AMERICAN EXPERIMENT

CLOSING MINNESOTA'S BUDGET DEFICIT

Why we should make spending cuts and not raise taxes

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8421 Wayzata Boulevard ★ Suite 110 ★ Golden Valley, MN 55426

NOVEMBER 2020

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Key Findings

- Minnesota has the fifth highest top rate of state personal income tax in the United States—9.85 percent on income over $164,400 a year. Only Oregon, New Jersey, Hawaii, and California have higher top rates.
- Minnesota doesn't just tax "the rich" heavily. Our state's lowest personal income tax rate—5.35 percent on the first dollar of taxable income—is higher than the highest rate in 25 states.
- At 9.80 percent on the first dollar of taxable revenue, our state has the fourth highest state corporate income tax rate in the United States. Only Pennsylvania, New Jersey, and Iowa have higher rates.
- Higher tax rates do not necessarily bring higher revenues. Minnesotans actually handed over a larger share of their incomes to the government in the 1990s with top income tax rates of 8.50 percent than they did in the 1970s with rates of 17.0 percent.
- There is a much stronger relationship between state GDP and tax revenues than top tax rates and state revenues: for total state tax revenues as a share of state GDP, the mean average is 6.6 percent and the median is 6.7 percent. In other words, there is very little variation in these numbers.
- This means that if policymakers want more money to fund government services, they should look to increase the state's GDP rather than its tax rates.
- The overwhelming balance of academic literature shows that tax hikes negatively impact economic growth. Of 26 papers reviewed by the Tax Foundation, 23—88 percent—found a negative impact of higher tax rates on economic growth.
- In total and per person, and in real inflation adjusted terms, Minnesota's state government has never spent more money than it is right now: $4,088 per Minnesotan, up 26.6 percent since 2010.
- Minnesota's welfare spending per person in poverty—$30,479 in 2018—is the third highest in the United States and nearly double the national average ($17,127).
- If Minnesota's state government spent the national average amount of welfare per person in poverty in 2018, it would have spent $9.0 billion instead of $16.1 billion—a savings of $7.1 billion. If Minnesota closed its deficit by cutting welfare spending by $2.4 billion, the amount of welfare we spend per person in poverty would still rank us sixth highest in the United States.
- If Minnesota closed its forecast budget deficit entirely with spending cuts, we would be returning spending in real, inflation adjusted, per capita terms to the level of 2016-2017.

Minnesota's fiscal situation

In February 2020, economic forecasts showed that Minnesota's state government had a projected budget surplus of $1.5 billion for the remainder of this biennium, FY 2020-21, which ends in July 2021.[1] In March, COVID-19 hit the state and the economy was brought to a sudden halt. By May, the surplus had disappeared and the state budget office projected a $2.4 billion deficit for the period ending July 2021.[2] May saw a prolonged period of rioting that left devastation in some sections of the Twin Cities and, however belated it may have been, a bill for their eventual quashing was added to state spending. On July 31st, the state budget office released a planning estimate for the next biennium, FY 2022-23: an additional $4.7 billion deficit.[3]

The state constitution requires a balanced budget each biennium. Lawmakers in St. Paul must ask themselves the question: How will we close this deficit? They will have three options: higher tax rates, lower spending, or some combination of both.

