# Minnesota's Tax Hike: The Executive Director's Cut

*by Billy Hamilton*

Public policy issues have many sides, and where you stand depends on where you sit. In a recent column,[1] I interviewed Minnesota Tax Commissioner Myron Frans. The interview focused on the tax bill lawmakers adopted earlier this year at the urging of Frans's boss, Gov. Mark Dayton (DFL). Passed by the Legislature in May and signed by Dayton shortly thereafter, the tax plan is projected to raise approximately $2.1 billion in additional revenue over two years, mainly by boosting taxes on high-wage earners, smokers, and corporations. The revenue will pay for added school spending and eliminate the state's looming budget shortfall.

Beyond the spending increases and deficit relief, the massive 552-page bill had another goal — property tax relief. Under the legislation, more homeowners and renters will be eligible for property tax refunds, and refund checks will be larger for many of them. Local governments will receive an additional $130 million in state aid over two years. The legislation also includes a 3 percent limit on local property tax levy increases, presumably to reduce the temptation to take up any slack created by the tax relief by increasing property taxes.

As a candidate in 2010 and later as governor, Dayton had argued that the state's traditional "three-legged stool" that mixed nearly equal levels of income, sales, and property taxes had become unbalanced, and that the tax system was increasingly unfair as a result. Significant reform was needed, he said, to restore the balance among the major tax sources that had eroded because of a combination of a stagnant sales tax base, the steady growth of the property tax, and the effects of the recession.

[1]"Minnesota's Three-Legged Stool: An Interview With Revenue Commissioner Myron Frans," *State Tax Notes*, Nov. 11, 2013, p. 355.

Not long after the column appeared, I talked to Mark Haveman, executive director of the Minnesota Center for Fiscal Excellence (MCFE), until recently known as the Minnesota Taxpayers Association. I was talking to Haveman about another column idea, but we started talking about my interview with Frans. It turns out that Haveman and MCFE have a distinctly different view of this year's tax legislation.

Haveman is as affable and engaging as Frans, and he likes movies — a major plus for me. He also writes colorfully about Minnesota taxes, which I also appreciate. In a recent blog posting, he combined movies and taxes: "The Minnesota property tax is the *Casablanca* of the state tax system — full of political intrigue, high entertainment value, and moments when we are 'shocked' to find out about behaviors that are in fact entirely predictable." That's an insight worth contemplating, and so are his views on Minnesota's recent tax changes, which differ strikingly from the commissioner's. This, then, is the executive director's cut of the state's recent tax legislation.

MCFE is no fan of the recent tax hike. The association opposed several parts of Dayton's original tax plan, which was released last January, and it wasn't particularly happy with the plan lawmakers finally approved. The legislation was, Haveman believes, based on several dubious assumptions about Minnesota taxes and is taking the state in the wrong direction. I offered to interview him on the subject because he offered some interesting insights from a different angle of what is one of the more important tax stories of the year.

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What's novel about this particular tax disagreement is that it's just that — a policy disagreement between points of view that disagree but still respect one another. That's true even when a politically volatile issue like taxes is involved. There are no dark conspiracy theories and no threats of economic Armageddon. That's why I love Minnesota. Not to generalize too broadly, but Minnesotans disagree on policy without being disagreeable — even about taxes. It's a lesson from which other states (and the federal government?) could benefit.

Nevertheless, the disagreement over the governor's tax legislation is real, and the disagreement starts with the notion of the state's over-reliance on property taxation and the associated idea that the state tax system has become unfair, the centerpieces of Dayton's argument for his tax plan. "The governor did a good job convincing people that these ideas were gospel around the state," Haveman said. "We think the arguments are, if not wrong, then dramatically overstated."

Much of the problem in Haveman's view began with the 2010 gubernatorial campaign. According to his reading of recent history, the Democratic-Farmer-Labor Party (DFL) and its candidate, Dayton, campaigned heavily on the need for property tax relief. "It was presented as a structural problem that needed to be addressed." In reality, though, the agenda was more about politics. "The bottom line is that this year's tax bill was about fulfilling election promises, not sound tax policy," he said.

