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In This Issue:

Minnesota Tax and Spending Rankings and the Policy Questions They Provoke

Mining the past and present raises several questions about the future.

One of the hallmarks of the start of any biennial legislative session are the committee hearings on the nuts and bolts issues designed to get members "up to speed" on the topics they'll be facing over the upcoming two years. Although these table-setting exercises benefit all legislators, they have been particularly important this year in the Minnesota House's Tax Committee, where only 9 of the 20 members were on the committee in 2017-18, and for the House's Property and Local Tax Division, where only 5 of the 13 members were on the division in the previous legislature.

Facts and figures are part of this effort, and there is no lack of data for lawmakers to consume. "Framing" studies which put Minnesota taxation and spending in a national context are particularly popular, and MCFE has contributed to that canon for decades. In this issue of *Fiscal Focus*, we highlight the primary findings from the latest editions of our three flagship comparison studies and identify some relevant policy questions they engender as the 2019 legislative session kicks into high gear.

Revenue — How Does Minnesota Compare?

MCFE has published *How Does Minnesota Compare?* (*HDMC*) annually since 1969, using government spending and revenue data collected by the U.S. Census to compare Minnesota relative to the 49 other states and the District of Columbia in a variety of tax and spending categories. The report has changed somewhat over time, most notably with the edition we published covering fiscal year 2013. At that time, we stopped using population and personal income to normalize tax collections and spending totals across all states. Instead, we began comparing revenues using a modified personal income basis ("cash income") that excludes pieces of personal income that cannot be used to support government operations (for example, the value of all Medicaid and Medicare benefits received by Minnesotans) and adds in other income streams that can be and are used to pay government taxes and fees (capital gains and distributions from retirement accounts). On the spending side, we report rankings on a "unit served" basis to better align government spending with its ultimate users/beneficiaries. We have also changed the methodology to adjust spending amounts for differences in purchasing power to accommodate state-to-state differences in the price of goods and services, recognizing that $1,000,000 of spending goes a lot further in Wyoming than it does in California.

Unsurprisingly, given Minnesota's emphasis on progressive taxation, Minnesota's tax ranking is highest for the individual income tax (6th of the 43 states plus DC that impose an income tax). Individual income taxes account for nearly 20% of all state and local government revenues in Minnesota and are the biggest source of tax revenues in the state. Minnesota's corporate tax collections also ranks in the top ten, which is noteworthy given that Minnesota uses single sales apportionment to determine what share of a company's profits the state can tax. Corporate tax payments are determined solely by the proportion of company sales made in Minnesota – not by the number of employees it has in the state or the value of property it owns in the state. Minnesota ranks only in the middle of the pack (21st) in state population but ranks 8th in corporate income tax revenues, collecting 23.6% more than the national average. That should offer some consolation to those who believe corporations too easily evade their financial obligations to the state.

On the other hand, Minnesota's sales tax ranks relatively low – 31st of the 47 states that impose a sales tax, despite having one of the highest state general sales tax rates in the nation. The low ranking is due in large part to two distinguishing features: a sales tax base that excludes some notable items like clothing and food, and greater reticence to grant local sales tax authority than most other states. Noteworthy, the tax that causes the most consternation among both taxpayers and policymakers – the property tax – is below average. (Table 1 next page)

Even though Minnesota is a high tax state, it is a middle of the road total revenue state. Compared to other states governments in Minnesota rely less on non-tax revenues – fees, fines, charges for service, etc. – and receive proportionately fewer dollars from the federal government.

Policy Question: Will single sales factor apportionment provide enough of a competitive buffer for Minnesota's high corporate income tax rates given current corporate base broadening interests?

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Table 1: Minnesota State and Local Government Revenues, As % of Total State Cash Income (100% = National Average)

Category	FY 2015		FY 2016		Rank	
	Amount	% US	Amount	% US	FY 15	FY 16
Ind. Income Tax	4.49%	125.5%	4.43%	126.2%	6	6
Corp. Franchise Tax	0.64%	114.9%	0.63%	123.6%	9	8
Property Tax	3.65%	94.3%	3.57%	93.6%	22	22
Sales Tax	2.74%	90.3%	2.66%	89.6%	31	31
Excise Tax	1.72%	127.5%	1.66%	124.8%	11	13
Other Taxes	0.90%	104.0%	0.93%	115.1%	22	19
Total Taxes	**14.13%**	**113.9%**	**13.88%**	**114.4%**	**8**	**7**
Other Own-Source Revenues	5.23%	94.9%	5.18%	95.0%	35	34
Revenues from Federal Government	5.15%	98.8%	4.88%	93.3%	29	33
Total Revenues	**24.51%**	**106.0%**	**23.94%**	**105.0%**	**22**	**23**

