FISCAL FOCUS

MINNESOTA CENTER for Fiscal Excellence

Sound tax policy. Efficient spending. Accountable government.

May – June 2019 Volume XL No. 3

In This Issue:

Session Reflections: About As Good As Could Be Expected

Our wrap up offers reactions and thoughts on some of the higher profile tax and fiscal issues making up the 2019 legislative session.

Just when you think we have experienced every possible type of ending to a legislative session in this era of deeply divided government, a new one comes along. After meeting the agreed upon legislative deadlines in an orderly way entering into the last few weeks of session, the all-important budget target deadline came and went creating a stalemate with time running out. That triggered the familiar super-secret leader negotiations, subsequent mad rush to assemble and pass large omnibus budget bills, and ultimately the now not-so-special special session.

This year had the look and feel of a "Price of Government"-ish approach to government budgeting: first agree on how much is available to spend, then prioritize and allocate from there until the money runs out. Of course, a price of government aficionado would recommend leaving more than 36 hours to accomplish that all-important second part. Like two years ago, it was 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 enough manner to meet the constitutional deadline. But facing the prospect of having to head home over Memorial Day weekend to face some constituent music, legislators put their shoulders to the wheel and finished their work in a brief special session.

In the end it strikes us the result is probably as good as could have been expected given the stark philosophical differences between the parties. The $48.5 billion general fund budget for FY20-21 is a $1.07 billion (2.3%) increase over current law February forecasted spending for FY20-21 and a $2.9 billion (6.4%) increase over the current biennium's spending. That's slightly more than 3% growth per year over FY 2018-19. Some have expressed concern that honest budgeting and fiscal responsibility took a hit with the bump in June accelerated sales tax collections and most notably the $500 million raid on the state's budget reserves to pay for current law spending in FY 22-23. It's a legitimate point and demonstrates the state budget is banking on Minnesota's economy to perform above expectations as we move forward. But if fiscal responsibility is the concern, this year's result pales in comparison to what could have been: over $1 billion more in new permanent spending and tax relief backed by $1.1 billion of hugely volatile, litigious, quantifiably questionable, and often temporary new revenue from foreign earnings and high-end capital gains taxation. This road not taken would have generated the session outcome most likely to trigger flop sweat within Minnesota Management and Budget.

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The Continuing Battle of Budget Framing

The accompanying table provides greater detail on changes in the general fund budget relative to the February forecast and therefore presents a state budget picture using a baseline that "holds harmless" all current law spending. As the budget debate this year showed, agreement on the appropriate frame of reference for presenting budget information is just as contentious as the budget decisions themselves. For example, while Health and Human Service spending appears to be essentially flatline, the growth over the previous biennium is actually a hefty $1.37 billion dollars, or 10.2%. In essence, Republicans believe available revenue should frame the budget debate; DFLers argue it's current spending. Both sides have valid, albeit irreconcilable, arguments resulting in an ongoing battle of public perception.

Federal Conformity Dust Settles

Compared to last year, lawmakers appeared more receptive to the idea that simplification and administrative matters deserved consideration as they tackled the thorny

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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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FY2020-21 General Fund Budget, February Forecast and As Enacted

Budget Area	FY 2020-21 Feb Forecast	FY 2020-21 As Enacted	Enacted vs Feb Forecast	
			Amount	Percent
Balance Forward	3,037,242	3,079,806	42,564	1.4%
Tax Revenues	46,061,695	46,131,005	69,310	0.2%
Non-Tax Revenues	1,510,714	1,711,841	201,127	13.3%
Other Resources*	368,767	368,767	—	—
Subtotal – Current Resources	$47,941,176	$48,211,613	$270,437	0.6%
Total Resources Available	$50,978,418	$51,291,419	$313,001	0.6%
E-12 Education	19,552,783	20,113,272	560,489	2.9%
Higher Education	3,255,828	3,405,828	150,000	4.6%
Property Tax Aids and Credits	3,738,896	3,840,757	101,861	2.7%
Health and Human Services	14,874,653	14,739,455	(135,198)	(0.9%)
Public Safety & Judiciary	2,359,892	2,490,366	130,474	5.5%
Transportation	247,455	331,475	84,020	34.0%
Environment	324,229	339,013	14,784	4.6%
Agriculture & Housing	228,348	287,853	59,505	26.1%
Jobs, Econ Dev, & Energy	279,361	299,531	20,170	7.2%
State Government & Veterans	1,089,749	1,150,285	60,536	5.6%
Debt Service	1,198,807	1,182,796	(16,011)	(1.3%)
Capital Projects & Grants	272,970	272,970	—	—
Estimated Cancellations & Other	(20,000)	17,319	37,319	NA
Total Expenditures & Transfers	**$47,402,968**	**$48,470,920**	**$1,067,952**	**2.3%**
Cash Flow Account	350,000	350,000	—	—
Budget Reserve	2,074,733	2,074,733	—	—
Stadium Reserve	98,389	98,389	—	—
Budgetary Balance	**$1,052,328**	**$297,377**	**($754,951)**	**(71.7%)**

* Includes dedicated revenues, transfers in, and prior year adjustments.
Note: Dollars in thousands, parentheses signify reductions.
Note: Budget areas organized by House committee structure.
Source: General Fund Tracking – 2019 – End of Session, Minnesota House Fiscal Analysis Department; calculations by MCFE.

issue of federal tax conformity. This is especially true on the individual income tax side as the state adopted full conformity with the federal government's higher standard deduction. On the business side, these matters took more of a back seat as tax revenue from base broadening was employed to provide the grease for the agreement. The federal conformity provisions the state adopted are projected to generate $650 million in revenue for FY 20-21 from pass throughs and C-corps. Annoyances like the punt on full Section 179 conformity and the intellectual inconsistency with federal reform objectives (like the decoupling of immediate expensing with adopting the new limitations on net interest expense deductions) were casualties of the revenue raising and redistributional demands within the agreement.

