Minnesota's Troubled "Price of Government"

Abstract

Since the early 1990's, the Minnesota Price of Government has been calculated to measure and track state and local government's claim on Minnesota income. However, since its inception, the composition of Minnesota Personal Income – the denominator of the POG – has changed dramatically. 20 years ago, five major non-money components of Minnesota Personal Income – that taxpayers cannot use to pay taxes or fees or remit in any way to finance government – were roughly 15% of the total. Today those non-money components are over 20% of the total, which represents a shift of approximately $13 billion in Minnesota Personal Income from money to non-money income. Moreover, the fastest growing sources of Personal Income growth are government transfer payments – including the value of Medicare and Medicaid benefits – which have grown over 2.5 times faster than wages and salaries over the past decade.

These findings have major ramifications for the interpretation of the Price of Government metric and its use in public policy debates. Including Personal Income in the POG understates state and local government's claim on money income – which is 20%-35% higher when substituting the household income measure used in the state's *Tax Incidence Study*. Moreover, trends in the composition of Personal Income and demographic trends significantly compromise its common use as a measure to evaluate affordability or benchmark a sustainable "level" of spending. If policymakers want to maintain a POG-type measure, the state should modify the current metric by replacing Minnesota Personal Income with some measure of money income. Even with this adaptation, we encourage caution in using the POG to assess the affordability of government or set a "price target" for government because some of the major demographic factors and trends affecting income will continue for the indefinite future.

Introduction

For nearly twenty years, the state's Department of Management and Budget (MMB) has prepared a Price of Government (POG) report to accompany the November and February economic forecasts and following the conclusion of each legislative session.[1] The POG metric measures the ratio of state and local government own source revenues[2] to statewide Personal Income. MMB staff have described the POG as "the state's main transparency method and tool for communicating the total cost of state and local government to citizens."[3]

Policymakers created the POG with broad-based political support, including the endorsement of Minnesota's business community, because it was seen as a simple, straightforward metric to track state and local government's claim on Minnesotans' income. Because it is seemingly so easy to understand and interpret, the POG has inevitably served as an evidence point in debates over budgets and acceptable levels of government taxation and spending.

However, simple metrics can often mask underlying complexity, rendering interpretations of the metric problematic in the process. This is especially true when major changes are taking place in the components of the metric, as has happened with Minnesota's Price of Government.

Specifically, two major trends have transformed Minnesota Personal Income since the POG was developed two decades ago. As a result, the use of the POG with respect to both evaluating taxpayer cost of state and local government and providing time-series comparisons about the level of investment Minnesotans make in state and local government are severely compromised.

Trend #1 – Rapid Growth in Non-Money Income as a Share of Total Minnesota Personal Income

"Personal Income" as determined by the U.S. Bureau of Economic Analysis (BEA) is an extremely broad measure. BEA economists designed it to capture the income associated with participating in "production activities" and with transfer payments (largely from the government). Minnesota's Personal Income for calendar year (CY) 2011 (the most recent year for which detailed information is available) was $238.2 billion, which can be broken into the following pieces[4]:

Table 1: Major Components of BEA Personal Income for Minnesota, CY 2011

Component	Amount ($000)	
	$ billions	**% of Total**
Wages & Salaries	129.7	54.4%
Dividends, Interest, & Rent	38.9	16.3%
Transfer Receipts	38.7	16.2%
Proprietor Income	20.4	8.6%
Employers' Pension and Insurance Contributions	20.2	8.5%
Employee & Self-Employed Contributions to "Social Insurance" Programs; and Adjustment for Interstate Commuters	(9.7)	(4.1%)
Total	**238.2**	**100.0%**

Source: Bureau of Economic Analysis *Annual State Personal Income and Employment, Table SA04.*

While "wages and salaries" is self-evident, some of the other components merit further description:

- Dividends, interest, and rent: represent income generated ***by*** assets, but not income from the ***sale of*** assets (this excludes capital gains).
- Transfer receipts: these are mostly government benefit payments to individuals – examples include Social Security payments, the value of Medicare and Medicaid benefits, and income maintenance benefits.

[1] See http://www.mmb.state.mn.us/supporting-documents-nov-12 for the most recent Price of Government report, from the November 2012 Economic Forecast.
[2] Own source revenues: all state and local revenues less "intergovernmental revenues" – grants from one unit of government to another, such as state Local Government Aid given to cities.
[3] Testimony before the Legislative Commission on Fiscal Policy, February 22, 2013 meeting.
[4] All BEA personal income data in this publication are as of the September 25, 2012 update. See www.bea.gov for data.

