<u>A Proposed Minnesota Response to the Federal Tax Cuts and Jobs Act</u>

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In the interest of promoting a compromise that majorities in the House and Senate and Governor Dayton all find acceptable, here is a proposed response to the federal Tax Cuts and Jobs Act ("TCJA"), and other federal law changes that should be taken into account.

1. If the following six point response called for by the TCJA's structural earthquake is not politically feasible, reduce by hundreds of thousands the number of taxpayers who need to compute Minnesota-only itemized deductions by making the proposed standard deduction and personal exemptions combined roughly equal to or even more than the increased federal standard deduction.
2. Handle the TCJA response in a single bill, separate from other tax law changes.
3. Make the bill revenue neutral, including in its overall impact on individuals and corporations.
4. Apply the KISS Principle ("Keep It Simple, Stupid") to drastically simplify the Minnesota individual income tax by reducing the tax breaks in existing deductions and credits in one of three ways – peck on the cheek, big smooch, or really big smooch - because Minnesotans deserve a KISS from our leaders after the kick in the teeth many of us got from Congress making our paying taxes to support our state and local governments much more expensive. (This happens because the vast majority of those who formerly itemized federal deductions no longer will, so they get no federal tax reduction whatsoever for the state and local taxes they pay, and virtually all of the roughly 13% of Minnesota filers who will still itemize will have their deduction for state and local taxes limited to $10,000, which is less than virtually all of them pay annually.)
5. Reduce every income tax rate in light of the simplification and the base broadening in the TCJA provisions to which Minnesota should conform, so that the simplification does not cause an overall tax increase. The current rates are 5.35, 7.05, 7.85 and 9.85% for individuals and 9.8% for corporations. If the 9.85% top rate is nonnegotiable, significantly expand one or more lower brackets so it kicks in at a higher income level. This would automatically make Minnesota more competitive as a state in which to live and do business, and also show some concern by our leaders for the Minnesotans who provide most of Minnesota's income tax revenue. Both responses to what Congress did are desirable.
6. Elements 3-5 combined probably would result in some individual income taxpayers getting a tax increase big enough to be troubling, since they would result in the heaviest users of deductions and credits getting an income tax increase, while average users paid the same and below average users would enjoy a cut. To minimize such income tax increases, expand the sales tax base in the same bill by enough to provide the revenue needed to reduce the income tax to the point that nobody gets too much of an increase.
7. Do not submit to voters a constitutional amendment that would dedicate more vehicle-related sales tax revenue to transportation funding, but consider making the sales tax expansion in element 6 big enough to enable a short term increase in transportation funding from the general fund and/or spend some of the $329 million surplus on transportation, with consideration of revenue system redesign to begin next year.

Explanation of a Proposed Minnesota Response to the TCJA

In December 2017, Congress passed the TCJA, the most consequential federal tax change since 1986. Importantly for Minnesota, the TCJA radically changed the federal individual income tax structure. The TCJA earthquake will affect all individuals', actually all taxpayers', federal income tax returns in 2018 and subsequent years.

The TCJA is important to Minnesota because federal taxable income ("FTI") determined under the Internal Revenue Code as of December 16, 2016, is the starting point for determination of Minnesota taxable income. If Minnesota law is not changed, Minnesota taxpayers will file their 2018 Minnesota returns based on old federal law no longer used for federal returns. That would be confusing and frustrating for taxpayers, and difficult for the companies that create tax preparation software and for the Department of Revenue ("DOR"). The need for a law this year to update Minnesota's references to the Internal Revenue Code cannot be overstated. Perhaps the worst consequence of failure to do so would be that Minnesotans who elected the federal standard deduction because it exceeds their federal itemized deductions under the TCJA would be stuck with using the former, half the size, federal standard deduction for their Minnesota return, even though their itemized deductions under the old federal law would add up to a lot more than the old standard deduction.

Responding effectively to this gigantic federal change is an equally gigantic practical challenge for two reasons. First, it no longer makes sense for Minnesota to start tax calculations from FTI because the TCJA repealed the personal exemptions, so FTI no longer takes family size into account; and the TCJA increased the standard deduction by so much that itemized deductions become a special preserve for a tiny fraction, perhaps roughly 13% of Minnesota filers, almost exclusively higher income filers, instead of the roughly 36% who have been itemizing. The national estimates I have seen suggest that the percentage of itemizers nationally will drop to much lower than 13%. Providing significant tax benefits to such a small segment of the population is terrible social policy.

Second, Governor Dayton and the Republican legislative leaders who will shape the Legislature's response come from different planets in their views on what tax and spending policies are best for Minnesota. For example, Governor Dayton's proposal and the House and Senate tax bills differ radically in important respects. Governor Dayton would provide far more tax relief to lower and lower middle income taxpayers and tax businesses more heavily than would the House tax bill. The House would cut the 7.05% individual rate and the corporate rate. The Senate would cut the 5.35% individual rate.

Given past experience, there appears to be a genuine risk that the Legislature and Governor Dayton will not agree on a tax bill, plunging Minnesotans and the Department of Revenue into a chaotic tax filing process for 2018. This is not a good situation.

The TCJA includes an intentional direct attack by the Republican majority in Congress and President Trump on Minnesota and other relatively high tax states. By nearly doubling the standard deduction and limiting the state and local tax deduction to $10,000 for the relative handful of taxpayers who will still itemize their deductions in computing their federal income tax, they have deliberately made it more economically painful for Minnesotans to pay their Minnesota taxes. Those who no longer itemize will no longer get the federal tax benefit ranging, after the TCJA, from 10-37% of the Minnesota income and property tax they pay. Probably virtually all of those who still do itemize will be hit by the $10,000 limitation on the state and local tax deduction. Whatever federal taxes people owe after the TCJA will quickly become their new normal, and it will not take them long to realize that all or a substantial portion of the Minnesota taxes they pay no longer reduce their federal income tax.

The TCJA is a kick in the teeth to the state and every local government in Minnesota, and therefore arguably to all Minnesotans. It is especially so for the 36% of Minnesotans who have been itemizing their federal income tax deductions. It is also an invitation for them to oppose state and local government spending and taxing, even if they received big federal tax cuts that considerably ease their financial pain in paying their state and local taxes.

Republican and DFL legislators and Governor Dayton may not agree on much, but hopefully they can agree that the federal government clobbering their constituents by making it more expensive for them to pay their Minnesota taxes is not a good thing.

<u>What's Wrong with the Paths that the Governor, the House and the Senate Are On?</u>

Governor Dayton's proposal and the House and Senate tax bills conform to a multitude of TCJA and other recent federal law changes. That is excellent, and there is no point in reviewing them here. All three would also change Minnesota's starting point from FTI to federal adjusted gross income ("FAGI"). Starting from FAGI is good, though I think they could do better as set forth below, and things go down hill fast after the good FAGI start.

Here is how perplexed Minnesota taxpayers might react to their legislators after filing their 2018 returns: "Thanks legislators for the $50 tax cut, though I'm not sure I really got one because I can't tell since my numbers differ from last year. Besides that my tax preparation fee went up by $100 because Minnesota's return is so much more complicated, and I spent many hours compiling itemized deduction details for Minnesota that I no longer have to bother with for my federal return since the federal standard deduction is so much higher than Minnesota's. I guess you think my time is worthless."

