Naatjes, General Tax Counsel and Vice President, Cargill; Judy McNamara, Vice President Taxes, Ecolog; and Jeff Hyde, Senior State Tax Counsel, IBM Corporation.

Framing the panel discussion, Doug Lindholm noted the concept of “business tax fairness” has two separate and very different interpretations. The first – preserving and promoting equitable and nondiscriminatory taxation of businesses - is well established as good public policy. The second interpretation is far more dubious and controversial: an expectation that businesses should conform to some preconceived societal notion
of fairness through their tax bills with an expectation that businesses should pay their “fair share” however that ambiguous notion is defined. The latter, he said, is receiving greater attention thanks to demagoguery from advocacy groups on tax avoidance that the mainstream press has eagerly picked up and reported on.

Highlighting numerous examples of recent provocative headlines regarding “corporate tax dodging,” and the hundreds of billions businesses “owe society,” he noted that despite the highly inflammatory, conspiratorial messages, there are no allegations of illegality or criminality. Rather, such messages are fundamentally premised on the notion that corporations are somehow not paying “their fair share” of taxes. This rather amorphous idea conflicts with the reality that: businesses are bound by tax laws, businesses have a fiduciary duty to minimize their obligations, and there is no patriotic duty to pay more than you legally owe. The fairness issue has special relevance in the United States, he continued, because we are only one of 6 countries using a worldwide system of taxation – i.e., a business head-quartered in the U.S. is taxed on all income earned worldwide. Even though a credit is given for taxes paid to other countries, the fact that our marginal corporate tax rate is the second highest in the world creates a huge disincentive to bring money back.

Lindholm continued by noting that what exactly constitutes a “fair share” of business taxation has been a topic for debate going back many decades. The establishment of the interstate highway system dramatically increased the mobility of capital in the United States, leading to issues of how to recognize and apportion income among the states and protect state tax bases. These complexities led to the drafting of the Uniform Division of Income for Tax Purposes Act (UDIPTA) in 1957 and the establishment of the Multistate Tax Commission to provide agreement and structure for managing these complex issues and making life easier for states and taxpayers.

Today, the digital economy has taken the concept of capital mobility to a completely new and international level, with even more opportunities for tax planning and even greater ability to move profits around. As a result, the complexities and issues surrounding tax bases and apportionment have increased exponentially. Unsurprisingly, this has prompted another, even more ambitious initiative: the OECD’s Base Erosion and Profit Shifting (BEPS) project, which Lindholm called “the international version of UDIPTA.” The parallels with the history of state taxation, he noted, are “amazing.” Like UDIPTA, the stated intent is to ensure that profits earned by companies are correlated with activities generating the profits. For UDIPTA the mechanism was formulary apportionment; for BEPS the mechanism is transfer pricing.

But the U.S. experience with UDIPTA offers a cautionary tale. Lindholm noted that sixty years later “nothing is easier for anyone” as many states have not adopted it and those that have often modified it. As a result, we have even less uniformity today. Such history does not bode well for this significantly more complicated and ambitious process.

How do business tax practitioners view the general idea of business tax fairness and major initiatives like BEPS to achieve fairness? Forum panelists offered considerable insights and commentary that occasionally seemed to be as therapeutic for them personally as it was informative for the audience.

Panelists began by reemphasizing the fundamentals – the fiduciary responsibility and obligations of business tax departments. Judy McNamara noted her department is not charged with designing business operations to avoid taxes; but rather to design tax strategies to accommodate business needs. “Business is the boat,” she said, pulling everything else along. Jeff Hyde echoed this idea noting that businesses make decisions based on return on investment. Taxes are a part of that calculation, he said, and more empirical data is coming out showing that taxation matters. Moreover, the lines between “international issues” and “state issues” are increasingly blurry. With respect to ROI, “states are simply part of the supply chain,” he said, and how they treat income coming back from overseas and its implications for ROI makes a big difference.

