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May – June 2017 Volume XXXVIII No. 3

In This Issue:

Sifting Through the Results of Another Legislative Session Spectacle

Our summary and analysis of the tax and spending outcomes from a legislative session that will be remembered for some time to come.

Even by the high bar recent legislative sessions have set, the messiness, confusion, and complexity surrounding the end of the 2017 edition has set a new standard. Or as one veteran lobbyist is reported to have said, "Every session is different; this one is the most different."

When the governor and legislative leaders agreed to a special session to begin immediately after the midnight deadline and last for only about a day, it suggested a successful and relatively orderly end to a turbulent four months of divided government. The Fourth of July explosions of rhetorical fireworks and point of order pyrotechnics that marked previous midnight deadlines, as legislative procedures and processes were trampled to beat the clock, were notably absent. In stark contrast, this year's conclusion reflected a Christmas Eve-like vibe – anticipation and curiosity surrounding the actual terms of agreement culminating with everyone going to bed and waking up to see what leadership and the governor had left for them the next morning.

However, it quickly became clear that the agreement framework did not have nearly enough of the specificity and detail needed to move bills to the governor's desk in an expeditious and collaborative manner. For most of "Christmas Day," House and Senate webcasts broadcasted a political version of the televised Yule log – rows and rows of mostly empty legislative desks accompanied by soothing music and the words "in recess at the call of the chair." When the special session deadline arrived, no bills had reached the governor's desk, the Senate had taken no final action on any of the seven major bills still in play, and only two of those seven had passed the House.

Lawmakers forged ahead, negotiations continued in real time, and about 40 hours after the special session was originally scheduled to end legislators adjourned it *sine die*. But it wouldn't be a budget session without a last minute injection of chaos – this time creating a constitutional showdown. Governor Dayton signed all the budget bills – ensuring no government shutdown – as well as the tax bill. However, his line item vetoes of the House and Senate budgets in response to the legislature's too-clever-by-half attempt to guarantee a signed tax bill potentially put several hard fought, agreed-upon tax and policy provisions back in play if they bring the legislature back to the table. Thus, the final word on the 2017 session has not yet been written although the epilogue may be drafted in the courtroom rather than in legislative chambers.

The Big Picture on Spending

Table 1 presents the outcome of the 2017 session compared to current law projections for FY 2018-19 from the February forecast. The table shows expenditures net of revenue changes, which generally provides the best sense of spending changes. The main caveat with the table involves the much discussed additional $300 million of spending on transportation. That $300 million is comprised of $96 million in new general fund spending in the transportation area as shown plus an additional $204 million in reduced general fund revenues (the sales taxes on auto parts, rental cars, and leased vehicles plus the rental car tax itself) that are now being dedicated to special transportation funds.

Ask interests in any individual spending area and the message undoubtedly would be that lawmakers should have done a lot more. But the general fund is about allocating based on priority and need, and lawmakers appear to have found priorities and needs in almost all areas of government and appropriated accordingly. E-12 education received a 2% per year bump in the all-important per pupil basic education aid. Nearly $200 million in aids and credits will be distributed across the state including $40.5 million in new general purpose aids to cities and counties. Even state government operations, whose budgets were under attack for most of the session in a pursuit of efficiency and budget restraint, saw a 6.4% increase in legislative appropriations. (Because the accompanying table shows the budget as enacted, the 6.1% reduction in state government accounts for the roughly $130 million defunding of the House and Senate.)

Both the governor and legislators have recognized the need to find savings and reduce rates of growth in spending in the Health and Human Services bill – or "the beast" as one legislator has called it. Minnesota's larger amounts of spending on health and human services compared to other states has long been a distinguishing fiscal feature

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The Minnesota Center for Fiscal Excellence is a nonpartisan, non-profit corporation founded in 1926 to advance economy and efficiency in government.

Fiscal Focus is published bimonthly for $150 per year by the Minnesota Center for Fiscal Excellence, 85 East Seventh Place, Suite 250, St. Paul, Minnesota 55101. ISSN # 1042-847X. UPS #519130. Periodical paid at St. Paul, MN 55101.