<u>Problem No. 1: Minnesota Standard and Itemized Deductions</u>

Starting from FAGI, all three retain personal exemptions (which is o.k., though I think they could do better on this too, as set forth below) and the standard and itemized deduction concepts, much as under the no longer applicable federal law, which is not good.

First, all Minnesotans who want to itemize their deductions for Minnesota purposes will have to complete something like federal Schedule A, Itemized Deductions, for Minnesota purposes only. This means more work to file their Minnesota returns. That is not good.

Second, under all three approaches, the allowable itemized deductions differ somewhat from what they will be for federal purposes. The House comes closer to conformity with federal law. Governor Dayton and the Senate pretty much keep all the old federal itemized deductions as they were. This raises the question of when a federal conformity bill become a federal non-conformity bill. It affects taxpayers who also itemize for federal purposes the most, since they will all have to cope with two sets of rules. But it affects in the same way those who think they might want to itemize federally, so calculate their federal itemized deductions, but decide not to because they don't add up to the nearly doubled federal standard deduction, and then turn to their Minnesota return, with a much smaller standard deduction, and have to apply that different set of rules to figure out what their Minnesota deductions are. And it may also affect even those who know they won't itemize federally because they may have heard about the major cutbacks in federal itemized deductions and get all confused because Minnesota keeps all or most of the old federal deductions.

It gets worse.

Third, the savings from itemizing automatically become a small fraction of what they used to be for taxpayers who no longer itemize federally. This is because these taxpayers no longer get any federal tax reduction whatsoever for all their carefully calculated itemized deductions. Thus, all the work they put into figuring out their itemized deductions saves them at most only their Minnesota marginal tax rate, which presently ranges from 5.35-9.85%. This means lots of work for a lot less savings than in the past.

Fourth, as Minnesotans grind through this process, it may occur to some who no longer itemize federally that they get a federal standard deduction of $24,000 (if filing married joint, $12,000 if single, $18,000 if head of household) so they don't need to bother with itemizing, but the Minnesota standard deduction is far less, and even after they go to all the foregoing work, they don't get as much tax benefit as they get for doing nothing on the federal return. How are these taxpayers likely to feel about our Minnesota tax system, and their legislators?

How many people are affected by this? I don't have exact numbers, but piecing some numbers together from DOR reports, the reality is close to this. Minnesotans file more than 2.6 million returns annually and more than 1 million of them historically have itemized federally. That looks like about 40% federal itemizers, though apparently the percentage most recently is 36%. The estimate is that about 13% of Minnesota filers will continue to itemize federally in 2018, which suggests that 23% of Minnesota filers will no longer itemize federally. And then there are those who have always just used the standard deduction. Most all of them still will do that, and that's roughly 64% of Minnesota returns, or about 1.7 million.

So about 1.7 million Minnesota returns are not affected by Problem No. 1, which translates into considerably more than 2,000,000 Minnesota adults, since a lot of the returns are from married joint filers. I guess that Governor Dayton and legislators might take some solace in that. On the other hand, the 1,000,000+ returns that will be affected tend to be toward the higher income end of the spectrum and almost certainly pay well over half of Minnesota's income tax, which is our largest tax.

It looks like 300,000+ Minnesota returns will itemize federally and for Minnesota, so they all get to go through the two sets of rules scenario. These are mostly at the higher end of the income spectrum, where federal tax cuts are concentrated, so maybe our leaders won't feel very sorry for them. But they also contribute enormously to Minnesota through large state and local tax payments, the federal benefit of which has just been reduced, so maybe our leaders should acknowledge that there is a problem with that.

That leaves about 600,000 Minnesota returns, and perhaps a million Minnesotans, in the boat of no longer itemizing federally, but very probably still itemizing for Minnesota and working through the tangle described above in order to do so, getting nowhere near the itemizing benefit they used to get, and maybe feeling just a wee bit resentful that they get a big federal standard deduction for nothing, but have to either accept a much smaller Minnesota one or go to all of the above-described work.

Whatever one might think about the TCJA, it undeniably greatly simplifies the federal income tax for many millions of Americans. Simple is better than complex, unless the complexity gets one something important. By striving, no doubt in good faith, to maintain a basically status quo outcome for Minnesotans in the income tax they pay and the deductions they get along the way, Governor Dayton and House Tax are headed at a high rate of speed in exactly the opposite direction – more complexity for Minnesotans.

Why on earth would anyone set up a system like this- more work with more complication for less benefit and an obvious invidious comparison with the federal tax return process? Actually, the reason is pretty clear – Governor Dayton and legislators are interested in not unduly rocking the boat of past practice, and in holding most everyone relatively harmless within the confines of the individual income tax. Unfortunately, so doing leads to the above-described mess for Minnesotans. As described above, Problem No. 1 means that they are in fact rocking the boat in an important way, and as described below, this mess is unnecessary and inadvisable.

Problem No. 2: Their Collision Course Risks Getting Nothing Done or Leaving Us with Problem No. 1

The collision course is nothing new – the Governor wants to put a lot of money (beyond questions involving the TCJA, but also using money that sensibly complying in large part with it provides) to reduce the taxes of lower income Minnesotans. The House wants to cut the corporate tax rate and the 7.05% individual bracket rate with some of the same money. The Senate initially appears to be closer to the Governor by cutting the 5.35% individual bracket, but does not go nearly as far in taxing and spending as the Governor does.

Two things are new. One is the administrative chaos into which the Minnesota income tax and everyone it touches will be put if they fail to respond to the TCJA. The other is that the usual way of settling such opening positions is highly unlikely to produce a sensible result because they alld start with FAGI and deploy a standard deduction and Minnesota-only itemized deductions, which produces Problem No. 1. They could, and probably will unless a lot of people make a very big stink in a hurry, compromise their differences while doing nothing about Problem No. 1. What comes out of this legislative session on the tax front simply is much more important than is usually the case, and what we have seen to date does not augur well for the outcome.

Problem No. 3: Both the Governor's and the House Proposals Are Fiscally Risky

Governor Dayton has earned a positive place in history as a governor who led a transition from state fiscal disaster to outstanding, positive recognition-gathering fiscal performance, fueled in no small part by increasing individual income tax revenue from higher income Minnesotans. The Governor has also had a bit of fiscal luck in that his time in office has, so far, been a time of economic growth, unmarred by recession.

Sooner or later, we will have a recession. When it comes, Minnesota's heavy reliance on the income tax likely will mean major fiscal trouble again. It seems inherently likely that a recession will occur in the term of the governor we will elect in November, given that the current economic growth cycle is within a few months of being the longest one on record.

Governor Dayton relies on one of the most volatile sources of state revenue, the corporate income tax, to fund supposedly permanent cuts in the income taxes paid by lower and middle income Minnesotans through an expansion of the working family credit and the addition of a new individual and dependent credit.

The TCJA's implications for state corporate income taxation are the subject of a recent article in a respected tax journal by well known state tax experts. The article runs 18 pages and merely sets forth descriptions of what appear to be the most major questions, mostly those involving the international provisions. Particularly important is that many of the international issues involve whether state taxation of the income is allowed under the U.S. Constitution, which is interpreted to prohibit states from taxing values not related to the particular taxing state. Assuming that the TCJA provisions remain in place for the indefinite future, it will take years to determine what states are allowed to do, including whether they can tax the billions of dollars of income that has accumulated overseas since 1986.