It's been said there are two seasons in Minnesota: winter and road construction. There are also two tax policy seasons in Minnesota: creation/enactment and "Frequently Asked Questions." The Department of Revenue is undoubtedly gearing up for lots of practitioner demands for guidance, understanding and additional clarification regarding interpretation of and compliance with the tax bill. As one very simple example, various provisions in the tax bill are retroactive to previous tax years. Legislators understood this was going to cause issues and included language that essentially holds people who have filed harmless from the retroactivity. One question that practitioners have already raised is how to deal with returns for tax year 2018 that have not yet been filed. Do they file under the new revised law or under the old law and assume their returns will be adjusted? Additional federal guidance on TCJA provisions and some possible yet-to-be-recognized language fixes offer further potential administrative challenges.

The political saga may be over, but some behind the scenes conformity-related drama is likely to continue.

From all indications, the source of Republicans' tax-related objections centered on the retention of the provider tax, not the conformity plan; the specifics of the federal conformity strategy itself appear to have had considerable bipartisan support. Yet it's difficult not to be a bit wistful of "what might have been" and our failure to take greater advantage of a rare window of opportunity to pursue more ambitious state tax reform geared toward cleaning up and improving the tax system relative to good tax policy principles.

Big Political Benefits from Relatively Small and Diffuse Economic Benefits

This session demonstrated how difficult it is to really move the needle on providing substantive tax relief from conformity base expansions absent bigger structural reforms. For example, the maximum benefit of the high-profile second tier rate cut (a $361 million revenue reduction in FY 20-21) for a married-joint filer will be $288 for tax year 2019. The relevant significance of this tax cut on household well-being is mitigated to some extent by the fact that this maximum benefit will accrue entirely to higher income filers whose taxable income maxes out in the third income tax bracket and can take full advantage of the second tier rate cut – between $154,020 and $269,010 for married-joint filers in 2019. (Legislators ensured little or no benefit would accrue to filers with income in the fourth tier by adjusting the fourth tier thresholds.) Based on the modeling underlying our income tax comparison study, we estimate the rate cut will yield about $73 of income tax relief for married-joint filers with $100,000 of income (near the median for couples) and two kids – or roughly $6 per month. Similarly, the increased Social Security subtraction for the median married-joint senior filer income of $75,000 reduces household income tax burdens $32, or $2.67 a month, at a cost to the state budget of $9 million. The biggest household economic effect in this budget is almost certainly the $100 increase in monthly MFIP benefits, the first such increase since 1986. That comes with a relatively modest $43 million biennial price tag.

Even if the household economic impact of tax relief is not that significant, the political returns from these decisions are substantial. Both sides have planted a flag on the all-important ground of having provided low and middle income tax relief.

The Uncertain Future of the State Gas Tax

It's difficult to put a finger on exactly what the primary objection to a gas tax increase was this year. Public polling showed state support for a 10 cent increase last year but opposition to an increase this year. Was it the sheer magnitude of the increase proposed by the DFL, which left ample room for negotiations but also framed the proposal itself as over-aggressive and out of touch? Was it the cognitive dissonance of raising this tax and other taxes in times of surplus? Was it the regressivity of the tax? Was it a concern that Minnesota's infrastructure development is plagued by what Bloomberg News has described as "inefficient project management, an inefficient government contracting process, and inefficient regulation" now plaguing U.S. infrastructure development?[1] Do the ample number of orange barrels and lane closures slowing traffic around the state suggest to taxpayers we can't handle more such investment at this time? Or was it state history showing how swiftly and decisively lawmakers can be punished at the ballot box for supporting a gas tax increase?

The likelihood is that all these and perhaps other factors contributed to its rejection. But what makes the gas tax debate a bit of a head-scratcher is that the tax itself functions as the platonic ideal of how taxes should work in the eyes of many citizens. It's a benefits tax implicitly offering a high degree of fairness (those who use the service pay for it) along with 100% certainty that every dime collected is dedicated to roads and bridges, an area which most Minnesotans seem to believe needs attention. Moreover, consider the following:

- In today's dollars the current gas tax is actually one cent lower than it was in 1925 when legislators first enacted a 2 cent per gallon tax. It's about half what it was in 1949 in real terms and 15% less than what is was after the tax rate was last increased in 2008.[2]

- When the gas tax was last increased, gasoline and motor oil comprised a 5.6% share of expenditures for Midwestern consumers. As of 2017 it represented a 3.4% share.

- As a percent of the average nationwide price of gas, Minnesota's gas tax rate is at or below historical lows, with the exception of the 1970s-era Arab oil embargo and the 2000s-era melt-up in gas prices.

