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September – October 2021 Volume XLII No. 5

SPECIAL REPORT
Tax Reliability: The State of Minnesota's "Big Three"

Nine years ago this fall, a piece of misshapen furniture was the cause célèbre of our state tax policy debate. In tax reform listening sessions held by the Dayton administration across the state, an unbalanced three-legged stool was used as a prop to symbolize what was wrong with the state tax system. The three legs of the stool represented the relative dependence on the state and local government's three primary revenue workhorses – individual income, sales and property taxes. It represented an apparently unstable, out of balance tax system that had become far too reliant on the property tax leg.

Compelling as it was, this portrayal was misleading, if not disingenuous. That's because the stool's legs represented tax revenue share at an exceptionally unusual moment in state fiscal history otherwise known as the Great Recession. Relative property tax share of the "big three" had skyrocketed because much more volatile sales and income tax collections had plunged no less dramatically. According to the Department of Revenue's own analysis at the time, if absolutely nothing changed the balance among three taxes emerging from the recession would have quickly returned to the same levels as in the 1980s and 1990s – a period likely regarded by many DFL reform advocates as a golden era of state tax policy.

More fundamentally, the implied notion that tax balance should strive to have each of the three major forms of taxation collect roughly the same amount of revenue has several conceptual problems. For starters, the Minnesota own source revenue system is, of course, much more than just the "big three." In 2020 the state collected $4.4 billion in other tax (and fee) revenue representing 16.9% of total state tax collections - a not inconsequential piece of the revenue puzzle. Second, since state and local government access to, and use of, different taxes can be very different, how a state chooses to divide public service delivery responsibilities between state and local government has implications for tax reliance. Finally, there are the time-tested principles of good tax policy which includes its own "big three" – equity, efficiency, and simplicity. Any attempt to pursue "balance" in a tax system must still be pursued in the context of these bedrock criteria.

However, there is an important and often underappreciated tax policy matter to contemplate here. What policy makers should consider when thinking about tax balance is reliability -- the system's ability to support expenditure programs over the long run and provide dependable streams of revenue even as the underlying economy structurally evolves and varies with the business cycle. Diversity in the tax system, like an investment portfolio, supports such an objective. But it also requires a closer look at the structure of specific taxes because "how" these taxes are collected in a state can have significant impacts on their growth trends and variability in collections. We take a closer look at the "big three" in this context by providing some current "vital statistics" pertaining to each tax, structural considerations impacting the revenue collections, and some relevant policy issues going forward.

Fiscal Focus (USPS 519130) (ISSN 1042847X) published Bi-monthly in February, April, June, August, October & December by the Minnesota Center for Fiscal Excellenece, 85 East Seventh Place, Suite 250, St Paul, MN 55101. Periodicals postage paid at St Paul, MN. Postmaster: Send address changes to Fiscal Focus, c/o Minnesota Center for Fiscal Excellence, 85 East Seventh Place, Suite 250, St Paul, MN 55101.

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Individual Income Tax: A Horse Ridden Long and Hard

Minnesota is more reliant on the individual income tax than ever before making the implications of its structural features more relevant than ever before.

Vital Statistics

- Based on latest state and local government census information, Minnesota's individual income tax collections are 24.7% above the national average on a "cash income" basis[1] placing us 6th highest in the nation (among states with an income tax). For some additional perspective, to drop out of the nation's top ten on individual income taxation, state income taxes collections would have to be reduced by approximately $1.6 billion per year or about 12.5 % (which translates into a roughly .9 percentage point reduction in marginal rates across the board).

- Minnesota's own source revenue collections are 44.1% more dependent on the individual income tax to fund state and local government operations than the national average. Looking specifically at the general fund, MMB reports the individual income tax now provides 52.5% of all general fund resources, an all-time high that exceeds the levels that existed before the state income tax rate cuts at the turn of this century. For any remaining stool enthusiasts concerned about mathematical balance, the income tax leg share measure is now over a percentage point "longer" than the property tax leg was at that highly anomalous moment in time nine years ago.

[1] Essentially all BEA personal income that can be remitted to government to pay for taxes and fees, plus capital gains and retirement distributions/benefits. Source: *How Does Minnesota Compare*, for Fiscal Year 2019 (publication forthcoming), MCFE.

