FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

A Feeling of *"TCJA Vu"*

We've experienced this session's tax conformity debate before. The ending may be different this time but will likely forego an important opportunity.

It's been almost a year since the 2018 legislative session ended with an acrimonious thud. The vetoes of the tax bill and the 1,000-page omnibus spending bill were accompanied by a heavy crossfire of bitter charges and countercharges. Since then new faces and personalities have arrived, and a greater sense of amicability permeates the 2019 session offering hope for a more productive outcome. However, the same stark philosophical differences about state government tax and spending policies lurk underneath the surface as press conferences and editorials have demonstrated. With the session's conclusion about a month away, an uncomfortable feeling of déjà vu is understandable. Differing conformity responses to the federal Tax Cuts and Jobs Act are a big part of the reason why.

Spring Repeats

The specifics of the conformity proposals have been tweaked since last year, but the overarching policy themes are intact. For the DFL, the centerpiece of their conformity plan is again securing more revenue. Like last year's proposal, Governor Walz and the DFL-controlled House seek to use the tax base expansion from federal conformity actions to raise substantial amounts of new revenue to support new permanent spending and to provide permanent targeted tax relief to correct for the TCJA's perceived distributional inequities. It tries to compensate for the TCJA as much as conform to it.

> **"States conforming to TCJA international provisions can reasonably anticipate legal challenges taking years to resolve. Accordingly, states should not build revenue from conformity into budgets."**

Meanwhile, for the Senate Republicans, the central theme of their conformity plan is again holding individual income taxpayers harmless from any action the state might take on conformity. Importantly, Senate Republicans intend for this hold harmless principle to apply not just in the aggregate, but at the individual level – a difficult, if not impossible, task given the TCJA's many moving parts and the multitudes of situations individual income tax filers can find themselves in. Therefore, Senate Republicans again place a heavy emphasis on trying to keep things as they used to be by retaining a considerable amount of old internal revenue code with respect to itemized deductions and enacting the old federal and dependent exemptions into state law – with a major tax relief kicker by lowering the second tier individual tax rate to try to cover all the bases.

Despite the major differences in philosophy and approach, there are some significant areas of agreement among all three players, as the accompanying table shows. All parties agree on conformity actions which are projected to raise $613 million in FY 20-21. All parties agree on conformity provisions that would cost about $200 million over that same period. That leaves around $400 million of consensus new conformity revenue to construct a biennial budget. Combined with the current budget surplus it's a large enough sum to suggest some type of "vote while holding your nose" compromise could be constructed.

But even if something can be cobbled together which grudgingly passes everyone's tax demands and spending tests, this session's tax bill likely will be less "successful" than what it could have been. That's because a significant opportunity presented by federal conformity – simplifying and easing tax compliance and administrative burdens while improving the state's revenue integrity on good tax policy principles – has received much less attention than it deserves.

Like last year, tax simplicity, compliance, and administrative considerations were overwhelmed by other matters like winners and losers and state budget ambitions. It would be naïve to suggest such "second tier" tax policy ideas addressing revenue system function, reliability, and integrity would ever replace "who pays and how much" as everyone's compass points in pursuing a conformity plan. But both sides' proposals contain

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elements suggesting indifference to these objectives, rather than just subordination.

For example, just a few years ago the DFL was expressing concerns about revenue dependency, balance, and stability in a call for state tax reform which employed the prop of an unbalanced three-legged stool to visualize the problem. Fast forward to the present and the three major revenue-raising legs, comprising $1.1 billion of the $1.2 billion the House is seeking in new revenues, are repatriated earnings (temporary), a new capital gains and dividend tax on the wealthy (highly volatile and potentially avoidable) and GILTI (inherently volatile, quantifiably uncertain, and perhaps constitutionally questionable). With respect to the $600 to $750 million (depending on the method) DOR estimates could be generated from conforming to the two forms of federal foreign earnings taxation, even the progressive Center on Budget and Policy Priorities of Washington DC has urged caution noting, "States conforming to TCJA international provisions can reasonably anticipate legal challenges taking years to resolve. Accordingly, states should not build revenue from conformity into budgets." [1]

Similarly, Republicans' insistence on trying protecting individual taxpayers by essentially retaining old federal itemizing law has its own consequences. It would mean a lot of taxpayers now benefitting from the higher federal standard deduction would have to deal with the unnecessary record-keeping hassle, time, and cost of itemizing for state purposes – all for a tiny fraction of the former benefit. That's a recipe for more costly tax compliance and inefficient tax administration complicated by larger and more costly state auditing responsibilities and greater tax avoidance potential since Revenue cannot piggyback on any IRS audits for these taxpayers who itemize at the state level only.