Minnesota already has some of the highest tax rates in the United States

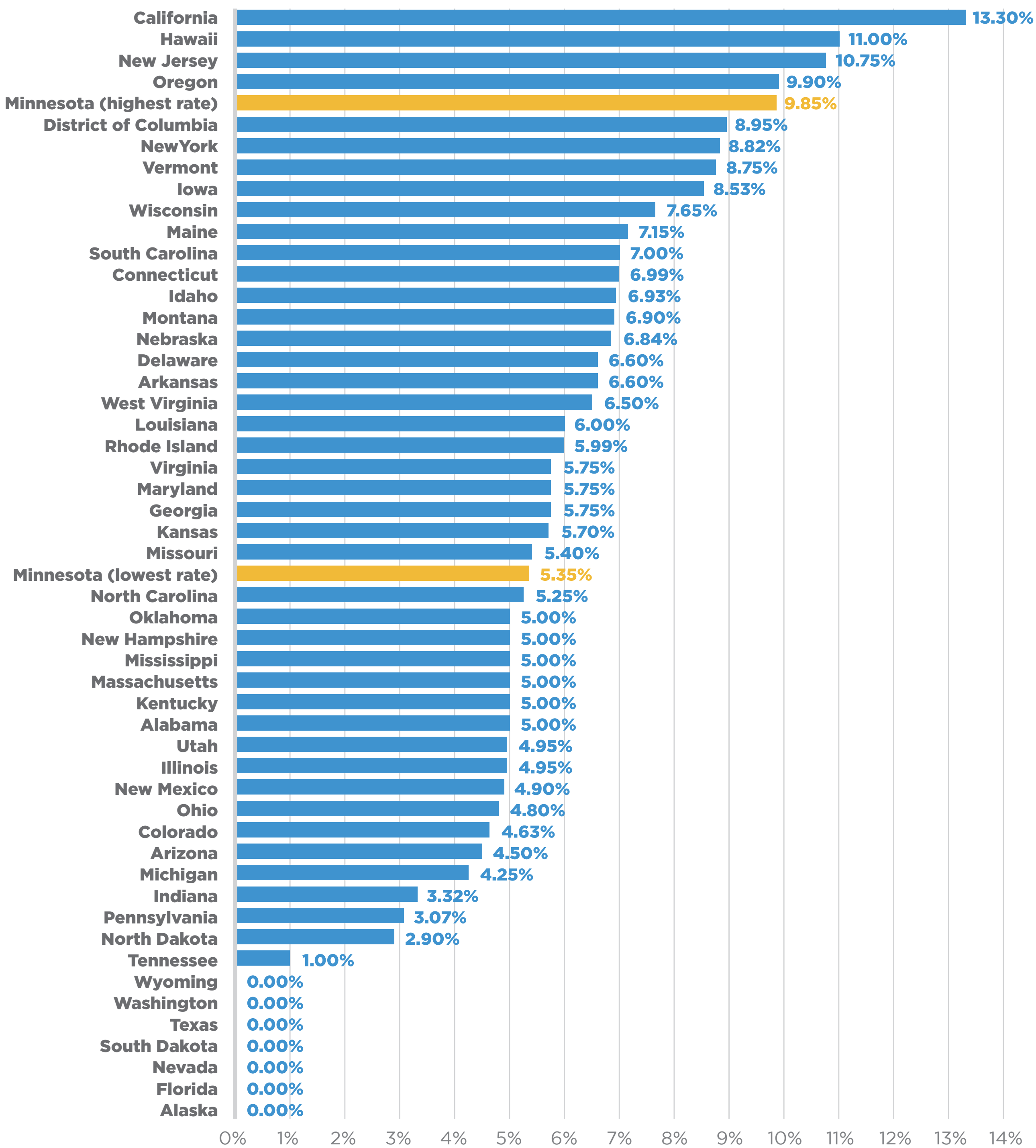
The first, and, by extension, the third, ought to be ruled out on the basis that Minnesota already has some of the highest tax rates in the United States.

As Figure 1 shows, Minnesota has the fifth highest top rate of state personal income tax in the United States—9.85 percent on income over $164,400 a year. Only Oregon, New Jersey, Hawaii, and California have higher top rates. But Minnesota doesn't just tax "the rich" heavily. Our state's lowest personal income tax rate—5.35 percent on the first dollar of taxable income—is higher than the highest rate in 25 states.

It is a similar story with state corporate income tax rates, as Figure 2 shows. At 9.80 percent on the first dollar of taxable revenue, our state has the fourth highest state corporate income tax rate in the United States. Only Pennsylvania, New Jersey, and Iowa have higher rates.

