NESOTA Department of Revenue

A Tax System that Makes Sense for Minnesota

Volume II: Design Guide for Tax Reform

September 2000

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Letter from the commissioner

Dear fellow Minnesotans:

After spending the last year talking with and listening to Minnesota citizens, I'm more certain than ever that there are significant problems in our current tax system. Taxpayers want to know that they are getting a "fair shake" from a tax system that is accountable, understandable and predictable.

Tax reform and tax relief are two different goals—and, ideally, you want both. Without reform, you can't correct the underlying problems that result in the unfairness, complexity, and lack of accountability of our current system. Reform is also needed if we are to have a tax system that keeps pace with our changing economy.

But tax relief and tax reform each require some hard choices.

Tax relief requires less overall government spending—or at least a limit to its growth. This may well mean that some citizens will have to get used to receiving fewer (or less costly) services from government in the future than they've received in the past. If we cut spending to lower taxes, someone, somewhere, will be affected.

Tax reform means changing structure and distribution: that is, who pays tax on what, and at what rates. **Tax reform** may mean that some citizens will pay less than they pay now, while others—particularly if they've gotten a good deal compared to others in the past—may well end up paying more.

Combining **tax relief** with **tax reform** creates the best opportunity to restructure our tax system while minimizing the "cost" of reform. However, decisions about how much overall tax relief can be achieved are really decisions about state and local spending, not just tax policy. In the meantime, some key questions about our tax laws are before us:

- Do we want to continue with a state income tax that has among the highest rates in the country for both the top and bottom tiers, but with plenty of deductions and credits? Or do we want to move to a simpler income tax with lower rates for everyone but fewer deductions?
- Do we want to continue with the third highest state sales tax rate in the nation, but that nets only the 26th highest in state and local collections, because we have more exemptions than most other states? Or do we want to lower the rate and impose it on more kinds of sales?
- Our local property tax now pays for many statewide public policy decisions made in St. Paul, including those on education funding. But should the local property tax reflect local spending decisions, and state-mandated decisions be paid for by state, rather than local taxes?
- Finally, are we content with the current mix of our "big three" taxes—income, sales, and property? Or do we want to change the mix, and, for example, pay more in income or sales and less in property tax?

These are the questions we are asking you to consider this fall as we begin the final design of Governor Ventura's tax reform package. We value your input, and thank you for your participation in reforming Minnesota's tax system.

Sincerely,

Matt Smith

Tax reform begins with budget principles

State and local taxes are part of government's budget decision-making process. When Governor Ventura first took office, he laid out budget principles that serve as parameters as we look at tax reform. They are:

- **Be fiscally conservative and prudent. NEVER forget it's the people's money.** This means we must do what's necessary—not necessarily what's nice to do. Prevent future costs where possible. Pay close attention to the future costs of policy and budget decisions, and insist that projected budgets be balanced for four years. Set a responsible budget, live within it, and settle up any actual surpluses with taxpayers at the end of the biennium.
- **Do the right things, and do them well.** Evaluate programs in tangible ways for real costs, effective results. Reform or eliminate programs if they are redundant or aren't producing desired results.
- **Provide incentives for desirable behavior.** Competition works and is even good in government. Match responsibility and accountability at all levels. Put decisions at the appropriate level, closest to the people. Leverage private and non-profit support. Support fees where users have a voice in the rates and program results.

Tax relief is reducing the overall level of taxation. **Tax reform** is changing the overall structure of the tax system. The most powerful and successful approach to dramatically improving our tax system is tax reform combined with overall tax relief. Tax relief opportunities will depend on other budget decisions and/or the revenue forecast. The governor's budget principles can help us challenge our tax system and ask the right kinds of questions as we discuss **tax relief *and* reform.**

Complicated web of government

The "tax price" of the government services citizens use is often hidden so they (and governments) don't know enough about true costs of services. Money is raised through a complex web of 3,490 overlapping government units, each with its own taxing and spending authority, resulting in over 6,000 unique state and local taxing jurisdictions.

Our state and local tax system is complicated by:

6,000+ Unique taxing jurisdictions, resulting from

3,490	***Overlapping government units made up of:***
87	***counties***
854	***cities***
1,794	***townships***
349	***school districts***
406	***"special districts"***

Financed by

48	***State/local taxes***
280	***Exemptions, deductions and credits***
205	***Intergovernmental aid programs***
–	***Uncounted fees and charges***

Things we need to know to reform taxes

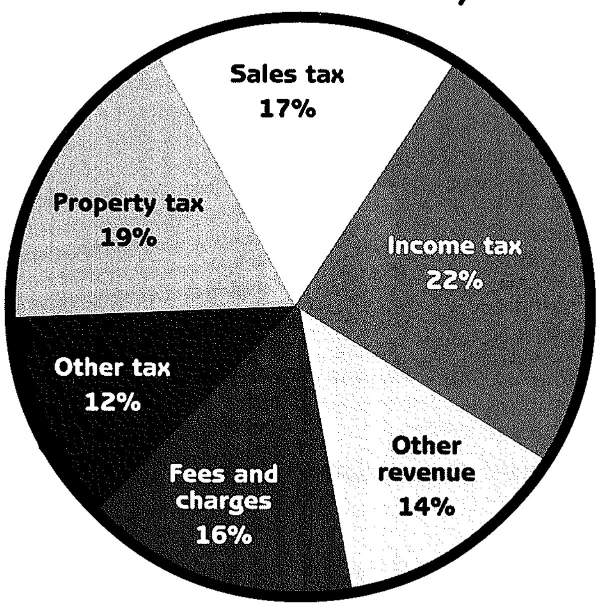
When discussing possible reforms to Minnesota's tax system, there are certain factors to consider:

1. Minnesota's economy is healthy.

This means that, as the economy grows, tax revenues grow. We continue to enjoy budget surpluses due to strong economic growth with more people working and paying income tax, more people buying things and paying sales tax. But, on the spending side, people are demanding more government services: for example, our aging population means that more seniors need care; at the same time, we have more children in school, which increases pressure on our education system; and tougher crime policy means more need for prisons. Taken together, more demands mean more costs to government. We need to ask ourselves: how much does government really cost?

Minnesota ranked 10th in growth of personal income between 1995 and 1999.

How much do we pay to support state and local government? Where does the money come from?



Estimated total for 2001: $25.7 billion (17.4 cents per dollar of state personal income)

Does the structure of the tax system have anything to do with the level of spending? What drives the total tax level in Minnesota?

