FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

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In This Issue:

Showtime! 2019 Session Preview

The cast of characters has undergone a change but the storylines will look very familiar.

Politics is often equated with theatre, and if more money buys bigger productions, then the recently-released November economic forecast suggests Minnesota's 2019 legislative session will feature no shortage of dramatic scenes, impassioned soliloquies, and unexpected plot twists. With opening night only a few weeks away, we take a look at the playbill.

Setting the Scene

Given the favorable economic conditions, no one has seemed all that surprised by the $1.5 billion surplus Minnesota Management and Budget (MMB) is projecting for the upcoming FY 20-21 biennium. Importantly, that surplus does not include an almost $500 million addition to the state's budget reserve fund, which would bring it to $2.07 billion for the end of the current FY 18-19 biennium, which ends on June 30. This leaves the reserve about $150 million short of the $2.22 billion MMB currently recommends as a target, based mainly on the volatility of the state's revenues and the amount of non-dedicated general fund revenues the state receives. However, the $1.5 billion surplus does include the $720 million legislators have left on the bottom line for the current biennium, with which they could finance additional spending or tax cuts for the period prior to June 30.

On the revenue side, growth is expected to be respectable, with $2.9 billion (6.4%) in new revenues for the coming biennium. However, as **Table 1** shows that growth is concentrated in tax revenues – non-tax revenues are projected to decline by about 9%. The forecast predicts the lion's share of tax growth in two areas: individual income taxes ($2.1 billion) and sales taxes ($879 mil-

Table 1: FY 2018-19 and FY 2020-21 General Fund Budgets, November 2018 Forecast ($000)

Budget Area	FY 18-19	FY 20-21	Change	
			Amount	Percent
Balance Forward	3,333,262	3,194,100	(139,162)	(4.2%)
Tax Revenues	43,390,238	46,487,232	3,096,994	7.1%
Non-Tax Revenues	1,603,018	1,470,804	(132,214)	(8.2%)
Other Resources*	416,714	368,675	(48,039)	(11.5%)
Subtotal – Current Resources	**$45,409,970**	**$48,326,711**	**$2,916,741**	**6.4%**
Total Resources Available	**$48,743,232**	**$51,520,811**	**$2,777,579**	**5.7%**
E-12 Education	18,844,711	19,600,659	755,948	4.0%
Higher Education	3,290,092	3,255,828	(34,264)	(1.0%)
Property Tax Aids and Credits	3,664,019	3,709,687	45,668	1.2%
Health and Human Services	13,403,320	14,904,596	1,501,276	11.2%
Public Safety & Judiciary	2,337,992	2,350,702	12,710	0.5%
Transportation	341,466	247,455	(94,011)	(27.5%)
Environment	356,838	324,222	(32,616)	(9.1%)
Agriculture	126,539	122,252	(4,287)	(3.4%)
Jobs, Econ Dev, Housing, & Commerce	561,779	386,364	(175,415)	(31.2%)
State Government & Veterans	1,229,906	1,099,375	(130,531)	(10.6%)
Debt Service	1,112,908	1,199,210	86,302	7.8%
Capital Projects & Grants	294,515	273,511	(21,004)	(7.1%)
Estimated Cancellations & Other	(14,953)	(20,000)	(5,047)	NA
Total Expenditures & Transfers	**$45,549,132**	**$47,453,861**	**$1,904,729**	**4.2%**
Cash Flow Account	350,000	350,000	—	—
Budget Reserve	2,074,733	2,074,733	—	—
Stadium Reserve	49,660	98,362	48,702	98.1%
Budgetary Balance	**$719,707**	**$1,543,855**	**$824,148**	**114.5%**

* Includes dedicated revenues, transfers in, and prior year adjustments.
Note: Dollars in thousands, parentheses signify reductions.
Note: Budgets shown based on current law.
Source: November 2018 Economic Forecast: Minnesota Management and Budget; percentage calculations by MCFE.

Minnesota Center for Fiscal Excellence

Tom Gottwalt, *President*
Aaron Twait, *Research Director*
Mark Haveman, *Executive Director*
Linda Edstrom, *Executive Secretary*

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Postmaster, send address changes to:

Fiscal Focus
c/o Minnesota Center for Fiscal Excellence
85 East Seventh Place, Suite 250
St. Paul, Minnesota 55101

Phone: (651) 224-7477 or (800) 322-8297
Fax: (651) 224-1209

E-mail: question@fiscalexcellence.org
Web Site: www.fiscalexcellence.org

lion). Corporate tax revenues are projected to decline by about $50 million, with taxes from all other sources projected to grow by about $130 million. The reasons driving the tax growth are positive signs for Minnesota's economy over the short term – wage and salary income are projected to grow by 5.1% next year and by 4.7% in 2020, with 4% to 4.5% growth projected for the sales tax base.