- Proprietor income: income generated by businesses for their owners.
- Employer pension and insurance contributions: basically, employers' costs for fringe benefits, except for Social Security and Medicare.
- The final portion represents employees' and self-employed persons contributions to "social insurance programs" – mainly Social Security and Medicare – and an adjustment for net flow of income between Minnesota and other states based on commuting patterns. Since more non-residents earn income in Minnesota than Minnesotans earn in other states, the adjustment is negative.

As these descriptions make clear, Minnesota's $238 billion Personal Income amount includes many items that an average Minnesotan would not think of as income that could be used to pay taxes. And the average Minnesotan would be right. Personal Income includes non-money benefits and "imputed" income – the market value of selected transactions that don't occur in the market economy and that cannot be used to pay taxes. Table 2 shows five major non-money income areas.

Table 2: Five Major Non-Money Components of BEA Personal Income for Minnesota, CY 2011

Component	Amount	
	$ billions	**% of Total**
Employers' Pension and Insurance Contributions	20.2	8.5%
Value of government sponsored medical benefits (mainly Medicare and Medicaid)	16.8	7.0%
Imputed interest[5]	7.9	3.3%
Imputed rent[6]	4.8	2.0%
Transfers to nonprofit institutions	0.7	0.3%
Total	**50.3**	**21.1%**

Note: Numbers may not add due to rounding.
Source: Bureau of Economic Analysis *Annual State Personal Income and Employment; Tables SA 04, SA 35, and SA 40*

As the table indicates, in 2011 non-money income – essentially irrelevant to assessing the tax price of state and local government and evaluating its affordability – represented over 20 cents of every dollar of Minnesota Personal Income. This is a major departure from the earliest days of Minnesota's Price of Government. As Table 3 shows; in 1990, these five pieces of non-money income were a much smaller share – 15.5% – of total Minnesota Personal Income. Most significantly, the share of government sponsored medical benefits has nearly doubled over 20 years from 3.8% to 7.0% of state Personal Income.

Table 3: Major Non-Money Components of BEA Personal Income for Minnesota, CY 1990

Component	Amount	
	$ billions	**% of Total**
Employers' Pension and Insurance Contributions	6.3	7.3%
Imputed interest	3.3	3.8%
Value of government sponsored medical benefits (mainly Medicare and Medicaid)	3.3	3.8%
Imputed rent	0.3	0.3%
Transfers to nonprofit institutions	0.2	0.2%
Total	**13.4**	**15.5%**

Note: Numbers may not add due to rounding.
Source: Bureau of Economic Analysis *Annual State Personal Income and Employment; Tables SA 04, SA 35 and SA 40.*

[5] This is the value of investment income earned on life insurance and the value of services that depository institutions provide without an explicit charge for doing so.
[6] This includes the value of things such as the rental value of owner-occupied housing, the value of farm products consumed at home by the producers, and pay-in-kind in the form of meals and lodging.

This change in the composition of Minnesota Personal Income has real ramifications. If these five non-money components of Personal Income were 15.5% in 2011 instead of 21.1%, then (if there were no change in the overall Minnesota Personal Income total), over $13 billion would have been shifted to other Personal Income components – mostly as money income – in 2011.

Trend #2 – Rapid Growth in Government Transfer Payments as a Share of Total Minnesota Personal Income

A related trend concerns the increasing role of government transfer payments in Minnesota's Personal Income growth. Some of these "transfer payments" are non-money in nature as described previously. But other transfer payments are money-based, such as Social Security and disability benefits, income maintenance benefits for low income households, and unemployment insurance compensation. Such transfer payments are often strongly related to subsistence income, making their taxation more challenging from the standpoints of both politics and principle.

Table 4 provides perspective on the increasingly important role the state and federal government has played over the last two decades in Minnesota's Personal Income growth. As the table shows, average annual growth rates in all the Personal Income components was robust during the first decade of Minnesota's POG – 1990 to 2000.[7] Since then, growth rates have declined by about half for wages and proprietor income and by nearly three-fourths for dividends, interest and rent. At the same time, income from government transfers has grown over 40% faster compared to the 1990-2000. Since 2000, Minnesotans' income from government transfers has grown over 2.5 times faster than statewide wage and salary income. As baby boomers begin to retire en masse, transfer payment growth rates are unlikely to slow anytime soon.

