FISCAL FOCUS

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In This Issue:

2020 Session at a Glance

Our look at a couple of the major tax and fiscal policy issues that will be occupying lawmakers attention this year.

What do you get when you cross a non-budget year with a $1.3 billion surplus, a split legislature with different legislative objectives, and a November when every legislative seat is up for grabs, all in the most surreal and contentious political environment imaginable? The best answer is a lot of proposals that go nowhere except on campaign literature. But there is work to be done and undoubtedly some things will get accomplished as the 2020 legislative session gets underway.

DFL House leadership and Republican Senate leadership have provided outlines of their priorities ("Minnesota Values" vs. "Vision 2020" respectively) absent much of the dollar-related detail that will only come after digesting the release of the February forecast. Outside of commitment to a bonding bill there are not a lot of shared priorities. For those policy topics where the circles do overlap, there are considerable differences of opinion on what exactly to do about them. Moreover, with what's at stake this November, how lawmakers are perceived and portrayed during the session is likely to be just as important to them as what they try to accomplish. It's the sign of an election year when one leader criticizes the other side's "continuing lurch toward socialism" while the other decries efforts to "shortchange Minnesota on behalf of the wealthy, corporations, and insurance companies" even before the gavel to open the session comes down.

2019 Clean Up

While everyone is eager to start tackling the budget surplus in their preferred ways, lawmakers have a couple of leftover issues arising out of the 2019 budget agreement they may wish to address. Neither require action this session, but both have potential implications for how much money is available for supplemental spending and/or tax relief proposals.

First and foremost is the approximately $500 million raid on the budget reserve last session. There is no trigger to restore that sum. It is possible that the statutorily required dedication of a forecasted surplus this November may refill some or all of the reserve. But if lawmakers decide that replenishing budget insurance ought to take first priority over current demands this session, that alone would put a serious check on everyone's ambitions.

Second was the bump in June accelerated sales tax collections to 87.5%. It raised $34 million to balance last year's biennial budget and continues for FY 2021. This bit of budgetary cosmetology and convenience can have noticeable cash flow implications for small businesses.

Meanwhile in Washington, the December passage of the federal "Consolidated Appropriations Act" contains the usual end-of-year federal extenders plus some retirement related tax changes which will throw Minnesota income tax out of whack with federal adjusted gross income. Whether the issues are pressing enough to enact a conformity bill in 2020 remains to be seen.

Tax Policy

Senate Republicans have predictably made relief the tax mantra of "Vision 2020" with two specific proposals mentioned most frequently. The first is a full exemption of Social Security income from state income taxation (see accompanying article for our analysis and discussion of this proposal). As we argue it reflects terrific politics and lousy tax policy – a perspective perhaps best validated by past republican legislative majorities and executive office holders who, despite being enthusiastic supporters of lower taxes all through the 1990s and 2000s, refrained from proposing Social Security exemptions.

The second is conformity to Section 179 expensing – the "Charlie Brown's football" of state tax policy. Conformity to Section 179 had the distinction of being included in the Governor's original tax proposal as well as the tax bills that passed the House and Senate during the regular session only to be dumped in the end. This common ground was once again a casualty in the negotiations from other budget demands – perhaps because everyone pointed their figures at the other parties in the negotiations to use their money to pay for it. The set-up this year is ideal to take care of this issue once and for all — a sizeable surplus to address a front-loaded expense (for effective tax year 2020 about $195 million total for FY21 and FY22 declining to $58 million by FY 23) with no long-term tails.

A compounding problem is the TCJA's changes to like-kind exchanges which makes Section 179 conformity all the more important. The prospect of having to paying state capital gains taxes on exchanges without the benefit of expensing new equipment

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is especially relevant to the beleaguered Minnesota farm economy who are letting their lawmakers know about it. Still, skepticism seems justified that this year's effort for full 179 conformity will end differently as once again there will be plenty of competing demands to use the money elsewhere. Odds are better that a less costly "Ag 179" conformity proposal gets adopted which limits it only to farmers.

On the DFL side, the "Minnesota Values" agenda offers little guidance or sense of what, if any, big tax policy priorities will be pursued in 2020. House Tax Chair Paul Marquart has once again made Section 179 a priority but noted if the dollars are not available to do so, his focus would transition to accomplishing a like-kind exchange fix, which would come at a substantially lower cost. Expect him to also reintroduce some taxpayer transparency and accountability initiatives which has been an interest for him since he took the committee gavel.