- The dependence is also reflected in the comparative growth rates of individual income tax collections with general fund expenditure growth. Over the last 10 years, average annual growth in individual income tax collections has been 5.26%, or 15.4% faster than the 4.56% average general fund expenditure growth over that same period.

Structural Considerations

The defining feature of our income tax structure is its progressivity. As a result, our increased reliance on the tax correlates to an increased reliance on the state's highest income earners. According to the latest Minnesota Tax Incidence Study, the 5% of all households with the highest incomes now account for 47.1% of state individual income tax collections, up from 43.2% ten years ago and 40.9% from 20 years ago. Over the last 20-year period the top 5% of households share of total state household income increased marginally (31.4% to 31.9%). Interestingly, for the top 1% of households, share of total income tax collections increased from 23.3% to 27.1% over the last twenty years while their share of total state household income actually decreased from 17.2% to 16.5%.

Tax scholars who have studied the changes in state income tax revenue relative to growth in a state's economy have long recognized that progressivity in rate structures is an influential factor in tax revenue productivity. But it comes with greater volatility. A seminal analysis from 30 years ago concluded states with progressive rate structures get greater tax revenue growth, but at the cost of almost twice the variability.[2] That was a generalized conclusion since this analysis did not factor in the differences that exist among states in their income tax structures (tax return starting points, where marginal rates are imposed, exemptions, deductions, credits, etc.) As the authors recognized – "*tax structure* (emphasis theirs) is an important determinant of the growth and variability of state taxes."

Undertaking this more detailed investigation is a complicated and mathematically complex task, but one 2018 study that examined the responsiveness of the state tax systems to GDP changes factoring in state tax policy changes and effects did offer some perspective on Minnesota.[3] Perhaps surprisingly, this study found Minnesota's long-run individual income tax productivity largely in synch with GDP changes over the 35 year study period (while other highly progressive income tax states like New York, New Jersey and California demonstrated much larger collection responses to changes in GDP). At the same time, Minnesota's income tax collections recovered from a GDP shock over twice as fast as the national average. It's worthwhile noting this investigation covered the period from 1967 – 2012 which includes the rate cuts around the turn of the century but before the adoption of the fourth tier, the passage of the TCJA and the state response to it, and all the volatility of the COVID economy. Overall, the study demonstrated the considerable diversity that exists among states in the volatility, reliability, and resiliency of revenue systems related to tax structure.

Policy Issues

With a bulging budget reserve and collections continuing to thump expectations, the state income tax system's ability to cope with business cycles, better accommodate the countercyclicality of a lot of government spending, and "keep pace" with the long-term economic trends, may seem like a non-issue. But times and circumstances do change, and tax experts generally agree that extreme reliance brings out the worst features in a tax. Whether the state's individual income tax needle now points to "extreme" can be debated, but the fact that our increasing reliance elevates the potential impact of its structural features cannot. Two policy issues deserve particular recognition.

Higher rates and the continuing push for yet more progressivity – Despite having declined in recent years, the volatility of the Minnesota individual income tax base is still over twice as volatile as the general sales tax base and about five times more volatile than the property tax.[4] Pursuing even greater dependence on the tax by creating greater dependence on the state's highest income earners – whether it be through a fifth tier, special capital gains taxes, or other proposed means – exacerbates income tax volatility in two ways. The first pertains to the income composition of higher income households. Salaries and wages have long been recognized as the most stable and predictable component of the tax base across the business cycle. As income rises and income composition changes, that relationship weakens. According to the latest IRS statistics on income for Minnesota only 40.6% of AGI from households earning $500,000 or more come from wages and salaries (and only 30.9% for incomes over $1 million). The bulk of the rest comes from almost certainly more volatile net capital gains, dividends, and business income.[5]

Salaries and wages have long been recognized as the most stable and predictable component of the tax base across the business cycle. As income rises and income composition changes, that relationship weakens.

