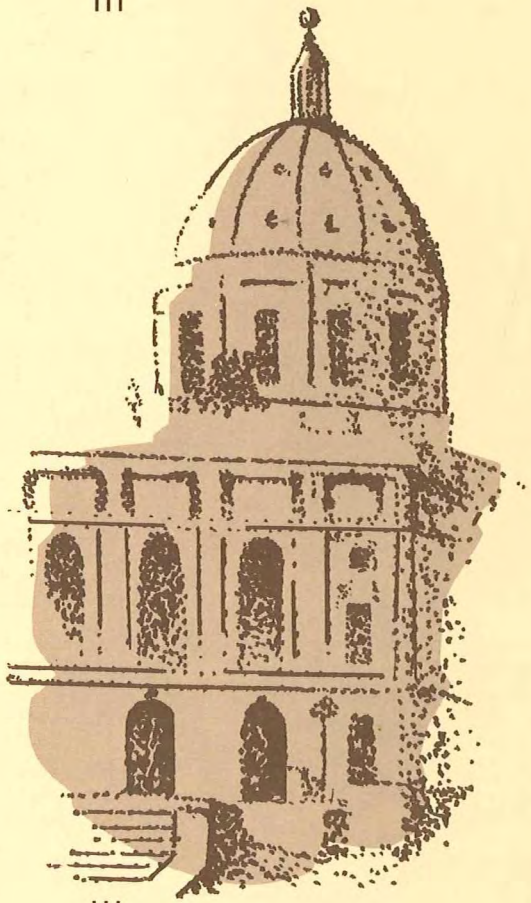
evaluation of

Direct Property Tax Relief Programs



Office of the Legislative Auditor State of Minnesota

February 1983

Evaluation Of

DIRECT PROPERTY TAX

RELIEF PROGRAMS

Office Of The Legislative Auditor
Veterans Service Building
St. Paul, Minnesota 55155
(612) 296-4708

February 4, 1983

PREFACE

In January 1982, the Legislative Audit Commission authorized the Office of the Legislative Auditor to study the state's major direct property tax relief programs. From the study, we will issue two reports.

This report examines changes in the level of property tax over the past fifteen years and evaluates the effectiveness of the relief programs enacted when the Legislature concluded that property tax levels were too high. The report will show that the state's complex set of property tax relief programs (direct and indirect) have brought Minnesota's residential property taxes down to their lowest point in recent years according to several relevant measures and a level lower than most other states. But the report will also show that these programs do not always target relief to those who need it the most. Without providing a detailed blueprint, the report attempts to point the way toward a more effective design of Minnesota's property tax relief system.

This part of our study was conducted by the Program Evaluation Division. Staff included Jim Nobles (Deputy Legislative Auditor for Program Evaluation), Elliot Long (Project Manager), Tom Walstrom, Dan Jacobson, and Rob Nevitt. We want to thank personnel from the Departments of Revenue and Finance, staff from the Minnesota Senate and House of Representatives, and many others for supplying us with data and advice.

A second report, completed by the Financial Audit Division, will examine the administration of the state's direct property relief programs. That report will be issued in approximately two weeks.

We are mindful that both reports address a complex set of problems that are not easily solved. But we are also hopeful that our analysis and recommendations will help in the very difficult decision-making that lies ahead. This report is solely the responsibility of the Office of the Legislative Auditor and does not necessarily represent the position of the Legislative Audit Commission or any of its members.

Gerald W. Christenson
Legislative Auditor

TABLE OF CONTENTS

LIST OF TABLES, FIGURES, AND MAPS

EXECUTIVE SUMMARY

Major property tax relief programs have been enacted and extended since 1967 in an effort to keep property taxes low, equalize the ability of communities across the state to raise revenue, and to help assure that low income property owners do not pay a disproportionate amount of property tax. As much as three quarters of state tax revenue is returned to school districts and local units of government in order to substitute state for local revenue and reduce reliance on the property tax.

Many aspects of the state-local fiscal relationship currently merit study. This report focuses on one important part, direct property tax relief programs. These provide property tax relief directly to taxpayers--as in the case of the circuit breaker--or to local taxing districts on behalf of taxpayers--as in the case of the homestead credit. Not counting some late reductions and shifts expenditures through direct property tax relief programs now total over $786 million per year. The homestead credit, which pays 58 percent of the tax bill on homesteaded property to a $650 maximum, totalled about $479 million in 1982. The income adjusted property tax refund for homeowners and renters (circuit breaker) cost $168 million and the agricultural credit cost $87 million. These are the three major direct property tax relief programs and the principal focus of this report.

It is not an objective of this study to recommend whether or at what level direct property tax relief programs should be financed in Minnesota. However, we believe it is time to take a careful, even critical look at these (and other) property tax relief programs for these reasons:

- The state is short of money and needs to look to property tax relief programs for substantial savings.

- Minnesota's property tax system and system of aids and credits have grown to be the nation's most complex. Better coordination of aids and credits and consolidation and simplification of the system is needed.

- There have been important changes in the property tax over the past 15 years. There is a real need for policy makers to review the present system and take stock of whether property taxes are high or low, and whether property tax relief programs are working as intended.

The common purpose of all direct property tax relief programs is to keep property taxes (mainly residential property taxes) low. These programs are predicated on the belief that without direct property tax relief, Minnesota's residential property taxes would be unacceptably high. Certainly, in 1967 when the homestead credit was enacted, and in 1971 when the reforms known as the Minnesota Miracle

were passed, the Legislature was acting in response to widespread sentiment that property taxes were too high and that state revenue ought to finance a greater part of the cost of delivering services at the local level. Over the years, direct property tax relief programs were greatly expanded. The homestead credit program, for example, grew from $78.8 million in 1968 to $479 million in 1982. The agricultural credit grew from $15.8 million in 1972 to $86.9 million in 1982. Other direct property tax relief programs were also enacted during the 1970s, such as the taconite homestead credit, reduced assessment credit, native prairie credit and wetland credit. Together these now cost over $33 million each year.

The great majority of direct property tax relief payments go to reduce homestead property taxes. In considering direct property tax relief programs, the first question is:

- Are residential property taxes unacceptably high or have property tax relief programs instituted since 1967 succeeded in keeping them at an appropriate level?

We examined property taxes over time, and in relation to personal income and property values. We also looked at property taxes in constant dollars (holding the effect of inflation constant) and we looked at what has happened to the property tax as a revenue source over the years. In addition, we examined variation in property taxes across the state. We found:

- In real dollars, average property taxes are lower in 1982 than they were in 1965. Even though property taxes turned up sharply in 1982, school and local government aids (indirect property tax relief programs) have kept gross property taxes approximately constant in real dollars since 1972, and direct property tax relief programs, chiefly the agricultural and homestead credits, have caused net taxes in real dollars to decline about 24 percent between 1971 and 1982.

- In relation to personal income, Minnesota's property tax declined considerably between 1966 and 1981 from $62.24 per $1,000 of personal income to $33.53. In 1966, Minnesota ranked seventh among the states in property taxes per $1,000 of personal income; in 1981 it ranked 25th.

- Property taxes declined dramatically as a source of combined state-local tax revenue during the last 15 years. In 1967, property taxes provided 51 percent of state-local tax revenue. In 1981, only 25 percent of tax revenue was derived from the property tax. In 1981, Minnesota's reliance on the property tax was lower than any neighboring state. As recently as 1972, Minnesota's reliance on the property tax was higher than the national average and in 1967, prior to the period of major property tax reform in Minnesota, only 12 states raised proportionately more revenue through the property tax.

- Another way of looking at the property tax is to relate it to real estate values. Taxes as a percent of property value is called the effective tax rate (ETR). The effective tax rate for all property was about 4.0 in 1971. As a result of tax relief programs enacted that year and subsequently, effective tax rates declined rapidly to 2.4 in 1975, 1.8 in 1978, and 1.2 in 1982. By 1982, property taxes as a percent of market value were about one-fourth of what they had been in 1971 and less than half of what they were in 1977.

- The effective tax rate on non-farm homesteads was 2.1 percent in 1975. Property taxes by this measure declined to 0.8 percent in 1981 and rose slightly to 1.0 percent in 1982. Farm owners' taxes show a similar pattern: a decline from 1.3 percent of market value in 1975 to 0.4 in 1981 and a rise to 0.5 percent in 1982.

- Minnesota has one of the nation's lowest effective tax rates on single family homes. A comparison among states using data on single family homes with FHA mortgages shows Minnesota's net property taxes to be 0.79 percent of market value in 1981. This is a lower tax rate than the effective tax rate in 42 other states. Outside the south only Arizona, Hawaii, and Wyoming have lower effective property tax rates on single family homes.

- Property taxes as a percent of market value on commercial property, apartments, public utilities and other classes not generally eligible for the homestead credit or other direct property tax relief payments have also declined significantly over the last seven years. For example, the effective tax rate on commercial property declined from 4.38 percent in 1975 to 2.83 percent in 1982. This of course reflects both increased aid to schools and local government but also increased property values.

In short, Minnesota's property taxes are at an historically low level even after a sizeable upturn in 1982. Taxes on homesteaded property are especially low when compared to the past or in comparison to other states. Minnesota's property tax relief programs have succeeded to a degree perhaps not widely appreciated.

Why isn't it generally understood that property taxes are relatively low in Minnesota?

- While property taxes have declined in relation to real estate values, personal income and the cost of living, because of inflation the average homeowner is in fact paying a larger property tax bill in 1982 than he paid in the mid 1970s. In 1975 the average property tax of Minnesota homeowners was $465; in 1982 it was $511.

- Property taxes turned up sharply in 1982 and are projected to increase over the next few years. Many homeowners are already receiving the maximum homestead and circuit breaker

credits payable under current law and it is unreasonable to expect an increase in state funding of property tax relief sufficient to prevent residential property taxes from rising in the future.

- Perhaps the most important factor that helps to explain why homeowners feel that property taxes are high is that for some, taxes are high. While the statewide average property tax is low, over-all, taxes are especially low in some areas and relatively high in other areas.

Property taxes are highest in the Twin Cities metropolitan area and in other urban centers and relatively low in rural areas. Across the state, average 1982 property taxes on non-farm homes vary from $911.07 in Hennepin County to $114.81 in Itasca County. Every county in the Twin Cities metropolitan area has average taxes over $675, while half the counties in the state have average taxes that are under $256.

Property taxes vary across communities for a number of reasons:

- Urban areas require relatively high taxes to finance services which are characteristic of such communities and not found in rural areas.

- Taxes vary because of a concentration of people needing public services (such as children of school age or clients of public assistance programs) in some communities and not others.

- Taxes also vary because of expenses induced by rapid growth, differences in property wealth and the property mix across communities, differing preferences for public services, and other factors.

No effort has been made in this study to disentangle the separate contribution of each of these factors. The main point to keep in mind is that people are likely to regard property taxes as high or low, depending on where they live. Also, while the cost of housing varies significantly across the state, and while personal income also varies considerably, the variation in property taxes is even greater. Thus, property taxes as a percent of market value or personal income--measures which reflect property tax burdens--also vary widely across the state.

- For example, in 1982, Hennepin County residential homesteads paid an average of 1.2 percent of market value in property taxes while homesteads in Cook County paid 0.23 percent. This amounts to a 422 percent difference in property taxes from the highest to lowest county when market value is held constant.

- Residential property taxes per $1,000 of personal income also vary widely across the state, from $21.21 per $1,000 of personal income in Hennepin County to $3.45 in Roseau County. (These figures are based on 1979 data, the last year for which income and property tax data can be matched.)

We examined the homestead credit, agricultural credit, and circuit breaker in some detail in order to learn how well the specific goals of each of these programs are being achieved.

HOMESTEAD CREDIT

The homestead credit is Minnesota's largest direct property tax relief program. In 1982, the homestead credit reduced the property tax liability of homeowners by $479 million, although because of late cuts in the state funding the cost to the state was reduced to $385 million for taxes payable in 1982.

The homestead credit became effective for taxes payable in 1968, and between 1968 and 1982 the amount paid through the homestead credit grew by more than 500 percent. This increase is largely due to increases in the homestead credit limits enacted by the Legislature in 1973, 1979 and 1980.

- In 1968 the homestead credit paid 35 percent of homestead property taxes to a maximum of $250. In 1982 the credit paid 58 percent to a maximum of $650.

The homestead credit (excluding the taconite homestead credit) grew from $79 million in 1968 to $242 million in 1979, to $479 million in 1982. The cost of the program increased 54 percent in 1974, 46 percent in 1980, and 20 percent in 1981, reflecting the fact that increased benefits became effective each of those years.

- Payments through the homestead credit have grown more than twice as fast as tax levies between 1968 and 1982. The homestead credit grew faster than gross taxes on homesteads five of the six years between 1975 and 1981. As a result of the growth of the homestead credit, gross tax increases in 1975, 1976, and 1979 on homesteaded property actually became net tax decreases for homeowners.

Thus, it is clear that the homestead credit has succeeded in its primary purpose of keeping homeowners' property taxes low by substituting state for locally raised revenue.

The cost of the homestead credit will increase in the future unless the Legislature decides to change the terms of the program, because property tax levies can be safely predicted to go up and because nearly two-thirds of the homes in the state do not receive the maximum credit of $650. A reasonable projection is that the homestead credit will cost $513 million in 1983 and $532 million in 1984, unless the appropriation for the program is capped as it was in 1982.

There are more than a million homesteads in Minnesota and if all received the maximum credit of $650, the cost to the state would be about $670 million per year or 39.7 percent more than was actually obligated in 1982. Thus, if the 58 percent rate and $650 maximum are kept into the future, the growth in the cost of the homestead credit will be limited compared to increases experienced in recent years and the 500 percent increase since 1968.

The homestead credit is looked to by many to insulate homeowners from future property tax increases, perhaps because it worked this way during the 1970s, even to the point of causing a net tax decrease in certain years when gross taxes rose. However, unless the benefits of the program are increased for all or some taxpayers, and costs increased as well, the homestead credit will cease to protect increasing number of homeowners from the full effect of property tax increases. As fast as the homestead credit program has grown since 1968, in 1982 over a third of homesteads across Minnesota, over one-half in the Twin Cities metropolitan area and over 60 percent in Hennepin County received the maximum credit and are no longer insulated against property tax increases.

We conclude that the homestead credit is accomplishing what it was designed to do: Keep residential property taxes in Minnesota low. However, the state's fiscal situation in 1983 and prospects for the near future are less promising than the conditions that prevailed through most of the 1970s when revenue growth driven by economic expansion and inflation permitted major increases in the homestead credit program.

It is debatable whether or not the homestead credit has made the Minnesota tax system more progressive. It should not be assumed that this is the case because state revenue sources that finance the homestead credit are not clearly more progressive than the property tax. And increases in the income tax due to inflation in the 1970s made the income tax less progressive, at the same time they financed increases in the homestead credit. By itself, the homestead credit has a slightly progressive effect on the property tax since it is capped at $650 and on the whole, upper income property owners receive a smaller percentage reduction in their property taxes than those with lower incomes. On the other hand, the $650 cap means that the homestead credit reduces taxes proportionately less in high tax areas such as the Twin Cities than in low tax areas, and actually works to increase the variation in taxes across the state.

Because the homestead credit provides a significant tax break to all Minnesota homeowners, it is not customary to discuss options that include reducing benefits paid through the program. Nevertheless, in light of the state's fiscal situation in 1983 and prospects for the next few years, the homestead credit may be looked at as a program that should be redesigned. The homestead credit provides property tax relief broadly rather than concentrating relief in districts with low property wealth or a high level of service needs. Nor does the homestead credit distribute relief directly to taxpayers with high property taxes in relation to income. Alternatives to consider are essentially those presented by the school aid, local government aid and circuit breaker programs. Redirecting the funds now

provided through the homestead credit program makes the most sense when viewed as part of an effort to preserve the effectiveness of these programs. Options for the homestead credit include:

- Distributing all or part of the money now going to school districts and local government via the homestead credit through the school aid and local government aid programs.

- Distributing all or part of the homestead credit through the circuit breaker. In effect this changes the homestead credit so that it is income sensitive.

- Reducing the homestead credit maximum, now $650, the homestead credit rate, now 58 percent, or both.

- Keeping the current rate and maximum, but exempting a minimum tax from the homestead credit.

We also have concluded that if the homestead credit is kept, the program, which represents 12 percent of annual general fund expenditures, should be administered with more precise and uniform standards and tighter controls. In our judgement, at present it is very difficult for the state and local assessors to audit and verify homestead credit eligibility.

AGRICULTURAL CREDIT

The agricultural credit is designed to lower school taxes for the owners of agricultural property, timberland and non-commercial seasonal recreational property. These property owners are considered to be low users of school district services in relation to their share of property wealth within school districts and therefore deserve property tax relief.

The agricultural credit became a state-paid direct property tax relief program in 1972. Prior to 1972, the agricultural credit--then computed as a mill rate differential--was a local shift of school tax effort.

In 1982, nearly $87 million was paid to school districts on behalf of the owners of these classes of property and the cost of the agricultural credit is projected to reach $96 to $98 million in 1983. The agricultural credit has grown rapidly in cost between 1972 and 1982 from $16 million to $87 million. The cost of the agricultural credit doubled between 1978 when it was $35 million and 1981 when it cost $71 million.

The rapid increase in the cost of the agricultural credit is due to increases in the market value and assessed value of agricultural property and significant increases in the program's benefits.

- Statutory changes increasing the benefits paid through the agricultural credit program became effective in 1976 and each year between 1978 and 1982.

As in the case of other direct property tax relief programs, we believe it is time to critically examine the agricultural credit in light of current conditions. The context of this examination is the same that guided our discussion of the homestead credit. The fiscal situation facing the Legislature in 1983 means that it is useful to examine alternatives that are aimed at saving money or using existing resources more effectively.

The purpose, efficiency, and fairness of the agricultural credit can be questioned on several grounds:

- The agricultural credit provides about $87 million to school districts in a way that works at cross purposes to the state's foundation aid program.

The basic purpose of state school aid is to equalize the tax effort necessary to finance a basic level of education across the state. The agricultural credit is paid to rural school districts in direct proportion to property wealth, in contrast to the foundation aid program that distributes aid inversely to property wealth per pupil.

Historically, the state assumption of the cost of the agricultural credit was a compromise included in the entire package of reforms enacted in 1971, known as the Minnesota Miracle. The agricultural credit was extended during the 1970s in part because the foundation aid program was strengthened and it was considered appropriate to compensate high-value agricultural districts which would not benefit from an increased foundation aid program.

- However, it may not be fully appreciated that the cost of the agricultural credit has grown about 450 percent since 1972. While the mandatory maintenance levy went down and back up during the last few years, the agricultural credit has been extended each year since 1978.

If the Legislature wants to reexamine the agricultural credit, a few additional problems are worth considering.

- Although it might be presumed that farms of equal value across the state receive an equal credit, the way the agricultural credit is designed means that small farms of given value receive a larger credit than large farms of the same value.

- Property in districts where assessed values are close to market values receives a higher agricultural credit than property in districts where assessments are low in comparison to market values.

- Any homestead that sits on ten acres of land is classified as agricultural and thus qualifes for the agricultural credit. The agricultural credit is thus paid to many homesteads that by most definitions are not farms.

There are a number of basic and technical changes in the agricultural credit that we believe are worth considering.

- Redesign the agricultural credit to be more consistent with the foundation aid program and categorical aid programs that tie school aid to service needs and requirements and the ability of school districts to raise money.

- If the school tax burden on agricultural property, timberland, and non-commercial seasonal recreational property is felt to be unfairly high, shift the tax effort within school districts through a locally paid credit or mill rate differential.

- Adopt a more restrictive definition of what constitutes a farm for the purposes of paying the agricultural credit.

- Eliminate the inequality that is presently built into the agricultural credit that results in farms over 320 acres receiving a smaller credit than smaller farms of equal value.

CIRCUIT BREAKER

In 1981, homeowners received $54.1 million and renters received $114.2 million through the circuit breaker program that provides property tax relief to homeowners and renters based on property taxes or rent paid in relation to income.

The circuit breaker began in 1976, succeeding smaller rent credit and senior citizen property tax relief programs. The total cost of the program for homeowners and renters grew from $121.7 million in 1976 to $195.2 million in 1978, then declined to $168.3 million in 1981.

- Circuit breaker benfits for homeowners declined when the homestead credit was increased in 1979 and 1980 because there is a dollar for dollar substitution between these programs for many homeowners.

- Estimates for 1982 and projections for 1983 and 1984 indicate that the circuit breaker will reverse its downward trend and grow to $219 million in 1984. These projections reflect the significant rise in property taxes in 1982, the expectation that taxes will continue to rise, and assume no change in the terms of the homestead credit and circuit breaker programs. If the homestead credit is reduced, the cost of the circuit breaker will rise.

To determine how well the circuit breaker is working and to identify how its design can be improved, we analyzed how well it achieves its objectives and reviewed criticisms of the circuit breaker made in the public finance literature. The circuit breaker has three major purposes.

- To make the property tax more progressive;

- To compensate renters for tax breaks received by homeowners through the homestead credit and income tax breaks;

- To relieve high property tax burdens relative to income for low and middle income households.

We found:

- Minnesota's property tax relief programs, particularly the circuit breaker, make Minnesota's property tax nearly proportional for homeowners and progressive for renters. Thus the circuit breaker is effective both in making the property tax more progressive and in providing additional aid for renters.

However, the circuit breaker is becoming less effective at relieving high tax burdens relative to income because more homeowners are reaching the income limits or the maximum credit. As result, by 1984, the circuit breaker will not be very sensitive to income or taxes in the Twin Cities metropolitan area and other high tax areas. For example, we found:

- In the Twin Cities metropolitan area and other high tax areas, nearly one-half of homeowners with incomes less than $33,000 will be at the circuit breaker maximum by 1984. As a result, the circuit breaker will soon give the same credit to homeowners who have high property taxes as it does to homeowners at the same income level who have average property taxes.

- All senior citizens and disabled persons whose gross property taxes exceed $1,450 will receive the same maximum credit of $1,000 regardless of whether their income is $20,000 or less than $5,000. The same situation exists for homeowners under 65 if their gross taxes exceed $1,650. By 1984, many senior citizens in the Twin Cities metropolitan area and other high tax areas will be in this situation. If gross property taxes increase by 25 percent between 1982 and 1984, gross taxes on homes in Minneapolis or St. Paul worth more than $68,000 will exceed $1,450.

- While family incomes have increased rapidly since the circuit breaker began in 1976, the circuit breaker's effective income limit for homeowners under 65 has declined from $36,000 to $33,000. As a result, many middle income homeowners are no longer eligible for a circuit breaker refund.

There are several alternatives which can improve the design of the circuit breaker. These include:

- Reduce the circuit breaker's 100 percent credit rate.

- Raise the circuit breaker's maximum credit amounts.

- Increase the circuit breaker's income brackets.
- Change to a sliding scale formula.

These options have the following advantages.

The options which increase the maximum credit and/or reduce credit rates will reduce the number of homeowners who are at the circuit breaker maximum credit and thus more effectively target property tax relief to homeowners with high taxes relative to their income.

Increasing income brackets can ensure that middle income homeowners do not become ineligible simply because their incomes have increased with inflation.

In addition, reducing the 100 percent credit rate ensures that homeowners pay at least a part of any property tax increase and thus may reduce the incentive for local governments to spend excessively. Because of this change, the circuit breaker would also more uniformly relate property taxes to house value and level of local services. Currently, nearly two-thirds of homeowners eligible for the circuit breaker will either pay the full burden of a property tax increase because they are at the maximum or pay none at all. Reducing the number of homeowners at these extremes would make the circuit breaker more equitable. This could be particularly important if the homestead credit were substantially reduced because more homeowners would be eligible for the circuit breaker and the number of homeowners who would be fully reimbursed for a property tax increase could rise substantially.

These changes will not necessarily increase the cost of the circuit breaker because cost savings from reducing the 100 percent credit rate can offset the additional cost of raising the maximum credits and income brackets. Another option which can have similar advantages as the options discussed above is the sliding scale formula, under which the credit equals a percentage of tax where the percentage declines as income increases.

One possible disadvantage of making these changes is that some homeowners will lose benefits. At a time when property taxes are rising rapidly, this may appear to place an unacceptable burden on these taxpayers. However, the homeowners who would lose the most from this change are those for whom the circuit breaker now rebates 100 percent of a property tax increase. By reducing benefits for these homeowners and raising benefits for homeowners at the maximum, tax increases can be distributed more evenly than they would be under the current circuit breaker.

We also examined the administration of the circuit breaker for renters and found that taxpayers' statements of rent paid are extremely difficult to verify and audit on a cost-effective basis. Our own extensive study of a sample of 560 claims suggests that in 1981, the state should have paid $104.5 million through the renter's credit rather than the $118.7 million actually paid.

POLICY OBJECTIVES IN THE STATE-LOCAL FISCAL RELATIONSHIP

We believe that direct property tax relief programs need to be deliberated in the context of the entire state-local fiscal relationship. A number of general principles have been advanced by various groups as a basis for reforming the state-local fiscal system. Those with broad support that we endorse as well include the following:

- Minnesota's state-local fiscal system needs comprehensive reform.

- Greater predictability and stability in state aid is needed by local government.

- The system as a whole including the property tax system should be simplified in order to promote understanding, reduce record-keeping costs, and promote uniform classification and assessment practices across the state.

- Many of the objectives of Minnesota's complex property classification and tax relief system could be better achieved through budgeted expenditures.

- State aid to local government should neither encourage nor discourage local spending. State aid should not provide cheap marginal dollars in support of local levies.

- While often maligned, the property tax is essential because it taxes a form of wealth that would otherwise go untaxed, and it is the only significant tax available to local government.

- Local government is best equipped to deliver a wide range of public services, while equity in taxing and spending dictates that the state carry a major part of the responsibility for financing those services. In order to assure that local government is effective, efficient and fair, local government needs a large measure of autonomy in spending decisions, and the ability to raise revenue adequate to finance services demanded, through the political process, by local residents.

- The over-all effect of state and local taxing and spending programs should be progressive. Individual taxes or spending programs need not pass this test, although it is an important criterion on which they should be judged.

In judging direct property tax relief programs against these criteria we conclude that:

- The homestead credit can be criticized because it makes cheap dollars available to local taxing districts and can thus encourage a higher local property tax than would otherwise be approved. The circuit breaker for homeowners as now designed can have this effect as well.

- Direct property tax relief programs are not the most complicated aspect of the property tax system. Even so, these programs can combine in ways that the legislature presumably did not intend. For example, some individual parcels of property of substantial value pay either no property tax or very little tax because of the additive effects of individual programs.

- There are costly administrative problems at the local level connected with the homestead and agricultural credits.

- It is questionable whether direct property tax relief programs other than the circuit breaker have a progressive impact on the Minnesota tax system.

Property tax relief has been an issue of singular importance in Minnesota over the last 15 years. It is not less important in 1983. This report is offered as a source of information that will help policy makers first understand a complex system, then decide what changes need to be made.

I. A COMPARATIVE AND HISTORICAL REVIEW OF THE PROPERTY TAX AND PROPERTY TAX RELIEF IN MINNESOTA

This chapter presents an overview of the property tax and property tax relief programs in Minnesota. The first section describes Minnesota's property tax relief programs and their costs. The next section reviews the historical factors that gave rise to the enactment of these programs. In the final section we analyze Minnesota's property tax levels over time and in comparison with other states. Essentially we ask: What is the property tax burden in Minnesota? How successful is the state's effort to reduce reliance on the property tax? The answers will form the basis for the critical analysis of the state's direct property tax relief programs that follows.

A. FORMS OF PROPERTY TAX RELIEF

Although the focus of our report is direct property tax relief, it is important to recognize that Minnesota provides property tax relief through a number of programs that transfer state revenue to local governments and individuals. We have divided these transfers into two broad categories: indirect property tax relief, such as school and local government aids that are paid by the state to local units prior to calculation of local levies, thus holding down the amount that must be levied; and direct property tax relief programs, such as the homestead credit and agricultural credit that reduce the tax bill received by individual property owners. Under these programs, the state pays to local taxing units a share of the gross tax liability on behalf of the property taxpayer. The state also provides direct property tax relief through refund programs, such as the circuit breaker for homeowners and renters. These refund programs are administered through the state income tax system.[1]

In fiscal years 1981 and 1982, almost 62 percent of state collected tax revenues were returned to local governments and individuals under the programs we have categorized as indirect and direct property tax relief. Table 1 presents a broad view of how the state's general fund was distributed in the last two fiscal years. As Table 1 shows, over 55 percent of the state's general fund expenditures were returned to local governments.

---

[1]The reader needs to be cautioned that some reports refer to programs such as school aids and local government aids as "direct aid," meaning they are paid directly to governmental units. We refer to these as indirect property tax relief because they are not tied directly to individual parcels of property and are typically designed to support general government functions and services. In contrast, the programs we have characterized as direct property tax relief are tied directly to individual parcels of property and result either in a credit paid by the state on behalf of a property owner or a tax refund to an individual.

TABLE 1

GENERAL FUND EXPENDITURES
FISCAL YEARS 1981 AND 1982

	- F.Y. 1981 - Expenditures In Millions		- F.Y. 1982 - Expenditures In Millions	
Aids to Local Governments:				
Schools	$ 1251.1*		$ 1443.9	
Counties	354.7		398.0	
Cities	310.7		308.9	
Towns	22.9		23.6	
Special Districts	40.4		39.7	
Pensions	157.4		170.5	
	$ 2137.2	55.7%	$ 2384.6	55.4%
Aids to Individuals:				
Care of Persons/ Medical Assistance	357.3		408.1	
Other	219.9		218.6	
	$ 577.2	15.1%	$ 626.7	14.6%
Aids to Non-Government Organizations	46.7	1.2%	42.5	1.0%
Loans	1.5	-	1.9	-
State Programs	1072.0	28.0%	1248.9	29.0%
Total Budget	$ 3834.6	100%	$ 4304.6	100%

Source: Local Government Task Force. Compiled from Department of Finance data, August 12, 1982.

*School aid payments of $243.7 included in fiscal year 1981 total.

1. INDIRECT PROPERTY TAX RELIEF PROGRAMS

All state aids to schools and local governments can be considered property tax relief because they replace dollars that, given a fixed level of local spending, would otherwise be raised through local property taxes. Table 2 presents a picture of how the major types of indirect property tax relief programs have changed and grown since 1968.

As Table 2 shows, the major form of indirect property tax relief is the education aid system. Historically, Minnesota funded schools through a locally imposed property tax. Over time, property taxes were supplemented by limited state aids. In 1971, the Legislature enacted a school aid system that substantially increased the amount of equalized foundation aid to school districts while imposing a limitation on the property tax rate for schools. The foundation aid program is designed to provide relatively more aid to districts with lower property wealth per pupil unit.[1] In general, levy limits are designed to hold down increases in school district and other local government levies and thus to assure that state education and other aids in fact are translated into property tax relief. Over $1.3 billion in various education aids was provided in 1982.

The local government aid program was enacted in 1971 for the general support of local government operations. Counties, cities, and towns receive aid based on a statutory formula. In 1982, approximately $240 million in local government aid was distributed. In addition, an attached machinery credit distributes reimbursements each year to school districts, county, city, and town governments for the revenue lost due to exemption of machinery and equipment from the property tax. In 1982, attached machinery aid amounted to $11.2 million.

2. DIRECT PROPERTY TAX RELIEF PROGRAMS

Under our categorization, direct property tax relief programs are those tied directly to individual parcels of property and result either in a credit paid by the state to local governments on behalf of property owners or a tax refund to an individual. These direct property tax relief programs are:

- Homestead Credit
- Circuit Breaker for Homeowners and Renters
- Agricultural School Credit
- Taconite Homestead Credit

---

[1] The state education aid system is much more complex than presented here. In addition to foundation aids, the state pays transportation aid, vocational education aids, and a variety of other aids. For a more detailed discussion, see Minnesota School Finance, Minnesota House Research Department, November, 1982.

TABLE 2

HISTORICAL SUMMARY OF INDIRECT PROPERTY TAX RELIEF
(In Thousands of Dollars)

Payable Year	Levy Coordinated Aids								Total Levy Coordinated Aids	State Education Aids[c]
	Sales Tax Per Capita Aids	Exempt Property Reimbursement	Local Governments Aids	Taconite Aids	Attached Machinery Credit	Wetlands Reimbursement	Native Prairie Reimbursement	Payment in Lieu DNR[c]		
1968	$37,910	$58,271	$ --	$ N/A	$ --	$ --	$--	$ --	$ 96,181	$ 266,186
1969	38,609	57,342	--	N/A	--	--	--	--	95,951	280,812
1970	57,741	79,274	--	N/A	--	--	--	--	137,015	311,136
1971	58,554	78,959	--	N/A	--	--	--	--	137,513	352,318
1972	2,441	--	98,865	7,127	--	--	--	--	108,433	495,042
1973	--	--	106,567	7,503	--	--	--	--	114,070	699,010
1974	--	--	135,132	9,744	8,824	--	--	--	153,700	747,923
1975	--	--	138,870	11,231	8,122	--	--	--	158,223	758,615
1976	--	--	159,855	21,983	8,236	--	--	--	190,074	856,814
1977	--	--	171,689	22,404	8,185	--	--	--	202,278	937,996
1978	--	--	197,798	27,078	11,493	--	--	--	236,369	978,430
1979	--	--	225,054	35,252	11,440	--	--	--	271,746	1,072,142
1980	--	--	245,446[a]	40,634	11,491[a]	--	--	5,113	302,684	1,148,100[a]
1981[b]	--	--	249,716[a]	40,960	11,238[a]	816	29	5,326	308,085	1,204,040[a]
1982[b]	--	--	240,562	46,520	11,238	979	21	4,883	304,203	1,311,912

Sources: (Levy Coordinated Aids) Department of Revenue and Department of Natural Resources.
(State Education Aids) FY 75 - FY 82 Statewide Accounting System.
FY 73 - FY 74 Appropriations Data.
FY 67 - FY 72 "Appropriation Statements" - Office of the State Auditor.

[a]Figures include payments shifted into 1982.

[b]Reflects spending reductions as of 11-12-82.

[c]Fiscal year data.

N/A Not Available

- Reduced Assessment Credit
- Wetlands Credit
- Native Prairie Credit
- Power Line Credit
- Disaster Relief Credit

In this section we briefly describe each direct property tax relief program. The major programs will be described more fully in later chapters of this report.

Table 3 shows that property tax relief through direct property tax relief programs, principally the homestead credit, agricultural credit, and circuit breaker has grown four-fold between 1973 and 1982, from $162 to $786 million. The principal component of this growth has been the homestead credit. The homestead credit was enacted in 1967 and provides a direct reduction of tax for all homesteaded property.[1] The percentage reduction has been increased several times over the years and is currently 58 percent, up to a maximum credit of $650. For farm homesteads the tax on the home plus 240 acres is eligible for reduction. The state reimburses local governmental units for the loss of revenue represented by the credit reduction on the tax bill. The homestead credit is paid to school districts and other taxing districts in proportion to the size of the tax levy of each taxing district in which a homestead is located. Table 3 shows that homestead property tax bills were reduced by $479 million in 1982. Because of budgetary shortfalls, the state has not reimbursed local governments for the full amount that property tax bills were reduced. For taxes payable in 1982, the state will actually pay approximately $385 million to local governments. Under the provisions of current law, it is estimated that the homestead credit will cost $506 million for taxes payable in 1983 and $529 million for taxes payable in 1984. The homestead credit program is treated in detail in Chapter 3 of this report.

The second major type of direct property tax relief is the property tax refund or circuit breaker program. This program provides homeowners and renters with an income tax credit or refund based on the amount of property tax paid in relation to income. Homeowners are eligible for this program when their property taxes exceed a specified percentage of household income ranging from .5 percent for incomes less than $3,000 to 4 percent for incomes over $100,000. Renters become eligible in the same way except they count 23 percent of their rent (excluding utilities) as property tax.

Of the two circuit breaker programs, only the renters credit has grown significantly in recent years. Expenditures through

---

[1] Eligibility for the homestead credit is determined by the assessor's classification of a property. Most generally, homesteaded property is that owned and occupied on January 2 as a place of primary residence.