Top rates of state personal income tax and Minnesota's lowest rate, 2020

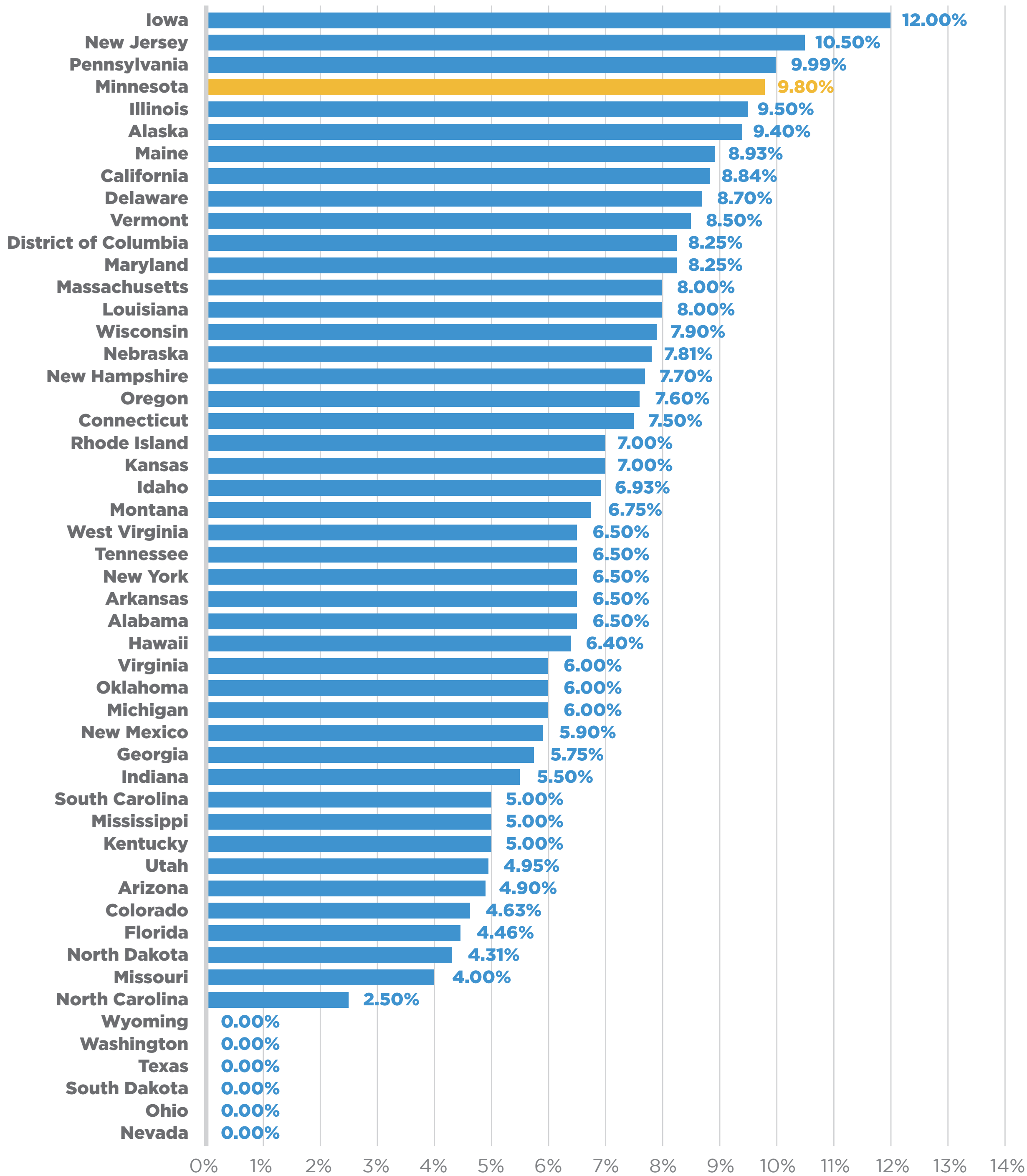
FIGURE 1



SOURCE: THE TAX FOUNDATION

Top rates of state corporate income tax, 2020

FIGURE 2



SOURCE: THE TAX FOUNDATION

Tax revenues do not appear to be driven by tax rates

If the state government attempts to close the deficit by hiking tax rates, historical experience suggests it won't succeed.

When a state government raises a tax rate it is attempting to appropriate a greater share of the income generated by that state's residents for itself. So, if higher income tax rates, for example, achieve their aims, we would expect to see an increase in the share of the state's Gross Domestic Product (GDP) taken in income tax following a tax hike.

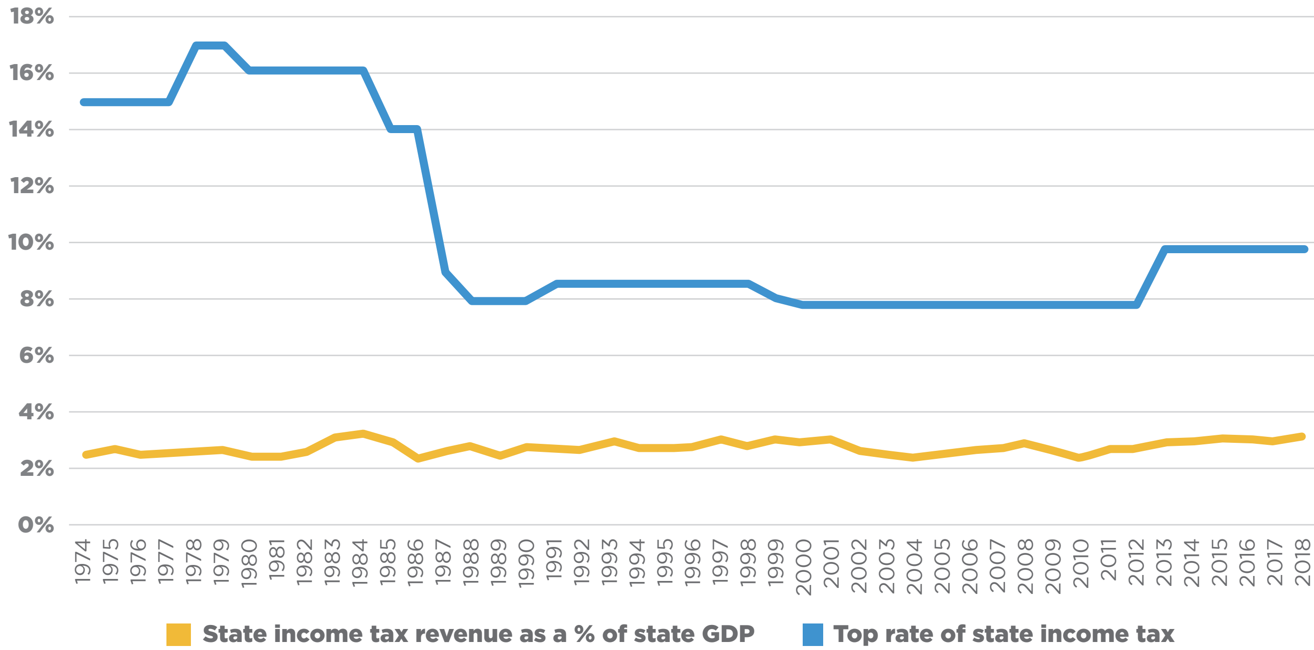
As Figure 3 shows, that does not seem to be the case in Minnesota. This shows the state's top rate of state income tax for a single filer and the share of the state's GDP taken in income tax. What is striking is how stable the share of state GDP paid in income tax is—both the mean and the median average for the period 1974 to 2018 are 2.8 percent. This is despite state tax policy. In the 1970s and into the 1980s, Minnesota's politicians tried to claim a large share of their citizens' income with top rates of tax up to 17.0 percent. But Minnesotans did not respond to these rates by handing over a greater share of their money, as shown by the stability of the revenue line. Indeed, they handed over a larger share of their incomes to the government in the 1990s, with top income tax rates of 8.50 percent, than they did in the 1970s, when rates were 17.0 percent.

