FISCAL FOCUS

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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

HIGHLIGHTS OF MCFE'S 91ST ANNUAL MEETING AND POLICY FORUM

Federal Tax Reform as *Seinfeld*

As our 2017 tax panel discussed, the ongoing federal tax reform debate features convoluted story lines, awkward situations, and outrageous characters, and may well end up being a show about nothing.

The good news: with the recent release of more elements of the federal tax reform plan, there is now about nine times more substance as there was in the blueprint released a couple months ago. The bad news: federal tax reform now totals nine pages instead of one. And that is generous. Like a third-grader's book report featuring massive margins and paragraph spacing to meet a teacher's minimum page expectations, one of the most distinguishing features of the updated reform plan is its copious amount of white space.

Nevertheless, the dearth of new information did not prevent an engaging discussion on federal tax reform by our distinguished 2017 annual meeting tax panel. Moderated by former revenue Commissioner Ward Einess, participants explored the prospects for reform, the politics surrounding it, and the potential implications for Minnesota. Panelists included Commissioner Cynthia Bauerly, Minnesota Department of Revenue; Doug Lindholm, President and Executive Director, Council on State Taxation; Max Behlke, State Budget and Tax Director, National Council of State Legislators; and Joe Crosby, Principal, MultiState Associates.

Reform in the Eye of the Beholder

Starting from a big picture perspective, panelists were asked if the proposal seems to meet tests of true tax reform. Can it be described as potentially game changing in terms of addressing needs and remedying problems that plague the tax system in its current design? Panelists commented that while ideas that would qualify as true reform

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Welcome to Fend for Yourself Federalism

Our 2017 fiscal policy panel examined a future in which more responsibilities devolve to states backed up by the type of uncertainty and unpredictability only the federal government can provide.

When President Trump released his budget earlier this year, some used the phrase "shock and awe" to describe the proposed cuts and the change in the federal/state relationship it represented. Even though Congress is likely to temper these cuts through its own budgeting and appropriations processes, it's clear the major push for tax relief combined with the federal government's challenges in funding its own existing and massive health care and retirement responsibilities is likely to have big ramifications for federal support for state and local government.

What does the current federal budget debate suggest with respect to future state and local government budgets? What services are most exposed? What are states doing to prepare for what is coming? And to what degree are states' own self-inflicted fiscal problems likely to make the impacts of federal cuts worse? This was the focus of our 2017 fiscal policy panel, moderated by American Public Media's senior economics contributor Chris Farrell. Panel participants were Donald Boyd, Director, Fiscal Studies, Rockefeller Institute of Government; Natalie Cohen, Managing Director and Head of Municipal Research, Wells Fargo; Myron Frans, Commissioner, Minnesota Management and Budget; and Robert Zahradnik, Principal, State Fiscal Health and Economic Growth, Pew Charitable Trusts.

Reactions to the Other Side of the Ledger

Because of the panelists' extensive state and local government finance expertise, each was asked to first offer their own thoughts

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certainly exist in the plan, they are lost in a sea of ambiguity making it impossible to answer that question. The current reform proposal, said Doug Lindholm, is "a moving target – sometimes ephemeral, sometimes non-existent." He cautioned against paying attention to ideas that appear to be reform features but due to their lack of detail are really nothing more than aspirational. Joe Crosby noted that territoriality in corporate taxation and the hints of a third tax system for pass through businesses could certainly be qualified as true reform, but in both cases considerable uncertainty remains surrounding the interpretation and actual implementation of these ideas.

"There is no sense of loyalty... The dynamic is really ugly."

Max Behlke discounted the idea of reform on more pragmatic grounds – doubting that this Congress could ever implement it. He noted the same dynamics that killed the health care bill are at work in tax reform and therefore any successful effort will place heavy emphasis on simple tax relief – making reform ideas much more difficult to implement. All this is compounded by perceptual issues like the 70%-plus of Americans who don't think corporations and rich people pay enough in taxes. Some rate reductions, he maintained, could certainly be an outcome but that is a very low bar for defining tax reform. Commissioner Bauerly concurred, observing that high profile and heralded reform goals are being undercut by details that have leaked out. For example, she noted, simplification has been trumpeted as a primary reform objective, but as the list of "will not touch" deductions and exemptions grows, it becomes more difficult to see how any meaningful simplification can be realized.

However this effort may turn out, everyone agreed it bears little resemblance to federal tax reform efforts of the past. Lindholm offered an interesting comparison and contrast of the current effort to the Reagan tax reform of 1986. He noted that reform took three years to come to fruition and included literally hundreds of Congressional hearings. "Anytime you undertake bipartisan tax reform," he observed, "somebody has to make tough choices, somebody is going to get their ox gored and the only way you get past that is if somebody has your back." President Reagan, he said, provided the necessary cover for lawmakers to take the tough votes and redirect any political blame. Notably, nothing like that exists today. "There is no sense of loyalty. Rather, everybody thinks they will be thrown under the bus for their vote… The dynamic is really ugly."

