Jeff Van Wychen, Director of Tax Policy and Analysis at Minnesota 2020

Modest tax increase an appropriate solution to state revenue problem

A Civic Caucus Focus on Competitiveness Interview

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Present

Pat Davies, Paul Gilje (coordinator), Randy Johnson, Sallie Kemper, Dan Loritz (chair), Paul Ostrow, Dana Schroeder, Clarence Shallbetter, Jeff Van Wychen. By phone: Audrey Clay, Janis Clay, Tim McDonald.

Summary of Discussion

Jeff Van Wychen, policy fellow and director of tax policy and analysis at Minnesota 2020, believes Minnesota has both a revenue and expenditure problem, but he focuses the discussion on the state's revenue problem. He stresses that both inflation and population growth must be taken into account when analyzing revenues and expenditures over time. If we ignore inflation and population growth, we might conclude that Minnesota doesn't have a revenue problem, he says. In nominal dollars, state general fund revenue has increased by more than a third over the last decade. But, after taking inflation and population into account, average real per capita general fund revenue from FY 2010-1017 ($3,203) will be 14 percent less than from FY 2000-2007 ($3,734). For most of the last decade, Van Wychen says Minnesota stumbled from deficit to deficit. The state used what he calls (1) budget "shifts and gimmicks" and (2) spending cuts to deal with the deficits. In inflation-adjusted dollars, per pupil state aid for K-12 education has fallen by 13 percent, state funding for higher education has fallen by 35 percent, and state funding for property tax aids and credits has fallen by 43 percent. He believes those decreases threaten Minnesota's future prosperity. He says to stay competitive, Minnesota must reinvest in education and workforce development. He concludes that the state can afford a modest, reasonable increase in taxes to address its revenue problem.

Background

Jeff Van Wychen is a policy fellow and director of tax policy and analysis at Minnesota 2020, a St. Paul-based, progressive, new media, nonpartisan think tank focused on fiscal policy, education, health care, transportation and economic development.

For over 25 years, Van Wychen was a policy analyst for various local governments and nonprofit organizations. Before becoming a consultant in 1998, he was a fiscal analyst for the City of Minneapolis and, prior to that, for the League of Minnesota cities. He served as a policy fellow at Minnesota 2020 from 2008 to January 2011, when he left to serve as the senior research analyst in the office of Governor Mark Dayton.

Van Wychen rejoined Minnesota 2020 in January 2013. He focuses primarily on fiscal policy and state and local budget issues. He maintains a comprehensive property tax model capable of assessing trends in property taxes and state aids within each Minnesota taxing jurisdiction.

He received a master's degree in political science from the University of Minnesota in 1984 and a bachelor's degree in history and social science from the University of Wisconsin, Stevens Point.

Discussion

(Note: View a handout containing the graphs and analysis Jeff Van Wychen, policy fellow and director of tax policy and analysis at Minnesota 2020, referenced in his discussion with the Civic Caucus. For further information, view Minnesota 2020's recent spending report, "Crumbling Fiscal Foundation" and its recent general fund revenue analysis .)

Minnesota has both a revenue problem and a spending problem.
Van Wychen said people looking at Minnesota budget issues tend to fall into two camps: the revenue-problem camp and the spending-problem camp. "Actually, we can have both a revenue problem and a spending problem at the same time," he said. "In Minnesota, we do have both."

Van Wychen contends that the spending problem is not so much born of extravagance or wastefulness, but rather is due to demographics and soaring health care costs, both factors over which the state has limited control.

Because his expertise is primarily in taxes and revenue, the discussion focused on the revenue side. Van Wychen made the following points:

In the mid- to late 1990s, Minnesota had too much revenue.
Every state revenue forecast from the mid-1990s until February 2001 reported a surplus. State lawmakers responded by cutting taxes. Some were temporary and some were permanent. In 1999 and 2000, the legislature enacted significant permanent income tax reductions.

At the same time, the state reduced local property taxes by shifting expenses to the state general fund. In the mid-1990s, we used the state surpluses to reduce education property taxes. This culminated with the elimination of the general education property tax in 2001. That same year we also eliminated the property tax for operating expenses for transit.

In retrospect, the state appears to have over-extended itself with the volume of tax cuts during the surplus years.
"There's nothing wrong with enacting tax cuts when you have surpluses, provided you're also willing to consider tax increases when you have deficits," Van Wychen said. "Unfortunately, that wasn't the case."

In order to measure how state revenue has changed over the past decade, we need to take inflation and population growth into account.

- Inflation is the decline in purchasing power of the dollar. In his analysis, Van Wychen used a measure known as the implicit price deflator (IPD) for state and local government purchases, which he called a better measure of inflation for the kinds of things state and local governments buy than the more commonly cited consumer price index (CPI).The IPD for state and local government purchases is a weighted average of all the things state and local governments purchase. It is heavily weighted by wages and salaries in state and local government, but also includes estimates for the entire range of government purchases.