The same is true of revenue more broadly as Figure 4 shows. For total state tax revenue as a share of state GDP, the mean average is 6.6 percent and the median is 6.7 percent. In other words, there is very little variation in these numbers in spite of very different tax rates.

There is an important policy lesson here. The dollar amount of tax revenue seems far more likely to be a function of the size of the state's economy than of its tax rates. This means that if you want more money to fund government services, you should look to increase the state's GDP rather than hike its tax rates. ∎

State income tax revenue as a share of state GDP and top rate of state personal income tax

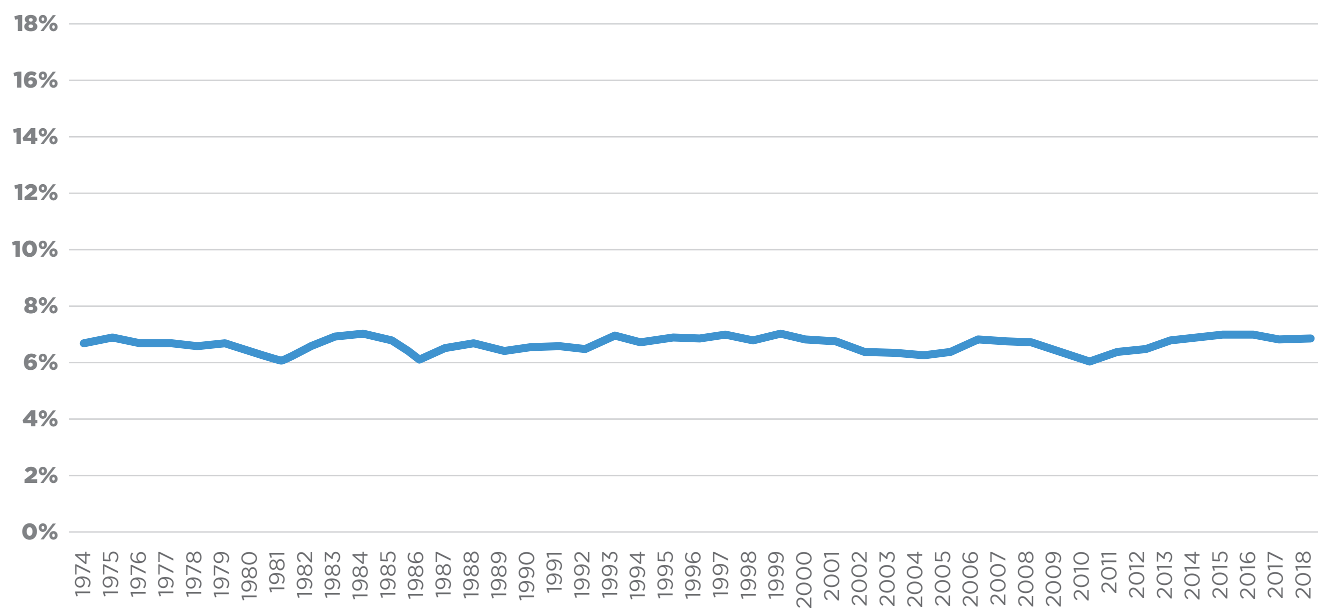
FIGURE 3



SOURCES: MINNESOTA DEPARTMENT OF REVENUE AND THE BUREAU OF ECONOMIC ANALYSIS

Total state tax revenue as a share of state GDP

FIGURE 4



SOURCES: MINNESOTA DEPARTMENT OF REVENUE AND THE BUREAU OF ECONOMIC ANALYSIS

High tax rates restrain economic growth

The balance of empirical research on the effects of state tax rates on economic growth is clear: high tax rates and tax hikes slow economic growth.