Single sales factor apportionment effectively transforms the corporate income tax into a quasi-sales tax dampening the impact of Minnesota's high corporate rate – at least for resident C corps with most of their sales outside Minnesota. But pushes to expand the state's corporate income tax base further without a concomitant rate reduction may wear very thin on the resident business community as well as make Minnesota's high "advertised rates" more problematic for new investment.

Policy Question: Should the relative "headroom" in sales taxation be exploited for tax reform purposes? If so, how?

The sales tax is the only Minnesota tax that could be considered to offer the state some "maneuverability' with respect to tax system design. But that may be changing quickly. With Minnesota's below average property tax burdens in the crosshairs, local sales tax bills from across the political spectrum have proliferated this year suggesting it's the one proposed form of taxation least likely to trigger a political immune response. Moreover, a proposal before the legislature (HF 1970/ SF 1272) would allow a city or group of cities blanket authority to enact a sales tax of up to 0.5% subject to a number of use conditions including approval of a voter referendum. Moving toward greater local reliance on sales taxes would reduce any headroom the tax offers to facilitate a redesign of the state's overall tax system.

Spending — How Does Minnesota Compare?

HDMC's spending rankings offer perspective on which areas of government spending Minnesota has emphasized relative to other states. As Table 2 indicates, overall Minnesota's state and local governments spend about 5-10% per household more than other states, after adjusting for differentials in prices between states.

What obviously jumps out is the state's relative spending on what the Census categorizes as "Public Welfare" – defined as "support of and assistance to needy persons contingent upon their need". Spending in this category includes MFIP and other pro-

Table 2: Minnesota State and Local Government Spending, Adjusted for State Price Differences (Spending per household unless otherwise noted; 100% = National Average)

Category	FY 2015		FY 2016		Rank	
	Amount	% US	Amount	% US	FY 15	FY 16
Total Spending	$25,362	105.2%	$27,233	110.0%	16	12
K-12 Education (per pupil)	$13,070	110.8%	$14,027	115.8%	18	16
Higher Education (per pupil)	$17,725	111.1%	$19,669	115.3%	25	23
Public Welfare (per person within 150% of poverty level)	$16,111	202.9%	$19,276	217.9%	3	2
Health and Hospitals	$1,526	67.2%	$1,578	66.2%	36	36
Natural Resources and Parks	$439	177.4%	$419	161.8%	10	12
Highways (per 1,000 road miles)	$33,328	78.8%	$37,649	85.5%	30	27
Police	$890	100.0%	$919	100.4%	17	18
Fire	$218	56.3%	$233	58.2%	45	44
Corrections	$454	70.1%	$484	74.2%	43	41
Interest on the General Debt	$756	85.1%	$770	88.5%	25	21
Other Spending	$3,489	80.3%	$3,598	81.9%	35	34

Table 3: Selected 50 State Property Tax Comparison Study Results, Payable 2017

Property Type	Market Value of Real Property	Ranking (Change From 2016)		Effective Tax Rate		Tax Burden Above/(Below) National Average	
		Urban	Rural	Urban	Rural	Urban	Rural
Home	Median (ETR)*	23 (-1)	22 (-1)	1.35%	1.25%	(9.6%)	(6.6%)
Commercial	$1,000,000	8 (+1)	2 (--)	2.85%	3.31%	+38.8%	+89.1%
Industrial (50% real)#	$1,000,000	17 (+1)	6 (+1)	1.79%	1.99%	+19.5%	+56.4%
Industrial (40% real)^	$1,000,000	23 (+2)	11 (+1)	1.43%	1.59%	+5.1%	+35.2%
Apartment	**$600,000**	**22 (--)**	**26 (-5)**	**1.69%**	**1.66%**	**(8.1%)**	**+2.3%**