TABLE 3

HISTORICAL SUMMARY OF DIRECT PROPERTY TAX RELIEF
(In Thousands of Dollars)

Payable Year	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983[2]	1984
State Paid Credits																	
Homestead Credit	$78,769	$ 95,305	$107,043	$126,553	$114,271	$120,136	$186,123	$203,061	$210,991	$225,496	$234,439	$242,340	$358,306	$432,835	$479,293	$506,000	$529,000
Taconite Homestead Credit	--	--	1,012	1,043	2,814	2,617	3,250	3,648	9,263	9,067	9,525	11,749	13,006	13,976	15,947	17,700	19,500
Agricultural Credit[1]	--	--	--	--	15,835	17,291	17,474	17,795	26,274	29,500	35,165	41,634	52,187	70,456	86,946	95,724	90,965
Native Prairie Credit	--	--	--	--	--	--	--	--	--	--	--	--	--	83	102	125	125
Reduced Assessment Credit	--	--	--	--	--	--	--	--	--	--	--	--	--	11,537	14,027	15,500	17,000
Wetland Credit	--	--	--	--	--	--	--	--	--	--	--	--	--	2,307	2,799	3,000	3,000
Supplemental Homestead Credit	--	--	--	--	--	--	--	--	--	--	--	--	--	422	465	500	550
Power Line Credit	--	--	--	--	--	--	--	--	--	--	--	--	--	--	136	160	170
	$78,769	$ 95,305	$108,055	$127,596	$132,920	$140,044	$206,847	$224,504	$246,528	$264,063	$279,129	$295,723	$423,500	$531,616	$599,715	$638,709	$660,310
Property Tax Refund (Circuit Breaker)																	
Homeowners Under 65	--	--	--	--	--	--	--	--	50,439	49,324	79,547	67,345	51,061	29,371	32,040	37,000	41,000
Renters Credit[3]	--	4,187	4,959	5,656	12,704	13,295	21,421	24,115	26,014	32,960	49,651	55,602	69,196	81,026	84,600	100,000	106,900
Homeowners Over 65/Disabled[4]	639[5]	1,567	2,400	3,187	7,320	6,786	7,160	6,796	33,232	37,922	43,817	42,588	36,079	24,747	27,500	31,500	35,200
Renters Over 65/Disabled[4]	--	275	376	400	1,417	1,878	2,856	3,100	11,970	14,042	22,151	24,497	29,920	33,124	30,600	33,300	36,190
Targeting	--	--	--	--	--	--	--	--	--	--	--	--	--	3,423	12,000	--	--
Senior Property Tax Freeze	--	--	--	--	--	--	472	4,704	286	863	--	--	--	--	--	--	--
	$ 639	$ 6,029	$ 7,735	$ 9,243	$ 21,441	$ 21,959	$ 31,909	$ 38,715	$121,941	$135,111	$195,166	$190,032	$186,256	$171,691	$186,740[6]	$201,800	$219,290
TOTAL DIRECT PROPERTY TAX RELIEF	$79,408	$101,334	$115,790	$136,839	$154,361	$162,003	$238,756	$263,219	$368,469	$399,174	$474,295	$485,755	$609,756	$703,307	$786,455	$840,509	$879,600

Source: Department of Revenue

Notes:
[1]The Agricultural Credit was calculated as a mill rate differential between payable years 1972 and 1976.
[2]Estimated amounts for 1983 and 1984.
[3]Prior to 1975, senior citizens could choose either the renters credit or the renters over 65 credit.
[4]Only senior citizens were eligible prior to 1973.
[5]Includes renters over 65 refunds.
[6]Renters credit reduced by 8 percent--1982 preliminary data.

the circuit breaker for homeowners have declined. This has occurred because incomes have increased faster than net property taxes and because of the rapid expansion of the homestead credit and other direct credits. In 1981, homeowners received $54.1 million and renters received $114.2 million from the circuit breaker programs. In 1984, according to Department of Revenue projections, homeowners will receive $76 million and renters will receive $143 million. The circuit breaker will be discussed more fully in Chapter 3.

Targeted relief is a program that provides a refund to homeowners whose net taxes have increased sharply. Targeted relief is based simply on an increase in net taxes and is not adjusted according to household income like the other property tax refunds. Targeted relief was paid in 1981 and 1982. Although the program is still in law, no money has been appropriated for future years.

The agricultural credit became a state paid credit in 1971. The agricultural credit is paid to school districts to reimburse them for the reduction of taxes on specified property classes. The agricultural credit is designed to reduce the portion of taxes that owners of agricultural, noncommercial seasonal recreation, and timber property pay for schools. For agricultural homesteads, the credit is equal to the sum of 18 mills times the assessed value of the first 320 acres, 10 mills times the assessed value of the next 320 acres, and 8 mills times the assessed value of any acreage over 640 acres. Non-homesteaded agricultural property taxes are reduced by the sum of 10 mills times the assessed value of the first 320 acres and 8 mills times the assessed value of any acreage over 320 acres. Non-commercial seasonal recreation property taxes are reduced by an amount equal to 10 mills times the assessed value. Timber property taxes are reduced by an amount equal to 8 mills times the assessed value.

In 1982, almost $87 million was provided to school districts through the agriculture credit. The program is projected by the Department of Revenue to cost $95.7 million in 1983 and $91.0 million in 1984. A discussion of the agricultural credit's purpose and an evaluation of its effectiveness is included in Chapter 3.

In addition to these major direct property tax relief programs there are several other programs that serve more limited purposes. The state pays taconite homestead, reduced assessment, wetlands, native prairie, power line and disaster relief credits to compensate local governments for tax relief given to individuals by these state programs. Together these other credits accounted for $33.5 million, or about 4.3 percent, of the $786 million in direct property tax relief for taxes payable in 1982. Because they account for such a small portion of property tax relief they are not discussed in detail in this report, although they are referred to from time to time. Nonetheless, these credits are important components of property tax relief for individual groups of taxpayers, and as such they are described briefly below.

The taconite homestead credit[1] and the supplemental homestead property tax relief[2] programs provide property tax relief to homesteaded property in taxing districts where taconite facilities are located. In 1982, homesteaded residential property and 240 acres of farm homesteaded property are eligible for, depending on the taxing district, either a 66 percent reduction in gross taxes not to exceed $445 or a 57 percent reduction not to exceed $380. These maximums go up automatically $15 per year. The taconite homestead credit is paid from a dedicated portion of the taconite production tax, not from the general fund. Because of the decreased production of taconite, annual payments from the taconite property tax relief fund are currently exceeding annual receipts. The fund is expected to be in deficit beginning in 1985.

The reduced assessment credit[3] was enacted in 1980 and first paid in 1982. The purpose of the credit is to provide a replacement for revenue lost to local governments from the preferential assessment of the homesteaded property of the blind and disabled, and of the housing structures for low income or elderly citizens financed through the Farmers Home Administration, Minnesota Housing Finance Agency, or under Title II of the National Housing Act. The credit is intended to eliminate the shift in tax burden to other classes of property within a taxing district that would otherwise result from preferential assessment. For taxes payable in 1982, the program cost $14.0 million. This amount is expected to rise to approximately $17 million in 1984.

The wetlands[4] and native prairie[5] credits compensate property owners for not developing certain land. In order to receive these credits the owners must agree to leave wetland and native prairie in its current state in the year the credit is received. The wetlands credit is applied to the owner's property or property that is contiguous to the parcel containing the wetland. The native prairie credit is applied to the owner's property or to other property that may be up to two townships away. The wetlands credit is equal to three-fourths of one percent of the average level of estimated market value of tillable land in the township, city, or unorganized territory in which it is located, times the number of acres owned. The native prairie credit is calculated in the same manner except it is equal to one and one-half percent of the average value of tillable land. The state also finances the cost to local governments of the wetlands and native prairie exemptions.

---

[1]Minn. Stat. §273.135-273.136.

[2]Minn. Stat. §273.1391.

[3]Minn. Stat. §273.139.

[4]Minn. Stat. §273.115.

[5]Minn. Stat. §273.116.

Both the wetlands and native prairie credits can act in conjunction with other credits to reduce the net taxes of individuals to zero. Whether or not this is the intended effect of these programs is unclear.

The wetlands credit cost $2.3 million in 1981, $2.8 million in 1982, and is projected to cost approximately $3 million in both 1983 and 1984. The native prairie credit cost approximately $100,000 in both 1981 and 1982, and is projected to cost approximately $125,000 in both 1983 and 1984.

There are two other minor credits that must be mentioned. Effective for taxes payable in 1982, the power line credit is paid to certain properties crossed by 200 kilovolt or greater transmission lines. Prior to 1982, utility companies made direct payments to property owners. A portion of utility companies' property tax payments is set aside to finance this credit. In taxes payable 1982, taxes were reduced $135,506 by the power line credit. The homestead disaster relief credit[1] was authorized by the 1982 Legislature. The disaster relief credit reduces the assessed value of all property within a disaster or emergency area by reassessing the property after the disaster or emergency occurs and subtracting the reduced assessment from the assessed value at the beginning of the year. The state then reimburses local governments for the difference in taxes collected. No payments have yet been made under this program.

B. DEVELOPMENT OF PROPERTY TAX RELIEF

Property taxes in Minnesota have been an important focus of political debate and discussion during the past fifteen years. Major reforms were enacted in 1967 and 1971 and significant property tax relief programs were implemented or extended throughout the 1970s. In this section we examine the historical factors that gave rise to the enactment of our current system of property tax relief.

By 1966, despite a complex property classification system and state aid to schools and local governments that totalled over $300 million a year, property taxes had risen to the point that Minnesota ranked seventh highest among the states in property taxes per capita and property taxes per $1,000 of personal income. In 1966, annual residential property taxes amounted to about 2.4 percent of market value. The 1967 legislature judged this level of property taxation to be unacceptably high and took the following action:

- enacted a three percent state sales tax to be used to provide local government aid;
- enacted a homestead credit equal to 35 percent of a homeowner's tax bill up to a maximum of $250;

---

[1] Minn. Stat. §273.123.

- abolished the state property tax levy; and

- provided income tax credits to senior citizens and renters.

The reforms of 1967 resulted in only a one year reversal of the long standing trend of rising property taxes. Figure 1 presents data on total property taxes and property taxes after subtracting property tax credits, chiefly the homestead and agricultural credits.

As Figure 1 shows, between 1960 and 1967, property tax collections grew steadily at a rate that works out to be between 5.6 and 7.8 percent per year. There is no difference between the growth of total taxes and net property taxes since there were no state paid property tax credits during these years. Due to the Property Tax Relief Act of 1967, net property taxes declined 15.1 percent between 1967 and 1968, and total property taxes declined 3.1 percent. Net taxes decreased more than total taxes because of the homestead credit which became effective for taxes paid in 1968.

But following the decline between 1967 and 1968, taxes assumed an even faster rate of growth than before: 20.5 percent between 1968 and 1969; 14.4 percent between 1969 and 1970; and 19.3 percent between 1970 and 1971. Some analysts think the reason the property tax relief programs of 1967 did not provide long-lasting relief is that, in the absence of state mandated levy limits, local government and school districts reacted to the suddenly increased state aid as a windfall that could be spent with little impact on local taxpayers. In addition, the late sixties were a time of high and increasing school enrollments and general population growth that put a great deal of financial pressure on schools and local government. By 1971, it was obvious that the property tax relief provided by the legislature in 1967 had been swallowed up by property tax increases during the next three years.

The Omnibus Tax Bill of 1971 incorporated a number of reforms that came to be called "the Minnesota Miracle." In part, the objective of this reform package was property tax relief, and as a consequence, between 1971 and 1972, the absolute level of the statewide property tax levy shows an annual decline for only the second time in the preceding 40 years.

The main features of the 1971 package were:

- Increased school aid to be distributed in a new way designed to equalize tax effort necessary to fund a basic level of educational services;

- A new system of local government aids to counties, cities, and towns.

- A system of levy limitations for both school districts and units of local government designed to ensure that local spending would not increase as a result of increased state aid;

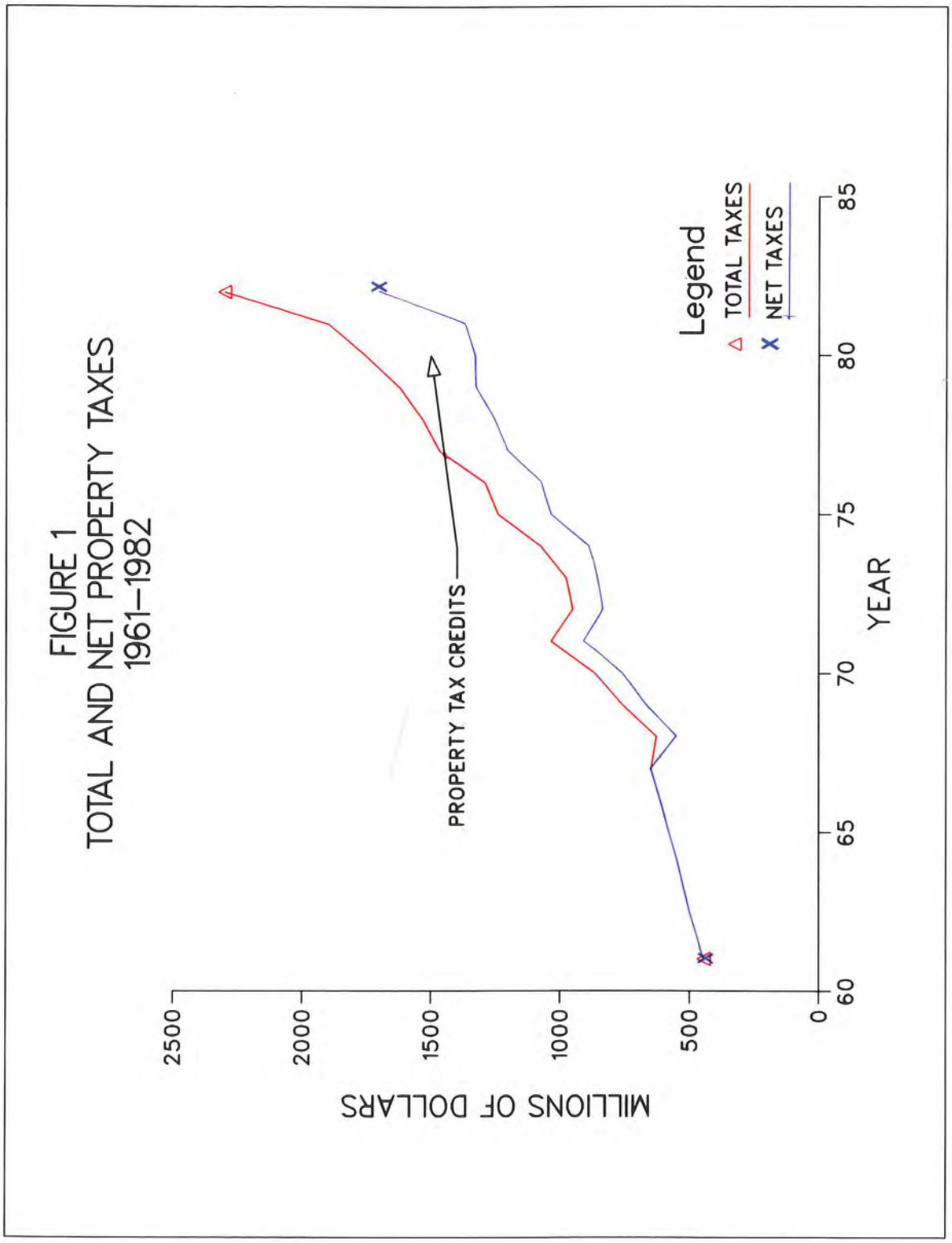


FIGURE 1
TOTAL AND NET PROPERTY TAXES
1961–1982
MILLIONS OF DOLLARS
2500
2000
1500
1000
500
0
60
65
70
75
80
85
YEAR
PROPERTY TAX CREDITS
Legend
TOTAL TAXES
NET TAXES

- State payment of the agricultural school mill rate differential (now called the agricultural credit).

School districts and other local taxing districts were guaranteed at least the level of aid received in 1970-71, so the potential of the 1971 reforms to equalize either tax effort or spending per pupil unit was limited. The impact on property taxes was clear, however; statewide, the effective property tax for education was reduced nearly 23 percent between 1971 and 1972. Total and net taxes both declined 8 percent between 1971 and 1972.

Following the reforms of the 1971 session, net taxes grew rather slowly (with the exception of 1975 and 1977) until 1982. This was accomplished by expanding direct and indirect property tax relief programs whenever it appeared that property taxes would go up too fast. Property taxes grew, for example, 2.3 percent between 1972 and 1973, 3.6 percent between 1975 and 1976, 0.2 percent between 1979 and 1980 and 2.8 percent between 1980 and 1981. But between 1981 and 1982 this trend changed; net taxes grew 24.3 percent, the first annual increase of this magnitude in history. This increase, which has been widely reported in the media, may create an impression that once again Minnesota is faced with a "property tax problem." Indeed, any significant increase in taxes is a matter for concern. But for a more complete understanding of Minnesota's property tax situation, it is necessary to look beyond a one-year percentage increase. Therefore, in the next sections we examine what has happened to property taxes over time:

- In constant dollars;
- As a percent of market value;
- Per capita;
- Per $1,000 dollars of personal income; and
- On residential and agricultural property, the principal targets of direct property tax relief programs.

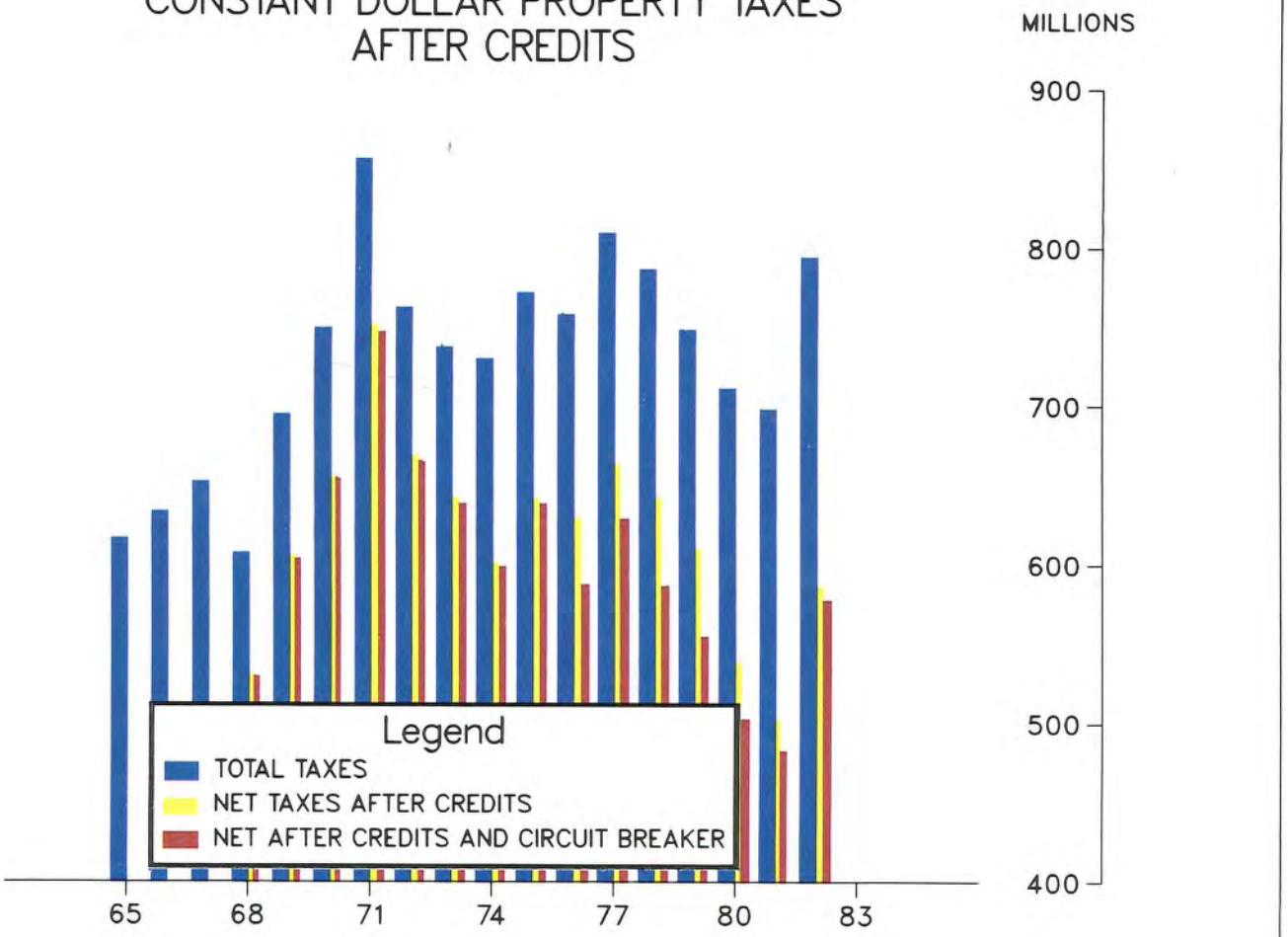
We will find that tax levies on property as a whole have increased (in fact increased nearly every year since the state's founding), but we will also find that other relevant factors have also changed--property values have escalated, incomes have grown, and government services have expanded. We will see that, even with the 1982 increase, property taxes over the last decade and a half have declined in relation to many other economic indicators.

C. THE PROPERTY TAX BURDEN IN MINNESOTA

1. PROPERTY TAXES IN CONSTANT DOLLARS

According to Figure 1, property taxes rose each year since 1960 with the exception of 1968 and 1972. Figure 2 presents data on

FIGURE 2
CONSTANT DOLLAR PROPERTY TAXES
AFTER CREDITS



gross property taxes, taxes net of direct credits, and taxes net of direct credits and the circuit breaker. All figures are corrected for inflation using the national consumer price index (CPI) with 1967 as the base year. It is clear that net property taxes in constant dollars have not risen since 1971; they fell considerably even though they turned up sharply between 1981 and 1982. The major state property tax relief programs successfully kept property taxes from growing as fast as inflation. School aids and local government aids (indirect property tax relief programs) kept gross property taxes more or less constant in real dollars since 1972 and direct property tax relief programs, chiefly the agricultural and homestead credits, caused net taxes to decline about 24 percent between 1971 and 1982. In real dollars, property taxes are lower in 1982 than they were in 1965.

2. PROPERTY TAXES AS A PERCENT OF PERSONAL INCOME

Another useful way to examine recent trends in the property tax is to look at the growth of property taxes in relation to changes in personal income in Minnesota and other states. Table 4 presents data from 1966 to 1981 on per capita personal income in Minnesota and Minnesota's rank among other states, as well as property taxes and other broad based taxes per capita and per $1,000 of personal income. The statistics in Table 4, it should be noted, are based on all property taxes, not residential property taxes alone.

Minnesota's per capita property tax rose from $165.28 in 1966 to $326.92 in 1981. But in relation to personal income, Minnesota's property tax declined considerably during this period, from $62.24 per $1,000 of personal income in 1966 to $33.53 in 1981. (These figures exclude property tax relief provided through the circuit breaker to homeowners and renters.) By this measure, Minnesota's property tax has declined more or less steadily since 1966. In 1966 Minnesota ranked 7th among the states in property tax per $1,000 of personal income. In 1981 it ranked 25th.

Minnesota's income and sales tax collections per capita have increased over this period. Individual income taxes per $1,000 of personal income rose from $23.30 in 1966 to $35.14 in 1981. General sales taxes per $1,000 of personal income were $17.28 in 1981, up from 10.11 in 1968, the first year a general sales tax was levied in Minnesota.

A closer look at Table 4 shows the impact of major property tax reforms in 1967 and 1971. In 1967, prior to enactment of the reforms, Minnesota's property tax per capita was $180.02, 5th highest among the states. By 1969, Minnesota ranked 22nd with a per capita tax of $156.02. But again, Minnesota's relative position worsened and in 1972, per capita property taxes were $213.98, 12th highest in the nation. In 1973, when the reforms of the 1971 session took hold, Minnesota was 21st among the states with a per capita property tax of $221.16.

In summary, property taxes per capita and per $1,000 of personal income have declined markedly since 1966. When we look at residential and agricultural property taxes separately, it will become

TABLE 4

MINNESOTA'S RANK FOR SELECTED TAXES
FISCAL YEARS 1967-1981

	1966		1967		1968		1969		1970		1971		1972		1973	
	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank
Per Capita Personal Income	$ 2,904	24	$ 3,116	20	$ 3,341	20	$ 3,635	18	$ 3,824	17	$ 4,032	20	$ 4,296	25	$ 5,137	18
State and Local Tax Revenues																
Per Capita	$331.75	9	$356.99	7	$391.70	7	$406.15	11	$441.96	15	$497.70	12	$578.00	8	$649.51	8
Per $1,000 of Personal Income	124.94	7	123.27	5	127.94	5	123.33	9	125.04	15	132.48	10	144.68	5	151.15	4
Individual Income Tax																
Per Capita	$ 61.88	7	$ 69.22	7	$ 74.77	6	$ 82.20	9	$ 90.86	10	$ 95.52	9	$124.03	6	$150.43	6
Per $1,000 of Personal Income	23.30	5	23.90	7	24.42	6	24.96	7	25.71	9	25.43	8	31.05	4	35.01	2
Property Tax																
Per Capita	$165.28	7	$180.02	5	$173.13	11	$156.02	22	$170.89	20	$210.67	13	$213.98	12	$221.16	21
Per $1,000 of Personal Income	62.24	7	62.16	6	56.55	9	47.37	21	48.35	20	56.07	15	58.07	13	51.47	19
Sales Tax - General																
Per Capita	N.A.	--	N.A.	--	$ 31.01	40	$ 47.02	34	$ 51.41	37	$ 54.81	41	$ 69.33	37	$ 76.81	38
Per $1,000 of Personal Income	N.A.	--	N.A.	--	10.11	38	14.28	35	14.55	37	14.59	40	17.36	36	17.87	37

	1974		1975		1976		1977		1978		1979		1980		1981	
	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank	Amount	Rank
Per Capita Personal Income	$ 5,442	19	$ 5,807	22	$ 6,183	25	$ 7,129	18	$ 7,910	19	$ 8,865	19	$ 9,724	18	$10,747*	18
State and Local Tax Revenues																
Per Capita	$695.84	8	$754.31	7	$822.68	7	$906.10	9	$1,001.38	9	$1,096.29	8	$1,124.73	9	$1,169.63	11
Per $1,000 of Personal Income	136.15	8	139.44	6	143.11	8	146.92	7	141.63	8	140.40	7	127.41	9	119.95	11
Individual Income Tax																
Per Capita	$179.06	4	$205.58	3	$214.25	4	$240.74	5	$268.10	5	$309.36	3	$309.71	6	$342.60	7
Per $1,000 of Personal Income	35.04	2	38.00	2	37.27	2	39.03	4	37.92	4	39.62	3	35.08	7	35.14	6
Property Tax																
Per Capita	$216.90	22	$231.18	22	$254.20	24	$271.02	23	$300.85	23	$311.10	23	$324.19	22	$326.92	22
Per $1,000 of Personal Income	42.44	23	42.73	23	44.22	22	43.94	22	42.55	23	39.84	22	36.72	22	33.53	25
Sales Tax - General																
Per Capita	$ 88.88	37	$ 97.91	35	$107.58	36	$117.69	38	$134.10	37	$149.75	35	$159.46	38	$168.47	36
Per $1,000 of Personal Income	17.39	37	18.10	35	18.71	35	19.04	36	18.97	37	19.18	36	18.06	37	17.28	36

N.A. = Not Applicable (The General Sales Tax did not go into effect until Fiscal Year 1968)

*From U.S. Department of Commerce, Bureau of Economic Analysis

Source: U.S. Department of Commerce, Bureau of the Census
Governmental Finance (G.F. No. 3 and 5 by year)

apparent that taxes have fallen even faster on these classes of property than have property taxes as a whole, since residential and agricultural property have been the specific target of direct property tax relief programs. The price of reduced property taxes, of course, is an increase in sales and income taxes. Property taxes are a much less important source of state-local revenue today than fifteen years ago. Just how much the property tax has declined as a revenue source is the question examined in the next section.

3. PROPERTY TAXES AS A SOURCE OF REVENUE

State and local government finances are inextricably intertwined; over fifty-five percent of the state's general fund expenditures consists of aid to local units of government and schools. If transfers for human services and other locally administered programs are included, the transfer of state tax revenue is as high as seventy-five percent. As a result, in order to describe the role of the property tax, or any other tax, as a source of revenue it is necessary to look at state and local revenue sources as comprising a single system.

Table 5 presents data for the period 1957 to 1981 on the percent of total state and local tax revenue derived from each major tax. Figure 3 presents these data graphically. As these exhibits show, property taxes have declined dramatically as a source of state-local tax revenue during the last fifteen years. In 1967, property taxes provided 51 percent of state-local tax revenue. In 1981, only 25 percent of tax revenue was derived from the property tax.

The decline of the property tax in Minnesota as a revenue source has dramatically altered Minnesota's position among the states in the percentage of state and local taxes accounted for by the property tax. According to an Advisory Commission on Intergovernment Relations (ACIR) tabulation of census data, Minnesota's property tax in 1980 raised 28.8 percent of state and local taxes, compared to the U.S. average of 30.7 percent. This is a clear departure from past practice. As recently as 1972, Minnesota relied on the property tax for 40 percent of tax revenue, a level that was higher than the national average. In 1967, prior to the period of major property tax reform in Minnesota, nearly 50 percent of state-local tax revenue was raised by the property tax and in 1967 only 12 states raised proportionately more revenue through the property tax.

Nationally, the property tax has been declining as a source of revenue for many years. However, the decline in Minnesota has been faster than in all but three other states between 1967 and 1980, and only California reduced its use of the property tax appreciably more than Minnesota during this period.

In summary, as a revenue source, property taxes are half as important now as they were in 1967. This has been accomplished through fifteen years of active reform of the property tax system and implementation of property tax relief programs.

TABLE 5

STATE AND LOCAL TAX SOURCES
PERCENTAGE DISTRIBUTION BY SOURCE
FISCAL YEARS 1957 - 1982

Year	State/Local Property Taxes[1]	Individual/Corporate Income Taxes	Sales and Excise Taxes
1957	51%	28%	21%
1958	54%	27%	19%
1959	57%	24%	19%
1960	56%	25%	19%
1961	56%	26%	18%
1962	56%	26%	18%
1963	56%	27%	17%
1964	55%	27%	18%
1965	55%	27%	18%
1966	51%	32%	17%
1967	51%	32%	17%
1968	46%	30%	24%
1969	41%	31%	28%
1970	41%	31%	28%
1971	42%	31%	27%
1972	40%	34%	26%
1973	34%	37%	29%
1974	31%	41%	28%
1975	31%	42%	27%
1976	30%	42%	28%
1977	28%	44%	28%
1978	27%	45%	28%
1979	25%	47%	28%
1980	25%	47%	28%
1981	25%	47%	28%

Source: Office of Legislative Auditor, Financial Audit Division.

[1]Net of circuit-breaker refunds.

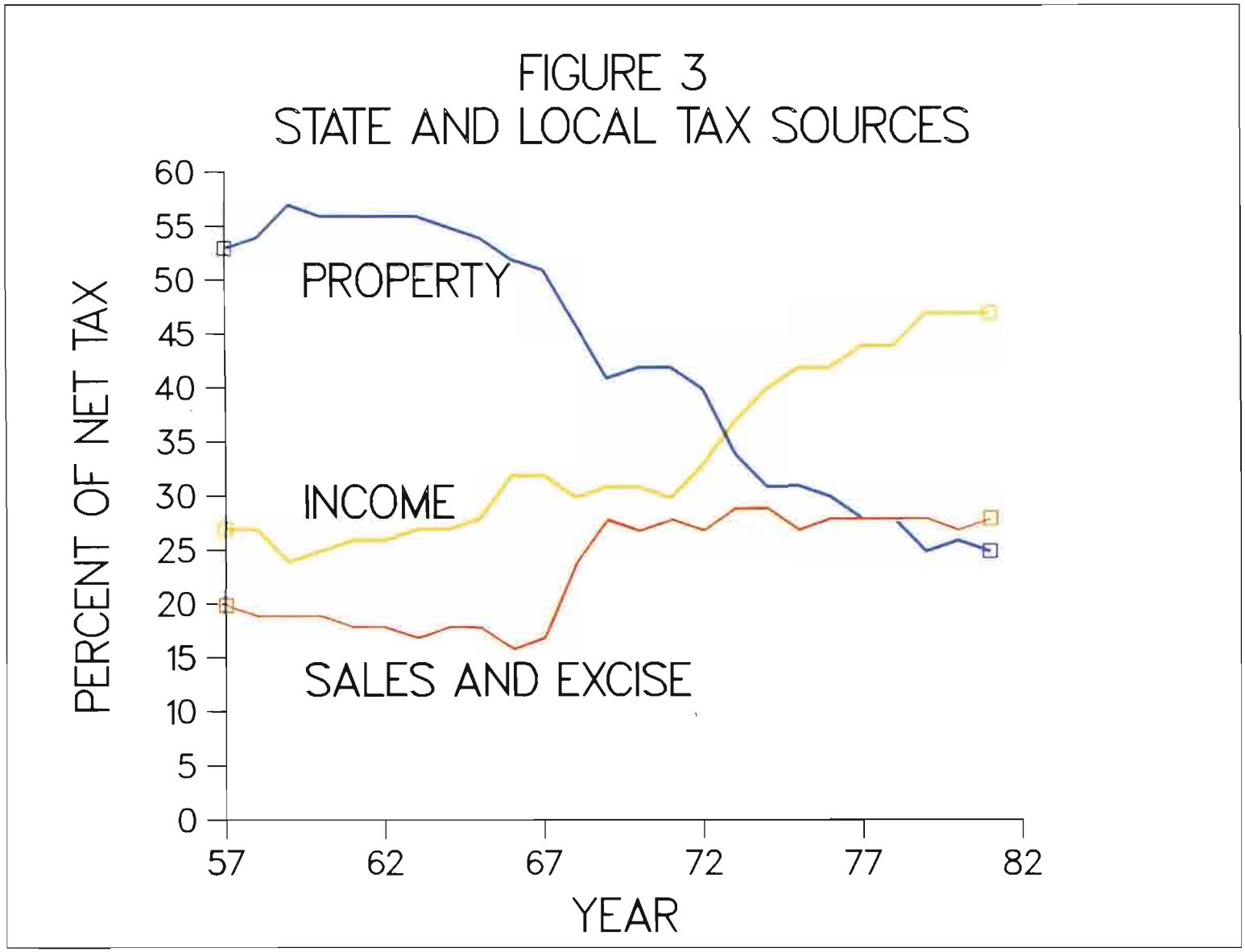


FIGURE 3
STATE AND LOCAL TAX SOURCES
PERCENT OF NET TAX
60
55
50
45
40
35
30
25
20
15
10
5
0
PROPERTY
INCOME
SALES AND EXCISE
57
62
67
72
77
82
YEAR

4. EFFECTIVE PROPERTY TAX RATES

The effective tax rate (ETR) is the annual property tax (after credits) as a percent of market value. The effective tax rate can be computed for all property, specific classes of property, or for a single parcel. The ETR is commonly used and understood as a measure of property tax burden. As a measure of property tax levels, the effective tax rate is easily grasped. Proposition 13 in California and Proposition 2½ in Massachusetts limited residential property taxes as a percent of market value. In Massachusetts property taxes were limited to an effective tax rate of two and one-half percent and in California to one percent.

This section examines what has happened to the effective tax rate in Minnesota over the last fifteen years and how Minnesota now compares to other states. In 1967, before the homestead credit and sales tax per capita aid, the effective tax rate for all real property was close to 3.0 percent. In 1968, the effective tax rate for all real property in Minnesota after subtracting the homestead credit was 2.3 percent. As we pointed out earlier, property taxes grew sharply between 1968 and 1971, 15-20 percent a year. As a result, the effective tax rate reached about 4.0 percent by 1971, a level many thought should not be allowed to go higher.[1]

As a result of the property tax relief programs enacted in 1971 and subsequent years, and rapid inflation in real estate prices during the second half of the 1970s, the effective tax rate in Minnesota has declined rapidly between 1975 and 1981. The effective tax rate on all classes of property was 2.42 percent in 1975, 1.80 percent in 1978, 1.16 percent in 1982. By 1982 it was about one-fourth of what it was in 1971 and about one-half of what it had been in 1977. These statistics which appear in Table 7 are discussed further in a later section. A declining tax as a percent of market value does not necessarily make it easier for people to pay their property taxes, although as we will see in the next section, the average property tax of Minnesota homeowners rose very little between 1975 and 1982 and actually declined in real dollars during this period.

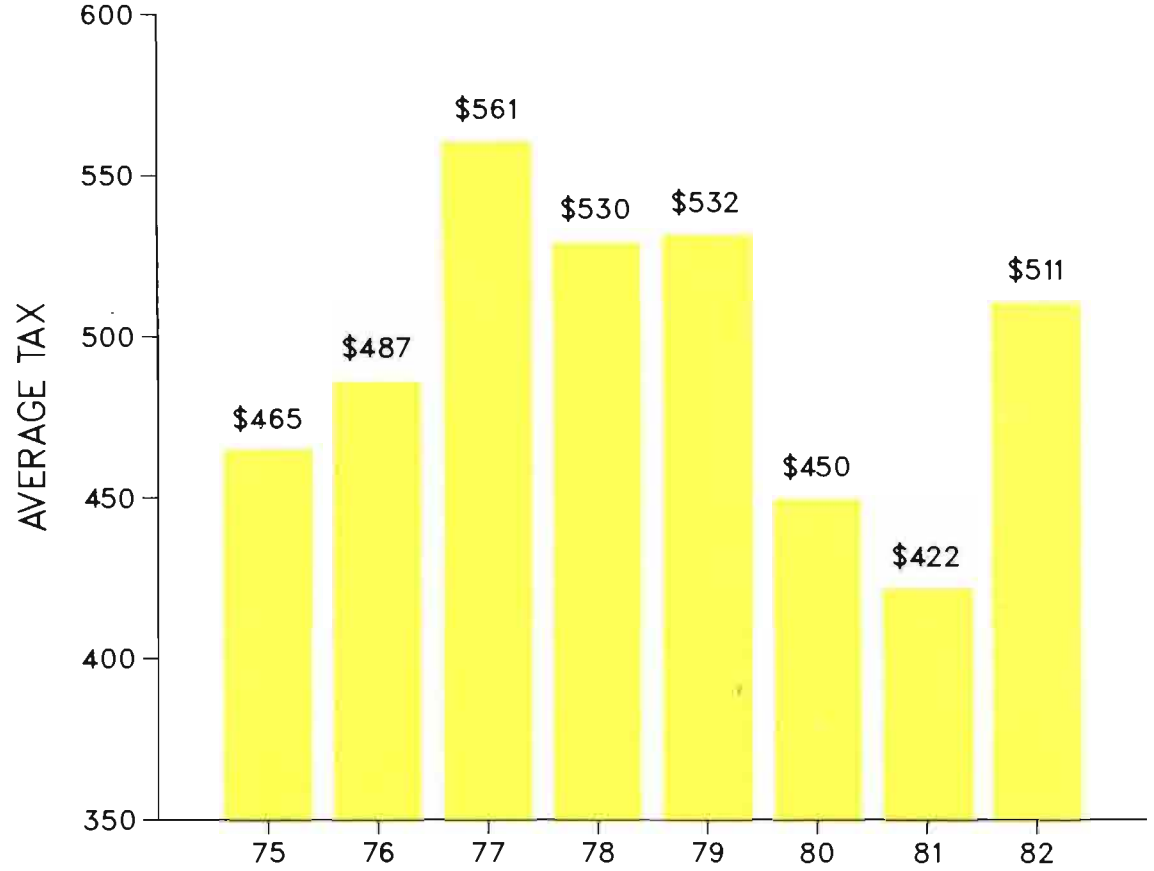
5. AVERAGE PROPERTY TAX OF MINNESOTA HOMEOWNERS

Figures 4 and 5 present a data series that shows what has happened to average property taxes on Minnesota homes in current and constant dollars, between 1975 and 1982. As Figure 4 shows, average net property taxes increased between 1975 and 1982 from $465 to $511. As Figure 5 shows, in constant dollars, average taxes have declined during this period from $529 in 1975 to $314 in 1982. Average property taxes in real dollars, however, turned upward in 1982 from a low of $280 in 1981.