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Table 1: FY2018-19 General Fund Budget, February Forecast and as Enacted

	Feb 2017 Forecast	May 2017 As Enacted	Change From Forecast	
			Amount	Percent
Balance Forward	2,722,888	2,706,992	(15,896)	-0.6%
Current Revenues	45,663,342	45,017,365	(645,977)	-1.4%
Total Resources Available	**48,386,230**	**47,724,357**	**(661,873)**	**-1.4%**
E-12 Education	18,271,866	18,756,681	484,815	2.7%
Higher Education	3,069,493	3,279,493	210,000	6.8%
Tax Committee Appropriations (Aids and Credits)	3,451,877	3,648,477	196,600	5.7%
Health and Human Services	14,324,310	13,852,758	(471,552)	-3.3%
Jobs and Economic Growth	369,189	392,311	23,122	6.3%
Agriculture and Rural Development	118,472	123,916	5,444	4.6%
Transportation	243,592	339,494	95,902	39.4%
Public Safety and Judiciary	2,165,970	2,319,534	153,564	7.1%
Environment and Natural Resources	314,053	322,429	8,376	2.7%
State Government	1,033,548	970,273	(63,275)	-6.1%
Debt Service	1,142,817	1,155,301	12,484	1.1%
Capital Projects	255,924	270,287	14,363	5.6%
Cancellation Adjustment	(20,000)	(20,000)	0	--
Dedicated/Other Expenditures (mostly reinsurance bill – Chapter 13)	0	142,192	142,192	NA
Total Expenditures	**44,741,111**	**45,553,146**	**812,035**	**1.8%**
General Fund Balance Before Reserves	**3,645,119**	**2,171,211**	**(1,473,908)**	**-40.4%**
Cash Flow Account	350,000	350,000	0	--
Budget Reserve	1,603,443	1,603,443	0	--
Stadium Reserve	40,301	40,301	0	--
General Fund Balance	**1,651,375**	**177,467**	**(1,473,908)**	**-89.3%**

Notes:
Expenditures presented by conference committee jurisdiction and are shown net of revenue changes
All revenue changes accounted for in the Current Revenues line.
Dollars in thousands, parenthesis signify reductions or negative balances.
Does not include vetoed appropriations for the Minnesota Senate, Minnesota House, and public pensions.
Data from Senate Counsel, Research, and Fiscal Analysis Office and House Fiscal Analysis; calculations by MCFE.

of the state – consistently 30-40% above the national average for many decades on a per capita basis and today over twice the national average on a per individual served basis.[1] Demographic trends are further fueling its growth rate. Such spending may be a hallmark of Minnesota's ethic but it also represents a powerful crowding out of other public goods and services Minnesotans hold dear.

Taming "the beast" can be done in three basic ways: 1) find savings through program redesign and operating efficiencies; 2) make the difficult decisions to cut programs and/or reduce program eligibility and benefit generosity; and 3) embark on shifts, transfers, and related numbers games. From all indications, the $472 million reduction in biennial spending has some of 1 and 2 as well as a significant helping of 3. The latter includes passing a $20 million tab for assessments for people with disabilities onto counties and raiding the Health Care Access Fund for one time money for ongoing programs – a funding source scheduled to disappear in two years.

In more challenging economic times various stakeholders would likely be exceptionally pleased with the decisions and results reflected in the summary table. But a $1.65 billion surplus does not reflect challenging economic times. So it wasn't surprising a phylum of spending interests joined together under the Twitter hashtag "#vetoeverything" with little common DNA other than shared opposition to the idea of subordinating greater spending to tax relief.

Tax Relief: Same Bucks, Different Tails

The early negotiating positions may not have foreshadowed it, but in the end the 2017 tax bill bears a strong resemblance in both size and substance to the ill-fated tax bill of 2016. The 2016 bill passed on a vote of 123-10 in the House, 55-12 in the Senate, and based on statements to the press, was vetoed only because of a one-word drafting error and a lack of attention to the importance of attending high school athletic events tax free.

The aborted 2016 tax bill would have reduced revenues for the FY 18-19 biennium by $375 million and increased aids and credits spending by $169 million, for a total general fund impact of $544 million. In comparison, the 2017 tax bill – based on a surplus nearly twice as large – reduces tax collections in FY 18-19 by $452 million and increases aids and credits spending by $196 million resulting in a $648 million impact on the general fund. Moreover, the specific provisions and lists of beneficiaries "then" vs. "now" is strikingly similar – families with child or dependent care expenses, indebted college students, college saving parents, counties and cities, farmers, and owners of lower valued business property, just to name a few.