Certainly, some appreciation of these issues can be found in the respective proposals. But it's fair to conclude that, with one notable exception, a focus on the unique opportunity the TCJA created to engage in tax code housecleaning to advance simplicity, understandability, ease of compliance (for taxpayers) and administration (for the government) has not been a priority.

Ingredients of a Not-So-Modest Proposal

In an ideal (a.k.a. imaginary) world, a standalone conformity bill separate from the regular omnibus tax bill would have allowed policy makers to first grapple with how to impose and collect state individual and corporate income taxes in a post-TCJA world before tackling the inevitable "how much" and "who" questions. That was never going to happen because conformity ideas do have revenue ramifications. Tax decisions are the most powerful form of leverage in end-of-session budget negotiations, and no one would ever want to concede any such leverage in the session's earliest stages.

But it's interesting to speculate on what a conformity bill that prioritized the tax system and good tax principles might actually look like. We consulted with several SALT experts for their thoughts on this matter for both organizing ideas and some specific conformity recommendations. Here is a synopsis of the most common ideas we heard and some reasoning behind them.

- **Organizing approach:** Such a bill should be pursued on a principle of revenue neutrality: the proposal should not to try to increase or decrease overall state tax revenues relative to the permanent features of the proposal and prior law. Attempts at revenue raising or tax cutting would immediately bollocks up the effort and introduce budget considerations that naturally want take precedence. Moreover, a revenue neutral approach would provide some additional insurance against being stung by inherently uncertain and potentially overstated revenue estimates accompanying new and complex conformity provisions, thus providing an extra measure to protect the integrity of the state's revenue base.

The principle of revenue neutrality should also be applied within three individual "buckets" of tax revenues affected by conformity – permanent individual income revenues, permanent corporate franchise revenues, and one-time revenues. This helps ensure that all the various tax expenditures, exemptions, and income subtractions which have been built up in the state tax code over time would get a long overdue review as part of the conformity effort.

Regrading prime areas of opportunity: Themes and variations abound with respect to specific conformity details and recommendations but a few stand out based on their tax policy merits:

- **Full conformity to the federal standard deduction.** As we have written before, full conformity with the TCJA's higher standard deduction would accomplish two important objectives: 1) it aligns filing requirements so Minnesota does not impose a filing requirement and tax obligation when the federal government does not; and 2) it minimizes the number of taxpayers who itemize on their Minnesota return but not on their federal return (estimates are 93% of state individual income filers would take the standard deduction). One individual also suggested this standard deduction should be increased even further for the elderly subject to an income phase out (with corresponding reductions to the Social Security subtraction) in recognition that current policy treats equals unequally by favoring one source of income over another and discriminates based on age.

  We, in turn, note the underappreciated tax relief benefits that would flow from fully conforming to the federal standard deduction. Full standard deduction conformity is a centerpiece of the House's tax plan, and in his remarks on the House floor, Tax Chair Paul Marquart noted that adopting the higher standard deduction would provide a tax cut for over 2 million Minnesotans, resulting in about a 7% reduction in taxes for the state's median income household as a result. Moreover, with the House's preservation of the federal government's former dependent exemption, a family of four in Minnesota with up to $32,900 in household income would have no income tax liability. Because of its unique ability to combine administrative benefits with tax relief to lower income households (only those who take the standard deduction benefit from the change), full conformity to the federal standard deduction should take precedence over the other higher profile but more targeted tax relief provisions like the Working Family Credit expansion, property tax refunds expansions, and any increase in the Social Security subtraction.

[1] Michael Mazerov, CBPP, in presentation to the National Council of State Legislators Task Force on State and Local Taxation, March 23, 2018.