Some people believe that extravagant wages and pensions have caused the IPD to grow faster than the CPI. However, the "employment cost index" (ECI) from the U.S. Bureau of Labor Statistics, a measure of the cost of wages and benefits, shows that this is not the case. Over the last decade, the state and local government ECI has not grown significantly faster than the private sector ECI and has actually grown less rapidly than the private sector ECI over the last four years.

The big reason for the more rapid growth in the IPD relative to the CPI is rising benefit costs (especially health care), which comprises a larger share of state and local government budgets than the typical household budget.

- Population growth is critical, he said, because as population grows, the state economy grows, the number of taxpayers grows, as does the number of people using public services and infrastructure. Minnesota's population growth over the last decade has averaged 0.7 percent per year.

If we ignore inflation and population growth, we might conclude that Minnesota doesn't have a revenue problem. In nominal dollars (i.e., not adjusted for inflation and population growth), state general fund revenue (specifically, current resources) has increased by more than a third over the last decade, from $25 billion in the FY 2002-2003 biennium to $35 billion in FY 2012-2013.It's projected to grow to $39 billion in FY 2016-2017.

But, after taking inflation and population into account, average real per capita general fund revenue from FY 2010-1017 ($3,203) will be 14 percent less than from FY 2000-2007 ($3,734). It stayed nearly flat from FY 2000 to FY 2007 and then took a sharp nose-dive through the next two biennia, due mainly to the Great Recession, although the revenue decline in Minnesota actually began before the Great Recession began. Revenues have recovered a bit since then, but we're nowhere near the level of real per capita state income at the beginning of the last decade.

Based on these facts, Van Wychen said, it's clear that Minnesota has a revenue problem.

For most of the last decade, Minnesota stumbled from deficit to deficit. With few exceptions, tax increases were off the table from 2003 to 2011, the years when Tim Pawlenty was governor. This left us with "shifts and gimmicks" and spending reductions as the primary mechanisms for dealing with the recurring budget deficits.

Because "shifts and gimmicks" are generally one-time in nature, they don't solve the state revenue problem, but merely postpone it.

- School aid shifts delay payments to school districts until the next biennium, thereby creating a one-time reduction in state expenditures, making it easier to balance the budget in the current biennium.

- Liquidation of endowments created with revenue from the 1998 tobacco settlement included the draining of medical education and tobacco-use-prevention endowments to help balance the budget early in the Pawlenty years.

- In 2011, the state sold tobacco bonds to be paid off with future state tobacco revenue, resulting in a one-time infusion of $643 million, which we used to balance the budget in the current biennium (2012-2013). This was essentially a sale of a future state revenue stream for the sake of a one-time upfront cash fix.

- Beginning in 2002, the state ignored the impact of inflation in expenditure forecasts, but continued to account for it in revenue forecasts. Before that, state forecasts counted inflation on both the revenue and expenditure sides of the state budget. Ignoring inflation made expenditures appear artificially low relative to revenues and helped create the illusion of a smaller deficit in future biennia than was actually the case.

"We capture the impact of inflation on revenues, but we discount the impact of inflation in about 70 percent of expenditures," Van Wychen said. "We do measure inflation for health care costs. The State Council of Economic Advisors has argued that we should account for inflation in other categories of state expenditures, except in the area of debt service." The nonpartisan State Budget Trends Study Commission made the same recommendation in 2010.

According to the official state budget forecast, the state will have a $782 million surplus by FY 2016-2017. However, he said, we'll still have a deficit of $1.5 billion if we fully account for inflation on both the revenue and expenditure sides of the state ledger.

Spending cuts are the other strategy used over the last 10 years.
Adjusted for accounting gimmicks and state takeovers, state general fund spending has fallen over the last decade by $5 billion in constant 2013 dollars. On a per capita basis, this translates to an 18 percent decline, from approximately $4,000 in FY 2002-2003 to approximately $3,275 in the current biennium.

- In inflation-adjusted dollars, per pupil state aid for K-12 education has fallen by 13 percent.

- State funding for higher education has fallen by 35 percent.

- Funding for property tax aids and credits has fallen by 43 percent.

"All of these things translate into larger class sizes, fewer course offerings, higher tuition at state colleges and universities, a deteriorating transportation system, higher local property taxes and much less funding for local services and infrastructure," Van Wychen said. "All of these things are a threat to Minnesota's long-term prosperity."

Minnesota can afford some modest increases in state tax revenue.
" How does Minnesota solve its revenue problem?" Van Wychen asked. "We don't need to go back to the revenue levels of the first half of the last decade. We can't afford to do that and by smarter spending, we don't need to. However, we can afford some modest increases in state tax revenue."

The "price of government" index has been declining.
The "price of government" equals total state and local government own-source revenue as a percentage of statewide personal income; it is calculated by Minnesota Management & Budget and is used to measure the size of government in Minnesota. It excludes revenues from the federal government. During most of the 1990s, this index was above 17 percent. Since 2000, it's been between 15 and 16 percent. Under current law, it's projected to drop to 14.3 percent by 2017, an all-time low.

Van Wychen said under Gov. Mark Dayton's original budget submitted in January 2013, the price of government would average 15.5 percent over the next four years, which is dramatically less than the 1990s and slightly less than over the previous four years and slightly less than during the Gov. Pawlenty years. The price of government under Dayton's revised budget should be even less than 15.5 percent, since new revenue from expanding the sales tax base was removed.