The second lies in behavioral responses to income taxation. Research has shown behavioral responses to changes in marginal tax rates are concentrated in the top of the income distribution – especially concentrated at the top 1% – with less evidence of any response from the middle and upper-middle income class.[6] Behavior responses

2 "Growth and Variability of State Individual Income and General Sales Taxes" Dye and McGuire, *National Tax Journal*, March, 1991

3 "State and Local Property, Income, and Sales Tax Elasticity: Estimates from Dynamic Heterogenous Panels" Anderson and Shimul, *National Tax Journal*, September 2018

4 "Minnesota Revenue Volatility and Budget Reserve Target" Presentation by MMB to Senate Finance Committee, January 2019. Updated October 13, 2021

5 The conditional volatility of the revenue components making up the individual income and sales tax base are estimated by MMB in setting the budget reserve target but were not made available to us.

6 "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," Saez, Slemrod, and Giertz, *Journal of Economic Literature* 2012, 50:1, 3–50

can include timing, shifting, and other forms of income avoidance in addition to physically moving. And while tax-induced migration is the behavioral response most frequently debated, the long-term behavioral response of businesses to individual income taxation and the resulting impacts on economic growth may be more important. All else equal, higher individual income taxes create an incentive for individuals to apply their talents elsewhere. But if employers must compensate employees for the higher burden with higher pre-tax wages to level the playing field, labor costs go up and the case for expanding and growing business within Minnesota becomes that much more challenging. As we recently discussed, in recent years Minnesota has experienced a small but steady net out-migration of moderate-to-high-income filers of workforce age, even in the years when Minnesota net migration of all working age filers was decidedly positive.[7]

New tax base exemptions focused on seniors – In our last legislative session, about a half dozen bills were introduced and heard in tax committee hearings to exempt various amounts of additional retirement income. They ranged from modest expansion of our existing Social Security exemptions to complete exemption of all government and private retirement income. Putting aside the potentially major horizontal equity problems (treating income equals equally) that can result, research has found the failure to tax pensions and retirement income is a statistically significant explanatory factor reducing the productivity of the income tax in relation to state economic growth and an indication that pension income is rising faster than other sources of income.[8] According to the IRS Statistics of Income, taxable private and government retirement income in Minnesota now constitutes over 11% of state AGI and has grown at an average annual rate of 6.0% over the past 5 years. With many more baby boomer retirements looming, policy makers need to carefully consider the long-term revenue reliability implications of tax proposals popular with a constituent demography that votes at above average levels but is often increasingly dependent on government services.

7 "Income Taxes, the TCJA, and Taxpayer Migration" MCFE *Fiscal Focus*, May/June 2021

8 "Tax Base Elasticities: A Multi-State Analysis of Long Run and Short Run Dynamics," Bruce, Fox, and Tuttle, *Southern Economic Journal*, October, 2006

Sales Tax: In Need of Attention

Minnesota's reliance on the state sales tax to fund government has dropped precipitously in recent years, partly because of the income tax's ascendance but also because of significant structural issues and challenges pertaining to the tax itself.

Vital Statistics

- Minnesota's sales tax revenue collections (state only) are 20.8% above the national average based on a percentage of personal income basis, placing us tied for 17th in the nation. A contributing factor is our general sales tax rate of 6.875% which is 6th highest in the nation. However, Minnesota sales tax reliance which represents 27.3% of total state tax revenue in FY 2020, is 19% below the national average or only 39th highest among the 50 states (again communicating our growing dependence on income taxation). That level of reliance is a slight rebound from 25.1% in 2018, but still a major drop from the turn of this century when the retail sales tax represented 35.1% of total collections. Only two states reduced their reliance on state sales taxes more than Minnesota in the last 20 years, while over half the states increased their relative reliance on the tax.[9]

- Looking specifically at the state general fund, sales tax collections over the past 10 years have grown at a modest 2.85% average annual growth rate –over one-third slower than the 4.56% rate of average annual general fund expenditure growth over that same period.

- Over the past ten years this 2.85% average annual growth rate has substantially lagged that of the individual income tax (5.26%), and all of the other general fund tax revenues combined (4.49%).

- Minnesota's **total state and local sales** tax collections, are 9.8% below the national average on a "cash income" basis[10] or 31st highest in the nation (among states with a general sales tax) indicating comparatively less use of sales taxation by local governments. For some additional perspective, to climb into the nation's top ten on state and local sales taxation, collections would have to increase by approximately $4.1 billion per year or about 56%.