In a review of the literature measuring the impact of taxes on economic growth, economist William McBride concluded:

> *...that there are not a lot of dissenting opinions coming from peer-reviewed academic journals. More and more, the consensus among experts is that taxes on corporate and personal income are particularly harmful to economic growth, with consumption and property taxes less so. This is because economic growth ultimately comes from production, innovation, and risk-taking.*[4]

Of the 26 papers reviewed by McBride, 23—88 percent—find a negative impact of higher tax rates on economic growth. The other three papers find no impact. Not one paper finds a positive impact. Of the six studies looking at state tax rates specifically, every one found a negative impact of high taxes on economic growth.

More recent research corroborates this conclusion. Of 12 papers looking at the impact of taxes on economic growth published since 2012, seven find negative effects, the other five find "mixed" or "unclear" effects, and none finds a positive effect.[5] Furthermore, research suggests that the negative effects on economic growth from increased taxes are more pronounced when, as in Minnesota's case, taxes are already high.[6]

Spending is already historically high

The facts that Minnesota's tax rates are already some of the highest in the United States, that hikes in tax rates do not appear to drive increases in tax revenues, that revenues seem to be driven by economic growth, and that tax hikes have been shown to retard economic growth should steer us toward relying on spending cuts to achieve fiscal consolidation. Indeed, there is plenty of scope for cuts to Minnesota's state budget.

As Figure 5 shows, Minnesota's General Fund spending was higher in real, inflation adjusted terms in 2019 than in any previous year. Of course, our state's population has risen over this period, but even accounting for that, as we do in Figure 6, we see that in per person, real terms Minnesota's state government has never spent more money than it is right now: $4,088 per Minnesotan, up 26.6 percent since 2010.

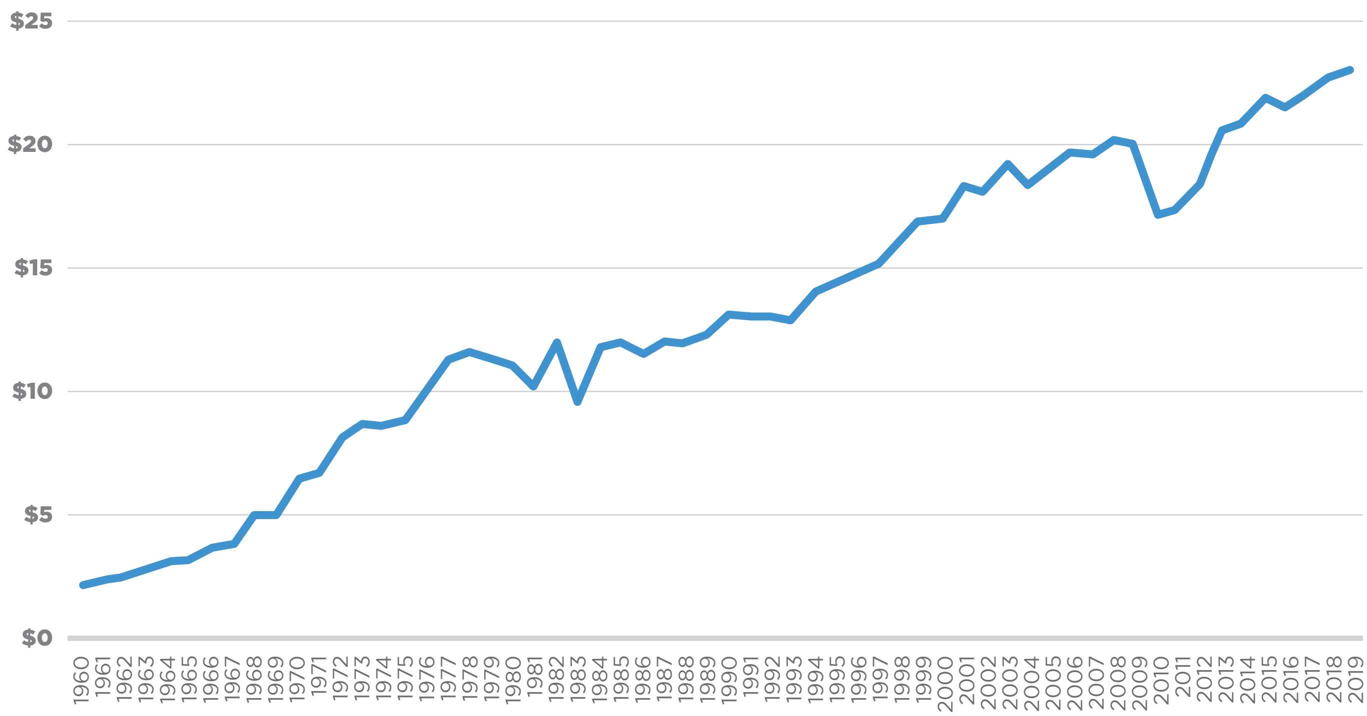
The two main areas of state government spending in Minnesota are education and welfare. Together, they accounted for 75.0 percent of state government spending in 2018.