The "Hands Across the Aisle" List of Common Ground Tax Provisions ($000)

ITEM	General Fund Impact	
	FY 20-21	FY 22-23
TCJA Conformity - Non-Business Individual Income Tax Provisions		
Change IIT Starting Point to FAGI	(3,600)	(3,600)
Repeal Deduction for Alimony Payments and Corresponding Inclusion of Received Alimony	3,900	7,400
Modify Limit on Wagering Losses	240	180
Disallow Charitable Deduction of College Athletic Seating Rights	3,100	2,400
Limit Mortgage Interest Deduction for Amounts Above $750,000	700	1,700
Disallow Exclusion for Qualified Moving Expense Reimbursement[1]	9,500	7,800
Suspend Exclusion for Certain Employer-provided Bicycle Commuter Fringe Benefits	70	60
Repeal Special Rule Permitting Recharacterization of IRA Contributions	750	750
TCJA Conformity - Individual Income Tax Provisions Relating to Pass-throughs		
Full Conformity with Section 179 Expensing (TY18); Eliminate 80% Addback (TY19)[2]	(126,100)	(64,000)
Conform to Expanded Bonus Depreciation, Maintain 80% MN Addback	19,400	14,200
Disallow Certain Active Pass-Through Losses, $500,000 Married Joint Filers[3]	94,100	82,000
Tax Gain on Sales of Partnership on a Look-Through Basis	3,500	5,500
Expand Definition of Built-in Loss for Purposes of Partnership Loss Transfers	970	700
Charitable Contributions and Foreign Taxes Accounted for in Determining Limite on Partner's Share of Loss	2,100	1,700
Repeal Rollover of Publicly Traded Securities Gain	870	500
Limit Net Interest Deduction to 30% of Income	182,100	247,100
Modify the Net Operating Loss Deduction	78,900	161,300
Repeal Deferred Gain on Like-kind Exchanges	8,000	9,900
Reduce Recovery Period for Real Property	(1,170)	(1,700)
Repeal Deduction for Local Lobbying Expenses	280	200
Limit Deduction for Employer-provided Meals	8,800	5,500
Limit Deduction for Employer-provided Transportation Benefits	4,700	4,300
Revised Treatment of Contributions to Capital	1,070	2,300
Modify Treatment of Interest for Producers of Beer, Wine, and Distilled Spirits	(2,400)	0
Modify Limit on Excessive Compensation	1,150	1,200
Repeal Exclusion of Interest on Advance Refunding Bonds	8,100	11,800
TCJA Conformity - Corporate Franchise Tax		
Full Conformity with Section 179 Expensing (TY18); Eliminate 80% Addback (TY19)[4]	(47,800)	(24,200)
Conform to Expanded Bonus Depreciation, Maintain 80% MN Addback	40,900	29,900
Repeal Rollover of Publicly Traded Securities Gain	1,850	900
Limit Net Interest Deduction to 30% of Income	47,000	42,000
Repeal Deferred Gain on Like-Kind Exchanges, Except Real Property	10,100	12,500
Reduce Recovery Period for Certain Real Property	(2,330)	(3,400)
Repeal Deduction for Local Lobbying Expenses	970	600
Limit Deduction for Employer-Provided Meals/Entertainment Expenses	23,900	15,000
Limit Deduction for Employer-Provided Transportation Benefits	18,100	11,600
Limit Deduction for FDIC Premiums	18,200	12,500
Revised Treatment of Contributions to Capital	3,850	6,200
Modify Treatment of Interest for Producers of Beer, Wine, and Distilled Spirits	(2,900)	0
Modify Limit on Excessive Compensation	9,700	7,200
Repeal Exclusion of Interest on Advance Refunding Bonds	6,300	6,200
Other Conformity		
Bipartisan Budget Act of 2018 (Individual and Corporate) - Selected Items	(11,070)	(80)
Disaster Tax Relief and Airport and Airway Extension Act of 2017	(2,490)	340
Total	**413,310**	**616,450**

[1] House disallows the exclusion permanently; the Senate and the Governor disallow for the life of the TCJA; no difference in FY 20-21 and FY 22-23 effects.
[2] House tax bill eliminates addback in FY 2018; Senate and Governor eliminate addback in 2019. Sheet uses larger Senate number since it is the closest to zero.
[3] House disallows the losses permanently; the Senate and the Governor disallow for the life of the TCJA; no difference in FY 20-21 and FY 22-23 effects.
[4] House tax bill eliminates addback in FY 2018; Senate and Governor eliminate addback in 2019. Sheet uses larger Senate number since it is the closest to zero.