- If the gas tax had been increased by $.01 every year after the last increase in 2008, we estimate the state would have put roughly a $1.7 billion dent in road and bridge needs. And under this scenario, the average car/SUV driver consuming 600 gallons of gas per year would be paying about $60 more per year in gas taxes today than over a decade ago, or 16 cents more per day.

All this suggests public perception of the tax is somewhat skewed, a conclusion echoed by a paper presented at the annual conference of the National Tax Association[3] a few years ago. Researchers found most people greatly overestimate how much they pay in fuel taxes. Half of survey respondents overestimated the magnitude of fuel taxes paid by *at least a factor of five*. Seventy-five percent overestimated the amount by at least a factor of three. Subsequent analysis showed that these misperceptions strongly influenced their views regarding support for more road and bridge revenue.

This suggests the future of highway finance will be influenced as much by misperception as principle or ideology – indicating that an investment in educating citizens may be deserved. However, in today's social media era with the confirmation bias and "fake news" accusations embedded in it, educational efforts have often become as difficult as passing a tax bill itself.

One thing we do know: Minnesota is now in the minority of states with respect to its gas tax policy. According to information provided by the Brookings Institute, thirty-four states have increased their gas taxes in the last six years. Moreover, several states also apply general sales taxes at the state or local level in addition to their gasoline excise tax. With competition within the general fund guaranteed to increase, the pressure on Minnesota to join other states in raising its gas tax is not likely to go away.

State/Local Relationship: Welcome Support for Spending Omitted from the Op-Eds

This year, at long last, city and county officials achieved an elusive policy goal: the restoration of the Local Government Aid (LGA) and County Program Aid (CPA) appropriations to their previous highest historical levels (2002). The purchasing power of this aid has certainly decreased over the intervening years, but the infusion of new general purpose money ($30 million more per year for both counties and cities) is undoubtedly a welcome development.

On the other hand, the failure of another proposal suggests that state government gives with one hand and takes with the other. Since 1997, local government's primary pension plan, PERA General, has received nearly $14 million in state aid annually to defray some of the costs employers (i.e., local governments) would otherwise be expected to make. A bill was proposed this year to lengthen the sunset date for the aid from June 30, 2020 to the earlier of June 30, 2048, or the year after PERA General achieves fully funded status. That provision was a casualty of the negotiated budget agreement. Local governments won't feel the pain now since it will be difficult for PERA to recoup that $14 million from them. But as an aging population puts pressure on the state's pension funds, at some point local governments might wish that 23 cents of every new LGA and CPA aid dollar given out this year ($14 million of $60 million) had been directed instead to local government pension support.

In fact, higher state aids to local governments have been subsidizing higher under-the-radar spending for years. As a prime example: in 2019 cities are receiving $109 million in additional LGA and counties are receiving $73 million in additional CPA relative to 2011 (even before the additional $60 million in the 2019 tax bill kicks in) for a combined total aid increase of $182 million annually. Since 2011 employer contribution rates for PERA General and PERA Police and Fire have increased 0.25% and 2.55%, respectively. Based on FY 2019 projected payroll the additional cost for local

[1] "The U.S. Has Forgotten How to Do Infrastructure" Bloomberg, May 27, 2017

[2] Based on change in CPI.

[3] "Perception of Gasoline Taxes and Driver Cost: Implications for Highway Finance" Fischer and Wassmer, 107th Annual Conference of the National Tax Association, 2014.

governments from the higher rates totals $41.43 million for FY 2019. Divide that total by $182 million in increased aid for 2019 relative to 2011 and you get… 23 cents on the dollar.

So at a time when the State Board of Investment has been routinely blowing away its investment return targets during much of the longest bull run market in history, the equivalent of nearly 25 cents of every new dollar of local government general purpose aid has needed to be redirected out of local service delivery and into pension support. It's worth keeping in mind next time the litany of essential services only made possible by LGA graces your editorial pages.

It Lives

There are two things we know about the provider tax: 1) it's the type of broad base, low rate tax that public finance wonks generally applaud; and 2) that didn't matter to Republicans who were really upset by its preservation. News reports suggested the challenge of putting together an HHS budget without it proved rather daunting. That shouldn't surprise anyone, especially with several hundred million in Medical Assistance spending poised to parachute into the General Fund if the projections about the Health Care Access Fund's future without the provider tax were to come true. That's a potential general fund competition / demographic combo even the most confident lobbyist should want no part of. Whether one likes it or not, the provider tax in its slightly diminished form probably can't be eliminated until some spending or revenue reform is found to avoid the hole in the state budget its repeal would leave behind.

This year's compromise provides much more than a state budget for the next two years. It also sets the stage politically for the 2020 elections as both sides will now retreat to their respective corners. In electing a full slate of representatives and senators, Minnesotans will be choosing between two starkly different visions of state tax and spending policies to guide the state's future. Whether that yields a distinct direction or another slog of future compromise remains to be seen. ■

Minnesota Takeaways From the Payable 2018 *50 State Property Tax Comparison Study*

Forthcoming results from the Payable 2018 report will show 2017 state general tax changes had an impact while homeowners remain solidly average.