The DFL controlled House, however, is not immune to the siren call of providing senior tax relief. A bill has already been introduced to prohibit property value increases on homeowners over 65 with incomes under $60,000, thereby shifting tax burden onto everyone else including lower income homeowners who do not have the good fortune of having most of their income already exempt from state taxation. From a broader perspective, this bill is one of many creative property tax proposals that inevitably get introduced each session (on a bipartisan basis) to target more tax relief to very specific property owner situations and circumstances, subject to a morass of specific eligibility conditions. All of this makes efficient, effective property tax administration a torture at best and impossible at worst. Why we can't just let the nation's most generous and accessible income-tested property tax refund program do its job (along with the special refund program and the senior deferral program) is one of Minnesota's great policymaking mysteries.

The Bonding Battle

Some type of bonding bill seems assured given everyone's strongly expressed commitment to getting one done. The size of the bill has often been — and again may be — a sticking point. The Governor is asking for $2.6 billion, the Republican held Senate has said the $1 billion neighborhood of recent years is more to their liking, while the DFL House has argued for as much as possible without jeopardizing the state's credit ratings. That number is more difficult to pin down, but the MMB's debt capacity forecast offers some perspective on what that might be. The state employs three debt capacity guidelines:

- Total tax supported principal outstanding shall be 3.25% or less of total state personal income
- Total amount of principal (issues and authorized but unissued) for state general obligations, moral obligations, and equipment and real estate leases is less than 6% of total state personal income
- 40% of general obligation debt shall be due within 5 years and 70% within ten years

Adherence to these guidelines places the maximum new debt authorizations for FY 20 at $3.5 billion.

It is reasonable to assume that these guidelines have been reviewed and "blessed" by the rating agencies, so there is little reason to question the wisdom of their use. Interestingly, however, there are no specific guidelines regarding debt service to protect current spending from being crowded out by debt payments. That may be considered unnecessary given the implications of the guidelines the state does use or, as Commissioner Frans has argued, such a guideline would reduce needed flexibility when a stimulus may be necessary. But current state taxpayers have an additional consideration that rating agencies (in the business of selling debt) and buyers of debt (at the front of the line for payment) may care far less about: maintaining the level and quality of public services current taxpayers expect from government while keeping a check on the tax prices being paid for those services.

What should inform this decision making is a more complete perspective on long term state financial obligations. That requires at least some recognition of the billions in "off the books" obligations from unfunded public pensions and related liabilities. Several years ago, J.P. Morgan began presenting a more holistic look at state debt and the degree of state fiscal stress it creates. They calculate state "IPOD ratios" – interest on all net direct debt, plus pension, OPEB ("other post employment benefit") and defined contribution payments as a percentage of state own source revenues. They then compare these to "revised IPOD ratios" – what states ***should*** be paying to meet these long-term obligations.[1] The good news is that in their latest (November 2018) update, Minnesota has one of the lowest revised IPOD ratios in the nation. The bad news is closing the gap between Minnesota's actual and revised IPOD ratios solely through tax increases would require an additional 3% of state own source general fund revenues for thirty years ($631 million in 2017). Importantly, as the report notes, "if spending cuts were chosen instead of tax hikes, they would be similar in magnitude." [2]

That estimate is subject to several key assumptions, and from our review of the methodology it appears the Minnesota revised estimate is likely overstated.[3] Plus, unfunded pension obligations are a qualitatively different kind of government debt for many reasons, not the least of which is that the state has returns from over $70 billion in invested assets to address the problem. The primary point, however, remains. Having $15.2 billion of unfunded liabilities based on the latest valuation reports — 25% more than the state's total existing debt obligations – it seems imprudent to simply ignore this issue especially given the inherent funding risks accompanying market volatility. It took years to pass a modest pension repair bill because of the modest budget implications. We went well over a decade failing to make our annual required contributions because we couldn't "afford to" given other budget priorities. There is plenty of recent evidence that demands for larger state pension aids and the need for larger employer contributions are no different from traditional debt service in demanding and competing for general fund resources.