Governor Dayton chose to ignore all of this uncertainty over the international provisions and take into account the revenue gains guesstimated by Minnesota's well informed revenue estimators, who nevertheless are just making less than well educated guesses on this, due to vast uncertainty relating to both the behavioral response to the changes by the business community (i.e., how can we game this new system to minimize our taxes, an intellectually and economically delightful exercise for those doing the gaming) and the legal authority of states to tax such income.

Governor Dayton would use this considerably larger amount of business tax revenue, and other tax increases on business, some that reverse what the Legislature just passed last year and other reforms that may well be justifiable, to cut individual income taxes more than House Tax would cut them, in at least three ways. He would create a new permanent tax credit which would reduce taxes for 1.9 million families; expand the Working Family Credit to reduce taxes for 329,000 families; and hold tight to the old federal law on itemized deductions instead of conforming in some respects to TCJA reductions in such deductions as House Tax does. The personal and dependent credit alone would, according to the Governor, provide an average tax cut of $117 for 1,900,000 families, which adds up to spending $222,300,000 on this provision alone, which apparently would make Minnesota unique in the country by having personal exemptions, a standard deduction and a personal and dependent credit.

House Tax took a more restrained approach, not conforming to, or at least not counting on any revenue from, the new federal international tax regime going forward, but conforming on the taxation of the income that has gone untaxed from 1986-2017, taxation of which can be spread over as many as eight years at the corporation's election. This is also subject to the above-referenced legal questions. House Tax, of course, did not reverse the tax cuts enacted last year, and also did not embrace other business tax reforms proposed by the Governor.

Senate Tax is more conservative than either the House or the Governor on the revenue production front, for it does not conform at all to the TCJA changes in taxation of international business income.

Governor Dayton proposed no rate cuts, but spent more money on lower income Minnesotans than either the House or Senate Tax, as described above.

The House Tax made supposedly permanent rate cuts in both the individual and corporate income taxes. House Tax would cut the second tier individual income tax rate from its current 7.05% to 6.95% in 2018, 6.90% in 2019, and 6.75% in 2020 and thereafter. This would benefit all Minnesotans with more than roughly $38,000 (married joint) or $25,000 (single) in Minnesota taxable income, at a cost of $106,300,000 in FY 2018-19 and $336,100,000 in FY 2020-21. The House would reduce the corporate income tax rate from its current 9.8% to 9.64% in 2018 and 2019, and 9.07% in 2020 and thereafter, at a cost of $24,300,000 in FY 2018-19 and $129,700,000 in FY 2020-21.

Senate Tax would cut the 5.35% bracket individual rate to 5.1%, at a cost of $266,300 in FY 2018-19 and $330,200 in FY 2020-21, but not otherwise cut rates unless November forecasts show a surplus, in which case the DOR would be required to cut rates. The total cost of the rate cuts in the current and next bienniums combined are about the same for House and Senate.

Both Governor Dayton and the House effectively fund permanent tax reductions in part with projected revenues from federal changes that are technically temporary under federal law. I have not checked the Senate Tax bill on this, and will skip the details.

Governor Dayton and legislative leaders are also fighting over the scheduled 2019 expiration of the health care provider tax. Governor Dayton would extend it; the House would not. If it is not extended, that will tend to create a hole in future budgets. This is almost certainly a fiscal fight for next year's legislative session that calls into question the wisdom of tax cuts now.

All of this occurs in the context of a revenue system that is not well suited to growing with the economy and with the near inevitable continued growth in health care spending as the population ages. Our sales tax grows much more slowly than the economy because the economy is increasingly a service economy and Minnesota generally does not tax services. The state business property tax now is a flat amount which will not grow at all. Excise taxes tend not to grow with the economy or the cost of government services.

If it were not for Problem No. 1, there would be no point in making this proposal. After all, the latest forecast projects a $329 million surplus for the FY 2018-19 biennium, and what Governor Dayton, the House and Senate Tax propose, though at odds with each other, would not obviously break the bank. But Problem No. 1 is real and the proposal here would solve it and be a modest start at moving Minnesota's tax system in the less risky fiscal direction in which it really needs to move.

I cannot help but be reminded of what happened in the first decade or so of this century. Governor Ventura wanted to replace the income tax with the sales tax. He never went so far as to try to do that, but he did submit to the legislature a fiscal proposal involving major income tax cuts and major sales tax base broadening. The Legislature, being full of confidence that the high tech revolution was ushering in a new day of endless prosperity and ever growing tax revenues, took him up on the income tax cuts, but refused to expand the sales tax base. A decade or more of fiscal hell ensued. The worst aspects of that came from the Great Recession, but fiscal irresponsibility by Minnesota's state political leaders preceded that. Now here we are again, with Governor Dayton, the House and Senate Tax proposing to take significant fiscal risks in the course of crafting a response to the TCJA.

Questions About the Proposed Response to the TCJA

Why Consider a Much Larger Standard Deduction?

Use of the KISS Principle could eliminate the standard/itemized deduction distinction, and that is what this proposal advocates. But political leaders may consider that to be politically infeasible pie in the sky thinking. If they do, considerable benefit could be had from making the sum of Minnesota's new personal exemptions and standard deduction close to, equal to, or more than the applicable new federal standard deduction and not importing the now-discarded federal level phase-outs of itemized deductions and personal exemptions into Minnesota law.

The new federal standard deduction is $24,000 for married joint filers, $12,000 for single filers, and $18,000 for heads of household. By comparison, under the House bill the proposed Minnesota personal exemption is $4,150 per person and the proposed Minnesota married joint standard deduction is $14,000, so married couples could earn $22,300 before incurring a filing or tax obligation. If the standard deduction were made $16,000, then the nontaxable threshold would be $24,300, about like the federal. Consideration could be given to an even larger Minnesota standard deduction, and that would support eliminating more itemized deductions.

Such an adjustment could reduce, potentially by hundreds of thousands, the number of Minnesotans who will incur Problem No. 1, needing to calculate Minnesota itemized deductions. It would also reduce the number of Minnesotans who would be required to file a Minnesota return, but not a federal return.

Another easily done simplification would be to eliminate the phase-outs of itemized deductions and personal exemptions as incomes rise. Under the TCJA, the federal tax is rid of these complications. They should not be imported directly into Minnesota law.

The money to pay for such changes could come at least in large part from eliminating the individual rate cut in the House and Senate bills, and from eliminating the personal credit in the Governor's proposal.

Why a Separate Bill?

There are three reasons for responding to the TCJA in a bill separate from other tax policy desires, like cutting or raising taxes for favored groups. First, responding effectively to the TCJA earthquake as laid out here would involve both the inherently surprising idea of a minor sales tax base expansion and minor ups and downs in individuals' income taxes that are more likely to be acceptable to the public if the changes are not combined with efforts to cut or increase taxes on particular groups of taxpayers; e.g., corporations, higher income individuals and/or low income individuals.

Second, Governor Dayton and Republican legislative leaders are unable to agree on much in the fiscal policy arena, so trying to do too much in one big, fat tax bill materially increases the odds that our leaders will fail to respond at all to the TCJA, plunging the 2018 tax return filing season into administrative chaos for taxpayers and the DOR.

