MINNESOTA Department of Revenue

Model Revenue System for Minnesota

July 1992

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FOREWORD

State and local governments in Minnesota collected $14.8 billion in taxes and non-tax revenues in fiscal year 1990. These payments for publicly provided goods and services represented 19.3 percent of the personal income of Minnesota residents. All of the citizens of Minnesota have a vital interest in the structure and performance of our large and complex state and local revenue system.

This report presents an overview of the Minnesota Department of Revenue's vision for our state and local revenue system. It outlines our view of the basic objectives of a model, or ideal, revenue system and discusses in detail the model features for each major revenue source. The report further discusses strategies for moving the current state and local revenue system toward the model.

The *Model Revenue System for Minnesota* provides a useful framework for structuring public discussion of important revenue issues and serves as a blueprint for identifying changes to improve the structure and performance of the state and local revenue system.

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CHAPTER 1 INTRODUCTION

A. Origin of the Model Revenue System for Minnesota

The original impetus for the model revenue system was the Minnesota Department of Revenue's strategic planning process, which produced this statement:

Our mission is to win compliance with Minnesota's revenue system.

To accomplish this mission, we work to:

- Develop sound revenue policy.
- Educate citizens about their rights and responsibilities.
- Serve citizens to help them comply with the law.
- Provide feedback on the extent of compliance.
- Use progressive enforcement approaches with those who do not comply voluntarily.

As in strategic planning for all types of organizations, it is important to expand on the mission statement by defining the meaning of the statement in detail and providing a means of measuring our current status and future progress. However, this report relates primarily to the winning compliance dimension in the first bullet, "Develop sound revenue policy." Other Department of Revenue actions are being taken to further define and measure the other parts of the mission statement.

In our mission statement and throughout this report, the term "revenue" is generally used rather than "taxes" to direct attention to the significance of both tax and non-tax revenue. In Minnesota and the United States, state and local government revenues consist of approximately 60 percent taxes and 40 percent non-tax revenues, such as fees, tuition and special assessments.

By reviewing numerous national publications and past state of Minnesota policy statements and discussing model provisions with outside interested parties and Department employees, we have derived five basic objectives of a model revenue system.

A model state and local revenue system should be:

1. Understandable

Taxpayers, public officials and revenue administrators can and do understand the revenue system. This objective can be enhanced by simplifying the revenue laws, educating taxpayers and disseminating information.

2. Fair

Taxpayer revenue burdens are progressive (revenue as a percent of income rises as income rises); revenue burdens on taxpayers with equal incomes, consumption or wealth (depending on the basis of taxation) are approximately equal; tax bases are broad and rates are low as a result of minimal exclusions; and enforcement is consistent and adequate.

3. Competitive

Minnesota's ability to compete with other states and nations as a location of economic activity is maximized. We recognize that the revenue system is only one of numerous factors involved in location choices and that public services, effectively delivered, can enhance competitiveness.

4. Reliable

The revenue system is stable, sufficient and certain. Stability means that revenues are relatively constant over the business cycle. Sufficiency means that revenues grow with the economy over time, providing adequate revenues for needed public services. Certainty means that revenue laws do not change frequently or significantly, facilitating taxpayer planning and revenue administration.

5. Efficient

Compliance costs are kept to a minimum for taxpayers and revenue administration and there is maximum compliance, neutrality between different forms of economic activity, and clarity and accountability in state and local relationships.

This listing still does not spell out the major features of a model revenue system, since these five elements frequently conflict with each other. For example, the most understandable income tax system could score poorly on both fairness and competitiveness. A clear and measurable description of a model revenue system requires considerably more details to indicate the major policy choices that are judged to strike the best balance among the five objectives. That is the purpose of this report.

B. Benefits of a Model Revenue System for Minnesota

We believe that the description will serve these purposes:

- Gradually improve Minnesota's revenue system so that it is more understandable, fair, competitive, reliable and efficient. These long-run gains will help improve the satisfaction of our citizens with their state and local governments, encourage compliance with the tax laws, and maintain a healthy Minnesota economy.