Two TCJA-related issues are worth mentioning with regards to the individual income tax projections. Although Administration officials were adamant during the 2018 session that state law prohibits individual filers from electing different deduction statuses on their federal and state returns, last summer Revenue quietly issued notice to the contrary. Had the state stuck to its guns, many Minnesotans would have had to give some of the tax savings they will realize through the higher federal standard deduction away to the state. The forecast indicates that the state's decision to reinterpret the provisions around deduction elections will save taxpayers $88 million in the next biennium. When combined with the $34 million in lower revenues resulting from taxpayers' decisions to change their federal tax accounting methods, as provided for under the TCJA, it's clear that even without any tax bill last year, TCJA policy is still affecting state revenue collections.

The Supreme Court's *Wayfair* decision has also made its way into the economic forecast. There had been some debate during the last year over just how much new revenue taxing on-line sales might generate, given that many major retailers with on-line presence were already collecting and remitting taxes. As the forecast indicates, that caution was likely warranted. The state's economists are predicting that about 25%, or $225 million, of the forecasted increase in sales tax revenues next biennium will come from taxing on-line sales.

This "off the books" expense is infinitely more deserving of the media's and the Council of Economic Advisors' constant scolding and fiscal hand wringing than spending inflation.

Moving to the other side of the ledger, under current law FY 20-21 spending is forecast to grow by $1.9 billion (4.2%) over FY 18-19 levels. Note that many of the spending areas shown in Table 1 decline between the current and upcoming biennia – we believe this is largely the result of one-time appropriations for FY 18-19 that, under the forecasting rules, are assumed to blink off. However, in many respects the major spending storyline remains unchanged from previous years: health and human services spending is expected to grow by $1.5 billion. As a result, an area of the budget now constituting about 30% of general fund spending is projected to consume over 50% of new general fund revenues. This is in spite of forecasters actually lowering their estimate for general fund spending on Medical Assistance (Medicaid) in FY 20-21 by $383 million, primarily because of lower managed care rates. This disproportionately rapacious consumption of new general fund revenues reflects a rate of spending growth that is actually ***smaller*** than the 13% growth rate seen on average between biennia since FY 1988-89. Another large ambition-denting factor is the $756 million in new spending that E-12 education claims also under current law. Ambitions will also be limited since the "structural surplus" – current revenues less current spending and transfers – is $873 million, with the other $671 million being one-time money. Many lawmakers will be leery of using one-time resources to finance ongoing tax cuts or spending increases.

No forecast presentation is complete without some reference to the effect estimated inflation would have on the forecast if state law allowed for it to be included. The state's Council of Economic Advisors continues to be critical that this practice, which would add $1.2 billion in forecasted spending for FY 20-21 and $2.9 billion for the FY 22-23 planning estimate, is not allowed. On the one hand, this inflation estimate responsibly does not double count inflation that is already included in the forecast. Contrary to public perception, forecasted changes for the state's share of special education funding and its share for managed and long term care spending both already include inflation adjustments. And the inflation estimate does a respectable job of omitting some significant amounts of general fund spending that logically do not merit automatic inflationary adjustments, like debt service and property tax refunds.

However, a strong argument can be made that other types of general fund spending should also be excluded from inflationary adjustments, like capital projects, other types of property aids and credits programs, and pension appropriations — all of which were, in fact, excluded when the state first started adding planning estimate inflation in 1991. More fundamentally, it is frankly naive to think that the forecast does not serve as a de facto budgeting tool as well. As a House Fiscal Analysis Department publication stated in 2002:

> "Planning estimate inflation has been a tool to provide more flexibility for a Governor and Legislature in assembling a new budget. The inflation creates a cushion of several hundred million dollars that is already counted as spending in the budget forecast" [1]

"Several hundred million" back then is $1.2 billion today, which is a very luxurious cushion. Including inflation enables considerable spending on new or expanded programs without ever having to recognize it as "new government spending."

Putting aside the complexities of if and how spending inflation should be included, the fuss over this topic pales in comparison to the biggest and most influential "spending reality" the economic forecast ignores. Governments in Minnesota have not made the full actuarially required contributions into the state's pension plans, as a whole, for well over a decade, and since FY 2002 these contribution shortfalls have contributed over $6.5 billion to these pension plans' unfunded liabilities. Last year, the plans were shorted another $390 million, and even with the highly-lauded pension changes signed into law earlier this year we fully expect the

1 *Planning Estimate Inflation in State Budget Forecasts*, House Fiscal Analysis Department, 2002.

valuation reports for FY 2018 to project yet another year of inadequate funding for FY 2019. Given that the pension benefits these missing dollars are supposed to finance are required to be paid regardless of what happens with the funding, this "off the books" expense is infinitely more deserving of the media's and the Council of Economic Advisors' constant scolding and fiscal hand wringing than spending inflation.