* Median value for Minneapolis was $235,200, per Census Bureau's *American Community Survey*
* Median value for Glencoe was $124,100, per Census Bureau's *American Community Survey*
# Where 50% of the total $2 million parcel value is land and buildings (real property)
^ Where 40% of the total $2.5 million parcel value is land and buildings (real property)

grams and payments made directly to "private purveyors" for medical care provided under a welfare program (i.e., Medicaid). Minnesota's spending of nearly $20,000 per resident at or below 150% of the poverty level ($36,450 for a family of 4 in 2016) is 218% of the national average – ranking second only behind the District of Columbia. This reflects both the relative generosity of these programs in the state and broader access to them. For example, according to latest information from the Kaiser Family Foundation, Minnesota Medicaid spending is $2,354 (18%) more than the national average per senior Medicaid enrollee, $11,995 (71%) more per disabled enrollee, $1,438 (44%) more per adult enrollee and $961 (37%) more per child enrollee.

K-12 education, higher education, and natural resources and parks also appear to be relative government priorities for Minnesota, as spending in all of those areas exceeds 110% of the national average for the relevant benchmarking metric. Conversely, spending on fire protection, health and hospitals, and corrections are below 75% of the national average. Minnesota's very low level of spending on fire protection is almost certainly related to the fact that the state is highly dependent on volunteer, on-call firefighters instead of full-time professionals.

Policy Question: How can the state prevent the crowding out effect from health and human service spending without making the needy more vulnerable?

Minnesota's governance and community ethic has always placed a very strong emphasis on "public welfare" spending as reflected in consistent top 10 national rankings going back to our first HDMC report a half century ago. But looking through history, that consistency has put growing pressure on other government services. Twenty years ago, public welfare consumed 19% of the general fund budget compared to a projected 31% today based on the most recent economic forecast. Moreover, that 31% portion of the budget is projected to consume 50% of all new general fund tax revenue in the next biennium. And as the Budget Trends Study Commission report from years ago flagged, demographic trends will exacerbate this problem in the years ahead.

Property Taxation: 2018 50 State Property Tax Comparison Study

While *HDMC* shows that Minnesota's overall property tax collections are somewhat below average, not all properties are alike. Our *50-State Property Tax Comparison Study* – a joint effort with the Cambridge, MA-based Lincoln Institute of Land Policy – provides greater comprehension as to how Minnesota's tax treatment of various kinds of property compares with other states. Our most recent report, from 2018, looks at taxes payable in 2017 – we expect the 2019 edition to be released in April or May.

For the uninitiated, the report examines property taxes on homestead, commercial, industrial and apartment properties with specific values located in the largest city in each state (i.e. "urban cities"), in a comparable rural city in each state, and in the largest 50 cities in the country. States and localities often treat different types of property differently: with variations in tax rates, exemptions, or assessment ratios, for example. Our study controls for these and other effects to compare effective tax rates (ETR) – taxes relative to property values – to provide the most meaningful comparison of property taxes between these cities.

As Table 3 indicates, there are differences in Minnesota's rankings both between different types of property and between urban and rural settings. Homeowners in both urban and rural Minnesota face ETRs that are average relative to the rest of the country, with owners of a median-valued home paying 1.25% to 1.35% of their home's value in taxes. Given the facets of Minnesota's property tax system that are designed to benefit homeowners – the homestead value exclusion and the differentials in class rates that effectively have commercial-industrial, utility, and railroad property subsidizing homeowners – these results should not be terribly surprising, even if they do contradict the conventional wisdom that homeowner property taxes are unaffordably high. Moreover, Minnesota's income tested property tax refund program is not included in these results. Given our relative generosity compared to refund programs in other states, our homeowner property tax rankings would likely be even lower.

Comparatively high burdens on commercial – and to a lesser extent, industrial – property continue to be the case. Commercial property tax burdens have been higher for years across Minnesota – both in our urban rankings, where Minneapolis' eighth-place ranking for a $1 million-valued commercial property represents the seventh top ten finish in a row – and in our rural rankings, where Glencoe's $1 million commercial property ranks second for the sixth consecutive year. These rankings will almost certainly drop for our upcoming payable 2018 property tax study, as the reduction in the state general levy and the exemption from that tax for the first $100,000 of market value that were enacted in 2017 come into play.

The state's rankings for industrial properties fare somewhat better, because manu-

Why City Choices Don't Significantly Impact Minnesota's 50-State Property Tax Study Rankings

Our use of Minneapolis and Glencoe to represent "urban" and rural" categories in the study often raises the question: would choosing different Minnesota cities for national comparison purposes would make a meaningful difference in the state's rankings? If local levies were the only force driving the relative size of tax bills and resulting rankings that would be the case. But they're not.