The 2019 edition (covering 2018 taxes payable) of the *50-State Property Tax Comparison Study* – our joint effort with the Lincoln Institute of Land Policy, will be released shortly and available on the Lincoln Institute's website in the near future. As a preview, we offer a look at the latest Minnesota findings.

This year represents the 19th edition of the report, which dates back to taxes payable 1995. For readers who aren't familiar with this flagship study of ours, the report examines property taxes on homestead, commercial, industrial and apartment properties with specific values located in the largest city in each state[4] (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: Homeowners Still Average; A Respite for Businesses

One major theme that remains unchanged since the mid-oughts continues to be the relative affordability of homeowners' property taxes. The 1.33% effective tax rate on a median-valued Minneapolis home is once again below average – for the 12th time in the last 15 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 tax rate on the median-valued home that is near the national average. 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 and special refund program targeting homeowners with large year on year increases are not included in these results. Given their relative generosity state rankings would almost certainly be further reduced if they were.

However, another long-term trend – the relatively high burdens Minnesota's property tax

4 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.

Selected Property Tax Study Results, Payable 2018

Property Type	Market Value of Real Property	Ranking (Change From 2017)		Effective Tax Rate		Tax Above/(Below) National Average	
		Urban	Rural	Urban	Rural	Urban	Rural
Home	$300,000	24 (—)	21 (+1)	1.36%	1.49%	(6.6%)	+5.6%
Home	Median (ETR)*	23 (—)	22 (—)	1.33%	1.24%	(7.8%)	(7.7%)
Commercial	$1,000,000	12 (-4)	6 (-4)	2.61%	2.64%	+34.2%	+51.6%
Industrial (50% real)#	$1,000,000	20 (-3)	13 (-7)	1.54%	1.59%	+8.5%	+23.4%
Industrial (40% real)^	$1,000,000	27 (-4)	15 (-4)	1.23%	1.27%	(4.8%)	+8.9%
Apartment	$600,000	19 (+3)	22 (+4)	1.64%	1.84%	(2.3%)	+12.3%

* Median value for Minneapolis was $250,400, per Census Bureau's *American Community Survey*
* Median value for Glencoe was $127,800, 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)

system places on business property – especially commercial parcels – are finally seeing some change. Commercial property tax burdens (i.e. office space) have been higher for years across Minnesota – both in our urban rankings, where a $1 million-valued property ranked in the top ten nationally between Payable 2010 and Payable 2017 – and in our rural rankings, where Glencoe's $1 million commercial property ranked second for six consecutive years prior to this edition of the study. However, the $100,000 exemption from the state general levy on businesses and cabins and the freeze in the levy itself seem to be yielding relative affordability benefits. As the table indicates, the rankings for both Minneapolis and Glencoe have both dropped four spots for Payable 2018, with Minneapolis moving out of the top ten altogether. Perhaps more importantly, Glencoe has moved from 89% above the study average for a $1 million commercial property – near if not at outlier status – to 52% above average. It's an indicator of the influential role the state general levy plays in Minnesota's property tax competitiveness and affordability.

The relatively high burdens Minnesota's property tax system places on business property – especially commercial parcels – are finally seeing some change.

Industrial (i.e., manufacturing) property also received similar relief, although its competitive position has always been much better relative to commercial parcels. The state's rankings for industrial properties are lower than those for commercial parcels 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. However, as our accompanying article in *Fiscal Focus* demonstrates, it's important not to overstate the value this blanket exemption provides – even for manufacturers.

Minnesota was an early adopter of exempting business personal property and has reaped competitive benefits from it as reflected in past national "model firm" tax comparison studies which ranked Minnesota as having one of the lowest effective property tax rates in the nation for capital intensive manufacturing. This edge, however, has eroded over time. 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 1995, 39 states taxed personal property in some form. Since then, 9 of those states have either enacted an exemption for a fixed amount of personal property value or increased the amount of an existing exemption; six states or locations have exempted at least one type of personal property (usually manufacturing machinery and equipment), and Ohio has exempted personal property completely. Assuming this trend continues, any competitive edge Minnesota's personal property tax exemption offers will continue to erode, and other structural features like the state general levy will take on greater influence.

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 1.79 times higher than the property tax rate on a median-valued home. Business subsidization of homeowner property taxes is not unique to Minnesota; In 42 of the 53 urban cities in the study the property tax system gives some sort of preferential treatment to homeowners. Nationwide, the most common cause for preferential treatment is a homeowner-specific exemption or credit (29 locations), with differentials in assessment ratios and nominal tax rates creating preferential treatment in 16 and 14 locations, respectively. In five locations that have parcel-specific provisions that limit growth in assessed value (such as California's Prop 13), the assessment limitations have been structured in a way that advantages homeowners over businesses.

On average, effective tax rates (local taxes only) on commercial properties are 1.66 times higher nationwide than on median-valued homes – but Minnesota's subsidies are above average and deliver significant benefits to homeowners. Last year our partners at the Lincoln Institute 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. We expect a similar result for payable 2018.