In my interview, Frans presented the issue differently. He argued that the traditional balance in the Minnesota state and local tax system had unraveled in recent years. He said, "Our research showed that in 1999, we had a balanced distribution between the three taxes — a third of the total each. By 2010, the property tax accounted for 40 percent of the total; the income tax, a third; and the sales tax, 27 percent."

Haveman said he thinks that assessment fuzzes up an important point. "The DFL analysis is based on the depth of the recession in Minnesota," he said. "The property tax picked up market share back then because sales and income tax collections plunged during the recession. According to the Department of Revenue, if nothing had been done, the balance among the taxes would have returned to exactly the same levels as in the 1980s and 1990s, a time often heralded as a golden era for the state by the DFL."

> ***'The property tax picked up market share back then because sales and income tax collections plunged during the recession,' Haveman said.***

Haveman also pointed out that the starting date for the much-discussed rate of growth in property taxes was a unique moment in state history. In 2001, lawmakers enacted a major buy-down of local property taxes by taking over the general education levy, which reduced school property taxes by more than $1.3 billion, or 55.4 percent, beginning in 2002 — a change described by then-Gov. Jesse Ventura as the "Big Plan."

This state takeover propelled the property tax's share to all-time lows — but only briefly, Haveman said. Other local governments were quick to backfill the new capacity created on local property tax bills. A recession and exploding health and human service spending made it difficult for the state to live up to its new education responsibilities, let alone pump more money into local aid. The predictable result was that cities, counties, and schools pushed their property tax levies higher, eventually canceling out the benefits of tax relief. Then the Great Recession came, sales and income taxes plummeted, and from all appearances, the system was out of whack. In reality, the imbalance was as transient as the reduction in property taxes produced by the Big Plan.

> ***Even before the recent legislation, Minnesota had created multiple mechanisms designed to reduce residential property taxes.***

Haveman's association, the MCFE, is a broad-based group with business members as well as many individuals. You don't normally expect this point of view from a tax association with business members, but, Haveman said, "We're big defenders of the property tax," and he believes the DFL's concern over the property tax is misplaced. "The property tax is a stable revenue source, it's difficult to evade, and it does a fantastic job of calibrating expectations placed on local government with taxpayers' willingness to pay for it," he added. He said that many of the common criticisms of the tax — like its regressive effects on some income classes — simply don't apply in Minnesota. "We have protections in spades," he said, mentioning the state's property tax circuit-breaker program, which he called "the nation's most generous," as well as other forms of tax relief for homeowners and renters.

Haveman has a point. Even before the recent legislation, Minnesota had created multiple mechanisms designed to reduce residential property taxes. First, owner-occupied homes valued at less than $500,000 are taxed at a lower rate than high-value homes, apartments, businesses, and other types of property. Second, homes valued at $413,800 or less are qualified for a homestead exclusion, which effectively shifts a portion of their tax burden onto other types of property within the same taxing jurisdiction. Approved in 2011, this provision replaced a state-paid homestead credit. Finally, the state offers a property tax refund to homeowners and renters based on their income and the size of their property tax bill (or, in the case of renters, the amount of their rent that is deemed to go for property taxes). This program already provided refunds of up to $2,530 for homeowners and $1,600 for renters.

Haveman said that although these benefits shift the property tax burden to other taxpayers — including business taxpayers — the Minnesota business community generally supports this form of tax relief. "It's the most efficient way to provide relief, and it's certainly preferable to tinkering with the classification rates," he said. "The business community supports channeling the relief to those who need help rather than sprinkling it among the needy and the non-needy."

"We go out of our way here in this state to make sure property taxes aren't unaffordable," Haveman said. Moreover, he said you have to wonder why the property tax is seen as such a major problem and another part of the three-legged stool — the sales tax — isn't. "According to DOR's tax incidence study, sales taxes are more regressive and even more disconnected from ability to pay than property taxes when you include the refund programs that became even more generous this year," he said.