Jerry Morris expanded on the mobility issue, noting that “total shareholder value drives every decision General Mills makes and that includes tax.” U.S. companies are at a major disadvantage because incurring our effective tax rate significantly harms a key business objective – mobilizing capital without any cost or friction. Taxation puts real pressure on capital structure and competitiveness. A major problem influencing current business tax fairness agendas, he noted, is the “naïve arrogance we remain the center of intellectual property and the generation of ideas.” Noting General Mills’ global presence in research and development, he said intellectual property is mobile and can be generated or created anywhere.

Scott Naatjes questioned the thinking and fundamental premise behind business tax fairness, the idea of base erosion. “What is base erosion? Some measure of income that someone simply believes they should be able to tax.” He noted the problem with this idea can best be understood by the starkly different attitudes which exist toward the same economic activity. He gave an example of a foreign company choosing to build a major factory employing 1,000 people in a community. Local economic development professionals and governments who would benefit from the revenues would laud such a decision. But if the parent company charged a royalty to the factory and financed it with debt, the same company would be “cast as villains” by the OECD because the tax base was “eroded” with an interest payment and a royalty payment.

With respect to BEPS specifically, Naatjes spared no criticism and pulled no punches arguing it is a revenue grab masquerading as a fairness pursuit with potentially disastrous implications for business. “Don’t believe the BEPS effort is neutral, he said, “and don’t believe there is economic substance you can actually judge. What you are seeing is erosion in the rule of law.” He continued by saying BEPS is really an effort to cajole countries into increasing taxes on capital, and the question is who is going to dare to move first. “If you have different operations in five countries each with a different function – all five countries think they earned everything. That’s how BEPS works.”

Of primary concern, he continued, are the implications for operations in developing nations – where the judiciary is “routinely bought and paid for.” Revenue authorities with subjective standards plus unlimited information about every aspect of your operations are a recipe for disaster. “This will
Full disclosure: most of the incredible administrative and technical complexity surrounding corporate income taxation flies over my head at a cruising altitude of 35,000 feet. Moreover, I know I would be simply awful at this job. As my kids can attest, after ten-plus years, I still can’t apportion the last glazed donut fairly. Being responsible for complying with literally thousands of local, state, national and international tax laws (and in the process making sure all these governments get their “fair share” of company profits) would be an unmitigated disaster.

But you don’t need a deep background in tax accounting or tax law to recognize tax populism -- the pursuit of more tax revenue masquerading as a fairness problem. It’s marked by oversimplification, fatuous numbers, and statements of fact or reality that are misleading or just plain wrong. As our forum highlighted, there is a whole lot of that going around.

As long as we have corporate income taxation, we will have tax strategies and tax planning. As our panel emphasized, such behavior by business is not inherently evil, but responsible, professional, and above all legal practice toward fulfilling their fiduciary responsibilities. Of course there are some troubling, hyper-aggressive planning practices described by one of our panelists as “putting 5 people on a beach and declaring them a 16 trillion dollar company.” But another way to view this type of problematic behavior is that it’s what you have to expect, on at least some level, if you are intent on using an increasingly challenged, unworkable (and many economists would argue fundamentally dumb) tax in light of the modern global economy. The big question is whether there is enough duct tape and Gorilla Glue in the world to “fix” it without creating other, and even bigger, problems.

Caught in the middle is the tax practitioner who lives in this world and ties damsels to railroad tracks as a hobby. It was clear from the panel discussion that the demagoguery surrounding their work is not only annoying but also offensive on both a personal and professional level.

So next time you see them, give a hug to your neighborhood corporate tax professional. Chances are they need it.

— M. H.

Turning to state-level fair share initiatives, Lindholm raised the issue of “tax havens” noting that Montana, Oregon and D.C. have now published lists of tax havens. Jeff Hyde replied that in his discussions with states pursuing this idea he emphasizes that having a lower tax rate doesn’t make a country a haven, and if that were the case the entire rest of the world could be considered a tax haven compared to the United States. No less disconcerting is that “fairness” in state taxation of foreign generated income is often interpreted as “we deserve 100% of it.” States were once laboratories of democracy,” he concluded, “but have now become incubators of very strange tax concepts.” Judy McNamara commented that on a personal level she fully understands and appreciates the public and media frustration and headshaking with respect to the most aggressive tax planning practices reported in the news. “I get it” she said, and being grouped with such practices is frustrating. Ultimately, however, the lasting solution is to stop moralizing and fix the tax code.

