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MINNPOST

Evaluating the economic assumptions of Dayton's budget

By [Louis D. Johnston](#) | 01/23/13



REUTERS/Fred Prouser

The Legislature should modify that part of the plan and not enact sales taxes on business-to-business services.

It's easy to get lost in the weeds of the

proposal and neglect the economic assumptions on which it is built. It's important that policymakers and citizens understand the economics before they get down and dirty with the details of the budget.

Dayton's budget rests on assumptions about taxes, spending and economic growth. He's probably safe with many of his assumptions, but he's shaky with others and there's one in particular – extending taxes to business-to-business services – that raises a big red flag among economists.

First, let's take a look at where the governor can best make his case. Dayton presumes that changes in tax rates will have small effects on household and business behavior. Specifically, he assumes that imposing a new top income-tax bracket -- on individuals earning more than \$150,000 and households with incomes over \$250,000 -- will not have much effect on their decisions about work and saving. Further, the sales tax expansion supposes minimal changes in spending behavior on goods and services.

The empirical evidence for both of these assumptions is mixed. Proponents and opponents of these



changes can and will find studies that support their points of view. The honest answer is that economists don't have a tipping point at which higher income taxes will reduce household saving or cause people to spend less time at paid labor and more time at home. Neither do we have conclusive evidence that expanding the sales tax will or will not significantly hurt clothing sales or, for example, household legal services in Minnesota.

Education spending

The governor's budget plan also assumes that increases in state funding for E-12 and higher education will promote long-term growth. Economic analysis is clear

that education plays an important role in economic growth. Early childhood education, specifically, pays great dividends for individuals and for society more generally. Higher high school graduation rates are also associated with higher levels of state income and higher rates of state income growth.

Again, the economic evidence about increased state funding leading to higher rates of educational attainment and economic growth is weak. Most studies of which I am aware show that state education spending is positively related to increased educational attainment and faster economic growth but the effect is not large, while others studies do not even find a positive relationship.

What's my own opinion on these assumptions? I think that his assumptions about the effects of tax changes on household behavior are reasonable. It is a good idea to expand the sales tax to a wider range of household purchases, including clothing and services, and to lower the rate. This will provide a less volatile revenue stream for the state and eliminate distortions between buying goods that are taxed (for example, tax software) and buying services that are not tax preparation by an accountant.)

And I'm inclined to believe that increased spending on early childhood education will have a positive effect on Minnesota's economy.

Troubled tax

But the governor gets in trouble in a key part of his plan: There's strong empirical evidence against Dayton's proposal to expand the sales tax to services businesses that sell other businesses. John Spry, associate professor of business economics at the University of St. Thomas in St. Paul, **points out** that this type of tax distorts business behavior in so many ways that the state's revenue gains are far outweighed by the inefficiencies created by new taxes.

The Legislature should modify that part of the plan and not enact sales taxes on business-to-business services. This is an important part of the governor's proposal; Minnesota Revenue estimates that it will raise about \$3 billion in additional revenue and thus eliminating it will significantly affect the

budget. Legislators should instead settle for a smaller rate reduction (say to 6 percent) or scale back the spending side of the budget enough to keep the lower tax rate.

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