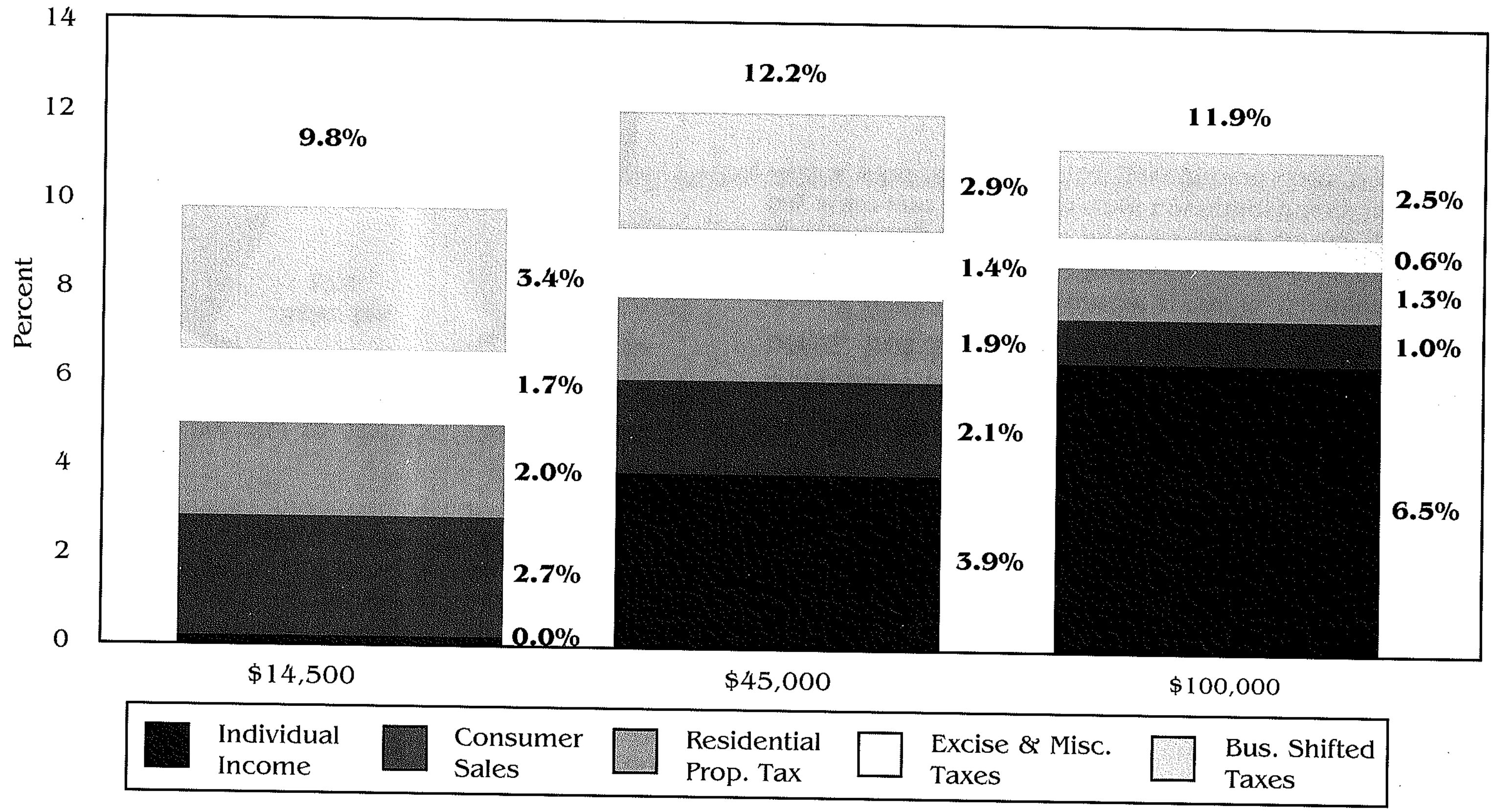
2. Our state and local tax burden is balanced in sources of revenue and in who pays, but high compared to other states.

Overall state-local government spending is about 17.4 cents of every dollar of Minnesota personal income. That means about 17.4 cents of every dollar earned goes to pay state and local taxes—not counting federal taxes. This is what state and local government costs taxpayers.

What is our current mix of taxes?

From taxpayer's perspective: Who is paying taxes?

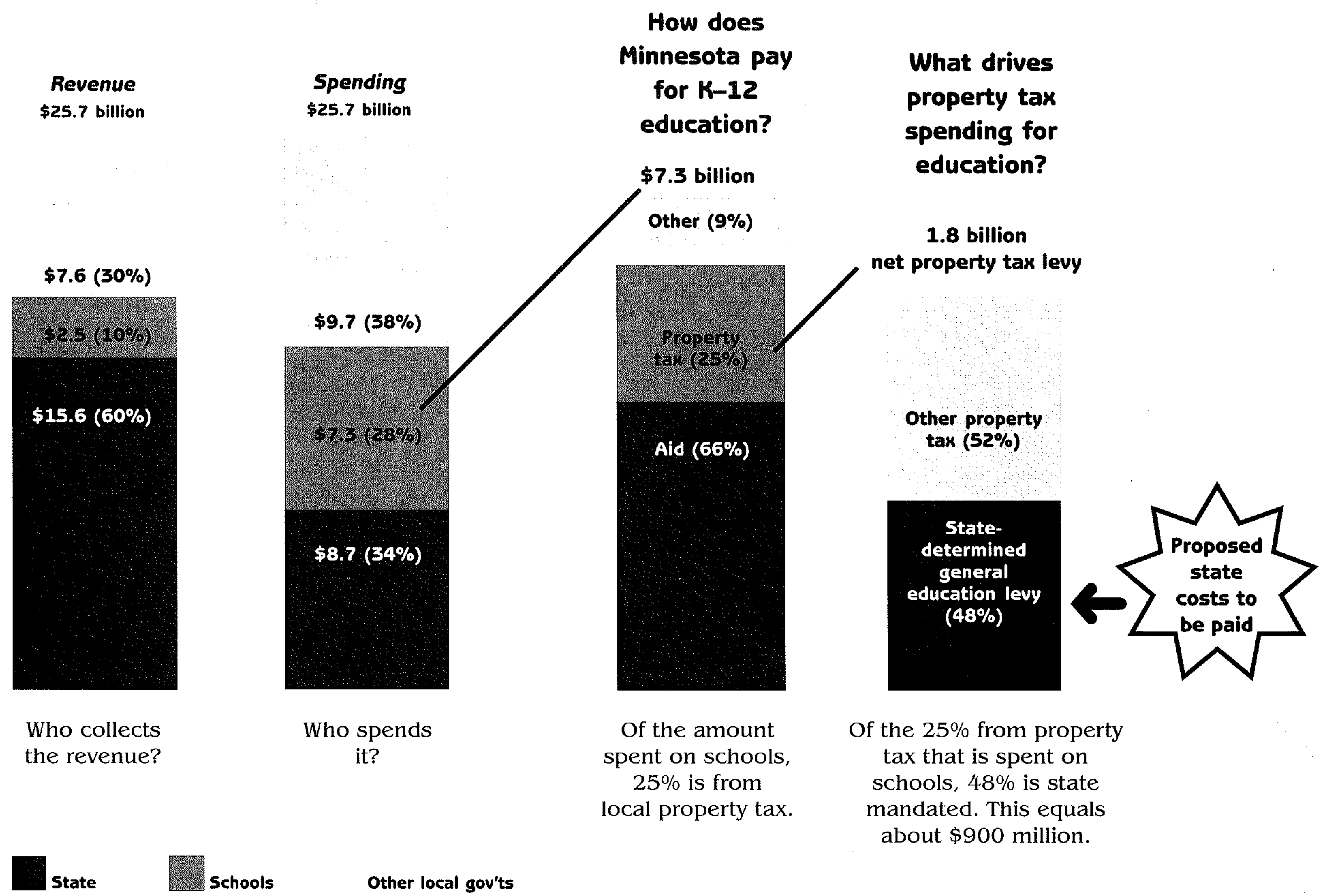
Taxes as a percent of income by tax type at selected levels of household income: 1998



In general, the percentage share of income used to pay the individual income tax increases as household income increases and the percentage share of sales taxes declines as income increases. Overall, total state and local tax burdens as a percent of income are fairly equal.

*Business shifted taxes are estimated taxes initially paid by businesses that are passed on to Minnesota taxpayers through product prices or lower wages.

What does paying for 100% state mandated K-12 costs mean for the property tax?