Moreover, Lindholm continued, even if legislators could reach closure on basic reform details and structures, the real work and heavy lifting would only be beginning. "What takes all the time in tax reform," he emphasized, "is the transition rules." He noted that in tax reform the transition process is where lobbyists earn their keep because the details can have such a big impact on both revenue projections and taxpayers. An accelerated timeline for bipartisan tax reform is essentially impossible because transition rules can't be written until there is an endpoint and negotiators are currently nowhere near that.

What's missing from the current reform proposal, he continued, are the tough choices. As an example, Lindholm pointed to the much-publicized reduction in business pass through rates. Lurking within this issue is the need for anti-abuse rules specifying what is business income and what is wage income (which is taxed at a higher rate and also subject to Social Security and Medicare). Tax writers can respond by crafting something clear and predictable that nobody is going to like, or something more flexible, permissive – and incredibly expensive. This has huge implications because so much more business is being done now in pass-through entities. For these reasons, he argued extreme skepticism about tax reform by the end of the year is not negativity, but realism.

SALT repeal would likely exacerbate these differences and cause wealthier states to subsidize poorer states to an even greater degree.

He concluded by saying many DC observers believe it would actually be easier to pass a bipartisan "60 vote bill" than a Republican-only "51 vote bill". That's because even though many formerly strident deficit hawks have suddenly and magically kicked their federal debt concerns to the curb, some are sticking to principle. And it only takes 3 of the latter to stymie party-line reform efforts. Building bipartisan reform with some moderate Democrats and Republicans may turn out to be an easier reform path but is guaranteed to be longer, requiring negotiations that will string it out for years.

Just Sign Something...Anything

The current tax reform push comes on the heels of some very high profile political failures for the current administration. So to what extent is reform by year-end a political "must have" driven by a sense of desperation to claim passage of any measure as a victory?

Crosby argued any optimism for tax reform in the near future is indeed predicated on the fact that the GOP have boxed themselves into a corner. There is tremendous pressure on leadership to accomplish something. The question is how much of this framework they will have to give away or negotiate away just to get *something* through.

Policy-wise, he continued, it would be easier just to do corporate reform on its own for the simple reason both sides recognize a need for it and deals may be easier to achieve. The problem is a "corporate-only" focus is a political non-starter. If something does get traction and pass quickly, it will be because a win is needed and quickly to temper the internecine battles within the GOP. But the resulting reform would likely be modest like some rate reductions and related tweaks within the existing structure.

Commissioner Bauerly took exception to the idea that any majority-only supported bill pushed through for purposes of political necessity and expediency should ever be considered "tax reform." Harkening to the discussion earlier, real reform, she argued, requires bipartisan participation. Based on her experiences working with Senator Schumer, she maintained the Republicans have a very willing partner if they are willing to negotiate. She noted that if simply being able to take political credit for something is the real objective, addressing expiring popular individual income tax extenders might offer a “win” before the end of the year.

Max Behlke pointed out timing challenges, noting the House and Senate are scheduled to be in session for only 24 more days jointly this calendar year. In addition, on December 8 the federal budget will run out which guarantees shutdown issues, and a continuing resolution will consume most if not all of the legislative oxygen at that point. Then there’s the ever-present wildcard of “tweeting” which can instantaneously redirect legislative time and attention away to other issues. That said, he agreed the GOP does desperately need a win, heightened by the fact that many Republican consultants believe if tax reform doesn’t materialize, the U.S. House might change hands. For these reasons, Behlke believes a spring 2018 timeframe is the most likely scenario for any bill that might materialize.

State Ramifications Seasoned by “SALT”

Anything the federal government does in tax reform has, of course, potentially significant implications for states and their revenue systems. States are concerned and frustrated with both the lack of input they have on these important decisions and their inability to plan given the uncertainty. So what should states generally and Minnesota specifically be concerned about?

Lindholm began by noting if it’s any consolation, states are not alone in their frustration. Hill staffers and their bosses are being besieged by every possible interest, but it’s proven difficult for anyone to draw conclusions about how a provision fits into the whole when no one has any idea what the whole will look like.

The major concern for states is the potential elimination of state and local tax (SALT) deductibility. In Minnesota, nearly 1 million filers claimed $12.3 billion of state and local tax deductions on their federal returns in 2015 representing 34.7% of all Minnesota individual income tax returns. It has taken center stage because it’s the last big “pay for” available for reform now that so many other provisions have been taken off the table. According to Lindholm, many economists are saying if it’s not eliminated tax reform is not going to happen because it would blow the deficit out of the water.