Education spending[7]

Every year between 2010 and 2018, spending on education has amounted to more than 35 percent of General Fund spending. Education spending grew over this period by 21.3 percent in real

Total General Fund spending, 1960 to 2019 (billions, 2019 USD)

FIGURE 5



SOURCE: MINNESOTA MANAGEMENT AND BUDGET

terms, the seventh highest rate among the states. But even after this, Minnesota's per pupil spending in 2018 amounted to $12,974 per pupil, only slightly above the national level of $12,612.

Welfare spending[8]

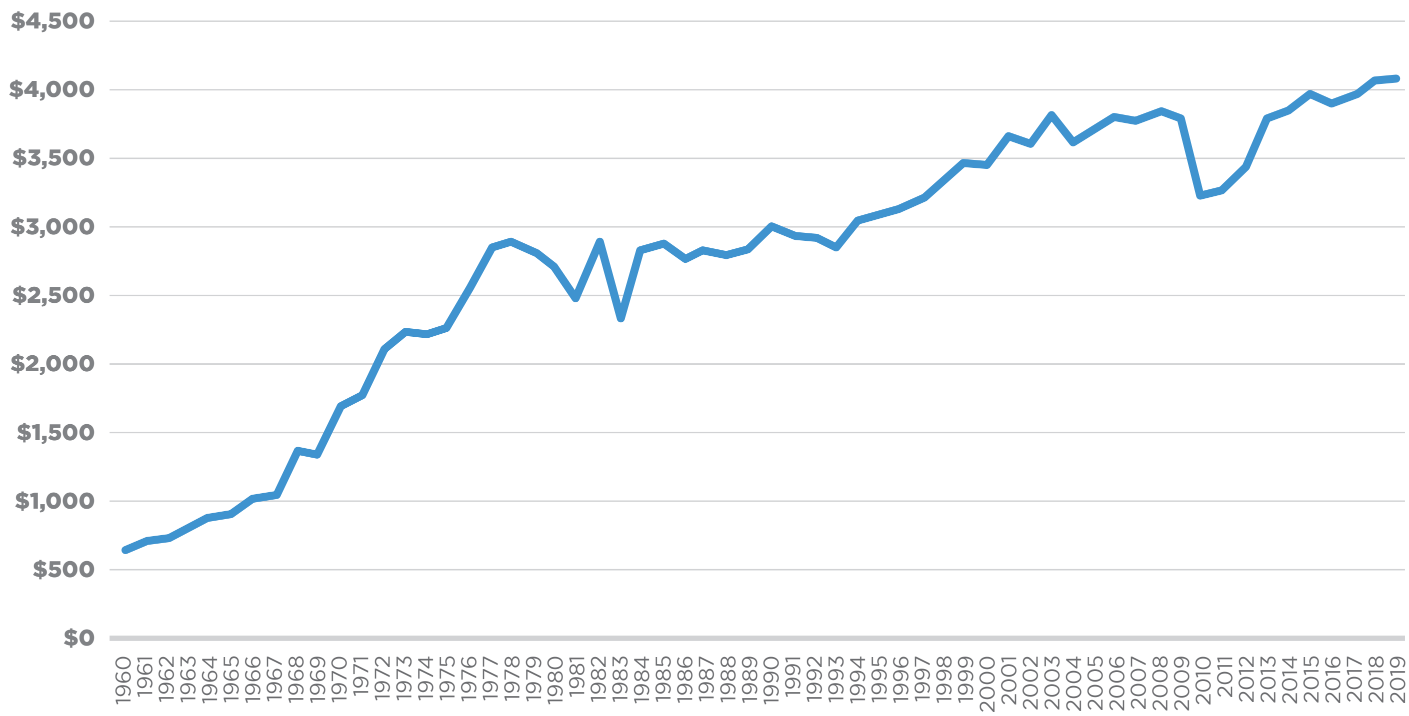
Welfare spending is the second biggest category. Every year between 2010 and 2018, spending on welfare has amounted to more than 30 percent of General Fund spending. Spending on welfare includes monies spent on assistance programs targeted toward low-income individuals and spending on Medicare and Medicaid, which make up a majority of public welfare spending.

In 2018, Minnesota's state government spent $30,479 in public welfare for each person in poverty. This compares to a national average of $17,127 and ranks our state third nationally for welfare spending, as Figure 7 shows. Only Massachusetts and Alaska spent more in welfare per person in poverty than Minnesota in 2018.