Since every business tax dollar is ultimately reflected in higher prices, lower wages or lower returns on investment why in the pursuit of fairness are we taxing business at all? It’s a question that can probably only be raised in a forum like ours. Noting that the economic burden of taxation will be borne by the factor that has the least capacity to change, Scott Naatjes argued we are in a world where capital flows freely everywhere but labor and consumption is sticky. Thus, he maintained, the question of whether business is paying their fair share is really a question of how much you want to burden labor and consumption.

A related question, he continued, is why we would want to have a system that treats identical economic things differently. Different tax treatment of business structures, different treatment of organizational entities, and different treatment of debt versus equity – all of these introduce fundamental unfairness and friction in a business tax system. There are simple solutions, he maintained, but politically impossible to understand and advance.

Discussion turned to fairness in state compliance issues, specifically regarding non-resident withholding which varies significantly between states. Panelists highlighted the practical challenges and uncertainties surrounding non-resident withholding, as well as federal extender bills, and international reporting risk. As panelists noted, these issues not only have potential legal implications for companies but also entail real economic risk.

One hour of panel discussion could only scratch the surface of the controversial issue of business tax fairness, but two takeaways...
<table>
<thead>
<tr>
<th>Question</th>
<th>Anton</th>
<th>Rolnick</th>
<th>Banaian</th>
<th>Madden</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are you bullish or bearish on the Minnesota economy and what does that mean for the budget surplus?</td>
<td>Relatively bullish, 3% growth, but urged spending restraint because surplus is not as large as it is represented to be</td>
<td>Bullish — MN has one of the best economies in the world. Key is continuing investments in education</td>
<td>Little more bearish due to demographics, Washington brinksmanship, and monetary policy. Cautioned surplus might not be so large in 2016</td>
<td>Bullish — but estimates 35% chance of recession next year</td>
</tr>
<tr>
<td>What was one thing the Governor got right on tax and spending policy last session and one thing he didn’t get right?</td>
<td>Right: Education spending Not Right: failure to include tax expenditure reviews into the budget process</td>
<td>Right: $250 million for early learning scholarships for most vulnerable kids Not Right: Emphasis on taxing business rather than end consumption and using tax incentives to attract business</td>
<td>Right: education investments and use of power that executive office provides in budget creation Not Right: Unwillingness to improve budget process by embracing idea of program sunset reviews</td>
<td>Right: investing in education Not Right: Vikings stadium and health care exchange roll out</td>
</tr>
<tr>
<td>What’s the biggest threat to state budget stability?</td>
<td>Aging population and revenue mix (little less reliance on income taxes and more reliance on consumption taxes)</td>
<td>Over reliance on income taxes rather than consumption taxes</td>
<td>Tax and spending implications of aging population</td>
<td>Insufficient rainy day fund to accommodate revenue system volatility from reliance on income rather than consumption taxes</td>
</tr>
<tr>
<td>How do we know when we have spent “enough” on a public good or service?</td>
<td>Conduct rigorous cost/benefit analysis for all programs and policies and use that data to guide government spending and investment priorities</td>
<td>Whatever return on investment calculations tell us. For example, money for “ready to learn” programs including scholarships and health care return 18%. We have spent “enough” when every child in poverty has access to this. Also, don’t mix up government investments in public goods with government investment in private goods.</td>
<td>First, define public goods more carefully -- not everything government spends money on can be construed as a public good Second - conduct cost benefit analyses but respect that the “scale up” of big ambitions may require many strategies including private sector involvement rather than one big government program.</td>
<td>Emphasize return on investment but recognize that return on investment from the public perspective differs from the return on investment from private interests inside and outside government lobbying government.</td>
</tr>
<tr>
<td>What is the right Minnesota “Price of Government” and if you can’t determine that, why care?</td>
<td>Concur with Madden, people decide (and can vote with their feet). Competition among states can inform us whether current efforts to provide public goods and services at the best cost are working.</td>
<td>Shouldn’t care. It’s conceptually flawed in several ways and its popular political use as a way to track if we are spending “enough” voids cost/benefit analyses of programs which are what we really should be basing decisions on.</td>
<td>It’s what people want - the function of citizen preferences. People get to decide.</td>
<td></td>
</tr>
<tr>
<td>Should expenditure inflation be included in the budget forecast and is it all or nothing proposition?</td>
<td>Almost all or nothing. We need to put it back in to support realistic and responsible budget planning</td>
<td>We should include it for transparency and for responsible planning purposes</td>
<td>Government is a “monopoly” – a single buyer – and concepts like inflation aren’t helpful because governments have power to choose what it buys and how it buys it. As a result it’s impossible to know what inflation rate is but formal inclusion gives government reason not to look for efficiency improvements</td>
<td></td>
</tr>
<tr>
<td>Can and should the state do something about income inequality?</td>
<td>Concur with Madden. Vast redistributions of income without investments in self sufficiency are not a solution</td>
<td>Continue investment in early childhood education for most vulnerable children, followed by investments in transportation infrastructure</td>
<td>Use it to improve the tax system if such grand bargains can be constructed. If not return it to taxpayers to the extent that it’s really there or save it for next year</td>
<td>Focus should be on poverty reduction not income inequality and focus on education and health care accordingly</td>
</tr>
<tr>
<td>What should we do with the state surplus?</td>
<td>Be careful, it’s not nearly as that big as its being portrayed</td>
<td></td>
<td>Put it into the reserve – our surplus isn’t that big and economic downturns will eventually come</td>
<td></td>
</tr>
</tbody>
</table>
were clear. First, as Lindholm concluded there is “a wide gap between perception and reality” with respect to business taxation. Few outside of tax professionals really understand the issues and the complexities. Especially when it is so easy to prey on this lack of understanding to advance political agendas and bad policy, it is incumbent for tax professionals (and organizations like ours) to educate others on how the tax system should and shouldn’t work.