Behlke noted the SALT deduction is a target because of its political convenience, not because it’s in any way a “worse” deduction than the many other tax expenditures getting a pass. The primary policy argument offered for its elimination is to end the federal subsidization of high tax states thus

Tax and Fiscal Facts Regarding the Minnesota/Federal Relationship

Total federal spending in Minnesota: $49.2 billion

- As a % of state gross domestic product: **15.1%** (8th lowest; national total: **18.9%**)
- Per capita: **$8,979** (5th lowest state, national total: **$10,567**)
- By component
  - o Federal salaries and wages: **$2.63 billion**
  - o Federal contracts: **$4.71 billion**
  - o Federal grants: **$9.95 billion**
  - o Retirement: **$18.39 billion**
  - o Medicare, income assistance and other non retirement benefits: **$13.54 billion**

Federal spending in Minnesota per dollar of federal receipts from Minnesota: $0.90

- National average: **$1.12** (exceeds $1.00 because of deficit spending)
- Minnesota rank: **44th highest**
- Minnesota is one of 13 “negative balance of payment” states

Minnesota state and local government revenues coming from federal government: $11.9 billion

- Share of all Minnesota state and local general revenues: **21.0%**
- National average: **22.5%**
- Minnesota rank: **37th highest**

Minnesotans claiming state and local tax deductions on federal return: 945,880

- As a % of all MN returns: **34.7%** (9th highest; national average: **29.6%**)
- Total federal SALT deductions in Minnesota: **$12.3 billion**
- Deductions as a share of state adjusted gross income: **6.2%** (9th highest)
- Average deduction per claimant: **$12,954 per return** (7th highest)

Minnesotans subject to federal alternative minimum tax: 92,700

- As a percent of all MN returns: **3.4%** (9th highest, national average: **3.0%**)
- Collections per return (only returns with AMT): **$6,900** (10th highest, national average: **$6,947**)

Minnesotans paying federal estate tax: 76 (1.5% of U.S. total)

- Total federal collections from MN: **$142.0 million** (9th highest, 0.8% of U.S. total)

[i] Federal fiscal year 2015 data. *Federal Spending in the States, The Council of State Governments*, May 2017.

[ii] Federal fiscal year 2015 data. *New York’s Balance of Payments with the Federal Government*, Rockefeller Institute of Government, Sept 2017.

[iii] State-local fiscal year 2015 data. *Survey of State and Local Government Finances, 2014-15*, Bureau of the Census, U.S. Department of Commerce (MCFE calculations).

[iv] Tax year 2015 data. Internal Revenue Service, Statistics of Income Division (MCFE calculations).

[v] Tax year 2015 data. Internal Revenue Service, Statistics of Income Division (MCFE calculations).

[vi] Tax year 2015 data. Internal Revenue Service, Statistics of Income Division (MCFE calculations).

equalizing the tax code across the nation. The problem with this argument, Behlke continued, is that SALT is just one of many federal subsidies provided to states. On the spending side, states differ dramatically in the various payments they receive from the federal government. Minnesota receives only $.90 for every dollar it sends to the federal government and is one of only 13 states with a negative balance of federal payments. Given the federal government's reliance on a highly progressive income tax, those states featuring negative balances of payments are (unsurprisingly) also predominantly wealthy states that would be most impacted by eliminating SALT deductibility. Rather than reduce unequal treatment among states, a SALT repeal would likely exacerbate these differences and cause wealthier states to subsidize poorer states to an even greater degree.

Elimination of SALT deductibility does face some major political hurdles. Panelists highlighted the fact that it would only take 25 House Republicans from high income states with high marginal income tax rates to kill any attempt to eliminate it. Crosby noted that this is not just an income tax issue – a conservative, high property tax state like Texas also benefits significantly from SALT deductibility and is also one of the 13 state "subsidizers" of the rest of the nation. Commissioner Bauerly noted this is a topic of great concern to Minnesota and pointed out that in a couple Republican-held congressional districts, nearly half of households take advantage of the SALT deduction.

State ramifications extend beyond the simple politics of policy winners and losers. Commissioner Bauerly highlighted several practical administrative implications inevitably accompanying federal reform that should not be overlooked. Whatever policies might be adopted are almost sure to raise new conformity matters and accompanying administrative challenges with respect to filing state returns. They may trigger other administrative needs like the enforcement of new anti-abuse provisions and establishment of anti-fraud protections. The theoretical appeal of a simple postcard sized return may sound wonderful, she posed, but in an era of identity theft, the dark web, and an IRS stretched to the limit, "what would it take to ensure the "postcard" is really me and not a criminal?"

Will Sales Tax Godot Finally Arrive?

States have not-so-patiently waited for federal action on e-commerce legislation for a very long time. The question was posed – is there any way to tie federal e-commerce legislation into federal tax reform activity?

Crosby argued there is "zero chance" of taking up any state and local issues as part of tax reform because from a federal perspective this is a commerce issue and procedurally there is no sense in adding another committee jurisdiction. Behlke agreed that tax reform is not the vehicle for federal action. He noted the e-commerce issue concerns state, not federal, revenues and the idea of offsetting a reduction in state spending or paying for a SALT elimination with the states' own money is "just ridiculous."

Panelists had some differences of opinion as to the broader question of whether federal action can be expected any time soon. Behlke thought there was a better chance that Congress would take up e-commerce this year than tax reform (although he said the odds aren't great for either). Crosby disagreed for several reasons. First, he said, a Supreme Court decision to hear the South Dakota *Wayfair* case would give Congress an easy out to wait for the Court to do something. In addition, the political landscape is balkanized. He estimated that among Republicans one-third want to take up an e-commerce bill, one-third don't want a bill, and one-third "want to stick their head in the sand" so they don't have to take a position. Finally, some states have been quite successful in their own e-commerce laws and don't want federal help out of fear it will place greater restrictions on their authority. Lindholm pointed out the electoral risk supporting a standalone bill creates. It would be irresistibly easy to build a primary challenge to incumbents on accusations of supporting a bill to "tax the internet" even though the statement would be untrue.