---

[1] Effective tax rates for 1967 to 1971 are from Hatfield, Rolland F., Report to Governor's Minnesota Property Tax Study Advisory Committee. November 1970.

FIGURE 4
MINNESOTA HOMEOWNERS AVERAGE PROPERTY TAX



SOURCE: Minnesota Department of Revenue

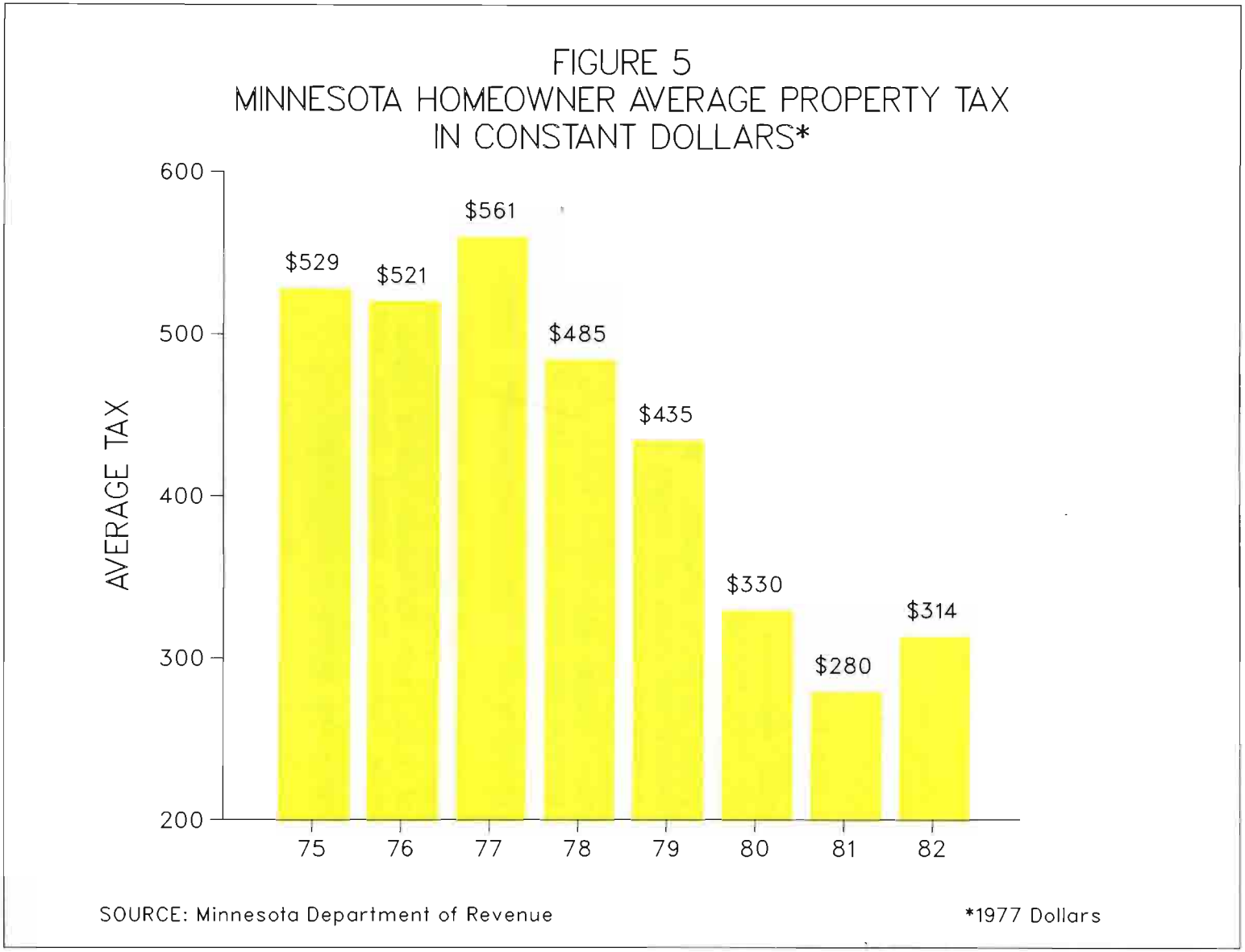


FIGURE 5
MINNESOTA HOMEOWNER AVERAGE PROPERTY TAX
IN CONSTANT DOLLARS*
AVERAGE TAX
600
500
400
300
200
$529
$521
$561
$485
$435
$330
$280
$314
75
76
77
78
79
80
81
82
SOURCE: Minnesota Department of Revenue
*1977 Dollars

Since the market value of homes increased rapidly during the 1970s, it is reasonable to expect that property taxes as a percent of market value (effective tax rates) would decline, but it might not be appreciated how much ETRs have declined between 1975 and 1982. In the previous discussion we looked at effective tax rates on all property. Figures 6 and 7 present effective tax rates on residential and farm homesteads. The effective tax rate on residential (non-farm) homesteads was 2.1 percent in 1975. This measure declined to 0.8 percent in 1981 and rose slightly to 1.0 percent in 1982. Farm owners' taxes show a similar pattern: a decline from 1.3 percent of market value in 1975 to 0.4 in 1981 and a rise to 0.5 percent in 1982. As a percent of market value, property taxes on residential and farm homesteads declined by half during the period 1975-1981. Although taxes turned upward in 1982, they are still lower than they were in in 1980 and far below the level of the mid 1970s.

One additional point: the averages in Figures 4-7 do not take account of money paid to homeowners through the circuit breaker program.

The best available data on interstate comparisons of residential property taxes comes from the Advisory Commission on Intergovernmental Relations (ACIR) and it is restricted to single family homes with FHA mortgages. Table 6 presents these data, and although the coverage of the information is less than complete, what Table 6 shows is truly dramatic. Minnesota has one of the nation's lowest effective tax rates on single family homes. In 1981, property taxes as a percent of market value (the effective property tax rate) in Minnesota was 0.79. This a lower effective tax rate than in 42 other states. States with lower rates are mostly in the south where taxes in general are lower than the rest of the nation. Among states outside the south, only Hawaii, Arizona and Wyoming have lower effective property tax rates on single family homes.

As recently as 1971, the situation was far different. Minnesota's effective tax rate was 2.05 percent compared to the national average of 1.98, and Minnesota had a higher effective tax rate on single family homes than several Plains and Great Lakes states. Today Minnesota's effective property tax rate on homes is now lower than all but a few states in the nation.

The sharp decline in residential property taxes in Minnesota is the deliberate result of indirect property tax relief programs that affect taxes on all property and direct property tax relief programs that are primarily focused on residential and farm homesteads. These programs have succeeded in lowering residential property taxes to the point that they are among the lowest in the nation. Even though property taxes net of direct property tax credits increased 24 percent in 1982 over 1981, non-farm residential property taxes as a percent of market value are still less than half of what they were as recently as 1977.

Nevertheless, we do recognize that declining effective tax rates do not mean that property taxes are lower in current dollars. Figure 4 shows that average taxes were $511 in 1982 and $465 in

FIGURE 6
RESIDENTIAL PROPERTY TAXES AS A PERCENT
OF MARKET VALUES
TAXES PAYABLE 1975–1982

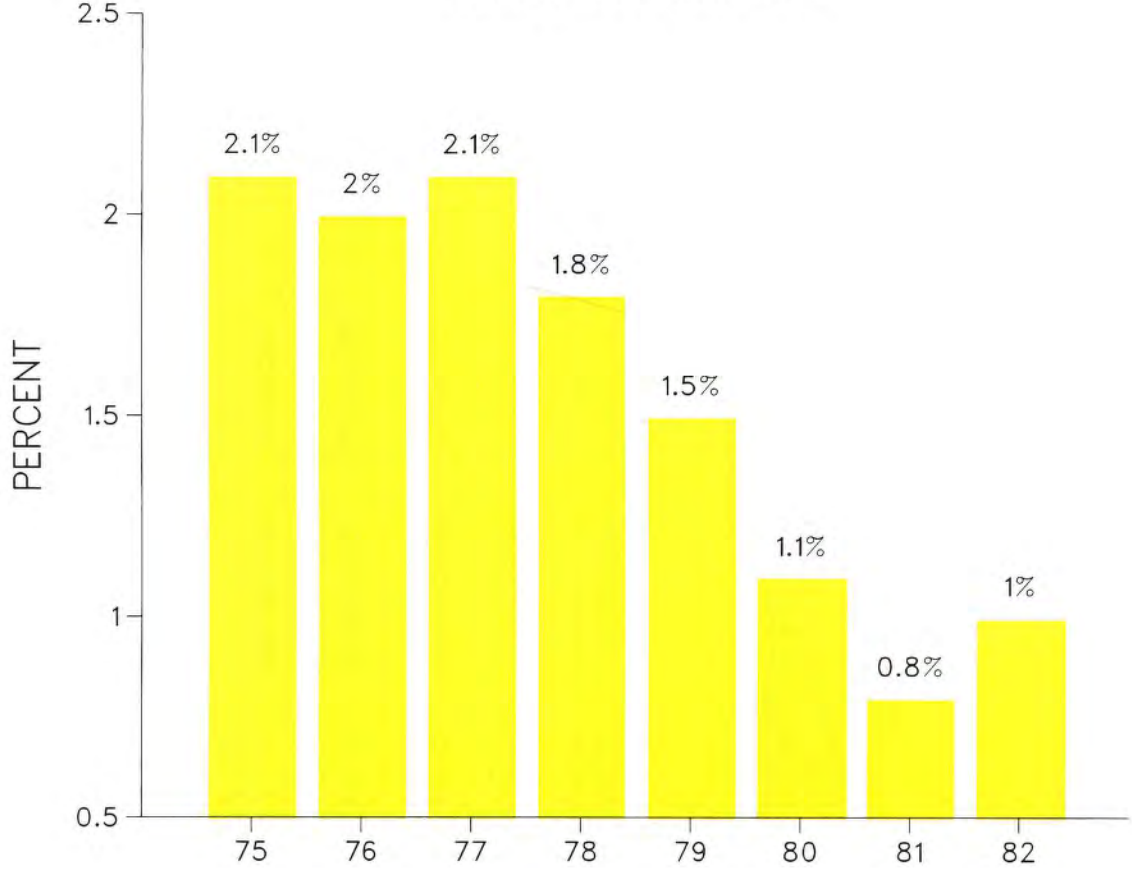


TABLE 6
AVERAGE EFFECTIVE PROPERTY TAX RATES, EXISTING SINGLE FAMILY HOMES WITH FHA INSURED MORTGAGES, BY STATE AND REGION, SELECTED YEARS 1958 - 1981[1]

State and Region	1981	1980	1977	1975[2]	1971	1966	1958
UNITED STATES	1.26	1.28	1.67	1.89	1.98	1.70	1.34
NEW ENGLAND							
CONNECTICUT	1.53	1.55[3]	2.17	1.94	2.38	2.01	1.44
MAINE	1.42	1.25[3]	1.65	1.86	2.43	2.17	1.58
MASSACHUSETTS	2.43	2.51[4]	3.50	3.26	3.13	2.76	2.21
NEW HAMPSHIRE	N.A.	1.73[4]	N.A.	(2.38)	3.14	2.38	1.81
RHODE ISLAND	N.A.	1.93[5]	N.A.	2.27	2.21	1.96	1.67
VERMONT	N.A.	1.60[5]	N.A.	(2.21)	2.53	2.27	1.63
MIDEAST							
DELAWARE	0.79	0.85	0.88	0.92	1.26	1.14	0.71
DIST. OF COLUMBIA	1.22	1.30	n.a.	1.78	1.80	1.37	1.08
MARYLAND	1.25	1.61	1.69	2.01	2.24	2.05	1.47
NEW JERSEY	2.53	2.60	3.31	3.15	3.01	2.57	1.77
NEW YORK	2.75	2.75	2.89	2.56	2.72	2.40	2.09
PENNSYLVANIA	1.50	1.57	1.85	1.71	2.16	1.88	1.50
GREAT LAKES							
ILLINOIS	1.47	1.50	1.90	2.21	2.15	1.96	1.35
INDIANA	1.13	1.19	1.66	1.64	1.96	1.64	0.84
MICHIGAN	2.74	2.54	2.63	2.38	2.02	1.81	1.45
OHIO	1.07	1.08	1.26	1.29	1.47	1.44	1.07
WISCONSIN	1.75	1.67	2.22	2.63	3.01	2.31	1.82
PLAINS							
IOWA	1.75	1.48	1.76	2.20	2.63	2.12	1.34
KANSAS	0.93	0.94	1.37	1.55	2.17	1.96	1.65
MINNESOTA	0.79	0.93	1.39	1.58	2.05	2.14	1.57
MISSOURI	0.95	1.00	1.59	1.85	1.79	1.64	1.12
NEBRASKA	2.31	2.37	2.48	2.50	3.15	2.67	1.90
NORTH DAKOTA	1.01	1.00	1.26	1.53	2.08	1.81	1.54
SOUTH DAKOTA	1.69	1.70	1.79	2.14	2.71	2.64	2.01
SOUTHEAST							
ALABAMA	0.38	0.56	0.74	0.75	0.85	0.66	0.56
ARKANSAS	1.42	1.53	1.49	1.41	1.14	1.09	0.84
FLORIDA	0.92	1.02	1.13	1.18	1.41	1.09	0.76
GEORGIA	1.21	1.24	1.27	1.33	1.44	1.30	0.84
KENTUCKY	1.14	1.19	1.25	1.23	1.27	1.03	0.93
LOUISIANA	0.28	0.26	0.61	0.64	0.56	0.43	0.52
MISSISSIPPI	0.86	0.93	1.10	1.12	0.96	0.93	0.66
NORTH CAROLINA	1.07	0.95	1.35	1.51	1.58	1.31	0.90
SOUTH CAROLINA	0.84	0.81	0.82	1.07	0.94	0.60	0.48
TENNESSEE	1.42	1.27	1.40	1.31	1.53	1.37	0.97
VIRGINIA	1.39	1.26	1.21	1.32	1.32	1.13	0.90
WEST VIRGINIA	0.37	0.43	N.A.	0.78	0.69	0.71	0.56
SOUTHWEST							
ARIZONA	0.74	1.16	1.72	1.54	1.65	2.41	2.14
NEW MEXICO	1.14	1.12	1.65	1.56	1.70	1.30	0.93
OKLAHOMA	0.82	0.91	0.95	1.27	1.35	1.11	0.86
TEXAS	1.68	1.57	1.84	2.06	1.91	1.62	1.36
ROCKY MOUNTAIN							
COLORADO	1.01	1.05	1.80	1.99	2.45	2.20	1.72
IDAHO	0.94	0.96	1.46	1.86	1.72	1.23	1.14
MONTANA	1.08	1.11	1.31	1.60	2.19	1.70	1.32
UTAH	1.03	1.02	1.03	1.20	1.49	1.52	1.05
WYOMING	0.47	0.50	0.87	1.12	1.38	1.34	1.17
FAR WEST							
CALIFORNIA	1.04	0.98	2.21	2.08	2.48	2.03	1.50
NEVADA	1.13	1.22	1.71	1.53	1.48	1.47	1.06
OREGON	1.56	1.72	2.25	2.18	2.33	1.98	1.55
WASHINGTON	0.95	1.06	1.75	1.86	1.62	1.14	0.92
ALASKA	N.A.	1.35	N.A.	1.73	1.61	1.42	1.12
HAWAII	0.36	0.42	N.A.	(0.95)	0.92	0.81	0.62

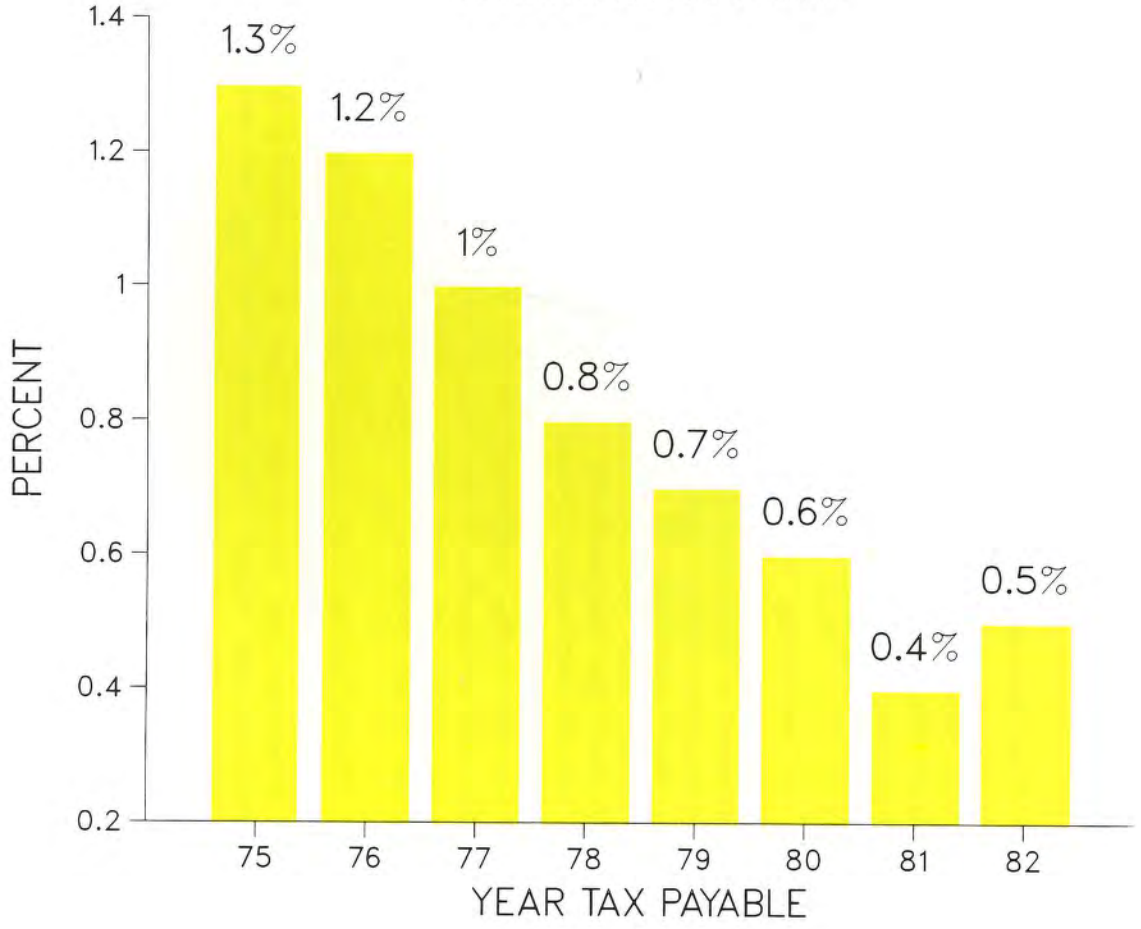
N.A. -- DATA NOT AVAILABLE

NOTE: THESE EFFECTIVE RATES ARE FOR EXISTING FHA INSURED MORTGAGES ONLY, WHICH REPRESENT SMALL AND VARYING PERCENTAGES (BY STATE) OF TOTAL SINGLE-FAMILY HOMES. THESE RATES MAY OR MAY NOT BE REPRESENTATIVE OF THE RATES APPLICABLE TO ALL HOMES IN A PARTICULAR STATE. THE UNITED STATES AVERAGE TAX RATE FOR 1981 (1.26) INDICATES THAT, ON AVERAGE, THE PROPERTY TAX ON A HOME WITH A MARKET VALUE OF $100,000 WOULD BE $1,260.

[1] EFFECTIVE TAX RATE IS THE PERCENTAGE THAT TAX LIABILITY IS OF THE MARKET OR TRUE VALUE OF THE HOUSE.
[2] FIGURES IN PARENTHESIS ARE FOR 1974, DATA FOR 1975 NOT AVAILABLE.
[3] FOURTH QUARTER OF 1977 INCREASED TO 1980 ON THE BASIS OF THE U.S. AVERAGE PERCENTAGE CHANGE.
[4] ACIR STAFF ESTIMATES BASED ON 1974 (LATEST YEAR READILY AVAILABLE) INCREASED TO 1980 ON THE BASIS OF THE U.S. AVERAGE PERCENTAGE CHANGE (75%) AND THE 1977 CENSUS OF GOVERNMENTS, "TAXABLE PROPERTY VALUES AND ASSESSMENT/SALES PRICE RATIOS" (25%).
[5] ACIR STAFF ESTIMATES BASED ON 1974 (LATEST YEAR READILY AVAILABLE) INCREASED TO 1980 ON THE BASIS OF THE U.S. AVERAGE PERCENTAGE CHANGE.

SOURCES: COMPUTED BY ACIR STAFF FROM DATA CONTAINED IN U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, HOUSING - FHA, MANAGEMENT INFORMATION SYSTEMS DIVISION, SINGLE-FAMILY INSURED BRANCH, DATA FOR STATES AND SELECTED AREAS ON CHARACTERISTICS OF FHA OPERATIONS UNDER SECTION 203b), VARIOUS YEARS.

FIGURE 7
FARM PROPERTY TAXES AS A PERCENT
OF MARKET VALUE
TAXES PAYABLE 1975–1982



1975. Nor do increased housing values mean that low income homeowners have ready cash to pay property taxes.

Next we turn to an examination of what has happened to property taxes on other classes of property.

6. PROPERTY TAX RATES BY CLASS OF PROPERTY

In Minnesota, as in about a quarter of the states in the union, different types of property are assessed at different fractions of market value for tax purposes. For example, in Minnesota the assessed value of unmined iron ore is set at 50 percent of market value, agricultural land not homesteaded at 19 percent of market value, the first $50,000 of agricultural homesteaded property at 14 percent of market value, and the first $27,000 of other homesteads at 16 percent of market value.

The Minnesota classified property tax was authorized by a constitutional amendment in 1906 and first implemented by legislation in 1913. In recent years, the Legislature has frequently changed the classification system and, as a result, Minnesota now has the nation's most complicated classification system. There are more than fifty legal classes of property.

In analyzing tax rates on classes of property, we compressed these legal classes into six use classes. This in also done by the Department of Revenue in computing assessment-sales ratios each year. Assessment-sales ratios are used by the Department of Revenue to adjust for variation in assessment practices across the state. Because school aids are distributed based on local tax effort, it is necessary for the department to study the relationship between assessed values and sales prices across the state in order to distribute aid fairly. We used the department's sales ratios to compute accurate market value information for six use classes of property, then computed property taxes as a percent of market value (the effective tax rate) for each class before and after payment of direct property tax relief credits.

The effective tax rate is the best available way to compare tax levels across classes of property. Table 7 presents state-wide data on effective tax rates by class of property before and after direct property tax relief credits are applied for each year between 1975 and 1982. Also presented is the percentage by which ETRs have changed between 1975 and 1982 for taxes before and after state paid direct property tax relief (excluding the income-adjusted property tax refund or circuit breaker).[1]

---

[1] On a state-wide basis the circuit breaker for homeowners does not have much impact on the effective tax rate. In 1981, on residential property the ETR including the circuit breaker would be 0.71 percent instead of 0.83.

TABLE 7

EFFECTIVE TAX RATES BEFORE AND AFTER DIRECT PROPERTY CREDITS BY USE CLASS

TAXES PAYABLE 1975 - 1982

	Percent Change 1975-1982	Before Credits: Effective Tax Rate Percentage 1975	1976	1977	1978	1979	1980	1981	1982
All Classes	-45.1	2.93	2.70	2.60	2.21	1.95	1.78	1.42	1.61
Residential	-42.2	3.01	2.90	2.88	2.46	2.15	1.89	1.49	1.74
Apartment	-35.3	4.11	3.61	3.73	3.64	3.22	2.84	2.56	2.66
Seasonal/ Recreational	-38.9	1.90	1.58	1.92	1.68	1.52	1.36	1.03	1.16
Farm	-46.8	1.58	1.38	1.34	1.07	0.96	0.95	0.73	.84
Commercial Ind.	-35.4	4.38	4.02	3.90	3.65	3.33	3.18	2.63	2.83
Public Utility	-11.8	3.48	3.17	3.23	3.11	3.06	3.07	2.81	3.07
		After Credits							
All Classes	-52.1	2.42	2.23	2.12	1.80	1.58	1.34	1.01	1.16
Residential	-54.0	2.11	2.04	2.08	1.76	1.53	1.14	0.83	.97
Apartment	-40.4	4.11	3.61	3.73	3.64	3.22	2.84	2.37	2.45
Seasonal/ Recreational	-46.3	1.90	1.58	1.71	1.50	1.36	1.21	0.90	1.02
Farm	-59.8	1.32	1.16	0.99	0.79	0.71	0.65	0.46	.53
Commercial Ind.	-35.4	4.38	4.02	3.90	3.65	3.33	3.18	2.63	2.83
Public Utility	-11.8	3.48	3.17	3.23	3.11	3.06	3.07	2.81	3.07

Source: Office of the Legislative Auditor calculations from Department of Revenue data.

First, without state-paid direct property tax credits, property taxes have declined as a percent of market value on all classes of property. Growth in aid to schools and local government along with state financing of other local government obligations is responsible for part of this decline. Inflation in real property values also outran increases in the cost of providing government services and this caused a decline in the ETR. ETRs for residential, non-commercial seasonal recreational and farm property declined the most. Taxes on apartments, public utility property and commercial-industrial property declined less, although by a substantial amount.

Direct property tax credits lower effective tax rates on all classes except commercial-industrial and public utility property. The effective tax rate on residential property (after credits were applied) declined 54.0 percent between 1975 and 1982, and the ETR on farm property declined 59.8 percent during the same period. In 1982, the effective tax rate was 0.97 percent for residential property and 0.53 percent for farm property after direct property tax relief credits. Before direct tax credits, the ETR on residential and farm property was 1.74 and 0.84 percent respectively. Thus, direct property tax relief reduced the ETR 33 percent on residential property and 37 percent on farm property.

As we have noted before, the effective tax rate on residential and farm property is low by historical standards in Minnesota and is also low compared to other states today. Effective tax rates are over twice as high on apartment property, commercial property and property owned by public utilities than on residential and farm property, because these classes are not generally eligible for direct property tax credits and their assessed value is set by law at a higher percentage of market value than are residential and farm property. However, effective tax rates on these classes of property have also declined since 1975 because of increases in indirect property tax relief.

D. CONCLUSION

Direct property tax relief programs are designed to keep property taxes low. Therefore, the first issue to be investigated in connection with a study of the relief programs is the question of whether property taxes are high or low. Judging this question requires a look at changes in the property tax over time, comparison of Minnesota's property tax to property taxes in other states, and an examination of property taxes in relation to other economic measures such as real estate values and personal income. We have made these comparisons and showed that Minnesota's property taxes--residential property taxes in particular--are low in historical perspective and in comparison to other states. These low tax levels have been achieved through more than a decade of active reform of the property tax system and rapid expansion of property tax relief programs.

II. GEOGRAPHIC VARIATION IN RESIDENTIAL PROPERTY TAXES

We have just reviewed historical trends in property taxes and the position of Minnesota relative to other states. On the whole, we have concluded that Minnesota's property taxes, especially residential property taxes, are low in historical perspective and low compared to other states. In the following section we look at variation in property taxes across the state and discuss the significance of geographic variation for legislative decisions on direct property tax relief programs. The major points to be drawn from this section are:

- There is wide variation in the level of property taxes across Minnesota. While taxes are low, overall, as a result of 15 years of expanding property tax relief programs, taxes are especially low in some areas and relatively high in other areas. In general, property taxes are highest in the Twin Cities metropolitan area and in other urban centers and relatively low in rural areas.

- Property taxes vary across communities for a number of reasons. Urban areas require relatively high taxes to finance services which are essential in such communities. High population density itself causes certain services to be either necessary or desirable.

- Taxes are also high in certain communities and not others because of a concentration of people needing public services, for example, children of school age or clients of public assistance programs.

- In addition, taxes vary because of expenses induced by rapid growth, differences in property wealth and the property mix across communities, differing preferences for public services, and other factors.

- The wide variation in property taxes across the state helps to explain why, after years of little or no growth in property taxes, many people feel property taxes are too high. Because of the way it is structured, the homestead credit actually increases the difference in property taxes between high and low tax areas.

- Certain property tax relief programs are tied to variation in service needs or requirements across communities or the ability of individual taxpayers to pay property taxes. The homestead and agricultural credits, however, reduce taxes in a way that is not tied directly to either service needs or ability to pay. Property tax relief programs such as these that work to reduce property taxes where they are already low (as well as where they are high) are hard to defend at a time of severe budget constraints and revenue shortfalls.

A. CAUSES OF GEOGRAPHIC VARIATION

The amount of tax paid on a particular parcel of property depends on its legal class, the budget and the property wealth of the taxing districts in which the parcel is located, and a parcel's eligibility for property tax credits.

In this section we examine in more detail why and by how much property taxes vary across the state. In addition, we examine how our system of property tax credits affects the geographic distribution of the property tax burden.

Figure 8 presents a simplified view of the factors affecting the amount of taxes paid on an individual parcel of property. Two types of factors are important: those associated with the taxing district as a whole and those specific to an individual parcel of property.

The first group of factors apply to all property in a taxing district and affect the mill rate. The mill rate in a taxing district is simply the taxing district's budget (after other sources of funds are subtracted) divided by the total amount of assessed value in the district. Mill rates vary because of several factors:

- Differences in service needs and requirements across communities. Different types of communities have different functional requirements.
- Differences in local preferences for public services.
- Differences in property wealth.
- Differences in the mix of property across taxing districts.

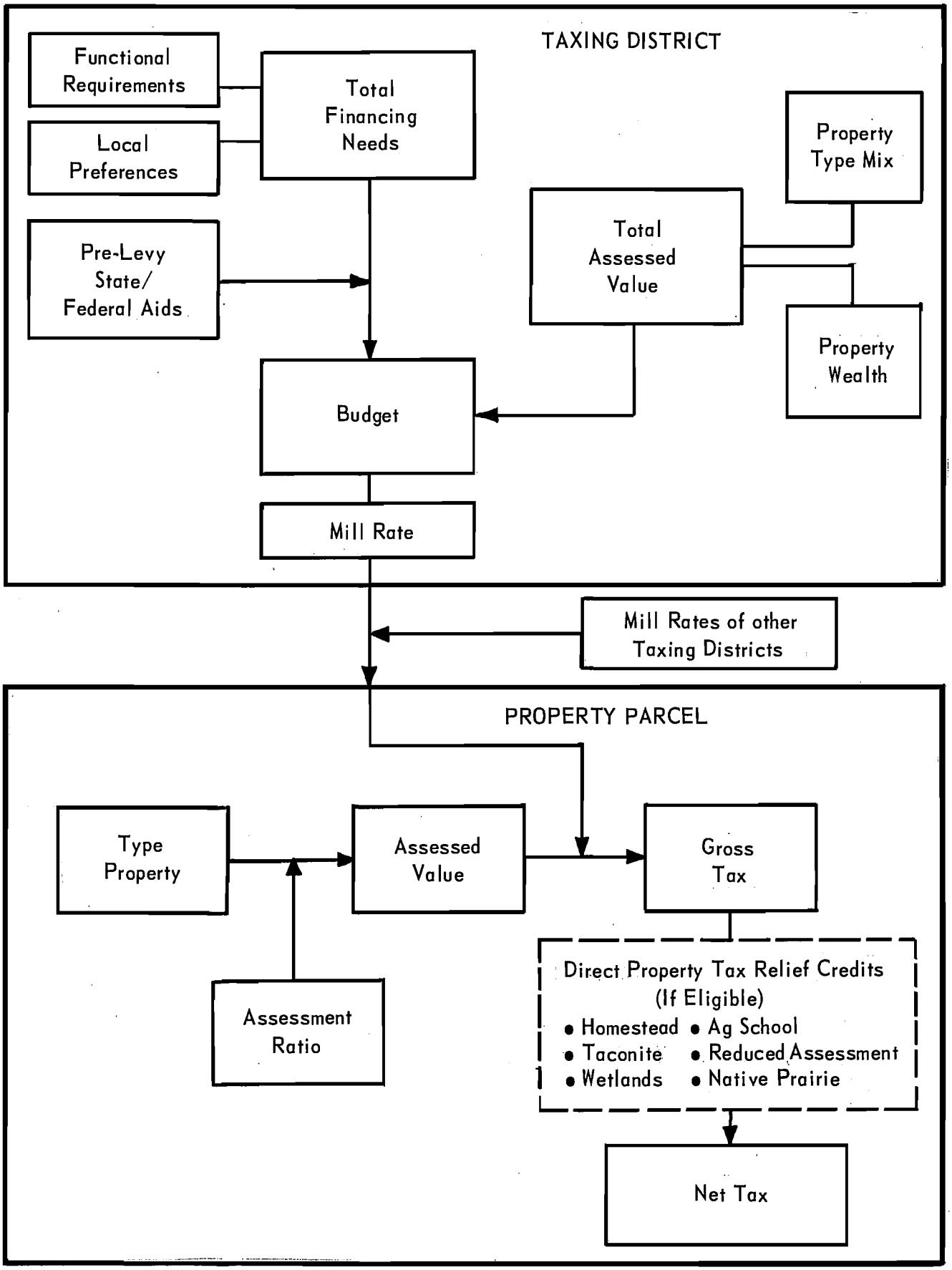
Functional requirements clearly differ between urban and rural communities. Urban or rapidly urbanizing communities require greater spending on public services and facilities than less developed or rural areas. While there are universal service needs and requirements of urban centers, there are also optional amenities and preferences for public services that vary from one community to another.

Property wealth also varies and variation in wealth results in differing mill rates because lower wealth taxing districts must, in general, have higher mill rates to finance needed or preferred services.

Related to property wealth is the mix of legal property types in the taxing districts. Property mix affects the mill rate because of Minnesota's statutory property classification system. Each legal class of property is assessed for tax purposes at a specific rate. For example, commercial property is assessed at 43 percent of market value while residential homesteaded property is assessed at 16 percent on the first $27,000 in value, 22 percent on the next $27,000, and 28 percent on any market value above $54,000. As a result of

Figure 8

MODEL OF PROPERTY TAX LIABILITIES AND CREDITS



differences in classification, owners of some classes of property (for example, commercial) pay tax on a higher percentage of their property wealth. Thus, the mix of property affects the total assessed value in the district, and therefore the mill rate. For example, districts with a high percentage of market value in commercial property have a relatively higher total assessed value and, therefore, a relatively lower mill rate than districts with equal total market value but with a high percentage of residential property.

The second group of factors explaining property tax variation is tied to the status of individual parcels of property. Once the mill rate for a taxing district is determined, the actual tax paid by property owners depends on the class and value of an individual parcel and whether or not the property is eligible for direct property tax relief programs. Eligibility for property tax credits is determined differently for each program. For residential homesteaded property, the market value is multiplied by the appropriate classification percentages and the result is multiplied by the mill rate to give gross taxes. Homesteaded property is eligible for the homestead credit, so 58 percent of the gross tax up to $650 is subtracted from the gross tax to yield the net tax. On commercial property, the gross and net tax is almost always the same since commercial property is generally not eligible for any direct credits.

The framework presented above can be used to understand why property taxes vary across the state. The next section shows the actual net and gross tax variation across the state for residential property and examines this variation in more detail. However, no attempt is made precisely to attribute variation in taxes to any of the several causes of variation, such as service needs and requirements associated with particular kinds of communities, property mix, or local preferences. We show the extent of variation in taxes across the state relative to variation in property values and income because we believe this will help illuminate the political debate over property taxes and tax relief programs that is likely to occur in 1983, and because we believe that extensive geographic differences in property taxes are a problem that the legislature may wish to address, especially because the homestead credit reduces property taxes less in high tax areas than low tax areas and thus increases rather than diminishes geographic differences.

B. RESIDENTIAL PROPERTY TAXES

The remainder of this chapter examines, in turn, geographic variation in taxes on residential (non-farm) and farm homesteads. These receive nearly all the property tax relief provided through direct property tax relief programs. Estimates of the total state paid direct property tax credits on residential homesteads totalled $437,265,000 in 1982, and $125,357,000 for farm homesteads.