- Provide a framework for discussing revenue policy issues with state and local public officials, civic organizations and the public. This purpose includes improving our ability to influence state executive and legislative branch revenue system proposals and law changes in the direction of model revenue policy.

- Provide an agenda to periodically review and revise the Department of Revenue's views on model revenue policy.

- Assist in Department of Revenue internal planning for administration of the revenue system. For example, should department funds be spent to improve the process of administering a complicated tax law? Or should improvements be delayed while trying for a law change?

C. Development of the Model Revenue System

In developing the model revenue system we have relied upon the opinions of national experts, as well as Department of Revenue employees, legislative staff, other state agencies and interested parties outside of state government. As a final step in the development of the model revenue system, the Department invited a group of citizens and tax policy experts to meet with the Department's Revenue System Team to discuss the report. The feedback from this two-day session was invaluable in identifying current revenue system issues and suggestions for reform.

- Consensus of National Experts

  Many articles and books discuss the meaning of "model revenue policy." We have studied this literature thoroughly and given it great weight in our description. However, none of the national rating systems is usable without extensive modification, for two reasons. First, the existing rating systems are quite general and do not state the preferred position on most of the practical revenue issues the Department faces. For examples, see Robert J. Kleine (1988) and Lincoln Institute of Land Policy (1989). Second, the national literature needs to be modified to take into account Minnesota needs, traditions and existing revenue system, as explained below.

- Minnesota Modifications

  The various national articles and books outlining model revenue policy describe general concepts that should apply to all states. On many issues, the consensus of experts falls within a range subject to state-by-state variation. For example, the national consensus generally favors a state-local tax structure that is not regressive; either proportional or progressive is considered suitable. (A tax or revenue system is described as one of the following: "regressive" if the percentage of income paid in taxes falls as income increases; "proportional" if the percentage of income paid in taxes remains constant as income increases; or "progressive" if the percentage of income paid in taxes rises as income increases.) Minnesota has a long tradition of progressive state taxation, and we propose that this be continued.

  Similarly, the national literature generally favors each major tax (income, sales, and property) making up 20 to 30 percent of state and local taxes. We support the concept of a balanced use of the three major state and local taxes. This balance is important to achieve the basic tax system objectives of fairness, competitiveness, reliability and efficiency. The percentage of state and local taxes contributed by each of the three major taxes should be maintained in the 20 to 30 percent range. The actual percentages will be determined by the role of each tax in meeting the multiple objectives for the overall state and local revenue system. The actual percentage target range for each major tax is discussed in the following chapters.

- Importance of Existing Minnesota Revenue System Features

  The "reliability" factor in the model revenue system makes it important that revenue laws do not change frequently or significantly. This suggests that borderline issues of model revenue policy should be decided generally in favor of the existing laws of a state. For example, Minnesota exempts business equipment from the property tax, while about 37 states tax business equipment. Either approach is viewed nationally as consistent with model revenue policy.

  Therefore, we favor continuation of Minnesota's present approach; for some other state that taxes business equipment, policymakers might favor continuing such taxation. For issues on which there is a clear national consensus, we usually favor changing Minnesota laws that conflict with the national consensus and with the objectives of being understandable, fair, competitive, reliable and efficient.

  The concept of giving weight to both the national consensus and the present Minnesota laws is illustrated in the table below.

CRITERIA FOR THE MINNESOTA MODEL REVENUE SYSTEM

FEATURE OF PRESENT MINNESOTA TAX SYSTEM?