Even though e-commerce will not be part of federal tax reform, the issue elevates the stakes for states with respect to any federal tax reform fallout. Behlke pointed out e-commerce has been growing at 15% for the past 6 years and now constitutes 11% of all retail sales with the mobile sales segment now realizing growth rates of 50%. States are already seeing how this is impacting sales tax receipts and forcing them to look for revenues elsewhere. Combine the SALT deduction with this trend and the state revenue raising challenge becomes that much more difficult.

Magic 8 Ball Reform – Ask Again Later

So what does the crystal ball say? Two things appear to be working in favor of a reform bill. From a policy perspective, there is genuine, bipartisan agreement that the corporate income tax as structured creates a disincentive to invest in the United States and needs attention. From a political perspective there is a powerful desire and pressing need to enact something and declare a political victory.

But panelists highlighted several obstacles which by themselves make reform difficult and in combination could scuttle the effort entirely. They include time constraints, the impact on the deficit, the exceptionally difficult politics behind the "pay fors," the absence of any bipartisan collaboration, the optics of business tax relief without individual income tax relief, and elevated levels of attention deficit disorder in D.C. The general consensus seemed to be that despite the obstacles political necessity will triumph sometime in early 2018 resulting in some dramatically scaled down tweaks and rate adjustments that will nevertheless be marketed as the grandest and most amazing tax package in the nation's history.

What also seems clear is that states are largely an afterthought in this whole debate. As Commissioner Bauerly argued, "state interests and state economies are served by thoughtfulness, not speed." Yet any reform will almost assuredly present states with some challenging tax policy decisions of their own. Whether or not, as Joe Crosby reflected after the meeting, the whole effort turns out be Seinfeld – "a show about nothing" – remains to be seen. The next several months does carry the prospects for some great observational comedy – except for the fact that the issues and needs at stake aren't exactly a laughing matter. ■

Welcome to Fend...

(Continued from P.1)

on the tax reform debate and the issues the morning's first panel raised. Don Boyd echoed the comments of Lindholm and others in contrasting and juxtaposing the highly detailed, serious, and studious reform effort of 1986 with the vague, imprecise, goalpost-shifting effort of 2017. In sharp contrast to nine pages of ambiguity, the 1986 effort featured "two thick volumes from the U.S. Treasury on every issue you can imagine" with accompanying arguments for and against various options. President Reagan supplemented that with his own analysis, which, albeit a bit more political, was nevertheless a very serious presentation of the issues detailing the rationale and reasoning behind their proposals. Everything was put on the table and vetted, not just politically expedient and actionable items.

The idea that the federal government will spend new money on infrastructure is a "myth that needs to be dispelled".

Boyd continued by expanding on the ramifications of eliminating state and local tax deductibility, noting that states that would feel the greatest impacts also happen to be the states the federal government relies on most to support its own large redistributional efforts. He concluded by noting that there are potentially real consequences for state budgets whether tax reform eventually materializes or not. That's because even debates about taxes can change behaviors. He provided the example of deferring dividends and capital gains based on expectations of future tax relief – evidence of which may be unfolding right now.

Natalie Cohen also reflected on the shifting motivations behind tax reform – from a sense of principle to what now appears to be a pursuit of political expediency. The result, she argued, is that states need to be "on guard" with respect to what smaller items get included and to think of the cumulative and interactive effects of various measures on both the tax and spending side. Bob Zahradnik observed one of the primary outcomes of federal tax reform would be to elevate the already high levels of uncertainty and exposure surrounding state budgets. States must actually balance their budgets and are already buffeted by risks of general economic conditions plus uncertainties surrounding federal revenue streams. Federal tax reform interjects yet another element of unpredictability making the jobs of state and local budget officers just that much more difficult.

Defining the Fiscal Uncertainty

The federal budget outlook is beset with even more ambiguity and uncertainty than that plaguing tax reform. As of this writing, the House budget includes $4.5 trillion of health care, other mandatory program, and domestic discretionary spending savings over 10 years, but includes budget reconciliation instructions for a proportionately modest $203 billion of actual spending cuts in 2018. The Senate is even less specific – $4.6 trillion in mandatory and discretionary savings but instructions for only ***$1 billion*** in cuts in 2018. In addition, the Senate budget doesn't even allocate that $1 billion to authorizing committees and leaves $2.2 trillion unallocated to specific budget functions.[1]

So what is the big picture and what sort of responses do states consider in this type of environment? Commissioner Frans began by commenting that the current degree of uncertainty and risk "is about as high as it can get," presenting a tremendous challenge for state forecasting. The state is looking most closely at the federal budget because tax reform is so vague and uncertain at this time. He offered some examples from the Department's April estimates of how the Trump administration's budget would cut federal support for several state departments:

- Agriculture – 21%
- Commerce – 16%
- Education –13%
- Health and Human Services – 17.9%
- Pollution Control Agency –12%
- Department of Labor and Industry – 3.8%
- Transportation – 13%

This does not include health care delivery associated with "repeal and replace" which the state estimated could cost the state $2 billion in FY 20-21.

