Freedom Foundation of Minnesota

POLICY REPORT

Analysis of Governor Dayton's Tax Plan

April 2013

Executive Summary

Following tough bipartisan criticism of his original biennial budget proposal, Governor Mark Dayton introduced a FY 2014-15 Supplemental Budget on March 14, 2013. This new budget, totaling $37.94 billion in spending, maintained most of the same spending priorities but dropped some of the most controversial revenue provisions.

The bottom line of the most recent Dayton budget proposal amounts to a $1.84 billion net tax increase to cover a $627 million forecasted shortfall, while dramatically increasing state spending in FY 2014-15, especially on K-12 education. Significantly, this new budget proposal does not include the Governor's previous proposal to expand the sales tax to a wide array of services, including business inputs, while reducing the overall rate. The revised Administration proposal also does not include a previously proposed $1.4 billion property tax rebate.

Essentially, Governor Dayton has set aside most of his "tax reform" proposals, and instead is relying on two revenue sources to support the bulk of his spending increases: the creation of a fourth tier personal income tax rate, and a cigarette tax increase.

Dayton's FY 2014-15 supplemental budget proposal includes $37.94 billion in spending, a $2.5 billion increase over the current biennium, and almost $1.2 billion above and beyond what the state was forecast to spend. The biggest portions of the budget, as usual, are K-12 spending at $15.5 billion (or 41 percent of general fund spending) and $11.6 for Health and Human Services (30.5 percent of general fund spending). The governor is also seeking to boost Local Government Aid (LGA) and local property tax aids, which account for a combined $2.8 billion in allocations for the biennium.

Dayton's $37.94 billion budget would increase spending by a staggering 7.6 percent in the upcoming biennium (FY 2014-15), and projects another massive spending increase of 7.4 percent in the following biennium (FY 2016-17), for a total of $40.75 billion in spending.

This underscores one of the fundamental problems with Governor Dayton's budget proposal. It is not merely a one-time boost in spending, but rather a new baseline that puts the state even further down the path to unmanageable and unaffordable future spending increases.

Meanwhile, Minnesota Management and Budget's (MMB) recently released its fourth consecutive positive economic forecast. The most recent economic prediction reduced the state's projected deficit for FY 2014-15 by about 40 percent and allowed for a partial repayment of the so-called "K-12 shift", under which policymakers delayed a portion of the state's aid payments to schools in order to help balance the state budget.

According to MMB, under current state law and assuming no changes in the tax code, "General fund spending for FY 2014-15 is estimated to be $1.295 billion more than FY 2012-13. Forecast spending in health and human services is estimated to be $708 million (6.6 percent) more than FY 2012-13 while K-12 spending estimated to be $797 million higher (5.5 percent)."[1] In total, projected spending for FY 2014-15 would be $36.7 billion. Governor Dayton has proposed spending almost $1.2 billion above and beyond that projection.

Remarkably, MMB's February forecast also provided an unexpectedly positive projection for the following biennium (FY 2016-17), showing the state budget finally achieving elusive structural balance, and even running a surplus. In fact, the state could pay off the remaining balance of the K-12 shift ($801 million) in FY 2016-17, and only run a modest deficit.