Third, solving this massive problem with a separate bill along the lines suggested here, and not doing anything else to affect income taxes, would create an opportunity for a well-focused 2018 election campaign, including getting public input on the relative preferences of lower income tax rates vs. deductions and credits with higher rates, and also on the core beliefs of the two parties – for DFLers, more investment in solving problems and hence conceivably some tax increases, and for Republicans, tax cuts, smaller government and reliance on individuals, families and the private sector to solve the problems.

Why Revenue Neutral?

The TCJA provides gargantuan federal income tax cuts for corporations, the owners of so-called pass-through businesses the income from which is taxed to individuals (sole proprietorships, partnerships, limited liability companies and S corporations) and very high income individuals generally. Those cuts are the result of rate reductions and, in the case of pass-through businesses, a deduction of up to 20% of the income they produce (which Governor Dayton, the House and Senate Tax wisely would not adopt for reasons set forth below). Given this, people may find it surprising that the TCJA as it affects Minnesota actually provides for somewhat more revenue, which comes from a host of detailed changes, some providing more deductions, but on balance broadening the tax base by reducing deductions or credits, and, in the case of multinational corporations, taxing income formerly siphoned off with little or no economic substance to the siphoning.

Thus, for example, in the House Tax bill as heard in committee on April 24, the changes that would conform Minnesota's tax base to the Internal Revenue Code as amended by the TCJA and a couple of other recent federal law changes, would result in a loss in individual income tax revenue of $11,215,000 in FY 2018-19, but a gain of $279,765,000 in FY 2020-21, and a gain in corporate income tax revenue of $56,000,000 in FY 2018-19 and of $168,730,000 in FY 2020-21. Governor Dayton's proposal would generate even more corporate tax revenue because he conforms more fully to the international tax changes than does the House.

People might logically think that if the federal government can dramatically cut taxes, Minnesota should be able to do so as well. But that logical thought ignores a vast difference between the federal and state governments. The federal government is not required to have a balanced budget. Minnesota is required by our Constitution to have a balanced budget. The TCJA is expected by almost all economists to result in an explosive increase in federal budget deficits that are already large. That in turn may result in the federal government cutting back on social safety net programs, which would put more pressure on all states whose political leaders are interested in all of their citizens having a chance at a decent life. Thus, the fact that Congress chose to hand out massive tax cuts actually suggests that states be more reluctant to cut taxes than they otherwise would be.

Revenue neutrality in the bill to cope with the TCJA is important to demonstrate to all Minnesotans the fairness of the solution. As discussed below, the only clear route to a simpler, fairer Minnesota income tax is to deploy a minor sales tax base expansion in getting to that result. Because tax changes, and especially expansion of any tax, are subject to demagoguery and a debate that is far more emotional than rational, Governor Dayton and legislators should take care to demonstrate exactly how their solution to the TCJA challenge is constructed. This clarity would be lost if, as in both the Governor's proposal and the House and Senate bills, it is combined with handing out tax goodies to favored groups.

The recession risk and Minnesota's extreme reliance on the recession-vulnerable income tax are additional reasons for revenue neutrality in the solution to the TCJA challenge. Pointing in the same direction is the larger than usual challenge for accurate revenue estimation posed by both the TCJA and the proposal outlined below.

Revenue neutrality for corporations should include a modest cut in the corporate income tax rate to whatever level the estimated impact of the federal base changes to which Minnesota conforms and the share of corporations' likely payments in the recommended sales tax base expansion together allow.

Revenue neutrality for individuals should include the impact of the federal conformity changes, the broadening of the tax base by the KISS Principle, the share of individuals' likely payments in the recommended sales tax base expansion, and the rate cuts made possible by all this income tax and sales tax base broadening.

Given Minnesota's projected FY 2018-19 surplus of $329,000,000, it is not realistic to think that our leaders will just sit on that money, and they may well want to enact some tax cuts. I merely suggest that such other changes be in a bill or bills separate from the solution to the TCJA challenge. Given their philosophical differences, it is unlikely that they could agree on further tax changes, but there would be considerable hope for spending an agreed upon amount of the surplus on one time purposes, like helping bridge the gap between Governor Dayton's desire for a large bonding bill and Republicans' apparent intention to have a much smaller one, or on providing some one time additional funding for transportation projects, which practically everyone agrees need more funding.

Why Apply the KISS Principle by Simplifying the Income Tax and Reducing the Rates?

There are five reasons to apply the KISS Principle by simplifying the income tax and reducing the rates. First, the TCJA income tax system earthquake means it no longer makes sense for Minnesota to continue with its super simple adoption of FTI as the starting point for individual income tax determination.

Second, giving up FTI as the starting point inevitably means that Minnesota's leaders have to face the question of whether or not to adopt a set of Minnesota itemized deductions along the lines of the set of federal itemized deductions. So far, in the interest of not rocking the boat, Governor Dayton, the House and Senate Tax have said yes to this. But what they have failed to notice is that they would thereby create Problem No. 1, making all potential Minnesota itemizers, which number well over 1,000,000 Minnesotans, go to a lot more work to file their Minnesota income tax returns. More work is not good unless it really accomplishes a lot. As Problem No. 1 and the discussion below demonstrate, that is not the case here. The KISS Principle enables our leaders to respond effectively without causing Problem No. 1.

Third, reducing income tax rates would make Minnesota more competitive with other states as a place to live and do business. We are toward the high end of the rates for both the individual and corporate income taxes. Reducing those rates without cutting revenues, as this proposal would do, would be an undeniably positive outcome. This is most true of the corporate rate and the 9.85% top rate. If the latter is too sacred to Governor Dayton and DFL legislators to be cut at all, the bottom income level of the top bracket might be increased considerably.

Fourth, reducing our individual income tax rates would be a recognition by our political leaders that the kick in the teeth administered by Congress to Minnesota and Minnesotans by drastically reducing availability of the federal deduction for state and local taxes paid, is not a good thing for Minnesota.

Fifth, applying the KISS Principle was explicitly endorsed by the Budget Trends Study Commission ("BTSC"), a bipartisan study effort triggered by Minnesota's seemingly endless fiscal struggles and highly volatile state general fund budget that produced a virtually unanimous report to the Legislature dated January 12, 2009, which included this recommendation at p. 27: "Minimize tax exemptions, deductions and credits (e.g., continue to tax pension income), unless necessary for federal conformity."

Why Broaden the Sales Tax Base When Trying to Respond Sensibly to Federal Income Tax Changes?

This is the toughest part of the proposal because what on earth does the sales tax have to do with solving an income tax problem? Only a tax policy wonk could come up with this. But political leaders might conceivably agree to it because it clearly is more economically and administratively rational than what they have come up with to date. The question is whether it is politically rational, which is to say part of an emotionally/psychologically sound approach to solving a very difficult public policy problem without causing an undue amount of mudslinging in the ensuing election campaign.

This is in the proposal because I don't want any Minnesotan to be stuck with a distressingly high income tax increase as a result of what our leaders do to solve the TCJA challenge, and I am afraid that that might happen if the entire solution were confined to the income tax.

Here is how it works. The proposal would vastly broaden the income tax base by eliminating many deductions and credits in the interest of simplifying the tax and cutting the rates. The revenue estimators in the DOR and on legislative staffs could fairly easily come up with multiple options for sets of lower rates that would raise the same amount of revenue as the current higher rates applied to the current narrower tax base.