It's in the tails – the revenue implications for the FY 20-21 out-biennium and beyond – where the real differences lie. Specifically, these changes in the tails can be traced to three primary differences between the 2016 and 2017 tax bills:

- **Retargeting of tax relief away from the state Working Family Credit and towards a new Social Security subtraction.** The 2017 bill essentially swapped out $93 million of biennial relief for lower income households with $117 million of relief for middle-income seniors. This change, however, has ramifications beyond simply creating a different group of winners. The long-term revenue tails of a new Social Security subtraction are guaranteed to be much larger than the future growth of any refundable credits for low-income earners. According to legislative staff the projected growth rate in general fund revenue losses from the subtraction from the FY 18-19 biennium to FY20-21

[1] Defined as number of individuals at or below 150% of federal poverty level, spending adjusted for state price differences. Source: *How Does Minnesota Compare?* MCFE, 2016

is over 10% – just as baby boomer Social Security eligibility ramps up in earnest.

- **Increasing the estate tax exclusion from $2 million to $3 million.** The Department put a $34.5 million revenue impact on this provision which more than doubles by FY 20-21 largely due to the four-year phase in of the provision.

- **Eliminating the automatic inflator on the State General Tax.** Both 2016 and 2017 tax bills included the $100,000 value exemption and a reduction in the levy to mitigate burden shifting, but the 2017 bill also prevents the state levy from being automatically increased every year based on a national measure of government inflation.

The governor cited major concerns about the state's long-term fiscal stability as the justification for his extraordinary veto of the House and Senate budgets. Given his expressed interest in leaving office with a structurally balanced budget plus all the uncertainty surrounding federal tax and spending policy, it's understandable why the administration appeared even more circumspect this year about providing tax relief.

As a result, the governor has targeted three tax relief provisions as conditions for calling Special Session II: repeal tobacco tax changes including reinstating tobacco tax rate indexing, canceling the estate tax exclusion increase, and restoring the state general levy's automatic inflator. Notably absent is the Social Security subtraction. Even though the tails are very large, criticizing senior tax relief and arguing retiree self-interest is a dangerous threat to Minnesota's fiscal stability and future well being isn't exactly conducive to electoral health. Smokers, the wealthy, and business have long proven to be politically safer targets.

Of these three tax-related provisions, only the general tax inflator repeal would likely compare to the significance of the new Social Security subtraction with respect to long-term revenue impacts.[2] The administration's concern about the freeze's long-term costs to the state should be evaluated against the policy arguments in favor of eliminating the automatic inflator. They are:

- Stopping the relentless and harmful state intrusion into local governments' primary tax base;

- Restoring the original policy intent of the state general tax – balancing revenue and tax competitiveness concerns at the state rather than the local level; and

- Restoring needed accountability into state tax policy decision-making.

Although the inflator has been repealed, there is absolutely nothing preventing lawmakers from raising $1 billion over the next 10 years through the state levy which the administration claims would be lost through a freeze. The only difference is that lawmakers would be held accountable and responsible for that attempt – and whatever would result from it – rather than getting to hide behind an obscure inflation statistic.

Tax Policy: Clearing Out the Inventory

Three years without a tax bill created a backlog of provisions that were discussed and passed in past legislative sessions but never enacted. In addition to a number of overdue administrative clean up provisions in the Department's technical and policy bills, the tax bill includes 16 TIF provisions and 18 local sales tax provisions – which we suspect is a record as far as the local option taxes are concerned. Most of the local sales tax authorizations are the familiar dedication to local capital needs. However, lawmakers broke some new policy ground and established a precedent in granting a 1% sales and use tax for a sanitary district serving a small city and township. While some view this authority as an example of precisely the type of collaboration local governments will increasingly need to engage in over time, others see new administrative, equity, and accountability concerns in granting this kind of local sales tax authority. Either way, it's a crack in the historical foundation of local sales and use tax authorization which will almost certainly be exploited in years to come.