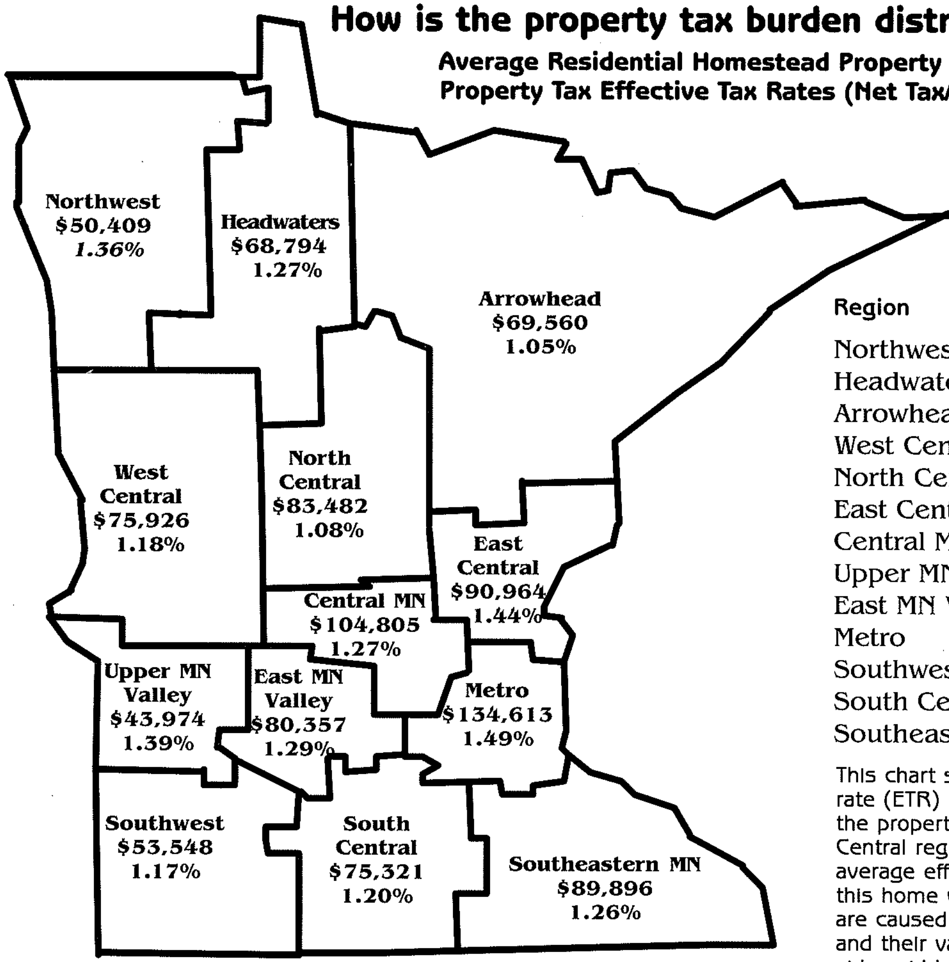
- Tax burdens vary significantly between different regions:

  Average property taxes on homes vary throughout the state—from 1.05 percent to 1.49 percent as a percentage of market value, and from under 1 percent to over 6 percent as a percentage of income. Homeowner property taxes are generally lower in Greater Minnesota than in the metro area.

- Property taxes on different types of residential property vary tremendously—farm homesteads vs. regular homesteads vs. renters vs. seasonal-recreational (cabins).

How is the property tax burden distributed in Minnesota?

Average Residential Homestead Property Values and Average Property Tax Effective Tax Rates (Net Tax/EMV): CY 2000 est.



Region	Average Valued Home	Effective Tax Rate	Average Property Tax
Northwest	$50,409	1.36%	$686
Headwaters	$68,794	1.27%	$874
Arrowhead	$69,560	1.05%	$730
West Central	$75,926	1.18%	$896
North Central	$83,482	1.08%	$902
East Central	$90,964	1.44%	$1,310
Central Minnesota	$104,805	1.27%	$1,331
Upper MN Valley	$43,974	1.39%	$611
East MN Valley	$80,357	1.29%	$1,037
Metro	$134,613	1.49%	$2,006
Southwest	$53,548	1.17%	$627
South Central	$75,321	1.20%	$904
Southeastern MN	$89,896	1.26%	$1,133

This chart shows the average home value and average effective tax rate (ETR) in each region of the state. The effective tax rate is equal to the property tax divided into market value. For example, in the East Central region the average valued home is $90,964 and has an average effective tax rate of 1.44 percent. The average property tax on this home would be $1,310. Regional differences in effective tax rates are caused by a number of factors, including the mix of property types and their values, the state classification system of properties, local aids paid by the state, and local budgeting decisions.

Who doesn't pay taxes?

High tax rates lead to more exemptions. Minnesota currently has 240 or so exemptions in the property tax, over 82 explicit exemptions in the sales tax and countless others in other tax types. In fact, there is a 200-page book published every biennium by the Department of Revenue that summarizes different exemptions from the tax code—each with its own constituency. It is a circular problem: high rates cause various groups to ask for exemptions; exemptions reduce overall revenue; lower revenue encourages higher rates.

3. Minnesota has some of the highest tax rates in the country.

What are some of the high rates? Minnesota has some of the highest tax rates in the nation:

- third highest property tax rate on market rate apartments and larger business (commercial) property
- third highest state sales tax rate
- fourth highest corporate income tax rate
- individual income tax: 10th highest top rate, third highest starting rate

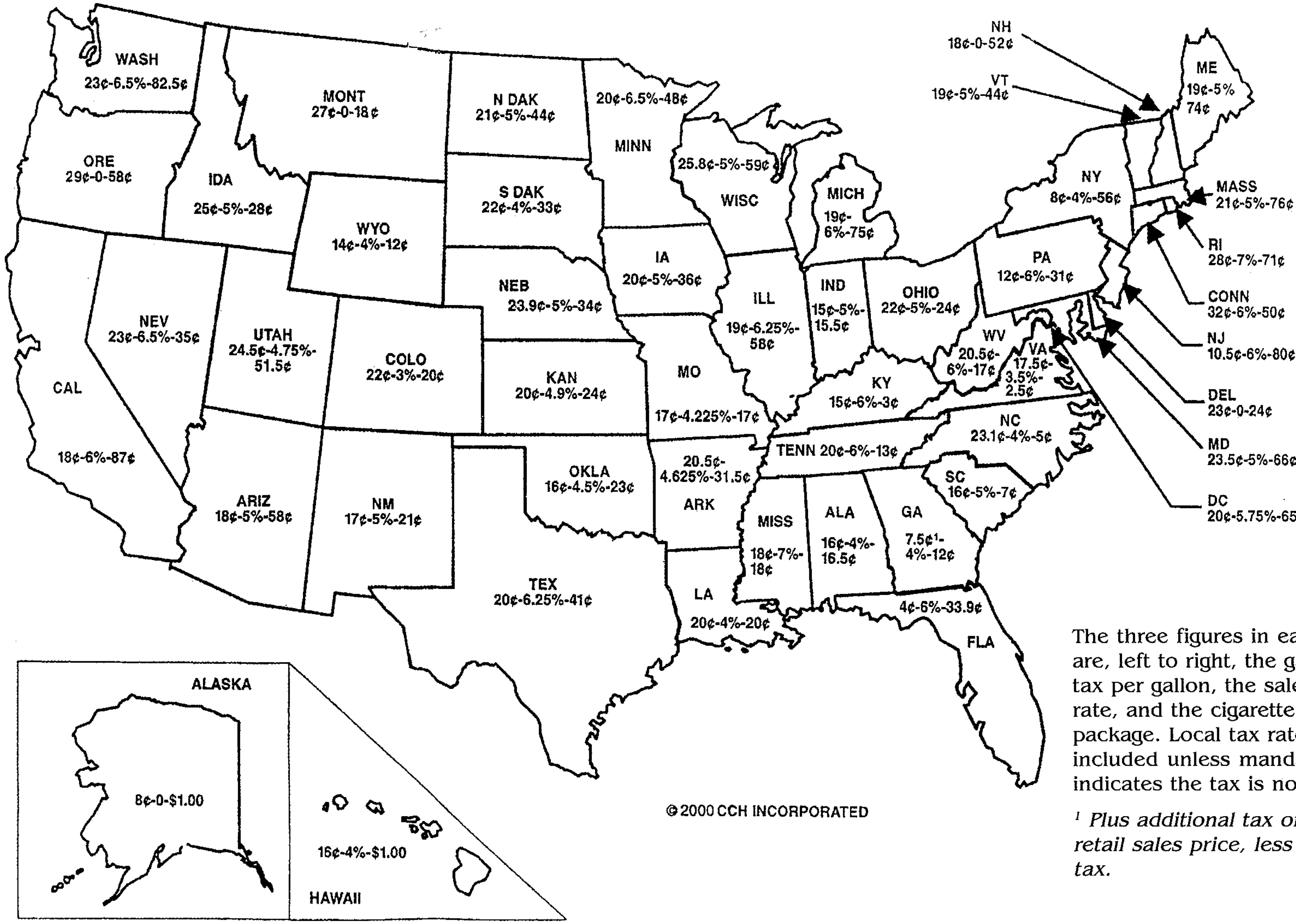
But a high rate doesn't necessarily mean that a tax raises a lot of revenue:

Our third highest sales tax rate results in the 26th highest state and local collections, due to a very narrow tax base that exempts many services and some goods such as food, clothing, even gasoline. These are taxed in many other states. Minnesota makes little use of local option sales taxes.