Regional competitiveness/affordability findings

Minnesota faces some challenges when it comes to regional competitiveness and affordability 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 are, at least for Payable 2018, rather competitive. Burdens range from 9% below the regional average for a $1 million industrial property (60% personal property) to 1% above the average for a $25 million commercial property. But Glencoe's taxes range from 22% above the regional average for a $1 million industrial property (60% personal property) to 28% above for a $25 million industrial parcel (50% personal property). Given Minnesota's trademark instinct to install progressive taxation, with a 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 offers an 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) and has roughly equivalent taxes to those found in Milwaukee. Glencoe has the second highest property taxes in the region at those values for both commercial and industrial properties, behind Manistique, Michigan. But the differences 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.

As we have mentioned already, for business and cabin properties Minnesota's property tax is not purely a local issue. The state general levy was set at $784.6 million for taxes payable in 2018 – a reduction from previous years since the state lowered

Effects of State General Levy on Minnesota Regional Competitiveness for $1 Million-Valued Commercial Property, Payable 2018

Urban Cities						
	Total Tax		Rank (of 53)		Tax vs Regional Average	
	With SBT	Without SBT	With SBT	Without SBT	With SBT	Without SBT
Minneapolis, MN	**$31,273**	**$23,884**	**12**	**24**	**(3%)**	**(24%)**
Chicago, IL	42,623	42,623	3	3	32%	36%
Aurora, IL	40,021	40,024	5	5	24%	28%
Des Moines, IA	37,465	37,465	6	6	16%	20%
Detroit, MI	45,943	45,943	2	2	43%	47%
Fargo, ND	11,625	11,625	49	49	(64%)	(63%)
Sioux Falls, SD	16,101	16,101	37	37	(50%)	(49%)
Milwaukee, WI	32,735	32,735	9	9	2%	5%
Upper Midwest Avg.	**$32,223**	**$31,728**	—	—	—	—

Rural Cities						
	Total Tax		Rank (of 50)		Tax vs Regional Average	
	With SBT	Without SBT	With SBT	Without SBT	With SBT	Without SBT
Glencoe, MN	**$31,713**	**$24,612**	**6**	**22**	**23%**	**(1%)**
Galena, IL	25,035	25,035	19	18	(3%)	1%
Hampton, IA	25,091	25,091	18	17	(3%)	1%
Manistique, MI	35,306	35,306	2	2	37%	43%
Devils Lake, ND	13,334	13,334	39	39	(48%)	(46%)
Vermillion, SD	22,645	22,645	25	25	(12%)	(9%)
Rice Lake, WI	27,364	27,364	11	10	6%	10%
Upper Midwest Avg.	**$25,784**	**$24,770**	—	—	—	—

the levy in 2017 in conjunction with the $100,000 exemption to prevent any burden shifting that would otherwise result. The state's encroachment into what is generally seen across the country as a revenue source belonging to local governments has competitiveness implications for Minnesota's business property owners and their tenants. Eliminating the state general levy and restoring the property tax to its historical local finance role would reduce burdens on commercial and industrial properties in Minneapolis and Glencoe by around 20% to 25%. The table 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 3% below the regional average to 24% below and the tax in Glencoe falling from 23% above the regional average to 1% below average.

The enactment of another $50 million reduction in the state general levy this session will further reduce the relative affordability and competitive property tax disadvantages Minnesota's businesses – particularly commercial enterprises – face. In debates about the state general levy, it's often overlooked that the ability to lower it was an intended policy design feature. Architects wanted to make future policy discussions on interstate business property tax competitiveness and affordability a state policy (and budget) issue rather than a local government issue. The idea was if this was a concern the governor and legislators could use the state general tax as a "relief valve" and dial down the levy accordingly rather than adjust classification rates with all the accompanying local burden shifting and political stress this creates.

In considering the fate of the state general levy, that policy purpose needs to be weighed against other policy considerations like the impacts of the state's intrusion into local government's primary tax base and the stability of the state tax system. As general fund competition for Local Government Aid and County Program Aid dollars only increases, the protection and preservation of a tax base that local governments can call their own will likely become ever more important. It's a tension that will influence property tax debates for many years to come. ■

Yes, Minnesota, Our Commercial Property Taxes Are High Relative to Most Other States

Rehashed, rewarmed criticism of our 50 State Study *still doesn't change the fact Minnesota's business property tax rankings are deserved.*

Minnesota's traditionally high business property tax rankings – and the role of the state general tax in contributing to those high rankings – have long been a political obstacle for policy advocates seeking to maintain or increase the property taxes businesses pay. As a result, over the last 20 years advocacy groups have delved deep into the methodology we employ in the *50 State Property Tax Comparison Study* we copublish with the Lincoln Institute of Land Policy – the nation's premier land policy research organization – to raise questions and cast doubt about the accuracy and legitimacy of our Minnesota business property tax findings.

The latest such effort was included in report commissioned this year on property taxes and E-12 finance by the Minnesota Rural Education Association (MREA). In its review of state property tax rankings, the MREA report argues that the findings included in the *50 State Study* do not capture the diversity and reality of Minnesota business property tax burdens cautioning, "in regard to business property tax rankings, the best approach may be to acknowledge what we do not know, rather than pretend we know more than we do." What's clear to us from a review of the MREA report is that criticisms of our study are based on things the authors do not seem to know – or choose to ignore – about property tax systems across the nation.