The big picture for Natalie Cohen is a future where lots of responsibilities and decisions are pushed down to the state level with both foreseen and unseen consequences. "Block granting" – a major theme this year – may offer states more flexibility but would also mean less money over time. Moreover, "flexibility" functionally translates into having to make very difficult and potentially contentious political decisions at the state level about eligibility thresholds and support levels.

Cuts may also end up being a crash course in government for taxpayers as Cohen identified several "sleeper" issues that could have compounding effects. As an example she highlighted the U.S. Department of Agriculture, where cuts might sound harmless but the department is where food stamps and school lunch program funding resides. When combined with potential cuts in federal education funding itself, the result is a compounding effect on state department K-12 funding and school district budgets. Similarly, while the public may associate Medicaid spending with health care for low-income households, the public may learn to its surprise that the program supports 60% of nursing home residents.

Bob Zahradnik emphasized how states need to prepare and plan for contingencies, noting on average one-third of state budgets are reliant on federal funds (Minnesota is 29.4% on an all funds basis) with Medicaid, transportation and K-12 education being the most influenced spending programs. He remarked it is in the states' best interest to understand these federal flows and plan for them, describing two examples of best practice in this area. Utah developed a federal funds study commission to analyze how federal dollars directly and indirectly impact the state. Meanwhile Virginia, one of the states most dependent on federal dollars, has established a federal funds reserve fund. He complimented Minnesota Management and Budget on its efforts to understand the influence of revenue volatility and tying it to general fund reserves, noting he has used Minnesota as an example of best practice across the country. Arguing that ultimately citizens care about whether services are provided and not where the money comes from, Zahradnik maintained the political argument "it's not our fault" won't work; the burden is shifted to the states to better prepare.

Donald Boyd classified federal spending into four areas – direct payments (dominated by Social Security and Medicare), procurement (dominated by defense spending),

[1] Committee for a Responsible Federal Budget: http://www.crfb.org/blogs/how-house-and-senate-budgets-stack

state grants, and employee compensation. Although the direct payments and procurement are the biggest targets, they are the least likely to get cut. The bullseye will be state grants dominated by Medicaid, highway money, support for other social services, and education and training.

Boyd zoomed in on the elephant in the federal grant room – Medicaid. Even if block grants commence without cuts and grow at something resembling population plus inflation, the change could still dramatically impact state behaviors for two reasons. First, it would change the price of delivering Medicaid services because anything more a state may want to spend over the block grant must come dollar for dollar from state or local government budgets (unlike under the current partial federal reimbursement design). Second, while federal government can finance larger enrollment costs in recessionary periods through deficit spending, states lack that flexibility because they operate under mandatory balanced budget requirements. If the state and local tax deduction is eliminated or capped, that further increases the price of Medicaid services – or for that matter infrastructure and any other general fund supported service.

Implications for State Economic Development

Much of the math justifying the tax and spending proposals being debated is based on expectations that greater economic growth will result. Yet the relationship also works in the other direction since government spending pays for a wide variety of necessary public goods and services supporting state economic activity, growth, and innovation. Are there implications for important economic development issues we should be cognizant of?

Panelists agreed that states will be challenged to strategically reexamine their workforce training and development programs – and potentially to rethink and redefine the problem itself. Highlighting some of Minnesota's demographic and labor market challenges, Commissioner Frans argued we will need to "step up our game" and develop the kinds of education and training opportunities that respond both to the new realities of labor markets and the competition for resources that would come with federal spending cuts. Observing that mobility – dramatically down since the Great Recession – is an underappreciated and influential factor in workforce shortages, Cohen noted that next generation economic development spending may require creative programs to help address workers' inability to relocate and get to where the jobs are. Zahradnik reflected one "benefit" that might arise out of the introspection created by new levels of federal austerity might be states' revisitations of the billions spent on economic development and tax incentives to see if they are actually getting their money's worth.

With respect to infrastructure, in the words of one panelist, "you are on your own" but then again most government infrastructure is state and locally owned. While the public may have high expectations of an infrastructure plan based on public statements during the 2016 election campaign with big accompanying numbers, Cohen argued the idea that the federal government will spend new money on infrastructure is a "myth that needs to be dispelled". She noted that all the talk so far has been about financing mechanisms like public private partnerships and not about spending actual federal dollars. Even the $305 billion Fixing America's Surface Transportation (FAST) Act of 2015, the first federal law in over a decade to provide long-term funding certainty for surface transportation infrastructure planning and investment, was paid for largely by a Federal Reserve surplus which was, in Cohen's words, "kind of a gimmick." Commissioner Frans reported that $3.5 billion in bonding requests for 2018 have already been sent to the governor, which will be trimmed to $1.0 - $1.5 billion before being submitted to the legislature.