> ***Haveman believes that Dayton made property tax relief central to his first term as governor because property taxes were on people's minds because of law changes in the years leading up to the 2010 election, when the state faced recurring fiscal problems.***

Haveman said his members' biggest property tax beef is with the statewide levy on commercial and industrial property, a product of the Big Plan in 2001 and created because the property tax class rate compression as part of the Big Plan was seen as too good a deal for business. According to a 2012 analysis by the Minnesota House Fiscal Analysis Department, the amount of this statewide general levy on these properties initially was $592 million, beginning with taxes payable in calendar year 2002. Each subsequent year the amount of the levy has been increased by the rate of increase in the price index for state and local government expenditures published by the U.S. Bureau of Economic Analysis, essentially the inflation rate for government goods and services.[2]

If all that's true, why did Dayton make property tax relief central to his campaign for office and his first term as governor? The answer, Haveman believes, is that property taxes were on people's minds because of law changes in the years leading up to the 2010 election, a period when the state faced recurring fiscal problems and during which Republicans controlled the governor's office but the Legislature was divided. In effect, these policies, right or wrong, set the political table for Dayton. The Republicans made relatively significant cuts in local aid programs, and the stalemate before the 2012 elections between the Republican-controlled legislative bodies and Dayton marked the end of the homestead market value credit program. "Both of those changes had the effect of putting pressure on local finances and redistributing tax burdens, raising the ire of many taxpayers in the process," Haveman said.

This is a recurring theme in state tax policy not just in Minnesota but nationally. Legislatures tinker with local property taxes or local aid, often to score political points or balance their state budgets, and then are surprised when local property taxes, generally the most important tax source for local governments, rise in response. As voters grow restive over higher taxes, state officials declare a property tax "crisis," which, ironically, they (or their predecessors) helped to create.

That's exactly what happened here. The DFL recognized that taxes were rising and saw an opportunity to make extraordinary political hay. It was the size and extent of the DFL's response once they controlled both the Legislature and the governor's mansion that caught Haveman off guard. "I was astounded it went as far as it did," he said. "I never saw the size of the proposed changes coming."

What's done is done, but Haveman still doesn't believe the whole effort was necessary to accomplish the administration's advertised goals — rebalancing the system and making it fairer. The system would have rebalanced naturally, he said, and there's also evidence that the property tax, the heart of the issue, is much fairer than Minnesotans have been led to believe. The best evidence of that fact comes from Frans's Department of Revenue.

The DOR maintains what's known as the Voss database that allows detailed analysis of property taxes at a level unavailable in any other state.[3] The database was named for former Rep. Gordon Voss, who served on the taxwriting committee and pushed for the information. The Legislature appropriated money for the system in 2008, and it was created by linking homestead records with household income,

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[2]Minnesota House of Representatives, Legislative Analysis Department, "Statewide General Property Tax — January 2012 Update" (Jan. 2012). In addition to commercial and industrial property, the statewide levy also includes, somewhat incongruously, a levy on seasonal residential recreational property — essentially resorts and cabins.

[3]For more information about the database and related reports, see http://www.revenue.state.mn.us/propertytax/Pages/voss.aspx.

home values, and property tax data. The DOR uses the database to calculate such things as effective tax rates (property taxes as a percent of market value), housing consumption (the ratio of estimated market value to income), and property taxes paid as a percent of income. It gives lawmakers a way to get hard numbers on the impact of property tax credits and refunds and other strategies for reducing property tax regressivity.

"You can see ability-to-pay issues developing long before they become a problem," Haveman said. "The idea of a property tax crisis in Minnesota has been overblown. It's the last fiscal worry the state has." Moreover, he said that even if rising property taxes were the problem that's been portrayed, that wouldn't be entirely bad since, he said, high property taxes get people mad and cause them to focus on government spending. "Embrace the hate," he said with a laugh.