- **Rationalize Charitable Contributions.** With Minnesota's shift to an AGI starting point and the accompanying move to take control over its own itemized deduction rules (agreed to by all parties) having separate charitable deduction incentives for itemizers and non-itemizers doesn't make sense. There is an opportunity to rationalize the system with a more powerful charitable contribution credit for those who do not itemize at the state level. Recommended features included: 1) creating a minimum contribution threshold to receive the credit to focus the giving incentive on the margin where it matters most; 2) setting the credit rate such that the provision is revenue neutral (the loss equals that from the current itemized deduction and non-itemizer subtraction); and 3) limiting the aggregate donations that would qualify for the credit to the standard deduction to encourage the biggest donors to continue to use the federal deduction, thus having the federal government, rather than the state, experience the revenue loss. It was also suggested that qualifying contributions be cash only to get rid of the compliance and administrative problems in valuing donations of used clothing and other property.

- **Adopt chained CPI.** The benefits of consistency with federal rules and the enhancement of state revenue collections from its adoption are more important than the slowdown in the growth of lower income redistributive programs like the Working Family Credit, (which as our own research indicates is already one of the nation's most generous).

- **Eliminate both corporate and individual alternative minimum taxes.** Experts noted retaining a Minnesota corporate AMT based on old federal concepts in an environment without a federal analogue is just not practical. Moreover, there is plenty of proposed corporate base expansion with or without foreign earnings provisions to offset this revenue loss. With respect to the individual AMT, the TCJA limitation on property tax and home mortgage interest deductions – two of the main drivers of AMT filings – make this an opportune time to simplify the tax by eliminating it.

What About Those Foreign Earnings Provisions?

The centerpiece of the conformity debate – certainly in a budget sense – is Minnesota taxation of foreign earnings. Entire forests have been clearcut to opine, editorialize, analyze, scrutinize, debate, and pontificate on the intricacy, constitutional legitimacy, and revenue-raising justifications of state conformity to deemed repatriation and GILTI. Less commentary has been offered on whether the cause of simplicity and ease of state tax compliance and administration are better served by conforming or not conforming to these provisions.

While "more federal conformity yields greater simplicity" is a maxim that holds true in most circumstances, that's not the case with respect to foreign earnings. Not conforming is superficially straightforward - the subtraction of two lines from federal taxable income on a state return – but non-conformity can affect other state return calculations making them more complicated. However, this annoyance factor pales in comparison with the complexity conformity creates in order to avoid multiple levels of taxation between the foreign jurisdictions, the U.S. federal government, and U.S. states. This results in the need to apportion income and/or apply a coordinated tax credit and is especially true with respect to GILTI.

Most foreign earnings are not displaced domestic income, and Minnesota can't ignore the fact that markets. profits, and taxes exist out of the United States. Income apportionment is critical in order to pass constitutional tests and presents a challenge for both taxpayers and tax administrators in dealing with potentially hundreds of legal entities in numerous countries. The challenge might be reflected by the fact that the majority of states with a corporate income tax are decoupling from these international provisions. For the states that are imposing, or potentially imposing, corporate income tax on either repatriated income or GILTI more than 2/3rds have not issued new guidance on how to apportion such income. It is worth noting that GILTI is a minimum tax intended to ensure that between the foreign jurisdiction and U.S. federal government, 13.125% tax is applied to foreign earnings. Without an apportionment and/or foreign tax credit mechanisms, multiple taxation of the same foreign income is exacerbated. Moreover, as the conformity experiences of some states in 2018 has shown, translating GILTI calculated at the federal level to the state level can be problematic for many other reasons including differences between federal and state rules.[2] As legendary tax scholar Walter Hellerstein has noted, the important question of whether states should embrace the taxation of this income should be accompanied by a consideration of the question "are the costs worth the benefits." As he concludes, "the apparent benefits of conformity and increased revenue may well be offset by the costs of conformity and the controversies over the inclusion…" [3]

Sentenced to Another Year?