Self-Inflicted Wounds

As Chris Farrell pointed out, we are in the ninth year of economic expansion, with very low unemployment and stock market records being set seemingly daily. All this would suggest we should be having discussions over what to do with relative plenty rather than stressing over looming austerity. The question arises whether states are ready to embrace a new era of "fend for yourself federalism". The answer appears to be "no" for a number of reasons – some largely out of states' control, others self-inflicted.

Boyd observed that in spite of the economy, there has not been much of a recovery in state and local finances. Zahradnik concurred noting by Pew's count 22 states had tax revenues in 2017 totaling less than their inflation-adjusted peak at the end of the Great Recession, signifying a lot of non-recovery. The reasons, according the panel, are many. Sales tax revenues lag growth in disposable income and taxable consumption due to both the difficulty of e-commerce collections and the shift to irregularly taxed services. Income tax receipts are growing more slowly relative to historical standards influenced in part by income disparities, investors' decisions to postpone realizing capital gains on the expectations of lower rates in the future, and a wide variety of preferential tax treatments provided to the fastest growing demographic – seniors. Cohen concluded "every one of the classic taxes that state and local government collects is in a state of transformation." Zahradnik agreed saying, "Smart states will rethink how they are taxing."

But states have also abetted the problem with their own fiscal mismanagement, and in no place is that more evident than in public pensions. Zahradnik remarked there is a growing understanding that the assumptions underlying public pensions are unsound. This leads to chronic underfunding of these plans and major redirections of state and local resources away from actual public services and into paying for legacy costs. Don Boyd concurred saying the system of reporting and funding is "deeply, deeply flawed – dangerously flawed," and "the Government Accounting Standards Board (GASB) hasn't fixed it at all." He presented a map which recalculates unfunded liabilities relative to the state economy, saying "on this map red is very, very bad and green is just bad." Noting that Minnesota can take pride in being modestly bad, according to his analysis public pension contributions nationwide would have to go up $120-140 billion each year just to tread water (between $300 and $500 per capita in Minnesota). Commissioner Frans highlighted the pension reform attempted earlier this year, saying he believes there is an opportunity to make incremental gains on the problem.

Is there a role for the federal government on this issue? Boyd maintained there is a national interest in this topic rooted in retirement security, the fiscal risk to states, and well functioning debt markets. However, federal government intervention is tricky because of sovereignty and moral hazard issues. He argued the federal role consists of the applying "rules of road and signage." "There are no police," he said and GASB rules are one of many things that have helped create this situation. "They didn't fix

From The Director: The State/Local Relationship is Not Immune

"A certain substance," as the saying goes, rolls downhill. So while our annual meeting panels discussed the potential implications of federal tax reform and federal budget resolutions for Minnesota, it's not unreasonable to reflect on what the implications could be downstream: the state's relationship with county and municipal governments.

Mark Haveman

We've already seen some evidence of fiscal obligations being passed along to local units of government to deal with. For example, any "what the heck" moment when you take a look at your Truth in Taxation notice in about a month may be partly due to the $20 million tab for assessments for people with disabilities which the state passed along to counties this year. But that could be a drop in the bucket if some of the changes being talked about in Washington ever get enacted.

If state governments get saddled with substantially more of the financial responsibility for delivering various services while at the same time federal tax obligations go up for a third of Minnesota households, you can bet the effect would reverberate down to the local government level. Even if federal actions turn out to be all bark and no bite, demographics alone have the ability to alter the state/local relationship as our own budget trends study commission found. The question is whether our policy dialogue is reflecting this understanding.

We don't see much evidence of that. Municipal and county government representatives appear remarkably sanguine about a nearly $900 million state intrusion into their primary tax base and quite supportive of the idea of having that grow both automatically and indefinitely. Meanwhile, editorial pages endlessly rhapsodize about the state/local relationship that existed decades ago and exhort a return to policies of a bygone era rather than explore policy paths that recognizes what our future holds.

It's not an accident that city and county aids have diminished or stagnated depending on how you choose to view the trends. It's not malevolence toward local governments generally and goodness knows it's certainly not because local governments aren't very powerful, influential and effective lobbyists. It's that the state has its own obligations and services to fund and they will take priority. History has proven over and over again that in times of budget deficits and stress, local government supports are the first thing on the chopping block. And in times of stiff competition for general fund resources in the future, state obligations will win.

For better or worse, like it or not, pressures of "fend for yourself federalism" will trickle down to the lowest levels of government. Whether we will have done much to prepare for it remains to be seen.

■

During our annual meeting business session, members elected the following individuals to serve on the MCFE board of directors. On behalf of our members and supporters, thank you for your service to the organization.