In 2000 Minnesota's sales tax base breadth was 52.7% greater than it is today – a function of the tax structure unresponsive to changes in the economy, technology, and demography.

Structural Considerations

From a sustainability/reliability perspective, the condition of the sales tax base is the primary concern. As one scholar put it, "unlike the income tax where legislators start with a relatively broad base and may shrink it over time through various deductions or exemptions, the sales tax starts with a relatively narrow base that must attempt to keep with real time changes in consumption patterns and new products."[11] Nor is the tax base immune from the introduction of new exemptions – both product and purchaser based. In keeping in some semblance of synch with the economy, it's a battle on two fronts, and the relative moribund performance compared to the rest of the Minnesota tax system suggests we are losing the battle.

9 "State Retail Sales Taxes in 2018" Mikesell, *Tax Notes State*, September 30, 2019; updated in "State Sales Tax Breadth and Reliance, Fiscal Year 2020, Walczak, Tax Foundation, February 2021. These figures differ from our *How Does MN Compare* report which combines and compares both aggregate state and local sales tax collections across states and uses "cash income" instead of personal income in calculations.

10 Essentially all BEA personal income that can be remitted to government to pay for taxes and fees, plus capital gains and retirement distributions/benefits. *How Does Minnesota Compare*, for fiscal year 2019, MCFE.

11 "Taxing Goods and Services in a Digital Era" Agrawal and Fox, *National Tax Journal*, March 2021

The breadth of a state's sales tax base can be roughly measured by the share of total state personal income (a proxy for GDP) included in the sales tax base. In 2020, Minnesota's sales tax base breadth was 32.09% which is actually 7.4% (2.29 percentage points) higher than the national average. Given our exemptions of some major purchasing categories like food and clothing (the latter exemption being quite rare among the states), Minnesota's sales tax base has a reputation of being much more constrained than the average state. These figures indicate that reputation is not justified. However, in 2000 Minnesota's sales tax base breadth was 52.7% greater than it is today – a function of the tax structure unresponsive to changes in the economy, technology, and demography. Nationally, average sales tax base breadth was 63.1% higher 20 years ago indicating Minnesota is far from alone in dealing with some challenging trends.[12]

There are many factors contributing to the shrinkage of the breadth of the sales tax base but two stand out. The first is the increasing role service consumption plays in the economy. When states first began adopting sales taxes 100 years ago services represented about 25% of household consumption. Today it's about 70%.[13] In their most recent taxation of services survey, the Federation of Tax Administrators finds Minnesota tied for 20th in the nation in the number of services taxed (67 out of 176 total services). We are above the national median in the number of utility, personal, business, and on-line services taxed and below the national median in the number of computer, professional, fabrication/repair/installation, and "other" services.

Certain services can have a disproportionate impact on both base breadth and revenue collections. Nowhere is this truer than in health care which is largely politically off-limits to sales taxation. Health care expenditures now account for 17.7% of the nation's GDP, up from 13.3 % in 2000. Health care's share of the economy is now three times larger than when Minnesota established its general sales tax.

The second is the pervasive role and impacts technology have in the modern economy and the disruptive force technology developments can exert on the structure and function of the state sales tax system. Internet commerce was the first major challenge states had to grapple with, and after many years (with a huge assist from the U.S. Supreme Court) states now have the ability to tackle the remote vendor problem. But new technology-driven challenges are materializing every day and will continue to do so in the future. These include the "sharing economy" (e.g. VRBO and Uber) which are peer-to-peer transactions of goods and services; digital products and cloud services; and other examples in which new and existing products are provided in a novel way. Many of these developments blur traditional statutory classifications making it unclear whether it falls into a taxed or exempt category. Such new product and service introductions also can entail administrative complexities making tax enforcement "complicated, expensive, or nearly impossible." [14]

Yet, a failure to address base-related developments have potentially profound implications for the health and welfare of the tax system. Inattention can trigger new neutrality and fairness issues including new examples of "bricks and mortar vs. e-commerce" type-conflicts. In addition, further constraints on the tax base increases pressure to push sales and other tax rates higher to maintain needed tax revenue.