Both state general fund spending and revenue will increase under the Dayton budget over the next four years.
In the next biennium, state general fund spending will increase by seven percent in nominal dollars and 2.4 percent in real per capita dollars.

But this is considerably less than the projected growth in the economy.
By the FY 2016-2017 biennium, under Dayton's proposed budget, Minnesota will recapture only one-third of real per capita decline in general fund revenue and spending over the last decade. (While all of the details of the new budget agreement recently announced by Governor Dayton and legislative leaders are not yet available, it will likely restore only about one-third or less of the real per capita general fund revenue and spending decline over the last decade.)

Dedicated revenues take away legislators' flexibility.
In response to a question, Van Wychen said it's generally not a good idea to pull things out of the general fund and give them dedicated revenues. "The Legislature needs to have the flexibility to respond to changing conditions and not get locked into dedicated revenues," he said.

Solving the state's structural budget problem should be measured by whether the state has the resources to do the things it needs to do to optimize economic performance and achieve other policy goals. Responding to a question, he said solving the problem shouldn't be measured by the price of government alone, but by the adequacy of revenues.

Redesign and reform are part of the solution to the state's budget problems.
In response to a question about redesigning services, Van Wychen said the goal of reform is to reduce expenditures and to be more efficient. He said the Dayton administration has attempted to slow the growth in expenditures in the health care area by contracting with nonprofits. "We're not going to solve this problem entirely by taxing ourselves back to the level we saw a decade ago," he said.

"To fully restore real per capita funding levels to where we were at the first half of the last decade, we'd have to have triple the tax increases that Gov. Dayton and the Senate are proposing," he said. "That's not going to happen. We can't afford that."

Local Government Aid funds (LGA) should be adjusted by inflation and population.
Responding to a question about local spending, Van Wychen said that back in the late 1980s, LGA encouraged local spending, since the formula was based on local property tax levies plus state aids; this arrangement gave cities an incentive to levy more in order to get more aid in future years. In 1989, the Legislature changed the formula to base it on cities' demographics, not past levy and spending patterns. For nearly a quarter century, the direct connection between local spending decisions and state LGA payments has been severed. Cities no longer have an incentive to spend and levy more in order to get more state aid.

"If local governments decide to spend more now, every marginal dollar comes from property taxes," he said. "There is greater accountability, because they have to tax themselves."

An interviewer commented that LGA has still created a very easy out for public officials to say there isn't enough state aid, so we must raise local property taxes. He said there is no sense elected local officials are truly responsible for property taxes. "LGA divorces accountability and people don't know who to blame," the interviewer said.

Van Wychen responded that the accountability problem arises when the state makes disproportionately large cuts to LGA. The solution to the accountability problem is to provide for stable and adequate funding for LGA. The current House and Senate tax bills include important LGA reforms that will make the aid distribution among cities more equitable in future years and provide a significant appropriation increase in 2014 to replace a portion of past state aid cuts; however, only the House bill adjusts the appropriation in future years to keep pace with inflation and population growth. "Adjusting for inflation and population growth is critical, because if all inflationary pressures and population growth have to be borne by the property tax, that leg of the three-legged revenue stool (income, sales and property taxes) will grow," he said. While LGA funding cuts should be expected when there is an unforeseen state revenue shortfall, these cuts should not be disproportionate to the cuts seen in other parts of the state budget.

State government alone may not be able to solve the problem of rapid growth in health and human services spending.
In response to a question, Van Wychen said some people have looked at health and human services and are seeing that growth will soak up a large proportion of the state budget and the overall economy. "There is a real need to get some sort of handle on health care costs," he said. "We may need more federal involvement. State government may not be able to completely solve the problem."

Businesses don't pay property taxes on personal property in Minnesota.
In discussing business property taxes, Van Wychen pointed out that in Minnesota, with one exception, we don't tax personal property. In manufacturing, 50 to 70 percent of a business's value is in personal value and that's exempt here. Most other states do tax business personal property, he said. The fact that Minnesota does not tax personal property provides Minnesota businesses with a tax reduction that helps to offset the higher taxes resulting from Minnesota's property classification system.

Increase competitiveness by reinvesting in education.
An interviewer asked how Minnesota could increase its competitiveness. "We must start reinvesting in education," Van Wychen responded. He said real K-12 per pupil state aid has dropped by 13 percent over the last decade, so that Minnesota is now at the national average in per pupil spending onK-12 education. "In higher education, the situation is even worse," he said. "If we're going to compete we need to focus on workforce development." Some of the investments in education won't immediately improve Minnesota's workforce, but will bear fruit down the road. For example, Van Wychen said, "All-day kindergarten won't improve our workforce for another 15 years or so."

Van Wychen concluded by saying Minnesota can afford a reasonable increase in state tax revenues. "The Governor, House, and Senate are proposing modest and reasonable increases in state revenue and spending; these are replacing only a small portion of the revenue and spending declines over the past decade," he said.