Property tax systems' structural features have major influences on tax rankings. Such features include both technical issues like classification schemes and assessment practices and broader topics related to the fiscal system, such as the existence of any state levies, the relationship between state and local governments, and access (or lack thereof) to revenues outside of the property tax to support local government. Importantly, these structural influences are not city-dependent but impact the property tax bills of every similar type of property across a state.

The purpose of the 50 State Study has always been to understand how state property tax system design affects property tax burdens. Our property tax study captures these influences, and the rankings reflect those influences.

To illustrate the considerable influence of state structural features, consider our rural commercial rankings. Our selection process for rural cities narrows the field considerably to improve comparability. Generally, we use cities that fall in one of two categories in the U.S. Department of Agriculture's rural-urban continuum, which classifies cities based on size and geographic location. All of our rural cities are county seats with populations between 2,500 and 10,000 to ensure as much as possible a set of cities that provide similar public services (especially in the public safety and public works areas) and to eliminate regional centers. Whenever possible, the cities are located in counties located outside of metropolitan areas, with the exceptions being where such counties do not exist – largely in northeastern states (think "rural Rhode Island").

Using this typology, 25 Minnesota cities could qualify for inclusion as a "rural" representative of our property tax comparison study. In conjunction with our payable 2016 report, we calculated the taxes for the $1 million commercial property for each of these 25 cities. Our report incorporates assessment error using sales ratio data from the Minnesota Department of Revenue, however, that data did not exist for commercial properties in several of these cities given the small number of sales that occurred. When we – conservatively – substituted the median sales ratio for the cities we did have data for, then in 16 of these 25 cities the $1 million commercial property would have ranked in the top 5 nationally. In 22 of the 25 cities the property would have ranked in the top seven. If, instead, we assumed a sales ratio of 100% (the standard procedure for our report), then 21 of the 25 rural cities would have been in the top 5. Such findings indicate that all cities share in the influence of the structural design of the Minnesota property tax system and that influence has the predominant effect on state rankings.

facturing plants with their higher levels of personal property (mainly machinery and equipment, inventories, and fixtures/office furniture) benefit much more from Minnesota's blanket exemption of personal property than commercial properties do. However, personal property taxation nationwide has been declining since 1995, the first year for which we prepared this study. At that time, 39 states taxed business personal property. Since then, one state – Ohio – has completely eliminated the tax. Nine other states have either enacted a fixed-value exemption or increased an existing one, while six other states or locations have fully exempted at least one type of personal property. Generally, these targeted exemptions focus on manufacturing machinery and equipment, which, given the competition for manufacturing facilities, should not be particularly surprising. This trend is likely to continue, meaning that the competitive edge Minnesota's personal property exemption provides for manufacturers will continue to erode.

Policy Question: What to do with the political football called the state general tax?

A consideration of our study findings (and for that matter, the Department of Revenue's recent *Residential Homestead Property Tax Burden Report*) suggests that far and away the state's most pressing property tax policy concern revolves around rural business taxation. By association, legislators will once again need to consider the role and impact of the state general tax, which typically accounts for about one-third of a business' property tax bill. Recent policy efforts to address this concern by exempting the first $100,000 of value have had an impact, but the proposed reinstatement of the state general tax inflator or the proposed change from a fixed levy amount to a fixed rate would undercut these gains. From a tax principle standpoint, the stability the state general levy has introduced into state government's volatile revenue mix has to be evaluated against the state's significant intrusion into local tax bases, which was the rationale behind the 2011 bipartisan Property Tax Reform Working Group's recommendation to phase out the tax. Like the Old Testament story of the rich man who doesn't take one of his own sheep to prepare a meal but uses a pet lamb that belongs to his poor neighbor, it must be asked if a state with a nearly $50 billion general fund budget and no limitations on revenue raising options at its disposal should be consuming local governments' far more limited and humble tax base.

Income Taxes: Comparison of Individual Income Tax Burdens by State

Similar to Minnesota's average overall property tax collections, the relatively high income tax collections reported in *HDMC* mask considerable variation among different types of taxpayers and taxpayers at different income levels. Our individual income tax comparison study reports on tax burdens and effective tax rates on five filer types – married-joint, single, head-of-household, senior married-joint, and senior single – at different household income levels ranging from $10,000 to $1 million in 41 states[1] and the District of Columbia. We create the dif-

[1] MCFE's Comparison of Individual Income Tax Burdens by State only includes 41 states plus DC as New Hampshire and Tennessee have highly limited income tax systems preventing meaningful comparisons with other states.