While pleased about the condition of Minnesota's finances, MMB Commissioner Myron Frans and other MMB staff were quick to warn that the path ahead may have some speedbumps and potholes. As state economist Laura Kalambokidis pointed out, forecasters are now expecting slower growth for 2021 through 2023 than they had in February, with the state's real Gross Domestic Product growth projected to fall from 1.9% in each of those years to 1.6%, 1.5%, and 1.4%; respectively. MMB's macroeconomic consultant, IHS Markit, expects the national economy to begin slowing in 2019 as the TCJA-related stimulus fades and a stronger dollar brings net exports down. Moreover, IHS believes Minnesota's labor force participation rate will fall after 2020 as the state's demographics continue to change. Perhaps the most positive medium-term economic news is that IHS only sees a 25% chance for a recession in 2020.

Protagonists and Antagonists

Last month's elections will also have a major impact on the 2019 legislative session. The result in the gubernatorial election was, in the end, not really surprising. Polls throughout the summer and fall correctly forecasted a win for the DFL candidate, Congressman Tim Walz, over Hennepin County Commissioner Jeff Johnson. Turnout for the election was high, as Walz's nearly 1.4 million votes were the most ever cast for a gubernatorial candidate in Minnesota history – with Johnson's nearly 1.1 million the second-most ever cast. (Both candidates surpassed the former record, Arne Carlson's total of 1.094 million in 1994.)

The DFL not only retained control of the governor's mansion; the party also took control of the Minnesota House in convincing fashion. The party picked up 18 seats, moving the chamber from a 77-57 GOP advantage to a 75-55-4 DFL majority – with four Republicans leaving the fold to establish a "New Republican" caucus. Notably, 16 of the DFL's 18 pickups came in the seven-county metro; the other two include a former member winning his seat back in the Bemidji area and the St. Cloud-based race where the GOP incumbent stepped away from the campaign late in the season. Most of the metro-area seats the DFL picked up were in third ring suburbs/exurban areas, many of which have not been prime DFL territory as of late – think Shakopee, Savage, and Maple Grove.

The GOP controls virtually all the Greater Minnesota legislative seats, with the exception of the Iron Range and some regional centers like Rochester, Mankato, and St. Cloud or college towns like Northfield or St. Peter. Given that the House DFL has basically built its majority on the Twin Cities suburbs, it will be interesting to see whether and how that plays into their legislative strategy and proposals during the next two sessions. The deepening of the geographic divide between the parties makes Gov.-elect Walz's "One Minnesota" message seemingly a challenge to deliver on.

The Minnesota Senate remains in GOP hands, with State Representative Jeff Howe defeating Stearns County Commissioner Joe Perske for the seat vacated when Sen. Michelle Fischbach was elevated to lieutenant governor. However, with the thinnest of margins (a 34-33 advantage), Majority Leader Paul Gazelka will have his hands full this session, since each member of his caucus effectively holds a veto over any proposal for which there is no DFL support. With a number of metro-area seats now looking more competitive than they might have prior to the election, keeping the caucus united might be a challenge as senators look ahead to 2020.

The dynamics between the two legislative bodies and the governor will also be very different in 2019-2020. In prior years, Governor Dayton served as a backstop for the DFL, using his veto power liberally to strike down bills the GOP-controlled legislature sent to him. Gov.-elect Walz is far less likely to need to use the veto, given the DFL's control of the House. Conference committees are also likely to take on a much greater significance, since they are likely to feature much more negotiation in a divided legislature than they have during the Dayton years, when the legislature was divided only in 2015-16.

Plot Lines

The stalemates and lack of productivity of recent years has kept several high-profile policy issues endemic to every legislative session on a more or less slow boil. For other topics the time is now up and decisions must be made.

- **Federal conformity.** One of the major failures of the 2018 session was the state's inability to respond to the federal government's TCJA-related changes. Legislators will take another crack at the issue in 2019, but this time informed by whatever trials and tribulations arise out of taxpayers' tax year 2018 filing experiences. One crucial (and arguably the most important) policy objective surrounding federal conformity – simplicity – was essentially shut out of the debate last year. Any potential discussions about making the tax system simpler and therefore easier to comply with (for taxpayers) and administer (for government) were immediately overwhelmed by political preoccupations over who pays and how much. It will be interesting to see if lawmakers want to repeat this experience. Fortunately, there is no rush to address this early in the session since our bed for tax year 2018 has already been made.

- **Provider tax fate.** The state's 2% tax on health care providers, hospitals, surgical centers, and wholesale drug distributors (the so-called "provider tax") is scheduled to blink off after December 31, 2019. These taxes raise about $650 to $700 million in revenue annually, which now principally go to support Medical Assistance, the state's Medicaid program. Legislators will need to determine whether they want the phaseout to continue as planned, or if not whether to continue the provider taxes in their current form or modify them somehow. We plan to release an Issue Brief exploring the policy issues surrounding this topic sometime during the first few weeks of the upcoming legislative session.