CONSENSUS OF LITERATURE	NO	YES
YES	Sales tax on haircuts **No Conclusion**	Circut breaker for all ages, homes and renters Truth in Taxation Index income tax **Include**
NEUTRAL	Property tax on business equipment **Exclude**	Total taxes progressive **Include**
NO	Sales tax on medical services **Exclude**	Dependent education expense deduction **No Conclusion**

D. Relationship to Earlier Minnesota Tax Policy Studies

The 1984 report of the Minnesota Tax Study Commission was a major reference for this report. Most of the recommendations in this report agree with those of the Tax Study Commission. However, there are several differences and reasons why this new report is needed:

- According to the Department of Revenue's mission statement, we need a system for numerically scoring Minnesota's revenue system. Many of the Tax Study Commission positions were stated too generally to allow for scoring.
- On a few issues, we disagree with recommendations of the Tax Study Commission; for example, the study proposed retaining city and county levy limits.
- The commission did not address some issues, such as taxing capital gains the same as earned income, providing tax breaks based on age and tax increment financing.
- Conditions have changed since 1984; for example, federal tax reform in 1986 changed important elements of the individual and corporate income tax system; and Minnesota's property tax and aid system has changed greatly.

While this report draws extensively on the 1984 Tax Study Commission report, it adds elements from the national literature covering additional issues, makes some positions more specific, reverses a few positions and updates to current conditions.

The Department of Revenue 1987 report *Minnesota Tax Reform* resulted from administration study teams on each major tax type, assisted by more than 200 outside advisors. These study teams reviewed the recommendations of the Tax Study Commission; their recommendations were generally consistent with those of the commission. The report provided the basis for adoption of numerous tax reforms during the 1987 legislative session.

Most of the recommendations in the *Model Revenue System for Minnesota* agree with those in the 1987 *Minnesota Tax Reform* report. However, this new report is a needed addition to the 1987 report, for the same reasons given earlier in the discussion of the Tax Study Commission report.

E. Use of the Model Revenue System in Preparing Legislative Proposals

The model revenue system will be a reference for the Department of Revenue in considering legislative proposals. Some Department of Revenue proposals and positions on bills each year are likely to be derived from this description. However, this description is *not* by any means a definite legislative agenda for the Department of Revenue, since legislative proposals are also dependent on other factors, including:

- state revenue surpluses or shortfalls;
- public interest and support (some of the positions supported in this description could be pursued by communication with the public and civic organizations, with legislative proposals dependent on the results of these communications);
- changing conditions such as actions by other states or economic conditions; and
- administrative and legislative tax system priorities.

As noted earlier, the purposes of this report, like those of the 1984 Tax Study Commission, are long-range. We want this description to *gradually* improve Minnesota's revenue system; provide a framework for discussions with state and local public officials, civic organizations and the public; provide an agenda for regular review of our positions; and assist in Department of Revenue internal planning.

We hope that future elected officials will refer to the latest version of this description, along with the many other factors they must consider, in preparing legislative proposals. This description of an ideal should not require drastic revisions with each new administration and legislature, and it is unlikely to reflect completely the views of each administration and legislature.

It should also be noted that many of the recommendations in the model revenue system are interrelated and should only be considered in combination with other changes. The property tax system discussion in Chapter 6 provides important examples of interrelated proposals. Model revenue system recommendations that involve these interrelationships should not be used in isolation to support individual proposals.

F. Future Changes in the Model Revenue System

We expect that specific features of this description will be reviewed and some revisions made each year. Changes in what are considered "model" revenue provisions are expected to result from actions of the federal government and other state governments, economic changes and changing patterns of public support for government services and sources of revenue.

This initial report is a major undertaking that has been completed by concentrating on important and well-developed current issues. In future revisions, it is likely that additional topics will be added and existing topics expanded. Some of the topics likely to receive expanded consideration in the future are as follows:

- Non-Tax Revenue

  Of the revenue raised by Minnesota state and local governments, 60 percent is from taxes and 40 percent from non-tax sources. Some of the largest non-tax revenues are from federal funds, public college tuition and dormitory fees, health care payments to public hospitals, city special assessments, net lottery receipts, sewer and water charges, license fees and fines. Since 1980, non-tax revenues have grown considerably faster than tax revenues, especially at the local level.

  The public often favors user charges over taxes; on the other hand, it could be possible to over-utilize user charges to finance excessive government spending without the scrutiny generally given to taxes. Future reports should examine Minnesota state and local user charges for their balance, equity and impact on government spending.