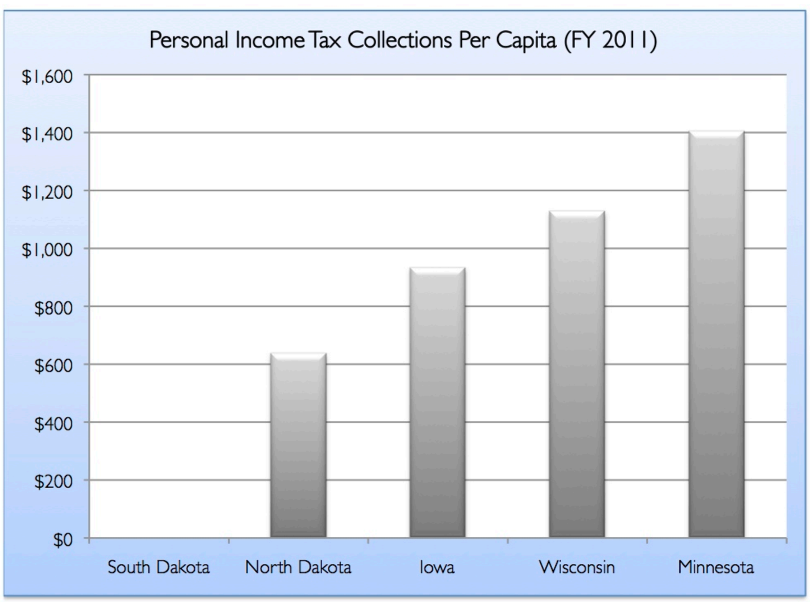
The improving fiscal picture reflects well on the relative fiscal restraint in the bi-partisan budget deal reached in the summer of 2011 that ended the state government shutdown. The recovering economy also changes the dynamics of the current legislative session, by calling into question the wisdom of, and need for, a budget containing billions in new spending financed by an ambitious package of tax hikes. In short, the economic data stands in stark contrast to the governor's proposed budget, which needlessly increases regressive cigarette taxes and imposes a new top personal income tax rate on Minnesota families and job creators. The result will be a less competitive and prosperous state economy, unsuited to compete with other states for jobs and investment.

Income Tax Background

Governor Dayton has sought tax increases on upper-income Minnesotans since his gubernatorial campaign in 2010. His current proposal includes a new, fourth-tier personal income tax rate of 9.85 percent, compared to the current top rate of 7.85 percent. It would apply to individuals with taxable income of $150,000 or higher and couples with combined taxable income of $250,000 or more.

The governor's income tax proposal is inconsistent with his populist rhetoric about taxing "millionaires and billionaires". It would also hinder economic growth, increase Minnesota's reliance on an inherently unstable revenue source, and make it more difficult for businesses to attract and retain top talent.

In 2011, Minnesota had the 5th highest per capita income tax collections in the nation, at $1,404. Only New York, Connecticut, Massachusetts, and Oregon collected more.[2] Minnesota's personal income tax collections also stand in stark contrast to neighboring states (see chart).



In addition, personal income taxes already account for an unusually high percentage of state and local revenue, a problem that Dayton's proposal would exacerbate. Personal income taxes accounted for 26.5% of all state and local revenues, the 10th highest rate in the nation.

Tax Plan Would Shrink Incomes, Kill Jobs

Personal income is an important economic measure of a state's well-being. Higher levels of personal income mean that a state's residents are able to buy more goods and services such as homes, cars, education and healthcare.

Fundamentally, personal income comes from two sources: the private sector and the public sector. The distinction between the two sectors is important because only the private sector creates new income. The public sector, in contrast, can only redistribute income through taxes and spending. More specifically, public sector spending consists of personal current transfer receipts (Medicare, Medicaid, Social Security, etc.) and government employee compensation (federal, state and local).

Minnesota's policymakers should be very concerned that there is clear evidence that public sector spending results in the "crowding out" of the private sector (see Methodology section for more details). Yet, despite this evidence, Gov. Dayton has suggested massive tax hikes that would significantly reduce the size of Minnesota's private sector relative to the public sector.

Increasing taxes on the private sector will have two consequences. First, higher taxes will mean less money in the pockets of individuals and businesses, which will reduce their ability to invest for the future. Second, greater public spending will crowd-out the private sector in competition for scarce labor and capital.

Overall, the Governor's plan would increase the tax burden on Minnesotans by $1.841 billion in Fiscal Years 2014 and 2015 (above forecasted growth), with the majority of projected new revenue coming from the new individual income tax bracket. This analysis is based on one year of the new tax increases, or $921 million.

As a consequence of these tax hikes, Minnesotan taxpayers will pay a steep price with higher tax bills, lower incomes and fewer jobs. Table 1 shows the impact of these tax proposals on Minnesota taxpayers. The most immediate impact is that the average household will face an increase in their tax bill of $433 under Gov. Dayton's plan.

However, more troubling, is that in the longer-run there will be a much higher economic cost to pay in either lower incomes or fewer jobs. Overall, the Minnesota economy will suffer a drop in personal income of $2.2 billion under Gov. Dayton's plan. The drop in personal income can manifest itself in one of two ways—lower household income for everyone or fewer jobs, though reality will lie somewhere in-between.