For all the reasons mentioned earlier, it's unlikely the 2020 legislative session will be looked back upon as a moment of great legislative productivity. However, plotlines

1 "The ARC and the Covenants 4.0: The State of the States, 2018, J.P. Morgan Private Bank

2 Based on 3% of all own source, non-dedicated general fund revenue collected in 2017: MMB November 2017 Economic Forecast

3 J.P. Morgan uses an interest rate assumption on net direct debt of 5% which is substantially higher than what Minnesota pays, and there appears to be an error in the Minnesota discount rate used by J.P. Morgan for its calculations. On the other hand, the methodology employs a 30-year amortization period for unfunded liabilities when the Government Finance Officers Association's standards recommends an amortization period 15 years, not to exceed 20, to avoid intergeneration transfer of obligations.

will begin to emerge following the release of the February forecast and the unveiling of the Governor's self-described "small" supplementary budget sometime thereafter. With this added context, there may be some opportunities for productive negotiations, hopefully without sacrificing fiscal responsibility for the sake of wooing voters. ■

Fire up the Seniors: The Push to Exempt Social Security

Problematic in principle but politically opportunistic, the justifications for exempting all Social Security income from state taxation conflict with policy, economic and demographic realities.

Back in 2017 with considerable bipartisan support, Minnesota enacted senior tax relief with a Social Security subtraction that departed from federal tax treatment of these benefits. The subtraction was subsequently increased in the 2019 session. For republican lawmakers these back-to-back legislative accomplishments have not "addressed the concern" but rather "stoked the fires" to have Minnesota go even further and join the 37 — and soon to be 38 — other states (seven of which do not have state income taxes) in totally exempting Social Security income. In interviews previewing the 2020 legislative session, Senate Majority Leader Gazelka has said this is the centerpiece of GOP's tax policy to do list.

From a budget standpoint, this proposal is not cheap. According to the Department of Revenue a full exemption effective in 2020 would cost the state $435 million in FY 21 and would only go up from there (although past proposals have called for multi-year phase outs to mitigate budgetary impacts). From a tax principle standpoint, it is a Superfund site of horizontal equity problems — "treating equals unequally" simply based on where income comes from. But from a political standpoint, it's shrewd and the reason why the majority of states with state income taxes exempt this income. The entertainingly-blunt tax author and scholar David Brunori once summed the overall situation thusly: "Tax breaks for old people are silly from a tax policy perspective. Under no theory of taxation should a person who turns 62 (or whatever age we pick) magically be exempt from taxation. Let's face it, states offer tax relief to old folks because those folks vote more than anyone else."

Good tax policy principles seldom serve as the north star for navigation in state tax policy debates. So instead it's worth evaluating the merits of the three primary arguments that will be used to justify this proposal.

Stop "Double Taxation" – Proponents argue since individuals have already paid social security taxes all through their working careers, taxing it again at retirement amounts to double taxation. However, the federal government's exclusion, first enacted based on the recommendations in 1983 from the National Commission on Social Security Reform appointed by President Reagan, was designed to address that specific issue.

The existing treatment of Social Security is not double taxation but, in reality, a more favorable tax treatment than private pension income.

Social Security is treated as an earned benefit by the federal government and therefore its taxation is modeled on the taxation of private pensions – paying income tax to the full extent that benefits exceed their contributions. As a 2019 Congressional Research Service report on Social Security taxation notes:

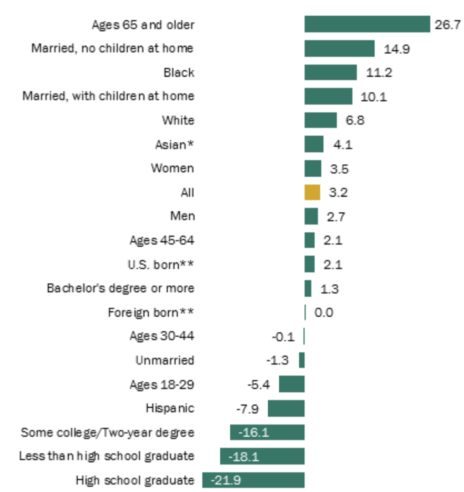
> *"In 1993, the Social Security Administration's Office of the Actuary estimated that, if pension tax rules were applied to Social Security, the ratio of total employee Social Security payroll taxes to expected benefits for current recipients (in 1993) would be approximately 4% or 5%. The actuarial estimates were that for workers just entering the workforce, the ratio would be, on average, about 7%. Because Social Security benefits replaced a higher proportion of earnings of workers who were lower paid and had dependents, and because women had longer life expectancies, the workers with the highest ratio of taxes to benefits would be single, highly paid males. The estimated ratio for these workers (highly paid males) entering the workforce in 1993 was 15% … Taxing no more than 85% of Social Security benefits (the estimated portion not based on contributions by a recipient, including highly paid males) would ensure that no one would have a higher percentage of Social Security benefits subject to tax than if the tax treatment of private and civil service pensions were actually applied."* [4]