Table 4: 42 State Income Tax Comparison Study, Tax Year 2014, Minnesota Results

Household Income	Filing Type									
	Single		Married-Joint		Head of Household		Senior Single		Senior Married	
	Rank	% US	Rank	% US	Rank	% US	Rank	% US	Rank	% US
$10,000	39	NA	—	—	38	NA	—	—	—	—
$20,000	19	99.3	41	NA	40	NA	#	*	#	*
$35,000	23	101.2	42	NA	28	73.5	12	148.6	#	*
$50,000	18	109.9	27	74.4	24	97.0	5	185.4	13	89.6
$75,000	8	119.4	23	95.4	11	117.2	1	179.9	3	223.5
$100,000	8	119.0	20	106.4	8	117.5	1	168.5	1	215.9
$150,000	8	122.2	15	112.7	10	116.9	1	154.3	1	163.8
$250,000	6	130.5	10	116.7	9	119.7	—	—	1	145.2
$500,000	—	—	2	140.8	—	—	—	—	—	—
$1,000,000	—	—	4	148.7	—	—	—	—	—	—

— No comparisons generated for this combination of income and taxpayer.
* Not shown because U.S. average tax is $50 or less, making state comparisons to national averages potentially misleading.
# Not shown because 2/3 or more of states are tied with $0 liability for filer.
NA: Not applicable, since the tax is negative due mainly to Working Family Credit benefits.

ferent taxpayers using information the Minnesota Department of Revenue provides from the database they create as part of their *Tax Incidence Study*[2] and calculate tax burdens on the nearly 1,600 households modeled in the report using the National Bureau of Economic Research's TAXSIM income tax simulator.

Our Minnesota-related findings from our most recent report, for tax year 2014, are presented in Table 4 – we expect the 2019 edition for tax year 2016 to be released in April or May. The table provides some justification for the concern expressed over the last number of years regarding taxation of senior income in Minnesota – the state's fastest growing and most mobile demographic group. In most cases, Minnesota seniors paid between 45% and 125% more in income taxes than that national average, depending on filer type and income level. Excluding the three filer profiles where the vast majority of states are tied with $0 liability, Minnesota senior income burdens were highest in the nation for 6 of the 10 senior households in the study, and were third and fifth in two others. However, it's important to remember that these results do not capture the partial exemption for Social Security income the state enacted in 2017, which will likely affect Minnesota's ranking.

The results also demonstrate the extent of the progressivity in Minnesota's state income tax, as the state's rankings rise sharply with income. Single filers rank 39th at $10,000 of household income but 6th at $250,000; head of household filers rank 38th at $10,000 of household income but 9th at $250,000; and married-joint filers rank 41st at $20,000 of household income but 4th at $1 million. Based on these tax burdens, Minnesota has one of the nation's most progressive state income tax structures – the difference in effective income tax rates between married-joint filers at $1 million and $20,000 of household income is 18.7% – an 8.63% rate for the $1 million filer vs a negative 10.03% rate for the $20,000 filer. That gap is the largest in the country –outpacing second-place New York by one percentage point and third-place D.C. by 1.6 percentage points.

Such findings highlight the highly favorable tax treatment Minnesota offers to lower earning households relative to other states. Minnesota's Working Family Credit is one of the most generous (if not ***the*** most generous) in the nation. The credit is robust at the lowest income levels – the $2,006 refundable credit at the $20,000 income level for married-joint filers is the second-largest in the nation, exceeded only by D.C.'s $2,184 credit. However, the credit is also very generous in that it phases out more slowly than similar credits in other states. For example, for married-joint filers with $35,000 of household income in tax year 2014, the Working Family Credit still offered a $1,653 credit – a decline of only 18%. Most credits in other states, which are not nearly so generous to lower income filers to begin with, have declined by 40% to 60% between these same income levels.

Policy Question: How progressive can our income tax system be given the new federal realities?

It's generally understood that federal tax reform has now made state income taxation far more economically and competitively relevant. For all practical purposes, the TCJA's new cap on state and local tax (SALT) deductibility has raised the effective top marginal tax rate of every state-level income tax. But the magnitude may come as a surprise.