- **Transportation finance.** Other committees may choose to look at methods of potentially making Minnesota's transportation spending more effective, but the tax committees will certainly be drawn into a debate over Minnesota's gas tax. According to data from the Federation of Tax Administrators, Minnesota's 28.5¢ per gallon rate is about 20th highest in the nation.

However, Gov.-elect Walz was clear on the campaign trail that he would be open to an increase. Advocates would need at least one GOP senator to break ranks – and the example party activists made of the six GOP representatives who voted to override Gov. Pawlenty's 2008 veto of that gas tax increase will surely be front and center in the mind of any potential Republican supporter. Other funding sources – including a reprise of dedicated sales tax revenues– may enter into the discussion.

- **Property tax relief.** Like the Terminator, this issue just keeps coming back. With housing values rising while growth in commercial and industrial values has slowed, tax base is sloshing over to homeowners and we have seen property tax increases of 40% on some Truth-in-Taxation statements. Unsurprisingly, this has riled homeowners and lawmakers appear ready and eager to jump in (yet again) to save the day. Will the DFL majority in the House make the state's property tax refund even more generous (which would tend to benefit the metro area and many of their newly-elected members) or turn to Local Government Aid (which would distribute somewhat more money to Greater Minnesota)? Our bet is both but that raises the bigger question: just how much local property tax relief can the state really afford when it has its own major spending obligations and responsibilities to address?

With a full and interesting legislative agenda and new personalities, it will be easy for citizens themselves to get wrapped up in the political intrigue and drama surrounding our budget debate. But that's not a bad thing. For as someone once said, "We must all do theatre to find out who we are and to discover what we could become." ■

Greatest Tax Research Hits of 2018

Behaviors prompted by federal reform, the unintended consequences of eliminating tax havens, and new insights into tax compliance are some of the topics covered in our review of tax research in 2018

In the social media era, "expertise" appears to be losing its clout with respect to public policy. Academics who have dedicated careers to the study and understanding of hugely complicated policy topics are undoubtedly frustrated to see 280 characters of attitude and opinion having more influence than pages of evidence, analysis and conclusions from their carefully designed research. (Although, to be sure, some of this growing policy impotence is a self-inflicted wound of insularity. Witness the National Tax Association annual meeting. Once a vibrant mix of tax practitioners, lawmakers, and academics advancing the intersection of tax research, policy, and practice, today you can't get served at the cash bar without being able to articulate and defend a regression approach.)

Nevertheless, the world of academia soldiers on offering insights into the complicated cause and effect relationships in public policy. As is our custom, our year-end edition of Fiscal Focus takes a look back at a handful of the interesting 2018 National Bureau of Economic Research Working Papers we came across in the areas of tax policy.

What Hath the TCJA Wrought?

Unsurprisingly, Congress' passage of the Tax Cuts and Jobs Act (TCJA) has created an irresistible laboratory for investigation. In the creatively-titled (for academia at least) "Tax Reform Made Me Do It!," [2] a member of the U.S. high priesthood of tax scholarship, Joel Slemrod from the University of Michigan, along with colleagues from MIT and the University of North Carolina examined the relationship between the actions corporations took and the statements made in response to federal tax reform. Just as interestingly, the researchers took a closer look at the characteristics of those companies that publicly expressed a cause and effect relationship between passage of the TCJA and their behaviors.

The researchers examined four different outcomes reporting during the first quarter (Q1) of 2018: bonuses and other actions that benefitted workers, announcements of new investments, share repurchases, and dividend announcements. According to the working paper:

- Researchers found only 4% of the public firms in their sample announced in Q1 that some of their tax savings would be directed toward workers. Of these 163 public firms that explicitly linked the passage of the TCJA to some sort of worker benefit, the most common award (72%) announced was a one-time worker bonus. (Note that in some cases, a firm announced more than one enhanced benefit.) To provide some quantitative perspective on this result, researchers were able to compare total worker bonuses with total staff expense for 43 of these companies and concluded that the $441.5 million in TCJA-prompted worker bonuses equaled 0.5% of annual staff expense for these firms.

- With respect to investment announcements, 22% attributed some form of investment due to tax reform. Many companies provided additional detail about what the investment would entail: 62% of this group identified investment in technology improvement and 45% of this group mentioned new capital expenditure.

- With respect to share repurchase plans, only 5% of the 179 announcements of new share repurchase plans made in Q1 explicitly tied the repurchase to the passage of the TCJA. There was evidence that share repurchases through already *existing* plans experienced an uptick but were not out of line with historical trends.

- With respect to dividend increases, 41 of the 344 firms that increased dividends in Q1 of 2018 publicly announced the increase was attributable to passage of the TCJA. However, researchers detected no obvious trend increase in either the number of firms, the dollar value of dividends provided, or the establishment of special dividends.