If this seems to paint a rather dismal picture of the condition of the typical state sales tax, many experts would concur. A recent analysis concluded "U.S. state sales tax systems are among the most inefficient and ineffective general consumption taxes in the world," and "this systemic failure is reflected in a dangerous underreliance on consumption taxes and an overreliance on income, payroll, and property taxes overall in the United States." [15] These authors identified four strategies to modernize state sales tax systems. All, however, entail political challenges associated with national legislative action and/or multi-state coordination and cooperation that would seem to rival anything a state would try to accomplish on its own.

Policy Issues

The sales tax remains an essential part of state finance, and its continued productivity is essential to the state revenue system adding needed reliability and diversity. However, state sales tax modernization efforts face some major reform headwinds.

The challenges of doing base expansion "correctly" – There is universal consensus among tax experts that the ideal sales tax should be imposed on all final personal consumption – both goods and services – and that it should exempt all intermediate, "business to business" transactions to avoid layering or "pyramiding" taxation on the final product or service. Minnesota's existing sales tax base already represents a significant departure from this ideal. According to a recent Ernst & Young analysis, Minnesota's share of state and local general sales taxes attributable to business inputs is 46.5%, 10th highest in the nation.[16]

Any base broadening efforts are likely to struggle further with improving on this ideal. For example, in 2013 the Dayton administration proposed sales tax reform/modernization which would have taxed a number of new services and products in conjunction with a 23% reduction in the general sale tax rate. However, according to an analysis at the time by the Department of Revenue, 80% of the total increase would have been paid by businesses. The primary challenge is the large overlap in the universe of goods and services purchased by both individuals and businesses. Discriminatory taxation of the same types of purchases introduces administrative complexity and is also prone to potential tax evasion problems. Moreover, economic concepts notwithstanding, individuals would likely object to the idea of paying the sales tax on the same product or service that the successful business down the road does not.

In short, any state sales tax base modernization effort is much more than simply selecting from a list of previously untaxed goods and services and adding them to the tax base. It would require a careful examination and understanding of potential economic distortions, competitiveness implications, and practical tax enforcement consider-

[12] Mikesell, 2019 and Walzcak update, 2020

[13] Agrawal and Fox, March 2021

[14] How Does the Depression-Designed the Retail Sales Tax Cope with the New Economy? Mikesell, Mullins, and Kioko, *National Tax Journal*, March, 2021

[15] "U.S. State Sales Tax Systems: Inefficient, Ineffective, and Obsolete", Frieden and Lindholm, *Tax Notes State*, November 30, 2020.

[16] Total State and Local Business Taxes: State-by-State Estimates for FY20, Ernst & Young, State Tax Research Institute, Council on State Taxation, October 2021

ations while balancing these issues with state revenue needs.

Dealing with sales tax regressivity – As the state's tax incidence study indicates, state sales taxes are regressive, and state policy makers have demonstrated they are keenly aware of this fact. On the rare occasions when bills expanding the sales tax base have been introduced, some form of refundable sales tax credit, expansion of the earned income tax credit, or other compensating policy measure has often accompanied it.

However, there are three underappreciated issues adding nuance to the relationship between tax regressivity and sales tax base expansion deserving recognition:

- Base expansion can make the sales tax less regressive. Research has found that state ability to now tax e-commerce along with adoption of marketplace facilitator language has made sales taxes less regressive since much of the increase in revenue has come from middle-income and upper-income consumers.[17] Similarly, "personal services tend to be more discretionary than consumption of goods. Consequently, higher income individuals tend to spend a greater share of their income on services which are frequently untaxed." [18] Even goods typically considered to be "off limits" to sales taxation because they fall into the category of basic needs have complicating considerations. For example, a study of consequences of the nontaxability of food under the Supplemental Nutritional Assistance Program concluded, "because SNAP effectively targets poor households and because SNAP benefits are nontaxable, the poor do not really benefit from the sales tax exemption for food at home. Indeed, almost surely they would be better off if food at home were in the tax base and revenue-neutral adjustments were made to the sales tax rate." [19]