- Dedicated Revenues

  Increasing interest is evident for the dedication or earmarking of revenue from specific tax sources to fund particular expenditure programs. Motor fuel taxes earmarked for transportation and the portion of the sales tax dedicated to the local government trust fund are two examples. Several questions should be answered in evaluating the desirability of expanding earmarking. Under what conditions is earmarking good fiscal policy? What are the potential problems of increased earmarking for budget flexibility over time?

- Local Revenue Diversification

  We see a need for revenue diversification for local governments. Diversification would provide a safety valve for excessive property tax burdens in some areas, take pressure off the state budget, and increase local government accountability and flexibility, which in turn would reduce state entanglement with local governments. Increased reliance on user fees and the adoption of a local option sales tax are two examples of local revenue diversification.

  At present, we are unable to spell out specific, scoreable methods of local revenue diversification. The best approaches are partly dependent on what happens with other features of the revenue system discussed in this report, including the degree to which more social service costs are paid for by the state, the nature of a new city local government aid formula, and further study of local non-tax revenues.

- Integration of the Property Tax Refund and Individual Income Tax Systems

  Presently, property tax refund (PTR) claims are processed separately from individual income tax returns; PTR checks are issued in August and September. Advantages to combining these two returns include that the "bottom line" income tax liability would be determined after subtracting the PTR payment. If fully integrated, this could be simpler for taxpayers and for Department of Revenue processing. More citizens eligible for a PTR payment might participate. Without major changes in the calculation of the PTR, there would be disadvantages regarding PTR processing interfering with income tax processing and property tax bills being received too late for PTR submission with income tax returns. Other possible disadvantages include a one-time "shift reversal" cost to the state budget and reduced understanding by citizens that PTR payments are part of the property tax system and should be considered in their evaluation of their property taxes.

- The Metropolitan Area Fiscal Disparities Program

  In 1971, the Metropolitan Development Act created a mechanism for sharing incremental growth in commercial-industrial property values among the seven Twin Cities metropolitan counties. The fiscal disparities program should be evaluated in terms of its effectiveness in achieving its policy objectives, including the reduction in property tax base disparities within the metropolitan area and coordination of regional economic development. Possible statewide applications of the fiscal disparities mechanism should also be examined, including the pooling of commercial and industrial property taxes.

- Unemployment Compensation and Workers' Compensation

  The unemployment compensation system required employer contributions of $375 million in 1989. The U.S. Bureau of the Census does not include these amounts in its reports of state and local revenues and expenditures. However, the system obviously has an impact on the competitiveness of Minnesota businesses, and costs are frequently combined with business taxes in discussions of the state business climate. A similar situation exists for workers' compensation, which involved employer contributions of more than $1 billion in 1989.

- Medical Care Provider Taxes

  The 1992 state Legislature adopted a two percent gross receipts tax on hospitals, doctors and other health care providers to fund a health care access program for the uninsured. The model revenue system features for health care taxes will be addressed in later versions of this report.

- Miscellaneous Taxes

  This report does not attempt to define "model" taxation regarding: estate tax, mortgage registry tax, deed transfer tax, lawful gambling taxes, the lottery, insurance taxes, taxes on telecommunications, and taconite and other mining taxes.

- Issues Regarding the Total Revenue System

  This version of the *Model Revenue System for Minnesota* treats each tax type separately. Only a brief discussion is included for many issues regarding the total revenue system, such as:

  ◊ Considering all tax types and non-tax revenues, are some segments of the economy or certain individuals paying more than their fair share, while others are paying less?

- ◊ Can some of the minor taxes be eliminated or merged? The ratio of revenue to compliance and administrative costs should be considered in answering this question. Also, is it more efficient to use direct expenditures financed from general revenues than to use minor, earmarked taxes to fund specific services?

- ◊ How do the various tax types interact with each other and raise issues? For example, is the issue of sales tax on replacement manufacturing equipment affected by the fact that we do not apply the property tax to such equipment? What is the effect of the income tax deduction for homestead property taxes on the distribution of property tax burdens by income levels?