In other words, the current "85% taxable cap" established by the federal government on Social Security income exists because actuaries determined that no Social Security beneficiary had paid through Social Security withholding for more than 15% of his or her own benefits. Since most beneficiaries are not "single highly paid males" (who have the highest ratio of taxes to benefits), the existing treatment of Social Security is not double taxation but, in reality, a more favorable tax treatment than private pension income.

Seniors are on fixed incomes and are more economically vulnerable – It's true that younger working households may generally have more income generating opportunities than senior households with the same incomes. It's also true that over the last nearly 50 years, as the accompanying

Older people, married couples and black adults improved their income status more than other groups from 1971 to 2015

Change in a group's share that is upper income minus the change in the group's share that is lower income (% point change)



Note: * Change was calculated from 1991 to 2015 because data were not available in 1971. ** Change was calculated from 2001 to 2015. Whites, blacks and Asians include only single-race non-Hispanics. Hispanics are of any race. Asians include Pacific Islanders.

Source: Pew Research Center analysis of the Current Population Survey, Annual Social and Economic Supplements

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4 *Social Security: Taxation of Benefits*, Congressional Research Service, November 2019

graphic shows, seniors are the undisputed heavyweight champion in improving their income status.

As Pew notes, "The biggest winners overall are people ages 65 and older. They are most likely to have moved up the income ladder since both 1971 and 2001. They are less likely to be lower income and more likely to be upper income than they used to be. Other age groups gained only slightly or lost ground." Pew also notes this change in the economic status of older adults may actually be understated since only income is included and not wealth. Another study found while the average married elderly household had total income equal to 64% of non-elderly households in 1990, by 2013 that percentage had grown to 101%. These significant gains have been achieved with the federal government taxing Social Security benefits at much higher marginal rates than states for over 35 years.

Most importantly, the progressive structure of Social Security benefit taxation insulates seniors whose economic welfare is most affected by its continued taxation. Moreover, the 2017 Minnesota income subtraction (which is phased out at higher incomes) significantly expanded protections to households with higher Social Security incomes. According to the Minnesota Department of Revenue, the number of households with taxable Minnesota Social Security income fell by 94.3% in the state's 4th income decile (household incomes from $33,700 to $44,700); 55% in the 5th decile ($44,700 - $57,700); and 24% in the 6th decile ($57,700 - $74,200). These declines do not include the effects of the 2019 subtraction enhancements.

Keep more Minnesota seniors in Minnesota – Taxes, seniors, and mobility is a complicated relationship. Seniors, of course, move for a lot of different reasons besides taxes. Taxes, of course, also pay for services and amenities seniors need and care about. Even among any seniors whose moves are solely motivated by lower taxes, all forms of taxation will likely be taken into consideration, not just one part of the system. For example, the influential retirement resource *Kiplinger* labels Texas a "not tax friendly state" for seniors despite having no income tax because of its high sales and property taxes.

The correlation versus causation issue has long made efforts to determine the role of taxes generally, and income taxes specifically, in relocation decisions difficult. However, data does offer two worthwhile insights on this topic.

First, tax policy changes don't seem to be necessary to retain most retirees. Research has found elderly populations are actually a very stable demographic to begin with. Less than one percent of the population age 65 and over moves across state lines in a given year – an estimate which has been quite steady over the last few decades and "has been declining, if anything." [7]

Second, the relationship between state social security exemptions and senior outmigration rates is inconclusive at best and non-existent at worst. According to the State Demographer's office, over the 5-year period from 2013-2017, Minnesota's average annual net outmigration rate of -0.13% for seniors 65 and over ranked 15th highest in the nation. Ten of the states[8] with higher outmigration rates fully exempt Social Security income. (Interestingly, the state that had highest net outmigration rate among the 48 contiguous states over this period is South Dakota, which has no income tax at all). Conversely, 7 of the 13 states that fully or partially tax Social Security income had positive net migration rates for seniors.