Over a dozen of the nation's leading tax scholars recently collaborated on a paper examining the TCJA's fallout and consequences in detail. One of the important realities they pointed out was that "the SALT deduction repeal in effect raised the tax price of progressive state income taxes by almost 40% for taxpayers in the highest bracket." Under pre-TCJA federal law the

[2] Since senior citizens often receive a substantial portion of their income tax-free, using data from income tax returns to create our taxpayer profiles becomes problematic. For example, the senior couple with $50,000 of household income in our tax year 2014 study has only $25,004 of federal adjusted gross income – a serious difference in purchasing power. Since the Tax Incidence Study gathers information on taxable and non-taxable income for its database, generating our taxpayer profiles at various household income levels from that source makes comparisons of senior and non-senior households at with similar resources (i.e., household incomes) far more robust.

effect is roughly the same as Minnesota raising its top rate from 9.85% to 16.3%.[3]

"Hold harmless" efforts by Minnesota like preserving the old federal tax code's itemized deductions in state tax law won't completely offset this impact. That's because the TCJA-related changes in the larger federal tax base far offset the state level tax benefits of maintaining itemized deductions. For example, based on our most recent national individual income tax comparison study, a married couple filing jointly in Minnesota paid $12,680 more in federal and state income taxes than the same filer in Texas, which has no income tax. Conforming to the TCJA increases that gap by $2,200. Even if we attempted to hold higher income earners harmless from conformity actions by preserving every old itemized deduction at the state level the comparative gap still increases by over $1,200. The state is simply not going to be able to compensate for the federal government's decision to cap the SALT deduction.

In short, federal tax law changes have reset to some extent the relationship between taxes and location decision-making. (There appears to be an implicit recognition of this potential even among greater progressivity advocates who have sought to preserve all the federal deductions available prior to the TCJA, which disproportionately accrue to higher income households.) Historically, the debate has been dominated by whether or not people leave the state, but now the in-migration of capital and talent is likely deserving of as much or more consideration. Economic geographers note the best prospects for the future lie in places that both experience income and employment gains and remain relatively affordable. Relative taxation is part of that equation, and if employers must compensate employees for the higher burden with higher pre-tax wages to level the playing field, their labor costs go up making the case for expanding and growing business within Minnesota that much more challenging.

Policy Question: What are the implications of more senior income tax relief?

There appears to be considerable bipartisan interest – if not consensus – on another round of senior income tax relief in the form of an expanded Social Security subtraction. Our study shows that if the concept of "competitiveness" can apply to an age demographic, such an effort may have merit. Clearly Minnesota suffers from an income tax disadvantage when it comes to the relatively mobile senior age group.

However, policymakers need to balance this mobility issue with concerns that economists have raised about providing tax preferences for senior incomes. Researchers from Carnegie Mellon University and the International Monetary Fund concluded that the combination of Pennsylvania's aging population and its exemption of all retirement income – including Social Security income as well as 401(k) and IRA distributions – from the individual income tax is "increasingly untenable", putting the integrity of the state's revenue system at risk.[4] And researchers from the University of Hartford, University of New Hampshire, and Reed College have determined that treating the elderly differently for income taxation purposes is consistently associated with lower levels of economic growth.[5]

Two other issues also deserve some consideration. First, there is zero economic justification for treating this type of income differently, triggering horizontal equity concerns – and potential political risk – in the process. We suspect a family of four living on $60,000 of household income might be a bit perturbed to find out their empty nest neighbors with the house paid off are the ones deserving of a special tax break. The second and related observation is this: according to the Pew Research Center,[6] since 1971 the senior 65-and-older demographic has improved their income status more than any other demographic – and it's not even close. Far better than the 45-64 demographic and ***far, far*** better than both the 30-44 and under 29 demographics.

As mentioned, all these studies will be updated this year. Look for our results – and analysis of their implications – in the months ahead. ■

The Case For A Bigger Standard Deduction

Love or hate the TCJA, its principal simplification effort presents an opportunity for Minnesota that shouldn't be wasted.

Given a federal tax reform process which featured much of the thoughtfulness and deliberative care of a Tic Tac purchase in a grocery checkout lane, Minnesota's federal conformity challenge last year was predestined to be difficult. In most years federal conformity bills are passed on a bipartisan basis early in the session and signed expeditiously. Lawmakers can readily get behind making tax filing and compliance simpler for taxpayers, easier for the state to administer, and less costly for both. But the TCJA presented anything but a normal conformity context.