Minnesota's tax ranking by major tax: FY 1996

	Minnesota level	Minnesota rank	Wisconsin level	Wisconsin rank	Iowa level	Iowa rank	S. Dakota level	S. Dakota rank	N. Dakota level	N. Dakota rank	U.S. Avg. level
Per capita income	$25,661	12	$23,319	23	$22,305	31	$20,906	38	$20,433	39	$24,426
Tax as a percent of income:											
Total state and local taxes	13.2%	5	13.3%	4	11.7%	16	10.1%	46	12.1%	11	11.3%
Property tax	3.7%	19	4.8%	7	4.0%	14	3.9%	15	3.5%	24	3.4%
Individual income tax	3.7%	3	3.6%	4	2.7%	17	-	-	1.3%	41	2.2%
Corporate income tax	0.6%	9	0.5%	14	0.3%	36	0.3%	41	0.6%	10	0.5%
State/local sales tax	2.6%	26	2.5%	33	2.6%	30	3.5%	13	2.6%	29	2.8%

State gasoline, sales and cigarette tax rates as of July 1, 2000



The three figures in each state are, left to right, the gasoline tax per gallon, the sales tax rate, and the cigarette tax per package. Local tax rates are not included unless mandatory. "0" indicates the tax is not levied.

[1] *Plus additional tax of 3% of retail sales price, less the 7.5¢ tax.*

4. Some Minnesota taxes are low compared to other states in some areas.

Is Minnesota lowest taxed in anything? Minnesota also has some low tax rates—especially given our higher overall level of spending and taxes:

- 20th highest cigarette tax
- 21st highest gas tax
- 26th highest property tax rate on low-to-moderate-valued homesteads

5. Can we keep having big tax cuts?

During the past two legislative sessions, Minnesota has put a lot of effort into cutting taxes:

- $2 billion in one-time sales tax rebates
- Over $1 billion annually in permanent state tax reductions (FY03):

  $775 million individual income tax
  $175 million motor vehicle registration tax
  $15 million corporate income, sales, and charitable gambling
  $135 million annual increase state-paid property tax relief for farms, business, rental housing

Tax cut totals during the 1999 and 2000 legislative sessions have been large, yet Minnesota's tax rankings haven't really changed much.

Despite this, Minnesota's overall state and local tax burden remains solidly in the top 10 nationally:

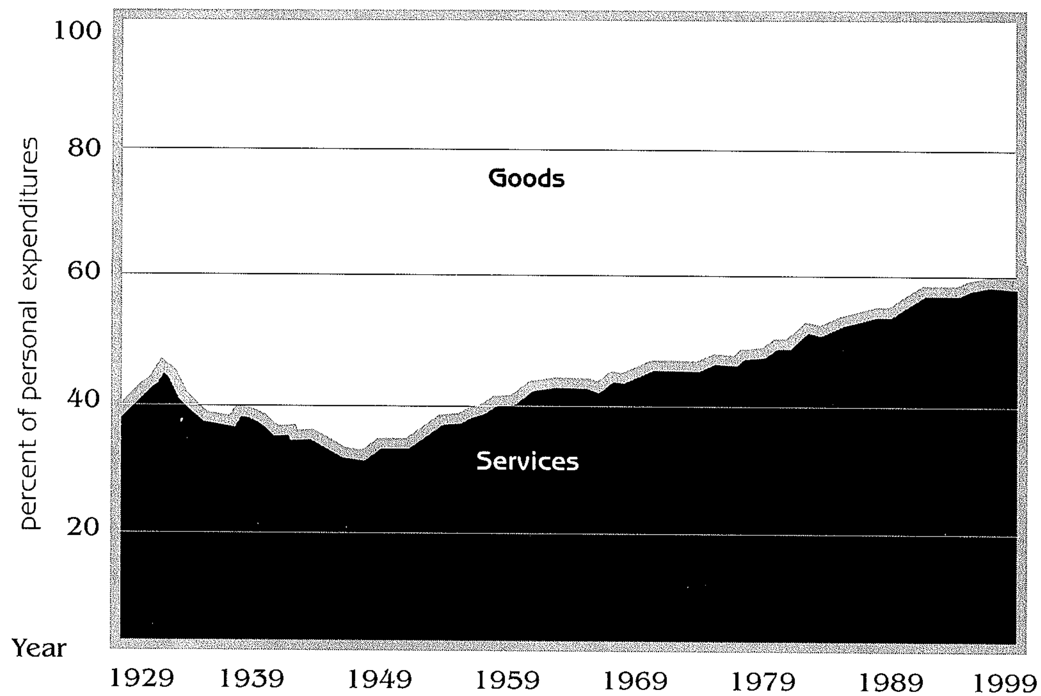
- Minnesota's ranking has fallen somewhat due to one-time tax rebates. If no other state had made permanent tax cuts last year, we'd be ninth, but other states cut taxes, too.
- Even after permanent reductions, Minnesota is still likely to be in the top 10.

6. National rankings aren't the only measure of taxes.

- Tax burdens reflect the amount of public services and spending by governments, so a high tax ranking goes hand in hand with high spending.
- Each state and community needs to strike a balance between the spending levels and the amount of tax burden.
- Our economy is shifting from industrial production to services, but our tax structure has not kept pace. As services (most of which are untaxed) grow as a significant part of our economy, the tax burden will fall on tangible products, such as real property or store-bought goods. [*See graph, page 14*]
- Every state and community needs to look to the future. In a global economy, where individuals and businesses are increasing mobile and can locate virtually anywhere, it is increasingly important that no state's tax rate stand out from those in the rest of the country.

The growing service economy:

In 1929, 61 percent of personal expenditures were for goods, and the remaining 39 percent went for services. By 1999, those percents were nearly reversed, with 58 percent of personal expenditures going for services, and 42 percent for goods.



Source: Minnesota Taxpayers Association
Bureau of Economic Analysis,
Consumer Expenditure Survery

7. State taxes are being challenged by technology changes and national policy.

- The growth of Internet and catalogue sales is a serious challenge to states' ability to collect sales tax. Loss of sales tax revenue will force state budgets to rely more on property or income taxes. It will be essential to find ways to level the playing field for bricks-and-mortar retailers and their Internet competitors.

While national rankings may be important, they describe only part of the problem in the tax system.

- Congress has deregulated the telecommunications industry. How will these changes affect the tax you pay on your bill?
- States are looking at deregulating parts of the energy/ electric utility industry. If you can start buying your power from a non-Minnesota company, how will this affect the taxes you pay on your electricity bill?

A recent national study showed that by FY03, Minnesota could lose up to $230 million in sales and use tax due to Internet transactions.

Conclusion

All of these points add up to the case for reforming the tax system. Tax reform and relief together can provide a powerful combination.

Taxpayers have told us they want a system that is

- fair
- understandable and simple
- predictable and accountable
- competitive

We need tax reform to:

Improve **fairness** by better targeting tax relief, eliminating exemptions and preferences that favor one taxpayer group over another, and measuring performance of the tax preferences we do allow.

Make it easier for taxpayers **understand** how to influence and control taxing and spending decisions at both state and local levels.

Sort out a complex tax and spending system to make it more **accountable** for taxpayers to better **understand** the level of government spending and who is making the decisions.

Address high tax rates to ensure that our tax laws are **competitive** and address changes needed in our tax laws to keep pace with economic and technological changes.

We need tax relief to:

Lower tax rates where Minnesota now stands out nationally—high rates can distort decision making and cause competitive problems in all areas—income, sales, property.

Align Minnesota's tax laws to the new technology, regulatory and global **competitive** environment.

Together, reform and relief can give more fairness to our tax laws, move Minnesota into a nationally and globally competitive position, and ensure that Minnesota has a secure funding stream to pay for services provided to its citizens.

What is the formula for a reformed system with lower rates?

A reformed system with lower rates can be achieved through:

- Less spending—a lower growth in government spending so the economy can grow faster than government.
- Closing and limiting tax exemptions and special preferences that cause everyone to pay higher rates and create unequal, unfair benefits for narrow industries or groups.
- Raise some of our "low" rates on certain taxes to help provide for reducing high tax rates elsewhere.

What do citizens want from a reformed tax system?