This must be done at an early stage of evaluating this proposal. My concern is that it might result in materially higher Minnesota income taxes for persons who made exceptionally heavy use of the eliminated deductions and credits. This is because it appears to me that a big base expansion and rate cut would mean that those who previously were heavy users of the eliminated deductions would get tax increases, while those who made roughly average use would see about the same level of taxes, and those who made below average use would get a cut.

Minnesota's sales tax base is narrower than that of most states. This means that we could expand the sales tax base a bit and not be doing anything weird compared with other states.

This extra revenue from the sales tax would enable our leaders to cut the income tax enough so that those taxpayers who lose the most tax reductions from losing deductions and credits do not suffer a too high income tax increase. Thus, Minnesota would rely a bit less on the income tax and a bit more on the sales tax than it now does.

To be clear, this proposal advocates including both the income tax proposals resulting from application of the KISS Principle and this sales tax base expansion in the same bill, and that that bill be revenue neutral. This is not a back door attempt to increase taxing and spending in Minnesota. It is an attempt to respond effectively to the TCJA challenge, which enacting Minnesota itemized deductions simply cannot do because it produces Problem No. 1.

The DOR has just published the latest edition of its Tax Expenditure Budget, which details, item by item, how much sales tax revenue would be gained by taxing more stuff at the current sales tax rate. All that is required to get to yes on this is for legislators of both parties and Governor Dayton to sit down with a copy of the Tax Expenditure Budget, discuss potential sales tax base broadeners to enable them to avoid Problem No. 1 and also avoid clobbering any Minnesota income taxpayer with a big tax increase. Assuming they want to achieve those two goals, this shouldn't take more than a few hours of discussion over a few days. The complication here is all in modeling the impacts of the options laid out below for the income tax base broadening and rate cutting.

Why Is Minnesota's Traditional Antipathy to the Sales Tax Mistaken?

Minnesota was slow to adopt a general sales tax, not getting the job done until 1967. Ted Kolderie's book, "Thinking Out the How", delves into the history of this antipathy and how the job got done in Chapter 8: The Sales Tax, at pp. 81-84:

> Opposition to a tax on sales was rooted in the conviction that it fell most heavily on the necessities of life, so was inherently inequitable and unfair to working people….
>
> [A study commission report] in 1956 introduced the idea of a credit to offset the regressivity. Nothing followed, however….
>
> [In 1965] the Star and Tribune editorial page supported broadening the tax base. The idea of a credit remained attractive….
>
> I [Kolderie] had come across a table showing how credits of different sizes would shift the incidence of the tax; showed in an article on the Star opinion page how a credit on 'the necessities of life' could take the regressivity out of a general sales tax. 'What this means is that the discussion about a sales tax should, and can, be shifted off the pros and cons of a sales tax in principle, onto a practical basis where agreement can be reached.'
>
> ….
>
> Late in 1966 the Citizens League took the question under study….[The committee was] co-chaired by John Mooty, … a senior Republican active, and Dave Graven, a law professor at the University of Minnesota [and] a DFLer… The report early in 1967 argued the need for the tax, proposed a three percent rate and advocated the offsetting credit.
>
> Graven made it compelling. No tax *source* is inherently anything: I can construct a regressive income tax on the back of an envelope in two minutes. Everything depends on what's covered, the rates applied and the exemptions or credits provided – and, of course, on the use to which the revenues are put….
>
> [The Legislature proceeded to pass the tax over a gubernatorial veto.] In the end, to keep it simple, legislators used exemptions rather than credits to take out the regressivity: No tax on food and clothing.

The more things change, the more they stay the same. Twenty years later, and now 30 years ago, when I was Commissioner of Revenue, the DOR considered the possibility of proposing to extend the sales tax to clothing, and our research indicated that the sales tax on clothing would be less regressive than the sales tax as a whole. I don't recall for certain, but suspect we never made the proposal because it was shot down before it got to that stage by legislative leaders (or maybe then-Governor Rudy Perpich).

Fast forward another 20 years or so to the bipartisan Budget Trends Study Commission Report to the Legislature of January 12, 2009. The BTSC Report has a handful of recommendations and a lot of findings, no doubt because it was harder to get bipartisan unanimity on recommendations than on findings. Finding #12 at p. 23: "Shifting consumption patterns have reduced Minnesota's sales tax base." This has no doubt continued because the economy has moved substantially from goods to services, and Minnesota exempts most services.

The BTSC did not come out with a recommendation to broaden the sales tax base. But Finding #11 at pp. 22-23 included that the sales and income tax bases go up and down with the economy in virtual "lockstep", but that the income tax is far more volatile than the sales tax, so that a vast shift in emphasis from the income tax to the sales tax would have the desirable outcome of making the revenue system less volatile (while conceding that other criteria are also relevant), and Finding #10 at p. 22 included the following observation:

> Expanding the sales tax base by including currently untaxed items (and reducing the sales tax rate to raise the same amount of revenue) can affect both the growth rate and the volatility of the sales tax revenue stream, but the magnitude of those effects is likely to be small for most individual items. For example, taxing clothing would have little impact on either the growth rate or the volatility of the sales tax base. Taxing personal services would increase the growth rate by a noticeable amount, but would have little effect on sales tax base volatility.

The BTSC Report clearly considers it reasonable to somewhat increase the role of the sales tax. To the extent that it would replace income tax revenue, it would tend to make the revenue system a little less volatile, but not by enough to be significant unless there were a huge change.

The extent of a sales tax base expansion on regressivity would depend on what products or services are made subject to sales tax. But in any event, regressivity can be minimized or eliminated by the household credit against the income tax which this proposal includes.

This proposal is for a modest sales tax base expansion to facilitate a revenue neutral solution to the TCJA problem. It is a call for Governor Dayton, legislators and the staff experts in the DOR and the Legislature to sit down and work this out so that they avoid creating Problem No.1, a considerable and pointless increase in income tax administrative complexity, for well over one million Minnesotans. This calls for exactly what Kolderie called for, and got, more than 50 years ago – a "[shift] off the pros and cons of a sales tax in principle, onto a practical basis where agreement can be reached." The agreements needed are on the amount of sales tax revenue needed to avoid unreasonable income tax increases and what now-exempt products and/or services should be taxed to produce that revenue.

Some will resist the notion that the sales tax base should be expanded at all, and especially as recommended here, that it be expanded in order to slightly reduce the income tax, for the sales tax is regressive. The response to that is that the roughly 64% of Minnesota income tax filers who have not historically itemized deductions, which tends to include the lower income reaches of the income tax filers, will enjoy income tax reductions as a result of the base broadening and rate cutting envisioned in this proposal; that the 36% of Minnesota income tax filers who have been itemizing will get some potential for a tax increase as a result of losing deductions; that 100% of Minnesota income tax filers will benefit from simpler filing; that the regressivity issue is addressed by the recommended household credit; and that the uses to which Minnesota state tax revenues are put are becoming more progressive all the time as the need for health care spending to assist needy senior citizens outpaces everything else in the budget.

Why Not Dedicate More Sales Tax Revenue to Transportation Funding?

The last key element of a potential KISS Principle compromise between the Legislature and Governor Dayton is to not submit to the voters a constitutional amendment dedicating motor vehicle-related sales tax revenues to the Hghway User Tax Distribution Fund, other road uses or anything else.