One subset of seniors may be more at risk — the relatively affluent seniors with higher incomes, greater mobility, greater tax exposure, and the ability to retire/relocate earlier (which the 65+ mobility analysis above does not capture). In addition, the state and local tax deductibility cap in the TCJA has now made state income taxes much more economically relevant than ever before.

The key question regarding the behavior of these seniors is to what extent exempting Social Security would actually influence their decision-making. Affluent seniors receive a much smaller proportion of their income from Social Security benefits. A study examining how income changes in transitioning from work to retirement found the top 40% of senior income earners received one-third or less of their income from Social Security – the top 5% less than 15%.[9] This relative share may, in fact, be significantly overstated. A 2017 research study by U.S. Census Bureau linking survey responses with administrative records from the IRS and other agencies found that the median household income of seniors aged 65 and over was 30% higher than what the Census reported, "mainly attributable to underreporting of retirement income from defined benefit pensions and retirement account withdrawals."[10]

For higher income seniors, any relocation decision-making based exclusively on income taxes (rather than all aspects of the Minnesota tax system) will be far more influenced by the existence of Minnesota's income tax structure — its marginal tax rates and brackets combined with state tax treatment of much larger amounts of other retirement income such as pensions and retirement withdrawals. Whether an exemption of what is often a relatively small fraction of their income could make an appreciable dent in the calculus, or "tip the scales" in favor of staying in the state seems very doubtful.

Even if a full exemption is successful at keeping more seniors as residents, the price tag of this policy deserves consideration. According to the latest information from the State Demographer, there are an estimated 890,000 seniors 65 years and older living in Minnesota. If we apply the national 1% rate of state out-migration to this population, that translates into a "retention price tag" of $49,000 per potential senior migrant to keep them here in FY 21 ($435 million / 8,900). If we very generously assume that one quarter of these individuals would decide to remain in the state because we exempt their Social Security benefits, that translates into $195,000 per retained senior. These "staying put" seniors (and any new ones "recruited" by our now more favorable senior tax policy) would have to generate over four times the size of the state's median 65+ household income in economic benefits to have this tax break pay for itself.

The Wisdom of the Crowd?

Unfortunately, a vicious cycle may be at work, with legislated favors leading seniors

[7] "How has Elderly Migration Changed in the 21st Century? – What the Data Can and Cannot Tell Us" Smith Conway and Rork, *Demography*, August, 2016

[8] Includes D.C.

[9] "Using Panel Tax Data to Examine the Transition to Retirement" Brady, Bass, Holland, Pierce, SSRN.#2928375 March 6, 2017

[10] "Do Older Americans Have More Income Than We Think?" Bee and Mitchell, U.S. Census Bureau, SESHD Working Paper #2017-39, July 2017

to greater involvement in politics and legislated burdens leading the young to greater apathy. It cannot bode well for America's future when the rising generation thinks there's no such thing as a level playing field. Let's be clear: The Concord Coalition does not believe that Americans ought to pay heavy taxes. What we do believe is that in a democracy, once the total cost has been determined, the burden should be fairly shared. Right now, the burden is not-and rolling back the Social Security benefit tax will only make matters worse.

"Taxes on Seniors—How Low Can We Go?" Concord Coalition

According to the State Demographer, the number of Minnesotans turning 65 in this decade will be greater than the past four decades combined. This year, Minnesota's 65+ population is expected to eclipse the 5-17 year-old K-12 population for the first time in history. The total number of older adults (65+) is anticipated to double between 2010 and 2030. By then, more than 1 in 5 Minnesotans will be an older adult, including all the Baby Boomers. Within this demographic shift will likely be a rising number of seniors introducing public finance burdens due to long term care and health care costs — a tab picked up by younger taxpayers adding equity insult to equity injury.

With the current make-up of the legislature and the executive branch, the odds of passing a full Social Security exemption this year are zero. However, these demographic figures and projections guarantee the topic will be a recurring and high-profile feature of state tax debates for many years to come. For anyone looking to cut any taxes, anytime, anywhere, for any reason, just on principle, not taking advantage of this golden demographic environment would amount to electoral malpractice.