With only a few weeks left in the session and the set up so similar to last year, it's not unreasonable to foresee an ending in which deeply divided government results in a more-or-less status quo budget passing (allowing 2020 to be a referendum on the state's direction) with federal conformity again kicked to the curb. An alternative would be to embrace the opportunity to rescue something positive out of the situation by pursuing a revenue neutral conformity plan that improves Minnesota's tax system on good tax policy principles. However, both time constraints and the apparent lack of political interest to do this makes this the longest of longshots.

Theory says good tax policy is guided by a consideration of many different, and often competing, principles which should be weighed and evaluated against each other. Politics, on the other hand, often is guided by a single memorable, appealing, but restricting message, or as G.K. Chesterton once said, "the clean and well-lit prison of one idea." One thing is certain: our increasingly partisan and ideological approaches to tax policy is making a jail break more and more difficult. ■

The Other State Fiscal Consequence of Federal Corporate Tax Reform

The TCJA has been a very fortuitous and beneficial development for Minnesota's struggling public pension plans but might also play a supporting role in a real state pension fix.

There is much to potentially criticize about the 2017 Tax Cuts and Jobs Act (TCJA) in-

[2] "Where in the World is Factor Representation for Foreign Source Income," Frieden and Donovan, *State Tax Notes* April 15, 2019

[3] "Differing State, Federal Rules Could Cause GILTI Glitches" Law 360, April 24, 2019

cluding the rushed, poorly vetted, and temporary nature of many of its provisions; its timing; its impact on the federal debt; and the many new administrative challenges, complexities, and opportunities for gaming the tax system. But as this legislative session's tax policy debate shows, collectively all these concerns play a distant second fiddle to distributional consequences. Just 6 years after legislators enacted Minnesota's controversial 4th income tax tier with a 9.85% rate, the call for tax fairness is back – only the focus has shifted from the wealthy to multinational corporations.

The 40% cut in the federal corporate rate combined with the even lower deemed repatriation rates on foreign income have raised the progressive community's ire. Critics note research indicating the vast majority of the corporate tax savings are not boosting wages or generating domestic capital investments but are being directed to shareholders through dividend increases and stock buybacks which disproportionately benefit wealthy households. According to one recent study, the top 10% of American households, as defined by total wealth, owned 84% of all stocks in 2016 through direct and indirect (trusts, mutual funds, pension plans, etc.) ownership.[4]

Nevertheless, in a corporate equity market worth about $48 trillion, even small ownership shares represent very big money, and "small owners" include the defined benefit pension plans providing retirement income for state and local public employees. According to the Pew Research Center, state and local public retirement systems held $3.8 trillion in assets in 2016, about $1.8 trillion of which was tradeable equities. So it's worth taking a closer look at what the TCJA has accomplished with respect to the health and welfare of Minnesota's underfunded pension plans.

The Contribution of Corporate Tax Reform Expectations to Stock Market Gains

From an investment return standpoint, the last few fiscal years have been unquestionably excellent for the state's pension plans. The Minnesota State Board of Investment (SBI) reported returns of 10.3% and 15.1% for fiscal years 2018 and 2017 respectively. Domestic equities within the SBI portfolio performed even better – 15.4% in FY 2018 and 19.4% in FY 2017. The first half of FY19 featured a notable correction as SBI domestic equities lost 8.8%. However, since the beginning of January stocks have rebounded sharply with the Russell 3000 – the benchmark index for the state's domestic equity portfolio – up 18.8% as of this writing.

Perhaps, in places not talked about at parties, there is grudging recognition that these large corporations and their TCJA-affected stock prices are currently saving the state from another round of difficult decision making with respect to its pensions.

Identifying the role the 2016 presidential election generally, and corporate tax reform specifically, played in recent stock market performance is a challenging task. Stock markets are forward looking mechanisms reflecting expectations about policies as well the enactment of the policies themselves. They also reflect general economic activity and conditions both domestically and internationally which are partly a function of policies enacted years in the past. Yet three research investigations we came across took this effort on offering interesting insights in the process.