Second, the best definition of business tax fairness is adherence to all the principles of sound tax policy – competitiveness, administrative efficiency, transparency, stability, equity, and minimal economic distortion. States that do this well will have a very good chance to obtain the revenue they need without chasing capital away.

The Economists’ Look at the Surplus

By some expectations, the state budget surplus could be as large as $2 billion heading into the 2016 session with no shortage of proposals on both the tax and spending side on what to do with that money. Our second panel brought together a group of distinguished economists to obtain some advice regarding the surplus from those trained to look at the Minnesota economy from a big picture perspective. Participants included: King Banaian, Dean, School of Public Affairs, St. Cloud State University; Toby Madden, Principal, Power Parametrics; Art Rolnick, Senior Fellow, Humphrey School of Public Affairs; and Paul Anton, Anton Economics.

Moderated by former MCFE president Todd Rapp and taped for rebroadcast on Minnesota Public Radio, panel discussion focused on several relatively “rapid fire” questions on the budget and the general economy. The accompanying table summarizes those questions and our panelists’ responses (note that not every panelist answered every question).

In response to an audience question about whether an expanded sales tax base should be used to support transportation through general fund appropriations, there was unanimous support among the panelists for the continued use of the gas tax. The gas tax is an efficient tax, its user fee-like qualities conform well to the benefit principle of taxation, and as a general rule we should try retain the relationship between the funding of roads and the use of roads.

Can tax reform be part of the agenda? Anton suggested if there is political interest in tax reform now is the time to do it. Surpluses offer the opportunity to “buy down” political resistance from those negatively affected by reform. He noted there are many reform ideas from tax commissions past worthy of consideration if the motivation to pursue reform really exists.

What was especially intriguing about the panel was the significant amount of shared opinion and concurrence on so many issues. Panelists shared a sense of conservatism, tempered ambitions, and fiscal prudence with respect to the 2016 surplus. Concepts such as improving the budget process through regular and robust cost benefit analyses of programs, and movement toward greater reliance on consumption taxes were endorsed by all. From those trained to look at the Minnesota economy from a perspective beyond elective politics, this is advice well heeded.