Two other administrative provisions of note which received considerable discussion and attention in previous sessions finally passed with little attention or fanfare this year. One is the marketplace providers and referrers language, which among other things substantively expands the definition of affiliate nexus that triggers the duty to collect sales tax on e-commerce. Minnesota's patience with federal sales tax Godot has worn thin, and this effort has caused considerable ripples and discussion in the national tax community. Yet here in the state the provision triggered little if any debate this year.

The second provision related to determinations of Minnesota residency for both individual income and estate tax purposes. Language explicitly prohibiting the location of an individual's attorney, CPA, financial advisor, or place of business where an individual applies for credit or opens/maintains an account from factoring into such determinations has finally been enacted into law. The provision offers closure on a topic that has been a thorn in the side of Minnesota's professional services community for a very long time.

Some high profile administrative provisions the practitioner community sought were not so fortunate. Language pertaining to a new private letter ruling program, dual audits, changes in penalties and assessment authority, and statute of limitation changes regarding refunds were all dropped from the final tax bill. Arguments for and against a private letter ruling program aside, it's likely the costs the Department would incur in administering such a program were a contributing issue – especially given the other costs associated with implementing and administering the bill's many new tax credits and the operating budget assault the Department faced for most of the session. Unfortunately, we do not know what those cost estimates were. We have seen situations in other areas of government in which a cost estimate developed by an affected interest group or agency becomes a major obstacle in advancing a policy initiative. This session's newly created Legislative Budget Office appears to be taking over the oft-criticized fiscal note process and may be an avenue for a more independent assessment of such policies.

Pensions: Another Proposal, Another Veto

The only special session bill the governor vetoed was the "preemption bill" – so-called for its controversial provision preventing local governments from regulating their local labor markets. Yet a completely different topic comprised 220 of the bill's 238 pages

[2] The estate tax exclusion might give a near term run for the money as far as impact is concerned, but based on discussions with our considerable tax planning membership base, interest in estate tax avoidance is a little more plentiful than the administration seems to believe.

– the omnibus pension bill, which included the latest effort to repair the state's pension system. With $20 billion in unfunded existing obligations (about $8.2 billion of which are city and county government employee obligations) all based on earning at least 8% per year one might expect the issue would be treated with no less seriousness and attention than a fight over local regulatory affairs. The fact that the pension provisions took a back seat to preemption and were essentially nothing more than a media and political footnote captures the remarkably nonchalant attitude and lack of urgency that continues to surround this topic.

This year's ill-fated effort included another package of contribution increases and retiree cost of living adjustments. Based on the recommendations of a commission the governor established to examine the issue, the assumed rate of return – which is used to evaluate the adequacy of contribution policies – would have been reduced to 7.5%. And it wouldn't have been a pension repair effort without another clock reset in the form of a fresh 30 years to pay off the unfunded liabilities to keep current costs down (at least on paper).

One new cost saving tweak proposed this year was the phased in elimination of "pension augmentation" in which future pension benefits for individuals who have left public employment are increased by an established annual interest rate until the defined benefit is claimed. This cost saving measure has one major drawback: the way defined benefit pensions work, the economic benefit of working in the public sector would be even more conditioned on making government a lifelong career choice. Any public service-minded individuals devoting anything less than 20 years of their working career to government service would find their own retirement security and interests irreparably damaged. Similarly, those already in government would be held hostage to longer careers in government due to simple retirement economics. Without augmentation, defined benefit plans become a retention tool on steroids. Whether this is good or bad depends on how important one believes labor mobility is to good government.

Yet even before being lumped in with the toxic preemption bill and undergoing the governor's veto pen these sustainability efforts were unraveling at the legislature. The provisions for TRA were conditioned on finding the $100 million in general fund resources necessary to cover school districts' increased contribution costs –which never materialized. Another amendment exempted PERA from most of the reforms in return for a study to generate solvency recommendations.