That proposal doubles down on a failed strategy – funding roads more or less entirely from dedicated revenues. The gas tax has long been the dedicated source of road funding. That tends to lead to a contention that, given that there is both broad agreement that the gas tax at its current level no longer provides enough revenue to get the job done and extreme reluctance to raise the highly regressive gas tax any further, some other dedicated source, preferably vehicle-related, must be found. With all due respect, that is nonsense. The dedicated nature of the gas tax is very much an historical accident. When it was enacted, Minnesota's main tax, both local and state, was the property tax. There was no income tax. There was no sales tax. In that environment, a dedicated gas tax made a lot of sense. Whatever one thinks of the wisdom of a dedicated gas tax, that is no justification for more dedicated taxes to fund roads or other transportation needs.

If more dedicated funding of transportation is desired, transportation experts could identify a number of possibilities that would make more sense than dedicating general sales tax revenue. They might include taxing carbon emissions and/or parking, congestion pricing, and differentially higher initial taxes and/or annual license tabs for gas guzzling vehicles.

If additional transportation funding is desired immediately, the sales tax base expansion recommended above could be extended, preferably in a separate bill, to provide some funding and/or a portion of the $329 million surplus could be spent on that purpose.

For the long term, I would like to see Minnesota undertake a serious effort to look at revenue system redesign and would volunteer numerous ideas to such an effort. Trying to talk the voters into a narrow constitutional amendment on a narrow subject is a bad idea. Consider this finding in the BTSC Report in Finding #10 at p. 22: "As an illustration, note that an unintended consequence of the full dedication of MVST receipts outside of the general fund was to increase the volatility of the state's general fund tax base by roughly 10 percent. This happened because the performance of the MVST helped by further diversifying the overall performance o the general fund." Far better for this campaign season would be the kind of debate that could be had over the advisability of retaining the lower income tax rate and broader base that this proposal envisions, or going back to an income tax featuring higher rates and lots of deductions and credits.

Details of a KISS for Minnesotans from Our Political Leaders

A KISS for Minnesotans could include any of a peck on the cheek, a big smooch or a really big smooch. Bigger, it turns out, is better because the bigger the smooch, the more Minnesota moves in the direction of just using the income tax to raise the revenue needed to fund the government at the lowest practicable tax rates, instead of having the system shot full of rewards for doing this or that, most of which taxpayers would do anyway, especially because the federal savings from many of the actions dwarf the Minnesota savings, and then having to have higher rates, which make Minnesota look bad compared with other states, in order to raise the revenue to both fund the government and pay for the little rewards to taxpayers, to get which rewards Minnesotans have to go through considerable unnecessary fuss and bother in preparing their returns.

A Peck on the Cheek

The peck on the cheek begins with making FAGI the starting point. Governor Dayton, the House and the Senate all do this.

Unfortunately from the KISS perspective, Governor Dayton and Senate Tax also propose retaining itemized deductions using the old federal rules and the House bill is similar, though more closely related to the new federal provisions. All three would impose significant complications on over one million Minnesota taxpayers, creating Problem No. 1 described above.

The key question for whether Minnesota's taxpayers will have significantly less or more complexity to cope with in filing their income tax returns is whether Minnesota will continue to deploy as alternatives a standard deduction and a set of itemized deductions. I urge legislators and the Governor to consider eliminating that distinction, and most of the deductions involved, and to take a look at replacing the personal exemptions with a credit.

Here is what I suggest for replacing the federal personal exemptions, standard deduction and itemized deductions that could be eliminated by starting with FAGI. These six recommendations also apply to the big and really big smooches.

First, make clear in the statute that the new federal deduction for 20% of certain pass through business income under IRC Section 199A is not allowed. While the provision as enacted seems to make this a deduction after FAGI and before itemized deductions, I would not trust Congress or the IRS on this. This deduction would affect only the individual income tax. The rationale for this at the federal level is the gigantic post-TCJA spread between the new corporate tax rate of 21% and the higher bracket individual rates of from 24-37%. There is no such spread under the Minnesota income tax, where the corporate rate is 9.8% and the higher bracket individual rates 7.85 and 9.85%. In addition, this deduction is going to be widely subject to abuse, having been described by some tax experts (people who make their living providing tax avoidance services to others) as the single worst Internal Revenue Code provision ever enacted. Neither Governor Dayton nor House Tax conforms, and that is a hopeful sign that compromise may be possible.

Second, allow a deduction for health insurance for all taxpayers who are not covered by an employer's health plan, so that every last Minnesota taxpayer who has health insurance gets it on a pre-tax basis. This will encourage all Minnesotans to become insured because there will be no other deduction for medical expenses. If we get a peck on the cheek, this deduction would apply only to those not covered by the self-employed health insurance deduction. If we get a big or really big smooch, that federal deduction would need to be adopted specifically by Minnesota.

Third, allow a credit of somewhere between 5-10% of charitable contributions up to a maximum contribution amount of 50-60% of FAGI to replace the current Minnesota deduction for a modest amount of contributions by non-itemizers. This would be a modest push back against the blow Congress struck against charitable giving by radically increasing the standard deduction, so that only about 5% of taxpayers will any longer have any federal tax incentive for making charitable contributions. Unlike the deductions to get from total income to FAGI, where the federal subsidy of the activity is significant, now the number of taxpayers who are rewarded for charitable giving by a federal tax reduction has plummeted. This negative development can be partially offset by this change in Minnesota law. The cost of doing this could be mitigated by only allowing the credit for contributions in excess of a threshold amount, in either or a combination of dollars or percentage of income, and by only taking into account the basis of contributed property, instead of fair market value (the gain is not required to be recognized as income).

Fourth, enact a household credit. This would effectively replace the personal exemptions that Congress repealed, and potentially the standard deduction too. And it could lead to further simplification in the future and to being able to expand the sales tax base with minimal concern for regressivity because this credit could effectively eliminate it. If there is strong preference for a deduction instead of a credit, that would cause no harm, though it would make cutting the rates more difficult, be less of a force for income tax progressivity and have less potential benefit for future tax system redesign. The most important thing would be to eliminate both the personal exemptions and the standard deduction with this credit or deduction. In either case, it might be either a flat amount based on family size or be phased down and perhaps out as incomes rise.

Fifth, adjust all the rates slightly downward, so that the net result is roughly revenue neutral within the individual income tax and the consumer revenue from the recommended sales tax base broadening, without taking other tax law changes into account. In particular, this means do not use corporate or other business tax increases to fund individual income tax cuts. That is what the forthcoming election is about. We need to solve the problem at hand now in a way that "both sides" concede is at least no worse than at present in terms of individual vs. business taxation and the like. Under all three KISSes, the tax base would be broadened by eliminating the itemized deductions for state and local taxes, interest expense, charitable contributions (but note the new credit above), casualty and theft losses, job expenses, miscellaneous deductions such as tax preparation fees and investment expenses (and all the others), and personal exemptions and the standard deduction (but note the income-adjusted household credit above). This broadened tax base would allow the same amount of revenue to be raised with lower tax rates.

Sixth, it might also be advisable to provide a deduction or credit for medical expenses deemed excessive; e.g., in excess of 7.5% or 10% of FAGI, in addition to the deduction for health insurance noted above. Not providing for this would encourage all taxpayers to have health insurance and discourage them from buying high deductible policies. Providing for it would cushion the blow, to the modest extent of Minnesota's tax rates, of excessive medical costs beyond the insurance premiums which, as noted above, clearly should be deductible, actually incurred.