Proponents have the apparent wisdom of 37 (and soon to be 38[11]) other states behind the cause. However, Minnesota should reject the wisdom of the crowds. There is an important reason why Minnesota has been a national outlier on this issue for a long time. That reason is reflected in the powerful long-term budget, spending, and tax fairness implications arising out of those very same State Demographer figures and projections. ■

[11] West Virginia will have fully phased out their taxation of Social Security benefits in 2022.

Time to Reassess the State Property Tax

As local levies rise accompanied by calls for more aid and more local sales tax authority, state government's still sizeable presence in the commercial and industrial tax base of local governments demands some renewed attention.

When the State General Levy Tax– the statewide property tax levy on business and cabin properties – was created in 2001 it served both political and policy interests. Politically, it generated revenue needed to grease the passage of tax reform (Governor Ventura's "Big Plan") while addressing the complaint that businesses were getting too sweet a deal from class rate compression which reduced business property subsidization of homeowners. Policy-wise it shifted responsibility for addressing property tax competitiveness problems from local governments to the state while introducing a modicum of additional stability to the state revenue system.

But it also marked a departure from a traditional and long-held idea in public finance – that the property tax should "belong" to local governments. Books have been written about how self-determination in raising revenue is the key to maintaining strong local governments, and how local governments' exclusive rights to the use of property taxes contributes to its effectiveness as a local tax, greater accountability, and promoting local autonomy. The existence of the state general tax means up to a third of business property taxpayers' payments support state rather than local government operations making hyper-sensitive local levy decision-making more difficult and contentious.

Minnesota is one of only two states that limit state property taxation to specific property types.

About a decade after its passage, some indications of buyer's remorse became evident. In 2010, the legislature established a Property Tax Working Group comprised of a bipartisan group of legislators and local government stakeholders to examine Minnesota's property tax system and develop recommendations on "how to make the system more simple, understandable, transparent, accountable, and efficient." The first "guiding principle" used by the working group to develop their 2012 recommendations argued for a return to the property tax's historical roots:

> ***Defend the Purpose*** *— The purpose of the property tax is to provide a* **local** *revenue source to pay for* **local** *services (emphasis theirs). Although the state should define a uniform structure, the tax should be accountable to local people and the state's involvements should be very limited. It should not be an arena for state legislators to serve constituent interests. The property tax is foremost a local revenue system, not a vehicle for state policies.*

Eight years later the tax has been cut and tweaked in several ways, but it remains a three-quarters of a billion dollar vehicle for state policies per year.

An Outlier Among the States

Just how unusual is Minnesota's claim on local tax bases? At first glance, findings from the 2018 Census of Governments gives the impression it's not that uncommon. Thirty-six of fifty states report state property tax collections, although as a share of total state revenue, the majority of state collections are very modest.[12] In 21 of the 36 states, property tax share is less than 4% of total state collections. Minnesota reports 3.1% of state tax collections from property taxation.

On closer inspection, however, most of these states' property tax collections are limited to state ad valorem taxation of tangible personal property, not real property. Annual ad valorem taxation for vehicle registration/

[12] State reporting methods may distort reported state property tax collections. Despite the Bureau's supporting technical documentation and government finance classification manual, states may still differ in their interpretation of this information resulting in different categorizations/accounting of revenues. One major example is Arkansas which in 2018 reported over $1.2 billion in state property tax collections (over 12% of state tax collections) despite having a ban on statewide property taxation. Our best explanation based on communication with an Arkansas official is that a state law which mandates all school districts must maintain a minimum rate of 25 mills for maintenance and operation of the district is being reported to the Census as a "state property tax collection."

licensing/title purposes is by far the most common example of this. Certain real estate transfer and related taxes in which the tax amount is determined by the value of the property is another state revenue source likely being classified as "state property tax revenue" by some states.

As the accompanying table shows, only 16 states levy taxes on real property. Within this smaller population Minnesota further distinguishes itself in three ways:

- Minnesota is one of only four states that use all or some portion of their real property tax collections for general fund appropriations. Most states dedicate 100% of their real property tax revenues to specific spending purposes — K-12 education and state debt service being by far the most common.
- Minnesota is one of only two states that limit state property taxation to specific property types. Most state real property tax collections apply to all property types.
- Minnesota appears to be one of a very small minority of states that levies to determine total state property tax collections. Most states employ a "rate driven system" that applies an established statewide mil rate to taxable property value.