The economic cost of Gov. Dayton's plan over the next 3 to 5 years ranges from:

- $1,014 less personal income for all households with no private sector job loss; or,
- No change in personal income per household but the loss of 35,712 private sector jobs.

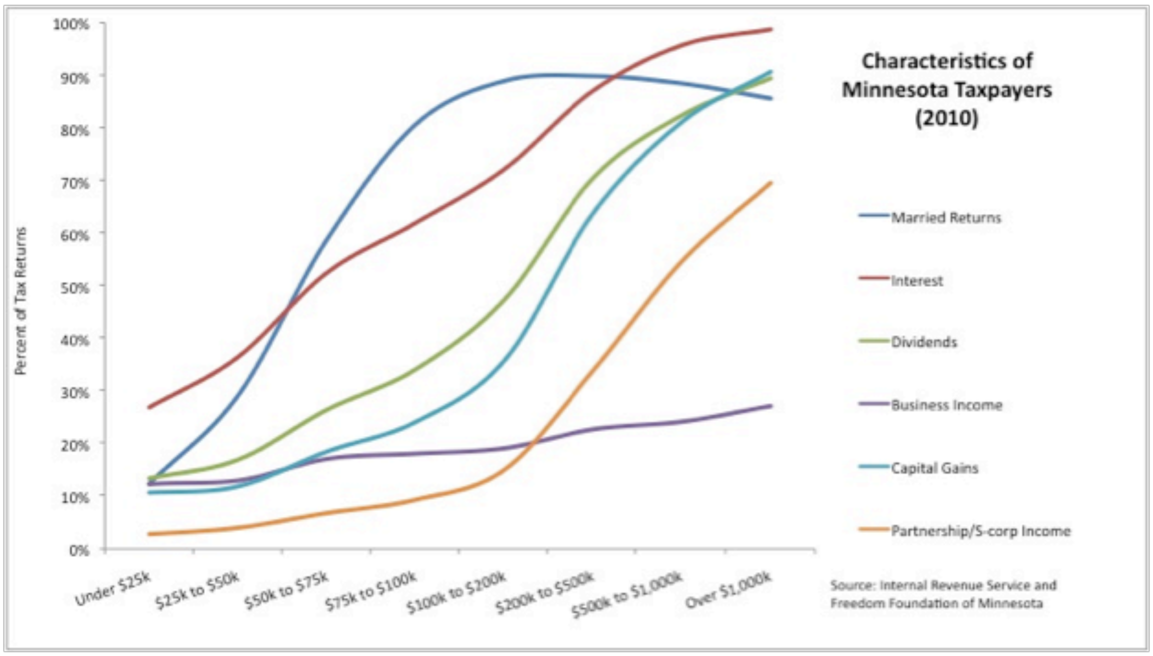
Estimated Economic Loss Due to Gov. Dayton's Proposed Tax Hikes				
Area	Gov. Dayton's Tax Increase Proposal			
	Tax Increase per Household	Personal Income Loss per Household	or	Job Loss Equivalent
Minnesota	$433	$1,014	or	35,712
Source: Freedom Foundation of Minnesota, see "Methodology Section" for details.				

These costs would be devastating to Minnesota's economy, especially as it continues its tepid recovery from the "Great Recession". Instead, the state would benefit from shelving tax increases and restraining spending, creating conditions under which the private sector can create jobs and increase personal incomes.

Who Are Minnesota's "Rich"?

An analysis of data from the Internal Revenue Service for 2010 shows the dramatic differences in the composition of income by various income groups.[3] Simply looking at total income can be misleading if one does not understand the underlying income dynamics since today's tax code includes a mish-mash of personal and business income.

The chart below shows the various characteristics of Minnesota's taxpayers by income group as a percent of tax filers within each income group. The first item to note is how marriage affects the perception of "rich" versus "poor." For those earning between $25,000 to $50,000, married filers account for 29.2 percent,. For those earning between $200,000 to $500,000 the number of married filers jumps to 89.9 percent.



