



# Mark Haveman & John James

## Do something this year to adjust to federal tax changes

A Minnesota Tax Policy Interview

*May 4, 2018*

### Present

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### Summary

Center for Fiscal Excellence Executive Director Mark Haveman and tax lawyer and former Minnesota Revenue Commissioner John James share the view that Minnesota needs a state income-tax conformity law this year to adjust to the changes brought about by the federal Tax Cut and Jobs Act (TCJA). They both criticize Governor Mark Dayton for his lack of interest and lack of leadership on the tax-conformity issue. (Following this Civic Caucus interview, the Legislature passed a tax law at the end of the legislative session, which the governor then vetoed.)

James wrote a paper proposing major changes in the state tax system, which he described in an [April 27, 2018, interview with the Civic Caucus](#) and shared with the governor, legislative tax leaders and other policymakers. He says that if the governor and the Legislature couldn't agree on these proposals, they could at least take the simple step of increasing the state income-tax standard deduction for one year. That would reduce the number of Minnesotans needing to itemize just for state income taxes.

Haveman predicts "an unmitigated disaster" next year without action this year by the Legislature and the governor. Although he says the TCJA has some major problems, he believes the need for changes at the state level because of the federal reform offers a unique opportunity for Minnesota to improve its tax system. But he says legislators have decided the best idea is to do no harm rather than improve the tax system.

James agrees that limiting the deductibility of state and local taxes on the federal income tax was a direct assault on high-tax states by the federal government. He makes the point that Minnesota sends a lot more money to Washington than we ever get back, because we don't have military bases.

Both Haveman and James say the federal changes in corporate income taxes are very important, but very complex. Haveman says those changes have left a lot of uncertainty at both the federal and state levels.

## Biographies

**Mark Haveman** is executive director of the Minnesota Center for Fiscal Excellence. He joined the organization in 2002 and took over the organization's leadership role in 2008. He is the author of numerous research and education publications on state and local tax policy and government.

Haveman was a member of former Governor Tim Pawlenty's 21st Century Tax Reform Commission, served four years on the Board of Trustees of the Governmental Research Association, and has served on policy and project advisory boards for the Lincoln Institute of Land Policy, the U.S. Environmental Protection Agency, the National Institute for Standards and Technology, as well as for several state agencies, academic institutions and private foundations.

He received his B.A. from Calvin College and his MBA from the University of Michigan.

**John James** is a tax and business lawyer and former Minnesota Commissioner of Revenue. After he came to the Twin Cities in 1974, he spent time with three Minneapolis law firms, a CPA firm and a public-policy consulting firm. He has worked solo since 2007.

James spent five years with the Minnesota Department of Revenue, serving first as assistant commissioner from 1986 to 1987 and then as commissioner from 1987 to 1991. While at the Revenue Department, he created the Appeals Office, drafted and secured passage of major tax reform-including Minnesota's Taxpayer Bill of Rights-and chaired the Multistate Tax Commission.

Upon leaving government in 1991, James co-founded what became the Public Strategies Group, with which he collaborated from time to time over the years. In 2011, he became a fellow with the Center for Policy Design to work with others to redesign multiple aspects of Minnesota state and local government, placing his emphasis on the state-local fiscal system and the state-local government relationship. Recently, he created a framework for ending Minnesota's transportation-funding crisis.


James was deeply involved in two significant public-policy designs outside the tax arena. In the 1970s, he helped design the Minnesota Interest on Lawyer Trust Accounts program. In the 1990s, he helped draft the Minnesota Limited Liability Company Act and secured support for it from the Department of Revenue, the Minnesota Legislature and the Internal Revenue Service.


James chairs the board of the Interest for Others Foundation and serves on the board of Minnesota Lakes and Rivers Advocates. He is a 1968 graduate of the University of Iowa and a 1974 graduate of Harvard Law School.

## Background

Continuing its focus on how Minnesota should respond to the major changes in the federal income tax in from the Tax Cuts and Job Act (TCJA), the Civic Caucus followed up recently on its [April 27, 2018, interview with tax lawyer and former Minnesota Revenue Commissioner John James](#). The Caucus

interviewed James again, joined this time by Mark Haveman, the executive director of the Minnesota Center for Fiscal Excellence.