Table 4: Compounded Annual Growth Rates in Components of Minnesota Personal Income: 1990-2000 and 2000-2011

Minnesota Personal Income Component	Annual Growth Rate	
	1990-2000	2000-2011
Wages and salaries	6.58%	2.80%
Employer pension and insurance contributions	5.85%	5.52%
Proprietor income	7.37%	3.95%
Dividends, interest and rent	6.30%	1.75%
Current transfer receipts	5.48%	7.71%
Employee & Self-Employed Contributions to "Social Insurance" Programs; and Adjustment for Interstate Commuters	6.87%	1.06%
Total	**6.43%**	**3.63%**

Source: Bureau of Economic Analysis *Annual State Personal Income and Employment, Table SA04.* Calculations by MCFE.

Implications for Interpreting the Price of Government

The composition of Minnesota Personal Income and its growing shares of non-money income and government transfer payments have major ramifications for the interpretation of the Price of Government metric and its use in public policy debates. Here we look closer at two of its common uses.

Implication #1: The POG is not an accurate measure for evaluating the tax price and affordability of state and local government

According to Minnesota Management and Budget, "the POG is a measure of the cost of all general government services statewide. It answers the question: How much do Minnesotans pay to state and local governments in total?"[8] While the POG numerator – state and local own-source revenues – provides a good sense of aggregate revenue collections, the POG

[7] The Price of Government matches state and school district fiscal years with calendar year financial data for other local governments and calendar year income data. Therefore, the first year for the Price of Government – 1991, a fiscal year – uses calendar year 1990 Personal Income data.

[8] Minnesota Management and Budget, *Price of Government.*

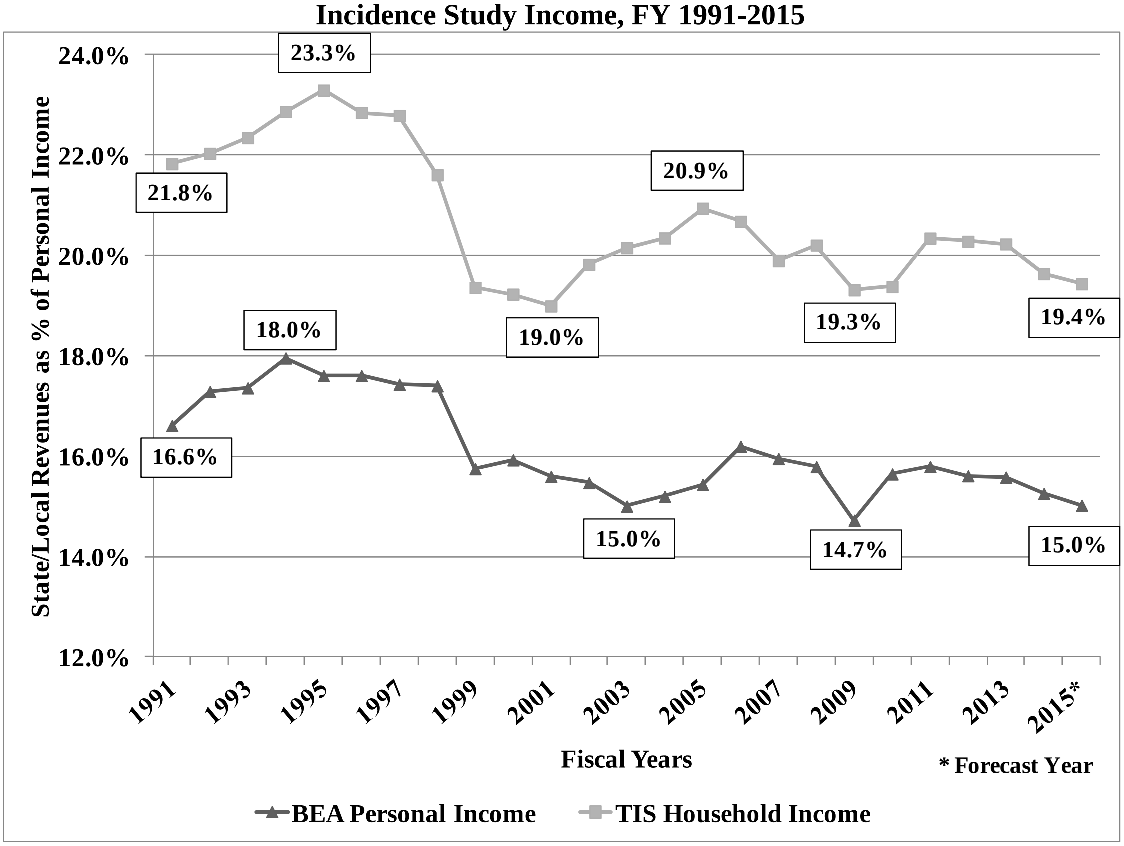
considerably understates the rate at which Minnesotans pay by including billions of non-money Personal Income in the ratio's denominator that cannot be used to pay taxes, fees, or be remitted in any way to finance government.