Here We Go Again

For over two decades criticism of the *50 State Study* findings has centered on the same two issues. The first is that the choice of Minnesota cities used for "urban" and "rural" comparison purposes (Minneapolis and Glencoe[5] respectively) are not representative of business property taxation in the state. Researchers point out the tax rates for both these communities are high relative to their urban and rural "peers" in Minnesota. The problem with this argument is that it combines a misrepresentation of the study's comparison intent with either a willful omission or gross misunderstanding of key issues affecting property tax rankings.

Since its inception, the *50 State Study* has been designed to enable national comparisons among the largest cities in each state – not an urban center relative to its own municipal neighbors. The criticism that Minneapolis' tax rate is high relative to its own suburbs is irrelevant.

The more interesting aspect of this criticism concerns rural rankings. That's because the choice of a specific city from among an eligible pool might appear to have potentially profound implications on national rankings. Indeed, the MREA report indicates – correctly – that Glencoe's net tax capacity (NTC) tax rate is on the high side compared to all the other Minnesota cities that meet the criteria for potential inclusion in the study. (Although at 15% higher than the average we would question whether this demonstrates the sort of outlier status that the MREA report suggests.)

So how does our choice of Glencoe instead of any other potential Minnesota rural city candidates[6] affect the study findings? The accompanying table provides the answer for tax year 2016, which was the basis of the MREA report. As the right-most column in the table shows, 11 of these 25 cities would rank second nationally in that edition of the *50 State Study* – by far the most common result. The city with the median tax burden – Pipestone – would rank 3rd if used instead of Glencoe. 18 of the cities – nearly 75% – would rank in the top 5, and 22 of the 25 – nearly 90% – would rank in the top 7. In short, while minor adjustments to state rankings might ensue from a change in rural cities, the primary findings and conclusions would not, unless we actually *did* use an outlier.

Property Tax Burdens on $1 Million Commercial Property, Payable 2016, Rural Minnesota Cities Eligible for *MCFE-Lincoln Institute Property Tax Comparison Study*

City	Effective Tax Rate	Net Tax	Rank	
			Of MN Cities	50-State
Waseca	3.805%	45,657	1	1
Mora	3.700%	44,395	2	2
St. James	3.462%	41,541	3	2
Windom	3.343%	40,119	4	2
Roseau	3.248%	38,975	5	2
Pine City	3.218%	38,611	6	2
Montevideo	3.169%	38,030	7	2
Litchfield	3.138%	37,650	8	2
Redwood Falls	3.121%	37,449	9	2
Wadena	3.062%	36,745	10	2
Glencoe	**3.008%**	**36,093**	**11**	**2**
Long Prairie	2.951%	35,409	12	2
Pipestone	2.917%	35,005	13	3
Blue Earth	2.876%	34,515	14	3
Park Rapids	2.844%	34,125	15	4
Two Harbors	2.827%	33,925	16	4
Little Falls	2.777%	33,321	17	5
International Falls	2.776%	33,306	18	5
Thief River Falls	2.712%	32,543	19	6
Morris	2.658%	31,897	20	7
Benson	2.621%	31,455	21	7
Breckenridge	2.525%	30,300	22	7
Detroit Lakes	2.158%	25,891	23	12
Luverne	2.033%	24,398	24	21
Jackson	1.868%	22,417	25	25

Note: Property tax data courtesy of the Minnesota Department of Revenue; calculations by MCFE.

So what explains these results and what is missing from the MREA's analysis?

- **Referendum tax rates.** Stunningly, especially for a study that spotlights E-12 education finances commissioned by an education advocacy group, the MREA report completely leaves out any mention of referendum tax rates. Had the analysis included this information, readers of the MREA report would have learned that Glencoe had a relatively low referendum tax rate for payable 2016 – ranking 18th of the 25 eligible cities, or 17% below the average. Glencoe's lower referendum tax rates work to offset the relatively high NTC tax rates the MREA report only mentions.

- **Assessment quality.** Even more significantly, the MREA report also fails to account for assessment quality – unlike our *50 State Study*. The Department of Revenue measures assessment quality annually through the use of sales ratio studies[7], which according to the Department "com-

[5] It is also important to recognize that continuity over time for a national investigation is an important consideration in selecting a representative city. Our choice of Glencoe was done in consultation with the Department of Revenue many years ago in identifying an "average" rural city and as our analysis in this article shows, nothing has evolved over time to warrant reconsideration of this choice.

[6] Note that the MREA report asserts that 27 cities in Minnesota could qualify as the state's rural representative in our 50-State Study. We dispute that finding; based on our methodology the number is 25. As our 50 State Study indicates, cities must be located in a county that scores a "6" or "7" on the U.S. Department of Agriculture's Rural Urban Continuum Codes classification scheme (https://www.ers.usda.gov/data-products/rural-urban-continuum-codes/.aspx). The most recent such codes, from 2013, show 34 Minnesota counties classified with a "6" or "7". 25 of the 34 county seats meet our population criteria (between 2,500 and 10,000) and therefore constitute the eligible population. It is unclear to us how the MREA report arrives at 27 cities; nor does the report list what those cities might be.