Luncheon Speaker Douglas Baker: A Report Card for Minnesota

Doug Baker
Chairman and Chief Executive Officer, Ecolab

As a company with $14 billion in annual sales, serving customers in more than 170 countries, St. Paul-based Ecolab is keenly attuned to the issues and trends shaping the landscape for economic growth and business competitiveness. As the leader of Ecolab, Chairman and Chief Executive Officer Doug Baker offered attendees a unique and highly engaging assessment of where Minnesota currently stands through his “report card” for Minnesota.

“Grading” the state, he began, starts with understanding the economic and demographic trends shaping the state’s future. He discussed four key themes: the introduction of millennials into the workforce, the increasing diversity of the state’s population, the changing role and influence of technology (which he noted has really only just begun and puts us on the precipice of another industrial revolution) and the realities of a global marketplace. Given that backdrop, Minnesota should focus on attracting and keeping talent, ensuring education systems that work, and supporting the development and growth of industries that matter in light of these trends.

So how is Minnesota doing? Baker highlighted the much-heralded CNBC “Best Places for Business” scorecard, which recently ranked Minnesota first in the nation. He noted our number-one overall ranking is due to higher weighting given to our quality of life and education factors; our relative per-
performance on cost of doing business and business friendliness was substantially lower. He cautioned that it’s a mistake to think these other areas of performance don’t matter.

Revisiting the CNBC report, Baker graded Minnesota on each area of performance.

Overall, Baker gave the state a B-grade, noting that the primary concern in each of these areas going forward is “how” we deliver the results everyone wants, needs, and has come to expect along with the need to revisit programs and practices to improve the return on investment of tax dollars.

He added one final issue of concern not captured in the scorecard but nevertheless critical to Minnesota’s continuing competitive success: fiscal policy. Based on current trends, he noted, spending growth is projected to exceed revenue growth through 2025 by nearly 40% (7.4% versus 5.3%). This “growing spending imbalance” is exacerbated by what he called a “tippier” fiscal system based in part on more volatile revenue sources. Moreover, he said, projections assume stability which does not exist – the reality is, “spending growth accelerates when things get bad and revenue growth turtles.” Fiscal discipline with an eye toward sustainability is vital to our continued success.

Baker concluded with a renewed call for cooperation between business and government, heralding this important dimension of the state’s culture. “The business community shouldn’t take Minnesota for granted,” he said, “and Minnesota shouldn’t take the business community for granted.” Both have to respect their complementary strengths and work together to have policies that make sense while pursuing better ways to achieve these shared objectives together.

State of the State: Minnesota Tax and Spending Rankings

Our latest reporting of tax and spending data from the U.S. Census finds Minnesota back in some familiar territory.

If there’s one rule of policy debate, it’s this: nothing tends to get attention like a ranking study. Since 1969, MCFE has been putting Minnesota tax and fiscal policy in a national perspective – taking the U.S. Census Bureau’s annual state and local government financial data and ranking state revenues and spending in various categories in our often-referenced How Does Minnesota Compare report – free on our website at http://www.fiscalexcellence.org/our-studies/how-does-mn-compare.html.

As is always the case, some background is in order. The Census Bureau goes to great lengths to rigorously survey local governments to create as accurate a financial picture as possible. This leads to considerable frustration when we release a report in October of 2015 that covers fiscal year 2013 for the state and school districts (July 1, 2012 to June 30, 2013) and calendar year 2012 for cities, counties, townships, and other local governments. With a time lag of roughly 2-3 years, it is impossible to produce How Does Minnesota Compare in a “timely” fashion. It’s important to keep in mind that this information basically precedes the effects of the 2013 legislative session, which saw the enactment of the fourth income tax tier and significant additional state spending in various budget areas. And it clearly precedes the increases in state aid to local governments, which for all intents and purposes only because effective during calendar year 2014 (and so will show up in the FY 2015 Census data – two years from now).

Back to the Future Tax Policy: A Return to the Top Ten

On the tax side, Minnesota has reestablished its reputation as a high-tax state. While Minnesota is a high-tax state, we are in no way, shape or form a high “non-tax” state.

Although Table 1 conveys a Lake Wobegon aspect to our tax system, the rankings do vary considerably. For all the angst about property taxes, total collections are only a tick above the national average. Consumption taxes – sales and excise taxes on items such as alcohol, tobacco, and motor fuels – are about 5% above the average. Income taxes are more notably above the national average, while collections of the extraordinarily volatile corporate income tax are a whopping 46% above the average.