During 1999 and early 2000, we asked hundreds of Minnesotans—both citizens and public officials from state and local government—what tax reform means to them. Here is what we heard:

- Fairness is the number one concern of both citizens and of public policymakers. Equal treatment wherever possible and respect for the ability-to-pay principle were cited most often as components of a "fair" tax.

"I just want to be sure my brother-in-law isn't getting a better deal than I am."

Citizen comment, Brainerd

- People want taxes to be simple and understandable. Citizens acknowledge they have to pay taxes for services, but want to at least understand who is taxing them and for what purpose.

"I would like to sit down with a calculator and be able to estimate my own property tax. The assessor uses a computer, but can't always explain the calculations. It is so complicated and should be simplified so we can do it ourselves."

Citizen comment, Hibbing

- People want a sense of predictability and control. There is a widespread sense that government, especially in the areas of taxes and spending, is out of citizens' direct control.

"With all the confusion in the property tax system, we end up looking like we're lying."

State legislator

- People want to ensure continuing economic prosperity throughout the state, and they want the tax laws to support that goal.

"I believe tax policy can positively influence the economic structure in a state."

State legislator

All of these sentiments are captured in our "What we Heard" report, available on our website at www.taxes.state.mn.us

What changes when we reform taxes? Who pays for which changes?

One way to measure tax reform changes is to look further at the "incidence," or who bears the burden of what tax. The chart on page 19 illustrates, by tax type, who pays what of a particular tax. When analyzing what the impact of any tax law change is on a particular taxpayer or group of taxpayers, we total up the amount paid, and determine what amount is imposed on resident households, non-residents and Minnesota businesses. For the business portion, estimates are developed that illustrate how business taxes are passed on, or shifted, to taxpayers who bear the true tax costs through higher prices, etc. By combining the shifted portions of the business taxes with the amount that falls directly on households, a true picture of who pays emerges.

What impact does the tax change have on the rich or the poor? One way to measure how regressive (where the burden falls on lower income taxpayers) or progressive (the burden falls on higher income taxpayers) is through a measurement called the suits index. The suits index measures the progressivity of a tax. Values between zero and one indicate a progressive tax, and between minus one and zero a regressive tax; zero represents a flat tax. The further the value is from zero, the more progressive or regressive the tax. The farthest right hand column is the suits measure.

2001 Tax Collection Amounts

($ Millions) **Preliminary 9/11/00**

Tax Category	Total	As Imposed: MN HH's	As Imposed: NR	As Imposed: Business	After Shifting: Minn.	After Shifting: Exported	Suits Index
Taxes on Income							
Individual income tax	5,862	5,676	186		5,676	186	0.189
Corporate franchise tax	723			723	359	364	-0.146
Total income taxes	6,585	5,676	186	723	6,035	550	0.169
Taxes on Consumption							
Total general sales	4,478	2,436	134	1,908	3,696	782	-0.176
General sales/use	3,949	2,085	134	1,730	3,262	687	-0.183
Sales tax motor vehicles	529	351		178	434	95	-0.124
Motor fuels excise tax	622	273	100	249	431	191	-0.253
Alcoholic beverage excise tax	59	53	6		53	6	-0.269
Cigarette and tobacco excise taxes	185	179	6		179	6	-0.471
Insurance premiums tax	180	108		72	137	43	-0.146
Gambling taxes	60	58	2		58	2	-0.363
MinnesotaCare taxes	140	136	4		136	4	-0.260
Total consumption taxes	5,724	3,243	252	2,229	4,690	1,034	-0.199
Taxes on Property							
Local							
Homeowners (gross)	2,138	2,138			2138		-0.067
Rental property (gross)	449			449	372	77	-0.210
Property tax refunds	(201)	(201)			(201)		0.811
Residential recreational (cabins)	107	86	21		86	21	-0.034
Commercial	1,265			1,265	629	636	-0.034
Industrial	433			433	46	387	0.205
Farms (other than residence)	234			234	234		-0.167
Utility	302			302	190	112	-0.171
Total Local	4,727	2,023	21	2,683	3,494	1,233	-0.041
State							
Motor vehicle registration tax	482	390		92	432	50	-0.117
Mortgage and deed taxes	129	87		42	111	18	-0.039
Total State	611	477		134	543	68	-0.101
Total property taxes	5,338	2,500	21	2,817	4,037	1,301	-0.049
Total Taxes	17,647	11,419	459	5,769	14,762	2,885	-0.008

Note: Table is based on the February, 2000 forecast, using 2000 legislative session tax laws and the 1999 Tax Incidence Study database (1996 data). The Suits indices in this table are calculated on taxes paid by Minnesota households after tax shifting; that is, after taxes imposed on businesses have been shifted to the ultimate payers. The suits index measures the progressivity of a tax. Values between zero and one indicate a progressive tax, and between minus one and zero a regressive tax; zero represents a flat tax. The further the value is from zero, the more progressive or regressive the tax. The farthest right hand column is the suits measure.

What do typical households pay in state and local taxes today?

Now let's take a snapshot of the average Minnesota household to begin exploring options to change our tax system.

What do typical households pay in state and local taxes today?

Look on the chart below and pick out a houshold that best describes yours. This is, on the average, what you spend in different taxes.

Married Filing Joint
2 children
Income about $60,000

Current Taxes	
Income	$2,400
Sales	1,100
Property	1,400
Gas	180
Liquor	20
Other	975
Total	$6,075

Single
Income about $35,000

Current Taxes	
Income	$1,700
Sales	700
Property	480
Gas	90
Liquor	40
Other	475
Total	$3,485

Farm Family
Income near $25,000

Current Taxes	
Income	$300
Sales	700
Property	300
Gas	135
Liquor	15
Other	600
Total	$2,050

Single Head of Household
2 children
Income low $30,000's

Current Taxes	
Income	$900
Sales	700
Property	600
Gas	120
Liquor	18
Other	500
Total	$2,838

Retired Couple Homeowners
Income about $30,000

Current Taxes	
Income	$180
Sales	680
Property	380
Gas	100
Liquor	15
Other	400
Total	$1,755

Married Filing Joint
2 children
Income about $100,000

Current Taxes	
Income	$4,800
Sales	1,650
Property	2,000
Gas	230
Liquor	35
Other	1,250
Total	$9,965

Reforming the property tax

Minnesota's property tax is the most complicated and least understood of all of our taxes. It has been the target for "reform" every year in recent history, and it seems that each time the state responds, the system gets more complicated and fairness becomes more elusive.

One thing we heard from taxpayers loud and clear is that the property tax is the most frustrating. Although Minnesota homes have a relatively low property tax ranking compared to other kinds of property, people are frustrated because it's hard to understand the tax, and who or what is responsible for increases (or decreases) in their tax bill.

Currently, we have a system characterized by multiple property classifications, numerous credits and special exemptions, significant variations in effective tax rates among types of property, and several complicated state aid programs, some of which have no clearly defined purpose. Our system is further complicated by the many areas of shared state and local responsibility for setting tax and spending levels.

While specific property tax reform objectives have varied throughout the years, some common themes have emerged from this and other reform agendas.

- Make the property tax system fair for all taxpayers
- Simplify the system without compromising fairness
- Make the property tax more affordable by targeting relief based on "ability to pay"
- Enhance understandability and government accountability
- Make the property tax a truly local tax

How can we reform the property tax? Here are some options:

1. **While the property tax should remain an important source of revenue for state and local services, who is levying the tax and for what purpose needs to be more clear.**

   Consider: *Make the property tax more of a "local tax" and clarify the role of the property tax in funding K–12 education, welfare, courts, public safety, health programs and transportation needs.*

   Consider: *Make more efficient use of state aid programs by targeting the aid to services that are shared state-local responsibility and that best address local service needs and revenue raising through local effort. Examine alternative local revenue-raising capabilities, including local option sales taxes, and fee-for-service alternatives.*

2. **Simplify the system so that local property taxes are more fairly distributed among types of property and taxpayers.**

   Consider: *Reduce the relatively high share of taxes paid by some types of property, such as apartments and businesses. Do not discriminate against housing choices, e.g., renting or owning, and try to treat all "residential" property the same.*

   Consider: *Rely more on targeted property tax relief based on ability to pay, rather than on untargeted credits or class rate preferences.*