Table 1: State Taxation of Real Property for State Expenditure Purposes[13]

State	Real Property Taxed	Revenue Generated from State Real Property Taxation	Disposition of Revenue
Minnesota	Limited to business and cabin property	2020 C/I Levy: $737.09 million 2020 Cabin Levy: $41.69 million 2020 Total Levy: $778.78 million	State general fund
Alabama	All real property	$359 million	K-12 education – 46% Property tax relief – 15% State general fund – 39%
Kansas	All real property	$739 million	K-12 education - $679 million State buildings fund - $60 million
Kentucky	All real property	$294 million	State general fund – 100%
Maryland	All real property	$835 million	GO bond debt service – 100%
Michigan	All real property	$2.085 billion	K-12 education – 100% (School Aid Fund)
Missouri	All real property	$34.2 million	Blind Pension Fund – 100% (social assistance program)
Montana	All real property	$273 million	School equalization - 94% University system - 6%
New Mexico	All real property	$83 million	GO debt service Conservation/natural resources
North Dakota	All real property	$4.5 million	UND Medical School – 100%
Vermont	All real property	$1.106 billion	K-12 education – 100% (Vermont Education Fund)
Washington	All real property	$3.349 billion	K-12 education – 70% Higher education – 30%
West Virginia	All real property	$6.9 million	State general fund
Wyoming	All real property	$250 million	K-12 education – 100%
Nevada	All real property	$158 million	State debt service – 100%
Alaska	Limited to oil and gas exploration, production, and pipeline transportation property	$125 million	State general fund

Sources: List of statewide property taxes was obtained from "How States Can Tax Wealth" Citizens for Budget and Policy Priorities Issue Brief, October 1, 2019. Some states CBPP identified as having limited statewide real property taxes are excluded from this analysis based on our review and subsequent discussions with state officials (see for example, footnote 2). Revenue totals obtained from most recent state Consolidated Annual Financial Reports and related materials. Revenue disposition information obtained from state CAFRs, state Departments of Revenue, Finance, or Treasurer's offices and contact with state officials.

Put it all together and it is quite reasonable to conclude there is nothing like the state general tax anywhere else in the country.

The Dedication Question

When lawmakers created the state general tax, there was a push to have this money dedicated to K-12 finance. That effort was rebuffed, but schools would have by far the strongest claim on any such dedication since the Minnesota Constitution makes it clear that providing for "a thorough and efficient system of public schools" is a state responsibility. The Legislature's 2012 Property Tax Working Group recommended restoring the property tax to being a true local tax and eliminating the use of property tax for state funding. However, the report also concluded, "if the state property tax continues to be levied, the revenue should stay within the local system and be given directly to school districts and other local units of government."

As Table 1 shows the most common beneficiaries of state property tax revenues across the nation are state public school systems. However, in many if not all these states, state property taxation arose out of education finance reform prompted by court-influenced equalization demands requiring the state to assume a larger role in education finance. That is something Minnesota has been doing for 50 years since the Minnesota Miracle, albeit with traditional general fund revenue sources.

There is no evidence to support a claim that the failure to dedicate state general levy revenue to schools has diminished or undercut the state's financial commitment to public education. According the latest information from the National Center for Education Statistics, Minnesota provides $3.73 of state support for every dollar of local property tax support for K-12 education. That ranks Minnesota 5th highest in the nation (behind two states that are essentially state K-12 systems) and nearly three times the national average. As Table 2 shows Minnesota's state share of K-12 financing is actually greater

[13] Several state-required property taxes that are collected locally but remain within localities or property taxes collected by the state solely for administrative purposes are not included in the table. An example is New Hampshire's "Statewide Education Property Tax" (or SWEPT) which remains in the districts where it is raised. Despite this, it is considered a "state tax" for accounting purposes and reported as such to the Census Bureau. Another example is Maine, which collects local property taxes at the state level to administer local finances for unincorporated areas of the state in cooperation with counties.