Nancy Hylden	Hylden Advocacy and Law
Christopher Arend	XCEL Energy
David Welliver	Deloitte
Ken Levinson	Faegre Baker Daniels
Patrick Shrake	Cargill
David Uphaus	BNSF Railway
Andrew Bosl	Ecolab
Jodie Scott	KPMG
Phil Albert	Medtronic
Tom Hanson	Winthrop & Weinstine
Todd Rapp	Rapp Strategies
Ward Einess	Einess Strategies
Beth Kadoun	MN Chamber of Commerce
Jill Larson	MN Business Partnership
Chris Martin	Grant Thornton
Rich Forschler	Faegre Baker Daniels

— M.H.

it and they are not going to fix it, and the actuaries themselves are unlikely to fix it." The first and probably only real role for the federal government is perhaps to put GASB under the auspices of the SEC (like FASB) or otherwise set the accounting and funding rules similar to what the private sector must abide by.

Any Glimpses of Sunshine?

After this frank assessment and discussion, meeting attendees might have been excused if they half-expected the ten plagues of Egypt to subsequently break out. If there are positives to take away on this issue, according to the panelists, it's the political fact that history tells us spending never gets cut as much as gets talked about. They observed that despite the foreboding budget offered by President Trump early this year, in the most recent continuing resolution a lot of line items actually went up, not down. And there is a lot of positive work and innovation going on in state and local government across the country that gets lost in the national news headlines. That's good news, because our laboratories of democracy will apparently need to concoct many new policy recipes for a long time to come. ■

The Economic and Fiscal Consequences of Immigration

Annual meeting luncheon speaker Kim Rueben of the Urban Brookings Tax Policy Center exposed the realities and myths surrounding this politically charged topic.

Perhaps the only other national policy topic garnering anything like the attention surrounding federal tax reform and budget matters is the issue of immigration – a topic that has been on a steady boil since last year's presidential primaries. The MCFE was fortunate to have as its annual meeting luncheon speaker a distinguished scholar who is on the front lines of both issues. Kim Rueben is a Senior Fellow and Director of State and Local Finance Initiatives at the Urban-Brookings Tax Policy Center – an organization at the center of the discussion surrounding the potential implications of federal tax reform. But in addition to her considerable work on tax policy, fiscal policy, and state finances she serves on a National Academy of Sciences panel studying the economic and fiscal consequences of immigration – a topic of major interest to Minnesota's business community specifically and state policy makers generally.

Rueben began by highlighting some of the preliminary findings from the Tax Policy Center's (TPC) simulation model on the fiscal and distributional impacts of the federal tax reform framework proposed by the White House and Congressional leadership. She began by noting the biggest challenge in modeling the effects of this reform is that so many important details are still unknown, forcing the Center to make assumptions based on previous statements and plan outlines from lawmakers about the details and goals of reform. Based on these assumptions and using static scoring, TPC estimates the proposal would cost $2.4 trillion over the first 10 years – $900 billion more than the Senate's proposed budget provides for, with the overall revenue raisers on the personal income tax side and the tax cuts on the business side. With respect to the distributional impacts, TPC finds that the biggest gains in after tax income would predominantly flow to the top 5% while the biggest tax increases would go to what might be described as middle to upper middle class taxpayers in the $100,000 - $250,000 income range. She noted future model runs will incorporate both more details as they become available and dynamic scoring estimates.

But the primary focus of her luncheon address was on the economic and fiscal consequences of immigration, based on her work with the National Academy of Sciences panel – an effort generating important new data about and understanding of the nature of immigration and its impact both nationwide and in the states. The panel studied how immigration patterns have changed, how it affects the national economy, and how it affects public revenue and spending at both the state and national level.

Rueben shared several interesting facts regarding the current state of immigration:

- Over the past 20 years the immigrant share of the population has increased from 9% to 13%
- Today, nearly 1 in 4 Americans are either immigrants or U.S. born children of immigrants
- Unauthorized immigration is higher than it was 20 years ago, but has stopped growing since the Great Recession. The total unauthorized immigrant population now totals about 11.1 million.
- Recent immigrants are more educated than immigrants of the past. In 1970, 51% of all immigrants came to the United States without a high school diploma. Today it's 26%. Over that same period the percent of immigrants with at least a Bachelor's degree has gone from 20% to 38%.
- The immigrant population has become more dispersed across the country. The foreign-born share of the Midwestern population has increased from 3% to 7% since 1970 (4.5 million). Minnesota's share of the U.S. immigrant population has increased from .5% to 1.5% over this same period.

"I didn't realize how much our labor force growth is going to depend on immigrants going forward."

What struck Rueben the most about these data and trends are their implications for the workforce of the future. "I didn't realize how much our labor force growth is going to depend on immigrants going forward," she remarked. As the U.S. labor force growth slows with the aging of the population, immigrants and their children will account for the vast majority of future labor force growth.

Turning to the economic effects of immigration, Rueben highlighted research findings that show high skilled immigrants have a positive effect on economic growth and productivity. High skilled immigrants raise patenting levels per capita and have also been found to feature greater rates of entrepreneurship. They increase the affordability and availability of a variety of consumer goods and services and demonstrate a greater willingness to relocate to respond to employment opportunities making labor markets more efficient.