As a result, seldom has a group of legislators worked so hard to accomplish so little. The package was touted as significant reform, and from a purely political perspective that description is accurate. Nothing comes easy in the world of pension policy especially when disproportionately influential retiree groups portray even the most modest changes affecting them as anesthetic-free oral surgery. But from the perspective of the public interest, the proposals remain woefully inadequate. While every legislative session might be different, at least one thing remains the same. Minnesotans will wait yet another year to see if the political will materializes to address the true existential threat to Minnesota's fiscal future. ■

Minnesota Takeaways From Our Latest 50 State Property Tax Comparison Study

Results from the newly-released Payable 2016 report and a look to the future

MCFE is pleased to announce the 2017 edition (covering 2016 taxes payable) of the 50-State Property Tax Comparison Study – our joint effort with the Lincoln Institute of Land Policy – has now been published and is available on the Lincoln Institute's website at *http://www.lincolninst.edu/publications/other/50-state-property-tax-comparison-study-1*. For the uninitiated, the report examines property taxes on homestead, commercial, industrial and apartment properties with specific values located in the largest city in each state[3] (i.e. "urban cities"), in a comparable rural city in each state, and in the largest 50 cities in the country. States and localities often treat different types of property differently: with variations in tax rates, exemptions, or assessment ratios, for example. Our study controls for these and other effects to compare effective tax rates – taxes relative to property values – to provide the most meaningful comparison of property taxes between these cities.

Minnesota Results: The Trends, They Aren't a-Changin'

With seventeen editions of this study now under our belt, some longer-term trends jump out as we look at our Minnesota results. One major theme continues to be the relative affordability of homeowners' taxes. The 1.39% tax rate on a median-valued Minneapolis home is once again below average – for the 10th time in the last 13 years. Good data on median home values in rural areas doesn't go back quite as far, but Glencoe checks in once again this year with a below-average tax rate on the median-valued home. Complaints about property tax burdens notwithstanding, these results should not be surprising given the combined effects of Minnesota's property tax classification scheme and the homestead value exclusion. It's important to recognize the state's income tested property tax refund program is not included in these results, and given its relative generos-

3 Since property tax systems in Chicago and New York City differ substantially from the systems applying to other cities in their states, the study also includes Aurora, IL and Buffalo, NY for a total of 53 urban cities.

Table 2: Selected Property Tax Study Results, Payable 2016

Property Type	Market Value of Real Property	Ranking (Change From 2015)		Effective Tax Rate		Tax Above/(Below) National Average	
		Urban	Rural	Urban	Rural	Urban	Rural
Home	$300,000	22 (-1)	20 (+2)	1.45%	1.59%	(5.3%)	+12.3%
Home	Median (ETR)*	22 (-1)	21 (+1)	1.39%	1.31%	(6.9%)	(1.7%)
Commercial	$1,000,000	9 (-2)	2 (--)	3.00%	3.01%	+43.2%	+74.0%
Industrial (50% real)#	$1,000,000	18 (-4)	7 (-2)	1.76%	1.81%	+13.4%	+40.9%
Industrial (40% real)^	$1,000,000	25 (-6)	12 (-5)	1.40%	1.44%	(0.4%)	+24.3%
Apartment	$600,000	22 (+1)	21 (-3)	1.75%	1.81%	(6.4%)	+12.4%

* Median value for Minneapolis was $227,500, per Census Bureau's *American Community Survey*
* Median value for Glencoe was $123,200, per Census Bureau's *American Community Survey*
# Where 50% of the total $2 million parcel value is land and buildings (real property)
^ Where 40% of the total $2.5 million parcel value is land and buildings (real property)

ity would likely further reduce state rankings if it was.

The other long-term trend continues to be the high burdens Minnesota's property tax system places on commercial – and to a lesser extent, industrial – property. Commercial property tax burdens have been higher for years across Minnesota – both in our urban rankings, where Minneapolis' seventh-place ranking for a $1 million-valued commercial property represents the seventh top ten finish in a row – and in our rural rankings, where Glencoe's $1 million commercial property ranks second for the fifth consecutive year. The state's rankings for industrial (i.e., manufacturing) properties fare somewhat better, because these types of properties with their higher levels of personal property (mainly machinery and equipment, inventories, and fixtures/office furniture) benefit much more from Minnesota's blanket exemption of personal property than commercial properties do.

Minnesota was an early adopter of exempting business personal property and has reaped competitive benefits from it. The edge that it gives industrial properties, however, is starting to erode. Another theme we have tracked over the years is the nationwide movement toward exempting personal property from taxation –through either a blanket exemption or a local option. In 2004, 40 states allowed property tax exemptions for manufacturers' inventories, 14 allowed them for manufacturing machinery and equipment, and 11 allowed them for fixtures. Twenty-one years later, 5 more states exempt machinery and equipment, 2 additional states exempt machinery and equipment, and 1 additional state allows inventory exemptions. Add to this the substantial partial personal property tax exemptions that Arizona, the District of Columbia, and Idaho have all enacted since then, and Minnesota's competitive position with respect to business property taxation is now more dependent than ever on levy amounts rather than structural advantages.