The first, an NBER working paper from scholars at Harvard University and the Swiss Finance Institute, studied the "elections expectations effect" by examining company stock reactions from election day through the end of 2016.[5] Regressing abnormal returns from S&P 500 companies during this period on firm characteristics, the study found the companies with high effective tax rates were clear winners. The relationship between corporate disclosed effective tax rates and abnormal returns, "proved strongly positive in the first day after the election," and "remained large and significant in the period running into year end." Companies with large deferred tax liabilities gained, while companies with significant deferred tax assets lost as the anticipated value of these assets declined. They concluded, "this relatively clean natural experiment also confirms that taxes are a very important component of firm value."

Continuing beyond the immediate post-election expectations effect, the same scholarly trio continued investigating this natural experiment throughout 2017 as the prospects for federal tax reform waxed and waned and the specific details shifted. A follow up paper[6] examined to what extent the anticipated and ultimately implemented tax reform was responsible for the steep increase in the stock market through the end of 2017. This time the researchers examined abnormal stock returns in the Russell 3000 occurring on what they called "milestone days" (major developments which occurred from the introduction of the tax bill in early November to the Senate passage of the revised bill) and regressed them again on firm characteristics affected by the TCJA. Once again researchers found "over the entire legislative period, the TCJA has a significant relative positive effect on high tax firms."

To what extent did tax reform drive the overall market? To find out, the researchers first examined the relationship between excess stock returns and the cash effective tax rate of firms (along with numerous controls) and then performed a time series regression on all these factors to determine just what drove the market's overall return during this period. They found a "highly significant and sizeable" relationship between the cash effective tax rates of firms and overall

4 "Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?" Edward N. Wolff, NBER Working Paper No. 24085, November 2017

5 "Company Stock Reactions to the 2016 Election Shock: Trump, Taxes, and Trade" Wagner, Zeckhauser, Ziegler, NBER Working Paper 23152, February 2017.

6 "Unequal Rewards to Firms: Stock Market Responses to the Trump Election and the 2017 Corporate Tax Reform," Wagner, Zeckhauser, Ziegler, American Economic Association Papers and Proceedings, 2018.

market moves. In other words, the market tended to move upward on those days when high tax firms outperformed low tax firms and vice versa. A similar and even stronger result applied for foreign revenue exposure. They conclude that while these results cannot prove a causal impact, "the findings strongly suggest that corporate taxes play an important role for aggregate stock market valuations."

If corporate tax savings matter, can an actual estimate be put on how much this influenced the market? That was the topic of an International Finance Discussion Paper from the Board of Governors of the Federal Reserve System.[7] It also looked specifically at the evolution of U.S. stock prices from the time of the 2016 presidential election through the actual passage of the TCJA. The researchers concluded a bit more than half of the 25% increase in stock prices during this period could be attributed to the actual increase in dividends (9%, or 36% of the increase) and the anticipation of higher dividends (4%, or 16% of the increase) due to the tax package.

Together, these research studies showed that the expectation and enactment of corporate tax reform has contributed to the stock market's performance and that some of the biggest beneficiaries were the stocks of higher effective tax rate companies most likely to benefit from the reform.

Tax Reform Impacts: Year of the Buyback

"The main reason stocks have done so well this cycle and could still have further upside potential, even as stocks are overweight by both the public and institutions, is that corporations continue to be huge buyers."

— Ned Davis Research Group

2018 marked the transition from expectation effects to actual tax reform policy effects. In one respect nothing changed as 2018 continued a multi-year trend that began with the end of the Great Recession of returning considerable amounts of operating earnings back to shareholders through dividends and stock buybacks (boosting share prices in the process). According to Standard and Poors, dividends and buybacks totaled 93% of S&P 500 operating earnings in Quarter 3 of 2018. But a breakdown of the two strategies reveals something interesting. Dividend growth maintained the general steady upward trajectory that has been in place since the end of the Great Recession. Stock buybacks, however, have been a different story. In 2018, announced buybacks increased dramatically to an all-time record $1.1 trillion, and companies are acting on them. According to Barron's about $800 billion of stock has been bought back, facilitated by the reduced corporate income tax rate and the even lower deemed repatriation tax rate for offshore cash holdings.