To approximate what a true "money income-based" price of government looks like would require the removal of non-money income from Personal Income and the addition of other sources of income that can be used to pay taxes or fees – notably capital gains and retirement and pension income apart from Social Security (which is already in Personal Income). Ironically, the tax data in the POG includes state income taxes generated on capital gains and pension income while the Personal Income measure excludes those same earnings. Making these changes would provide a measure that better reflects Minnesotans' ability to finance state and local government.

Fortunately, we have a good proxy for this in the Minnesota Department of Revenue's *Tax Incidence Study*, which creates a comprehensive database of both taxable and nontaxable income for Minnesota households.[9] How would an alternative Price of Government using the *Tax Incidence Study's* income measure compare to current reported numbers?

Figure 1 compares the two approaches. Although the trend lines for both "price of government" measures follow somewhat similar patterns, substituting tax incidence income for Minnesota Personal Income as calculated by the BEA has one major effect: the "bite" state and local governments take out of Minnesotans' income is now substantially higher – ranging around 20% to 35% more over time than current POG reporting suggests.

Figure 1: Minnesota State and Local Government Own-Source Revenues Relative to BEA Personal Income and Tax Incidence Study Income, FY 1991-2015



Sources: Minnesota own-source revenues, *Price of Government*, November 2012 economic forecast, Minnesota Management and Budget; Minnesota Personal Income – total and components, Bureau of Economic Analysis, U.S. Dept of Commerce; Tax Incidence Study Household Income, *2013 Minnesota Tax Incidence Study*, Minnesota Dept of Revenue. Calculations by MCFE.

[9] Appendix A of the *2013 Tax Incidence Study*, Minnesota Department of Revenue, has more information on the Tax Incidence database. See http://www.revenue.state.mn.us/research_stats/Pages/Tax_Incidence_Studies.aspx.

Implication #2: Using the POG to evaluate and judge long-term trends in the level of investment Minnesotans make in state and local government is problematic.

Another common use for the POG involves comparing the burden state and local governments make on Minnesotans over time. In current debates, POG historical norms are often used to evaluate current levels of state spending on public goods and services. It is often argued that if Minnesota could afford a certain percentage claim on Personal Income by government in the past, it can continue to do so in the future. However, trends in Minnesota's Personal Income composition combined with demographic trends complicate the task of maintaining the Price of Government as currently defined and sustaining it over the long term.

Income trends

The increasing share of the non-money portion of Minnesota Personal Income as calculated by the BEA that we documented earlier has implications for long-term comparisons of the Price of Government metric. As Table 2 and Table 3 indicated, five major non-money pieces of Personal Income increased from 15.5% of the total in 1990 to 21.1% of the total in 2011. The remaining parts of Personal Income – which we assume are money income that taxpayers can use to finance government – fell from 84.5% to 78.9% over this period.

Since the money share of Minnesota Personal Income is now smaller than it was in the early 1990s, government needs to impose a higher burden on the money income portion to yield the same overall POG figure than it did 20 years ago. In FY 1991 – the first year the POG was calculated – the Price of Government was 16.6% of Minnesota Personal Income. That required a 19.7% rate on what we will conservatively call the "money income" portion – Minnesota Personal Income minus the five major non-money pieces detailed in Table 2 and Table 3. In FY 2012, applying this 19.7% rate to the "money income" portion now yields only a Price of Government of 15.5% of Minnesota Personal Income. To equal the 16.6% POG rate from FY 1991, state and local government needed to collect 21.0% of Minnesotans' "money income" in FY 2012 – or roughly $2.6 billion more than would have been needed without any underlying changes in the composition of Minnesota Personal Income.