As noted earlier the Census data covers fiscal year 2013 – which for state government ran from July 1, 2012 to June 30, 2013. Importantly, that period largely predates the fourth income tax tier that legislators and

Table 1: Minnesota State and Local Government Tax Collections, FY 2013

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Collections per $1,000 of Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
</tr>
<tr>
<td>Property Tax</td>
<td>$32.65</td>
</tr>
<tr>
<td>Individual Income Tax</td>
<td>$34.85</td>
</tr>
<tr>
<td>Sales and Excise (Consumption) Taxes*</td>
<td>$37.22</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>$5.31</td>
</tr>
<tr>
<td>Other Taxes</td>
<td>$7.07</td>
</tr>
<tr>
<td>Total – All Taxes</td>
<td>$117.10</td>
</tr>
</tbody>
</table>

Note: Percent of U.S. average calculated using only states the levy the tax in question.

*The Census reports Minnesota’s motor vehicle sales tax as a separate tax instead of as part of total general sales tax collections – as is done in most states. This artificially deflates Minnesota’s sales tax rankings. We are adjusting for this difference by combining all consumption taxes (including sales, motor vehicle sales, fuel, alcohol, and tobacco) into one category.

Sources: Bureau of the Census, 2013 Annual Survey of State and Local Government Finances; Bureau of Economic Analysis, State Personal Income: 2014; calculations by MCFE.
Governor Dayton enacted near the end of the 2013 legislative session. Estimates at the time suggested that the fourth tier would raise about $585 million in the first year alone. Adding $585 million to the FY 2013 revenue totals gives a sense of where Minnesota might fare in the FY 2014 numbers that will come out next year. Those additional tax revenues raise Minnesota’s income tax collections by about 6.5% – to $37.13 – which in turn raises the state’s ranking two spots, from sixth to fourth – behind high-income New York, sales tax-less Oregon, and Maryland.

Spending: And the Winner Is... Human Services (Again)

On the expenditure side governments in Minnesota are spending at levels close to the national average, continuing a trend that is now almost a decade long. Table 2 shows Minnesota spending amounts, ranks, and spending relative to the national average for large- to medium-sized budget areas. Over half of state and local spending is concentrated in two areas: what the Census defines as “public welfare” (spending toward the “support of and assistance to needy persons contingent upon their need” – essentially “human services”), and education (both K-12 and higher ed). As the table indicates, relative to other states Minnesota has prioritized three areas of spending: highways, natural resources and parks, and human services.

Table 2: Minnesota State and Local Government Spending, FY 2013

<table>
<thead>
<tr>
<th>Selected Budget Areas</th>
<th>Spending per $1,000 of Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
</tr>
<tr>
<td>Public Welfare</td>
<td>$48.23</td>
</tr>
<tr>
<td>K-12 Education</td>
<td>$40.28</td>
</tr>
<tr>
<td>Higher Education</td>
<td>$18.10</td>
</tr>
<tr>
<td>Highways</td>
<td>$14.65</td>
</tr>
<tr>
<td>Health and Hospitals</td>
<td>$13.61</td>
</tr>
<tr>
<td>Natural Resources/Parks</td>
<td>$6.96</td>
</tr>
<tr>
<td>Police</td>
<td>$6.74</td>
</tr>
<tr>
<td>Interest Payments on Debt</td>
<td>$6.51</td>
</tr>
<tr>
<td>Housing &amp; Development</td>
<td>$3.49</td>
</tr>
<tr>
<td>Corrections</td>
<td>$3.44</td>
</tr>
<tr>
<td>All Other Expenditures</td>
<td>$29.70</td>
</tr>
<tr>
<td><strong>Total – All Budget Areas</strong></td>
<td><strong>$191.70</strong></td>
</tr>
</tbody>
</table>

Note: Numbers do not add due to rounding.
Sources: Bureau of the Census, 2013 Annual Survey of State and Local Government Finances; Bureau of Economic Analysis, State Personal Income: 2014; calculations by MCFE.