Table 8 shows the average net property tax on non-farm homesteads by county for 1982. Average property taxes vary greatly across the state. The highest average tax was $911 in Hennepin

TABLE 8

RESIDENTIAL HOMESTEAD PROPERTY TAXES
(Taxes Payable 1982)

COUNTY	AVERAGE NET TAX	AVERAGE HOMESTEAD MARKET VALUE	EFFECTIVE TAX RATE	COUNTY MEDIAN INCOME (1979)*	COUNTY	AVERAGE NET TAX	AVERAGE HOMESTEAD MARKET VALUE	EFFECTIVE TAX RATE	COUNTY MEDIAN INCOME (1979)*
HENNEPIN	$911.07	$76,124	1.20%	$12,617	WABASHA	$251.87	$40,844	0.62%	$10,880
CARVER	794.62	75,077	1.06	13,624	TODD	246.76	37,099	0.67	8,435
SCOTT	782.00	69,272	1.13	14,682	POLK	246.55	36,997	0.67	10,011
DAKOTA	781.62	77,433	1.01	15,992	COTTONWOOD	246.49	39,451	0.62	11,153
RAMSEY	770.13	67,722	1.14	12,622	MARTIN	243.80	43,541	0.56	11,226
WASHINGTON	740.19	80,872	0.92	17,189	POPE	242.83	37,158	0.65	8,113
ANOKA	678.33**	68,097**	0.98**	16,539	CARLTON	242.80	32,176	0.75	13,418
OLMSTEAD	584.87	60,804	0.96	12,970	CROW WING	242.49	48,339	0.50	9,842
CHISAGO	529.69	56,820	0.93	13,314	SIBLEY	240.99	41,917	0.57	9,941
BLUE EARTH	504.31	53,144	0.95	10,474	FILLMORE	239.09	39,698	0.60	9,370
NICOLLET	473.02	58,847	0.80	11,693	BECKER	235.50	42,582	0.55	8,779
SHERBURNE	431.23	59,520	0.72	15,117	MEEKER	233.55	45,819	0.51	9,936
ISANTI	427.06	50,951	0.84	13,187	SWIFT	232.78	31,540	0.74	9,314
BENTON	425.73	49,380	0.86	11,224	PIPESTONE	228.16	34,878	0.65	9,400
RICE	425.29	54,163	0.79	11,759	WILKIN	226.34	31,913	0.71	10,903
WRIGHT	418.56	57,693	0.73	13,336	WADENA	224.81	33,288	0.68	8,616
MCLEOD	417.77	53,069	0.79	12,456	OTTER TAIL	222.67	41,046	0.54	8,959
CLAY	404.73	47,723	0.85	11,176	LAKE-WOODS	222.23	32,244	0.69	8,184
STEARNS	366.27	51,810	0.71	10,407	BIG STONE	220.15	27,736	0.79	9,138
ST. LOUIS	355.71	42,531	0.84	13,533	ROCK	215.75	35,865	0.60	11,292
STEELE	354.50	54,488	0.65	11,927	TRAVERSE	214.12	30,282	0.71	9,594
WINONA	352.72	43,874	0.80	10,541	PINE	212.02	36,945	0.57	9,444
GOODHUE	351.57	51,369	0.68	11,934	CHIPPEWA	211.81	34,945	0.61	10,073
MILLE LACS	338.79	42,066	0.81	10,367	HUBBARD	209.41	43,527	0.48	8,449
KANDIYOHI	338.39	52,862	0.64	10,273	LAKE	206.84	43,520	0.48	17,919
DODGE	330.49	47,120	0.70	12,243	REDWOOD	203.29	35,562	0.57	10,200
LESUEUR	317.86	46,584	0.68	10,698	LAC QUI PARLE	202.82	32,346	0.63	9,405
WASECA	315.80	49,325	0.64	10,965	RENVILLE	197.31	37,879	0.52	10,448
DOUGLAS	312.65	49,107	0.64	9,384	WATONWAN	197.27	36,775	0.54	10,567
KOOCHICHING	304.25	36,621	0.83	12,148	MURRAY	192.98	37,802	0.51	9,506
KANABEC	302.51	37,725	0.80	9,668	NORMAN	191.69	30,379	0.63	8,975
BELTRAMI	301.93	45,798	0.66	8,832	LINCOLN	190.69	27,844	0.68	7,781
PENNINGTON	301.27	42,709	0.71	10,584	FARIBAULT	190.10	34,998	0.54	10,543
MOWER	299.37	42,288	0.71	11,728	RED LAKE	189.82	26,344	0.72	8,413
HOUSTON	297.11	44,340	0.67	10,825	GRANT	158.04	28,773	0.55	8,530
BROWN	289.33	48,302	0.60	11,090	MAHNOMEN	155.71	27,362	0.57	7,248
FREEBORN	286.34	44,739	0.64	11,659	ROSEAU	153.80	31,001	0.50	10,000
JACKSON	283.41	38,895	0.73	10,528	AITKIN	151.87	46,027	0.33	7,798
STEVENS	271.21	36,569	0.74	9,358	MARSHALL	148.51	31,633	0.47	8,689
MORRISON	268.81	41,685	0.64	8,772	KITTSON	147.45	23,156	0.64	9,313
NOBLES	264.80	39,011	0.68	10,514	CLEARWATER	137.30	27,072	0.51	7,952
YELLOW MED.	264.42	34,168	0.77	9,708	COOK	133.14	58,719	0.23	10,394
LYON	260.34	39,865	0.65	10,743	ITASCA	114.81	37,872	0.30	13,346
CASS	255.27	48,420	0.53	8,138					

SOURCE: OFFICE OF LEGISLATIVE AUDITOR CALCULATIONS.

*FROM MINNESOTA DEPARTMENT OF ENERGY, PLANNING AND DEVELOPMENT - STATE DEMOGRAPHY UNIT, "MEDIAN INCOME ESTIMATES FOR MINNESOTA COUNTIES 1979."

**ESTIMATE

county while the lowest average tax was $115 in Itasca county. This amounts to a 692 percent difference in average residential homestead taxes across the state. This same information is presented graphically in Map 1, and as it shows, residential property taxes are highest in the seven county metropolitan area. The average net tax on non-farm homesteads in the seven county area works out to $846.48 per year while the average for the remainder of the state is $317.08.

Map 1 also shows that net residential property taxes outside the Twin Cities area are relatively high in counties containing a significant urban center.[1] The lowest residential net property taxes in the state are found in predominantly agricultural counties and in five of six counties which have significant taconite mining and processing facilities.[2]

Average net homestead taxes vary among counties, in part, because residential property values also vary. Table 8 also shows the average market value of non-farm homes (adjusted for differences in assessment practices) and property taxes as a percent of market value (the effective tax rate) by county. Average homestead market values vary by 249 percent across the state from a high of $80,872 in Washington county to a low of $23,156 in Kittson county, and as Table 8 shows, the effective tax rates vary 422 percent between counties with the highest rates located in the Twin Cities metropolitan area and other counties containing large urban centers. In 1982, Hennepin county residential homesteads paid an average of 1.2 percent of market value in property taxes while homesteads in Cook county paid 0.23 percent.

Thus, while differences in property taxes across the state are due in part to variation in market values, when market values are held constant, considerable variation remains--422 percent between the highest and lowest counties.

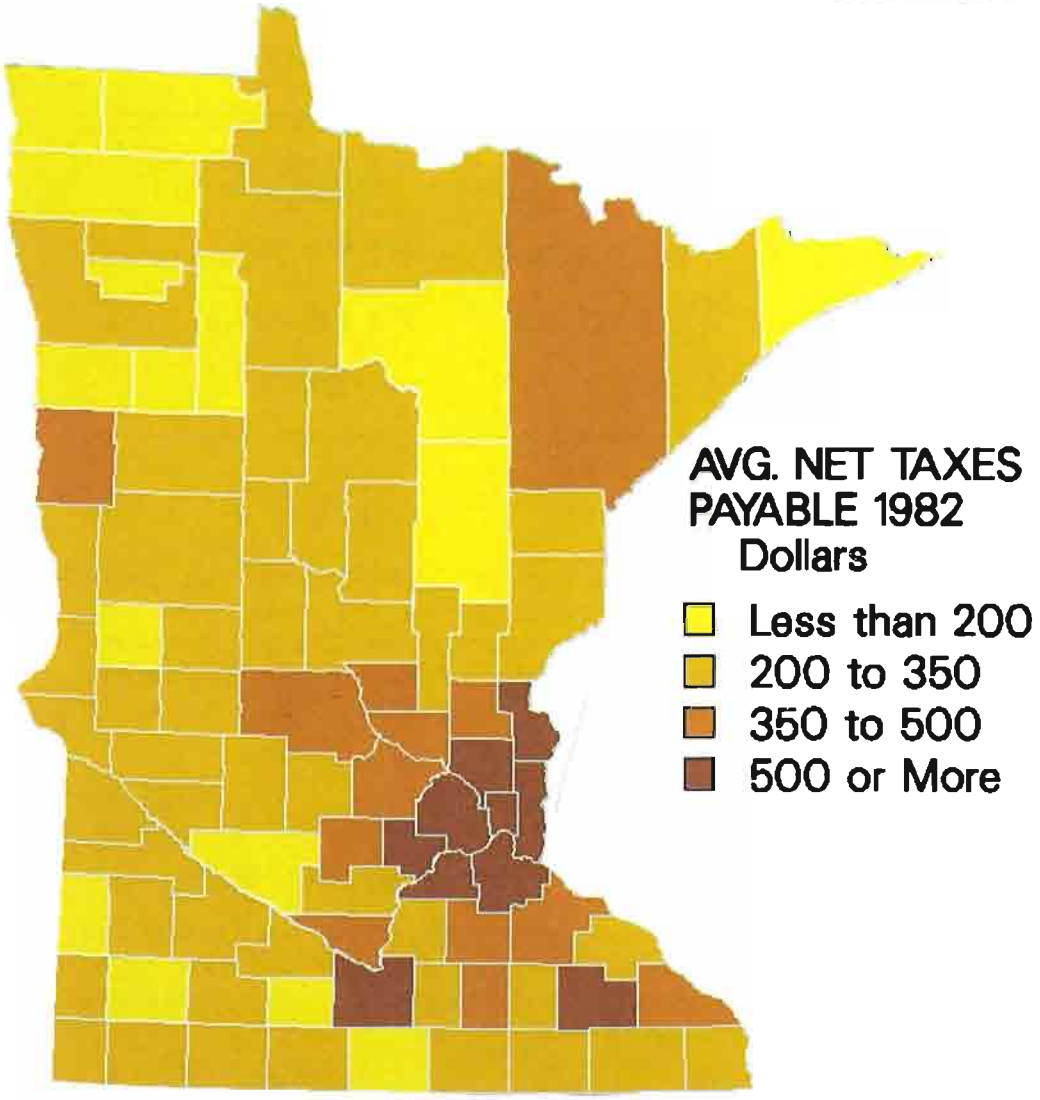
In addition, the variation in county-wide residential property tax burden across the state, as measured by effective tax rates, is over twice as great as the variation in county median incomes. In order to obtain some perspective on the level of geographic variation in property taxes it is useful, as a general yardstick, to look at how income varies across the state. While median income varies from a low of $7,248 in Mahnomen county to a high of $17,189 in Washington county, a 137 percent difference, property taxes as a percent of

---

[1] St. Louis county is an exception. But this generalization holds true for the counties in which Moorhead, Rochester and Mankato as well as other cities are located.

[2] The taconite homestead credit which is financed by the taconite production tax reduces residential property taxes considerably in certain iron range areas. The taconite production tax is paid by taconite mining and processing facilities in lieu of property taxes.

MAP 1: RESIDENTIAL HOMESTEAD PROPERTY TAXES 1982



market value (the effective tax rate) varies about three times as much, and average property taxes vary even more as we have just seen. Table 9 summarizes the range of variation in these measures across all counties.

TABLE 9

COMPARISON OF EFFECTIVE TAX RATE
AND COUNTY MEDIAN INCOME VARIATIONS

	Average Tax	Effective Tax Rate	County Median Income (1979)
High	$911 (Hennepin)	1.20%(Hennepin)	$17,189 (Washington)
Low	$115 (Itasca)	0.23% (Cook)	$ 7,248 (Mahnomen)
Difference	692%	422%	137%

1. RESIDENTIAL TAXES IN 16 CITIES

Table 10 shows the average residential homestead net property tax paid in 1982 for 16 selected cities across the state. As with the previous county-wide comparisons, average residential property taxes vary greatly across Minnesota cities. The average residential homestead in Bloomington pays over four times the property tax of the average homestead in Hibbing.

Table 10 also shows the residential effective tax rates for the 16 selected cities in 1982. Effective tax rates in these cities vary substantially, although less than the variation in average taxes.

In general, Table 10 shows that effective tax rates are highest in the Twin Cities metropolitan area and larger outstate cities such as Rochester, Duluth, Mankato, and Moorhead. Tax rates are lower in the smaller, outstate communities.

2. GEOGRAPHIC DIFFERENCES IN PROPERTY TAXES IN RELATION TO PERSONAL INCOME

We conclude our examination of geographic variation in non-farm residential property taxes by looking at how taxes vary across the state in relation to personal income. The basic question is: to what extent does variation in residential property taxes simply reflect variation in personal income? Table 11 shows that residential property taxes per $1,000 of personal income varies widely across counties in Minnesota. The variation in this measure from county to county is over 500 percent.

TABLE 10

RESIDENTIAL HOMESTEAD PROPERTY TAXES
FOR 16 SELECTED CITIES
TAXES PAYABLE 1982

City	Average Net Tax	Effective Tax Rate
Bloomington	$985.79	1.20%
Burnsville	883.10	1.02
Minneapolis	688.38	1.13
St. Paul	676.01	1.11
Mankato	631.16	1.19
Rochester	621.73	1.04
Duluth	548.94	1.29
Moorhead	503.66	1.00
St. Cloud	466.04	0.89
Willmar	411.72	0.79
Winona	345.69	0.90
Worthington	345.66	0.76
Albert Lea	318.31	0.72
Bemidji	255.03	0.68
Brainerd	253.44	0.66
Hibbing	234.30	0.49

Source: Office of Legislative Auditor calculations.

TABLE 11

RESIDENTIAL NET PROPERTY TAXES PER $1,000 COUNTY PERSONAL INCOME
TAXES PAYABLE 1979

County	Net Tax Per $1,000 Personal Income ($s)	County	Net Tax Per $1,000 Personal Income ($s)	County	Net Tax Per $1,000 Personal Income ($s)
Hennepin	21.21	Benton	10.84	Pine	8.14
Scott	19.95	Wabasha	10.69	Meeker	8.08
Washington	19.27	McLeod	10.46	Fillmore	8.08
Carver	19.20	Polk	10.35	Lake of Woods	8.01
Ramsey	17.67	Carlton	10.27	Yellow Medicine	7.96
Dakota	17.13	Brown	10.15	Jackson	7.94
Anoka	16.18	Freeborn	10.11	Stevens	7.79
Olmsted	15.63	Morrison	10.09	Clearwater	7.67
Koochiching	14.38	Big Stone	10.08	Cook	7.59
Chisago	14.19	Mille Lacs	10.02	Pipestone	7.56
Crow Wing	13.32	Waseca	9.87	Faribault	7.53
Mower	12.89	LeSueur	9.68	Pope	7.49
Hubbard	12.65	Goodhue	9.56	Grant	7.04
Douglas	12.59	Dodge	9.56	Lake	6.77
Aitkin	12.56	Martin	9.53	Sibley	6.71
Blue Earth	12.48	Steele	9.41	Watonwan	6.66
Clay	12.17	Chippewa	9.30	Itasca	6.52
Wright	12.07	Wadena	9.29	Kittson	6.40
St. Louis	12.02	Lyon	9.10	Redwood	6.25
Cass	11.87	Kanabec	9.07	Rock	6.21
Stearns	11.85	Houston	9.03	Norman	6.09
Isanti	11.77	Todd	8.90	Lincoln	5.98
Nicollet	11.75	Nobles	8.84	Murray	5.73
Becker	11.71	Traverse	8.82	Red Lake	5.43
Kandiyohi	11.56	Pennington	8.82	Renville	5.38
Rice	11.52	Ottertail	8.80	Lac Qui Parle	5.28
Beltrami	11.46	Swift	8.70	Mahnomen	4.80
Winona	11.16	Cottonwood	8.67	Marshall	3.65
Sherburne	11.10	Wilkin	8.20	Roseau	3.45

Source: Office of Legislative Auditor calculations from:

- Department of Revenue basic data.
- Department of Energy, Planning and Development - State Demography Unit, "Population Estimates for Minnesota Counties 1979."
- U.S. Department of Commerce - Bureau of Economic Analysis, "Local Area Personal Income."

Map 2 is a graphic presentation of the data shown in Table 11. Residential taxes per $1,000 personal income are shown to be highest in the seven county metropolitan area. Tax burdens in this part of the state vary from $16.18 in Anoka county to $21.21 in Hennepin county. Taxes are lowest according to this measure in outstate agricultural counties with Roseau county showing the lowest burden of $3.45.

A comparison of variation in taxes per $1,000 personal income to the previously discussed measures of tax burden shows that the geographic distribution of all measures is remarkably similar. Counties in the Twin Cities area and counties with large population centers have a relatively high property tax burden while rural, predominately agricultural counties have lower taxes. Certain northern counties without high agricultural property wealth such as Becker, Hubbard, Cass and Aitkin show a high tax burden using the tax per $1,000 income measure, while their residential effective tax rates are low.

In summary, residential property tax burdens vary dramatically across the state. The magnitude in variation for all measures is well over 400 percent, suggesting that the over-all statewide average presented earlier is an inadequate reflection of the situation across the state. Over-all, property taxes are low compared to other states, but since they vary 400-600 percent across the state (depending on which measure is chosen) they may well not be seen as low by many taxpayers, especially those in urban areas.

3. IMPACT OF DIRECT PROPERTY TAX RELIEF PROGRAMS

As we have seen, property taxes vary substantially across the state as measured by:

- average net homestead taxes;
- effective tax rates; and
- residential taxes per $1,000 personal income.

This section examines the impact of direct property tax relief programs on geographic variation in residential property taxes by examining the difference between gross and net taxes across the state.

Table 12 shows the average gross and net residential homestead property tax for each county in 1982. The difference between average gross and net taxes represents the share of the average gross homestead tax which the state paid through direct property tax relief programs. For example, in Ramsey county the state paid 43.4 percent of the average gross property tax bill of residential homesteads in 1982.

MAP 2: RESIDENTIAL PROPERTY TAXES COMPARED TO INCOME 1979

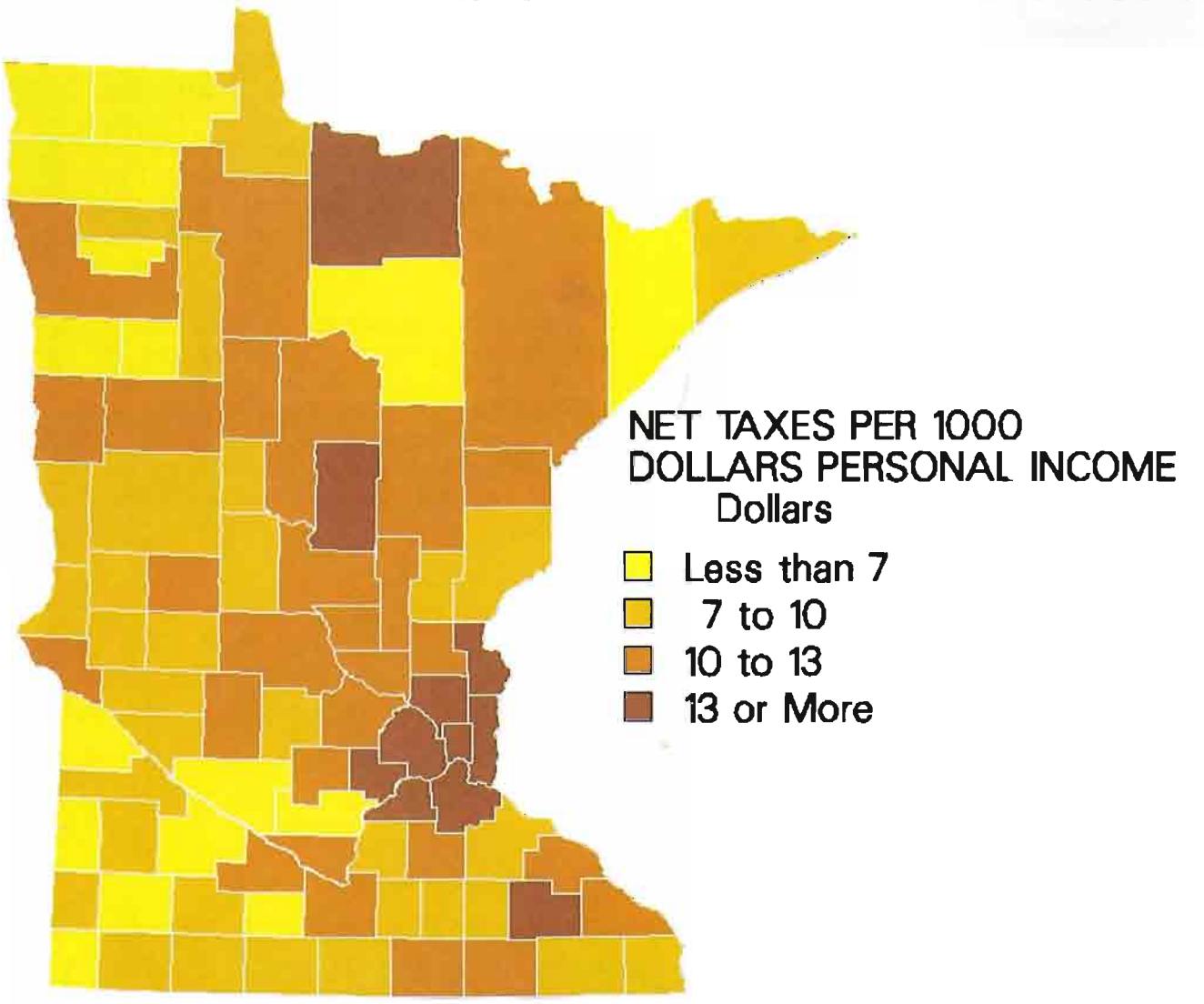


TABLE 12

AVERAGE GROSS AND NET RESIDENTIAL HOMESTEAD PROPERTY TAX
TAXES PAYABLE, 1982

COUNTY	AVERAGE GROSS TAX	AVERAGE NET TAX	PERCENT REDUCTION	COUNTY	AVERAGE GROSS TAX	AVERAGE NET TAX	PERCENT REDUCTION
ITASCA	$518.94	$114.81	77.9%	BECKER	$ 516.98	$235.50	54.4%
COOK	583.46	133.14	77.2	DOUGLAS	685.16	312.65	54.4
AITKIN	500.91	151.87	69.7	MOWER	650.69	299.37	54.0
LAKE	670.55	206.84	69.2	MILLE LACS	732.98	338.79	53.8
MAHNOMEN	378.72	155.71	58.9	POPE	525.16	242.83	53.8
ST. LOUIS	856.48	355.71	58.5	STEVENS	585.11	271.21	53.6
CROW WING	583.40	242.49	58.4	WASECA	680.01	315.79	53.6
MARSHALL	351.51	148.51	57.8	ROCK	464.54	215.75	53.6
GRANT	372.70	158.04	57.6	LYON	559.60	260.34	53.5
MURRAY	453.80	192.98	57.5	KANDIYOHI	726.88	338.39	53.4
CLEARWATER	319.69	137.30	57.1	TRAVERSE	459.59	214.11	53.4
FARIBAULT	441.11	190.10	56.9	DODGE	708.39	330.49	53.3
KITTSON	341.47	147.45	56.8	KOOCHICHING	649.67	304.25	53.2
MEEKER	539.63	233.55	56.7	FREEBORN	611.41	286.34	53.2
NORMAN	441.91	191.69	56.6	JACKSON	604.92	283.41	53.1
REDWOOD	467.93	203.29	56.6	WINONA	752.27	352.71	53.1
LINCOLN	436.88	190.69	56.4	ISANTI	910.02	427.06	53.1
BIG STONE	504.15	220.15	56.3	NOBLES	563.77	264.80	53.0
FILLMORE	544.06	239.09	56.1	STEELE	751.73	354.49	52.8
WADENA	510.98	224.81	56.0	WILKIN	473.44	226.34	52.2
RENVILLE	447.10	197.31	55.9	BROWN	603.45	289.33	52.1
HOUSTON	672.88	297.11	55.8	WRIGHT	870.72	418.55	51.9
SIBLEY	544.80	240.99	55.8	GOODHUE	724.26	351.57	51.4
PINE	479.13	212.02	55.7	STEARNS	753.94	366.26	51.4
TODD	557.22	246.76	55.7	SWIFT	477.38	232.78	51.2
MORRISON	605.91	268.81	55.6	BELTRAMI	618.98	301.93	51.2
WATONWAN	443.28	197.26	55.5	RICE	869.76	425.29	51.1
POLK	553.94	246.55	55.5	SHERBURNE	880.79	431.23	51.0
WABASHA	564.88	251.87	55.4	CLAY	826.10	404.73	51.0
CHIPPEWA	474.68	211.81	55.4	YELLOW MEDICINE	539.59	264.42	51.0
MARTIN	546.00	243.80	55.3	NICOLLET	947.51	473.02	50.1
CARLTON	542.03	242.80	55.2	BENTON	849.78	425.73	49.9
PIPESTONE	508.58	228.15	55.1	MC LEOD	833.02	417.77	49.8
COTTONWOOD	549.04	246.49	55.1	CHISAGO	1,012.71	529.69	47.7
OTTER TAIL	495.40	222.66	55.1	BLUE EARTH	955.55	504.31	47.2
PENNINGTON	670.22	301.26	55.0	ANOKA*	1,278.10	678.33	46.9
LAC QUI PARLE	450.26	202.82	55.0	OLMSTED	1,081.58	584.86	45.9
LAKE OF WOODS	493.24	222.23	54.9	WASHINGTON	1,317.21	740.19	43.8
LE SUEUR	704.83	317.86	54.9	RAMSEY	1,360.69	770.13	43.4
KANABEC	669.27	302.51	54.8	SCOTT	1,368.29	781.99	42.8
HUBBARD	462.33	209.41	54.7	DAKOTA	1,352.39	781.62	42.2
RED LAKE	418.60	189.81	54.7	CARVER	1,350.61	794.62	41.2
ROSEAU	338.24	153.80	54.5	HENNEPIN	1,505.13	911.07	39.5
CASS	560.43	255.27	54.5				

SOURCE: OFFICE OF LEGISLATIVE AUDITOR CALCULATIONS.

*ESTIMATE

From Table 12, we see significant differences in the percentage reduction of residential gross tax bills from county to county. The state pays 77.9 percent of the average gross tax bill in Itasca county but only 39.5 percent of the average gross tax bill in Hennepin county.

Of course, Hennepin County receives more homestead credit dollars from the state per homestead than Itasca County because taxes are higher in Hennepin County. The point of the analysis that follows is that in percentage terms, the homestead credit reduces taxes less in high tax areas than low tax areas. This occurs because of the $650 cap on the homestead credit and the fact that more homesteads are at this maximum in high tax counties than in low tax counties.

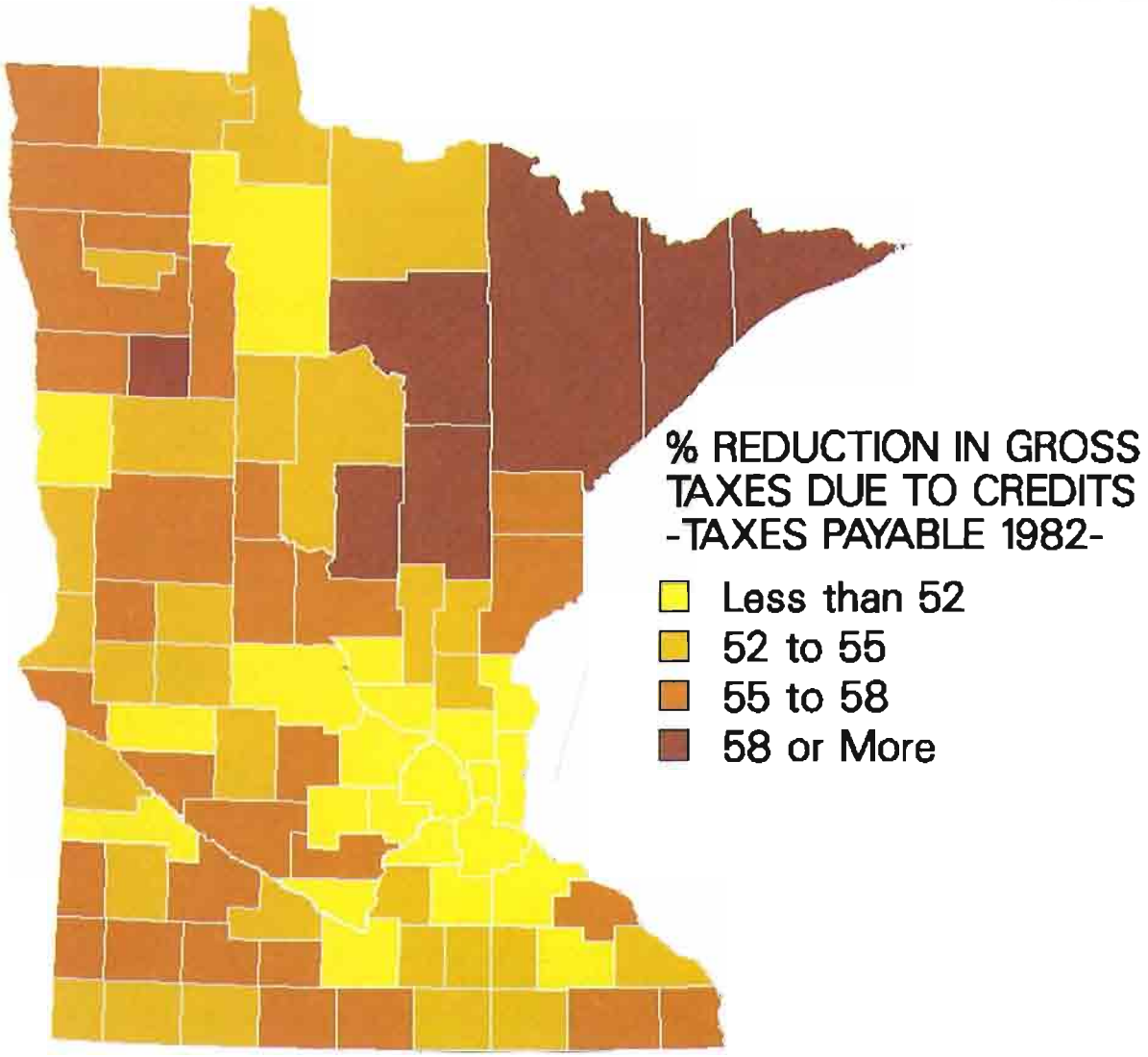
Map 3 shows the geographic distribution of percent reduction in average gross tax bills by county. Gross tax bills are reduced the greatest amount in the six large taconite producing counties in northeastern Minnesota and in Mahnomen county. Each of these counties has its average gross bill reduced by more than 58 percent. Average tax bills are reduced least in the seven county metro area and in Chisago, Blue Earth and Olmstead counties, all of which receive less than a 48 percent reduction in residential taxes. As we saw earlier, these are the counties with the highest residential property taxes in the state.

The percent reduction in gross residential tax bills in a taxing district is a function of the number of homesteads in the district at the homestead credit maximum and the amount of tax levies on these homesteads, and the eligibility of homesteads for other state direct property tax relief programs. For example, a county with a large number of homesteads receiving the $650 maximum homestead credit receives a smaller percentage decrease in the average gross tax bill than a county with very few homesteads at the maximum. Counties with large numbers of homesteads eligible for the taconite homestead credit programs receive an additional decrease in the average gross tax bill.

Table 13 shows the number of homesteads at the $650 homestead credit maximum for the seven county metro area and the 80 remaining counties in the state.

Over one-half of the homesteads in the Twin Cities metro area are currently at the $650 homestead maximum, compared to 10.3 percent of homesteads in the remainder of the state. Thus, gross tax bills are reduced less by the homestead credit in the seven county metro area than in the rest of the state.

MAP 3: EFFECT OF STATE CREDITS ON RESIDENTIAL PROPERTY TAXES*



* Homesteaded property only.

TABLE 13

NUMBER OF NON-FARM HOMESTEADS
AT THE $650 HOMESTEAD CREDIT MAXIMUM
1982

	7 County Metro Area	80 Remaining Counties
Total Number of Residential Homesteads	469,014	434,321
Number at the $650 Maximum	258,196	44,847
Percent at Maximum	55.0%	10.3%

The taconite homestead credit is the only other major state direct property tax relief program which is directed to non-farm homesteads. This program, which cost $16.4 million in 1982, is only available to homesteads located in the six northeastern Minnesota counties which contain large taconite mining and processing facilities (Cook, Itasca, Lake, St. Louis, Crow Wing and Aitkin).[3] This program, in combination with the homestead credit program, reduces residential gross taxes in these counties more than any other region in the state (except for Mahnomen county). Four of the counties (Lake, Aitkin, Cook and Itasca), receive average reductions of over 69 percent.

Table 14 shows the impact of direct property tax relief in four counties that together exemplify all counties in the state.

A high tax county, such as Ramsey, receives a far smaller reduction in taxes than does a low tax county such as Polk. This is due to the fact that the average Ramsey county gross tax bill is quite high ($1,360.69) and therefore a large percentage of homesteads are at the homestead credit maximum. As a result, only part of the property tax on these homes is reduced 58 percent by the homestead credit. Polk county, on the other hand, has generally low residential taxes on average ($553.94), and as Table 14 shows, all but 6.6 percent of homesteads in Polk County receive a 58 percent reduction of their tax bills through the homestead credit. St. Louis County receives both homestead and taconite homestead credits offsetting the impact of the $650 homestead credit ceiling and allowing average gross tax bills to be reduced more than 58 percent across the county.

A comparison of gross tax bill reductions between the Twin Cities metro area and the remaining counties of the state is presented in Table 15 and it shows that direct property tax relief programs increase the difference in average property tax bills among the two areas.

[3]Koochiching county received a small amount of taconite homestead credit money in 1982.

TABLE 14

COMPARISON OF TAX REDUCTIONS IN FOUR COUNTIES
1982

	Ramsey	St. Louis	Blue Earth	Polk
Gross Residential Homestead Taxes	$141,827,011	$49,869,281	$8,878,940	$3,590,615
Credits:				
Homestead	61,159,796	19,081,948	4,170,881	1,983,493
Taconite Homestead	--	10,050,408	--	--
Other	394,626	25,243	22,017	8,957
Net Homestead Taxes	$ 80,272,589	$20,711,682	$4,686,042	$1,598,165
Percent of Homesteads at $650 Homestead Maximum	54.8%	14.2%	23.4%	6.6%
Average Gross Residential Tax Bill	$1,360.69	$856.48	$955.55	$553.94
Average Net Residential Tax Bill	$ 770.13	$355.71	$504.31	$246.55
Percent Reduction	43.4%	58.5%	47.2%	55.5%

Source: Office of Legislative Auditor calculations

TABLE 15

COMPARISON OF GROSS AND NET AVERAGE RESIDENTIAL HOMESTEAD TAXES
1982

	Average Gross Tax	Average Net Tax
Twin Cities Metro Area*	$1,435.23	$846.48
80 Remaining Counties	693.59	317.08
Difference	107%	167%

*Anoka County data unavailable.

The percent difference in average net homestead tax bills between metro and outstate counties is about one and two-thirds times greater than the difference in average gross tax bills. Thus, homesteads in outstate counties on the average receive proportionately more tax relief from direct property tax relief programs than do metro homesteads. Of course, the Twin Cities metro counties receive most of the money spent through the homestead credit program, although they will receive less in the future because a large and growing number of homes receive the maximum allowable credit.

In summary, the impact of direct property tax relief programs on residential homestead taxes is not uniform across the state. Taxing districts in outstate counties receive proportionately more direct property tax relief than Twin Cities homesteads. This effect increases the disparity in average homestead taxes between the Twin Cities metro area and outstate counties. For the same reason, direct property tax relief programs also reduce property taxes proportionately more in low tax cities than in high tax cities. This tends to increase disparities in average tax bills between the urban and rapidly urbanizing communities of the state, and the non-urban or rural communities.

It would be simple (if expensive) to redesign the homestead credit so that all taxing districts (outside of taconite producing areas) received a 58 percent reduction of gross taxes. This could be accomplished by removing the $650 cap on the homestead credit. If increasing the cost of the program is unacceptable, the rate at which the credit is paid could be reduced from 58 percent to a lower level. On the other hand, it may well be judged that the homestead credit is accomplishing exactly what it was intended to accomplish, and that it was not designed to equalize taxes across the state. However, if the geographic inequalities shown in this chapter are thought to be a problem, it may be argued that the homestead credit ought to be redesigned or eliminated in favor of the tax relief programs that distribute money according to service needs or ability to pay.

C. PROPERTY TAXES ON FARM HOMESTEADS

Farm homesteads received over $125,000,000 in direct property tax relief in 1982. The major sources of this relief were the homestead and agricultural credit programs and this outlay represents a substantial commitment by the state to reduce farm property taxes. First we will look at variation in property taxes on farm homesteads across the state, then the impact of state property tax relief programs.

Table 16 shows the average net tax and net effective tax rate on farm homesteads for each county in 1982. The average net tax on a farm homestead ranges from a low of $106.10 in Carlton county to a high of $3,390.82 in Washington county. This wide range of average taxes is due in large measure to variation across the state in the size and value of farm homesteads.

Effective tax rates (taxes as a percent of value) are also presented in Table 16 and these, too, vary substantially across the state. While most counties have effective tax rates between .30 and .60 in 1982, four counties have tax rates greater than .95 and six counties have effective rates below .29.

Map 4 shows the geographic distribution of farm homestead effective tax rates. Counties located in the major agricultural areas of the state all fall within the .30 to .60 effective tax rate range (except Clearwater county) indicating modest variation (100 percent) within the agricultural heart of the state.[1] In contrast, wide variation in effective tax rates exists in the north-central and northeastern part of the state which is much less agriculturally oriented.

Considering the state as a whole, the variation in farm effective tax rates is much greater than variation in general measures of economic well being. Table 8, presented earlier, shows that county median income varies by 137 percent across the state. Farm homestead effective tax rates vary by over 900 percent from 1.79 in Lake county to .17 in Cook county.[2] This large variation in tax burden is a product of a number of variables including differences in mill rates, property mix and eligibility of farm homesteads in the county for direct property tax relief.