Table 3: Effects of State General Levy on Minnesota Regional Competitiveness for $1 Million-Valued Commercial Property, Payable 2016

Urban Cities						
Locations	Total Tax		Rank (of 53)		Tax vs Regional Average	
	With SBT	Without SBT	With SBT	Without SBT	With SBT	Without SBT
Minneapolis, MN	**$36,026**	**$27,309**	**9**	**22**	**6%**	**-17%**
Chicago, IL	46,288	46,288	3	3	36%	41%
Aurora, IL	41,217	41,217	6	6	21%	25%
Des Moines, IA	36,151	36,151	8	8	6%	10%
Detroit, MI	49,057	49,057	1	1	44%	49%
Fargo, ND	11,984	11,984	50	50	-65%	-64%
Sioux Falls, SD	16,915	16,915	39	39	-50%	-49%
Milwaukee, WI	34,181	34,181	10	9	1%	4%
Upper Midwest Avg.	**$33,977**	**$32,888**	—	—	—	—

Rural Cities						
Locations	Total Tax		Rank (of 53)		Tax vs Regional Average	
	With SBT	Without SBT	With SBT	Without SBT	With SBT	Without SBT
Glencoe, MN	**$36,093**	**$27,928**	**2**	**10**	**29%**	**4%**
Galena, IL	24,615	24,615	21	21	-12%	-8%
Hampton, IA	32,403	32,403	7	6	16%	21%
Manistique, MI	35,174	35,174	3	2	26%	31%
Devils Lake, ND	14,398	14,398	35	35	-48%	-46%
Vermillion, SD	24,271	24,271	23	23	-13%	-9%
Rice Lake, WI	28,512	28,512	8	7	2%	7%
Upper Midwest Avg.	**$27,924**	**$27,924**	—	—	—	—

Minnesota's business property owners continue to subsidize homeowner and renter property taxes in a meaningful way. The local-only property tax rate on $1 million commercial land and buildings in Minneapolis (without the state general levy) is about 2 times higher than the property tax rate on a median-valued home. Business subsidization of homeowner property taxes is not unique to Minnesota; 45 of the 53 urban cities in the study give some sort of preferential treatment to homeowners. On average, effective tax rates on commercial properties are 1.67 times higher nationwide than on median-valued homes – but Minnesota's subsidies are above average and deliver significant benefits to homeowners. Our partners at the Lincoln Institute have calculated that, if the tax base in Minneapolis were changed so that the differential in homestead and commercial rates was at the national average, taxes on the median valued home would be $455 – or 14% – higher.

Regional competitiveness findings

Minnesota faces some serious challenges when it comes to regional competitiveness, especially with respect to rural business taxes. If we look at medium-and higher-valued properties at locations across the upper Midwest (Illinois, Iowa, Michigan, Minnesota, North Dakota, South Dakota, and Wisconsin), Minneapolis' property taxes range from roughly equivalent to the regional average for a $1 million industrial property to 8% above the average for a $25 million commercial property. But Glencoe's taxes range from 24% above the regional average for a $1 million industrial property to 31% above for a $25 million commercial. Given Minnesota's trademark instinct to install progressive taxation wherever it can, with Minnesota's two-tier property tax structure for commercial and industrial property taxes it should not be surprising that higher valued properties are at the greatest disadvantage when compared to other states.

Minneapolis has a competitive advantage over four upper Midwestern locations at the $1 million and $25 million level for commercial and industrial properties: Detroit, Des Moines, Chicago, and Aurora (IL). Glencoe has the highest commercial property taxes in the region at those values, and fares only slightly better for industrial taxes, ranking second behind Manistique, Michigan. But the differences

Why City Choices Don't Significantly Impact Minnesota Rankings

Our use of Minneapolis and Glencoe to represent "urban" and rural" categories in the study often raises the question: would choosing different Minnesota cities for national comparison purposes would make a meaningful difference in the state's rankings? If local levies were the only force driving the relative size of tax bills and resulting rankings that would be the case. But they're not.