This makes perfect sense since in the modern economy where both husband and wife are in the workforce, marriage often results in a doubling of household income. A single person earning $40,000 would fall in the "under $50,000" category whereby a couple earning a combined $80,000 would show up in the "$75,000 to $100,000" category. By this metric, the married couple misleadingly looks better off economically than the single person.

The second item to note is that the percentage of taxpayers that have some kind of business income soars at the income levels over $1,000,000—98.7 percent of taxpayers have interest income, 89.4 percent of taxpayers have dividend income and 90.7 percent of taxpayers have capital gains income.

More importantly, the percentage of taxpayers that have partnership/S-corporation income is dramatically higher for those earning over $1,000,000 (69.6 percent). This is over four times as high as those earning between $100,000 and $200,000 (15.2 percent) and ten times as high as those earning between $50,000 and $75,000 (6.9 percent). The income from S-corps is particularly problematic because, unlike C-corps, S-corp income is taxed at the personal level. This pass-through income is not necessarily indicative of the taxpayer's actual financial condition (see next section, "History of the S-Corporation", for details).

Along the same lines, the Tax Foundation published a report titled "Putting a Face on America's Tax Returns" which shows that "the vast majority of taxpayers who face the highest marginal tax rates [meaning high-income] tend to be married couples. But aside from being married, they also tend to be dual-income, residents of high-cost urban areas, older, college educated, and engaged in business activities."[4]

For tax year 2012, Minnesota had three tax rates: 5.35 percent, 7.05 percent, and 7.85 percent. These increasing tax rates are called a "graduated" or "progressive" income tax structure and can lead to all kinds of economic distortions. To see how, consider two hypothetical households—a single taxpayer with wages of $50,000 and a married couple with two children with combined wages of $100,000, S-corp income of $50,000, capital gains income of $20,000 and interest/dividend income of $5,000.

As shown in the table below, taxes for the single taxpayer are straightforward and amount to a tax bill of $2,435. As a percent of total and actual income (there is no difference for this taxpayer), this amounts to a tax burden of 4.9 percent.

Table 1
Hypothetical Taxpayers and Their Minnesota Personal Income Tax Bill
Calendar Year 2012

Single	Income	Married (2 Children)	Income
Wages	$50,000	Husband Wages	$50,000
		Wife Wages	$50,000
		S-Corporation	$50,000
		Capital Gains	$20,000
		Interest/Dividends	$5,000
Total Income	$50,000	Total Income	$175,000
Tax (a)	$2,435		$9,923
Tax Burden as a Percent of *Total* Income	4.9%	Tax Burden as a Percent of *Total* Income	5.7%
Tax Burden as a Percent of *Actual* Income	4.9%	Tax Burden as a Percent of *Actual* Income	7.9%

(a) Tax based on standard deduction only.
Source: Minnesota Department of Revenue and Freedom Foundation of Minnesota

The married couple's tax bill is not so simple. The problem stems from the S-corp income, which is derived from a family-owned business that is in financial trouble. The business needs to make some necessary investments to stay competitive so, for the next few years, all profits will be retained to fund additional business activity. However, the profits must still be distributed to shareholders for taxation. So, this family's share of profits comes to $50,000 even though they won't actually receive $50,000—this is often referred to as "phantom income."

As a result of having to pay taxes on the S-corp income, the family will have to sell some stocks resulting in $20,000 worth of capital gains. They also receive $5,000 in interest and dividends from personal savings for college/retirement. The end result is that they will owe $9,923 in personal income taxes to the state of Minnesota.

At first glance, it looks like this family is better off than the single taxpayer, the single taxpayer is getting a much better tax deal with their state tax burden of 4.9 percent on their actual income. The family's income may be 3.5 times higher, but their tax bill is 4.1 times higher thanks to Minnesota's increasing marginal tax rates. Adding insult to injury, their overall tax burden is significantly higher at 7.9 percent of actual income—keep in mind that they never received the $50,000 from the S-corp which was kept by the business as retained earnings. Given this reality, combined with punitive tax proposals at the federal level (not to mention in Minnesota), it is not surprising that an increasing number of S-corps are considering structural changes to lessen their tax burden.[5]

This simple illustration shows that the interplay between personal and business income within the tax code can lead to misleading conclusions about the actual financial condition of taxpayers. A "high-income" family with children who own a Minnesota business could be one step away from financial disaster while a "low-income" single taxpayer may be better off in terms of after-tax income.