Indeed, Minnesota's welfare spending is so high compared to other states that if its state government spent the national average per person in poverty—$17,127—it would have spent only $9.0 billion in 2018, which is $7.1 billion less than the $16.1 billion it actually spent. If Minnesota closed its deficit by cutting welfare spending by $2.4 billion, the amount of welfare we spend per person in poverty would still rank us sixth highest in the United States. ■

Per capita General Fund spending, 1960 to 2019 (2019 USD)

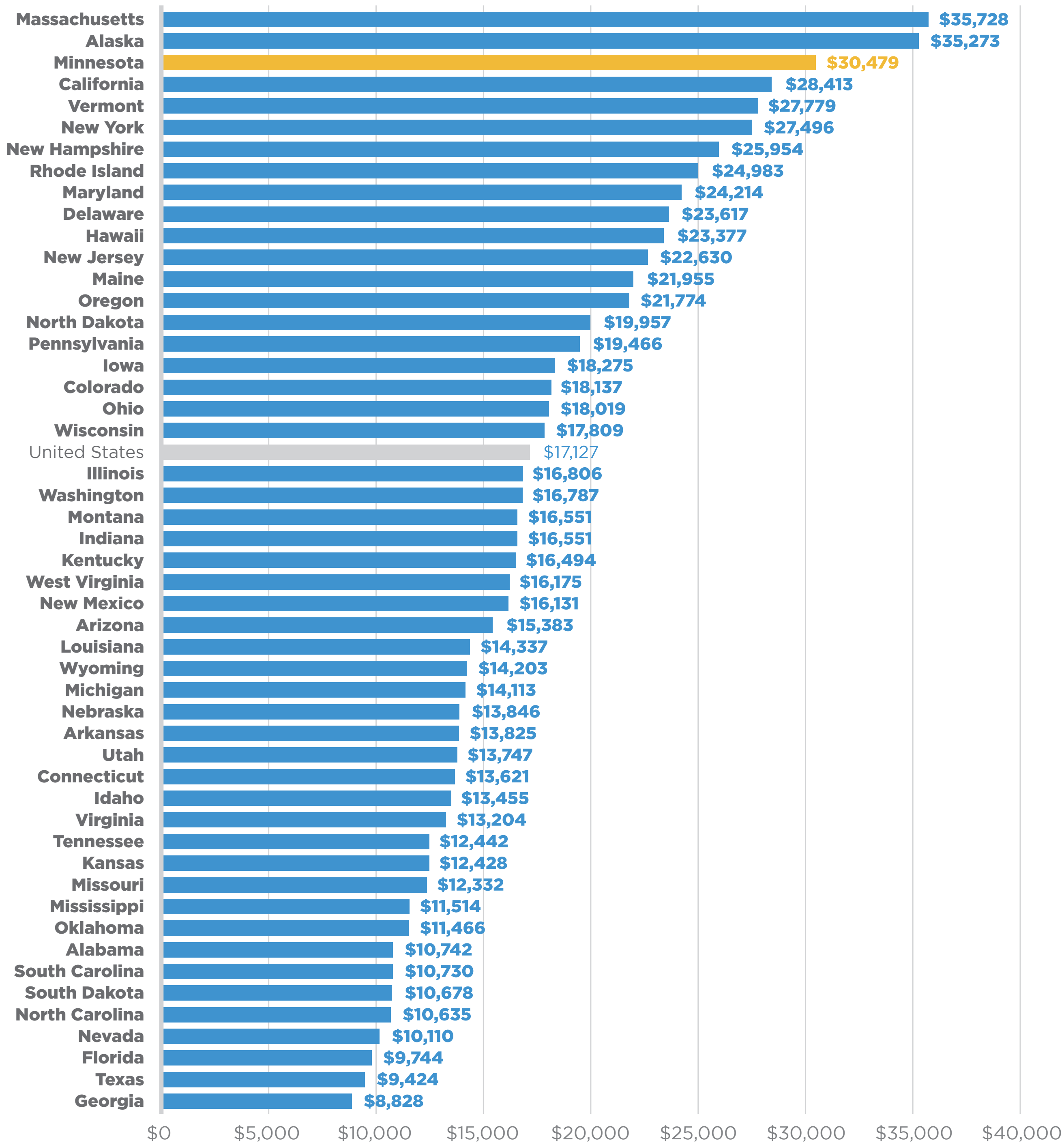
FIGURE 6



SOURCE: MINNESOTA MANAGEMENT AND BUDGET

Welfare spending per person in poverty, 2018 USD

FIGURE 7



SOURCE: CENSUS BUREAU

Conclusion

Given these elevated levels of state government spending, there is ample scope to meet the forecast budget deficit entirely through spending cuts without threatening key services. The budget for the current biennium that runs from July 1, 2019 to June 30, 2021 is $48.3 billion with a $2.42 billion deficit forecast. If we took this amount out of the amount of projected spending for FY 2021—$24.4 billion[9]—we would be returning spending in real, inflation adjusted, per capita terms to the level of 2016-2017.

The facts are: Minnesota's tax rates are already some of the highest in the United States; hikes in tax rates do not appear to drive increases in tax revenues; tax revenues seem to be driven by economic growth; tax hikes have been shown to retard economic growth; and in total and per person, and in real terms, Minnesota's state government has never spent more money than it is right now. Together, these should steer us toward relying on spending cuts to achieve fiscal consolidation.