Higher-than-average highway spending isn’t much of a head-scratcher. As a cold-climate state with a lot of transportation infrastructure Minnesota’s operating and maintenance costs (think snowplowing and freeze-thaw issues) will simply be higher than those in warmer areas. Higher spending on natural resources and parks shouldn’t be too surprising either – the state’s traditionally high levels of spending have been supplemented in recent years by the dedicated sales tax revenues approved by voters back in 2008. Higher spending in the human services area is more of a policy decision than the other two areas, but policymakers have made it a spending priority for as long as we have published this data. Although human service spending relative to personal income fell about 11% from 2012, it is still the largest public sector spending area, nearly 20% higher than K-12 education, and continues to be the only spending area where Minnesota ranks in the top ten.

Much has been made about the effects an aging population will have on government finances. Although the full impact of the “silver tsunami” is still some years off, policymakers are already dealing with difficult financial trends. Consider that since 1990:

- Public welfare spending has grown about 65% faster than personal income (351% compared to 212%)
- Public welfare spending has grown about 75% faster than state and local government tax collections (351% vs 198%)

It’s difficult to see how these spending trends can continue into the long-term without either serious crowding out of other areas of government spending and/or additional taxes and federal revenue. Legislators on the human services committees are likely to experience their own version of Groundhog Day for a long time to come – continually trying to find ways to bend the cost curves down.

Explaining High Taxation and Average Spending

Perhaps the most striking finding that comes out of the Census Bureau data is the disconnect between relatively high tax revenues and relatively average spending. How can Minnesota rank 27th in government spending when we’re 9th in total state and local government tax collections? The answer is that taxes are only one source of state and local revenues.

The total spending numbers we report in How Does Minnesota Compare provide details on “general government” spending –
essentially all government operations except for utilities, liquor stores, employee retirement (pensions), unemployment benefits and workers compensation. In Minnesota, 58.4% of the total revenues governments use to support their general operations come from taxes. That’s the 8th highest percentage in the nation – making us highly dependent on tax revenues to support this activity.

Governments use money from two other sources to finance general spending. One source is the non-tax revenues that state and local governments raise – user fees/charges and interest earnings, among other things. The other source is payments from the federal government – largely to support human service programs and delivery of educational services. While Minnesota is a high-tax state, we are in no way, shape or form a high “non-tax” state. Nor do we seem to be particularly adept at securing federal funds. As Table 3 shows, state and local governments rank 31st in the nation in non-tax revenue collections, and we rank 36th when it comes to federal revenues. Add this up, and we come out to be a fairly ordinary state with regard to financing government operations – total government collections are about 20% of statewide personal income – only 4.6% above the national average.

This broader look at finances helps explain Minnesota’s spending results.

That Minnesota should rely so heavily on taxes instead of user fees or other charges to finance government shouldn’t be particularly surprising, given our passionate pursuit of financing government in as progressive a manner as possible. User fees, by their very nature, are designed to recoup the costs of providing whatever service a citizen or business is requesting. It’s hard to bake progressivity into that cake. The flip side is that it is very hard to finance higher-than-average public sector spending with lower-than-average federal support and non-tax revenues unless you are willing to take taxes to another level. That was certainly a motivation behind the 2013 changes that will be fully reflected in next year’s Census results.

A Look Ahead: Redesigning How Does Minnesota Compare

We published our very first edition of How Does Minnesota Compare in December 1969. It was a ten-page pamphlet that provided much of the same information readers can find in our expanded publication today. Back then it represented significant investment of time and effort – our staff collected data from the Census and BEA materials that were mailed to the office, calculated the results by hand, typed up the publication and distributed paper copies by mail or in person. The value-added proposition was real and substantial.

But times have changed. Today Census data is easily and freely available to anyone with a computer and Internet access. Many other organizations, including the Minnesota Department of Revenue, routinely publish some or all of this information. Moreover, other benchmarking and comparison studies we have done have offered insights into the limitations of metrics such as these but also into how we can make measures and comparisons more meaningful and useful from a policy analysis and development perspective.

For these reasons, over the next year we will be working on a new template for How Does Minnesota Compare – one that brings more substance and understanding to our national rankings and (hopefully) more value and relevance to state policy debates. We look forward to sharing this new product with you.