Haveman said one of the biggest problems with the administration's tax strategy is the illusion that it will somehow buy down property taxes. He said this is the third time the state has tried this strategy since the 1970s, starting with the sweeping "Minnesota Miracle" in 1971, in which individual income, corporate income, sales, liquor, and cigarette taxes were all increased to pay for new local and school aid programs. Lawmakers tried again in 2001 with the Big Plan. Now, they've tried again, and Haveman thinks the state will have no more success lowering property taxes now than 40 years ago or a dozen years ago. "Forty years of experience says they can't," he said. "Every time the property tax is bought down, the added local capacity is eventually sucked up by cities, counties, and school districts, and it's as if nothing has happened — except that state taxes are higher than they were."

There is evidence Haveman is right on this score, something he wrote about in a recent blog posting. He wrote, "After a legislative session filled with passionate commentary and testimony about out of control, soul-crushing property tax burdens, voters promptly turned around and approved school referenda levies at a record-setting rate. (88 percent or 50 of 57 school districts.)"[4] He added that the DOR recently reported that despite $400 million in additional property tax aids and credits and $485 million in added K-12 education funding over the next biennium, local levies could go up by about $150 million, or around 2 percent, in 2014. This is in stark contrast to the $120 million decline in property taxes originally projected by the state.[5] "It is," he wrote, "another in a long history of 'Captain Renault' moments for property tax policy: a sense of 'shock' over behaviors and outcomes well understood."

Haveman believes that rather than dumping cash in buy-down schemes that won't work, the state should focus on property tax system design, education, and transparency reforms to establish stronger accountability to local taxpayers. In the same blog posting, he pointed out that a November 2012 report by the state's Property Tax Working Group provided an excellent blueprint for reform but is "currently gathering dust."[6]

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The same fundamental misunderstanding applies to the governor's argument that the tax system generally and the income tax specifically were unfair and that higher taxes were needed on upper-income taxpayers to restore equity. "We start off by saying the Minnesota income tax system as a whole is not unfair. Our state consistently ranks in the top three or four most progressive state income tax systems in the country, because of both our progressive tax structure and having one of the most generous and accessible state level earned income tax credits," Haveman said.

Haveman added that during the legislative session, the DFL majority argued that their tax plan would create a "structurally balanced" budget, by which they meant a budget that not only balanced for the next two years but also for the two-year budget period that follows in 2016-2017 biennium. An analysis done by the MCFE after the legislative session last June suggests that lawmakers were successful — at least in part. "Legislators and the governor certainly delivered on that goal — the expected revenue in fiscal 2016-2017 of $41.45 billion are 14.8 percent higher ($5.3 billion) than the 2013 February forecast estimate," the report says. "With those numbers, structural balance in the out biennium should be a layup."[7]

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[4]Mark Haveman, "Another Captain Renault Moment for the Minnesota Property Tax," Minnesota Center for Fiscal Excellence, Fiscal Fitness (Nov. 2013).

[5]"Property Taxes Could Drop by $121 Million Next Year," *Minneapolis Star Tribune*, July 30, 2013.

[6]Minnesota Property Tax Working Group, "Report of the Property Tax Working Group," a report to the Minnesota Legislature (Nov. 30, 2012).

[7]MCFE, "Going Big and Going Home," *Fiscal Focus*, vol. XXXIV, no. 3 (May-June 2013).

The problem, as Haveman sees it, is that the budget also loaded new spending demands onto the state budget that could come back to haunt the state down the line. Based on state estimates, this year's budget will add about $2.2 billion in new spending in the fiscal 2016-2017 biennium on top of existing spending demands — and that total is likely to rise because it excludes inflation. The new spending is going to have to be financed, and it's here that the state may be asking for future trouble, Haveman believes. The budget is structurally balanced in the short-run, but it may be far less secure in the long-run because of this year's tax changes. According to the MCFE report, "The new sources of revenue to support this spending are highly volatile. Tobacco taxes are known for their ability to disappoint revenue expectations; corporate income taxes are notorious for their cyclicality; and the top 2 percent of taxable individual income is almost certainly chock-full of capital gains."