Were these announcements and actions politically or economically motivated? Researchers found evidence of both at play. Companies that had the highest pre-TCJA tax rates and expected their tax rate to decrease the most were more likely to provide worker related benefits and assert more investment. However, corporations with PACs emphasizing Republican candidates over Democrats were also more likely to announce TCJA-tied worker benefits. Researchers concluded political motivations may have played a role in these announcements but firms with the most to gain from reform were most likely to announce actions in response to reform.

[2] "Tax Reform Made Me Do It!" Hanlon, Hoopes, Slemrod, NBER Working Paper #25283, November 2018.

Issues Motivating Corporate Tax Reform

Aside from the effects of TCJA itself, several policy issues embedded in the recent tax reform debate also received a fair amount of research attention. Chief among them is the desire to stop profit shifting to tax havens by multinational companies. Such pursuits are premised on the argument that profit shifting only affects tax revenues but has no meaningful impact on real economic outcomes. But in "Unintended Consequences of Eliminating Tax Havens" [3] a Duke University researcher revisits an historical example of a U.S. policy change to limit profit shifting and finds economic fallout – negative impacts on both domestic investment and employment.

For decades, the federal government exempted U.S. multinationals from income taxes if the income originated in affiliated corporations located in Puerto Rico or other U.S. possessions. In 1976, the exemption was replaced with a tax credit but concerns persisted that the provision was a conduit for profit shifting. "Section 936" as it was called was repealed as part of the Small Business and Job Protection Act of 1996. In the year prior to the repeal, 682 domestic "Section 936 firms" with Puerto Rican affiliates employed nearly 11 million workers in the continental United States. [4]

The study uses firm-level data to examine what happened to these now-exposed "tax haven using firms" with respect to investment and employment and compares them to "non-exposed" firms (i.e., U.S. firms not utilizing Section 936 and therefore not exposed to its repeal) using a wide variety of controls, robustness tests and related checks. Prior to the repeal both exposed and non-exposed firms featured very similar investment and employment trends. However, following repeal "Section 936" firms reduced global investment by 23%, increased the share of investment abroad by 17.5% and reduced U.S employment by 9.1% relative to non-exposed firms. These responses had a significant effect on the U.S. economy as impacted firms lowered domestic investment by 38% and reduced payroll by 1 million jobs. Moreover, the firm level effects were geographically concentrated in the U.S. and had long term impacts. The study found fully 15 years after the repeal of Section 936 local U.S. labor markets that were more exposed to the repeal saw slower growth in employment, wages and home values and had become more reliant on government transfers.

The study concludes firms do respond to limits on profit shifting as they do in response to tax increases: by lowering global investment and reducing economic growth. As a result, an accurate cost benefit analysis of policies that aim to limit profit shifting, "should include the unintended consequences of these policies and account for employment and investment losses in the United States." But perhaps most importantly, the author argues these findings have relevance for current efforts and proposals to combat profit shifting such as are in the TCJA. Such unilateral polices "can backfire" the study concludes, and argues multilateral approaches are better able to address these concerns while limiting the unintended consequences.

> **"The quantity, quality and location of innovation are all affected by the tax system and the effects are quantitatively important."**

Another topic driving interest in tax reform is innovation – do taxes affect the amount, quality, and location of research and development (R&D) work by both individuals and firms? That is the question behind "Taxation and Innovation in the 20th Century,"[5] which systematically examines the effects of individual and corporate income taxation on U.S. inventors and firms over decades.

The scope of this investigation was rather remarkable – researchers created a dataset by compiling 80 years of detailed information on the R&D activities of both private and publicly traded firms, and 100 years of federal and state individual and corporate income tax data. Their principal sample period alone, which covered the years 1940 through 2000, contained 1.95 million U.S. inventors and 2.78 million patents. The researchers investigated both state-level effects and the effects of taxes on individuals and firms and concluded taxes matter across all the different dimensions of innovation.

- *State Level Effects* – Researchers found both individual and corporate income taxes have significant effects at the state level on patents, patent citations (an indicator of the quality of the patents), inventors in the state, and the share of patents produced by firms as opposed to individuals. For example, a one percentage point higher top corporate marginal rate leads to around 6.3% fewer patents, 5.9% fewer citations, and 5.1% fewer inventors. Approximately 50% of the corporate tax's impact on patents, citations, and inventors can be assigned to a reduction in innovative activity and 50% to movement of this activity across state lines. Researchers also found a lag in the effect of tax changes on innovation at the state level with the strongest effects appearing 1-3 years after the tax increase or decrease.

- *Individual level Effects* – While both individual and "corporate" inventors (individuals working for corporations) demonstrated sensitivity to income taxation, corporate inventors were found to be much more sensitive to taxes on both individual and corporate income than their non-corporate counterparts. Taxes had an impact on inventors' location choices – average tax rates were found to be a strong negative predictor of location decisions. However, two factors weaken these tax effects: 1) the tendency for inventors to remain in their home state rather than move, and 2) "agglomeration forces" (the existence of professional networks and amenities offering continuing education and learning).