Property tax systems' structural features have major influences on tax rankings. Such features include both technical issues like classification schemes and assessment practices and broader topics related to the fiscal system, such as the existence of any state levies, the relationship between state and local governments, and access (or lack thereof) to revenues outside of the property tax to support local government. Importantly, these structural influences are not city-dependent but impact the property tax bills of every similar type of property across a state.

The purpose of the 50 *State Study* has always been to understand how state property tax system design affects property tax burdens. Our property tax study captures these influences, and the rankings reflect those influences.

To illustrate the influence of state structural features consider our rural commercial rankings. Our selection process for rural cities narrows the field considerably to improve comparability. Generally, we use cities that fall in one of two categories in the U.S. Department of Agriculture's rural-urban continuum, which classifies cities based on size and geographic location. All of our rural cities are county seats with populations between 2,500 and 10,000 to ensure as much as possible a set of cities that provide similar public services (especially in the public safety and public works areas) and to eliminate regional centers. Whenever possible, the cities are located in counties located outside of metropolitan areas, with the exceptions being where such counties do not exist – largely in northeastern states (think "rural Rhode Island").

Using this typology, 25 Minnesota cities could qualify for inclusion as a "rural" representative of our property tax comparison study. We calculated the taxes for the $1 million commercial property for each of these 25 cities. Our report incorporates assessment error using sales ratio data from the Minnesota Department of Revenue, however, that data does not exist for commercial properties in several of these cities given the small number of sales that occurred. If we – conservatively – substitute the median sales ratio for the cities we do have data for, then in 16 of these 25 cities the $1 million commercial property would rank in the top 5 nationally. In 22 of the 25 cities the property would rank in the top seven. If, instead, we assumed a sales ratio of 100% (the standard procedure for our report), then 21 of the 25 rural cities would be in the top 5. Such findings indicate that all cities share in the influence of the structural design of the Minnesota property tax system and that influence has the predominant effect on state rankings.

between Minnesota and both Dakotas are stark, in no small part because they, along with Iowa and Illinois, also fully exempt personal property from taxation.

For business and cabin properties, Minnesota's property tax is not purely a local issue. The state imposes its own property tax on those kinds of properties, which was set at $864 million for taxes payable in 2016. The state's encroachment into what is generally seen across the country as a revenue source for local governments has competitiveness implications for Minnesota's business property owners and their tenants. Eliminating the tax would reduce burdens on commercial and industrial properties in Minneapolis and Glencoe by around 20% to 25%. **Table 3** demonstrates the effects of eliminating the tax on a $1 million commercial property. In both cases competitiveness improves markedly, with the tax in Minneapolis falling from 6% above the regional average to 17% below and the tax in Glencoe falling from 29% above the regional average to just 4% above average.

A look to the future

So what does the future hold for Minnesota's property tax rankings and tax competitiveness? Some of that will be determined by other states as changes in Minnesota's rankings often depend as much on what policies other states pursue. However, three ideas stem from state and national developments.

First, the state general tax exemption lawmakers enacted last month for the first $100,000 of a parcel's value will significantly improve business tax competitiveness for some but not all Minnesota businesses. The exemption would reduce the taxes on the $100,000-valued commercial property in Glencoe by almost 22% – dropping the ranking from 6th to 25th. At higher values, though, the effect is largely negligible; with taxes falling by about 2% for each of the $1 million commercial examples and by about 0.1% at the $25 million level – with no change at all in rankings.

Second, without a freeze of the state general levy, future levy increases will fall disproportionately onto higher valued business properties in metropolitan areas, in turn putting pressure on urban rankings. This brings into sharp relief the horizontal equity problems created by trying to make business property tax relief dependent on real estate ownership and its value. Small businesses who happen to own their own low-valued space will find this change very beneficial. Those small businesses who happen to rent space instead in higher valued buildings – largely in metropolitan areas – won't notice a thing and instead will likely see their burdens increase over time.