- Income vs. Consumption Incidence. The regressivity of our sales tax is measured on income-based incidence, which is the share of income consumed by the tax across income deciles. However, many economists argue that annual expenditures are a superior and more reliable measure of household well-being than annual income. Therefore, whether a certain tax is regressive or not should also be analyzed by examining whether the tax places a higher burden on lower-expenditure households than on higher expenditure households. Research has shown that the reported regressivity of taxes can change significantly using an expenditure-incidence perspective. For example, as one scholar concluded, even the incidence of the gas tax becomes far less regressive for the simple reason that "low expenditure households devote a smaller share of their budget to gasoline" and as a result "the share of expenditure devoted to gasoline is much more stable across the population than the ratio of gasoline outlays to current income." [20]

- Tax Regressivity Supports a Lot of Progressive Spending. Judging the merits of a specific tax exclusively on its progressivity fails to recognize that our progressive spending programs demands a revenue system that won't harm economic growth. Economists have long identified taxes on consumption as the best means to accomplish this objective. That is why the value added tax – an alternative (and regressive) consumption-based tax – is a staple of government revenue systems around the world, especially among governments featuring larger social safety nets and strong redistributive spending programs.[21] An expansion of our sales tax base may introduce some modest additional regressivity but at the same time enable progressivity in the overall fiscal system.

Keeping up with the sources of GDP growth – Health care delivery is generally viewed by the public as taxation *non grata*, and our tax system largely reflects this. Many items like prescription and over-the-counter drugs, medical devices and their replacement parts, and prescription eyeglasses are exempt from the general sales tax. In addition, health care insurance, employee health benefits, and property receive favorable tax treatments or are exempt from other types of taxation. All this means a large and rapidly growing part of the state economy is paying a relatively lower percentage of state and local taxes than other economic sectors. At the same time public spending growth is being heavily influenced by health care expenditures. During the recent contentious debate over the fate of the state provider tax, (a gross receipts tax that functions more or less as a non-pyramiding replacement for a general sales tax on health care service delivery albeit at a substantially lower rate) an underrecognized policy topic was the provider tax's role in improving the stability and responsiveness of Minnesota's tax system to changes in the economy while reducing pressure on the rest of the tax system. The provider tax may not be the optimal way to address this reality, but it does point to an issue that is not going away and that will likely remain part of our tax debate in the future.

Property Tax: Productive, Reliable, yet Detested

As the foundation of local finance and a relative asterisk in state finance, real property taxation is largely immune to the productivity and reliability challenges sales and income taxes face. But its significant structural complexity is a "tax" on public understanding and acceptance making local reliance on the tax more difficult.

Vital Statistics

- Based on state and local government census information, Minnesota's property tax collections are 6% below the national average on a "cash income" basis[22] placing us 23th highest in the nation. For some additional perspective, to climb into the nation's top ten on property taxation, state and local property taxes would have to increase by approximately $3.25 billion per year or 33.4%

- Minnesota's state and local own source revenue collections are 13.9% less dependent on the property tax to fund government operations than the national aver-

[17] "Bill Fox on State Taxes, Now and In the Future" Hamilton, *State Tax Notes*, August 16, 2021

[18] Walczak, February, 2021

[19] "The Success of SNAP (Food Stamps) and the Desirability of Taxing Food" *Proceedings of the Annual Conference on Taxation of the Annual Meeting of the National Tax Association*, 108th Annual Conference on Taxation, 2015.

[20] "Is the Gasoline Tax Regressive?" Poterba, *Tax Policy and the Economy*, National Bureau of Economic Research Volume 5, 1991

[21] Despite its recognition as a vastly superior form of consumption taxation, the VAT has never has never gained political traction in the United States. There are many reasons for this, likely including political ideology. As former Treasury Secretary Larry Summers once quipped, a VAT has little political support because liberals think it is regressive and conservatives think it is a money machine, and the U.S. will finally adopt a VAT when liberals think it's a money machine and conservatives think it's regressive.

[22] *How Does Minnesota Compare*, (for fiscal year 2019, publication forthcoming), MCFE.

age. Looking specifically at the general fund, MMB reports the property tax provides 3.0% of all general fund resources. Property taxation provides schools and other local units of government with 51.2% of their own source revenues – a revenue share largely stable compared to ten years ago (50.6% in 2011).