- ◊ Are existing tax expenditures effective in meeting their objectives? To support this evaluation, the biennial *Minnesota Tax Expenditure Budget* should be expanded to include analysis of who benefits from major tax expenditures and the evaluation of alternatives for achieving the same results.

- ◊ What is the proper role and potential for using the tax system to achieve broader social objectives — a cleaner environment, for example?

G. Scoring the Model Revenue System

An important Department of Revenue use of the model revenue system will be the measurement of progress in improving Minnesota's state and local revenue system. Scores will be developed for the measurable factors in the model system; a weighted average of the individual scores will provide an overall measure of the fiscal health of the state and local revenue system. The rating system will be used internally by the department to evaluate progress toward the goals outlined in this report.

CHAPTER 2
GENERAL CHARACTERISTICS OF A MODEL STATE AND LOCAL REVENUE SYSTEM

Many features of the *Model Revenue System for Minnesota* involve overall state and local revenues rather than specific revenue types. For example, whether some taxes are too progressive or others too regressive can only be judged by determining whether *total* state and local taxes provide the desired degree of progressivity. As another example, a balanced use of taxes on income, consumption and wealth is necessary to achieve the equity goals of the model revenue system and a reliable source of revenue to state and local governments.

Some tax types, while regressive in their distribution of tax burdens, are necessary to provide overall balance, reliability, efficiency, competitiveness and accountability in the state and local revenue system. Each individual tax type should be evaluated in terms of its contribution to the general characteristics of the overall system, as well as on its own merits. Most of the features listed here are general and provide guidance for the more specific features listed in the sections on specific tax types. The general features apply to the structure of the state and local revenue system and are not designed to determine the appropriate level of state and local taxes.

A. The revenue system should be *understandable.*

- Each tax or revenue source should be as simple as possible to increase voluntary compliance and lower compliance and administrative costs.

- Taxpayers should understand how their tax is determined.

- Taxpayers should know which governmental unit is responsible for each tax and spending component, and the services funded by the taxes. This understanding is critical to establishing accountability in Minnesota's complex state and local fiscal system.

- Deductions, exclusions and exemptions should be kept to a minimum in each tax system.

B. The revenue system should be *fair.*

Two distinct approaches help evaluate the fairness of a tax. First, the benefit principle identifies a fair tax as one where payments for services reflect benefits received by the taxpayer. This approach clearly links taxes with expenditures in defining fairness. The benefit principle is most applicable in cases where state and local governments are providing identifiable goods and services to specific groups of taxpayers. Examples include special assessments for sidewalks benefiting particular neighborhoods, recreational fees and college tuition. All or a portion of the costs of these activities are usually financed through fees, user charges or tolls, not general taxes. The motor fuel tax is an example of the indirect use of a benefit tax to finance highways.

The second approach used to define the fairness of a tax is the ability-to-pay principle. This is the approach we are using to evaluate fairness in the model revenue system, which deals primarily with broad-based taxes used to finance general government spending. According to this principle, a tax system is fair if taxes are imposed in line with ability to pay, generally measured by a taxpayer's income. The model revenue system establishes specific goals for tax equity using the ability-to-pay principle.

1. **The overall distribution of state and local taxes should be at least proportional. The overall progressivity in state taxes should be used to offset the regressivity of local taxes.**

   This goal, known as "vertical equity," requires the following:

   - State personal income taxes as a percent of income should increase as income increases; both marginal and average tax rates should increase with income.

   - Consistent with the multiple objectives of the model revenue system, the personal income tax should be relied upon to achieve the desired degree of progressivity in the overall state and local revenue system.

   - The property tax refund program should be expanded to reduce the regressivity of the local property tax for lower-income individuals.

- Any significant increase in effective sales tax rates on low-income taxpayers due to higher tax rates or base broadening should be addressed through low-income credits.