As a result, comparing a taxpayer in the "$25,000 to $50,000" income category with a taxpayer in the "over $1,000,000" income category is not an apples-to-apples comparison. Only 4.1 percent of taxpayers earning between $25,000 and $50,000 have any partnership/S-corp income while 69.6 percent of all taxpayers earning more than $1,000,000 have partnership/S-corp income. It is absurd to compare the income of an individual with that of a doctor's office, yet that is exactly what is happening when using income tax data to make such comparison between aggregate income groups.

History of the S-Corp

In 1958, subchapter S of the Internal Revenue Service tax code was enacted that created the modern S-corporation as we now know it. The primary reason for its creation was to eliminate the double-taxation of income that exists under traditional C-corporations.

For instance, dividends paid by a C-corp can only be paid out of after-tax income, which is one layer of taxation. Individuals must then declare the dividends as income, which results in two layers of taxation for the same stream of income. S-corps avoided this double-taxation by taxing business income only at the personal level.[6]

However, S-corps remained a small part of the corporate landscape until two major events that dramatically increased their desirability.

First, individual income tax rates were higher than corporate income tax rates until the Tax Reform Act of 1986 which dramatically lowered the individual tax rate to 28 percent. As a result, the popularity of S-corps increased significantly.

Secondly, the payroll tax rate for Social Security and Medicare topped 14 percent (combined employee and employer rate) for the first time in the mid-1980s. Unlike wages and salaries, S-corp dividends are not a subject to payroll tax which also boosts the popularity of S-corps over C-corps.

However, S-corps do have important limitations such as a restricted number of stockholders and types of stocks that can be issued. Nonetheless, as of 2007, S-corps represent 63 percent of all corporations in America.[7]

Conclusion

The governor's budget and tax plan are ostensibly intended to make Minnesota's tax system fairer and more progressive, despite the increase of regressive sin taxes as well as punitive taxes on small businesses and families.

Even the liberal Institute on Taxation & Economic Policy understands who shoulders the biggest tax burden in our state: the bottom 20 percent of income earners in Minnesota have a combined state and local tax rate of 8.8 percent, compared to 11.1 percent nationwide. By contrast, for all income groups above the median, Minnesota's combined state and local tax burden is higher than the national average.[8]

And the pieces of Dayton's tax plan most associated with so-called tax fairness – the fourth-tier personal income tax rate and "snowbird tax" – are likely to exacerbate the trend of Minnesotans moving their families, businesses, or money out of state. A recent study by the U.S. Public Interest Research Group (U.S. PIRG) Education Fund estimates that Minnesota loses $629 million in individual income tax revenues each year to offshore tax havens, the 5th highest of any state. Not surprisingly, the states at the top of those rankings (California, New York, and New Jersey) also have some of the highest tax burdens in the nation.[9]