Using credits instead of deductions to take family size into account and effectively eliminate tax on the first $x of income (replacing the standard deduction) would make the tax more progressive. Using a credit instead of a deduction for charitable contributions and perhaps excessive medical expenses would recognize the fact that it is more of a sacrifice for lower income than for higher income taxpayers to make charitable contributions or pay high medical costs.

Another possibility to consider is to retain a deduction or credit for unreimbursed employee business expenses. The TCJA eliminates this deduction at the federal level. That is a bit unfair to such employees. Independent contractors get to deduct all of their business expenses. Employees need not include in income the business expenses for which their employers reimburse them. So employees getting no tax benefit for expenses they incur to earn their salaries that are taxed get differentially worse treatment. This point was pounded upon by the DOR at the recent House Tax Committee hearing on the tax bill. Yet the DOR's complaint illustrates the importance of taking into account the magnitude of the changes wrought by the TCJA, which our leaders are not doing effectively. Here is what they ignore.

First, employers and employees are not stupid. They can adjust to the TCJA change. Some employers may decide to reimburse their employees for more expenses, which would be like a tax free salary increase. Some employers and employees might decide a switch to independent contractor status would make sense, which would let the former employees deduct all of their expenses (but also have a host of other considerations, which might make this not a smart move). Employers who do not want to reimburse the expenses because of the administrative effort or a fear of getting taken to the cleaners by their clever employees might instead grant a slight salary increase. And employees might find a different job if the loss of this deduction is important to them.

Second, such employees have already lost a big federal benefit from no longer being able to deduct these expenses. The loss of the Minnesota benefit amounts to only 5.35-9.85% of the expenses in question. That relatively smaller loss can be taken into account in the response they and the employers make to this change.

The TCJA is an earthquake for individual income taxation. People will adapt. Trying to preserve a status quo from which the federal government has retreated is not a good strategy for Minnesota.

That eliminating itemized deductions could permit rate reductions is demonstrated by the DOR's individual income tax sample for tax year 2015. It estimated the amounts of federal itemized deductions claimed by Minnesota resident taxpayers as follows:

Home mortgage interest	$5,768,538,883
Property tax	3,171,727,182
Cash charitable contributions	2,879,141,667
Non-cash charitable contributions	958,872,091
Medical expenses	1,790,051,999
Employee business expenses	1,188,423,784

Most Minnesotans who formerly claimed these deductions on their federal income tax returns will no longer do so because of the near doubling of the federal standard deduction. This proposal is all about redesigning Minnesota's individual income tax so that several of them could be eliminated for Minnesota purposes as well, while still providing a fair tax system by reducing tax rates instead of having higher rates in order to fund the tax breaks for a much more limited group of Minnesotans.

The Big Smooch

The peck on the cheek would retain all of the deductions from Form 1040, lines 23-35, that take one from "total income" on Line 22 to FAGI on line 37. The big smooch would ask the question of which, if any, of these deductions might be eliminated to drive rates down and simplify tax return preparation. Because every taxpayer with these deductions gets a percentage federal tax savings from them ranging from 10-37%, depending on the taxpayer's federal tax bracket, the additional Minnesota savings of from 5.35-9.85% is relatively insignificant and unlikely to change behaviors. The question is whether to reward behaviors that people would do anyway, or reduce the rates for all.

The deductions that could be eliminated by the big smooch are educator expenses; certain business expenses of reservists, performing artists, and fee-basis government officials; health savings account deduction; moving expenses; deductible part of self-employment tax; self-employed SEP, SIMPLE, and qualified plans contributions; penalty on early withdrawal of savings; alimony paid; IRA deduction; and student loan interest deduction. (The moving expense deduction on Line 26 is largely eliminated by the TCJA, but retained in Governor Dayton's proposal. The domestic production activities deduction on Line 35 already is disallowed by Minnesota.) Those deemed so significant that they should be retained even though the federal tax break is much more significant could be retained. The point of advocating for the big smooch is not that legislators should be slavishly tied to going all in on it, but that so doing would be a good way to cut rates more and find out in the campaign which items voters think are really significant.

As noted above, I would ensure that all Minnesotans with health insurance get a deduction for it, which is another way of saying that the self-employed health insurance deduction would be retained. I would also be inclined to retain the deduction for alimony paid, which the TCJA would repeal for divorces after 2019, because alimony can be a significant burden on the payor and allowing a deduction makes it less likely that payors will default.

My views on the merits of individual deductions are not important; I include these by way of urging legislators and Governor Dayton to carefully consider the big smooch. Considering each of these deductions on its merits could lead either to starting with total income and including the retained deductions as subtractions on Schedule M1M, or starting with FAGI and including the rejected deductions as additions on Schedule M1M. The former seems better psychologically – taxpayers are more likely to like seeing a subtraction from income than an addition to it.

Yet another possibility would be to convert the retained tax breaks to credits at a flat percentage of the amount of the item, which could enhance income tax progressivity.

The Really Big Smooch

The really big smooch would go beyond dealing with federal income tax provisions to eliminating special Minnesota provisions that provide tax breaks. This would be good for achieving maximum simplicity for taxpayers and for promoting consideration in the campaigns of what tax breaks are really worth retaining for the long run. Those that are deemed to meet that test could be reinstated in 2019 or some later year, or not removed for this year. In the meantime, Minnesota's income tax rates would be as low as practicable and the individual income tax return preparation process as simple as practicable.

There are quite a few of these tax breaks that could be eliminated in the interest of expanding the base in order to allow maximum practicable rate reduction. Some are subtractions found on Schedule M1M, at many of lines 18-43. Others are credits reported on Form M1, lines 16, 18, 25 and 26 and subsidiary schedules referenced there. Considering these items for elimination could occur equally well with either the FAGI or total income starting point.

The Schedule M1M subtractions that could be considered for repeal in a really big smooch include education expenses (but bear in mind that the income-adjusted household credit would help lower income families); non-itemizers' charitable contributions (which I would replace with a more generous credit described above); the elderly and disabled subtraction (not so needed due to the household credit); federal active duty military pay; certain National Guard or other reserve component pay; expenses associated with human organ donation; military pension or retirement income; awards for AmeriCorps service; railroad maintenance expenses; contributions to a qualified education savings plan; Social Security subtraction; interest earned from a designated first-time homebuyer savings account; and subtraction for discharge of indebtedness of educational loans. (The subtraction from Schedule M1NC will go away by updating to the current Internal Revenue Code).

Other nonrefundable credits reported on Form M1 line 18 and Schedule M1C include those for long term care insurance premiums (which would be deductible as noted above), past military service, increasing research activities, employer transit passes, SEED capital investment credit, education savings account contribution credit, credit for attaining master's degree in teacher's licensure field and student loan credit.

Refundable credits reported on Form M1 line 25 and Schedule M1REF that could be considered for repeal include the K-12 education credit and the credit for parents of stillborn children. The child and dependent care credit and working family credit might well later be consolidated into the household credit recommended above, but there is no need to do that this year.

Refundable business and investment credits reported on Form M1 line 26 and Schedule M1B that could be considered for repeal include the angel investment tax credit, the historic structure rehabilitation credit, the Greater Minnesota Internship Credit and the Enterprise Zone Credit. If any of these is considered, so should be any comparable credits against the corporate income tax.