- *Firm Effects* – Corporate tax rates had a significant effect on the number of patents, their quality (as captured in citations), and the number of research workers. Individual income tax rates also influenced firm level outcomes but less so than the corporate tax rate. Interest-

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3 "Unintended Consequences of Eliminating Tax Havens" Serrato, NBER Working Paper #24850, July 2018.

4 Although the repeal of Section 936 is often credited as a major factor contributing to Puerto Rico's fiscal crisis, studies have shown the crisis began after the full phase out of Section 936.

5 "Taxation and Innovation in the 20th Century" Akcigit, Grigsby, Nicholas, Stantcheva, NBER Working Paper #24982, September 2018, revised October 2018.

ingly, it was the marginal tax rate at the median income level rather than at the 90th percentile of income that reflected tax impacts. The top corporate tax rate was found to have a significantly negative effect on the decision to locate an R&D lab in a given state.

As the authors conclude, "the quantity, quality and location of innovation are all affected by the tax system and the effects are quantitatively important." Yet, at least with respect to corporate income taxation we can't help wonder if these relationships might be evolving in light of single sales factor apportionment, which renders the location of plant and people irrelevant to state corporate income tax burdens.

But as the debate over federal tax reform illustrated, equity issues are no less a fixture of today's tax policy discussion. While corporate tax cuts may foster innovation and economic growth, new research suggests that comes with a trade-off that concerns many policymakers. In "Corporate Tax Cuts Increase Income Inequality" [6] researchers found state corporate income tax reductions increased capital investment in the state but were also responsible for growth in income inequality. Researchers found that between 1990 and 2010 a 0.5 percentage point reduction in state corporate taxes explained 12.4% of the total increase in the share of income accruing to the top 1% of earners. Notably, the size of the effect is much greater than that which would be implied if the cut created no behavioral responses – i.e., no effect on the location of firms, workers, wages, or investment. Growth in income inequality was also a function of 1) gains from increased investment in the state that are concentrated on top earners, and 2) taxpayers at the top of the distribution shifting income from salary and wages to capital income to reduce taxes.

One final corporate tax study captured our attention this year. Policymakers have long observed that many households do not take advantage of program benefits to which they are entitled and taxpayers often do not take full advantage of tax benefits that are available to them. This is typically chalked up to a simple lack of awareness, but complexity can be a contributing factor. In "The Costs of Corporate Complexity" [7] investigators found these same situations also exist in business. In a sample of 1.2 million observations of corporate tax returns, researchers found only 37% of eligible firms claimed their refund for tax losses. Moreover, a cost benefit analysis did not explain the low take up. For small businesses, their knowledge of the refund's availability and how to file for it, along with the sophistication of the tax preparers they use, explains the underutilization. For larger firms, the researcher posits that complex interactions with other tax code provisions including the alternative minimum tax and interference with ongoing audits explain decreases in credit takeup.

The Compliance Question

For all the countless empirical investigations devoted to tax issues over the decades, surprisingly few have centered on tax compliance and enforcement. That is apparently changing as a literature review[8] documents an "explosion" of activity from around the world examining the other two pillars of the tax system – tax remittance and enforcement. This new wave of investigation is examining the magnitude and nature of tax evasion and evaluates the effectiveness of various policy measures in addressing compliance concerns. Real money is at stake; according to the latest IRS estimates in the literature review, the federal tax gap estimate is $406 billion, representing 16.3% of the estimated actual (i.e., remitted plus unremitted) tax liability.

Here are a few facts and interesting findings culled from the various studies worthy of consideration:

- Unsurprisingly, the extent of information reported to the IRS has a major impact on compliance rates. Where there is little if any third-party reported information (like self-employment income), the noncompliance rate is 63%. Where there is substantial third-party reporting, noncompliance drops to only 7%. For wages and salary income, noncompliance is 1%.

- Appeals to personal responsibility, conscience, duty, and the public good with respect to tax remittance don't demonstrate any significant effect on increased compliance.

- Compliance responses to enforcement initiatives like audit threats can vary by income. One proposed explanation: higher income and self-employed filers (and their accountants) view an audit threat as part negotiation and see taxable reported income as the opening bid that does not necessarily result in finding and penalizing all noncompliance.

- Communication content matters. Letters to taxpayers that contain general statistical information about the probability of being audited and penalty rates increased tax compliance by 6.3% or about one-fourth its current level. Adding a paragraph that evading taxes increased the probability of being audited increased tax compliance by about 7.4%.

- The staying power of such communication with respect to compliance efforts is less clear. Interventions improve compliance in the short term but taxpayers may become desensitized to these efforts.