- Based on the latest Department of Revenue information (2019), the statewide median homestead property tax burden (after factoring in property tax refunds) is 2.5% percent of household income versus 2.8% ten years ago.

Structural Considerations

Minnesota's property tax is a levy-driven rather than rate-driven which means (with a few exceptions like local referendum levies) the productivity of the tax is essentially a function of whatever elected officials decide to collect. With respect to the tax base there is no more "predictable" tax base than the existence of real property. Put it together it should come as no surprise the reliability of the property tax is far greater than its income and sales tax counterparts.

According to MMB the property tax base has one-quarter of the volatility of the income tax base and about half of the sales tax base. Its structure also makes the tax highly resilient and enables local governments to recover more quickly from recessions. A study cited earlier in this report determined that after a GDP shock, the revenue path fully returned to trend for Minnesota property tax revenues after just one year. [23] The intrinsic nature of the tax itself generates highly controllable, dependable revenue and is therefore an excellent foundation for local government operations. Of course, general economic conditions and a wide variety of state actions like aid cuts can inject volatility into local levy decision-making. As a result, in considering revenue predictability and reliability, it is difficult to separate the structural characteristics of the property tax from the structure and complexities of state intergovernmental finance.

[23] Anderson and Shimul, *National Tax Journal*

The primary structural consideration pertaining to the tax itself lies in the extraordinary complexity of the state property tax system. Local reliance on the tax is influenced by its political acceptability, and the complexity of the system inflicts a "tax" on public understanding and acceptance. As the state's 2012 Bipartisan Property Tax Reform Working Group noted:

> *"When complexity is too great, taxpayers have little hope of identifying how their taxes are specifically calculated. This breeds anger and distrust as they are expected to take it on faith that they are being treated fairly and correctly. They do not know how to keep state and local government officials accountable for outcomes and hear mixed messages that they cannot assess. They are unable to plan for and adapt to changes."*

As our vital statistics show, Minnesota is well below the national average in property tax reliance to fund government and the tax is consuming a smaller share of household income than it did ten years ago at the state median. Yet in response to public aversion to the tax, lawmakers frequently portray increases in local reliance on the tax as a problem that needs to be addressed with some form of policy intervention.

Policy Issues

Whether or not to restore the property tax to a being true local tax – The State General Tax is a $775 million state levy on business and cabin property. It's a relative drop in the bucket in the grand scheme of state finance but it does introduce a small modicum of stability to General Fund collections. Through the years there have been several proposals to enhance the productivity of this tax through automatic inflators or converting it to a rate-based system. At the same time, others have called for the state to scale back or eliminate its footprint in the local tax base. In recommending its elimination the state's bipartisan Property Tax Reform Working Group stated, "the property tax is foremost a local revenue system, not a vehicle for state policies." The result is a tax in some sense of policy limbo. From a revenue system health perspective, the question policymakers need to be examining is whether the amount of general fund revenue diversification and stability benefits offered by this tax is worth the state's intrusion on local government's primary tax base and resulting levy setting impacts.

Making progress on the 2012 recommendations – In our opinion, the aforementioned report of the Property Tax Reform Working Group is among the best blueprints for tax reform in state history. Its recommendations have been largely ignored over the past ten years. To be sure enacting these recommendations is a daunting task partly because, as in all tax reform, tax winners and losers result. However, it is an excellent recipe to make system more simple, understandable, transparent, accountable, and efficient which are all keys to the tax system's long-term health and welfare.

Conclusion: Changes in Latitudes, Changes in Attitudes

Tax balance is not a mathematical construct but the characteristic of a tax system that achieves greater revenue reliability and dependability while adhering to principles of good tax policy. Relative reliance on a particular tax is a consideration in tax balance, but the structures of the taxes themselves and how they support or undermine critical tax policy principles like equity, efficiency, and simplicity are equally, if not more, important. Tax structures and their adherence to good tax principles have crucial long-term implications for the pro-

From a revenue system health perspective, the question policymakers need to be examining is whether the amount of general fund revenue diversification and stability benefits offered by this tax is worth the state's intrusion on local government's primary tax base and resulting levy setting impacts.

ductivity, dependability, and resiliency of a revenue system.