Use of tax savings and repatriated cash for stock buybacks has earned the scorn of many who see it as a tool for management self-dealing by goosing executive compensation tied to earnings per share growth and offsetting dilution from stock-based compensation all while coming at the expense of actually investing in the business. There has been some evidence to suggest that companies engaging in buybacks aren't the best investments. According to a report by Trim Tabs Asset Management in the late summer of 2018, of the 350 of companies in the S&P 500 that had repurchased their shares up to that point, 57% had underperformed the overall market. The S&P 500 Buyback ETF was underperforming the S&P index by 23%.

Yet it remains a way to return cash to investors and an especially popular one when management believes its stock price has fallen below the company's intrinsic value during market corrections. A closer look at 2018 reveals buybacks spiked in Q1 in conjunction with the sell-off in February that kicked the S&P 500 into correction territory, then spiked again in Q4 as another market correction took place. These efforts, according to Barron's, "have been one of the biggest supports to the nearly 10-year old bull market rally"[8] stabilizing equity prices at times when both retail and institutional investors were becoming nervous about national and global economic developments.

The combined impact of both those market corrections resulted in a lousy calendar year 2018 for the state's domestic equity portfolio as it lost 5.3%. But as a J.P. Morgan analyst noted, "With the largest one-way buyer returning in size to the market post earnings, we expect liquidity to improve and equities to move higher"[9] which certainly seems to have transpired. Even if buybacks deserve the skepticism surrounding them, pension commission and state budget discussions this year would have likely looked a little different without TCJA corporate tax savings and tax-favored repatriated cash flow at work behind the scenes.

Comparing the Fiscal Impact on the State

The SBI is, of course, agnostic to tax policy and politics in its investment mission. From its latest asset listing (June 2018), we calculate SBI held a $3.5 billion equity stake in the ten S&P 500 companies with the largest offshore cash holdings[10]; ten companies that represent 11.8% of the SBI's entire domestic equity portfolio. We also identified 44 S&P 500 companies which had $3 billion or more in stock buybacks in 2018, cross-referenced them with the SBI asset list, and found those companies represented $6.3 billion or 21.5% of the entire domestic equity portfolio.[11] Occasionally legislators introduce bills to rid the state of what are considered socially irresponsible investments like tobacco or fossil fuel companies. Despite the hypercriticism currently directed at big corporations, there has been no attempt to rid the state of investments in multinationals which are big users of tax havens. Perhaps, in places not talked about at parties, there is grudging recognition that these large corporations and their TCJA-affected stock prices are currently saving the state from another round of difficult decision making with respect to its pensions.

What many do want to do, as our accompanying article highlights, is tax the savings and the repatriated cash which has helped extend the longest running bull market in history. According to data provided by the Minnesota House's Fiscal Analysis Department, the two primary corporate revenue raisers being considered this year – deemed repatriation of foreign income and GILTI – are expected to raise $540 - $750 million in the coming biennium (depending on the ap-

7 "Why Has the Stock Market Risen So Much Since the U.S. Presidential Election?" Blanchard, Olivier, Collins, Jahan-Parvar, Pellet, and Wilson, International Finance Discussion Papers 1235, August 2018.

8 2018's Record in Stock Buybacks Could Be Shattered in 2019.

9 "A Powerful Bullish Force Could Soon Bolster the Stock Market" Yahoo Finance, October 27, 2018

10 They are Google, Amgen, Apple, Cisco Systems, Gilead, Johnson & Johnson, Merck, Microsoft, Oracle, and Pfizer. According to Credit Suisse, these ten companies held $703 billion in cash overseas.