   Consider: *Eliminate some of the arbitrary distinctions that are made between uses of property in our classified system so the system can be more easily understood and administered.*

3. **Enhance credibility and trust among taxpayers and elected officials for the assessment process by ensuring that all property is subject to high quality, annual assessment.**

   Consider: *Enhance ongoing review, evaluation and reporting of market value trends and assessment practices to improve taxpayer understanding and to make assessors more accountable for assessment practices.*

   Consider: *Ensure "best practices" by providing more education and training opportunities for assessors.*

4. **The system, from point of assessment through distribution of tax revenues, needs to be simplified without sacrificing fairness. The system needs to be more efficient and less burdensome to administer.**

   Consider: *Simplify property classification system by eliminating arbitrary distinctions between uses of certain types of property.*

   Consider: *Eliminate the use of ineffective tax credits and other preferential treatment of property.*

   Consider: *Use technology to make the system more efficient in managing and distributing data and information.*

5. **Taxpayers must understand how the property tax works and what to expect, and how they can participate in the process in order to affect spending and taxing decisions.**

   Consider: *Use information from taxpayer focus groups to make changes to improve the valuation notices, improve participation in Truth-In-Taxation and make the property tax statement more understandable and useful to the taxpayer.*

   Consider: *Improve the assessment appeals process to make it more taxpayer-friendly.*

Reforming the sales tax

Minnesota has one of the highest sales tax rates (6.5 percent), with one of the lower collections rates in the country. The other states that have a 6.5 percent sales tax, Washington and Nevada, don't have an income tax. We have a high rate and a narrow base.

A narrow base, or low collection rate, means we exempt a lot of things; that is, we impose the tax on a narrow set of goods and some services, and not on other goods and most services. The tax is paid by all—rich, poor, private sector, government sector, and even in some cases, the nonprofit sector.

Even though Minnesota has a high rate, the amount of things we don't tax, compared to other states, leaves us in 26th place in state and local sales tax collections. Our high rate means we pay 30 to 50 percent more in sales tax for things than our neighbors, who tax things differently. Many of those things we don't tax are services. As the sales tax base is shifting away from goods and more to a service-based economy, we will need to examine what we choose to tax and what we don't. In fact, data from the Bureau of Economic Analysis Consumer Expenditure Survey shows that consumption of services has grown as a percent of personal consumption 15 percent since Minnesota adopted the sales tax.

If we don't get our high sales tax rate in line and take a close look at what we currently exempt, it will seriously affect the future of our sales tax. We will either have to rely more heavily on income and property taxes to make up the difference in lost revenues, or we may, down the road, have to look at an even higher sales tax rate.

Our sales tax is also confusing for both taxpayers and retailers. In fact, while the average consumer may not notice it, the sales tax law has become confusing to the point of being ridiculous: for example, we tax sneakers for running, but not sneakers to wear around the house. We tax chocolate-covered peanuts as candy, but not dry roasted peanuts as food.

Role of the Internet and the sales tax

Approximately three years ago, Congress passed a moratorium on access charges for Internet services. This means states could not pass laws to tax your AOL or other Internet service provider connection.

Businesses that sell through the Internet or catalogue sales have told states such as Minnesota that it is impossible for them to collect and remit sales taxes in 50 different states with 50+ laws governing state and local sales taxes. We agree. That is why Minnesota and other states are working on ways, through technology and other changes, to make it easier for companies to collect and remit sales tax on the same purchases that you would pay tax on when bought at your local store. It's fair for local retailers, fair for taxpayers.

In an economy where state boundaries are becoming increasingly irrelevant, it is important for states, like Minnesota, to make the laws fair and consistent for everyone. If we don't, losses in sales tax dollars would have to be made up somewhere else—the property tax or income tax being two likely places. The following page shows possible options for sales tax reform.

How can we reform the sales tax? Here are some options to discuss:

1. **Create a "streamlined" system to allow retailers, who collect and remit the tax, to be able to comply with Minnesota laws, regardless of how they are selling taxable goods and services.**

   Consider: *Adopt model legislation and technology improvements to make it easier for sellers of goods and services to collect and remit sales and use tax owed to Minnesota.*

2. **Look to other states to make Minnesota similar on how we tax certain goods and services. This base broadening can mean a lower rate and a simpler, fairer system.**

   Consider: *Look at what we currently exempt and what we currently tax and make our sales tax more like those of our neighboring states. Are we competitive? What could we not exempt to lower the rate to be more competitive with our neighbors, Wisconsin, Iowa and South Dakota?*

3. **Some of our taxes on certain goods are low compared to other states.** ***[See the map of the country on page12.]***

   Consider: *Cigarette taxes are currently 20th highest in the country, yet higher taxes are seen by health experts as a way to keep people from smoking and to pay for tobacco-related public health costs.*

Reforming the income tax

Minnesota enacted significant income tax reforms in 1985 and 1987, but since that time the income tax system has regained almost all of its former complexity with an expanded number of deductions, credits and other modifications.

In 1984, Minnesota's individual income tax return was two pages, it had 13 additions to federal income, 16 subtractions, a 22-line schedule to calculate a deduction for federal income taxes and Minnesota itemized deductions, seven non-refundable credits, two refundable credits, and two add-on taxes.

In 1987, the Minnesota individual income tax was simplified. The 1987 return became one page. It had two additions, three subtractions (another subtraction was allowed because of litigation on state taxability of railroad retirement benefits), two non-refundable credits, one refundable credit, two add-on taxes, and no 22-line schedule for calculating a federal tax deduction and itemized deductions.

By 2000, the Minnesota return has again become very complex for taxpayers. The income tax system has become a vehicle for non-tax-related social policies. Since that time, a number of new credits and subtractions that benefit a relatively narrow set of constituencies have been added to the form. The return is again two pages. It has five additions, 16 subtractions, seven non-refundable credits, three refundable credits, and two add-on taxes.

In reforming the income tax and applying sound tax policy principles to the system, we see certain themes or objectives emerge from reform discussions:

- The income tax system needs to be at least as progressive as it now in order to offset the regressivity of the other taxes.
- The income tax system would be simpler to understand and more equitable to the entire population if we reduced the many special preferences currently allowed to some taxpayers.
- It's important to keep only tax-related issues on the income tax form.
- A reduction in assorted tax preferences would result in a broader base and lower rates, which would allow Minnesota to be more competitive with other states.
- The system should be neutral as to taxpayer's filing status.

Continued on page 26

What specifically can be done to reform the system?

1. **The tax system should be neutral as to the filing status of taxpayers.**

   Consider: *Base the income tax system on a large, inclusive definition of income (Federal Adjusted Gross Income) to maintain a more progressive tax base than the current method of using Federal Taxable Income.*

   Consider: *Keep the tax "marriage neutral" whenever possible, preserving the recently-enacted "marriage penalty offset."*

2 **The tax form should be easy for taxpayers to understand, not a complicated maze that's too difficult to work through without the assistance of a tax preparer.**

   Consider: *Allow only those adjustments to income that are required by federal law, or that reflect expenses of earning income.*

   Consider: *Reduce significantly the number of tax preferences that reward taxpayers for certain expenditures.*

   Consider: *Streamline assorted low-income tax credits administered through the income tax system and expand the current Working Family Credit.*