1. IMPACT OF DIRECT PROPERTY TAX RELIEF PROGRAMS

Table 17 and Map 5 show the reduction in average farm homestead tax (and correspondingly, farm homestead effective tax rates) for each county in 1982. Direct property tax relief programs

---

[1] We have defined agricultural counties as counties which have 60 percent or more of property value in agricultural use.

[2] However, the variation in farm homestead effective tax rates for agricultural counties as a group is much more consistent with the variation in county median incomes.

TABLE 16

FARM HOMESTEAD PROPERTY TAXES
TAXES PAYABLE 1982

COUNTY	AVERAGE NET TAX	EFFECTIVE TAX RATE	COUNTY	AVERAGE NET TAX	EFFECTIVE TAX RATE
WASHINGTON	$3,390.92	0.99%	SCOTT	$1,277.00	0.59%
NICOLLET	2,706.88	0.52	HOUSTON	1,219.12	0.61
WASECA	2,570.74	0.53	MURRAY	1,202.06	0.33
WATONWAN	2,526.49	0.47	MAHNOMEN	1,184.07	0.47
CHIPPEWA	2,222.68	0.55	MARSHALL	1,181.89	0.38
BLUE EARTH	2,220.00	0.43	LAKE	1,111.17	1.79
WILKIN	2,164.79	0.41	PENNINGTON	1,099.31	0.40
COTTONWOOD	2,155.48	0.39	ROSEAU	1,024.10	0.40
TRAVERSE	2,107.61	0.40	STEARNS	981.23	0.50
JACKSON	2,090.65	0.39	HENNEPIN	891.92	0.55
DODGE	2,043.63	0.50	POLK	875.99	0.34
MOWER	2,036.12	0.46	LYON	853.34	0.42
FARIBAULT	2,010.20	0.35	WABASHA	844.98	0.56
DAKOTA	2,000.00	0.56	POPE	844.66	0.40
NOBLES	1,971.91	0.47	HUBBARD	812.68	0.98
MARTIN	1,922.40	0.34	WINONA	811.46	0.62
REDWOOD	1,852.69	0.36	BECKER	776.41	0.40
FREEBORN	1,811.33	0.44	WRIGHT	753.38	0.42
RENVILLE	1,794.50	0.34	DOUGLAS	711.79	0.42
BROWN	1,749.44	0.31	CHISAGO	665.71	0.54
STEVENS	1,717.76	0.46	TODD	640.00	0.49
SIBLEY	1,712.09	0.39	RED LAKE	619.69	0.34
LE SUEUR	1,679.66	0.51	LAKE OF WOODS	612.50	0.56
SWIFT	1,676.42	0.45	BENTON	562.91	0.43
PIPESTONE	1,671.47	0.51	OTTER TAIL	561.19	0.39
KITTSON	1,665.21	0.48	MORRISON	540.33	0.41
YELLOW MEDICINE	1,659.92	0.43	SHERBURNE	485.75	0.51
ROCK	1,634.80	0.45	MILLE LACS	477.75	0.43
NORMAN	1,627.34	0.48	WADENA	463.83	0.49
OLMSTED	1,598.70	0.55	PINE	425.65	0.48
CLAY	1,586.20	0.48	CROW WING	419.70	0.27
GOODHUE	1,567.54	0.48	KANABEC	414.54	0.43
CARVER	1,532.20	0.57	ST. LOUIS	403.16	0.37
RICE	1,510.07	0.59	CASS	393.92	0.41
MC LEOD	1,495.34	0.47	ISANTI	376.42	0.36
GRANT	1,492.38	0.40	CLEARWATER	317.89	0.25
BIG STONE	1,449.16	0.46	KOOCHICHING	305.95	0.41
MEEKER	1,407.15	0.46	BELTRAMI	208.45	0.26
FILLMORE	1,325.27	0.43	ITASCA	207.86	0.27
KANDIYOHI	1,310.31	0.48	AITKIN	207.74	0.20
LAC QUI PARLE	1,304.49	0.43	ANOKA*	178.63	0.36
STEELE	1,288.17	0.41	COOK	137.58	0.17
LINCOLN	1,282.38	0.46	CARLTON	106.10	0.41
RAMSEY	1,279.13	1.14			

SOURCE: OFFICE OF LEGISLATIVE AUDITOR CALCULATIONS.

*ESTIMATE

MAP 4: FARM HOMESTEADS EFFECTIVE TAX RATES 1982

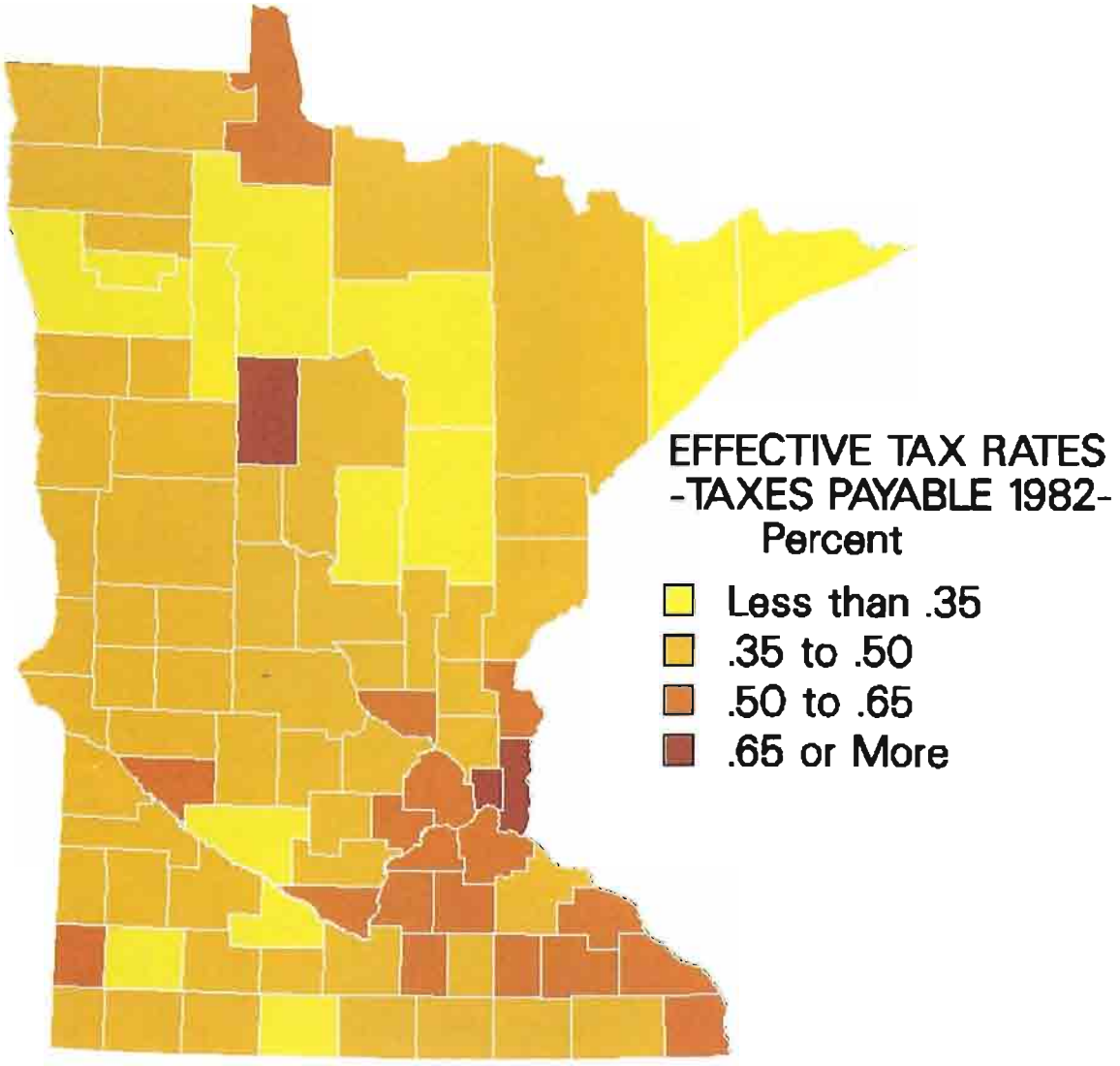


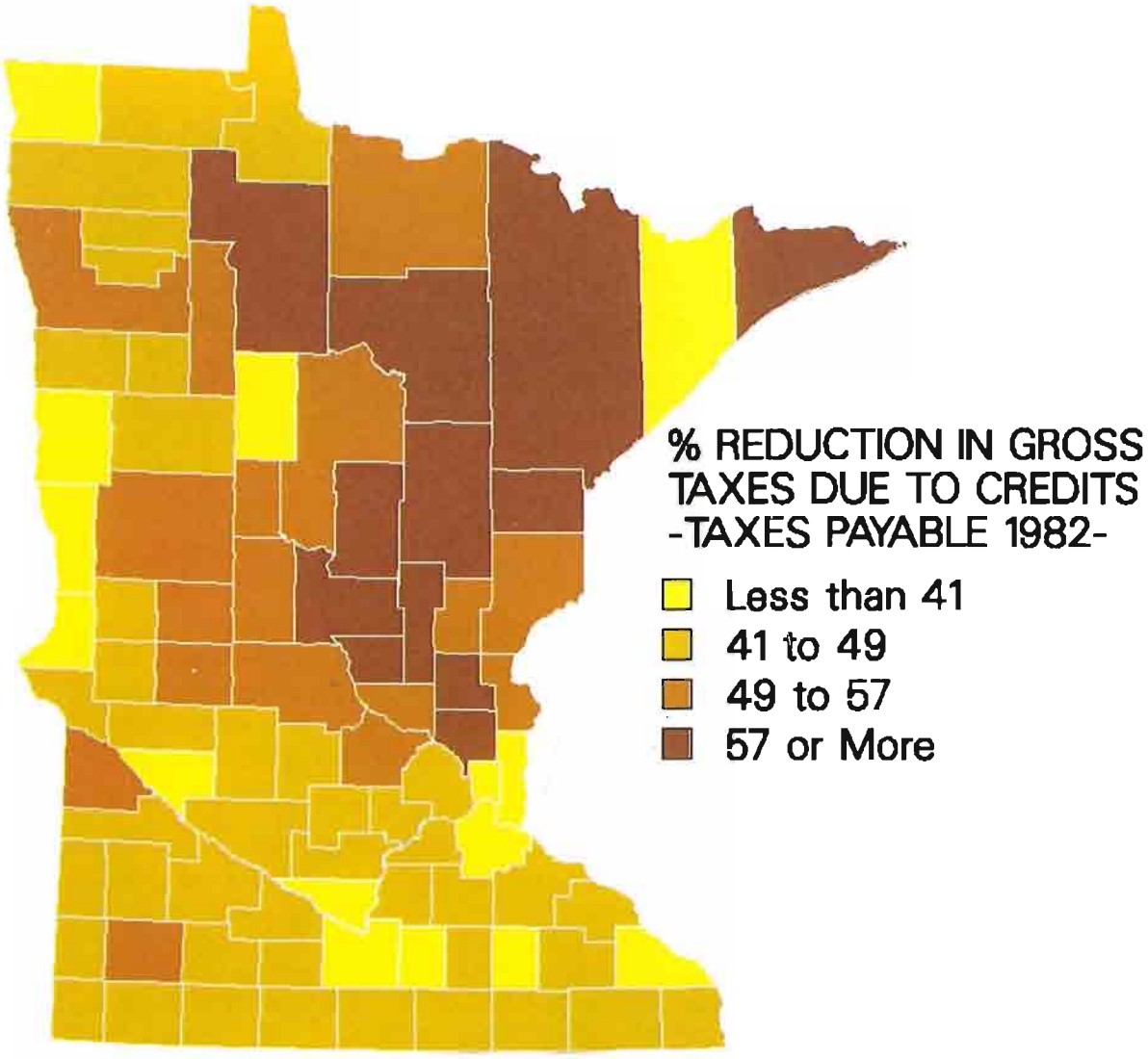
TABLE 17

REDUCTION IN FARM HOMESTEAD TAXES
TAXES PAYABLE 1982

COUNTY	AVERAGE GROSS TAX	AVERAGE NET TAX	PERCENT REDUCTION	COUNTY	AVERAGE GROSS TAX	AVERAGE NET TAX	PERCENT REDUCTION
COOK	$ 614.18	$ 137.58	77.6%	LYON	$1,594.87	$ 853.34	46.5%
ITASCA	761.84	207.86	72.7	MEEKER	2,626.31	1,407.15	46.4
AITKIN	721.85	207.74	71.2	JACKSON	3,895.71	2,090.65	46.3
BELTRAMI	621.22	208.45	66.4	PENNINGTON	2,037.37	1,099.31	46.0
ANOKA*	518.63	178.63	65.6	YELLOW MEDICINE	3,057.75	1,659.92	45.7
ISANTI	1,035.52	376.42	63.6	SIBLEY	3,149.29	1,712.09	45.6
ST. LOUIS	1,079.30	403.16	62.6	ROCK	3,004.69	1,634.80	45.6
CROW WING	1,027.77	419.70	59.2	HOUSTON	2,235.80	1,219.12	45.5
MORRISON	1,290.13	540.33	58.1	COTTONWOOD	3,932.86	2,155.48	45.2
CARLTON	252.98	106.10	58.1	RED LAKE	1,124.97	619.69	44.9
MILLE LACS	1,131.42	477.75	57.8	SWIFT	3,026.67	1,676.42	44.6
BENTON	1,313.83	562.91	57.2	STEVENS	3,094.42	1,717.76	44.5
KANABEC	957.60	414.54	56.7	BIG STONE	2,603.69	1,449.16	44.3
KOOCHICHING	698.15	305.95	56.2	MARSHALL	2,109.01	1,181.89	44.0
CLEARWATER	721.64	317.89	55.9	MCLEOD	2,663.65	1,495.34	43.9
OTTER TAIL	1,266.12	561.19	55.7	NOBLES	3,507.42	1,971.91	43.8
CASS	887.30	393.92	55.6	ROSEAU	1,819.69	1,024.10	43.7
DOUGLAS	1,577.93	711.79	54.9	PIPESTONE	2,961.32	1,671.47	43.6
MURRAY	2,656.86	1,202.06	54.8	SCOTT	2,249.44	1,277.00	43.2
POPE	1,847.82	844.66	54.3	WABASHA	1,486.18	844.98	43.1
WADENA	1,014.28	463.83	54.3	NORMAN	2,860.56	1,627.34	43.1
SHERBURNE	1,048.86	485.75	53.7	MOWER	3,575.91	2,036.12	43.1
TODD	1,381.07	640.00	53.7	RICE	2,620.00	1,510.07	42.4
PINE	912.56	425.65	53.4	MAHNOMEN	2,040.47	1,184.07	42.0
WRIGHT	1,601.35	753.38	53.0	CARVER	2,639.19	1,532.20	41.9
CHISAGO	1,367.20	665.71	51.3	LE SUEUR	2,886.06	1,679.66	41.8
POLK	1,778.98	875.99	50.8	OLMSTED	2,715.20	1,598.70	41.1
LAC QUI PARLE	2,560.13	1,304.49	49.0	WATONWAN	4,278.30	2,526.49	41.0
STEARNS	1,923.12	981.23	49.0	WILKIN	3,657.88	2,164.79	40.8
LINCOLN	2,507.27	1,282.38	48.9	DODGE	3,452.39	2,043.63	40.8
LAKE OF WOODS	1,194.34	612.50	48.7	TRAVERSE	3,552.56	2,107.61	40.7
BROWN	3,406.46	1,749.44	48.6	BLUE EARTH	3,717.65	2,220.00	40.3
MARTIN	3,721.89	1,922.40	48.3	CLAY	2,651.31	1,586.20	40.2
RENVILLE	3,453.76	1,794.50	48.0	CHIPPEWA	3,712.30	2,222.68	40.1
FARIBAULT	3,860.39	2,010.20	47.9	KITTSON	2,752.24	1,665.21	39.5
REDWOOD	3,556.00	1,852.69	47.9	WINONA	1,338.07	811.46	39.4
BECKER	1,488.46	776.41	47.8	WASECA	4,203.51	2,570.74	38.8
GRANT	2,849.55	1,492.38	47.6	DAKOTA	3,240.41	2,000.00	38.3
STEELE	2,445.90	1,288.17	47.3	RAMSEY	2,072.18	1,279.13	38.3
KANDIYOHI	2,482.20	1,310.31	47.2	NICOLLET	4,271.36	2,706.88	36.6
HENNEPIN	1,686.36	891.92	47.1	HUBBARD	1,252.03	812.68	35.1
FILLMORE	2,501.08	1,325.27	47.0	LAKE	1,567.28	1,111.17	29.1
FREEBORN	3,401.66	1,811.33	46.8	WASHINGTON	4,592.60	3,390.82	27.7
GOODHUE	2,93056	1,567.54	46.5				

SOURCE: OFFICE OF LEGISLATIVE AUDITOR CALCULATIONS.
*ESTIMATE

MAP 5: EFFECT OF STATE CREDITS ON FARM PROPERTY TAXES 1982*



* Homesteaded property only.

reduced average farm homestead taxes from 28 to 78 percent across the state in 1982. This represents a 178 percent difference in average tax reductions from the highest to lowest county.

The four counties with the highest net effective tax rates (Lake, Ramsey, Washington, and Hubbard) received among the lowest percent reductions in farm homestead taxes. In contrast, the counties with the lowest net effective tax rates generally received the greatest percentage reduction. Thus, as was the case for non-farm homesteads, there is more variation in net taxes than gross taxes on farm homesteaded property.

The agricultural credit reduces taxes most in districts with high agricultural property values. These areas are not in general high tax areas of the state. The homestead credit works the same for farm homesteads as for non-farm homesteads. It reduces taxes proportionately more in low tax areas than high tax areas. Again, we believe the question raised by this finding is whether direct property tax relief programs make sense if they reduce taxes in low tax areas more than in high tax areas, or whether there isn't a better way to distribute property tax relief, especially in a time of budget shortages.

III. DIRECT PROPERTY TAX RELIEF PROGRAMS

This chapter examines in detail the homestead credit, agricultural credit, and circuit breaker, Minnesota's three major direct property tax relief programs. We look at each program's history, growth, and objectives. We also evaluate the effectiveness of each program and present a discussion of policy alternatives.

No attempt is made to provide a blueprint for legislative action; rather this report discusses the steps to be taken to move the system in alternative directions that may be judged desirable. In addition to policy alternatives we identify technical improvements to each program that we believe will make the programs work better. The administration of the homestead credit and circuit breaker for renters is the subject of a separate report Administration of Direct Property Relief Programs. However, the major findings of this study are summarized here. Finally, this chapter includes a brief section on the additive effects of direct property tax relief programs including the minor programs such as the wetland, native prairie, and reduced assessment credit that were otherwise not studied in detail.

A. HOMESTEAD CREDIT

The homestead credit is Minnesota's largest direct property tax relief program. In 1982, the homestead credit reduced the tax liability of homeowners by $479 million. Currently the homestead credit reduces the property tax on owner-occupied housing by 58 percent, up to a maximum of $650.[1,2]

---

[1]In 1982, the homestead credit was figured on a maximum of 108 percent of a taxing district's 1981 levy except for school districts. A maximum appropriation was also set for 1982 and 1983, which in 1982 resulted in a reduction in homestead credit payments to all taxing districts. In some previous years the homestead credit was calculated on the non-debt levy of local units rather than the total property tax. Taxes were reduced by $479 million in 1982 by the homestead credit, but because of a series of state spending reductions, taxing districts received only $385 million. In previous years the state reimbursed taxing districts on the full amount of the homestead credit. To soften the impact of the 1982 cuts, local taxing districts were allowed to speed up property tax collections.

[2]An additional $16 million was paid through the taconite homestead credit. In certain iron range areas, depending on the iron ore value of the taxing district or the presence of taconite mines or electric generating facilities, an additional 57 or 66 percent, up to a maximum of $375 or $430 is paid by the state before the regular homestead credit is calculated. The taconite homestead credit is paid from taconite production tax receipts.

1. HISTORICAL GROWTH OF THE PROGRAM

Table 18 shows the annual growth in tax levies between 1967 and 1982 and the growth in the homestead credit. Over the period 1968 to 1982, total tax levies have grown over 200 percent, but the homestead credit has grown more than 500 percent. A closer look at Table 18 shows that the homestead credit has grown every year but one since its inception in 1968, and by substantial amounts between 1973 and 1974 and between 1979 and 1981. The explanation of this pattern of growth is fairly simple. In 1968 the homestead credit was equal to 35 percent of the property tax owed by homesteads to a maximum of $250.[1] Effective in 1974 the credit was expanded to pay 45 percent of a homeowner's tax bill up to a maximum of $325. This explains why the cost of the homestead credit program increased 54.3 percent between 1973 and 1974, while total taxes went up about 10 percent during the same year. Before 1974, the cost of the homestead credit rose at about the same rate as property taxes as a whole. In 1973, 14.1 percent of all homesteads were receiving the maximum credit of $250. In 1974, these homesteads were suddenly eligible for a credit of up to $325.

Between 1974 and 1979, homestead credit expenditures grew at an annual rate ranging from 4.0 to 9.2 percent, reflecting the growth in taxes on homesteaded property and the proportion of homesteads receiving the maximum credit. By 1979, nearly 49 percent of all homesteads were receiving the $325 maximum credit and for these homeowners the homestead credit had ceased to protect against property tax increases.

In the 1979 and 1980 sessions, the legislature extended the homestead credit again. Effective in 1980, the homestead credit was increased to pay 50 percent of the tax on homesteaded property to a maximum of $550. And effective in 1981, the rate increased to 58 percent and the maximum to $650. Reflecting these increased limits, homestead credit expenditures grew 46.1 percent in 1980 and 20.4 percent in 1981. In 1982, the credit grew 7.2 percent. In 1982, 34.8 percent of homesteads were at the maximum and the homestead credit totalled $479 million. As noted on Table 18, the actual cost of the homestead credit for taxes payable in 1982 was $385 million due to late spending cuts. There are now somewhat over one million homesteads eligible to receive the homestead credit and if each received the maximum credit, (and a state appropriation covered the full obligation of the program) the cost to the state would be about $670 million a year or 39.7 percent more than the total credit in 1982. Thus, if the 58 percent rate and $650 maximum remain fixed into the future, the growth in the cost of the homestead credit will be modest compared to the increases experienced in recent years. The more than 500 percent increase in the cost of the homestead credit since 1968 is largely due to increases in homestead credit limits effective in 1974, 1980 and 1981.

---

[1] In this year the credit went only to the non-debt levy, but this is very close to the total levy.

TABLE 18

ANNUAL GROWTH IN TOTAL TAXES
AND HOMESTEAD CREDIT EXPENDITURES

	Total Taxes	Annual Growth	Homestead Credit	Annual Growth
1982	$2,305,082,386	21.1%	$479,293,456	7.2%
1981	1,904,137,599	8.3	432,835,086	20.4
1980	1,758,838,100	8.0	358,306,951	46.1
1979	1,628,312,735	5.8	242,340,322	4.2
1978	1,538,696,661	4.5	234,439,049	4.0
1977	1,472,445,842	13.5	225,495,743	6.5
1976	1,297,320,467	4.1	210,991,252	6.6
1975	1,246,500,553	15.3	203,060,500	9.2
1974	1,081,485,121	10.1	186,123,018	54.3
1973	982,660,767	2.6	120,135,635	4.8
1972	957,373,983	-8.0	114,271,199	-8.2
1971	1,040,697,641	19.1	126,552,877	18.1
1970	873,460,307	14.3	107,042,737	13.4
1969	764,221,165	20.6	95,304,787	21.0
1968	633,833,536	-3.1	78,768,510	--
1967	653,858,024	5.9		

As a point of comparison, if the homestead credit still were limited to a maximum of $250, and if all 1,029,593 homesteads in Minnesota in 1982 received the maximum credit, the program would cost $257 million. If the maximum were $325 (as it was in 1974) and all homesteads were at the maximum, the cost would be $335 million. A $550 maximum implies a maximum program cost of $566 million. Actually, even in 1982 close to 15 percent of Minnesota homesteads received a credit of less than $200, so these figures overstate what the actual cost of the homestead credit would be if a lower maximum credit were in effect today.

Thus, the major explanation for why homestead credit costs have increased over 500 percent since 1968 is that the original program was expanded several times. In recent years the homestead credit has been a source of concern because its cost has grown faster than state revenue, and that growth in the cost of the program depended in part on decisions taken in 4,000 local taxing districts around the state rather than in the state legislature. As we have just seen, however, the big growth in the program has resulted from legislative action that deliberately increased the rate at which the credit is paid and the maximum credit paid.

2. PROJECTED GROWTH

Precise calculation of the cost of the homestead credit into the future is limited by the fact that 4,000 more or less independent taxing districts make budgetary decisions that can affect the exact cost of the program. Rough calculation of the cost of the program a few years into the future is not difficult however, given information on the number of eligible homesteads in the state and assumptions about the growth in this number, the number of homesteads at the maximum--these are receiving all the money they are going to get--and assumptions about growth in taxes on homesteaded property across the state. Under the assumption that levies in cities, town, and special districts will increase the same amount in 1983 and 1984 as they did between 1981 and 1982 and that school district levies will increase 15 percent in 1983 and 8 percent in 1984, the Department of Finance using a Revenue Department model has estimated that the homestead credit will cost $513 million in 1983 and $532 million in 1984 compared to $479 million in 1982. Projections made independently by the House of Representatives Research Department are in general accord with these figures. These projections can and will be refined as more is learned about actual 1983 levies.

3. OBJECTIVES OF THE HOMESTEAD CREDIT

On one level, the purpose of the homestead credit is simple: to reduce property taxes on owner-occupied property. Along with other property tax relief programs that are designed to keep property taxes low, the homestead credit has succeeded in bringing property taxes in Minnesota down to a level that is low in comparison to other states. While the general purpose and impact of the homestead credit is clear, it has a variety of other effects that may be viewed as

advantages or disadvantages and these will be explored in the remainder of this section. Two aspects of the homestead credit are of paramount importance. The homestead credit is one means by which local services can be financed with revenue raised through taxes thought to be preferable to the property tax, the only significant tax available to local government in Minnesota.[1] And second, the homestead credit is looked to by many to insulate property owners from future property tax increases.

Table 19 shows more directly than any data reviewed to this point how the homestead credit by itself has affected property taxes levied on homesteaded property. Unfortunately, the data series presented in Table 19 does not go back before 1974, and for 1974 and 1975 it is not possible to disentangle the homestead and agricultural credits for farm homesteads.

Looking first at non-farm homesteads, Table 19 shows how gross taxes have grown between 1974 and 1982 and how the homestead credit has grown. Between 1974 and 1982, gross taxes grew from $466 million to $959 million or 106 percent. The homestead credit grew from $165 million to $393 million or 138 percent. The net tax paid by non-farm homesteads rose only 73 percent during the period and actually declined over-all between 1976 and 1981. Declines in net taxes on non-farm homesteads occurred in 1978, 1980, and 1981, and although it is not shown, a major decline also occurred in 1974 due to 54 percent increase in the homestead credit that year over 1973.

Agricultural homesteads receive a sizeable tax credit through the agricultural credit program in addition to the homestead credit. And starting in 1981, agricultural property including agricultural homesteads could qualify for the wetland and native prairie credits. We have not been able to separate out the amount of money paid through the homestead credit program from the agricultural credit in all years. Thus, for farm homesteads we compare gross taxes on farm homesteads to total credits between 1974 and 1982 and are restricted to 1976-1982 for a separate look at the homestead credit.

Even with these data limitations, it is clear enough what has happened to gross taxes on farm homesteads between 1974 and 1981 and the role of the homestead credit in keeping taxes down.

Table 19 shows that between 1974 and 1982, gross taxes on farm homesteads increased 181 percent from $95.7 million to $269 million. Total credits--basically the agricultural and homestead credits--

---

[1]The question of whether the property tax in fact places a disproportionate burden on low income taxpayers is discussed in connection with our analysis of the income adjusted property tax refund program later in this chapter and an examination of the relationship of the property tax to income that is presented in the next chapter. Although it comes as a surprise to many, Minnesota's individual income tax is not uniformly progressive nor the property tax uniformly regressive.

TABLE 19

TAXES AND CREDITS ON FARM AND NON-FARM HOMESTEADS
1974 - 1982

Year Payable	Gross Tax		Total Credits[2]				Net Tax	
	Amount	Annual Change	Homestead[1] Credit	Agricultural Credit	Amount	Annual Change	As a Percent of Gross Tax	Amount	Annual Change
Non-Farm Homesteads									
1982[3]	$959,313,843	24.4%	$437,264,975	--	$437,264,975	11.1%	45.6%	$522,048,868	38.2%
1981	771,185,685	6.6	393,456,555	--	393,456,555	21.6	51.0	377,729,130	-5.6
1980	723,690,402	5.1	323,608,114	--	323,608,114	44.8	44.7	400,082,288	-14.0
1979	688,461,000	3.6	223,419,000	--	223,419,000	3.9	32.5	465,042,000	3.4
1978	664,810,007	-0.5	215,045,409	--	215,045,409	4.4	32.4	449,764,598	-2.6
1977	667,819,585	14.0	205,980,873	--	205,980,873	6.2	30.8	461,838,712	17.8
1976	586,004,606	8.2	193,966,976	--	193,966,976	7.1	33.1	392,037,630	8.7
1975	541,819,526	16.2	181,079,211	--	181,079,211	9.4	33.4	360,740,315	19.9
1974	466,414,058	--	165,510,166	--	165,510,166	--	35.5	300,903,892	--
Farm Homesteads									
1982[3]	$269,037,362	34.4	$ 58,024,135	$64,462,142	$125,357,044	18.5	46.6	$143,680,318	52.3
1981	200,122,946	3.6	55,553,641	48,819,820	105,763,936	28.5	52.9	94,359,010	-14.8
1980	193,119,831	17.3	50,124,100	32,212,951	82,337,051	42.8	42.6	110,782,780	3.6
1979	164,631,939	13.2	35,053,023	22,624,539	57,677,562	12.0	35.0	106,954,377	13.8
1978	145,493,544	8.6	34,012,020	17,479,532	51,491,552	11.0	35.4	94,001,992	7.4
1977	133,936,323	15.5	33,122,138	13,272,967	46,395,105	10.1	34.6	87,541,218	18.5
1976	115,999,918	9.0	30,422,892	11,715,771	42,138,663	17.9	36.3	73,861,255	4.5
1975	106,405,352	11.1	--	--	35,744,605	5.8	33.6	70,660,747	14.0
1974	95,751,696	--	--	--	33,786,128	--	35.3	61,965,568	--
All Homesteads									
1982[3]	$1,228,351,205	26.5	$495,289,110	$64,462,142	$562,622,019	12.7	45.8	$665,729,186	41.0
1981	971,308,631	5.9	449,010,196	48,819,820	499,220,491	23.0	51.4	472,088,140	-7.6
1980	916,810,233	7.5	373,723,214	32,212,951	405,945,165	44.4	44.3	510,865,068	-10.7
1979	853,092,939	5.3	258,472,023	22,624,539	281,096,562	5.5	33.0	571,996,377	5.2
1978	810,303,551	1.1	249,057,429	17,479,532	266,536,961	5.6	32.9	543,766,590	-1.0
1977	801,755,908	14.2	239,103,011	13,272,967	252,375,978	6.9	31.5	549,379,930	17.9
1976	702,004,524	8.3	224,389,868	11,715,771	236,105,639	8.9	33.6	465,898,885	8.0
1975	648,224,878	15.3	--	--	216,823,816	--	33.4	431,401,061	18.9
1974	562,165,754	--	--	--	199,296,294	--	35.4	362,869,460	--

Source: Department of Revenue estimates 1974-1981. Office of Legislative Auditor preliminary estimate 1982.

[1] Includes Taconite Homestead Credit.
[2] In 1981 and 1982, the total includes Native Prairie, Wetlands Credits and a portion of Reduced Assessment Credit.
[3] Preliminary estimates for 1982. Anoka County amounts were projected because actual data were unavailable.

increased 271 percent, from $33.8 million to $125.3 million. Since credits grew faster than gross taxes, the growth of net taxes was controlled to some degree, although net taxes grew 132 percent between 1974 and 1982. Net taxes were essentially stable between 1978 and 1981, growing only 0.4 percent during this period. As Table 19 makes clear, the homestead credit constitutes well over one-half of the direct property tax relief received by farm homesteads, although between 1976 and 1982 homestead credit payments to farm homesteads increased 91 percent compared to a 450 percent increase in the agricultural credit.

The impact of direct property tax relief on all homesteads is shown in the final panel of Table 19 and graphically in Figure 9. The homestead credit is a major part of total direct property tax credit payments shown in yellow in Figure 8. Because there are about seven times as many non-agricultural homesteads as agricultural homesteads, and because the homestead credit provides a majority of direct property tax relief even to agricultural homesteads, most of the shaded area is accounted for by the homestead credit. In 1981, for example, $499 million in direct property tax relief went to homesteaded property and of this, 90 percent or $449 million was paid through the homestead credit. In 1976, the homestead credit accounted for about 95 percent of all direct property tax relief on homesteaded property.

If it wasn't clear before, Figure 9 shows the impact of the homestead credit. In 1982, on non-farm homes the homestead credit paid 46 percent of the gross tax liability of homes. The homestead and agricultural credits together paid 47 percent of the tax liability of agricultural homesteads. As recently as 1974, the homestead credit paid about 35 percent of the tax on non-farm homesteads and the homestead and agricultural credits paid about the same percent of property taxes on agricultural homesteads.

Thus, direct property tax relief programs, chiefly the homestead credit, now pay over half the gross tax liability of farm and non-farm homeowners. Even so, most state aid to local governments is not paid in the form of direct property tax relief, it is paid directly to schools and local government and affects gross tax liability. Even if property tax relief programs are frozen at current levels, the homestead credit will continue to be a significant tool by which state revenue finances local government and schools.

In addition to substituting state for local revenue, the homestead credit is looked to by many to insulate homeowners from future increases in property taxes. Table 20 shows (again) how much has been spent through the program between 1972 and 1982; the total number of homesteads receiving varying amounts of the homestead credit including the number of homesteads receiving the maximum credit each year; and the average homestead credit.

Obviously, once a homestead is receiving the maximum credit, future property tax increases are fully borne by the property taxpayer.[1] And as long as gross taxes increase more and more

[1] Except to the extent that he qualifies for income adjusted property tax refund.

FIGURE 9
TOTAL HOMESTEAD PROPERTY TAXES AND CREDITS

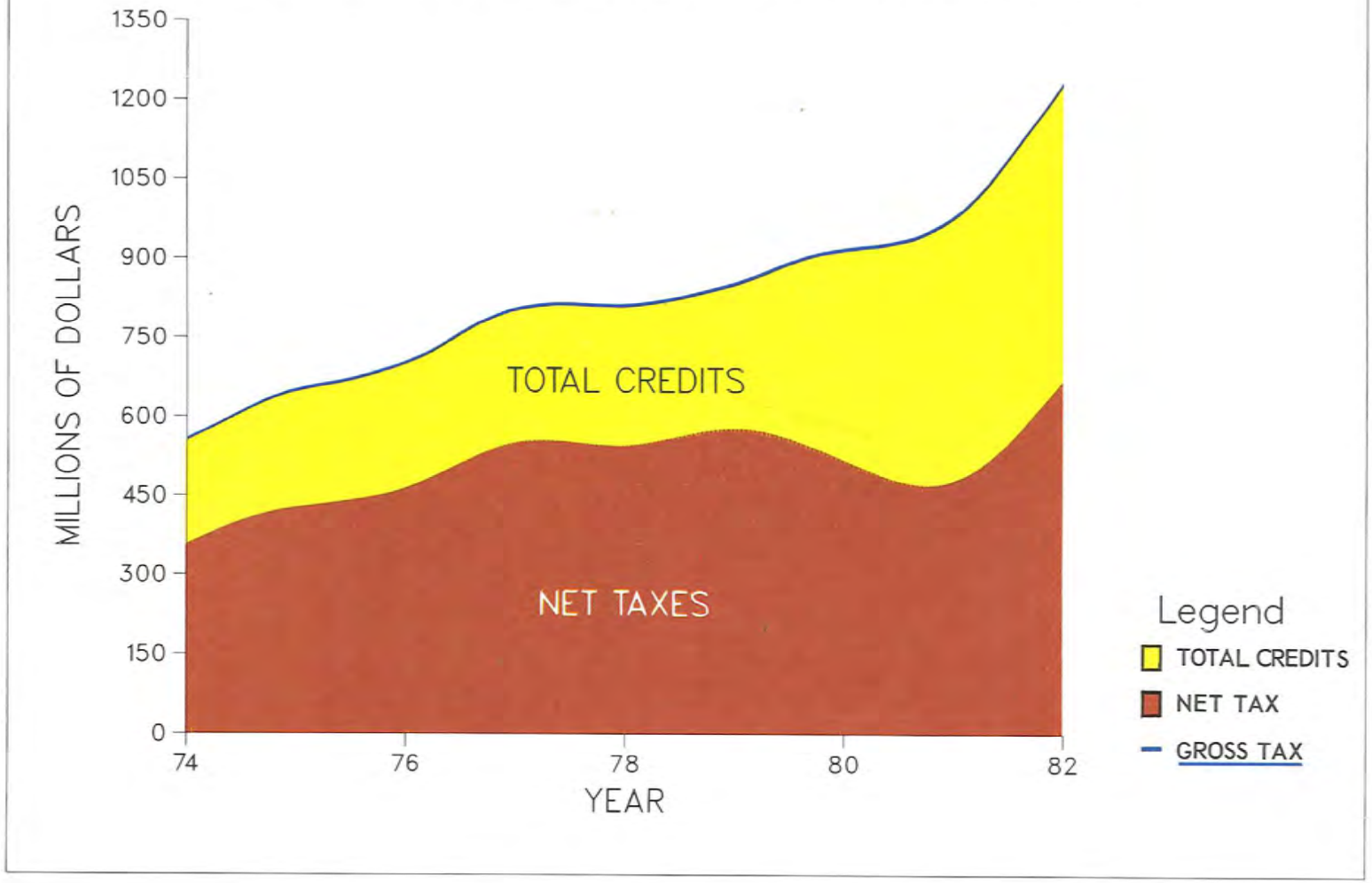


TABLE 20

DISTRIBUTION OF THE HOMESTEAD CREDIT BY SIZE

	Homestead Credit Expenditures	Total Number of Homesteads	Percentage Distribution by Size of Payment					Average Credit
			Less Than $200	$200-350	$350-500	$500-650	$650 Maximum	
1982	$479,293,456	1,029,593	14.8%	14.8	16.6	19.0	34.8	$466
1981	$432,835,086	1,030,428	19.6%	17.3	21.2	17.9	23.9	$420
			Less Than $175	$175-325	$325-425	$425-550	$550 Maximum	
1980	$358,306,951	1,040,813	22.6%	20.2	15.4	17.6	24.1	$344
			Less Than $175	$175-325	$325 Maximum			
1979	$242,340,322	1,012,118	29.1%	22.0	48.9			$239
1978	$234,439,049	999,115	30.9%	21.9	47.2			$235
1977	$225,495,743	972,299	32.0%	23.2	44.8			$232
1976	$210,991,252	954,139	35.4%	26.5	38.1			$221
1975	$203,060,500	915,373	35.8%	28.6	35.7			$222
			Less Than $325	$325 Maximum				
1974	$186,123,018	899,181	72.6%	27.4				$207
			Less Than $250	$250 Maximum				
1973	$120,135,635	837,061	85.9%	14.1				$135
1972	$114,271,199	875,258	87.8%	12.2				$131

Source: Department of Revenue, Abstract of Tax lists.

homesteads will be "at the maximum" unless the maximum credit is regularly increased. The maximum homestead credit remained at $325 between 1974 and 1979. During this period, as Table 20 shows, the number of homesteads receiving the maximum credit increased from 27.4 percent to 48.9 percent. Subsequently, the maximum was increased to $550, then to $650. The $650 maximum has been in effect since 1981. In 1981, 23.9 percent of all homesteads were at the maximum. As Table 20 shows, the number of homesteads at the maximum grew to 34.8 percent in 1982.