The flood of tax revenues currently pouring in to state coffers combined with the Fed's largess may be instilling an Alfred Neuman-esque, "What, me worry?" attitude among lawmakers toward the state tax system at this time. But Minnesota policymakers have some things to think about. Our increasing reliance on increasingly progressive income taxation has reached a political and practical limit. Taxes on consumption are recognized as providing government with one of the best ways to raise revenue without deterring economic growth, but our relatively struggling state sales tax is beset with base challenges stemming from changes in the economy, technology, and demography. The property tax offers a degree of revenue reliability and stability no other tax can provide, yet its complexity undermines public faith in the tax and causes lawmakers to propose new initiatives that can weaken its most valuable public finance attributes.

It's in this context that the benefits, and limitations, of the state budget reserve need to be considered. It is a vital budget tool to manage revenue system volatility arising from relative tax emphasis and economic circumstances. However, it is scaled to a shortfall in forecast revenues occurring within one budgeted biennium and is impotent in dealing with any longer-term behavioral and economic consequences of our tax structure. In short, the reserve is not and cannot be a substitute or panacea for good tax policy.

Policymakers are not tone deaf to the importance of these issues. The establishment of a new tax expenditure review commission passed with bipartisan support is an excellent step and will shed some needed light on the tax policy choices embedded in the tax code. But progress will likely require some tempering of the partisan mindsets which have come to dominate our tax debates in recent years. Among the DFL, it's the relentless demand for ever-greater progressivity in the revenue system. Among Republicans it's the resistance to any rate or base changes that could raise revenue in any policy context or for any larger systemic purpose. The polarity of these two mindsets offers very little opportunity to gear Minnesota's tax system for the future. ■

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Tuesday, November 9

Join MCFE members and our distinguished speakers for our annual meeting webinar examining two timely policy issues of relevance to effective, efficient, and accountable Minnesota government.

Registration is FREE and open to everyone – both members and non-members. Simply send your name, organization and email address to *ledstrom@fiscalexcellence.org*. You will receive a confirmation notice and access link prior to the event.

POLICY FORUM AGENDA

ZOOM SESSION 1: 9:00 AM – 10:15 AM

FEDERAL ACTION, STATE REACTION:

National And International Tax Developments And The Implications For Minnesota Tax Policy

As Minnesota continues to grapple with the implementation fallout of the federal 2017 Tax Cuts and Jobs Act, another wave of federal tax action looms on the horizon. In addition to the Biden administration's sweeping tax proposals, the global tax system has been described as being "on the brink of an historic change in international tax rules." These prospective changes present both potential benefits but also risks given the globally unique and complicated structural relationship between the U.S. federal system and state tax systems and their combined impact. Our distinguished panel of tax experts will examine the existing and emerging tax policy developments and the downstream implications for state tax policies.

Panelists:

Joe Crosby, Chief Executive Officer, MultiState

Harley Duncan, Managing Director, State and Local Tax, KPMG

Karl Frieden, Vice President and General Counsel, Council on State Taxation

ZOOM SESSION 2: 10:30 – 11:45 AM

GOVERNMENT HUMAN CAPITAL REFORM:

Transforming Human Resource Systems To Meet The Needs Of 21st Century Government

The National Academy of Public Administration declares there is "no time to wait." The National Association of State Chief Executive Officers declares it to be "Job One." The issue is the modernization and transformation of government human capital systems, often still rooted in rules, regulations, and human resource design objectives and constructs that date back 50-100 years. Such civil service reform is needed to obtain the talent needed to address the demographic, economic, and operational challenges governments face today while meeting the performance and accountability demands citizens expect. Our distinguished panel of government human resource officials and practitioners will examine the objectives of reform, key elements, and their implementation issues and challenges.

Panelists:

Dr. Howard Risher, Author and human resources consultant,

Dr. Ronald Sanders, Fellow, National Academy of Public Administration (NAPA)

Kristin Batson, Deputy Commissioner for Enterprise Employee Resources, Minnesota Management and Budget

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