Of particular concern to Haveman are the personal income tax changes. They are likely to make the overall tax system more unstable and unbalanced, he said, adding, "Now that we've passed the new tax law, where are we? Our three-legged stool has become a rocking chair. The income tax will account for more than 40 percent of the total, higher than the metric used to 'prove' the property tax was out of balance in 2010. Also, by targeting only the top 2 percent of income earners, we are targeting proportionately more non-wage income, which is strongly susceptible to the business cycle." Given all this, the center sees trouble brewing. "It wouldn't be too surprising if the projection of structural balance is in jeopardy by the beginning of the next budget cycle," says the center's report.

Another issue on Haveman's mind is what effect the recent changes will have on the state's economic development prospects. He said the state's performance coming out of the recession has been impressive. According to a recent *State Policy Reports* study, Minnesota was among the top states in economic performance during the first quarter of 2013. The state ranked sixth in economic momentum, third in personal income growth, and seventh in employment growth — all highly encouraging after a decade of relative underperformance. The state is also on its best financial footing in years.

But what happens next? Will the new spending lawmakers approved along with the higher taxes polish Minnesota's image or tarnish it? Haveman fears it may be the latter, and he thinks it's time for the state to give more thought to the viability of its traditional approach to government. He said the state generally ranks well in most state business climate rankings because of its quality of life, but that could change if the state continues on its present course. "We shouldn't make the mistake of putting ourselves on too high a pedestal," he said. "We have our own vulnerabilities. Minnesotans could really benefit from a little more economic paranoia."

In this regard, Haveman said that the state is having the wrong debate. "We should have a debate on the value proposition of our public spending," he said. The state, he said, is ignoring another three-legged stool — the three-legged stool of state spending policy. He lists the three legs of this stool as spending adequacy, priority, and productivity. "We have been so focused on adequacy," he said. "It's our Achilles' heel. Minnesotans like public services, so we've always traded higher taxes for more services, but there comes a time when you have to look at what's being spent and evaluate whether it's really a priority and whether we're getting the best possible results from the tax dollars we're spending."

Haveman believes the pressures on the revenue system can also lead to worse tax policy where economic development is concerned. As taxes rise ever higher, Haveman said, Minnesota is forced to invest more heavily in the "deal model" of economic development policy. Its tax climate is less friendly and is becoming pockmarked with special tax advantages granted to attract jobs and investment. The center's newsletter recently zeroed in on the potential problems with this strategy: "The fruits of that strategy will be visible, and its benefits touted, in future ribbon-cutting ceremonies. What we won't know and can never know is the amount of entrepreneurial activity, in-migration of talent, expansion interest, and business siting that never materialized because our new tax and cost environment disqualified us from further consideration."

***Despite the assurances of politicians and tax experts — and the data spewed from countless economic models — no one really knows how any given tax policy will change a state in the long run.***

"Many Minnesotans seem to believe that our economy is totally impervious to the impact of higher taxes," Haveman said. "We ask ourselves: 'Who wouldn't want to live here?' We do have a lot of great things going for us. But we have no idea how many businesses are crossing us off their list of possible locations because of the taxes we just passed. We have just made a big bet on our irresistibility. It's hard to predict how the changes will work out in the long run. It's the great unknown," he added.

And there we have one of the great frustrations of state tax policy. Despite the assurances of politicians and tax experts — and the data spewed from countless economic models — no one really knows how any given tax policy will change a state in the long run, and by the time it might be possible to sift through the data to find out, no one cares because they've moved on to the next Big Plan. I suspect the effects of most tax changes, up or down, are rather less than most people believe, but there are no black-and-white answers — there are only decisions — decisions most often made based on conviction first and data second. That's why most public polices have many sides. In legislatures, conviction comes before data, and as the saying goes, if you torture the numbers enough, they'll confess to anything. ✰

*Billy Hamilton was the deputy comptroller for the Texas Office of the Comptroller of Public Accounts from 1990 until he retired in 2006. He is now a private consultant.*