11 Note that these two lists are not mutually exclusive.

proach); declining thereafter as the deemed repatriation income phases out. If we apply the 4% estimate of the effects the corporate tax reform package had on the growth in stock prices we cited earlier to the 21.4% net gain of the state's domestic equity portfolio in 2017, that yields $890 million of positive fiscal benefit for Minnesota's pension plans just in anticipation of the TCJA. Even if we limit the state fiscal impact to just one year of domestic stock price appreciation, ignore potential TCJA impacts on the state's over $10 billion stake in alternative investments such as private equity (and the merger and acquisition activity within it), and assign zero long term market or economic benefits from corporate tax reform, the asset appreciation is larger than the revenue we hope to collect in the next bienniumfrom international conformity" to the end of this sentence (so it reads "in the next biennium from international conformity.

"Happy Hour in Minnesota"?

The real question is one of staying power. Many analysts see the tailwind subsiding in the not-too-distant future as the high bar of earnings growth becomes increasingly difficult to exceed, thus setting the market up for a bigger fall. As Goldman Sachs put it, "while there's a fair amount of debate about how much this fiscal expansion extended the economic cycle, for markets our analysis suggests we're closer to the end of the day than the beginning. Hence there's less reason to behave like it's morning in America than happy hour in America." [12]

That alone should create questions about the staying power of the "path to full funding" mantra being communicated in the wake of last year's pension fixes. But the state also has found its own way to extend the happy hour buzz through its stability fixes by keeping its pension tab to a minimum:

- Using a 7.5% assumed annual rate of investment return that according to the plans' own actuaries has only a slightly better than a one in three chance of being achieved over the next 20 years. [13]

- Discounting future pension liabilities at the same rate as expected asset returns which means a larger pool of liabilities grow at the same rate as a smaller pool of assets hope to grow, all else being equal.

- Creating another fresh 30-year amortization period for unfunded liabilities which is 10-15 years longer than what the Government Finance Officers Association recommends in its standards of practice.

Arguments about fiscal irresponsibility within the TCJA are more than matched by the high risk, extend and pretend culture in which current state pension finance operates.

Connecting the Dots

It's in this context that the DFL's plans for revenues resulting from taxing foreign earnings in the next biennium need to be reevaluated. DFLers have proposed considerable new permanent tax reductions and spending predominantly supported by taxation of foreign earnings. This enabling revenue is quantifiably questionable, highly volatile, prone to litigation, and – in the case of deemed repatriation – temporary. It's a highly unstable, uncertain foundation for such big ambitions.

To protect the state's fiscal integrity, it's important to mitigate the considerable fiscal and legal risk accompanying attempts to generate revenue from taxing foreign earnings. If the state insists on pursuing the taxation of foreign earnings it would be imperative to use money *only after it has been collected* and then only use it for one-time spending. The state has a laundry list of such possibilities – highway projects, local sewer and water grants, and communication infrastructure to name a few. Pension reform should be added to this list.

Minnesota's pension funding is still trying to get by on the cheap with large intergenerational transfers of obligation and risk. As a result, substantive pension reform – whether within or outside of the existing defined benefit system – that puts state retirement systems on a truly sustainable path in a fiscally responsible and manageable way will inevitably require some infusion of cash. Notably, corporations that still operate defined benefit plans and are still trying to recover from the Great Recession are using considerable amounts of their tax savings and repatriated cash for this specific purpose.[14] The difference is that corporate defined benefit plans operate under the far more stringent valuation and funding rules of ERISA while states have created their own administrative Wild West. As a result, states have even greater urgency to tackle this problem, especially those like Minnesota more economically exposed to long term negative impacts from comparative tax disadvantages stemming from the elimination of the SALT deduction.

Unsurprisingly, nothing like this has been even hinted at. The spending wishes of the present outweigh the spending demands of the future, failing the instant gratification test. Moreover, it simply remains too easy to make current pension plan health look better than it is. However, as pension expenses gradually grow and swallow up larger and larger portions of state and local budgets, governments will be forced to do more with less. Absent in all the discussion about needed state investments is this undeniable fact: real pension reform is no less a vital investment in Minnesota's future. ■

[12] The Tax Bill Accelerated the Bull Market — And May Make Its End More Painful," Marketwatch, April 19, 2018

[13] The MSRS valuation report notes the probability of exceeding the current 7.5% assumption over 20 years is only 39%.

[14] "Tax Reform to Fuel Increased Corporate Pension Contributions" Wall Street Journal, January 9, 2018

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