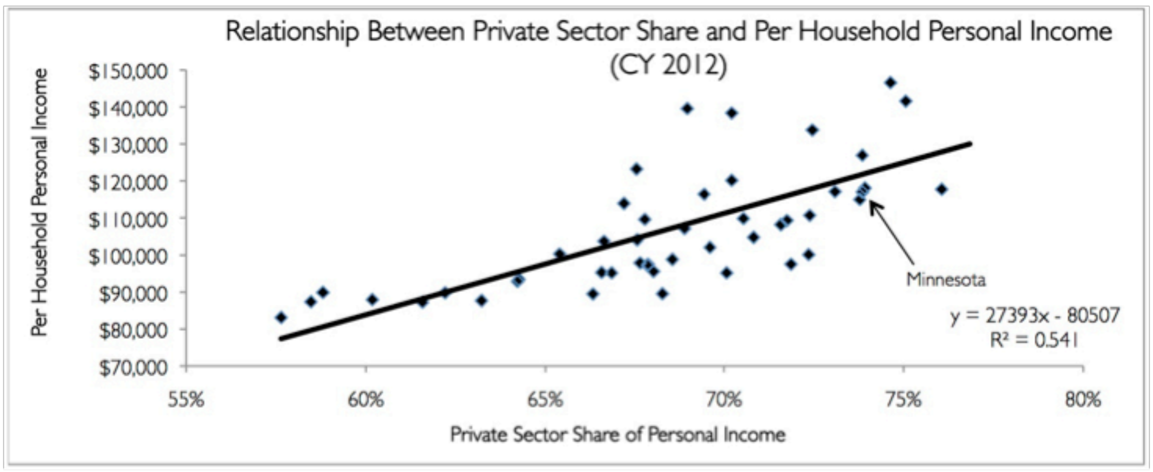
Minnesota policymakers would be wise to heed the lessons learned the hard way in several other states that have attempted to "tax the rich". In some cases, those tax plans were also cloaked in the language of "tax reform". Instead, it's a return to a by-gone tax-and-spend era that garnered an anti-business reputation for Minnesota. Indeed, states like California and New York, with punitively high taxes and unsustainable growth in government spending are suffocating the private economy, hindering economic growth and drove taxpayers and jobs out of those high-tax states. Minnesota should want to follow their lead.

Instead, policymakers should judiciously follow the direction of nearly a dozen states that are reining in runaway government spending and initiating true tax reform. According to a recent economic analysis by economist Art Laffer, from 2002 until 2012, "62 percent of the three million new jobs in America were created in the nine states without an income tax, though these states account for only about 20 percent of the national population."

The Tax Foundation cautioned policymakers against taking the Dayton approach to tax "reform": "Taxing business inputs and implementing increasingly progressive income taxation can harm economic growth for years to come. The plan is an example of a state operating under the facade of positive and pro-growth reform while failing to understand the relationship between a state's tax structure and its ability to attract business."[10]

Methodology

The economic loss estimates in this study are derived from the significant positive correlation between per household personal income with the private sector share of personal income for 2012 as shown in the chart below. Put simply, the greater the private sector share, the greater per household personal income.



States with larger private sectors will grow faster over time than states with smaller private sectors. When examining all the 48 lower states, the analysis finds that, on average, a 1 percentage point decrease in the size of the private sector yields a decrease in per household income of approximately $2,739.

Increasing Minnesota's taxes by $921 million would shrink the private sector by up to 0.37 percent. That means, in the near future, the average household in Minnesota would see their income drop by up to $1,014 ($2,739 times 0.37 percentage points). The overall loss in personal income would be up to $2.2 billion ($1,014 per household for 2,125,672 households).

The drop in personal income could hit Minnesota's taxpayers by 1) reducing income for everyone or 2) destroying jobs for a small subset of households. To represent the range of possibilities, the lost personal income is shown on a per household basis (lost personal income divided by households) and on a per job basis (lost personal income divided by the average private sector compensation)—reality will lie somewhere in-between.

This analysis estimates a reduction in the long-term growth in the economy and does not necessarily mean an elimination of existing household income or jobs. It does mean that future pay increases and job creation will be lower than they would be in the absence of higher taxes and spending. This analysis does not take into account matching federal funds, such as Medicaid, that may also be received by the state and would further shrink the private sector.

For a real-world example, compare two states that are similar in many ways—climate, demographics, geography, etc.—except for the size of the private sector—New Hampshire and Maine. And prior to 1951 both Maine and New Hampshire had similar fiscal policy in that neither had a sales or income tax. As such, both states had nearly identical private sectors and incomes.

In 2012, New Hampshire had the second largest private sector (76.1 percent) and the 13th highest per household personal income ($117,761) whereas Maine had only the 41th largest private sector (65.5 percent) and the 41st higher per household personal income ($92,870). As such, New Hampshire's per household personal income is 26.8 percent higher or $24,890 thanks to a more vigorous private sector.

The personal income data is from the Bureau of Economic Analysis (www.bea.gov) which is adjusted into "per household" using data from the Census Bureau (www.census.gov). The economic loss estimates are made on a statewide basis.

Endnotes

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