[7] The Department's *2015 Sales Ratio Study*, which applies to the valuations used to determine payable 2016 property taxes, only reports class-specific sales ratio data for a city or county if there were six or more sales of that type of property. Some of these 25 counties did not meet the six-sale threshold for commercial property, and no sales ratio was reported for 2016. For these counties, we used the average sales ratio for 2014-2018. In four counties, no commercial sales ratios were reported for any of the five years between 2014 and 2018. In those cases, we assume the sales ratio is the average for all other counties.

pares real estate sales prices to market values calculated by assessors to measure the overall accuracy of their appraisals."

Assessment quality has a direct impact on local property tax rates because rates are calculated by dividing the total tax levy by the total property value being taxed. Underassessment of property shrinks the tax base and requires a higher tax rate to yield the same property tax levy. The converse is also true: overassessment of property will yield a lower property tax rate, all other things being equal. It is once again surprising that the MREA report would somehow overlook this feature of the property tax system, especially since many of the state's education finance formulas use property values that have been adjusted for assessment quality to ensure that all districts are treated equally.

- **A failure to understand that property tax structural features, rather than local levy decisions, have the predominant influence on interstate tax rankings.** Business properties in these 25 cities (and for that matter in every city in Minnesota) are all exposed to different local levy amounts. But they all participate together in Minnesota's property tax classification system, are all exposed to the state general levy, are all affected by local government access to state aid programs, are all affected by Minnesota's decisions about how to divide up responsibilities between state and local governments, and all share in the same general limitations the state imposes on alternative local revenue raising authority. No less importantly, all of Minnesota's cities also share in the ***absence*** of structural features other states may have in place like assessment limitations and levy limits. In short, MREA's report focuses on one piece of the puzzle but does not understand – or chooses to ignore – that with respect to interstate tax rankings, both urban and rural, it is these shared characteristics that have the greatest influence.

Here We Go Again, Part 2

The second chronic criticism discussed in great detail in the MREA report is even more technical: a claim that the study's treatment of business personal property[8] understates the property tax advantage Minnesota's exemption of personal property conveys to businesses, thus preventing meaningful or useful interstate comparisons. Specifically, critics note the tremendous diversity in personal property's share of total property value across the myriad of different commercial property types and assert that the single 83% real/17% personal split on which our commercial rankings are constructed is both an oversimplification and differs from with the Department of Revenue's estimate of a 70%/30% split for commercial property statewide. It follows, goes the argument, that using assumptions with higher proportions of personal property would show Minnesota in a better light, since more property would be untaxed vis-à-vis other states. As with the issue of city selection, this criticism combines a misrepresentation of our study with a gross misunderstanding of the tax treatment of personal property nationwide.

With respect to interstate tax rankings, both urban and rural, it is these shared characteristics that have the greatest influence.

Contrary to how it is represented in the MREA report, the *50-State Study* does not purport to analyze an "average" commercial property. In fact, the text explicitly states that the "analysis looks specifically at taxes on office buildings and other commercial properties without inventory on site".[9] Our study purposely uses office property to represent commercial rankings for two reasons. First, this type of property is the predominant form of commercial property in Minnesota. According to estimates we prepared for a 2018 white paper prepared for our Lincoln Institute partners, we identified seven NAICS sectors and one NAICS subsector representing businesses where typical office activities take place.[10] Our modeling indicates that this group encompasses about 55% of total commercial sector property value (both real and personal property).

Second, we also use this subset of property to represent commercial rankings because the concept of "interstate tax competitiveness" applies most readily to this property type. Most other types of commercial businesses – notably retail, construction, restaurants, hospitals and care facilities, and entertainment/recreation facilities – are tied to population centers and the services they demand. New office space generally entails new jobs, which in turn drives economic growth – making tax competitiveness especially important for this large section of the commercial property tax base.

Report misrepresentation aside, the criticism of our treatment of personal property also suggests ignorance – or purposeful neglect – with regards to how other property tax systems across the nation treat personal property. These oversights neuter the criticism on several fronts:

- **Inclusion of personal property that is already subject to a registration tax.** Embedded in the MREA critique is the faulty assumption that all personal property is, or ought to be, subject in all instances to the property tax. That is highly problematic for commercial business types whose very large personal property shares are already subject to taxation in some other form. A primary difference between our modeling and the modeling done by Revenue is that we remove personal property that is typically subject to a tax in lieu of property taxes including aircraft, watercraft, and motor vehicles.

  Some of the commercial business types the MREA report identifies has having the highest proportions of personal property include Rental/leasing services; (91.1%), Water Transportation (80.5%), Truck (77.0%), Air Transportation (67.5%), and Construction (59.0%). Given that much of their personal property

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[8] Broadly speaking, "personal property" is any property outside of land and buildings. Major categories include machinery and equipment, inventories, office equipment and furniture, and motor vehicles.

[9] *50-State Property Tax Comparison Study for Taxes Paid in 2018*, p 19.

[10] These are NAICS sectors 51 (Information), 52 (Finance and Insurance), 53 (Real Estate Rental and Leasing), 54 (Professional, Scientific, and Technical Services), 55 (Management of Companies and Enterprises), 61 (Educational Services), and 81 (Other Services); and NAICS subsector 561 (Administrative and Support Services).

are motor vehicles, watercraft, and aircraft that are subject to these alternate forms of taxation, it's disingenuous to suggest that Minnesota's personal property tax exemption somehow advantages these types of businesses on these types of property. (One important side note: when we eliminate these types of property from our modeling, we find that office space has, in total, 82.5% of total property value in land and buildings and 17.5% personal property – very close to the study assumptions of 83.3%/16.7%.)