Finally, we expect to see Minnesota's exemption for personal property become less of a competitive advantage as the trend toward exempting personal property from taxation continues. Of course, this exemption is already relatively immaterial for commercial properties considering the high number of states and localities that exempt commercial inventories. But as more states move toward exemptions of manufacturing machinery and equipment or increase their existing partial exemptions, it would not be

From The Director: Another Lost Year in Pensionland

Mark Haveman

Tax cuts aren't the biggest threat to the state's fiscal well-being

What is the most interesting committee to watch at the state capitol? For my money it's the Legislative Commission on Pensions and Retirement. The topic is deathly, the technical details stupefying, but nowhere else in government is the subordination of the public interest to private interests, political pressure, and fiscal convenience so visible and unvarnished. It's both important and fascinating to witness.

If you want a seat, get there early because it's always standing room only an hour before the show begins. Over here are the uniformed public safety officers whose piercing, stoic stares make you feel like you're going 55 in a 40 zone just sitting in a hearing room chair. Over there are retired teachers. Although many of them have been out of the classroom for a decade or more, they are still more than able to give "the look" that makes you immediately sit up straight and swallow your gum. Commission members know they are being watched – very, very closely.

To the testimony table come the representatives of each of the three major pension stakeholder groups – government employers, active employees, and retirees – all grudgingly committed to yet another round of "shared sacrifice" in order to repair these plans. The specific details of the testimony may vary but everyone's talking points can essentially be summarized as follows:

- Affirm unending affection and support for the existing defined benefit system structure
- Explain why your proposed share of the next round of shared sacrifice is too great
- Get more money from the state to address bullets 1 and 2

There are, however, some important people missing from the shared sacrifice testimony list because they are unable to attend. They include the 4th grader from the future who can't get the extra help he needs in a class size of 35 especially since the district had to cut funding for educational assistants; the government employees from the future whose wages have stagnated because more and more compensation resources had to be redirected to pension support; senior citizens and low income households from the future who have watched welfare services atrophy over several years under belt tightening; and the homeowner from the future who is paying astonishingly more in property taxes and fees to support higher government spending but at the same time seeing a lot less public investment. In other words, they are the millions of future Minnesotans sacrificing their well-being as the expectations and demands of the present cause the needs of the future to be thrown under the bus

There was a lot of emphasis about making sure this year's tax bill did not endanger the state's fiscal health or jeopardize the state's long term welfare. There is very good reason to be cautious, partly because of the policy uncertainty and political chaos taking place in Washington, DC but also because the state tax system is now more volatile thanks to emphasizing and prioritizing revenue progressivity over revenue stability.

But with all the attention this year on revenue adequacy, it's become too easy to forget about spending tails which are no less of a threat. And in public pensions, we have the granddaddy of spending tails – billions and billions of dollars in already existing unfunded obligations being foisted onto future taxpayers with new obligations being created every year. Yet the implications are already being felt. School districts were adamant this year that their operating budgets absolutely could not absorb the cost of any contribution increases. According to TRA, $237 million in new state aid is needed to cover these costs over the next four years – ***which would only keep the plan's current 70% funded condition (at a 7.5% return assumption) from getting any worse.*** The question which should be on everyone's mind is, what will the "ask" on the general fund grow to be to continue to hold school districts harmless in year 5? In year 10?

With a $1.65 billion surplus there was an opportunity to make some significant progress on this issue. Appropriate some meaningful cash into the funds but handcuff that action to substantive reforms on the benefits side that would stop the export of current obligations onto future taxpayers. LCPR staff even put together an interesting portfolio of new reform avenues to consider. But money could not be found – undoubtedly a casualty of biennial spending and tax relief priorities. Meanwhile, stakeholders' testimony expressing hostility to even the modest tweaks of cost of living adjustments on the benefits side made it abundantly clear we are a long ways off from being able to implement anything resembling a true solution to the problem.

A retirement expert recently called the pension issue "the financial equivalent of climate change," saying "we must address it now or accept that its adverse consequences will haunt future generations, putting an impossible strain on our children and grandchildren." "Pension change denial" is alive and well in Minnesota and we wonder what it will take to snap us out of our manifest indifference. — M.H.

surprising to Minnesota's industrial property tax burdens climb over the long run relative to the national average as structural advantages diminish while levy disadvantages – like the existence of the state general tax levy – continue. ■

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Look for more details on the event and registration information in the future

As always the MCFE Policy Forum is open to everyone. Members: please consider hosting a friend or colleague and introducing them to the MCFE.