Table 2: Division of Education Finance Responsibilities Between State and Local Governments: Minnesota vs. States Dedicating Statewide Property Tax Collections to K-12 Education

State	State Share of Total K-12 Revenues (including federal)	State Share of State and Local K-12 Revenues Only	K-12 Spending Per Pupil
Minnesota	**66.8%**	**70.8%**	**$14,766**
Alabama	54.7%	61.5%	$12,064
Kansas	63.1%	69.0%	$13,510
Michigan	60.2%	66.0%	$11,940
Montana	47.7%	54.6%	$12,775
Vermont	89.3%	95.7%	$18,905
Washington	62.2%	67.1%	$13,440
Wyoming	57.6%	61.3%	$19,063

Sources: 2018 Digest of Educational Statistics, National Center for Education Statistics; Table 235.20; *How Does Minnesota Compare* FY 2017, MCFE, December, 2019

than all the states with K-12 dedicated state property taxes with one exception (Table 2).[14] Minnesota's spending per pupil is also greater than most of these states. Importantly, Minnesota business properties do not "escape" education finance responsibilities from not dedicating the state property tax. All taxable commercial/industrial property pays every type of local school levy, whether based on net tax capacity or referendum market value.

Even if there is agreement with the Working Group's recommendation that if you can't get rid of the tax, then give it to schools, there is a big implementation challenge making this idea problematic. Distribution complexities aside, government revenues are fungible, and lawmakers would inevitably take the existence of this dedication into account as part of their broader education finance decision-making and the general fund appropriations process. As we witnessed with the passage of the Legacy Amendment several years ago, efforts to circumvent the fungibility problem with "supplement not substitute" type language are chock full of complex interpretation issues, questions and determinations rendering such provisions largely unenforceable.[15]

Even if these revenues would be dedicated, there is reason to doubt K-12 education finance would be meaningfully changed.

Love Thy Enemy

As annoying as property taxes are to citizens, they remain indispensable to local finance. Last November, 88% of school operating levies and more than 70% of school bonding levies on Minnesota ballots passed – one of the highest success rates ever. It's impossible to imagine any kind of state tax increase that would have enabled this support for schools. Minnesota ranks 14th in the nation in K-12 spending per pupil. Of the 13 states that spend more per pupil, 8 of them receive more money from local property taxation than they do from the state.

Protection and preservation of the local tax base is one of the best things the state could do to support not just education finance but all local governments. The ongoing challenges and needs of local government will get a lot of air time in front of the legislature over the next couple months. This will be accompanied by calls for different types of state action. Restoring the property tax as a true local tax needs to be part of this discussion. ■

[14] Vermont converted all local school property taxes to a state-levied property tax and is essentially a centralized state system.

[15] In its 2011 evaluation report on the Legacy Amendment, the OLA identified and discussed the many challenges surrounding compliance with the "supplement not substitute" provision. The OLA's several pages of analysis on this topic might best be summed up by this statement: "We know that some legislators, agency officials, and other stakeholders were expecting that, through this evaluation and our financial audits, the Office of the Legislative Auditor would provide detailed guidance on what the Legislature and recipients of Legacy money must do—and not do—to comply with the "supplement not substitute" provision. We found no basis from which to offer that kind of guidance."

From The Director

Mark Haveman

This issue discusses two tax policies in some detail — the state general tax which essentially no other state in the nation does, and a full exemption of Social Security which the vast majority of states do except Minnesota. Aside from making Minnesota a national outlier, these topics may seem to have nothing in common. But I think there is an underappreciated thread that connects them: the triumph and growing influence of compelling tax politics over tax policy.

I've been with the MCFE for less than twenty years, but I've talked to enough longtime capitol veterans to know this wasn't always the case. Many of my members remember a time long ago when lawmakers on both sides would refrain from putting tax and spending ideas into play they knew were not in the best interest of the state but were red meat for voting constituencies and could be weaponized to pick up some legislative seats. Those days appear to be over. Retail tax and spending policy has won.

I don't know if this was just some odd moment in time, or some ethic or attitude that was also uniquely Minnesotan. But I strongly suspect it was an underrecognized and underappreciated contributor to Minnesota's economic performance over the years.

We need to compete with smarter and more efficient taxing and spending. How we do these things matter as much, or more, as how much we do them. Republicans argue we can't afford our tax burdens and Democrats argue we can't afford not to "invest." What we really can't afford is tackling these topics the way we've been approaching them.

— M. H.

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