There is wide variation across the state in the average homestead credit paid and the percent of homesteads at the maximum. Where taxes are high (because of high residential property values, high mill rates or both) more homesteads are at the maximum. In general, taxes are higher in the Twin Cities metropolitan area than in the balance of the state for reasons already discussed. Table 21 compares the seven county Twin Cities area to the balance of the state on the size distribution of the homestead credit.

Table 21 shows the extent of the difference between the Twin Cities area and the remaining 80 counties of the state in the number of homes receiving various levels of the homestead credit including the percent receiving the maximum credit. As 21 shows, 55 percent of homes in the seven county Twin Cities metropolitan area are at the maximum compared to 17 percent of the rest of the state. Only one percent of the homes in the seven county area receive less than $200 in homestead credit (meaning their gross tax is less than $345) while 27 percent of homes outside the seven county area receive a homestead credit less than $200.

Thus, over a third of all homes state-wide and over half of the homes in the Twin Cities are at the maximum. Homes just at the maximum experience the largest percentage increase in property taxes when taxes go up. Homes under the maximum have 58 percent of any tax increase paid for by the state until they reach the maximum.

As homestead taxes rise about the point where they receive the maximum credit, the impact of the homestead credit in lowering taxes diminishes. Elimination of the homestead credit therefore affects taxes on a $200,000 home less than on a $100,000 home in the same location.

In summary, as fast as the homestead credit program has grown since 1968 and especially in the late 1970s, over a third of homesteads across Minnesota, over one-half in the Twin Cities metropolitan area and over 60 percent in Hennepin county receive the maximum allowable credit and are no longer insulated against property tax increases driven by increased local budgets.

4. ADMINISTRATION OF THE HOMESTEAD CREDIT: DETERMINING ELIGIBILITY

Legislative reference to the homestead credit is part of the state's property classification laws; payment of a homestead credit

TABLE 21

DISTRIBUTION OF THE HOMESTEAD CREDIT BY SIZE

TAXES PAYABLE 1982

	Twin Cities Area Counties Percent of Homesteads Receiving Credits					
	Less than $200	$200-350	$350-500	$500-650	$650 Maximum	Total
Hennepin	1.0%	4.0%	10.3%	24.5%	60.2%	100.0%
Anoka	1.5	3.9	16.4	40.2	38.0	100.0
Carver	1.8	7.8	17.2	19.5	53.7	100.0
Dakota	1.3	5.8	15.7	28.0	49.2	100.0
Ramsey	0.7	3.1	13.0	28.5	54.8	100.0
Scott	1.1	5.8	12.2	21.9	59.0	100.0
Washington	1.0	5.3	14.4	28.5	50.8	100.0
Twin Cities Metro Area	1.1	4.2	12.4	27.3	55.0	100.0
Balance of the State	26.6	24.0	20.2	11.9	17.3	100.0
State Total	14.8	14.8	16.6	19.0	34.8	100.0

Source: Calculated from Abstract of Tax lists.

follows from receiving a homestead classification. There is no "Homestead Credit Act" expressing legislative intent, program definitions, guidelines for administrative rules, or local government and state agency responsibilities and authority. Though there is no explicit definition in statute of what constitutes a homestead, a homestead has come to mean any real property that is occupied and used by the owner on January 2 of the assessment year. In addition, any real property that was not used for the purpose of a homestead on the January 2 assessment date, but was used for the purpose of a homestead on the following June 1 could be classified as a mid-year homestead for the last half of that year and would qualify for one-half of the homestead credit. Furthermore, it is assumed the Legislature intends that a property owner be given the benefits of a homestead in only one place.

The establishment of criteria to define ownership and occupancy has largely evolved from decisions of the Department of Revenue and from judgments rendered by the Minnesota Tax Court and the Attorney General. What has emerged is a practical construction of the statutes that establishes ownership and occupancy criteria that can be applied in determining homestead status.

(1) Ownership is determined by such documents as:

- Warranty Deed
- Contract for Deed
- Certificate of Real Estate Value
- Proof of Inheritance
- Homestead Declaration Card

(2) Occupancy is evidenced by:

- An owner's occupancy of the property on January 2. Although the January 2 date is generally required for occupancy, the courts have focused on the owner's intent, recognizing that the owner may not always be physically present on January 2.

- An owner's intent to make the property his principal dwelling. By implication this means the owner has only one homestead.

Although the laws and policies governing the homestead classification establish some objective guidelines for determining homestead status, their application can require subjective judgment. As a result, it is possible for residential properties to be misclassified as homesteads because of inconsistent interpretation and application of the homestead definition by the assessors. This can create variations within and among counties and also lead to assessors being in conflict with local Boards of Review, the Department of Revenue, and the Minnesota Tax Court.

In addition, the system lacks standardized administrative requirements and, as a result, there is variation among the counties in homestead classification procedure, documentation, recordkeeping, and data processing. For example, while some counties tend to rely on mechanical or computerized methods, other counties rely more on personal knowledge and familiarity with their assessment district. While both systems have strengths and weaknesses, the lack of uniformity presents significant problems for documenting and verifying information. Because these systems are so diverse, misclassified homesteads can go unnoticed for many years, if not indefinitely.

Local costs associated with administrating the homestead classification are also becoming burdensome for many counties. For example, during a meeting with the Legislative Committee of the Minnesota Association of Assessing Officers, we were told that administrative costs directly associated with making and verifying homestead classifications could exceed 20 percent of the total assessor's office budget in many counties. In Hennepin County, the cost of mailing homestead declaration cards alone, was over $32,000 per year.

Administrative costs also have indirect impacts. Several counties indicated to us that the time and resources required to make homestead classifications greatly affects the time available to assess the value of property. To the extent assessors are not able to devote sufficient time to making assessments, the quality of those assessments may be adversely affected.

The Department of Revenue has broad legal authority over the state's property tax system. In practice however, the department currently limits administration of homestead credits to the training and licensing of assessors and the evaluation and verification of aggregate credit amounts payable to local taxing jurisdictions. At no point in the classification process does the department systematically record, evaluate, or audit individual property classifications and credit eligibility.

The Department of Revenue is currently writing rules on homestead classification. In addition to providing rules that would more precisely define property ownership and occupancy, the department is also exploring the feasibility of establishing rules to require the use of standardized forms and documentation for all homesteaded property in the state.

Although such a policy may appear to be contrary to the Department of Revenue's current decentralized role in overseeing the property tax system, the department has often centralized certain aspects of the system when it felt it would be beneficial to the state. For example, in recent years the department has found it necessary to standardize property tax statements, valuation notices, and certificates of real estate value. Therefore, any degree of standardization of the homestead classification procedures would be consistent with current general state policy.

In another report, Administration of Direct Property Tax Relief Programs, we consider options for improving the administration of the homestead classification and credit program. We suggest that

the Legislature and the Department of Revenue consider changes such as the following:

- Adopt an explicit definition of homestead and homestead credit eligibility.
- Establish firm filing dates for when a full or mid-year homestead application can be made.
- Require all assessors to inform new homeowners of homestead law, policies, and application procedures.
- Require that a definition of a homestead be included on all application forms and renewal cards.
- Require all property ownership contracts to be recorded with the county auditor, including all contracts for deed.

If the homestead credit is maintained, the program, which represents over 12 percent of annual general fund expenditures, should be administered with more precise and uniform standards and tighter controls. In our judgment it is currently impossible for the state and local and county assessors to systematically audit and verify homestead classifications and therefore homestead credit eligibility. Although we have not quantified the number of misclassified residential properties, the fact remains that the current system inhibits effective and efficient auditing. A program that is as important and expensive as the homestead credit should not, in our view, be left without proper administrative controls and safeguards to ensure that its dollars are going only to those who are legally eligible to receive them. Again, we consider these issues more fully in another report, Administration of Direct Property Tax Relief Programs.

5. POLICY ALTERNATIVES

The homestead credit is a mechanism that could protect taxpayers against future property tax increases but so are a variety of other tax relief mechanisms either in place or potentially available. The question of whether the homestead credit is the preferred mechanism to soften property tax increases, or whether property taxes should be allowed to rise, or whether some other means should be chosen to control taxes depends on how the characteristics of each are evaluated in the political process.

The homestead credit provides something akin to across the board property tax relief to home owners. Aid is distributed at a flat rate of 58 percent to a maximum of $650. Thus, the homestead credit is only income-sensitive to a rough degree. And unlike school aids and to some extent local government aid, the homestead credit does not provide aid in a way that is tied to local need or local tax effort.

In our judgement, the questions boil down to these:

- Should the homestead credit be relied upon to insulate homeowners from increases in the property tax?

- To what extent should local services be financed through the homestead credit instead of property taxes or local government aid and school aids?

- Should an income-sensitive tax credit--perhaps it could be called a homestead credit--be chosen as a better tool for distributing scarce state property tax relief dollars than the present homestead credit?

- Should the homestead credit as it exists be changed in other ways? Should the rate or maximum be raised or lowered?

On the basis of the foregoing discussion and presentation of data, we have concluded that the homestead credit is accomplishing what it was designed to do: keep residential property taxes in Minnesota low and substitute state revenue for local (property tax) revenue as a means to finance local services. However, the homestead credit totalled $479 million in 1982 and the cost will rise in the future unless deliberate action is taken to limit cost increases that are built into the program.

The state's fiscal situation in 1983, and prospects for the next few years are less promising than the conditions that prevailed through most of the 1970s when revenue growth driven by economic expansion and inflation permitted major increases in the homestead credit program. State revenue is now not growing fast enough to finance the built in growth of the homestead credit much less any liberalization of the program's benefits. Minnesota is faced a shortage of money, and since three-fourths of the state budget is returned to local government in one form or another, it is in these programs that the legislature will need to look if significant savings are to be found.

In this light, it is possible that the homestead credit will be looked at as a program that can be cut or even eliminated because it provides property tax relief broadly rather than concentrating relief in districts with low property wealth or a high level of services needs, or distributing relief directly to taxpayers with high property taxes in relation to income. These alternatives are, essentially those presented by the school aid, local government aid, and circuit breaker programs. Focusing property tax relief more precisely may be viewed with increased favor in an era of scarce resources.

In any case, we believe it is useful to look at possible changes in the homestead credit and their advantages and disadvantages. One thing is clear: If changes are made in the way a fixed amount of money is spent, there will be winners and losers, and the option of providing increased aid to some while holding all harmless seems less possible than in the past when major reforms were undertaken in the property tax system.

Homestead Credit Options

1. Distribute all or part of the money now going to school districts and local government via the homestead credit through the school aid and local government aid programs.

The homestead credit distributes property tax relief in a broad fashion. School aid and local government aid programs are designed to provide aid to districts with relatively high service requirements and relatively low property valuation. Thus, they do more than simply substitute state for local revenue. They are spending programs calculated to accomplish specific objectives.[1]

In the case of school aid, an increasing number of districts are projected to be ineligible for state foundation aid because the state mandated local levy has been increased without a compensating increase in the state foundation aid formula.

If aid paid to school districts through the homestead credit program were paid through the foundation aid program, this problem would be alleviated to some extent. The part of the homestead credit going to other local taxing districts could be paid to them through local government aid programs.

While the shape of school and local government aid programs for the future will be worked out by the 1983 legislature, and no suggestions are provided here concerning how this should be done, the general option of distributing property tax relief through these aid programs stands as a major alternative to the homestead credit. A change in the classification system lowering the assessment rates of homesteaded property could be made at the same time in order to offset the fact that school and local government aid provides relief to all property taxpayers rather than just homeowners. Another idea that has been suggested is for the state to assume the entire cost of the foundation aid program by eliminating the mandatory 26 mill foundation levy at the same time the homestead credit is abolished.

2. Distribute all or part of the homestead credit through the circuit breaker program. In effect, change the homestead credit so that it is income-sensitive and state administered.

We have identified a number of administrative weaknesses in the homestead credit. These may be viewed as a sufficient justification for changing the way in which a half-billion dollars a year is spent through the homestead credit. One option is to assume state administration of the homestead credit by incorporating it into the income tax system.

---

[1]This is not to deny that there are many who would like to see major changes in these programs, nor to suggest that such changes should not be made.

This is how the circuit breaker program for homeowners is administered. Actually, the circuit breaker program for homeowners could accurately be called an income adjusted homestead credit. The current program for homeowners under 65 years of age now distributes only about $29 million compared to $63 million in 1979, and compared to $1.2 billion in school aid and $479 million in the homestead credit. One reason the circuit breaker refund for homeowners has dried up is that the homestead credit has been increased and, within limits, there is a dollar for dollar substitution between the programs. The homestead credit is deducted in the process of computing individual property tax refunds. Because of this fact, any limit on expenditures through the homestead credit that affects individual tax bills will result in more money being spent through the property tax refund for homeowners. Elsewhere we discuss the implications for the circuit breaker for limits on the homestead credit.

A variety of specific proposals can be debated. Our point here is that a second major option for the homestead credit is to make it income-sensitive. As with all proposals, some people will benefit and others will lose if a fixed amount of money is spent in a new way. The homestead credit program is popular and will not be easy to scale back or eliminate, but even if it is just not expanded, more money will be spent through the circuit breaker in the future if property taxes go up in relation to income. The circuit breaker could also be indexed against inflation in order to protect against what has happened to it because of inflation during the last few years.

3. Reduce the allowable maximum on the homestead credit, now $650.

If the homestead credit maximum were $550 instead of $650, the cost in 1982 would have been about $49 million less than it was. While this contributes to a solution of the state's money problem, data reviewed earlier show that money would be disproportionately taken from high tax areas, cities rather than outlying areas across the state, and the Twin Cities metro area rather than the balance of the state.

4. Reduce the homestead credit rate, now 58 percent.

This would also save money but at the expense of low tax rather than high tax areas (assuming the $650 maximum was kept). The homestead credit now pays 58 percent of the gross tax on owner-occupied property no matter how low the tax is. Low tax areas benefit from this feature and would lose under any plan to lower the homestead credit rate from 58 percent.

5. Keep the current rate and maximum but exempt a minimum tax from the homestead credit. This minimum could be expressed as a flat dollar amount or a fraction of (equalized) assessed or market value and could reflect the part of property tax that mainly serves property rather than people.

Certain government services mainly serve property such as fire and police protection. It can be argued that these are appropriately financed through the property tax while education, welfare, and other people-oriented services should be borne mainly by the state and nation since the need for these services is unequally distributed in relation to the property tax base.

By establishing a minimum tax not subject to direct tax relief programs, the state could provide less tax relief for property services and more for people services.

6. Establish an upper limit on the extent to which direct property tax relief programs reduce the property tax bill on individual parcels.

As we discuss later in this chapter, cases exist where a combination of the homestead credit, taconite homestead credit, agricultural credit, reduced assessment credit, wetland and native prairie credits together pay 100 percent of the property tax owed on individual parcels. While these cases are rare, in a significant number of cases eighty percent or more of the tax liability of property is paid through a combination of direct property tax credits. We believe it makes sense to set an upper limit on the percentage of property tax paid by direct property tax relief programs.

The homestead credit makes money available to local government at low cost in the sense that local officials are spared the requirement of standing for election on the basis of the full tax implications of local spending decisions. This effect must be weighed against the purpose of the homestead credit which is to substitute state for local revenue in financing local services, and to provide property tax relief to homeowners. To the extent that the homestead credit works to encourage local spending, it is not providing tax relief nor substituting state for local revenue sources.

The issue is: At what level does the homestead credit introduce an undesirable incentive for local government to spend more than local voters would otherwise approve. It may be argued that there is nothing wrong with encouraging a higher level of local public services, but most legislators are not in favor of more government services in general, but in better services of specific kinds such as education or public transportation. And there are better policy tools than the homestead credit to accomplish specific objectives in these or other areas.

The homestead credit at 58 percent plus the taconite homestead credit and agricultural credit end up paying close to one-half the residential homestead property tax state-wide, over 70 percent in some counties, and occasionally up to 100 percent of the tax bill on individual parcels. The undesirable consequences of this level of property tax relief need to be considered and weighed against the benefits of providing across the board property tax relief.

B. AGRICULTURAL CREDIT

The agricultural credit is designed to lower school taxes for the owners of agricultural property, timberland and non-commercial seasonal recreational property. These property owners are considered to be low users of school district services in relation to their share of property wealth within school districts, and therefore deserve property tax relief.

The agricultural credit became a state-paid direct property tax relief program in 1972. Prior to 1972, the agricultural credit--then computed as a mill rate differential--was entirely a local shift of school tax effort.

In 1982, nearly $87 million was paid to school districts on behalf of the owners of these classes of property and the cost of the agricultural credit is projected to reach $96 to $98 million in 1983. While the circuit breaker for homeowners and renters costs more, if benefits to property owners alone are considered, the agricultural credit is the state's second largest direct property tax relief program.

The agricultural credit has grown rapidly in cost between 1972 and 1982, from $15.8 million to $86.9 million as Table 3 on page 6 shows. The cost of the agricultural credit doubled between 1978 when it was $35.2 million and 1981 when it cost $70.5 million

The rapidly increased cost of the program is due to two basic factors--increases in the value of agricultural property and significant increases in the program's benefits. Table 22 shows how the agricultural credit has been computed over the years. For example, for taxes paid in 1976, the agricultural credit on homesteaded property was increased to equal 12 mills times the assessed value of the first 120 acres and 10 mills times the assessed value or the remainder. Non-homesteaded agricultural property, timberland and seasonal recreational land received a credit figured on 10 mills.

As Table 22 shows, the agricultural credit was liberalized in 1976 and every year between 1978 and 1982. Either the mill rate applied to property in various acreage ranges was increased or the acreage ranges were changed to yield a higher credit amount.

Effective in 1982, the agricultural credit on agricultural homesteads equals 18 mills times the assessed value of the first 320 acres, 10 mills on the next 320 acres and 8 mills on the assessed value over 640 acres. For non-homesteaded agricultural property, the credit is equal to 10 mills on the first 320 acres, 8 mills on the rest. For non-commercial seasonal recreational property, the credit is equal to 10 mills times assessed value; 8 mills is used for timberland. The agricultural credit is applied prior to calculation of the homestead credit for homesteaded property.

Table 23 presents preliminary data showing estimated total agricultural credit payments to be made in 1983 and the amount of money paid to school districts on behalf of the owners of different types (and subclassifications) of property.

TABLE 22

AGRICULTURAL CREDIT FORMULA
1972 - 1982

Year Taxes Payable	Acreage Range	Farm Homesteads	Farm Non-Homesteads	Seasonal Recreational	Timber
1982	0-320	18 mills	10 mills	10 mills	8 mills
	320-640	10	8	10	8
	640+	8	8	10	8
1981	0-240	17	10	10	10
	240+	10	10	10	10
1980	0-240	15	10	10	10
	240+	10	10	10	10
1979	0-160	15	10	10	10
	160+	10	10	10	10
1978	0-120	15	10	10	10
	120+	10	10	10	10
1976-77	0-120	12	10	10	10
	120+	10	10	10	10
1972-75	All	8.3	8.3	8.3	8.3

The agricultural credit on a parcel of property equals the mill rates shown above times the assessed value of property in each category.

TABLE 23

PRELIMINARY AGRICULTURAL CREDIT ESTIMATES
Taxes Payable 1983

	Assessed Values *	Mill Rate	Credit	Percent of Total
Farm Homestead				
1st 320	$3,813,000,000	18	$68,634,000	
320 - 640	84,000,000	10	840,000	
Over 640	92,000,000	8	736,000	72.3%
Total	$3,989,000,000		$70,210,000	
Farm Non-homestead				
1st 320	$1,151,000,000	10	$11,510,000	
Over 320	1,136,000,000	8	9,088,000	
Total	$2,287,000,000		$20,598,000	21.3
Total Farm	$6,276,000,000		$90,808,000	94.3%
Timber	$ 6,100,000	8	$ 40,000	0.01
Seasonal Recreational	539,000,000	10	5,390,000	0.056
Total	$6,821,000,000		$96,247,000	100.0%

Source: Department of Revenue

*Based on preliminary valuation increase data from the counties.

The agricultural credit is projected to cost $96.2 million in 1983 by the Department of Revenue, up from about $87 million in 1982. As Table 23 shows, 72.3 percent of the agricultural credit is paid on behalf of agricultural homesteads, 21 percent on agricultural non-homesteads, 0.1 percent on timberland and 5.6 percent on seasonal recreational property. As Table 23 makes clear, this is due to the distribution of assessed values across these property classes, and the fact that the mill rate on which the credit is figured is highest for the first 320 acres of agricultural homesteads.

Future changes in agricultural credit expenditures depend mainly on what happens to the market value and thus the assessed value of agricultural and seasonal recreational property. Changes in assessment practices that affect assessed values will also affect agricultural credit payments. Unlike the homestead credit and other major property tax relief programs. The agricultural credit is not tied to changes in property tax levies or tax effort. The Department of Finance estimates that the credit will cost $98 million in 1983 and $108 million in 1984. (For 1983 their estimate is two million dollars higher than the estimate of the Department of Revenue shown in Table 23.) These projections assume that the benefits of the program will stay as they are over the next two years.

1. CRITICISMS OF THE AGRICULTURAL CREDIT

The purpose, effect, and fairness of the agricultural credit can be debated on several grounds. The agricultural credit became a state-paid property tax relief program as part of the package of reforms enacted in 1971, known as the Minnesota Miracle. Prior to this time, beginning in 1942, owners of agricultural, timber and seasonal recreational property benefitted from a lower school district levy applied to their property while other local property owners bore a greater share.

Starting in 1972, the state picked up the cost of the agricultural mill rate differential. This concession to the interests of rural school districts with high property wealth was necessary in order to win legislative approval of the entire package of reforms enacted in 1971, even though it runs contrary to the main thrust of the changes in school financing enacted that year. Up to the present time, the agricultural credit provides tax relief in direct proportion to school district property wealth while the foundation aid program, which is the cornerstone of the Minnesota Miracle, is intended to accomplish the opposite--to concentrate aid in school districts with low property wealth per pupil. This is not the only compromise that was necessary in order to pass the 1971 reforms, but since the cost of the agricultural credit has grown about 450 percent between 1972 and 1982, the program merits a careful examination in light of current conditions. Other compromises were necessary in 1971 to win legislative approval of the entire package and these should be examined as well if the original objectives of the foundation aid program are still held to be valid. Of course, any individual property tax relief program or provision needs to be considered as part of the total package of which it is a part.

Another problem with the agricultural credit is that the credit paid on farms of equal value varies across the state, since the credit is computed by applying a mill rate schedule that is tied to the physical size of the farm. The first 320 acres of owner-occupied farms receive a credit worth 18 mills times assessed value, additional acreage qualifies for a credit figured at a lower rate. Since the value per acre of farmland and the average size of farms varies considerably across the state, farms in areas where land is most productive and where farms are smaller receive a higher credit than farms of equal value in areas where land costs less.

Another point worth noting is that the agricultural credit and homestead credit as currently designed, both work to offset taxes on the same property. The homestead credit pays 58 percent of the taxes owed on agricultural homesteads (defined as including the farm residence plus 240 acres). The agricultural credit, at the same time, is figured on the value of the farm residence as well as the surrounding agricultural land. Of course the homestead credit is figured on the tax liability that remains after the agricultural credit is figured in, so the credits are not simply added together. Some have criticized the conceptual overlap between the programs nevertheless and suggest that the homestead credit should be paid on the farm residence plus one acre, and the agricultural credit should be computed on the value of agricultural land only. These proposals are generally advanced by those who are interested in finding a way to spend less on the agricultural and/or homestead credits.

While the homestead credit on any piece of property is capped at $650, the agricultural credit is not limited by any statutory maximum. Thus, the agricultural credit lacks even the rough link to economic well-being contained in the design of the homestead credit which does limit the amount of property tax relief received by property rich individuals.

The agricultural credit can be criticized because it is paid on any homestead of ten acres or more. These include many that would not, by most definitions be considered farms. It can be paid on even smaller parcels if their use is clearly agricultural.

The agricultural credit induces administrative problems at the local level that may not be obvious at first because of the complex interaction of a schedule of mill rates on the value of homesteaded and non-homesteaded property in several acreage ranges. Since farms are often owned by families and corporations, and since they are often composed of non-contiguous land that may cross taxing district boundaries, it can be a real headache to properly classify property for the purpose of computing the agricultural credit.

2. POLICY ALTERNATIVES

(1) Redesign the agricultural credit. Support education through the foundation aid program and categorical aid programs that tie school aid to service needs and requirements and the ability of school districts to raise money.

(2) If the school tax burden on agricultural land, timberland and non-commercial seasonal recreational property is felt to be unfairly high, shift the tax effort within school districts through a locally paid credit or mill rate differential.

(3) At a minimum, eliminate the inequality resulting from (in effect) giving a larger credit to physically smaller farms. Tie the agricultural credit directly to (equalized) assessed value. If a progressive credit is desired, compute the credit by applying a rate schedule to intervals of assessed valuation so that proportionately more relief is distributed to farms of low assessed value.

(4) Beyond this, if certain school districts have expenses or service needs in relation to tax capacity which are not adequately reflected in foundation and categorical aid programs, these programs themselves should be modified to better accomplish their objectives in an equitable fashion. Because of the overall complexity of the property tax system, it is less preferable to remedy the defects in one program by establishing another program that works at cross-purposes to the first, because there is no guarantee that the programs will continue to be examined together into the future as pressure to make changes to one or the other arises and is dealt with by the Legislature.

The context of this examination of policy alternatives relating to the agricultural credit is the same that guided our discussion of the homestead credit. The fiscal situation facing the Legislature in 1983 means that it is useful to examine alternatives that are aimed at saving money or using existing resources more effectively. There is no question that the agricultural credit reduces property taxes and will be strongly defended by those it benefits.

But the agricultural credit works at cross-purposes with the foundation aid program, and does not distribute property tax relief on the basis of income, or the service needs and taxing effort of school districts. While the formal purpose of the agricultural credit may continue to be judged as valid, to reduce the school tax burden of the owners of agricultural and seasonal recreational property, this objective can more appropriately be accomplished through a locally paid credit or millrate differential.

If the agricultural credit is restructured while the homestead credit is left in place, many agricultural homesteads will not bear the full effect, since 57 percent of agricultural homesteads across the state are below the homestead credit maximum. While the taxes of non-homestead agricultural land, timberland, and seasonal recreational property will not be protected, these classes of property only receive 28 percent of the dollars distributed through the agricultural credit.

C. THE CUMULATIVE EFFECT OF DIRECT PROPERTY TAX CREDITS

The state's direct property tax relief programs have been put in place incrementally over the years. The homestead credit was first passed in 1967, the agricultural credit became a state paid program as part of the 1971 reforms. More recently, several smaller programs have been put in place and benefits paid through major programs have been increased. In addition to a careful separate examination of the major programs, we believe it is useful to look at the cumulative effect of all programs on the tax liability of individual parcels because, in fact, together direct property tax relief programs can and do reduce the tax bill on substantial parcels to very low levels and occasionally to zero. In this analysis, we are looking only at programs that result in a credit on property tax statements. The circuit breaker provides additional tax relief to individual taxpayers.

Six major property tax credits may appear on a taxpayer's statement in 1982. They are deducted in the following order:

1. Agricultural School Credit
2. Wetlands Credit
3. Native Prairie Credit
4. Reduced Assessment Credit
5. Taconite Homestead Credit
6. Homestead Credit

The agricultural school, wetlands, native prairie, and reduced assessment credits are deducted directly from the gross tax amount. The taconite homestead credit is based on the gross tax less the agricultural, wetlands, native prairie, and reduced assessment credits. The homestead credit is 58 percent of the remaining tax after all other credits are subtracted, up to a maximum of $650.

In order to determine the cumulative effect of these direct property tax credits, we examined the tax files of four counties for taxes payable 1982. We looked at the tax statements of residential and farm homesteads in Blue Earth, Sherburne, St. Louis, and Stearns counties. We found that in some cases individuals received several credits and as a result the state paid a high percentage of their taxes. However, most taxpayers in these counties received only one or two of the direct credits.

Table 24 shows the percentage of taxes that the state paid in 1982 for residential homesteads in the four counties. Generally, residential homesteads are eligible only for the homestead credit, although in some cases other credits are received. For example, class 3cc homesteads (property owned and occupied by the blind or disabled) qualify for a reduced assessment credit, and certain iron range districts receive the taconite homestead credit. In isolated

TABLE 24

PERCENT OF PROPERTY TAXES PAID THROUGH DIRECT PROPERTY TAX RELIEF PROGRAMS

RESIDENTIAL HOMESTEADED PROPERTY*
SELECTED COUNTIES

TAXES PAYABLE 1982

County	Percent	Number of Homesteads	Percent of Residential Homesteads
Blue Earth	50-60%	7,689	83.6%
	60-70	15	.2
	70-80	14	.2
	80-100	1	--
Sherburne	50-60%	5,084	80.5%
	60-70	12	.2
	70-80	37	.6
	80-90	29	.5
St. Louis	50-60%	23,880	42.0%
	60-70	1,161	2.0
	70-80	9,154	16.1
	80-90	17,505	30.8
	90-100	74	.1
Stearns	50-60%	16,115	92.7%
	60-70	58	.3
	70-80	30	.2
	80-90	24	.1

Source: County Tax Files

*Certain residential homesteads excluded. Circuit breaker returns not included.

cases the wetlands and native prairie credits may also be applied to residential homesteads. As a result of direct credits, the state pays between 50 and 60 percent of most residential homestead taxes. However, there are examples in all four counties of homesteads where the state pays over 80 percent of the gross tax.

Farm homesteads could conceivably receive all direct property tax credits, although in 1982 none did. More normally, a farm homestead's gross tax is reduced by the homestead and agricultural credits. In iron range counties, many farms are also eligible for the taconite homestead credit. As Table 25 shows, farm homesteads pay a smaller portion of their gross taxes than residential homesteads because they are eligible for both homestead and ag credits. Table 25 also shows that, in a few instances, the state is paying almost all of the gross tax on a parcel of property. Table 26 shows actual examples of how this can happen.

The wetlands credit in particular contributes to the state paying all of the gross tax. In 1982, $708,859 in wetlands credits could not be used because the property owners were already paying no tax. In other words, if there weren't a limit on the wetlands credit, the state would have paid all of the recipient's property taxes and then sent the property owners a check. The same phenomena holds true for the native prairie credit, although it is a much smaller program.

It is unclear whether the additive effect of direct property tax credits are, in all cases, an intended result of tax relief programs. Even if the additive effects are intended, it is still proper to question whether the state should be paying 80 percent or more of an individual's taxes. When the state pays such a high percentage of local property taxes, there are two bad results. First, it is inequitable for some individuals to pay little or nothing for local services. Secondly, the more widespread the phenomena, the less responsibility local officials must take for local spending decisions. Since the cost to the taxpayer of raising additional tax revenues is low, local officials have few incentives to check spending increases.

A policy option we think ought to be considered is to require each individual taxpayer to pay a minimum percentage of gross taxes. Where this percentage is set is a question for policymakers, and some adjustments could be possible for special situations. The minimum percentage also could vary with the assessed value of the property. However, the basic principle that everyone should pay at least a minimum percentage of his property tax, regardless of the unique situation, should remain intact.

TABLE 25

PERCENT OF PROPERTY TAXES PAID THROUGH DIRECT PROPERTY TAX RELIEF PROGRAMS

FARM HOMESTEADED PROPERTY*
SELECTED COUNTIES

TAXES PAYABLE 1982

County	Percent	Number of Homesteads	Percent of County Farm Homesteads
Blue Earth	50-60%	222	12.3%
	60-70	417	23.1
	70-80	12	.7
	80-90	1	.2
	90-100	3	.2
Sherburne	50-60%	57	3.2%
	60-70	1,299	73.6
	70-80	243	13.8
	80-90	45	2.5
	90-100	32	1.8
St. Louis	50-60%	41	1.5%
	60-70	748	27.5
	70-80	210	7.7
	80-90	1,585	58.3
	90-100	7	.3
Stearns	50-60%	688	17.4
	60-70	2,157	54.6
	70-80	12	.3
	80-90	1	--
	90-100	0	--

Source: County Tax Files

*Certain farm homesteads excluded. Circuit breaker refunds not included.

TABLE 26

INDIVIDUAL PARCELS WITH LOW NET TAX

SELECTED COUNTIES
FARM HOMESTEADS

TAXES PAYABLE 1982

County	Market Value	Assessed Value	Gross Tax	Ag Credit	Wetlands Credit	Taconite Homestead Credit	Homestead Credit	Net Tax	Percent State Paid Tax
Sherburne	$254,900	$17,070	$1,432	$307	$765	$0	$205	$155	89.29%
	403,500	29,762	2,291	489	818	0	570	413	82.0
	117,700	7,295	608	131	477	0	0	0	100.0
	141,500	8,076	585	145	439	0	1	0	100.0
	151,800	14,645	988	264	392	0	193	140	85.8
Blue Earth	116,237	19,385	1,581	349	216	0	580	437	72.4%
	155,283	26,804	1,877	482	837	0	310	248	86.8
	117,210	19,670	1,370	352	126	0	507	384	72.0
St. Louis	55,530	7,849	850	141	0	445	144	120	85.9%
	45,400	6,355	597	114	0	315	94	73	87.8
	72,100	10,999	847	198	0	365	160	125	85.2
	70,980	10,783	894	194	0	445	143	112	87.5

Source: County Tax Files.

D. CIRCUIT BREAKER

The circuit breaker is, after the homestead credit, Minnesota's second largest direct property tax relief program. In 1981, homeowners received $54.1 million and renters received $114.2 million from the state under this program. In 1984, according to Minnesota Department of Revenue projections, homeowners will receive $76 million and renters will receive $143 million. Benefits through the program are based on the amount of property taxes or rent paid in relation to household income. Homeowners are eligible for this program when their property taxes exceed a certain percentage of household income. This percentage ranges from 0.5 percent for incomes less than $3,000 to 4.0 percent for incomes over $100,000. Renters become eligible in the same way except that they count 23 percent of rent (excluding utilities) as property taxes.

Income-related property tax relief programs are commonly divided into two types--the threshold type and the sliding scale type. Under the threshold type formula, the credit equals property taxes in excess of a certain percentage of income up to a maximum credit amount. Under the sliding scale type formula, the credit equals a percentage of tax where the percentage declines as income increases. Minnesota's circuit breaker is a threshold type formula under which a household becomes eligible when property taxes after the homestead credit exceed a certain percentage of income. To determine the amount of circuit breaker credit, one first calculates a total credit based on gross property taxes and income, and then subtracts the homestead credit from the total credit to obtain the circuit breaker credit. If the homestead credit equals or exceeds the total credit calculated under the circuit breaker formula, the homeowner is not eligible for the circuit breaker.

The circuit breaker currently has an income limit of $33,000 for homeowners who are under 65 and not disabled because their homestead credit always equals or exceeds the total credit allowable under the circuit breaker formula. There is no income limit for senior citizens or disabled persons because their circuit breaker maximum is higher than the homestead credit maximum at all income levels.

Table 27 summarizes the threshold percentages and maximum credits by income level for the current circuit breaker. The maximums for senior citizens and the disabled are up to $200 higher than they are for other households.