Looking back, the immediate comingling of conformity decisions with supplemental budget and tax redistribution issues spelled its doom. Policymakers subordinated administrative simplicity to matters of winners and losers, "holding taxpayers harmless," and righting the perceived wrongs of federal action. There is little reason to expect much different in 2019. Tax simplicity may get a hat tip from policymakers but these other issues are the ones that drive tax debates. Besides, simplicity in taxation has never been a hallmark of Minnesota's tax system, and state policymakers have never been particularly shy about wanting to add complexity into the tax code. For example, in just the first month of the 2019 session, 44 new income tax deductions, credits, or subtractions were proposed by legislators from across the political spectrum.

At its core, conformity is still a tax administration issue, and making the tax system easier to deal with and less costly for both taxpayers and the state shouldn't automatically take a back seat to tax levels, fairness, rates, and related matters. All of which raises the question, what would an income tax conformity plan that emphasized and prioritized ease of filing and compliance, administration, understandability and transparency look like? One avenue is getting on the TCJA's core simplification bandwagon and significantly boosting the state's standard deduction.

Objectives and Tactics

With respect to individual income tax conformity, three primary objectives deserve at-

[3] Calculated by taking the top income tax rate of 9.85% and dividing it by the difference between 100% and the 39.6% reduction that is foregone by the cap on the SALT deduction. 9.85% divided by 60.4% = 16.31%

[4] *The Fiscal Implications of Pennsylvania's Aging Population*, Strauss and Deng, *State Tax Notes*, January 19, 2015

[5] *Do Income Tax Breaks for the Elderly Affect Economic Growth*?, Brewer, Conway, and Rork. Available at https://cheps.sdsu.edu/docs/seminar/Conway_Tax%20_Breaks_Elderly.pdf

[6] "The American Middle Class Is Losing Ground," Pew Research Center, December 9, 2015

tention to advance simplicity in tax administration and filing:

1. **Align filing requirements so Minnesota does not impose a filing requirement and tax obligation when the federal government does not.** For decades, if an individual in Minnesota has not had a federal filing obligation, they haven't had a state filing obligation. That could change depending on the nature of Minnesota's conformity response. This creates both the potential for leakage in the revenue system from historical conditioning and an administrative hassle and public relations headache for the Department of Revenue chasing down non-filers – especially when the return on compliance action would be so low and the taxpayer annoyance factor so high given the tax amounts involved. The hassle would be exacerbated by the fact that the Department would not be able to rely on the IRS for help with this group of taxpayers.

2. **Minimize the number of taxpayers who itemize on their Minnesota return but not on their federal return.** Because of the TCJA's most notable simplification feature – the large expansion in the federal standard deduction -- the Joint Committee on Taxation estimates that the number of households itemizing on their 2018 federal returns will decline by 61% to just 18 million – about 12% of filing households. House Research estimates the number of Minnesota filers itemizing federally will be cut by almost two-thirds, to 13%. Itemizing at the state level has always been significantly less valuable because the state tax rates are lower than at the federal level. It makes little sense to have individuals who will now benefit from the higher federal standard deduction hassle with all the record keeping and documentation requirements associated with itemizing for state purposes only when the result will be a small fraction of the former total benefit. Nor is the cause of efficient tax administration served by more forms, complication, and greater state auditing responsibilities (since Revenue cannot piggyback on any IRS audits for these taxpayers' itemized deductions) for a dramatically decreased number of filers.

3. **Get off the federal extender rollercoaster. Most of the TCJA's individual income tax changes are temporary and expire for tax year 2026.** Odds heavily favor that Congress will engage in its usual practice and renew at least some subset of the provisions at the end of 2026 for short time periods. That works for the federal government, but it creates political and budget havoc for states that have to balance their budgets. When that date approaches, the state's economic forecast will assume that the expiration of these provisions will generate additional income tax revenue. When these "extender" bills are passed by the federal government, policymakers would be facing a turbocharged conformity agenda that could dramatically alter the state budget picture – all in a political context in which many will see not conforming as a tax increase. It would be like the current provider tax debate on steroids. The way to avoid this chaotic future is to have the state take greater control of its own tax destiny.