None of these possibilities are intended to say that such special deductions or credits are stupid or wasteful, but rather just to recommend a hard look at them in the interest of broadening the tax base and cutting the rates as much as practicable.

Again the possibility arises of converting retained benefits that are now deductions into credits to increase income tax progressivity.

A slightly smaller big smooch could be achieved if the standard/itemized deduction distinction is retained by converting some of the foregoing deductions (and perhaps converting some credits) into itemized deductions. This would achieve some simplification and save some money that could be plowed into a larger standard deduction.

The Bigger the Smooch, the Better

Within limits that legislators and the Governor would ultimately determine, the bigger the smooch, the better. Here's why.

First, the bigger the smooch, the more all rates could be cut, and/or the more rate brackets below the top bracket could be expanded, while still raising the same amount of revenue. Even the highest income Minnesotans deserve some rate reduction because the cost to them of paying their state and local taxes is dramatically increasing due to their no longer getting the federal subsidy that is now at 24-37% of their state and local taxes, due to either no longer itemizing or having their state and local tax deduction limited to $10,000. It is no answer to say that they are not really out of pocket if they got equivalent or better federal breaks from the increased standard deduction. The point is that the federal benefit to Americans from paying their state and local taxes has been dramatically cut back. State and local governments are going to have to deal with this ugly reality, and a slight rate reduction would at least be recognition that our state's political leaders recognize the seriousness of the situation. In addition to that, if Minnesota can raise the same amount of revenue with lower rates, it will help our competitive position vs. other states as a location in which to live and do business.

Second, while tax breaks are beloved by politicians, and no doubt appreciated by taxpayer/voters too, given that Minnesota's income tax rates range from just 5.35-9.85%, deductions do not provide all that much dollar benefit and probably don't affect most behaviors, especially if the deductions are also allowed under federal law, which is much more likely to affect behavior because the rates are much higher. That applies to all of the deductions that take one from total income to adjusted gross income, and is a major reason for Minnesota to consider starting with total income instead of FAGI. Much the same is true of small Minnesota income tax credits.

Third, filing Minnesota income tax returns could be made a lot simpler instead of a lot more complicated as all three proposals would do, and that would be widely appreciated.

Fourth, the TCJA's massive federal tax law changes look very unstable. It contains several provisions that are questionable, unclear or both, and is thought by most economists to be virtually certain to explode the federal deficit. Major changes may be made if the Democrats regain the majority in Congress. Making Minnesota's tax as simple as practicable would position us most effectively for possible future federal changes.

Fifth, a really big smooch would create a lot of potential tax subjects to discuss in civil fashion in the campaign – what do voters care about? Legislators could justify the KISS changes as potentially temporary in order to minimize rates, position Minnesota effectively for what comes next federally, and letting Minnesotans be heard on tax policy: Would voters rather have this, that and the other breaks and a higher rate with more complexity, or forget the breaks and enjoy simplicity and a lower rate?

Moreover, a really big smooch aimed at simplicity and overall equity from reduced rates would shift the focus off the question of whether one's tax went up or down by a few dollars. Was there anything magical about exactly how much Minnesota income tax you paid last year? Probably not, so our leaders should abandon the quest for not increasing any Minnesotan's income tax, instead pursuing the goal of an income tax that is so much simpler for taxpayers that minor increases and decreases, which often would not even be noticeable because taxpayers' economic results change from year to year, would not be seen as a problem.

Summing Up on the Prospects for a KISS for Minnesotans from Our Leaders

If Republican legislative leaders and Governor Dayton are willing to call a temporary truce in the perpetual war over tax policy and spending levels, all Minnesotans can benefit from applying the KISS Principle to the Minnesota individual income tax. My hope as a citizen is that legislators of both parties and Governor Dayton will agree on a really big smooch, making clear in a joint public statement that no legislator should be voted in or out based on voting for the smooch, but rather that it is intended as a graceful way of dealing with a difficult situation in which Congress caused an earthquake in income tax structure at a time when the long term policy views of the Governor and the Republican legislative majorities are diametrically opposed. The compromise we need could have our leaders highlight their philosophical differences – Republicans wanting less taxation and smaller government; DFLers generally wanting government to invest more in solving problems, which means the same level or slightly more taxation. They could highlight this and fight the election over it, which they surely will, but still agree on a KISS for Minnesota's taxpayers for the 2018 tax year.

Here is a possible joint statement, which might be signed by Governor Dayton and the legislative leaders of both parties in both houses:

We often do not agree on the big picture when it comes to appropriate levels of taxing and spending by Minnesota state government. Those of us who are DFLers often see needs for more investment in solving problems we face as Minnesotans, which sometimes translates into a perceived need to raise taxes. Those of us who are Republicans often believe that Minnesota government should tax and spend less, and that Minnesotans would be better off overall if we spent less on government, government did less, and more income was left with the private sector.

We do agree that the Tax Cuts and Jobs Act passed by Congress last December was a structural earthquake for both the federal and Minnesota income taxes that will, if it is not significantly modified by Congress, significantly adversely affect Minnesota governments' ability to raise the revenue to run our governments because it makes paying state and local taxes significantly more expensive for the roughly 36% of Minnesotans who lately have itemized deductions for federal income tax purposes. We also agree that this unfortunate fact makes it advisable to reduce income tax rates, even though some of us would not otherwise be inclined to do that.

The only ways to reduce income tax rates without also reducing revenue are to expand the tax base by reducing deductions and/or credits, or rely more on other taxes. The TCJA creates an opportunity for us to dramatically simplify Minnesota's income tax, which will have the good result of making filing easier, and also expand the income tax base, which would allow for rate cuts that do not reduce total revenue, but would tax the next dollar of income for every taxpayer at a lower rate and somewhat slow future growth of state tax revenue.

The tax bill upon which we have agreed eliminates many deductions and credits in order to provide the maximum feasible rate cuts without reducing tax revenue and causing budget problems unless significant spending cuts are made, and also slightly broadens the sales tax base to tax ____ [whatever is agreed upon] in order to keep the loss of income tax deductions and credits from causing any Minnesotans to suffer a significant income tax increase.

Probably no legislator is in favor of all of the cuts we have agreed upon, and some legislators may be against all of them, but a majority of legislators have decided that the prudent thing to do in response to what Congress did to Minnesota and Minnesotans in the TCJA is to broaden the income tax base by eliminating deductions and credits as much as we can agree upon, in order to cut income tax rates as much as we can agree upon, and to broaden the sales tax slightly to prevent unreasonable individual income tax increases from occurring.

We fully expect that House members running for reelection and other House and gubernatorial candidates will advocate for restoration of some of the deductions and credits we are eliminating, which will also mean tax rates will have to rise or programmatic spending will have to be cut, or new public service needs not met, or money-saving service delivery efficiencies discovered, in order to do that. We believe that members running for election would not be being inconsistent by favoring restoration of deductions or credits they just voted to eliminate because the vote to eliminate them was needed to deal effectively with the TCJA, and whether or not some should be restored can appropriately be taken up in the future as the economy and the tax system evolve.

If such a seemingly implausible thing were to happen, would Minnesotans then love our tax system? Perhaps not, but a really big smooch from deploying the KISS Principle certainly could make it less of a pain in all of our backsides. It would be well worth delaying final resolution of the complex problem of how best to respond to the TCJA beyond the May 21 constitutional deadline for adjournment into a special session if the key leaders had agreed by May 21 to try this approach.