TABLE 27

THRESHOLD PERCENTAGES AND MAXIMUM CREDIT AMOUNTS UNDER MINNESOTA'S CIRCUIT BREAKER

Household Income	Threshold Percent of Income	Under Age 65 and Non-Disabled		Senior Citizen or Disabled	
		First Maximum	Overall Maximum	First Maximum	Overall Maximum
Gross Loss - $ 0	.0%	$650	$1,000	$850	$1,000
$ 1 - 2,999	.5	650	1,000	850	1,000
3,000 - 3,999	.6	650	1,000	850	1,000
4,000 - 4,999	.7	650	1,000	850	1,000
5,000 - 5,999	.8	650	1,000	850	1,000
6,000 - 6,999	.9	650	1,000	850	1,000
7,000 - 7,999	1.0	650	1,000	850	1,000
8,000 - 8,999	1.1	650	1,000	850	1,000
9,000 - 9,999	1.2	650	1,000	850	1,000
10,000 - 10,999	1.3	650	1,000	850	1,000
11,000 - 11,999	1.4	650	1,000	850	1,000
12,000 - 19,999	1.5	650	1,000	850	1,000
20,000 - 20,999	1.6	650	1,000	850	1,000
21,000 - 21,999	1.6	633	975	833	992
22,000 - 22,999	1.6	617	950	817	983
23,000 - 23,999	1.8	600	925	800	975
24,000 - 24,999	1.8	583	900	783	967
25,000 - 25,999	1.8	567	875	767	958
26,000 - 26,999	2.0	550	850	750	950
27,000 - 27,999	2.0	545	820	745	930
28,000 - 28,999	2.0	540	790	740	910
29,000 - 29,999	2.0	535	760	735	890
30,000 - 30,999	2.0	530	730	730	870
31,000 - 31,999	2.2	525	700	725	850
32,000 - 32,999	2.2	520	670	720	830
33,000 - 33,999	2.2	515	640	715	810
34,000 - 34,999	2.2	510	610	710	790
35,000 - 35,999	2.2	505	580	705	770
36,000 - 40,999	2.4	500	550	700	750
41,000 - 44,999	2.6	500	550	700	750
45,000 - 52,999	2.8	500	550	700	750
53,000 - 65,999	3.0	500	550	700	750
66,000 - 81,999	3.2	500	550	700	750
82,000 - 99,999	3.5	500	550	700	750
100,000 - and Over	4.0	500	550	700	750

Source: Minnesota Department of Revenue.

To illustrate how the circuit breaker works, consider a homeowner under 65 who is not disabled and whose household income is $15,000. The threshold equals 1.5 percent of $15,000, or $225. If this homeowner's gross tax were $500, the total credit would be $275 [the difference between the gross tax ($500) and the threshold ($225)]. However, since $275 is less than the homestead credit of $290 (58 percent of $500), this homeowner would not receive a refund through the circuit breaker. Now, if the gross tax were $875 instead of $500, the total credit would be $650 ($875 minus $225). Since the homestead credit would be $508 (58 percent of $875), the circuit breaker credit would be $142 (the difference between the over-all credit and the homestead credit). Note that the total credit equals the first maximum of $650 shown in Table 27. As long as the total credit does not exceed the first maximum, it increases dollar for dollar with increases in the gross property tax. However, after the total credit reaches the first maximum, the total credit rises one dollar for every two dollar increase in gross property taxes until the total credit equals the over-all maximum. For example, if the gross property tax were $1,075, the difference between gross property taxes and the threshold would be $850 ($1,075 - $225). Since $850 is more than $650, the total credit would be $650 plus one-half of the remaining $200 ($850 - $650), or a total of $750.

1. COST HISTORY

Minnesota has had income-related property tax relief programs since 1968, but they became a major cost after the current circuit breaker began in 1976. Table 28 shows that the circuit breaker's cost has exceeded $120 million every year since 1976 and is projected to reach $200 million per year in 1983. Prior to 1976, the total annual cost of the two programs replaced by the circuit breaker never exceeded $35 million. One of the programs replaced by the circuit breaker provided property tax relief for senior citizens and the disabled based on income and taxes (or imputed taxes in the case of renters). The second program was a rent credit program for all ages but was not based on income. Costs increased in 1976 because the circuit breaker expanded coverage to homeowners under 65 and increased benefit levels for both homeowners and renters.

The total cost of the circuit breaker grew from $121.7 million in 1976 to $195.2 million in 1978 and then declined to $168.3 million in 1981. The cost increased in 1978 because of higher benefits and declined in the following three years because of large increases in the homestead credit. Circuit breaker benefits for homeowners decline when homestead credit increases because there is often a dollar for dollar substitution effect between these two programs. As a result, the benefits for homeowners fell from $123.4 million in 1978 to $54.1 million in 1981. During this same time period, the benefits for renters grew from $71.8 million in 1978 to $114.2 million in 1981 because of increases in both number of applicants and credit amounts.

TABLE 28

HISTORICAL SUMMARY OF INCOME-RELATED PROPERTY TAX RELIEF (CIRCUIT BREAKER) AND RENTER'S CREDIT
(In Millions of Dollars)

Year Payable	Income-Related Property Tax Relief (Circuit Breaker)				Renter's Credit	Total
	Homeowners Over 65/ Disabled*	Homeowners Under 65	Renters Over 65/ Disabled*	Renters Under 65		
1968	$ 0.6	$ --	$ --	$ --	$ --	$ 0.6
1969	1.6	--	0.3	--	4.2	$ 6.0
1970	2.4	--	0.4	--	5.0	$ 7.7
1971	3.2	--	0.4	--	5.7	$ 9.2
1972	7.3	--	1.4	--	12.7	$ 21.4
1973	6.8	--	1.9	--	13.3	$ 22.0
1974	7.2	--	2.9	--	21.4	$ 31.4
1975	6.8	--	3.1	--	24.1	$ 34.0
1976	33.2	50.4	12.0	26.0	--	$121.7
1977	37.9	49.3	14.0	33.0	--	$134.2
1978	43.8	79.5	22.2	49.7	--	$195.2
1979	42.6	67.3	24.5	55.6	--	$190.0
1980	36.1	51.1	29.9	69.2	--	$186.3
1981	24.7	29.4	33.1	81.0	--	$168.3
Estimated						
1982	27.5	32.0	30.6	84.6	--	$174.7
1983	31.5	37.0	33.3	100.0	--	$201.8
1984	35.2	41.0	36.2	106.9	--	$219.3

Source: Minnesota Department of Revenue, Local Government Aids and Analysis Division.

*Prior to 1973, only senior citizens were eligible for this program.

Estimates for 1982 and projections for 1983 and 1984 indicate that the cost of the circuit breaker program will reverse its recent downward trend and will grow from $168.3 million in 1981 to $219.3 million in 1984. This shift will occur because property taxes rose significantly in 1982 and are expected to continue rising in the future. Further, these projections assume that there will be no change in the homestead credit or circuit breaker programs. If the homestead credit were reduced, cost estimates for the circuit breaker would be higher.

2. PURPOSES OF THE CIRCUIT BREAKER

Three major purposes have shaped Minnesota's circuit breaker. These are:

- to make the property tax more progressive;
- to relieve high tax burdens relative to income for low and middle income households; and
- to compensate renters for tax breaks already received by homeowners through the homestead credit and income tax.

These objectives are generally consistent with each other but the circuit breaker could be designed to accomplish more of one objective at the expense of another. For example, relieving excessive tax burdens relative to income and giving more aid to renters both make the tax system more progressive. But giving less aid to renters and more aid to middle income homeowners with high taxes may be consistent with the second objective but inconsistent with the first and third objectives.

As we will show in Chapter IV, the circuit breaker effectively makes the tax system more progressive and provides aid to renters. In this section, we focus on how well the circuit breaker accomplishes the second objective, that of relieving excess property tax burdens for low and middle income households.

For all income levels over $3,000, the average statewide property tax isn't very high, amounting to less than 2.5 percent of household income. However, there is great variation in property taxes for individual homeowners at any particular income level. Property taxes vary because of differences in house value and location. In turn, house value varies because of differences in wealth, family size, and housing preferences as well as income. An underlying principle behind the circuit breaker is that at any income level, the credit should increase as property taxes increase and at any tax level, the credit should increase as income declines. We have analyzed how well the circuit breaker targets aid to those with high tax burdens in relation to income.

We found that the circuit breaker is becoming less effective because more homeowners are reaching the income limits and the maximum credit. While family incomes have increased rapidly since

the circuit breaker began in 1976, the circuit breaker's income limit for homeowners under 65 has declined from $36,000 to $33,000 because of increases in the homestead credit. Changes in the homestead credit affect who is eligible for the circuit breaker because if the homestead credit exceeds the total credit calculated under the circuit breaker formula, the homeowner is ineligible for the circuit breaker. In 1976, only high income families were over the income limit but now the median family income in the Twin Cities metropolitan area is coming close to the $33,000 income limit. As a result, many middle income homeowners will no longer receive circuit breaker refunds regardless of how high their property taxes become.

Similarly, while gross property taxes have been increasing, the circuit breaker's maximum credit has not changed since 1980. Consequently, as can be seen from Table 29, the number of homeowners at the maximum has grown rapidly from 1978 to 1982 and will continue to grow in the future under the current circuit breaker program. In the Twin Cities metropolitan area, nearly half of homeowners with incomes less than $33,000 will be at the circuit breaker maximum by 1984.

TABLE 29

HOMEOWNERS AT THE CIRCUIT BREAKER MAXIMUM
IN 1978, 1982, AND 1984

	Among Homeowners with Incomes Under $33,000*					
	Number of Homeowners at the Maximum			Percent of Homeowners at the Maximum		
	1978*	1982	1984	1978*	1982	1984
7 Metro Counties	38,710	75,840	109,840	9%	27%	47%
80 Outstate Counties	10,990	25,410	44,100	**		
State Total	49,700	101,250	153,940	**		

Source: Office of Legislative Auditor analysis of Minnesota Department of Revenue's computer file of circuit breaker returns filed in 1978.

*For 1978, includes homeowners with incomes under $36,000, which was the circuit breaker's income limit for homeowners under 65. Now, the income limit is $33,000.

**Breakdown of homeowners by income not yet available for non-metropolitan counties. Data for the seven county metropolitan area was obtained from the 1978 Annual Housing Survey.

This means that in the Twin Cities metropolitan area, the circuit breaker will soon give the same credit to homeowners who have high property taxes as it does to homeowners at the same income level who have average property taxes.

Another problem that occurs when many homeowners reach the maximum credit is that many homeowners with the same property tax will receive the same credit regardless of whether their income is $20,000 or less than $5,000. All senior citizen and disabled homeowners with incomes less than $20,000 will receive the maximum credit of $1,000 if their gross property taxes exceed $1,450. The same situation exists for homeowners under 65 if their gross taxes exceed $1,650. By 1984, many senior citizens in the Twin Cities metropolitan area will be in this situation. If gross property taxes increase by 25 percent between 1982 and 1984, all senior citizens and disabled persons who have incomes less than $20,000 and who own homes in Minneapolis or St. Paul worth more than $68,000 in 1982 will receive the same maximum credit.

These situations lead to the question: at what tax level should homeowners reach the circuit breaker's maximum credit? In the past, the level was well above the average tax in the Twin Cities metropolitan area. Soon it will be at the average tax level, and homeowners will bear the full burden of any tax above that average. Critics of the circuit breaker may argue that this is desirable because those with higher taxes tend to have more wealth and/or receive more services and thus do not deserve more credit.

Supporters of the circuit breaker may argue that high taxes may reflect larger families, preferences for housing instead of other goods, or inequities in assessment practices and community tax rates. As a result, they would argue that homeowners with high taxes deserve more credit than homeowners with average taxes.

To determine whether the circuit breaker should target more credit to homeowners with high taxes, one must answer questions such as: how much higher should taxes be on a $95,000 house compared to a $75,000 house when each homeowner has the same income? Table 30 shows how property tax burden varies with income and house value in four cities in Hennepin county for property taxes payable in 1982 and projected taxes payable in 1984. The four cities include two with tax rates higher than the metropolitan average (Robbinsdale and Minneapolis), one with a tax rate near the median for the metropolitan area (Bloomington), and one with a below average tax rate (Edina).[1]

---

[1]These rankings are based on Citizens League estimates of 1982 property taxes paid on a $75,000 house in 96 metropolitan communities. See CL News, (Minneapolis, MN: Citizens League), March 30, 1982.

TABLE 30

PROPERTY TAX BURDEN BY INCOME AND HOME VALUE FOR SELECTED CITIES

Income		Net Tax After Circuit Breaker — Home Values 55,000	75,000	95,000	115,000	Net Tax As Percent of Income — Home Values 55,000	75,000	95,000	115,000
				1982 (Estimated)					
$10,000	Robbinsdale	$230	$474	$1,007	$1,546	2.3%	4.7%	10.1%	15.5%
	Minneapolis	181	398	804	1,292	1.8	4.0	8.0	12.9
	Bloomington	152	355	685	1,139	1.5	3.6	6.9	11.4
	Edina	130	294	516	925	1.3	2.9	5.2	9.3
25,000	Robbinsdale	412	676	1,132	1,671	1.6	2.7	4.5	6.7
	Minneapolis	371	599	929	1,417	1.5	2.4	3.7	5.7
	Bloomington	346	557	810	1,264	1.4	2.2	3.2	5.1
	Edina	311	465	699	1,050	1.2	1.9	2.8	4.2
35,000	Robbinsdale	412	819	1,357	1,896	1.2	2.3	3.9	5.4
	Minneapolis	371	666	1,154	1,642	1.1	1.9	3.3	4.7
	Bloomington	346	581	1,035	1,489	1.0	1.7	3.0	4.3
	Edina	311	465	866	1,275	0.9	1.3	2.5	3.6
				1984 (Estimated)					
11,400	Robbinsdale	$367	$836	$1,509	$2,183	3.2%	7.3%	13.2%	19.1%
	Minneapolis	307	645	1,255	1,865	2.7	5.7	11.0	16.4
	Bloomington	270	539	1,106	1,674	2.4	4.7	9.7	14.7
	Edina	219	447	895	1,406	1.9	3.9	7.9	12.3
28,500	Robbinsdale	575	1,046	1,719	2,393	2.0	3.7	6.0	8.4
	Minneapolis	464	855	1,465	2,075	1.6	3.0	5.1	7.3
	Bloomington	433	784	1,316	1,884	1.5	2.8	4.6	6.6
	Edina	389	707	1,105	1,616	1.4	2.5	3.9	5.7
39,900	Robbinsdale	575	1,186	1,859	2,533	1.4	3.0	4.7	6.3
	Minneapolis	464	995	1,605	2,215	1.2	2.5	4.0	5.6
	Bloomington	433	889	1,456	2,024	1.1	2.2	3.6	5.1
	Edina	389	733	1,245	1,756	1.0	1.8	3.1	4.4

1982 Assumptions:

1. To estimate the value the assessor would place on the house, we adjusted the above house values by the 1980-81 assessment-sales ratios.
2. We used 1982 tax laws and actual 1982 tax rates.

1984 Assumptions:

1. Gross property taxes would increase by 25 percent between 1982 and 1984.
2. Income would increase by 14 percent.
3. The homestead credit and circuit breaker programs would not change.

At each income level and in all four metropolitan cities, homeowners pay at least 50 percent more property taxes on a $75,000 home than they pay on a $55,000 home and they pay at least 50 percent more taxes on a $95,000 home than they pay on a $75,000 home. Taxes rise rapidly as home values increase for three reasons. First, under Minnesota's classification structure, the portion of a home's estimated market value above $54,000 is taxed at a substantially higher rate than the initial $54,000. Second, houses in the metropolitan area generally reach the maximum homestead credit at values between $55,000 and $75,000. Finally, houses in the Twin Cities metropolitan area often reach the first circuit breaker maximum when their value is near $55,000 and reach the over-all maximum between $75,000 and $95,000.

Further, under current property tax relief programs, these differences will become larger in the future. For example, in 1982, Minneapolis homeowners who are under 65 and earn $25,000 pay a tax of $599 on a $75,000 home and $929 on a $95,000 home, a difference of $330, or 55 percent. Thus, the difference in taxes between these two homes is already large, and will become larger as taxes increase, because the $75,000 home is not at the maximum in 1982 but the $95,000 home is at the maximum circuit breaker credit. If gross property taxes increase by 25 percent and income increases by 14 percent, the taxes on the $75,000 home will grow by 43 percent compared to 58 percent on the $95,000 home. As a result, the homeowner would pay a tax of $855 on the $75,000 house and $1,465 on the $95,000 house, a difference of $610, or 71 percent.

3. CRITICISMS OF THE CIRCUIT BREAKER

In the previous section we concluded that the circuit breaker successfully achieves most of its objectives. Although it is becoming less effective at relieving high tax burdens, this problem can be avoided by adjusting the circuit breaker's design. Even though the circuit breaker may meet its objectives, critics claim that it creates undesirable side effects and new inequities. Steven Gold, economist for the National Conference of State Legislatures, summarizes criticisms of the circuit breaker in his book, Property Tax Relief.[1] These criticisms include the following:

- The circuit breaker creates an incentive for some local governments to spend excessively.
- At any income level, the circuit breaker gives the most credit to homeowners with the greatest property wealth.
- In some situations, the circuit breaker is inconsistent with the principle that taxes should be related to benefits received.

---

[1]Steven D. Gold, Property Tax Relief (Lexington, Mass.: D.C. Heath and Company, 1979), pp. 55-72.

- A rebate system should not be based on a single housing expense such as the property tax when there are other more significant housing expenditures which could be included.

- The circuit breaker should not give more credit to senior citizens than it gives to other homeowners with the same income and taxes.

In this section, we review these criticisms in light of Minnesota's current circuit breaker. In the following section, we examine policy alternatives, such as the sliding-scale formula, which reduce the magnitude of some of these problems.

One criticism of property tax relief in general and the circuit breaker in particular is that it makes local governments less accountable for their spending decisions and thus may lead to excessive spending. Under the current circuit breaker, when property taxes exceed a certain percentage of household income, the circuit breaker will fully reimburse the homeowner for future tax increases up to a maximum credit. For example, a homeowner with an income of $10,000 pays a tax of $130 if the gross tax is between $310 and $780 (between $310 and $980 for elderly and disabled homeowners). Thus, local governments could enact large tax increases without affecting some homeowners.

There is some evidence, though not conclusive, that the circuit breaker in Michigan may have affected elections on local spending issues.[1] This may be an important consideration if many areas in Minnesota have a large percentage of homeowners who would be fully reimbursed for future tax increases. In order to estimate how many homeowners would be fully reimbursed for tax increases, we analyzed a 10 percent sample of circuit breaker returns.

We estimate that in 1982, the circuit breaker reimburses 100 percent of a property tax increase for 8 percent of homeowners in the Twin Cities metropolitan area and for 18 percent of outstate homeowners. The amount by which the gross property tax could be increased without affecting the tax actually paid by these homeowners varies from $1 to nearly $850, depending on how close they are to the maximum credit.

We also estimated the number of homeowners who would be fully reimbursed for property tax increases in 1978 and 1984. As shown in Table 31, this number has declined since 1978 and will continue to decline in the future if no changes are made in the circuit breaker and homestead credit. This decline has occurred because fewer homeowners are eligible now than in the past and because more homeowners reach the maximum when gross property taxes increase. But if the homestead credit were substantially reduced, more homeowners would be eligible for the circuit breaker and the number of homeowners who would be fully reimbursed for a property tax increase could rise substantially.

---

[1] Gold, Property Tax Relief, p. 65.

TABLE 31

HOMEOWNERS FULLY REIMBURSED BY THE CIRCUIT BREAKER FOR A PROPERTY TAX INCREASE

	Number of Homeowners (1978)	Number of Homeowners Fully Reimbursed			Percent of Homeowners Fully Reimbursed		
		1978	1982	1984	1978	1982	1984
7 Metro Counties	433,000	71,000	33,000	18,000	16%	8%	4%
80 Outstate Counties	566,000	153,000	103,000	84,000	27	18	15
State Total	999,000	224,000	136,000	102,000	22%	14%	10%

Source: Office of Legislative Auditor analysis of Minnesota Department of Revenue's computer file of circuit breaker returns filed in 1978.

Henry Aaron, economist at the Brookings Institution, criticizes the circuit breaker because at any income level, homeowners with the greatest wealth receive the most credit.[1] This occurs because homeowners with the most wealth tend to have more expensive homes and pay higher taxes and because the circuit breaker increases credit as taxes rise. This is a weakness of the circuit breaker as well as other property tax relief programs which relate credits to taxes. This argument especially applies to situations where the circuit breaker refunds all taxes in excess of a certain percentage of income. For homeowners in this situation, differences in wealth have no affect on property taxes. One can also argue that the circuit breaker is inequitable when taxes are not related to services received. Persons who have the same income and who own homes of the same value can pay the same taxes because of the circuit breaker even if their communities provide different levels of services.

The Advisory Commission on Intergovernmental Relations argues that 100 percent of property tax increases should be rebated because it removes inequities in the property tax arising from fiscal tax disparities and from faulty assessment practices.[2] However, many analysts counter that aid to local governments is the best way to deal

[1] Henry Aaron, Who Pays the Property Tax? A New View. (Washington, D.C.: The Brookings Institutition, 1975).

[2] Advisory Commission on Intergovernmental Relations, Property Tax Circuit Breakers: Current Status and Policy Issues (Washington, D.C.: 1975), p. 10.

with these property tax inequities.[1] This approach not only avoids undesirable side effects but also is more comprehensive since it covers property taxes on all types of property. The problem with direct property tax relief programs is that they cannot easily separate the desirable effects of the property tax from the undesirable effects. For example, including net worth in the circuit breaker's credit formula may be impractical because net worth is difficult to measure and verify.

These conflicting objectives lead to the question: How should the circuit breaker balance these desirable and undesirable effects of the property tax? While this is a difficult question to answer, there appears to be little reason for the credit rate structure of Minnesota's circuit breaker. The term "credit rate" refers to the proportion of a tax increase rebated by the circuit breaker to the homeowner. Under Minnesota's circuit breaker, the credit rate equals 100 percent prior to the first maximum, 50 percent between the first and second maximum, and 0 percent thereafter. Nearly two-thirds of homeowners who are eligible for the circuit breaker are either at one extreme of 100 percent or the other extreme of 0 percent. Reducing the number of homeowners at these extremes would make the circuit breaker more equitable.

Aaron also criticizes the circuit breaker because there is no compelling reason to build a rebate system around a single expense such as the property tax.[2] The property tax is one of many housing expenses which may be a heavy burden for a family's income. Many homeowners may have high housing expenses because of high interest rates and home prices even if their property taxes are low. Other homeowners who bought their home when interest rates and housing prices were low may have low total housing expenses even though their property taxes are high.

Yet, for families with the same income, the circuit breaker will give more credit to homeowners with high property taxes and low total housing expenses than to homeowners with low property taxes and high total housing expenses.

Another criticism of the circuit breaker is that it gives more credit to the elderly than to other homeowners with the same taxes and incomes. Under Minnesota's circuit breaker, the maximum credit for the elderly is up to $200 higher than it is for the non-elderly. The difference in the over-all maximum becomes smaller for low income households.

The property tax can be especially burdensome for the elderly because they tend to have high taxes and low incomes. But under programs which take income and tax load into account, the

---

[1]Gold, Property Tax Relief, p. 64 and, George E. Peterson, Ed., Property Tax Reform (Washington, D.C.: The Urban Institute, 1973), and, Citizen's League, Reducing Property Tax Inequities Among Taxpayers and Cities, 1975.

[2]Aaron, Who Pays the Property Tax? A New View.

issue is not whether the elderly deserve tax relief, but whether the elderly deserve special treatment beyond what their income and tax situations would lead to. A burden peculiar to the elderly is the sudden drop in income that many experience at retirement. Since property taxes tend to keep rising, the elderly face either a difficult cash flow problem if they remain in their homes or the stress that can occur if they must give up their homes. These problems, however, should be weighed against the financial advantages which the elderly enjoy over the non-elderly at the same income level. Special programs for the elderly include Medicare and a double exemption on the income tax. Furthermore, the elderly tend to have fewer dependents and higher net worth than do younger families. The arguments in favor of special treatment of the elderly apply primarily to low income elderly homeowners. As a result, there appears to be no justification for giving middle and high income elderly significantly higher maximums.

4. POLICY ALTERNATIVES

Many of the problems with the circuit breaker can be eliminated or reduced by changing the design of the circuit breaker. Alternatives listed below are divided into those that raise costs and those that reduce costs. These alternatives keep the current threshold approach of the circuit breaker. Another alternative is to change the threshold formula to a sliding scale formula. This alternative could cost more or less than the current circuit breaker, depending on the specific design chosen.

Options which increase costs:

- Raise the circuit breaker's maximum credit amounts.
- Increase the circuit breaker's income brackets.

Options which reduce costs:

- Reduce the circuit breaker's 100 percent credit rate.

Options which can either increase or decrease cost:

- Change to a sliding scale formula.

The options which increase the maximum credit and/or reduce credit rates will reduce the number of homeowners who are at the circuit breaker maximum credit and thus more effectively target property tax relief to homeowners with high taxes relative to income. In addition, raising the maximum can increase the income limit for homeowners who are under 65 by setting the circuit breaker's over-all maximum higher than the homestead credit maximum. Currently, homeowners who are under 65 and earn more than $33,000 are not eligible because the homestead credit maximum is higher than the circuit breaker maximum in this income range.

Increasing income brackets can ensure that middle income homeowners do not become ineligible simply because their incomes have increased with inflation. This will help maintain tax differences between middle and high income homeowners. However, by itself, it will not help resolve the problems caused by too many people reaching the maximum.

While all three of these options can improve the circuit breaker, reducing the circuit breaker's 100 percent credit rate has several advantages over the other two. First, it reduces costs whereas the other two options increase costs. These cost savings can be used to also raise the maximums and/or to increase the income brackets.

In addition, reducing the 100 percent credit rate ensures that homeowners pay at least a part of any property tax increase and thus may reduce the incentive for local governments to spend excessively. Because of this change, the circuit breaker would also more uniformly relate property taxes to wealth and level of local services. These improvements would be especially important if the Legislature substantially lowered either the homestead credit's $650 maximum or its 58 percent credit rate because many homeowners would become eligible for the circuit breaker and would receive 100 percent rebates on future property tax increases.

One possible disadvantage of reducing the credit rate is that some homeowners will lose benefits. At a time when property taxes are rising rapidly, this may appear to place an unacceptable burden on these taxpayers. However, the homeowners who would lose the most benefits from this change are those for whom the circuit breaker now rebates 100 percent of a property tax increase. By reducing benefits for these homeowners and raising benefits for homeowners at the maximum, tax increases can be distributed more evenly than they would be under the current circuit breaker.

We conclude that adopting all three of the above options will improve the effectiveness of the circuit breaker without necessarily increasing costs. If funds are not sufficient to maintain the current circuit breaker program, reducing the 100 percent credit rate appears to be the most effective alternative. Another option which can have similar advantages as the options discussed above is the sliding scale formula. Since this formula replaces the 100 percent credit rate with variable rates depending on income, it avoids problems caused by the 100 percent credit rate. How well it targets property tax relief to homeowners with high taxes depends on its specific maximums, credit rates, and income limits.

A criticism of the sliding scale circuit breaker is that it gives more credit to homeowners with low taxes and thus either is more expensive than the threshold approach or gives less credit to homeowners with high property taxes.[1] In Minnesota, this criticism is not as valid as it is in other states because Minnesota also has a

[1]Gold, Property Tax Relief, pp. 64-65.

homestead credit which gives credit to homeowners with low taxes. In fact, if the homestead credit and circuit breaker were replaced by a comprehensive sliding scale credit program, less credit would go to high income homeowners with low taxes and more funds would be available for homeowners with high taxes. Further, such a sliding scale program would maintain the relation between income and credit for homeowners with low taxes as well as for homeowners with high taxes. Under the current circuit breaker and homestead credit, many homeowners are not eligible for the circuit breaker because their taxes are not high enough, and thus they receive a credit equal to 58 percent of gross property taxes regardless of income.

E. ADMINISTRATION OF THE CIRCUIT BREAKER FOR RENTERS (THE RENTER'S CREDIT)

A major problem with the circuit breaker program for renters is that the information requested to determine the tax refund is subject to easy manipulation. This is especially true for information documenting the rental contract between the claimant and the landlord. The auditability of this information is also seriously restricted because of limited accessability to non-taxable income data and cost inefficiencies associated with verifying rent paid.

In order to qualify for a renter's property tax refund, claimants must have been full or part-year residents of Minnesota during the respective tax year and must have leased or rented the unit in which they resided during that year. The unit in which the claimants lived must also have been subject to property taxes or payments "in lieu" of property taxes.

If a rental unit is occupied by two qualified married individuals, only one claim per household is allowed. If the unit is rented by two or more unrelated individuals, then each must file a separate claim with the rent divided equally between them. Their individual household incomes are then used to determine individual refund amounts.

To receive a renter's property tax refund, a claimant completes a Minnesota property tax refund return (M-1PR) providing total household income and rent paid for the given tax year. The claimant must also attach a certificate of rent paid (CRP) which is intended to document both the total rent for occupancy and other relevant information such as the number of occupants living in the unit, whether utilities are included in the rent, the rental period, and whether property taxes were paid. Given the nature of the information requested and the system by which it is reported, serious problems are presented which restrict and often prohibit effective auditability of individual claims.

In providing total household income, claimants are required to report not only their federal adjusted gross income but also non-taxable income from such sources as social security, unemployment

and workers' compensation and public assistance.[1] The major problem is that documentation of non-taxable income is not required, nor is it readily available from either the recipient or from the provider. Thus, unlike reporting income for income tax purposes which is verified by such documents as W-2 forms provided by both the taxpayer and the respective employer, the state is severely restricted in being able to verify the non-taxable income amounts as reported.

In order to systematically verify household income for all claims, the state would have to conduct computer matches which would compare the claimant's reported income with records maintained by other state and federal agencies. This method, however, can be very costly and technically difficult and for some income sources such as public assistance payments and social security benefits, access to the information is either denied or severely restricted by data privacy laws. As a result, the accuracy and truthfulness of a claimant's reported or unreported household income is unverifiable.

Claimants are required to document their rent by submitting a certificate of rent paid (CRP), completed by their landlord(s), indicating the amount of rent they paid and the number of tenants occupying the unit. The CRP is subject to manipulation by both the renter and the landlord, the relationship between which can often be quite precarious. For example, the system is dependent upon a landlord's willingness to cooperate with the law by making CRP's readily available to all tenants and not cheat the system by providing favors to occupants.

The system also assumes that every landlord in the state maintains accurate records on all their rental units and respective tenants so that information documenting rent paid, rent value of furnishings, charges paid for utilities, charges paid for other items or services, and number of tenants per unit can be accurately provided. It might be asking too much of the system to assume that all landlords can accurately maintain such information.[2]

Other than responding to demands by tenants, the system provides little incentive to the landlord to accurately and faithfully administer the CRP. Although Minnesota law requires landlords to provide a CRP to each of their renters, the penalty for not doing so amounts to only $20 for each failure to act (M.S. 290A.19). Because the penalty is so low, it is not cost effective for the state to enforce

---

[1]Total household income includes: federal adjusted gross income; workers' compensation, unemployment compensation payments, public assistance, social security and deducted amounts for Medicare; veterans and disability payments; railroad retirement payments and all other pension and annuity payments; non-taxable interest; dividends exclusion and capital gains deductions.

[2]For example, it may be difficult for a landlord to keep track of the number of occupants per unit if he manages several buildings in different locations, or if the landlord manages a rather large low-income complex where it is not uncommon to discover families doubling up in single residential units in order to reduce costs.

the provision, especially in cases involving only a few tenants per landlord. Furthermore, even if a CRP is submitted with the M-1PR, there are no guarantees that the landlord provided the information. The fact is the CRP could easily be completed by the claimant and signed by the landlord or by a friend.

Furthermore, a claimant is even permitted to complete and file a rent paid affidavit in lieu of a CRP. Although the incidence of rent paid affidavits being filed is relatively low (approximately 1 percent in 1981), in such cases and to the extent the information appears to be reasonable, the state is placing full faith and trust in the claimant in providing accurate and truthful information pertaining to both rent paid and non-taxable income.

It is far more beneficial to a claimant to manipulate rent paid than to omit income. For example, a $109 addition to rent will change the refund bracket increasing the refund by usually $25. However, it requires a $500 omission in income to affect the refund bracket resulting in a much smaller refund differential (approximately $6 to $11).

Not only does the CRP represent an unreliable tool to document rent paid, it is virtually impossible to systematically verify the information in a cost effective manner. For example, verification of reported rent on the CRP might require a computerized match with the landlord's reported rental income on his federal or state income tax return, or it may require extensive individual audits. These methods, however, would be either technically difficult, if not impossible, or hard to justify on the basis of costs and benefits. This is especially true when the average refund amount is approximately $273 per claim (tax year 1980, payable 1981). As a result, unless there are inconsistencies, omissions or exaggeration of rent, the CRP is generally accepted.

Currently, the Department of Revenue reviews all claims for property tax relief including M-1PR refunds for renters. Reviews made during the processing phase are designed primarily to uncover internal problems such as omissions, mathematical correctness, and consistency.[1] Based upon this review, claims which have problems or appear to be suspicious are selected for further scrutiny.[2] These claimants are then usually subject to having either to respond to letters seeking clarification, or to becoming subjects of individual audits (both the renter and landlord may be audited).

---

[1]For example: is the form signed by the claimant; is the CRP attached and completed correctly; does the information on the CRP match with what is reported on the M-1PR, etc.

[2]For example: several claims having identical income and rent amounts warrant suspicion; if the claimant does not report federal gross income, this may be a serious omission; and if rent seems too high relative to reported income, this may also be cause for further evaluation.

Prior to sending out refunds, a computer match, based on social security numbers is also performed against all other property tax relief and income tax refund claims. This is done in order to identify individuals receiving more than one refund. These claims are then more closely evaluated and reasons sought as to why multiple claims have been made.

As indicated earlier, efforts to verify information on all claims is limited. Specifically, because of data privacy laws, the Department of Revenue is not able to gain access, for purposes of verification, to information on a claimant's reported income, or lack of income, from: welfare and Medicare; social security; workers' compensation; veterans and disability benefits; railroad retirement payments; and other pension and annuity payments.

However, the Department of Revenue does attempt to verify income items which appear on federally maintained data files such as federal gross income, dividends exclusions, and capital gains.[1] In addition, since the Department of Revenue recently acquired authorization to access data maintained by the Department of Economic Security, it is also developing the capacity to verify unemployment compensation.[2]

In effect, current review and audit efforts by the Department of Revenue is limited for two reasons; first, to conduct a more extensive systematic audit of both reported income and rent would probably not be cost effective, and second, data privacy laws and technical difficulties restrict or prohibit accessibility to most non-taxable income information. As a result, unless there were obvious problems with the completion of the forms, many types of improprieties may exist which would be very difficult to discover. For example, many types of situations, such as those listed below could exist and easily "slip" through the current review and audit system.

- Welfare income could be excluded from household income when it should have been reported.

- Two or more unrelated individuals renting the same unit could arrange for only one person, based on a single income, to collect the refund--with either a rent paid affidavit filed in lieu of a CRP or the CRP improperly administered by the landlord.

---

[1]The purpose of this match is to determine if the federal gross income reported on the M-1PR is consistent to that reported on both state and federal income tax returns. However, this method has some limitations because there are several legitimate reasons as to why the income amounts would differ. For example, a claimant may have been only a part-year resident of the state, recently married or divorced.

[2]See Minn. Stat. §268.12, Subd. 12.

- The rental property may not have been subject to property taxes, although the CRP indicated that property taxes were paid.

- A college student under the age of 21 could be renting but claimed as a dependent by his/her parents.

- The tenant could be related to the landlord and as a result, no legitimate rent transaction actually occurred.

It could be argued that the above examples represent exceptions to the rule and may only represent a small proportion of all claims made. However, common sense would indicate that these types of situations in all likelihood are not that unusual. In fact, there is evidence to suggest that these types of problems and others may be more prevalent than previously suspected.

In order to estimate the potential cost to the state of misrepresentations made by renters on their rent credit forms, our office conducted an extensive audit on a random sample of 560 claims. Projecting the results of this sample to the population of all claims, we estimate that in 1981 the state should have paid $104.5 million in renter's property tax relief as opposed to the $118.7 million actually paid.[1] This represents a potential cost of approximately $14 million attributed to claims that should have been adjusted downward or denied.

It should be emphasized, however, that the purpose of our study was only to estimate total potential costs to the state and not to demonstrate audit procedures that could be effectively used to recover those costs. In fact, based upon the audit we performed on the random sample of 560 claims, the potential audit recovery would not have been cost beneficial. We do not feel, however, that our costs can be projected to the population because of certain fixed start-up costs and the unknown factor of how efficiently the audit could be conducted if it were done on a large scale. For the Department of Revenue to recover these overpayments would require enabling legislation and an analysis of efficiency and effectiveness of a large scale recovery effort.

---

[1]The projection of our sample results indicates that there is a 95 percent probability that the true value of this number lies in the range of $104,463,378 ± $6,165,680 as opposed to the actual renter's property tax relief paid of $118,720,265. Conversely, one can conclude from our sample results that there is a 95 percent probability that renter's property tax relief has been overpaid by $14,256,887 ± $6,165,680. It should also be noted that our sample was selected from calendar 1980 M1PR returns filed in 1981. We included in the population all returns where the taxpayer had checked the renter category, including renters who may also have been disabled, senior citizens or partial-year homeowners as well. The summation of renter's property tax relief paid to this category of filers was $118,720,265.

Finally, it should also be noted that the Department of Revenue has uncovered a limited number of illegal or fraudulent cases. However, the emphasis is placed on prosecuting only large-scale or organized fraud. Isolated incidents or claims of low value, if identified for improprieties, are usually not prosecuted. Rather, the claims are merely adjusted accordingly or denied.