- There is some evidence that "public shaming" (e.g. public notifications of tax crimes or tax debt) can be effective compliance motivation for some types of taxpayers.

- Political alignment with the party of the presidential administration has a positive impact on compliance.

- Compliance issues exist at both ends of the income spectrum. The ratio of misreported income to true income increases with income peaking at adjusted growth income in the 99.0 to 99.5 percentile. However, the ratio of underreported tax to true tax is highest for the lowest income taxpayers.

- Recent studies based on information leaks from foreign financial intermediaries suggest the superwealthy evade as well as avoid taxes. One study estimated the top 0.01% evade about 30% of the income and wealth taxes they owe.

- In a few places around the world compliance rewards (like being entered into a lottery for tax holidays) improved compliance rates.

While these studies suggest a wide variety of potential avenues to pursue, the author closes with an important acknowledgement: knowing the effect on compliance "is by no

[6] "Corporate Tax Cuts Increase Income Inequality" Nallareddy, Rouen, Serrato, NBER Working Paper #24598, May 2018.

[7] "The Costs of Corporate Tax Complexity" Zwick, NBER Working Paper #24382, March 2018.

[8] "Tax Compliance and Enforcement", Slemrod, NBER Working Paper 24799, July 2018

From The Director: Questions Beleaguered Property Taxpayers Should Be Asking


Mark Haveman

December in Minnesota. Holidazzle. Vikings angst. And lots of taxpayer grumbling and anger over projected property tax increases. 'Tis the season for trying to figure out just why property tax bills are going up (and to hear lots of pledges from politicians eager to do something about it).

Minnesota's homeowner property tax burdens are substantially below the national average, and according to the Department of Revenue's latest *Residential Homestead Property Tax Burden Report*, property taxes relative to median homestead income are 18% lower in the seven-county metro and 9% lower in Greater Minnesota than they were 10 years ago. It doesn't matter. The volatility and unpredictability of the property tax has long made it the most unpopular tax. But the icing on the cake of taxpayer frustration is being unable to understand why property taxes are going up – "Truth in Taxation" statements notwithstanding.

There is no lack of detailed information on local government budgets available at your fingertips. There is often a troubling lack of context for that information, which makes taxpayer oversight and judgment about the efficacy of local levy decisions so difficult. And occasionally the comments and context local governments provide confuses more than helps.

At the extreme is one example we came across from a county commissioner arguing that the state general levy freeze enacted in 2017 shifted property tax burden onto local homeowners, which is flat out wrong. A much more common example is the "local tax rate comparison" bar graph which has become a staple of many taxpayer outreach efforts. They inevitably show a city or county in a highly favorable light compared to selected peers. The problem is property tax rates aren't like income and sales tax rates, which directly influence how much revenue government collects. These rates are just something local governments mathematically derive to allocate their property tax levies among property owners. Higher property tax rates in one location can collect less property tax revenue than lower rates in another location, depending on the overall amount of value in the community. At best such comparisons distort perspective; at worst they distract from levy decisions and other changes which really drive changes in how much property tax a government collects.

So what should taxpayers do about this? Here are three questions we think taxpayers should ask to get to the heart of the issue.

"Just exactly how was the dollar amount of the levy derived?" Remember when your sixth-grade math teacher never let you get away with just giving the answer? You always had to "show your work." That same principle should absolutely apply to any explanation to taxpayers about property taxes. One of the property tax's major advantages is that local officials set the levy amount after determining spending needs, projected changes in state and federal aids, projected changes in non-property tax revenues, and projected use of (or additions to) reserves. In short, there are (or should be) mathematical calculations behind every levy. And most importantly, if that mathematical derivation is presented and compared to the previous year, it would be elementary to assign reasons for levy growth to the correct causes. (In all our years, we've never seen a local government present a levy change this way. If any reader has, please pass it on to our attention.)

"Can you tell me how you are managing government inflation?" Inflation is a reality for local government budgets but it can be a convenient scapegoat when communicating budget information to taxpayers. It's a generic idea used in newsletters and budgets-in-brief to explain higher spending levels that citizens reflexively accept as a legitimate reason for levy growth. To be sure, fuel, road salt, indemnity insurance, contractual expenses and other procurements can be affected by price increases outside of government's control. But, the vast majority of government spending, especially for cities and school districts, are labor costs over which governments themselves have considerable influence and control. In short, the issue is not the existence of generic "inflation" but how governments are managing inflation and controlling costs especially in their largest expense.

"Is the government doing anything it really shouldn't be doing?" To some extent this will always be in the eye of the beholder, but special government ventures can create undue taxpayer exposure. The place to look are government "enterprise funds" which are government's foray into business management and the world of profit and loss. Such government enterprises are often managed responsibly and successfully but occasionally ambitions exceed sound fiscal judgment – especially when the business operations at issue demand high levels of expertise, operate in a highly competitive and changing environment, and require significant capital investment. Given that these ventures operate outside the general fund and therefore largely off the budget radar, taxpayers can have a particularly difficult time evaluating them.