Importantly, she observed, the evidence shows these beneficial economic outcomes do not come at the expense of native populations. The effect immigration has on native wages and employment is actually very small, Rueben noted, because immigrant labor demonstrates more of a complementary effect rather than a substitution effect on the pre-existing labor force. Immigrants tend to be employed in jobs that are different than native populations. To the extent any negative effects were found, they were typically among groups that were the closest substitute to lowest skilled immigrants like native born high school dropouts and prior immigrants.

For the same reason, she continued, there was little evidence of effects on overall employment levels of native workers – with the possible exceptions of influencing the number of hours worked by native teens and employment rates of prior immigrants. On the other end of the immigrant wage/skill continuum, studies have found a generally positive impact of skilled immigrants on the wages and employment of both college and non-college-educated natives, with some adverse effects on natives in some narrowly defined fields. What is rather clear, she concluded, is that immigrants should not be the scapegoat for the labor and wage effects of globalization and technological change.

With respect to fiscal impacts on federal and state budgets, studies demonstrate both some positive and negative effects – and also some irony with respect to proposed federal immigration policy reforms. Rueben observed how fiscal impacts can be determined by examining the difference between immigrants' contributions to government revenues and expenditures from their consumption of public services. At the national level, immigrants tend to have a lower fiscal contribution than natives and a higher contribution to expenditures influenced heavily by education delivery because immigrants tend to have more children than the native population. But the magnitude of the fiscal burden, she observed, depends on whether you assume an average or marginal cost approach to these calculations. If one assumes immigrants should share in the responsibility of the government deficits incurred before their arrival (average cost) then immigrants – 18% of the population – account for 22% of the deficit. If one assumes they should only be responsible for the differences between revenues and expenditures they themselves have added (marginal cost), then that same 18% of the population accounts for only 4% of the deficit.

At the state level, the story is more complex. The net impact of immigration on fiscal balance sheets is influenced heavily by both the demographics of the immigrant population and state policies. In Minnesota, the net difference between revenues and expenditures for first generation immigrants vs. "natives" (defined as persons who are neither immigrants nor children of immigrants) is -$7,250 on an average cost basis and -$5,550 on a marginal cost basis. Much of that is a function of educating children as first generation immigrants have nearly twice as many kids per individual as "native" households. However, second generation households (i.e., children of immigrants) generally contribute most to the bottom line of state and local fiscal balances.

Overall, the fiscal story is one of negative short run effects, particularly at the state level where education dollars are generated and spent. In the longer term, the fiscal impact of immigrants is positive for the federal government though it remains negative at the state level due to education costs. As Rueben noted, taken together national and state level analyses should raise questions of why the clear "fiscal winner" in immigration – the federal government – is taking such an aggressive approach to immigration reform and why it is not showing more support in investing in immigrant children who are the source of its fiscal returns.

Limiting immigration, Rueben concluded, is likely bad for our economic future. Reflecting on the tax and fiscal policy panels earlier in the day she remarked that so much of the math behind the tax reform and budget proposals is dependent on achieving rates of economic growth significantly above recent norms. But few people seem to recognize those high growth rates will require a lot more people in the workforce, which makes anti-immigration policies self-defeating from a growth perspective. "Immigration is one of the positive things going on in this country right now" she remarked – a truth we probably can't recognize soon enough. ■

Latest National Tax and Spending Rankings from *How Does Minnesota Compare?*

MCFE has released our latest edition of How Does Minnesota Compare (HDMC) — our annual comparison report on state and local government finance based on recently released Census Bureau data on public sector tax collections and spending across the country for fiscal year 2015.

For its tax rankings, HDMC uses a modified personal income basis to reflect income available to remit to government to pay taxes and fees. We exclude types of personal income that cannot used to support government operations (for example the value of all Medicaid and Medicare benefits received in the state) but add in other income sources that can be and are used to pay taxes and fees (notably capital gains and distributions from retirement accounts).

Spending rankings are reported on a "unit served" basis to better align government spending with its ultimate users and beneficiaries. Spending rankings are also adjusted for state purchasing power differences to accommodate state-to-state differences in the price of goods and services.

Notable Findings for Minnesota

- Total Minnesota state and local taxes were 13.9% higher than the national average based on a modified personal income basis. Minnesota's rank increased from 9th to 8th in the nation.
- Higher-than-average taxes offset lower-than-average revenues from the federal government and lower state reliance on non-tax revenues. Total state and local government revenues are 6% above the national average, placing Minnesota 22nd in the nation.
- Total Minnesota state and local spending per household was 5.2% above the national average, placing Minnesota 16th in the nation. Minnesota's only top ten spending rankings are in spending on "safety net" programs (described by the Census as "public welfare") – which is over twice the national average based on spending per number of individuals at or below 150% of the federal poverty guidelines – and natural resources and parks (per household basis). Spending on roads and transportation infrastructure per 1,000 road miles is 78.8% of the national average.

For the full report and accompanying tables, visit our website:
http://www.fiscalexcellence.org/our-studies/hdmc-fy15-final.pdf

MINNESOTA CENTER for
Fiscal Excellence

85 East Seventh Place
Suite 250
St. Paul, MN 55101
(651) 224-7477

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