James wrote a paper explaining his proposed changes to Minnesota's tax system in response federal changes,  ["A Proposed Minnesota Response to the Federal Tax Cuts and Jobs Act."](#) He sent this May 4, 2018, version of the paper to the governor, legislative leadership and other policy leaders.

Haveman wrote an article on the issues surrounding the state's attempt at conformity with the federal TCJA,  ["The Enormity of Conformity"](#) in the March-April 2018 issue of *Fiscal Focus*, the Center for Fiscal Excellence newsletter.

The Civic Caucus previously interviewed Haveman on [Jan. 29, 2010](#) ; [June 22, 2012](#) ; and [June 7, 2013](#) . The Caucus has interviewed James on [April 27, 2018](#), [Jan. 15, 2010](#) , and [Sept. 17, 2010](#).

## Discussion

### John James's opening remarks

**Governor Mark Dayton and the Legislature could bump up the state income-tax standard deduction, so fewer Minnesotans would have to itemize just for state income taxes.** Tax lawyer and former state Revenue Commissioner John James opened the discussion by repeating this conclusion from his [April 27, 2018, interview with the Civic Caucus](#).

James said if the Legislature and the governor don't accept his other proposals for changing Minnesota's tax system in response to the federal Tax Cuts and Jobs Act (TCJA), they could at least take the step of increasing the state income-tax standard deduction. James said this step would reduce the number of Minnesotans needing to itemize just for state income taxes. This is an issue because the TCJA significantly increased the federal standard deduction, which will greatly reduce the number of people who itemize for the federal income tax.

**The strategy on the governor's part is to veto the tax bill and then negotiate with the Legislature.** James made that prediction before the tax bill had passed the Legislature and said, "These guys don't even talk to each other." (Since this interview, the Legislature passed a tax bill, which Governor Dayton vetoed.)

### Mark Haveman's opening remarks

**Minnesota Center for Fiscal Excellence Executive Director Mark Haveman made five major points:**

1. We absolutely need some tax conformity bill at the state this year. "It will be an unmitigated disaster next year if we don't do something," Haveman said. "The administrative and the filing issues would be extraordinary. We can't *not* do something."

2. The TCJA has some major problems. "I'm not a big fan of it," Haveman said. "From a simple standpoint of process, it was incredibly poorly thought out, it was rushed, and there remain all sorts of

uncertainty and technical fixes that need to be addressed. Then there are substantive issues and concerns, including the use of debt to finance tax relief and the distributional effects that exist at the federal level."

3. There was a political reflex to Minnesota's response to the federal changes. "The instinct of the Democrats was to run away from it as fast as humanly possible, because it's so politically toxic at the federal level," Haveman said.

4. Whatever problems and concerns people may have with respect to federal reform should not preclude a thoughtful effort on federal conformity. Even if one hates the TCJA, there is a very real and practical need to craft a good conformity response, Haveman said. "Sound, efficient tax administration demands a careful and thoughtful response," he said. "There is actually an opportunity here. Any time the system is open, as it is right now with the federal reform, a window opens for a state to improve the quality of its tax system. That opportunity exists in spite of whatever objections one may have about what the federal government has or hasn't done."

5. Unfortunately, the opportunities and the ideas that have the most relevance for a good policy response at the state level are politically useless. Haveman said transparency, administrative efficiency, and improving the performance and quality of the revenue-generating system are essential ideas and substantive concerns revolving around the TCJA should not change the pursuit of these objectives with respect to Minnesota tax conformity. However, "it's not the currency by which a state conformity response is now being pursued here," he said. "It's all about the politics—who wins, who loses; what the head counts are; and who holds state taxpayers more harmless than anybody else." He said all the really important objectives are getting lost in the shuffle or, frankly, ignored.

"That sums it up," said James. "The other thing is we have a split in control. If they'd do something sensible, neither side could throw bombs at it. But there's very little chance they're going to do something sensible. That's a tragedy. I just don't see how they'll get to a sensible point. And it's not a partisan political thing to say that."

**Limiting the deductibility of state and local taxes on the federal income tax was a direct assault on high-tax states by the federal government.** An interviewer made that point and James responded that Minnesota sends a lot more money to Washington than we ever get back, because we don't have military bases. "The blue states that are getting hit disproportionately by limiting the deductibility of state and local taxes also are definitely supporting the red states," Haveman said.