Appendices

Appendix A Summary of Minnesota's Property Classification Rate System

Summary of property classification rates for major types of property: CY2000

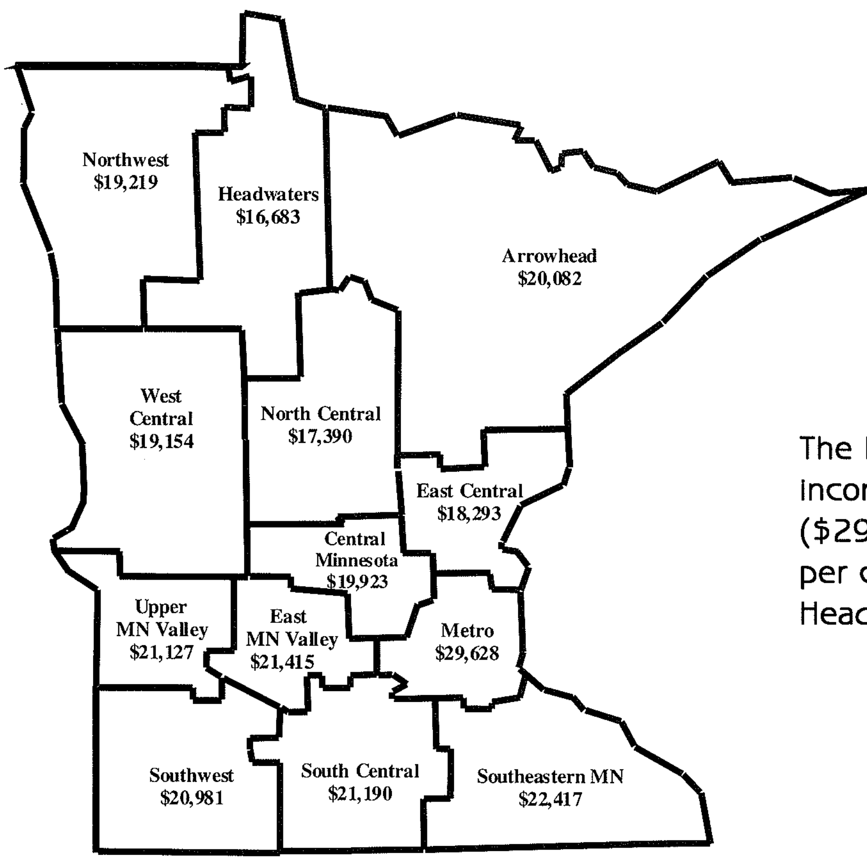
Residential Homestead	
<$76,000	1.00%
>$76,000	1.65%
Residential Non-Homestead	
Single:	
<$76,000	1.20%
>$76,000	1.65%
2-3 Units	1.65%
Apartments	
Regular	2.40%
Small City	2.15%
Low Income Apartments	
Title II	1.00%
FHA	1.00%
Commercial/Industrial/Public Utility	
< $150,000	2.40%
> $150,000	3.40%
Seasonal Rec. Commercial	
Homestead Resorts (1c)	1.00%
Seasonal Resorts (4c)	1.65%
Cabins	
<$76,000	1.20%
>$76,000	1.65%
Agricultural Land & Buildings	
Homestead:	
<$115,000	0.35%
$115,000 - 600,000	0.80%
> 600,000	1.20%
Non-Homestead	1.20%

Minnesota's property classification rate system results in a wide variation in effective tax rates (Tax/MV) between different types of property

Property Type	Estimated Average ETR Pay 2000
Residential Homestead	1.41%
Residential Non-Homestead	1.93%
Apartments	3.16%
Low Income Housing	1.97%
Commercial/Industrial	4.38%
Season Rec. Commercial	1.55%
Cabins	1.50%
Farm Homesteads	0.70%
Farm Non-Homesteads	1.19%

Appendix B How are income resources distributed in Minnesota?

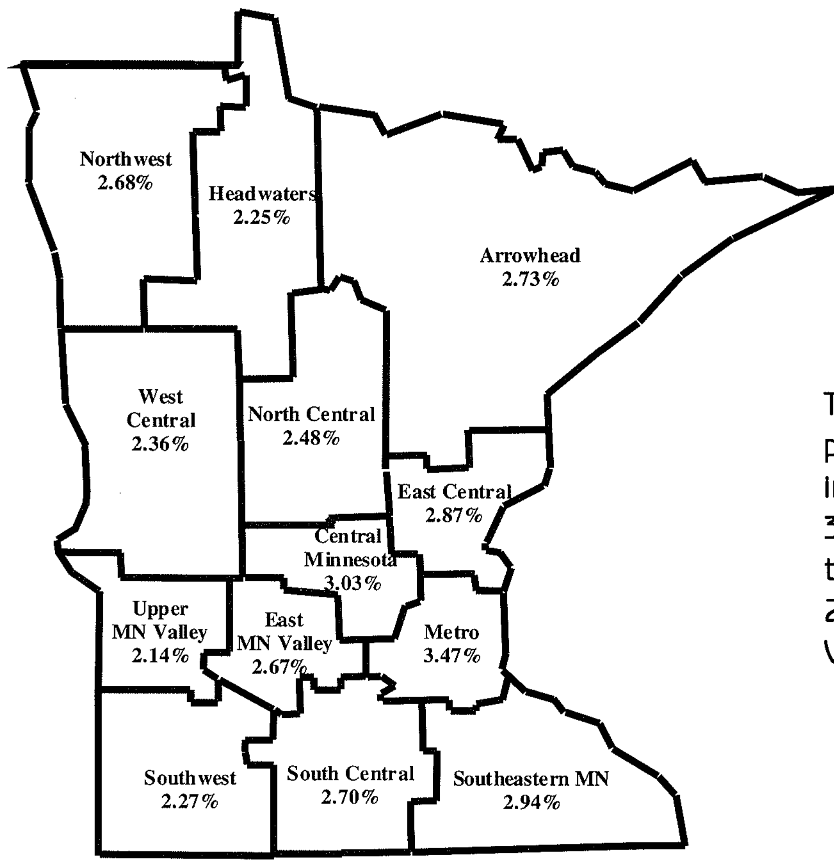
Income per capita, calendar year 1996



The highest level of per capita income is in the Metro Region ($29,628) and the lowest level of per capita income is in the Headwaters Region ($16,683).

Appendix C How is the income tax burden distributed in Minnesota?

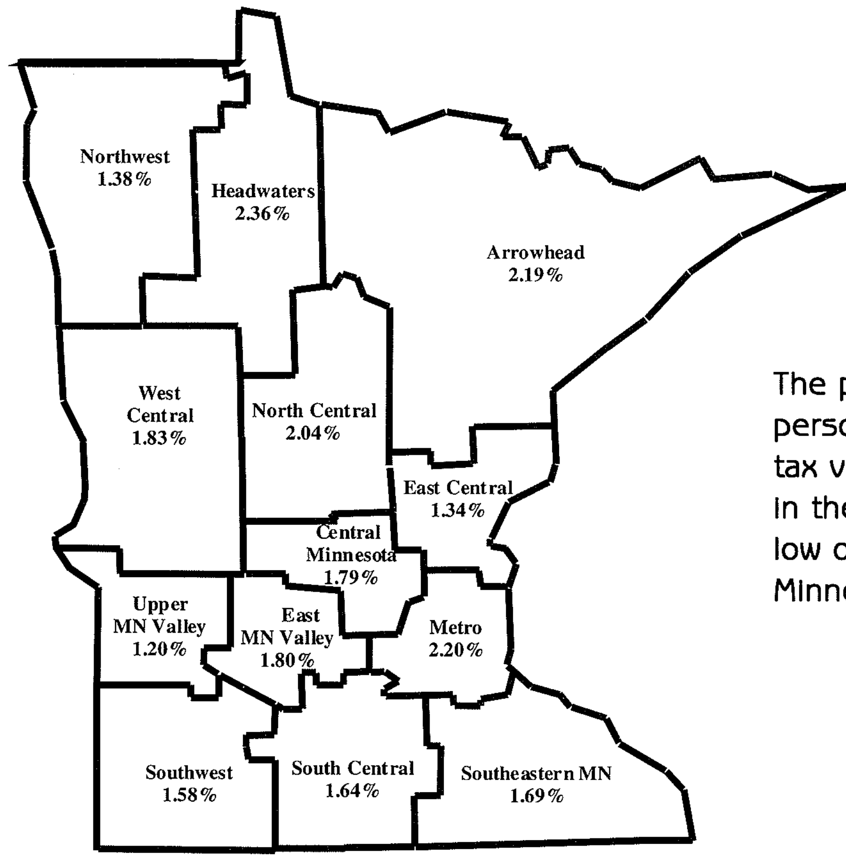
Income tax as a percent of income, calendar year 1996



The highest percentage of personal income paid in individual income taxes was 3.47% in the Metro Region; the lowest percentage was 2.14% in the Upper Minnesota Valley Region.

Appendix D How is the sales tax burden distributed in Minnesota?