Table 5: Federal and State Itemized Deductions for Selected Taxpayers in MCFE Individual Income Tax Comparison Study for Tax Year 2014, Assuming TCJA Provisions in Effect

Taxpayer Status and Household Income	Itemized Deductions		
	Federal Return	State Return	State as % of Federal
Single, $75,000	$10,910	$6,998	64%
Single, $100,000	$12,564	$7,169	57%
Single, $150,000	$16,106	$8,933	55%
Married-Joint, $100,000	$14,539	$10,736	74%
Married-Joint, $150,000	$21,217	$14,410	68%
Head of Household, $75,000	$13,353	$10,026	75%
Head of Household, $100,000	$14,894	$9,910	67%
Single-Senior, $75,000	$10,375	$6,603	64%
Married-Joint-Senior, $100,000	$17,883	$13,614	76%
Married-Joint-Senior, $150,000	$21,012	$14,053	67%
Married-Joint-Senior, $250,000	$21,055	$16,100	76%

Note: Assumes $10,000 cap on state and local tax deduction at federal level.
Calculations by MCFE.

The tactics to achieve these outcomes are technically simple and straightforward. First, switch to federal adjusted gross income (FAGI) from federal taxable income as the starting point for calculating state income taxes. This was a point of agreement among all parties last year, primarily to ensure state income taxation remains responsive to household size – an outcome negatively impacted by the TCJA's elimination of personal exemptions. (The enhanced federal child tax credit offsets this to some extent but is subject to age and family income tests). Moving to FAGI allows the state to address this issue with its own modifications while at the same time establishing greater control and predictability over its own tax policy and avoiding the potential chaos of uncertainty over future federal action.

Second, conform as much as possible to the federal government's increased standard deduction. This is much more controversial and both budgetarily and politically problematic. First, it would be expensive – according to data published by the Department of Revenue's Research Division, the cost of fully conforming to the federal amount would be approximately $2.5 billion for the coming biennium – and would require an 80% reduction in state personal and dependent exemptions to be revenue neutral (independent of any other conformity actions). No less problematic is the bi-partisan emphasis on attempting to protect Minnesota filers from a tax increase resulting from state conformity actions. There appears to be a shared assumption that simply retaining all the old federal deductions in state law creates the conditions for meeting that objective. However, income changes under TCJA provisions will complicate this calculus by affecting the phase out levels of various deductions, the taxability of Social Security benefits, etc. In short, other moving pieces in the tax system will often undercut these well-intentioned efforts.

But increasing the state's standard deduction to pursue these objectives is not as heavy a lift as it may seem. Our most recent individual income tax study features 19 taxpayers who more often than not itemize deductions on their returns. However, had

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the TCJA's provisions been in effect[7], 11 of these taxpayers would have had a greater benefit from the new, higher standard deduction than from itemizing deductions. As Table 5 shows, for purposes of these taxpayers' Minnesota returns, their itemized deductions range from 55% to 75% of the federal amount. These differences stem from the fact that, at the state level, state income taxes are not a deductible expense.

This suggests that the state could create a new higher standard deduction at around 60% to 70% of the federal amount and largely align itemizers for state purposes with itemizers for federal purposes. Setting the deduction at this lower amount not only seems as though it would help meet the objectives outlined above, but would also have the added benefit of freeing up additional dollars for creating an exemption or credit for purposes of making the system responsive to issues of family size. It's even possible that a little money might be left over to take a second simplification swing at some of the income subtractions which have grown like creeping charlie in the state tax code over the years.

It's not surprising lawmakers would approach the idea of reducing targeted tax preferences very gingerly. That's especially true in Minnesota in light of the new federal limit on state and local tax deductibility which hits progressive income tax states like Minnesota particularly hard. That change has made state income taxes more competitively and economically relevant and larger limitations on deductibility might add further insult to the injury on those most exposed by the SALT limitation.

But the "hold harmless" expectations are often a chimera in the first place. And besides, there are real policy, administrative, and taxpayer benefits to be gained by not reflexively subordinating simplicity to other objectives when deciding how to conform. It would be nice to flip the 2018 experience around. First explore how simplicity and efficiency in state tax compliance and administration can be supported and advanced given the new federal reality. With that goal in mind, then debate tax distribution, tax levels, tax rates, and budget considerations to determine how state conformity should fit into the broader tax bill – with the understanding that any small savings taxpayers might realize from Minnesota-only itemizing will often end up in the pockets of the tax professional who is needed to deal with this additional complexity. ■

7 Namely for these filers, the higher federal standard deduction, the $10,000 cap on the federal deduction for state and local taxes.