Endnotes

1 Minnesota Management & Budget, "Budget & Economic Forecast," Minnesota Management & Budget, St. Paul, February 2020.

2 Minnesota Management & Budget, "Interim Budget Projection," Minnesota Management & Budget, St. Paul, May 2020.

3 Minnesota Management & Budget, "Revenue Update," Minnesota Management & Budget, St. Paul, July 2020.

4 William McBride, "What Is the Evidence on Taxes and Growth?" The Tax Foundation, Washington, D.C., 2012.

5 Negative results come from: Margareta Dackehag and Åsa Hansson, "Taxation of Income and Economic Growth: An Empirical Analysis of 25 Rich OECD Countries," Lund University working paper, 2012; Karel Mertens and Morten O. Ravn, "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States," *American Economic Review*, Vol. 103, No. 4, June 2013, pp. 1212-1247; James Cloyne, "Discretionary Tax Changes and the Macroeconomy: New Narrative Evidence from the United Kingdom," *American Economic Review*, Vol. 103, No. 4, June 2013, pp. 1507-1508; Karel Mertens and José L. Montiel Olea, "Marginal Tax Rates and Income: New Time Series Evidence," *Quarterly Journal of Economics*, Vol. 133, No. 4, 2018, pp. 1803-1884; Rudolf Macek, "The Impact of Taxation on Economic Growth: Case Study of OECD Countries," *Review of Economic Perspectives*, Vol. 14, No. 4, 2014, pp. 309-328; Bernd Hayo and Matthias Uhl, "The macroeconomic effects of legislated tax changes in Germany," *Oxford Economic Papers*, Vol. 66, Issue 2, 2014, pp. 397-418; Sandra V Lizarazo Ruiz, Adrian Peralta-Alva, and Damien Puy, "Macroeconomic and Distributional Effects of Personal Income Tax Reforms: A Heterogenous Agent Model Approach for the U.S.," IMF working paper, No. 17/192, 2017.

"Mixed" or unclear results come from: William G. Gale and Andrew A. Samwick, "Effects of Income Tax Changes on Economic Growth," Brookings Institution working paper, February 2016; Soledad Artiz Prillaman and Kenneth J. Meier, "Taxes, Incentives, and Economic Growth: Assessing the Impact of Pro-business Taxes on U.S. State Economies," *Journal of Politics*, Vol. 76, No. 2, 2014, pp. 364-379; William G. Gale, Aaron Krupkin, and Kim Rueben, "The Relationship Between Taxes and Growth at the State Level: New Evidence," *National Tax Journal*, Vol. 68, No. 4, December 2015, pp. 919-942; Branimir Kalaš, Vera Mirović, and Jelena Andrašić, "Estimating the Impact of Taxes on the Economic Growth in the United States," *Economic Themes*, Vol. 55, No. 4, April 2015, pp. 481-499; Nazila Alinaghi and Reed, W. Robert, "Taxes and Economic Growth in OECD Countries: A Meta-Regression Analysis," Victoria University of Wellington working paper, 2017.

6 Nir Jaimovich & Sergio Rebelo, "Non-linear Effects of Taxation on Growth," National Bureau of Economic Research working paper, No. 18473, October 2012.

7 "Education" is defined as: "Schools, colleges, and other educational institutions (e.g., for blind, deaf, and other handicapped individuals), and educational programs for adults, veterans, and other special classes. State institutions of higher education includes activities of institutions operated by the state, except that agricultural extension services and experiment stations are classified under Natural Resources and hospitals serving the public are classified under Hospitals. Revenue and expenditure for dormitories, cafeterias, athletic events, bookstores, and other auxiliary enterprises financed mainly through charges for services are reported on a gross basis. Elementary and secondary education comprises payments for instructional, support services, and other activities of local public schools for kindergarten through high school programs. Direct state expenditure for other education includes state educational administration and services, tuition grants, fellowships, aid to private schools, and special programs." Census Bureau, available at https://www.census.gov/programs-surveys/gov-finances/about/glossary.html.

8 "Public welfare" is defined as: "Support of and assistance to needy persons contingent upon their need. Excludes pensions to former employees and other benefits not contingent on need. Expenditures under this heading include: Cash assistance paid directly to needy persons under the categorical programs Old Age Assistance, Temporary Assistance for Needy Families (TANF) and under any other welfare programs; Vendor payments made directly to private purveyors for medical care, burials, and other commodities and services provided under welfare programs; and provision and operation by the government of welfare institutions. Other public welfare includes payments to other governments for welfare purposes, amounts for administration, support of private welfare agencies, and other public welfare services. Health and hospital services provided directly by the government through its own hospitals and health agencies, and any payments to other governments for such purposes are classed under those functional headings rather than here." Census Bureau, available at https://www.census.gov/programs-surveys/gov-finances/about/glossary.html.

9 Minnesota Management & Budget, "General Fund Spending Major Area (FY 1990-2023)," Minnesota Management & Budget, St. Paul, February 2020.

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