- **Drastically overstating the importance of Minnesota's personal property tax exemption when it comes to commercial inventories.** The MREA report implies Minnesota's exemption of commercial inventories conveys a major tax benefit that goes unrecognized in the study. What the authors of the MREA report do not seem to understand is that 39 states and the District of Columbia categorically exempt business inventories from property taxation. In four other states, local governments may tax business inventories on an optional basis. Only seven states – Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, Texas, and West Virginia – mandate property taxation of business inventories. As in our "city choice" findings, modeling a facility with substantial retail inventory has little effect on commercial property tax rankings. When we modeled the property taxes on a $1 million commercial retail establishment for payable 2016 in our white paper, the property taxes for Minneapolis ranked 11th overall – down slightly from the 9th highest ranking for office space, but nowhere near the reduction that critics assert through the misrepresentation of the taxation of inventories nationwide.

- **Unfamiliarity with state freeport exemptions.** As commercial enterprises which, according to the DOR estimates cited in the MREA report, have 66% of their total value in personal property, wholesale trade businesses are featured prominently in the MREA report as "properties which derive a large advantage from Minnesota's personal property exemption." That might be true if 96% of the urban cities in our study across the nation did not offer similar advantages to wholesalers.

What critics of the *50 State Study* fail to understand is the importance "freeport exemptions" have for the property taxes owners of wholesale trade businesses pay. Generally, freeport exemptions apply to goods or merchandise held for short periods of time (the period varies but is generally no more than a year) that are to be shipped to an out-of-state destination. In this way, much if not all of a warehouse's inventory that might otherwise be subject to property taxes is exempt. Our own modeling indicates that inventories are roughly 75% of a warehouse's total personal property. Research done for our 2018 white paper shows that for the 53 urban cities in our payable 2016 report, only businesses in Anchorage and Atlanta were unable to take advantage of a complete freeport exemption. This (again) goes a long way toward negating the advantage Minnesota's blanket personal property exemption provides. As the findings in our white paper show, Minneapolis' ranking for a warehouse with $1 million of real property for payable 2016 would be 19th highest – down 10 spots from the office space ranking because of the relatively high proportions of other types of personal property besides inventories. But once again Minnesota's personal property exemption does not deliver nearly the level of competitive advantage that critics imply for a commercial property type which constitutes only 15% of the total commercial property value office space represents.

And It Will Happen Again in the Future

As our accompanying article on the payable 18 study results finds, Minnesota's business property tax competitiveness/affordability rankings have actually improved this year – influenced by the state general tax levy freeze and $100,000 valuation exclusion enacted in 2017. Ironically, as we note in our accompanying property tax article, policy architects intended the state general tax to serve as a relief valve should business property tax competitiveness or affordability issues become a concern.

From The Director


Mark Haveman

We have some important news to share with respect to some MCFE staffing changes over the next few months. It starts with the upcoming departure of an exceptionally talented individual and great friend. Aaron Twait, MCFE's research director for the past 12 years will be leaving MCFE this fall to pursue a new career in the ministry. He will be enrolling in Luther Seminary this September in their Masters in Divinity program. We will miss his keen analysis and insights, Excel wizardry, and ridiculous productivity.

Here's the good news, I am exceptionally pleased to announce and welcome Bob DeBoer as MCFE's new Research Director beginning this September. A familiar name in Minnesota public policy circles for decades, Bob was the Director for Policy Development for the Citizens League for nine years. Prior to that he was the Director of Communications for the Office of the State Auditor and also served in several capacities for the Minnesota House of Representatives including Committee Administrator for Taxes and Local Government and as a media specialist and writer for the House Information Office. Bob's extensive experience in research and policy analysis combined with his considerable communication and data skill sets makes him an outstanding addition to the MCFE team.

We have brought Bob on part time during this summer to work with Aaron to familiarize himself with the development of our various studies and workproducts in order to make the transition as smooth as possible.

Over 93 years, a lot of moments of organizational transition have occurred, but we have always been fortunate to have highly talented and dedicated professionals ready to step in and continue our important work. Our good fortune continues. Please join me in thanking Aaron and welcoming Bob when you have the opportunity.

— M. H.

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This policy consideration is understandably a non-issue for spending interests. Building an argument for more tax dollars is the objective, which is entirely appropriate for them to do. Misrepresenting and questioning the validity of research which may inconveniently present a potential obstacle to that objective is not.

It would be welcome if at least some advocacy research money and energy would be redirected internally for a change to examine ways in which the E-12 system could be reformed to secure a financially healthier and more sustainable trajectory. One suggestion would be to examine more closely the issues and relationships highlighted in our 2015 education finance report, "How Much is Enough?" One critical question raised in our investigation: how does the single salary schedule – a compensation system design first introduced in De Moines in 1921 and essentially unchanged since its inception – affect the sustainability of Minnesota education finance 100 years later?

We are not holding our breath. In future years, we expect a continuing reprise and rehash of these same two decade-old arguments no matter how many times we refute them. So until this changes – and in response to the MREA report's exhortation to "acknowledge what we do not know, rather than pretend we know more than we do" – our own recommendation is simple: look in the mirror. ■