The interviewer asked what the rationale was for raising the federal standard deduction and changing the deductibility of various things. Haveman responded that it was an attempt to simplify federal taxation.

**Eighty to 85 percent of people will no longer itemize on their federal income taxes.** James made that remark and said in Minnesota, 13 percent of tax filers are projected to itemize for federal taxes. "That makes getting a break for what you're doing on itemized deductions become the preserve of a small group of high-income people," he said. "That just doesn't seem right to me."

Another problem in the federal bill, James said, is that people who don't itemize no longer get a break for charitable contributions.

**What is the political feasibility of making the sales tax a better tax?** An interviewer asked that question and another one: What would have to happen in terms of side payments to low-income people to make that politically viable? James responded that the mechanism for doing that, as he suggested in his paper, is a household credit for poor people.

"You could cut the sales tax to somewhere between 3.5 percent to four percent, if you'd tax everything," James said. Some of the really big things that should be subject to the sales tax, he said, are clothing, food and health care. "What you could do is absolutely incredible in terms of cutting the rate."

**Changes in corporate income taxes are very important, but very complex.** Haveman made that comment and said, "Conformity to federal corporate income-tax changes, especially with respect to foreign earnings, are chock full of constitutional, legal and administrative questions. As a result, at the state level, 'it's absolutely ridiculous to bank on anything.'"

James said that includes the federal changes to the international corporate tax provisions and the 20-percent deduction for qualifying pass-through businesses. He said "pass-through" means that the income is taxed to the owner(s), instead of the business. This affects some S corporations, LLCs, partnerships and sole proprietorships.

Haveman said even the seemingly simple and straightforward changes in corporate income taxes have hidden complexities. For example, he noted the new limitation on net interest deductibility. "But because Minnesota is a state that groups wholly owned or majority-owned companies and other entities as a single entity for tax purposes, that is going to require the establishment of new implementation rules," he said. "There will be unique circumstances that will inevitably pop up that may be a recipe for potential legal challenges going forward."

"On the corporate income-tax side, we need to let this stuff settle out a little bit before we do anything," he said. "I certainly think Dayton is making a huge mistake to bank on new corporate revenue to finance permanent tax cuts for individuals."

**Haveman's first message to legislative tax leaders, the governor and the state Revenue Department would be to "do something."** "What should have been done from the outset," Haveman said, "is for the governor to have said, 'This goes beyond partisanship,' and then to have segregated the surplus debate from the conformity debate and to have systematically taken a close look at the state response through the lens of the state budget, tax filing and efficient tax administration. Approach the bill as a conformity bill, not as a tax relief bill, and see what makes sense for the state of Minnesota. That didn't happen."

"They should sit down and take a look at what they're actually doing here," James said. "And the press is incapable of delving into this in enough detail. All they're saying is that if everybody gets a tax cut, that must be good. But do people really care if their taxes go up or down by \$50 or \$100 a year?"

"The relative tax impact we're talking about is small compared to the potential for an administrative nightmare," Haveman added. "Is it worth the administrative complexity required to hold 98 percent of people harmless?"

James said he anticipates that the fees tax preparers charge to Minnesotans to do their Minnesota tax returns will go up, because of the new complexity and the need for new software. And, he pointed out, you can't deduct the tax preparation charges anymore. "This is the level that they're totally ignoring," he said.

**Will the loss of the federal deduction for charitable contributions make a difference for small nonprofit organizations?** James thinks it will make a difference in the amount of charitable deductions people make. Haveman said, "Tying the value of a charitable contribution to your income always seemed weird to me. Couldn't you create a flat credit for contributions?" Then, he said, all taxpayers-even those who don't itemize-could benefit. The credit could start above a certain baseline, so people would have an incentive to contribute more. James agreed.

**How do you get it done?** An interviewer asked that question and said people in the Legislature are often carrying water for someone else. "How do we get to the lobbyists and try to bring some sensibility there?" the interviewer asked. "We need to get the legislators and pushers and opinion makers to realize anything we do has some kind of reaction somewhere else. How do we do the least amount of harm? During campaigns we get sound bites. You can't put this into a sound bite."

James responded that he thinks the different tax-bill approaches are governor-driven and legislator-driven and not lobbyist-driven. "Get the legislators to sit down and confront what they're really doing before they do it to us," he said.