The current poster child for projects meeting these criteria is government broadband. Government certainly has a role to play in making broadband accessible to underserved areas, but mission creep in the form of ventures into government owned retail networks have resulted in spectacular and costly failures around the country, including a couple here in Minnesota. Prompted by the siren call of economic development and third-party consultants, the push now is to build fiber networks and lease the infrastructure to ISP providers. Problems arise when such efforts take place where the private sector has a very established presence. In one Twin Cities community, $600,000 in revenues from utility funds (taxpayer payments for water, sanitary sewer, street lighting, and storm drainage/water quality services) were used to subsidize the creation of a fiber network. According to budget documents, that network is expected to lose about $270,000 in 2018. Undeterred, now other communities in the county and the county itself are looking to embrace the same business model. Put aside the predatory nature of subsidized municipal entry and the danger of unintentionally reducing private sector investment. In these circumstances government budgets rich in fiber have an

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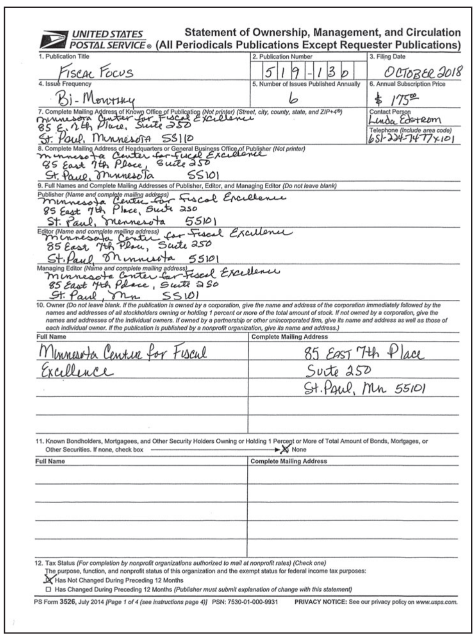

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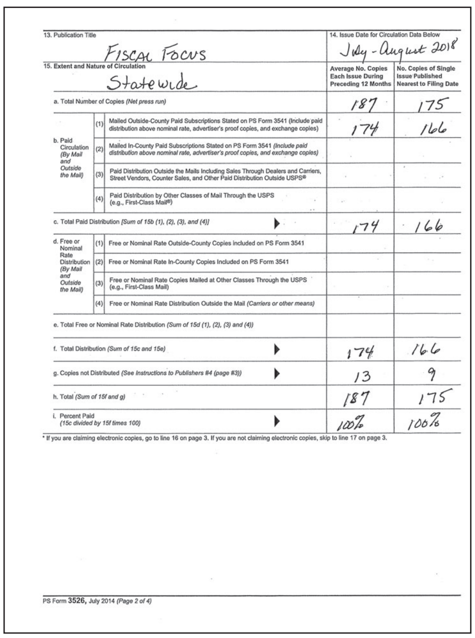

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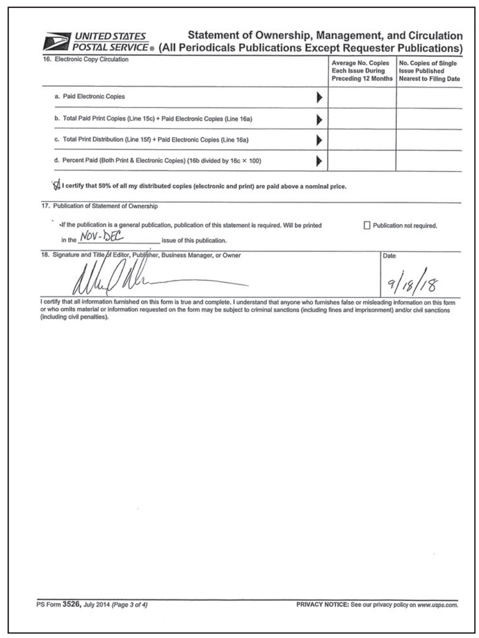

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means sufficient information for guiding policy decisions." Policymakers also need to know about the social costs of these policies including intrusions on privacy and the rights of taxpayers. It's easy for the latter to get lost in the "pay their fair share" debates but acknowledgment of rights and responsible taxpayer protections is a no less critical part of a sound, effective tax system. ■

excellent chance of creating something taxpayers will have to clean up later.

The property tax is the most untransparent transparent tax. On the one hand, its "in your face" presence makes it a great way to calibrate people's expectations of government with their willingness to pay for it. On the other hand, the complexities of modern government and its ability to control narratives makes it difficult for taxpayers to make independent judgements about how their tax dollars are used. Investment of effort by both taxpayers and their governments is needed to manage the discord which increasingly threatens this essential revenue source for local government.

— M. H.