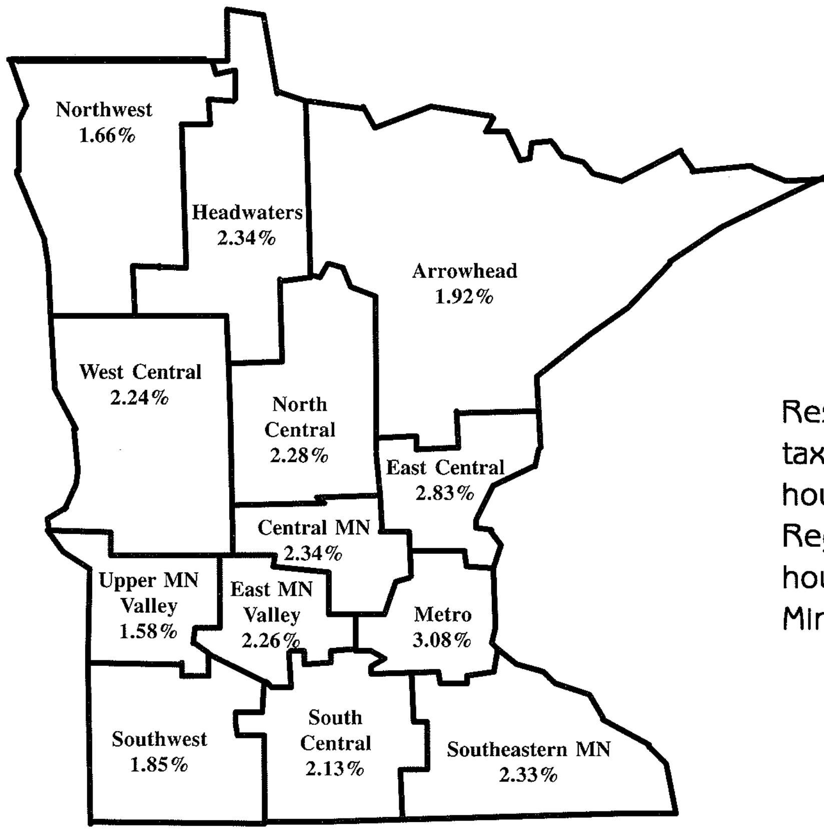
Sales tax as a percent of income, calendar year 1996



The percentage share of personal income paid in sales tax varied from a high of 2.36% in the Headwaters Region to a low of 1.20% in the Upper Minnesota Valley Region.

Appendix E How is the property tax burden distributed in Minnesota?

Residential homestead property tax as a percent of household income



Residential homestead property taxes vary from a high of 3.08% of household income in the Metro Region to a low of 1.58% of household income in the Upper Minnesota Valley Region.

Appendix F Types of taxes

Income tax

The income tax in Minnesota is paid on certain income by income bracket, with over 30 additions and subtractions and 10 credits for certain low-income, education, health care and other social programs. The 1999 legislature approved a reduction to 5.5 percent for the lowest bracket, 7.25 percent for the middle bracket and 8.0 percent for the highest bracket. In 1999, revenues collected from the income tax were $5 billion.

Sales tax

Minnesota has a 6.5 percent rate on certain tangible personal property and specific taxable services sold or used in Minnesota. Approximately nine communities around Minnesota have local sales taxes, in addition to the Minnesota tax, at varying rates. In 1999, revenues collected from the state sales tax were about $3.6 billion.

Property tax

Minnesota's property tax base is net tax capacity or referendum market value of real and personal property. The property tax system is one of the most complicated in the country, made up of 13 major classifications, 35 subclassifications and exempt properties, and 12 credits. Tax capacity is calculated using market value times the classification rate.

In 1999, the certified levy was a total of about $4.6 billion. Of that:

- $1.4 billion is for counties
- $1.8 billion is for school districts
- $1.1 billion for cities (includes Tax Increment Levies)
- $161 million is for other special districts
- $95 million is for townships.

Corporate taxes

Minnesota taxes corporate Minnesota taxable net income at 9.8 percent rate. In 1999, revenue collected from the corporate income tax was about $700 million.

Other taxes

Minnesota has many "special taxes" whereby the tax is imposed are on a specific product and/or the tax is dedicated for a specific purpose. Examples include Motor Fuels Excise Tax (Gas Tax), Cigarette, Health Care Provider Tax, Alcohol Tax, Gambling Tax, Mortgage and Deed Tax and other special taxes. In 1999, total revenue collected from all of these taxes was about $2.6 billion.

Appendix G   Sources for National Rankings

10th in growth of personal income between 1995 and 1999

Source	Date Located	Reference Year
BEA	8/2000	1995-1997

3rd highest state sales tax rate

Source	Date Located	Reference Year
FTA	6/2000	as of 1/1/2000
CCH	6/2000	as of 7/1/2000

4th highest corporate income tax rate

Source	Date Located	Reference Year
FTA	6/2000	as of 1/1/2000

10th highest top rate individual income tax

3rd highest starting rate individual income tax

Source	Date Located	Reference Year
FTA	6/2000	as of 1/1/2000

26th highest state and local sales tax collections

Source	Date Located	Reference Year
Census (MTA)	6/2000	FY 1996

Tax rankings by major tax

Source	Date Located	Reference Year
Census (MTA)	6/2000	FY 1996

State gasoline, sales and cigarette tax rates as of July 1, 2000

Source	Date Located	Reference Year
CCH	6/2000	as of 7/1/2000

20th highest cigarette tax

Source	Date Located	Reference Year
FTA	6/2000	as of 1/1/2000
CCH	6/2000	as of 7/1/2000

21st highest gas tax

Source	Date Located	Reference Year
CCH	8/2000	as of 7/1/2000

BEA=Bureau of Economic Analysis
FTA=Federation of Tax Administrators
CCH=Commerce Clearing House
MTA=Minnesota Taxpayers Association

Glossary of selected tax terms

Cabins A popular term for type of property (seasonal recreational residential property) that includes all seasonal residential property (but is most typically represented by lake cabins) which is treated as a unique class for property taxation.

Classification System A method of property valuation where different types of property are classified into different groups or classes based on type of use, and taxed at different rates.

Class Rates Percentages of market value applied to different classes of properties that are defined by state law and used to compute the tax capacity of property. Tax capacity is the resulting percentage of property market value subject to the local government tax rate.

Credit A subtraction amount from taxes owed.

Effective Tax Rate (ETR) Total tax as a percentage of the value of the respective tax base. For the property tax, the ETR is tax divided by market value. For the individual income tax, the ETR is tax divided by total personal income.

Exemption A portion of the tax base that is excluded from being taxed.

Farm Homestead Agricultural land and a residence that meets qualifications as a homestead (owner-occupied as a primary residence) for property tax purposes.

Farm Non-Homestead Agricultural land and residences that are not owner-occupied.

Homestead A residence occupied by the owner. Homestead property owners benefit from low class rates and credits that are available only to homesteads.

Intergovernmental Aid Aid given from one unit of government to another.

Levy (verb) To impose a tax. (noun) The amount of tax that is imposed.

Levy Limit The maximum amount of property tax a local unit of government may impose as determined by state law.

Limited Market Value The increase in market value is restricted by state law. For property taxes payable in 2000, value increases are limited to 8.5% for homesteads, farms and cabin properties.

Local Government Aid (LGA) State general aid determined by a formula and given to cities and townships.

Progressive (Tax) Taxing those with a greater ability to pay at a greater rate.

Proportional (Tax) Taxing those with different ability to pay at a constant rate.

Regressive (Tax) Taxing those with greater ability to pay at a lower rate.

Tax Capacity The basis upon which property taxes are levied. Tax capacity is the proportion of market value subject to the local government tax rate (market value x property class rate = tax capacity).

Tax Shifting Changing the relative shares of who pays for a tax. (For example, reducing the class rate for homesteads would reduce the share of tax paid by homesteads and shift the tax to all other types of property.)

Truth-in-Taxation A process to encourage public participation in local tax and spending decisions by providing taxpayers with notice, the opportunity for public discussion, and advisory statements concerning proposed tax decisions by local governments.

Unique Taxing Jurisdiction (UTJ) An area in which the combination of overlapping tax rates (from different levels of government) provides a single rate.

For more information about the tax reform initiative, see our website at www.taxes.state.mn.us, or email us at taxreform@state.mn.us. You can also write us:

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c/o Commissioner Matt Smith
600 North Robert Street
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