Such a difference reflects the implicit dangers in using historical POG trends to evaluate the affordability of state and local government in the here and now.

Demographic trends

According to recent projections from the State Demographer's office, the proportion of Minnesotans aged 65 or older is expected to grow from 14.8% in 2015 to 23.3% by 2035.[10] Such growth suggests that non-money transfer receipts to senior households will steadily increase its share of statewide Personal Income over the next few decades. This raises the fundamental question of whether long-term trends in state and local government revenues should be measured against a barometer that includes the value of government-sponsored Medicare and Medicaid benefits.

But even the tax treatment of senior households' money income presents challenges with respect to maintaining historical POG levels. According to the *2013 Minnesota Tax Incidence Study* the effective tax rate on the household income of seniors (those households where the taxpayer and/or spouse is at least age 65) is 11.3%. We calculate the effective tax rate on the household income of all other Minnesotans at 11.6%.[11] The disparity in the previous *Tax Incidence Study* was even greater – with effective rates on senior income of 10.7% and on all other Minnesotans at 11.6%.[12]

Why do senior households have lower overall tax burdens? Two factors outlined in the 2009 report of the Budget Trends Study Commission provide some insight. The report notes that the average income tax paid by individuals aged 65-69 is about 40% less than their counterparts in the 55-59 age range, largely because so much senior income is not taxable. The

[10] Minnesota Department of Administration. Minnesota State Demographic Center; Minnesota Population Projections: 2015-2040; published October 2012. Available at: http://www.demography.state.mn.us/projections2015-2040.htm

[11],Data from Tables 5-1, 5-2, 5-3, 5-4, and 5-5, *2013 Tax Incidence Study*, Minnesota Department of Revenue. Calculations by MCFE.

[12] Data from Tables 5-1, 5-2, 5-3, 5-4, and 5-5, *2011 Tax Incidence Study*, Minnesota Department of Revenue. Calculations by MCFE.

report also notes that seniors also pay less sales tax then their non-senior counterparts, largely because they have different consumption patterns (i.e – their purchases are smaller and/or they tend to buy fewer "big ticket" items).[13]

Given that the proportion of senior income will grow over the next few decades as the proportion of senior citizens in Minnesota grows, a growing proportion of the state's household income will be subject to lower effective tax rates. Thus, to maintain recent POG levels in the 15%-16% range as senior income and population share grows, other types of households will have to bear higher taxes unless the effective tax rate on senior household income also rises. Higher senior taxation is both politically unlikely and practically challenging, especially since senior households in Minnesota already receive no favorable state treatment of retirement or Social Security income and have one of the highest effective income tax rates in the nation.[14] Without higher senior taxation, though, a commitment to sustaining POG norms means effective tax rates will need to rise for non-senior households.

Conclusion

The creation of a simple, easy-to-understand metric to track government's claim on citizens' income may be a worthwhile endeavor to pursue. The problem with the current Price of Government is twofold. First, although the state and local own-source revenue the POG reports provides good information on aggregate revenue collections, issues with the Personal Income statistic means that the rate of collections versus income it calculates does a very poor job of providing a sense of state and local government's claim on citizens' money income. Second, because of the transformations that have occurred and continue to occur in the Minnesota Personal Income base, the POG presents a distorted perspective on government affordability and subsequent political debates about acceptable levels of taxation and spending. In short, since the composition of Personal Income is so different today than when the POG was created, historical price of government norms have little usefulness in benchmarking the affordability of state and local government or spending over time.

If policymakers want to maintain a POG-type measure, the state should modify the current metric by replacing Minnesota Personal Income with some measure of money income. Such an adjustment would better deliver on the stated intent and purpose of the metric.

Even in the event of such a change, we encourage caution in using the POG to assess the affordability of government or setting a "price target" for Minnesota government. Powerful demographic factors are shaping the income landscape, and trends affecting the size and origin of money income in Minnesota have potentially major implications for "targeting" an acceptable level of government claim on Minnesotans' income. We encourage a closer examination and a better understanding of income trends and components before utilizing the POG in this manner.

[13] Report of the Minnesota Budget Trends Study Commission, http://www.mmb.state.mn.us/budget-reports-trends/324-budget-trends-reports/3060-report

[14] See MCFE's *Tax Year 2008 and 2010 Individual Income Tax Burden Comparison* studies. Available at https://www.fiscalexcellence.org/our-studies.html.