An interviewer asked if the University of Minnesota's Humphrey School of Public Affairs could get the House and Senate majority and minority tax leaders, the governor and the state Revenue Department together and lock them up until they reach an agreement. Another interviewer said he doesn't know if there's any expertise on state and local finance at the University of Minnesota, with the exception, perhaps, of the state economist.

Another interviewer suggested the University's Carlson School of Business could do something. James added that Kristin Hickman at the University's Law School is knowledgeable about tax issues.

Another interviewer suggested that perhaps the Jefferson Center could get 25 citizens on a citizen jury and ask them to come up with something that would be revenue neutral. "You hash it out and shame the elected officials with what these folks could come up with," he said.

**Five or six years ago, the state Department of Revenue funded a blue-ribbon commission on how to bring tax expenditures back into the budget process.** "It was a fantastic report," Haveman said. "It brought together both sides of the aisle and top-flight economists on how to think systematically about the tax-expenditure budget. It identified and ranked which expenditures should be looked at first."

"But it's sitting on a shelf somewhere," he continued. "I'm not even sure if it received a legislative hearing. It was a terrific, thoughtful report."

"Ultimately, you've got to get to the governor and the Legislature," James said. "It's a pity that the governor doesn't care about this, but he doesn't."

"There is knowledge around about how the world works," said another interviewer. "But to guide the public discussion, there has to be someone with a bully pulpit. The current governor has been absent without leave on this. If there's no captain of the ship, there's no compass direction. I'm mystified by the lack of the governor's interest on this topic."

**What is the unintended consequence of ever more progressive taxation?** Haveman noted research by a professor at Northwestern University on the relationship between the structure of the tax system and the relative progressivity of the overall fiscal system. Research has shown that heavy emphasis on ever more "soak the rich" forms of taxation triggers more aggressive political defense responses that lead to declines in the progressivity of the overall fiscal system over time. "It's not an accident," Haveman said, "that some of the fiscal systems in the world heralded most by progressives are funded by far more regressive tax systems than exist here in the United States."

**What we're missing is getting some productivity out of the taxes that are spent.** An interviewer made that comment and added that we need to get results from the tax money we're investing. He asked if there was any way to put a requirement for results into a tax bill.

Haveman responded that he wishes there were more interest in mixing policy and finance. "Governor Dayton has always emphasized that the Legislature shouldn't mix policy with budget finance," he said. "But I think the only way to make progress is to condition additional financial support for programs through tax increases or appropriations processes with agreements on fundamental changes in how spending programs are designed and how money is spent in them. That's a politically risky approach to take, but an increasingly necessary one and we've missed opportunities in the past."

**Tax expenditures are in part driven by the belief that on the spending side, we can't spend money on certain things.** An interviewer made that comment and said that leads to tax expenditures, like income-tax deductions for donations to private colleges. James agreed that we have some tax expenditures because the Legislature won't appropriate the money for things like rehabilitation credits.

Haveman said his organization tracks every tax bill introduction for its members. "You can't believe the number of bills that are introduced every year for exclusions and exemptions to encourage various types of behaviors," he said. "They certainly don't all get enacted, but over time some do, which creates sclerosis in the tax system. You slowly accumulate new exemptions, new exclusions, new subtractions, which create more and more pressure on the income-tax rate to stay high, because you're narrowing the tax base a little bit all the time."

Another interviewer said, "The tax-expenditure issue has also reared its ugly head in Minneapolis." He said a deal was cut that the city would not raise the valuation for a building if it provided affordable housing. "It seems crazy to me," he said.

The interviewer said that the city has also considered creating value-capture districts where the city could capture the increased value on apartment buildings and put it into a fund for afford housing. Haveman commented, "It's the local government version of dedicated funding."

**Legislators have decided the best idea is to do no harm rather than to improve the tax system.**

Haveman made that comment and said legislators have done that because they don't want to get slammed by their opponents' campaign literature in the fall.

**If legislators and the governor wanted to do the simplest thing, they could just significantly increase the state standard deduction for one year.**

James made that comment and said that would mean fewer people would have to go through the trouble of itemizing deductions just for the state income-tax return.

**Don't try to provide income-tax relief with temporary money.** Haveman made that remark and said the governor's proposal definitely tried to do that, as did the House and Senate proposals, to some extent. "Keep the surplus separate from the tax issue," he said.