IV. PROPERTY TAX AND INCOME

The property tax is often criticized because it places a disproportionate burden on low and moderate income persons. How a tax is distributed among different income groups is commonly described in terms of whether a tax is progressive, proportional, or regressive. A tax is progressive if high income persons pay a larger percentage of their income than low income persons pay. A tax is proportional if all income groups pay the same percentage of their income and it is regressive if high income persons pay a smaller percentage of their income than low income persons pay. One major purpose of property tax relief programs is to make the tax system more progressive by shifting taxes from the property tax to other more progressive taxes or by targeting aid directly to people with high tax burdens relative to their income. However, many economists question whether the property tax is as regressive as has been previously assumed. In this chapter, we briefly review what the literature says about who pays the property tax and examine the relationship between income and residential property taxes in Minnesota. We also examine how this relationship changes over time as property taxes increase. Finally, because property tax relief means increases in other taxes, we address how property tax relief programs affect Minnesota's tax system as a whole.

A. LITERATURE REVIEW

The traditional view that the property tax is highly regressive is based on the assumption that owners of businesses and apartments shift most of the property taxes to consumers and renters. Under this view, only the tax on land is absorbed by the owner of rental and commercial property. Homeowners pay the entire tax since they cannot shift the tax to other persons. Since consumption of housing and consumer goods make up a larger proportion of income for low income households than it does for high income households, the property tax is viewed as regressive.

During the 1970s, new studies came forth to argue that the property tax is not regressive. They conclude that property taxes reduce the rate of return on capital and as a result, most of the property tax is borne by the owners of capital. Since capital ownership is highly concentrated in high income households, the tax is viewed as progressive. Henry Aaron, economist at the Brookings Institution, pulled the new view together in his book, Who Pays The Property Tax? A New View.[1] Aaron argues that empirical studies which support the old view are biased in favor of regressive outcomes because they use annual income instead of permanent income. Aaron demonstrates that one year's income will often be a misleading indicator

[1] Henry Aaron, Who Pays the Property Tax? A New View. (Washington D.C.: The Brookings Institution, 1975).

of the household's financial condition and that income over an extended time period is a better predictor of consumption, particularly housing consumption. If this is the case, property taxes will be more progressive when income is measured over several years instead of one year. There is now a sizable body of literature that generally agrees that the property tax[1] is not as regressive as previously thought under the old view.

Several economists do not entirely accept the new view, however, particularly the claim that tax on residential property is progressive. Netzer points out that there is little empirical support for many of Aaron's theoretical arguments.[2] For rental property, the key factors are what proportion of the property tax is shifted to renters and what is the relationship between the renter's income and taxes attributable to the renter's unit. There is a lack of reliable empirical data on both of these questions. Netzer and Peterson argue that in a highly complex property tax system, many local conditions affect whether the tax is progressive or regressive and extensive empirical analysis is required before one can accurately estimate who pays the property tax.[3] As for Aaron's argument on permanent income, Netzer concedes that using permanent income may make the property tax less regressive but counters that (1) by itself, it is not significant enough to make a tax on housing consumption progressive and (2) current income may be a better indicator of ability to pay.[4]

In summary, there is consensus in the economics literature that the property tax is not as regressive as was portrayed under the old view, but doubt remains as to whether the over-all effect is progressive or regressive. The residential portion of the property tax is generally considered to be more regressive than the business portion of the tax.

---

[1]Steven D. Gold, Property Tax Relief, (Lexington, Mass.: D.C. Heath and Company, 1979). Dick Netzer, "The Incidence of the Property Tax Revisited," National Tax Journal, (December, 1973), pp. 515-535, Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, (New York: McGraw-Hill, 1976). Edgar K. Browning and Jacquelene M. Browning, Public Finance and the Price System, (New York: Macmillan Publishing Co., Inc., 1979). Harvey E. Brazer, George E. Peterson, et al., "The Property Tax: Progressive or Regressive?", American Economic Review Papers and Proceedings, 64, (May, 1974) pp. 230-235.

[2]Netzer, Ibid.

[3]Netzer, Ibid; Peterson, Ibid.

[4]Netzer, Ibid.

B. INCIDENCE OF THE RESIDENTIAL PROPERTY TAX

In this section, we examine the incidence of residential property taxes in Minnesota and how it is affected by direct property tax relief programs. In this discussion, the incidence of a tax refers to how the tax is distributed among different income groups.

The economic literature raises numerous questions about the validity of available data on property taxes and income. As a result, it is not possible to measure accurately the incidence of the property tax as a whole. Even so, it is useful to examine data on residential property taxes and income in Minnesota because the tax on residential property is often considered to be the most regressive and objectionable part of the property tax.

To look at the relationship between income and property taxes in Minnesota, we developed a data base from Minnesota Department of Revenue computerized files of circuit breaker returns and income tax returns. We matched circuit breaker returns filed in 1978 with income tax returns for tax years 1975 through 1978. We used circuit breaker returns filed in 1978 because more homeowners filed in that year than any other year. In fact, due to increases in the homestead credit and increased income in relation to property taxes, nearly twice as many homeowners filed in 1978 compared to 1981. Based on actual and projected changes in property taxes and family income, we estimated the incidence of the property tax in 1982 and 1984 under the current property tax relief programs and under some alternative programs.

This data has several advantages over other published data on income and property taxes. First, the property tax data from circuit breaker returns is documented by property tax statements sent by counties to individual homeowners, and thus is more reliable than self-reported data used by most other studies. Second, we used four years of income data (1975 through 1978) whereas most studies use only one year's income. Consequently, we could test whether the property tax on homes remains regressive when measured over several years of income.

Finally, this data enables us to estimate how Minnesota's property tax relief programs affect the incidence of the residential property tax now and in the near future. Based on actual and projected changes in property taxes and family income since 1978, we estimated the incidence of the property tax in 1982 and 1984 under the current property tax relief programs and under some alternative homestead credit programs. This can not be done with existing studies on property taxes and income. Existing studies conducted nationally or in other states are inadequate because Minnesota's property tax system differs greatly from systems in other states. The last comprehensive study on property taxes and income in Minnesota was conducted by Hatfield in 1969 and thus does not reflect the major

changes in Minnesota's property tax that took place during the 1970s.[1] Each year, the Minnesota Department of Revenue publishes circuit breaker refund data, but the most current data are inadequate because of the large decline in homeowner applicants. Further, published data from previous years are inadequate because they are based on old versions of the homestead credit and circuit breaker programs.

While this data source has many advantages, there is one important limitation. Since the data source includes only persons who applied for the circuit breaker refund in 1978, it excludes homeowners with high incomes or very low property taxes. To estimate how much this will affect our results, we estimated the percentage of homeowners within different income brackets who applied for a circuit breaker refund in 1978 by comparing circuit breaker data with census data and income tax data. We found that the percentage of homeowners who applied for a circuit breaker refund ranged from about 80 percent at low incomes, to about 60 percent at middle incomes, and then rapidly dropped after incomes rose above $26,000 in 1977 (equivalent to about $38,000 in 1981). If we assume that most of these non-filers were not eligible for the circuit breaker because they had very low property taxes, the property tax will be somewhat more regressive than indicated.

Our analysis of income and property tax data analyzed under the old view of property tax incidence indicates that Minnesota's property tax relief programs make the residential property tax nearly proportional for homeowners and slightly progressive for renters. The use of the old view of property tax incidence tends to make the property tax appear more regressive than it really is.

1. PROPERTY TAX ON HOMES

Table 32 shows the relationship between income and property taxes before and after the homestead credit and the circuit breaker credit. Gross property taxes as a percent of household income significantly increases as income decreases, particularly in the low income range. Average gross property taxes exceed 10 percent of income for homeowners with incomes less than $10,000, but are less than 5 percent of income for homeowners with incomes over $30,000.

The relationship between gross taxes and income is only slightly less regressive when one uses four years' average income instead of one year's income. This indicates that the regressiveness of the tax for homeowners is not removed by the time interval used to measure income. Arguably, four years of income does not always reflect a homeowner's permanent income. For example, the value of the elderly's homes probably more closely reflects their pre-retirement income rather than their post-retirement income. But, the regressive relationship between income and gross property taxes persists for homeowners under 65 as well as for homeowners over 65.

---

[1] Rolland F. Hatfield, Report to Governor's Minnesota Property Tax Study Advisory Committee, November 1970.

TABLE 32

1982 PROPERTY TAXES ON HOMES BEFORE AND AFTER HOMESTEAD CREDIT AND CIRCUIT BREAKER CREDIT

	1 Year Income		4 Year Average Income								
			Tax as Percent of Income						Percent Reduction		
Income	Number of Homeowners	Gross Tax as Percent of Income	Number of Homeowners	Gross Tax	Net Tax Before Circuit Breaker	Net Tax After Circuit Breaker	Average Gross Tax	Average Net Tax	Total	Due To Homestead Credit	Due To Circuit Breaker
$ 0-$3000	11,710	75.72%	9,800	64.67%	33.57%	16.15%	$ 681	$ 153	77.48%	49.54%	27.94%
3000- 5000	28,700	14.64	27,310	14.35	6.77	2.53	581	103	82.24	52.73	29.51
5000-10000	85,930	10.64	81,810	10.52	5.17	2.62	771	196	74.53	50.74	23.79
10000-15000	80,110	7.84	76,070	7.75	3.97	2.59	956	322	66.33	48.78	17.55
15000-20000	73,380	6.46	75,000	6.30	3.32	2.45	1,100	430	60.93	47.22	13.71
20000-25000	77,500	5.63	79,140	5.55	2.99	2.45	1,247	552	55.74	46.01	9.73
25000-30000	76,830	5.14	81,340	5.05	2.83	2.54	1,388	700	49.57	43.99	5.58
30000-35000	61,930	4.86	63,840	4.84	2.88	2.76	1,584	897	43.36	41.01	2.35
35000-40000	41,290	4.73	43,170	4.69	2.96	2.92	1,745	1,087	37.68	36.81	0.87
40000-45000	24,480	4.54	24,480	4.50	2.99	2.97	1,914	1,262	34.06	33.65	0.41
$45000-50000	12,220	4.58	12,200	4.54	3.18	3.17	2,157	1,505	30.23	29.92	0.31

SOURCE: Analysis of Department of Revenue computer files of income tax returns and circuit breaker returns. Office of Legislative Auditor.

NOTES: The data in this table includes only homeowners who filed for a circuit breaker refund in 1978. As a result, the actual average tax amounts are less than those shown above.

Income includes taxable and non-taxable household income as defined under the circuit breaker program.

Both the homestead credit and the circuit breaker reduce the regressiveness of the property tax on homes, making taxes nearly proportional to income over a wide income range. Net taxes are slightly regressive between $3,000 and $25,000 of income; slightly progressive between $25,000 and $40,000. If homeowners who do not apply for circuit breaker refunds because their property taxes are too low were included, we estimate that the property tax would be more regressive than shown in Table 32 but would still be nearly proportional for homeowners with incomes between $3,000 and $40,000. It is difficult to estimate tax burdens for homeowners with incomes over $40,000 because data quality rapidly declines as income rises above $40,000. Although the net tax remains substantially regressive below $3,000, less than two percent of homeowners are in this income range.

While the homestead credit distributes large amounts of credit to all income groups, it makes the property tax on homes less regressive because it reduces property taxes by a larger percentage for low-income homeowners than for high-income homeowners. This occurs because high income homeowners more often reach the maximum and thus their homestead credit equals less than 58 percent of their gross property tax.

However, the circuit breaker is the key to making the property tax nearly proportional to income. On the one hand, if the homestead credit were not supplemented by the circuit breaker, the net taxes would remain predominantly regressive, ranging from over 5 percent of income for incomes less than $10,000 to under 3 percent for incomes $20,000 and above. On the other hand, if the homestead credit were eliminated or the maximum credit reduced, the property tax would be more progressive than it is now.

2. PROPERTY TAX ON RENTAL PROPERTY

Measuring the incidence of property taxes for renters is considerably less reliable than it is for homeowners. While data on the relationship between income and rent are reasonably accurate, measuring the tax incidence also depends on the ratio of taxes to rent and the share of taxes actually shifted to the renter. Minnesota's circuit breaker assumes that the renter pays 23 percent of the rent (excluding utilities) for property taxes. Tax-rent data representative of the entire state's rental property are not available but several studies indicate that the average ratio does not significantly exceed 23 percent in the Twin Cities metropolitan area.[1] However, these

[1]The following analyses found average ratios of property taxes to rent ranging from 18.5 percent to slightly more than 23 percent in the Twin Cities metropolitan area. See Coopers and Lybrand, Analysis of Minnesota Property Taxes and the Tax Burdens on Owners of Single-Family Homes and Renters of Multi-Family Units, prepared for the Minnesota Multi-Housing Association, 1980. Minnesota Department of Revenue, Research Office, Tables on property tax/rent ratios. Urban Coalition, staff memos analyzing the Coopers and Lybrand study, December 1981.

studies found that the ratio varies considerably by such factors as age of building and location. The statewide ratio is likely to be lower than the Twin Cities ratio since taxes are lower outstate.

Since even the old view of property tax incidence recognizes that not all of the property tax is shifted to the renter, it is unlikely that the renter's property tax burden exceeds 23 percent.

Table 33 presents property tax burdens in 1980 for renters before and after the circuit breaker credit based on the assumption that the property tax burden equals 23 percent of rent. The tax burden is regressive before the circuit breaker and slightly progressive after the circuit breaker. To the extent that the property tax is not shifted to the renter and is absorbed by the owner, the incidence of the property tax would be more progressive than shown by the data because ownership of rental property is concentrated in higher incomes. The progressiveness of the tax will also be affected if the ratio of taxes to rent varies by income. But this difference would have to be very large to make the tax regressive.

TABLE 33

1980 PROPERTY TAX BURDENS FOR RENTERS BEFORE AND AFTER CIRCUIT BREAKER REFUND

Income	Number of Filers	Tax as Percent of Income Before Circuit Breaker	Tax as Percent of Income After Circuit Breaker
$ 0-$3000	42,487	11.69%	0.49%
3000- 5000	62,948	7.09	0.66
5000-10000	119,799	5.00	1.04
10000-15000	93,380	3.86	1.45
15000-20000	50,915	3.26	1.51
20000-25000	24,026	2.97	1.67
$25000-30000	9,130	2.87	1.96

Source: Calculated from Property Tax Relief for Minnesotans, 1980, (St. Paul, Minnesota: Minnesota Department of Revenue).

Assumption:

Property tax shifted to renters equals 23 percent of rent (excluding utilities).

C. TRENDS OVER TIME

We have shown that the homestead credit and circuit breaker programs considerably reduce the regressiveness of the property tax on homes. However, two recent trends may reduce the ability of these programs to make the property tax less regressive. First, it seems unlikely that the state can afford to continue increasing property tax relief as fast as gross property taxes increase, as it did during the 1970s. Second, in recent years there has been a large shift away from income sensitive property tax relief for homeowners towards the homestead credit, which is not related to income. While homestead credit expenditures increased from $234 million in 1978 to $433 million in 1981, circuit breaker credit for homeowners declined from $123 million in 1978 to $54 million in 1981.

Table 34 shows the relationship between income and property taxes for 1978, 1982, and 1984. 1984 figures are based on the Minnesota Department of Finance's estimated growth in gross property taxes of 26 percent between 1982 and 1984 and the Minnesota Department of Revenue's estimated growth in income of 14 percent.

TABLE 34

NET TAX AS A PERCENT OF INCOME
1978, 1982, 1984

Income		Net Tax as % Income			Percent Change		
Group	1981 Range	1978	1982	1984	78-82	82-84	78-84
Low	$ 3,000-14,000	2.18%	2.59%	3.73%	19%	44%	71%
Middle	14,000-35,000	2.35	2.53	3.39	8	33	44
High*							
	$ 3,000- 7,000	2.11%	2.60%	4.00%	23%	54%	90%
	7,000-14,000	2.21	2.59	3.59	17	39	62
	14,000-21,000	2.30	2.46	3.26	7	33	42
	21,000-28,000	2.28	2.47	3.31	8	34	45
	28,000-35,000	2.50	2.73	3.60	9	32	44

*Data on high income households are not included because only a small percentage of high income households are in the data base.

The data show that property taxes on homes are becoming somewhat more regressive. Between 1978 and 1982, the ratio of taxes to income increased by 19 percent for the low-income group but by 8 percent for the middle income group. Between 1982 and 1984, we estimate that the ratio will increase by 44 percent for the low income group compared to 33 percent for the middle income group.

The reasons for this trend include the following. First, the increase in the homestead credit maximum from $325 in 1978 to $650 in 1982 helped many middle and upper-income homeowners but not any low-income homeowners. Raising the homestead credit maximum does not help low-income homeowners because their circuit breaker refund would decline by the same amount as their homestead credit would increase.

Second, more families are reaching the maximum credit for the circuit breaker. Tax increases which are fully absorbed by the household represent a larger percentage of income for low-income households than for middle and high-income households. Consequently, as more low-income households reach the maximum, the tax becomes less progressive.

To assess whether this is a problem, it is useful to consider whether low-income homeowners living in an average house are paying high property taxes or just homeowners living in expensive homes. This distinction is important because for homeowners with expensive homes, income alone may not be a good indicator of their economic condition.

Table 35 summarizes the tax situation for low-income owners of a typical house in low tax non-metro counties and in the Twin Cities metro area. In most non-metropolitan counties, the net tax for low-income homeowners is very low and will increase slowly in the next several years under the current circuit breaker. In 1982, approximately one-half of non-metropolitan counties had an average gross tax of less than $550. An owner of such a home with an income of $10,000 would pay a net tax of $130. Gross taxes could increase to $780 (or $980 for disabled and elderly) before net taxes would rise above $130.

TABLE 35

EFFECT OF PROPERTY TAX INCREASES
ON TYPICAL LOW INCOME HOMEOWNERS

Age	Income	Gross Tax			Net Tax		
		1982	1984	Percent Increase	1982	1984	Percent Increase
7 Metro Counties							
Over 65	$ 5,000	$1100	$1375	25%	$145	$375	159%
Over 65	10,000	1100	1375	25%	190	375	97%
Under 65	5,000	1100	1375	25%	245	383	56%
Under 65	10,000	1100	1375	25%	290	428	48%
80 Non-Metro Counties							
Over 65	5,000	550	688	25%	40	40	0%
Over 65	10,000	550	688	25%	130	130	0%
Under 65	5,000	550	688	25%	40	40	0%
Under 65	10,000	550	688	25%	130	130	0%

In the Twin Cities metropolitan area, the circuit breaker keeps taxes low for the average low-income homeowner in 1982. But it will not protect most low-income homeowners from future tax increases. In 1982, the average gross tax for low-income homeowners (less than $14,000) in the Twin Cities metropolitan area was about $1,100. A homeowner over 65 with an income of $10,000 would receive a credit of $910 and pay $190 in tax. This would put the homeowner over the circuit breaker's first maximum of $850. The homeowner would pay 50 percent of future tax increases until credit reaches $1,000 and thereafter 100 percent. As a result, if gross taxes increase by 25 percent by 1984, the net tax would nearly double, reaching $375.

D. OVER-ALL INCIDENCE OF PROPERTY TAX RELIEF PROGRAMS

One purpose of property tax relief programs is to make Minnesota's tax system more progressive. Some proponents of these programs argue that shifting taxes from the property tax to other taxes such as the income tax will make the state's tax system more progressive because the property tax is more regressive than other taxes. This argument is not necessarily correct for two reasons. First, it is not clear whether the property tax is being replaced by more progressive revenue sources in Minnesota. While property taxes have decreased during the 1970s, the income tax, sales tax, and user charges have all increased. There is not any reliable research evidence that the property tax is more regressive than the sales tax or user charges.

Second, any revenue source can be changed in many different ways--some progressive, some regressive. Even under the progressive income tax, additional revenue has been raised in regressive ways as well as progressive ways. One progressive way to increase the income tax is to add a surcharge equal to a fixed percentage of the income tax liability. The income tax, itself, is progressive, as illustrated in Table 36. Since a surcharge is directly proportional to the income tax, the surcharge is also progressive.

One regressive way to increase income tax revenue is to keep income tax brackets the same from one year to the next and to let inflation put tax-payers into higher tax brackets. The Minnesota Department of Revenue has shown the effect of this type of tax increase by comparing taxes with indexing and taxes without indexing. Table 37 makes this comparison at different income levels for 1981 taxes. If income tax brackets were not indexed between 1978 and 1981, the resulting tax increases would represent a higher percentage of income for moderate-income persons than for high-income persons. While this tax increase would be predominatly regressive, it would not be regressive for low-income persons who do not pay income taxes or who qualify for the alternative income tax because they would not be affected by changes in income tax rates or brackets. This tax increase would be predominatly regressive because income tax rates rapidly increase through the low incomes and then level off in the

TABLE 36

INCIDENCE OF 1983 MINNESOTA INCOME TAX

Minnesota Gross Income	Single, No Dependents		Married, No Dependents Filing Separately on Combined Return		Married, 2 Dependents Filing Jointly	
	Tax	Tax as Percent of Income	Tax	Tax as Percent of Income	Tax	Tax as Percent of Income
$ 4,000	$ 33	0.8%	$ -0-	-0-	$ -0-	-0-%
5,000	76	1.5	-0-	-0-	-0-	-0-
6,000	126	2.1	-0-	-0-	-0-	-0-
7,000	179	2.6	26	0.4	-0-	-0-
8,000	239	3.0	65	0.8	66	0.8
9,000	303	3.4	102	1.1	137	1.5
10,000	371	3.7	152	1.5	215	2.1
11,000	444	4.0	201	1.8	291	2.6
12,000	519	4.3	249	2.1	367	3.1
13,000	594	4.6	304	2.3	445	3.4
14,000	672	4.8	359	2.6	528	3.8
15,000	755	5.0	417	2.8	612	4.1
20,000	1,175	5.9	748	3.7	1,070	5.3
25,000	1,599	6.4	1,115	4.5	1,548	6.2
30,000	2,043	6.8	1,499	5.0	2,039	6.8
35,000	2,474	7.1	1,896	5.4	2,515	7.2
40,000	2,884	7.2	2,295	5.7	2,976	7.4
50,000	3,697	7.4	3,091	6.2	3,898	7.8
75,000	5,622	7.5	5,041	6.7	6,115	8.15
100,000	7,497	7.5	6,955	7.0	8,199	8.2

Source: Tax amounts obtained from Glenn Nelson, "Minnesota's 'Progressive' Income Tax: Myth and Reality," unpublished paper. In turn, these tax amounts were based on Minnesota Tax Analysis Program of the Minnesota Department of Revenue.

Assumptions:

1. Deductions = 16 percent of income.

TABLE 37

EFFECTS OF INCOME TAX INDEXING ON TAXPAYERS AT DIFFERENT INCOME LEVELS

Minnesota Gross Income	1981 Unindexed Tax	1981 Indexed Tax	Difference	Percent Change	Change as % of Income
Single Taxpayer					
$ 5,000	$ 0	$ 0	$ 0	0%	0%
10,000	521	420	101	19.4	1.01
15,000	950	824	126	13.3	0.84
20,000	1,148	1,014	134	11.7	0.67
25,000	1,536	1,369	167	10.9	0.67
30,000	1,908	1,736	172	9.0	0.57
40,000	2,623	2,421	202	7.7	0.51
50,000	3,280	3,052	228	7.0	0.46
75,000	4,776	4,472	304	6.4	0.41
100,000	6,109	5,760	349	5.7	0.35
Family of Four--Two Wage Earners (65%-35% Income Split)					
$ 5,000	$ 0	$ 0	$ 0	0%	0%
10,000	8	8	0	0	0
15,000	550	429	121	22.0	0.81
20,000	722	579	143	19.8	0.72
25,000	1,092	905	187	17.1	0.75
30,000	1,455	1,248	207	14.2	0.69
40,000	2,195	1,927	268	12.2	0.67
50,000	2,878	2,588	290	10.1	0.58
75,000	4,491	4,109	382	8.5	0.51
100,000	6,000	5,542	458	7.6	0.46

Source: Minnesota Department of Revenue, Research Office.

Assumptions:

1. 1981 unindexed tax is based on tax laws for tax year 1981 except that income tax rate and brackets were from tax year 1978.
2. Taxpayers and families making under $20,000 use the standard deduction at the state level and the zero bracket amounts at the federal level.
3. Federal itemized deductions are 23 percent of income.
4. Minnesota itemized deductions are 20 percent of income.
5. Minnesota tax liability shown includes the effect of personal credits.
6. Federal taxes were necessary in order to compute state taxes and were calculated under 1981 provisions.
7. The low income alternative tax was used where applicable, assuming no non-taxable income.

high incomes. Thus, inflation pushes low-income tax-payers into higher brackets faster than it pushes high-income tax-payers. This means that the income tax became less progressive during the 1970s prior to income tax indexing in 1979. It also means that much of Minnesota's property tax reform was financed in a regressive way rather than in a progressive way as has commonly been assumed.

We conclude from these arguments that it is not clear whether indirect property tax relief programs such as school aids and aid to local government have led to a more progressive or more regressive tax system in Minnesota. As a result, justification for these programs should be based on factors other than making the tax system more progressive. However, the incidence of the homestead credit and circuit breaker programs can be more accurately determined. We show below that they have led to a more progressive tax system.

Table 38 compares the incidence of the circuit breaker, homestead credit, and two different income tax increases. In each case, the incidence is measured in terms of change in tax as a percentage of income. Several conclusions can be drawn from this table. Together, the homestead credit and circuit breaker are progressive. Total credit as a percentage of income steadily increases as income decreases. Total credit equals about 8 percent of income for households with an income of $5,000, 4 percent for households with an income of $11,000 and less than 2 percent for households with incomes exceeding $31,000. Clearly, these two programs have made the tax system more progressive regardless of which other major revenue sources are used to finance them. Individually, the circuit breaker program is highly progressive and the homestead credit program is progressive, although not nearly as much as the circuit breaker. The circuit breaker is clearly progressive enough to more than offset the possible regressiveness of other taxes used to finance it. The effect of the homestead credit is less clear. If it is financed with an inflation-driven income tax increase, the tax and the credit will to a large extent offset each other.

Furthermore, if the homestead credit were to be reduced, the circuit breaker would often make up deductions in the homestead credit on a dollar for dollar basis, particularly for low income homeowners. For example, changing the maximum homestead credit by $100 affects only homeowners whose income exceeds $23,000. Consequently, as shown in Table 38, raising the homestead credit maximum by $100 makes the tax system more regressive, even if it is financed by the progressive income tax surcharge.

TABLE 38

COMPARISON OF INCIDENCE FOR CIRCUIT BREAKER, HOMESTEAD CREDIT, INCOME TAX INDEXING, AND INCOME TAX SURCHARGE

Property Tax Relief Program Credits As A Percent of Income, 1982					Income Tax Changes As A Percent of Income			
						Change in Income Tax Due to Indexing 1978 - 1981*		10 Percent Income Tax Surcharge 1983
Income	Homestead Credit & Circuit Breaker	Circuit Breaker	Homestead Credit	Change Homestead Credit Maximum from $650 to $550	Income	Single	Family of 4	Family of 2**
$ 0 - 3,000	17.77%	11.78%	5.89%	0%				
3,000 - 5,000	8.38	5.54	2.84	0	$ 3,000	0%	0%	0%
5,000 - 10,000	5.73	3.29	2.43	0	5,000	0	0	0
10,000 - 15,000	3.77	1.89	1.87	0	10,000	1.01	0	.15
15,000 - 20,000	3.01	1.19	1.81	0	15,000	0.84	0.81	.28
20,000 - 25,000	2.14	0.56	1.57	.01	20,000	0.67	0.72	.37
25,000 - 30,000	2.24	0.34	1.89	.04	25,000	0.67	0.75	.45
30,000 - 35,000	1.94	0.14	1.79	.09	30,000	0.57	0.69	.50
35,000 - 40,000	1.69	0.05	1.63	.18	35,000			.54
40,000 - 45,000	1.48	0.02	1.45	.19	40,000	0.51	0.67	.57
45,000 - 50,000	1.32	0.03	1.29	.18	45,000			
					50,000	0.46	0.58	.62

*See Table 37 for assumptions.

**Married, no dependents; filing separately on combined form; Deductions = 16 percent of income.

V. POLICY OBJECTIVES IN THE STATE-LOCAL FISCAL RELATIONSHIP

Direct property tax relief programs make up a large part of state aid to local government. In 1982, the homestead credit, agricultural credit, taconite homestead credit, reduced assessment credit and other direct property tax relief programs amount to $600 million in aid to local taxing districts. These aids appear as credits on individual property tax bills, but the money is sent directly to local units of government and school districts in proportion to each taxing district's share of the property tax levy. An additional $168 million was distributed to individual taxpayers through the circuit breaker program. Thus, direct property tax relief programs are an important part of the state-local fiscal relationship.

Concern over the state-local fiscal relationship has been spurred by revenue shortfalls and unexpected aid cutbacks, as well as growth in the state's financial commitment to direct property tax relief programs, resulting from legislative decisions made in previous years when the revenue picture was distinctly more positive.

Legislative debate on property taxes and property tax relief programs is properly part of a broader debate on state aid to local governments. A number of organizations, committees, and lobbies including the Citizens League, Minneapolis Chamber of Commerce, the Association of Minnesota Counties, and the Legislative Local Government Policy Task Force, along with other individuals and groups have recently issued reports and recommendations designed to reform the state-local fiscal relationship.

There is no reason to expect groups as diverse as these to agree in every particular on the solution to the problem but there is general agreement that there is a problem and that major reform rather than a piecemeal approach needs to be undertaken.

We feel it is useful to conclude our report on direct property tax relief programs with a review of the principles on which there is general agreement and then to examine the implications of these generally accepted principles on direct property tax relief programs. The major principles that we feel should guide legislative deliberations during the 1983 session are as follows:

- Minnesota's state-local fiscal system needs comprehensive reform.

There are several reasons why comprehensive reform that goes beyond the immediate budget situation is required. The fiscal strain caused by direct property tax relief programs along with other state aids to local government and schools is long-term rather than temporary in nature. At the same time, fifteen years of active implementation and expansion of state aid programs and direct property tax relief programs have left property taxes in Minnesota low compared to where they were historically and in comparison to other

states. However, the property tax relief programs are costly, and together form a system that is complex, difficult to understand and poorly understood. In fact, the growing complexity of the system makes it more and more difficult for the legislature to take action toward any coherent purpose. Further tinkering with the system should be avoided if it adds to the system's complexity or inadvertently dilutes the historic commitment of the state to equalization of the ability of schools and local government to provide basic services.

- Greater predictability and stability in state aid is needed by local government. Sudden cuts or increases do not contribute to wise spending decisions.

It is now well understood that the state's major revenue sources are quite volatile and move with the national economy. All state transfers of money to local government are equivalent to a substitute of revenue sources that are unstable for a revenue source (the property tax) that, whatever its faults, is slow to react to economic cycles. While there is general recognition that the state cannot afford to promise growing aid payments in the face of declining revenue, there is no reason to expect initial agreement on the solutions to the problem. These include allowing local government and schools greater authority to raise revenue on their own; dedicating a share of state tax revenues to local units rather than a specific dollar amount; and reviewing the totality of state property tax relief programs to see which are expendable in a time of scarcity.

- The state-local fiscal system, including the property tax system, property tax relief programs and other state aid programs, should be simplified in order to improve understanding of the system in the legislature and among the general public. Simplification is also needed in order to reduce record-keeping costs and to promote uniform classification and assessment practices across the state.

- It is preferable to achieve targeted goals through budgeted expenditures rather than manipulation of the tax system.

Minnesota has the most complex property classification system in the nation with over 50 legal classes of property. It also has a state aid system which is complex and depends on accurate and uniform assessment of property across the state if it is to be fair. Time spent by local assessors classifying property is time that cannot be spent on assessment. Also the administrative cost of accounting for assessed value in a large number of legal classes needs to be weighed against the benefits achieved, although the use of the classification system to accomplish particular objectives is a good way to hide both the costs and benefits of legislative action.

Minnesota also has a wider variety of direct property tax relief programs than any other state, and some of these programs create major administrative headaches at the local level. Without questioning the validity of the objectives of the agricultural credit, powerline credit, wetland or native prairie credits, it can be suggested that these purposes could be more easily carried out through direct appropriations, other aid programs or even within the property tax system in a simpler way.

- State aid to local government should neither encourage nor discourage local spending. State aid should not provide cheap marginal dollars in support of local levies.

It may be argued that state aid encourages local spending or even requires it. But there is general agreement that it is not desirable to encourage spending beyond a certain point or for purposes that are not related to the basic services that the state seeks to guarantee. The homestead credit is the best example of a property tax relief program that insulates local government from the full tax consequences of spending decisions and can distort the way in which local government might otherwise choose to raise money. For example, a special assessment might be the best or fairest way to raise money for certain services, but it will not be used if a taxing district can obtain partial state payment through the homestead credit by raising revenue through the property tax levy. In order to prevent state aid from encouraging local spending, the state has instituted levy limits, but the complex combination of state aids, and variation in local needs and preferences has led to a situation where some local units receive more aid than they need and others are left unable to finance services that most people would regard as basic and essential.

- While often maligned, the property tax is essential because it taxes a form of wealth that would otherwise go untaxed and it is the only significant revenue source now available to local government.

The property tax is one of three broad based taxes available (income and general sales taxes are the others) that raise money by broad application at relatively low rates and it is preferable that revenue be raised through the application of broad based taxes. Also, theoretical and philosophical arguments aside, Minnesota requires a mix of revenue sources that is not too different from that of other states, especially neighboring states, if it is to avoid unwanted consequences, especially in border communities.

- Local government is best equipped to deliver a wide range of public services, while equity in taxing and spending dictates that the state carry a major part of the responsibility for financing those services. In order to assure that local government is effective and efficient, local government needs a large measure of autonomy in spending decisions, and the ability to raise revenue adequate to finance services demanded, through the political process, by local residents.

- State aid to local government should include incentives to promote efficiency, effectiveness and innovation in the delivery of services.

The principal challenge of a state aid program is to provide aid while not destroying the incentives that make the local administrative system work well. The state has a vital role in equalizing local capacity to raise money for certain basic people-related services such as education. At the same time, state aid should not insulate local officials from the consequence of spending decisions, nor prohibit the

local electorate and locally elected officials from determining what services (beyond those that the state defines a responsibility for) ought to be available, and at what level they ought to be provided.

- The over-all effect of state and local taxing and spending programs should be progressive. Individual taxes or spending programs need not pass this test, although it is one criterion on which they should be judged.

A related point is that the state-local fiscal system, including the property tax system and related aids and credits, education and local government aids, levy limits, and other state aids, needs to be considered as a whole while individual components are debated. The result of adhering to this approach should be better coordination among aids, better comprehension of the system in the legislature and among local administrators, and a more effective system in general.

A. IMPLICATIONS FOR DIRECT PROPERTY TAX RELIEF PROGRAMS

The purpose of this brief section is not to reach firm recommendations and conclusions about the direct property tax relief programs that have been the focus of this report, but to make a few obvious connections between these programs and the general principles discussed above.

The homestead credit, as noted earlier, can be criticized because it makes cheap marginal dollars available to local taxing districts and thus can work to encourage a higher local property tax levy than would otherwise be approved.

The homestead credit now costs close to $500 million per year and any reform of the system designed to either save money, improve the effectiveness of state aid programs, equalize resources across the state, or make property tax relief sensitive to income will necessarily have to examine how the dollars now flowing through the homestead credit might be spent more purposefully.

The homestead credit and agricultural credit along with certain other direct property tax relief programs have grown substantially in cost over the last fifteen years--mostly because of periodic and even frequent expansion of the programs by the legislature but also because of factors outside direct legislative control, such as growth in real estate values and increases in the cost of providing government services. Since the state's obligation through direct property tax relief programs can grow while state revenue sources are shrinking, direct property tax programs need to be examined if greater stability and predicability in state aids are to be achieved.

Direct property tax relief programs contribute to the complexity of the entire property tax system, although individually they are simple compared to the complexity of school and local government aid formulas. This report has demonstrated that while simple in

concept, there are significant difficulties in the local administration of the programs. The agricultural credit for agricultural homesteads is computed as the amount of money yielded by multiplying 18, 10 and 8 mills, respectively, against the assessed value of the first 320, next 320 and remaining acreage. Ownership of farms is often in a family or corporation rather than a single person or couple and the location of the land that constitutes an agricultural homestead need not be either contiguous or in the same taxing district. Correct classification of agricultural and residential property for the purpose of accurately computing the agricultural and homestead credits is a problem.

In addition some direct property tax relief programs such as the wetland credit, native prairie credit, or reduced assessment credit might better be removed from the property tax system altogether so that these programs that really have nothing to do with raising revenue can be better evaluated each biennium.

The homestead credit and agricultural credit are not income sensitive; they can and do reduce the taxes of property owners who have the ability to pay a reasonable property tax. Since real property is a form of wealth and one measure of economic well-being, it is appropriate that it ought not to escape appropriate taxation.

The homestead and agricultural credits are a tool for substituting state for local revenue and since local revenue is almost exclusively raised through the property tax, it is a substitute of revenue raised through the individual and corporate income taxes, general sales tax and other state sources that are widely thought to be progressive, for revenue raised through the property tax, thought to be a regressive and therefore inferior tax.

We have analyzed the incidence of individual income tax and residential property tax and have concluded that while the homestead credit has a progressive impact on the property tax it is small and aimed at the middle income range. There are more effective means to accomplish this end, such as the circuit breaker. Direct property tax relief programs that merely substitute state for local revenue should not be assumed to have a uniformly progressive effect because the property tax is less regressive than widely assumed and is probably proportional or even progressive over a significant part of the income range. And, the state individual income tax which has a schedule of nominal rates that appears progressive is only slightly progressive over a broad income range. Other state revenue sources are presumably even less progressive, such as the corporate income tax and general sales tax.

In summary, we believe direct property tax relief programs can be criticized because they are inconsistent with a number of principles defining what the state-local fiscal relationship should look like. Although they were not included in this study, the same general point can be made about the present local government aid and school aid programs. We believe a thorough review of the state-local fiscal relationship by the legislature is required and that the principles listed above can provide direction for the effort.