This goal implies that Minnesota's tax system progressivity should be maintained at the 1988 level, meaning that Minnesota would continue to be one of the most progressive states. (The choice of 1988 as a reference point is a pragmatic one: the Department of Revenue recently completed a benchmark study of the distribution of state and local taxes in 1988.) However, this position also takes note of Minnesota's present relatively high progressivity compared to most states and, therefore, opposes any major changes that would further increase progressivity, except for the targeted low-income relief identified above. This position is based on competitiveness with other states, given the mobility of some businesses. While many claims of the effects of taxes on the "business climate" seem exaggerated, we believe that progressivity far beyond the level of other states could damage competitiveness and be harmful to the employment opportunities of low- and middle-income people.

2. **Taxpayers with similar levels of income, consumption or wealth (depending upon the tax base) should pay approximately the same amount of tax.**

   To achieve this "horizontal equity" goal:

   - tax bases should be broadly defined with all sources of income taxed uniformly,

   - deductions, exclusions and exemptions should be minimized, and

   - differential rates on essentially similar activities, sources of income, types of wealth or forms of business should be avoided.

3. **A balance of income, consumption and wealth tax bases should be used to provide a comprehensive measure of ability to pay.**

C. The revenue system should be *competitive.*

- Marginal tax rates should be kept low for all taxpayers rather than the tax system providing significant subsidies for particular groups of taxpayers.

- The state should minimize efforts to pick winners and losers in tax system design.

- Tax policy should focus on the long run and not overreact to short-run immediate concerns.

- Any business subsidies for economic development should be provided directly by appropriations, not indirectly by tax expenditures.

- Progressivity may be restricted by interstate mobility of some businesses and their employees.

The general thrust of the first four bullets above is to make the *general* tax structure competitive for all types of businesses and their employees, rather than to devise special targeted tax breaks for particular businesses or business expansions. Any special tax provisions for some businesses will require higher tax rates for the bulk of businesses, making Minnesota less competitive across-the-board. If it is truly believed that an economic development subsidy should be provided to a particular business, the subsidy should be provided by an appropriation, not by a tax expenditure; this approach assures full scrutiny of the expenditure every two years and limits the expenditure to the intended business.

D. The revenue system should be *reliable.*

- Revenue should grow at the same rate as personal income to provide *sufficient* revenues.

  Since 1970, Minnesota and all other 49 states in total have maintained state-local taxes at roughly a constant percentage of personal income. Taxes tend to grow slower than personal income in recession years and faster than personal income in boom years, but the general trend is for taxes and personal income to grow in parallel. It appears that tax growth parallel to personal income growth has been sufficient to finance needed government services for Minnesota and most other states.

Minnesota state and local governments should certainly work to hold tax growth below the rate of personal income growth. However, this factor provides an objective growth standard and, if met, will ensure that taxes stay under control relative to Minnesotans' ability to pay taxes. A change to a higher level of taxes relative to personal income should require explicit legislative and executive action to increase taxes.

- The system should be *stable* over the economic cycle but provide sufficient growth in step with income over time.
- The revenue system should provide political stability by avoiding frequent tax rate changes.
- A balanced use of income, sales and property taxes should provide greater revenue stability over the business cycle in combination with a state budget reserve or "rainy day" fund.
- The tax structure should be *certain* and predictable to facilitate longer-run planning by taxpayers.

E. The revenue system should be *efficient.*

To achieve this goal, the revenue system should:

- maximize the percent of taxpayers voluntarily complying with the law,
- minimize economic distortions caused by tax-motivated behavior,
- minimize compliance costs for taxpayers, including record keeping,
- minimize administrative costs of collecting taxes,
- use a balanced revenue structure to avoid high tax rates on any one type of base,
- tax all sectors of the economy,
- support tax system features that tend to maximize long-term growth in Minnesota personal income, and
- strengthen government accountability by clearly identifying responsibility for fiscal decisions.

The Department of Revenue must support the efficiency of the revenue system by undertaking activities to maximize long-range net state revenues (taxes minus Department of Revenue collection costs).

CHAPTER 3
INDIVIDUAL INCOME TAX

Individual income tax is the mainstay of the Minnesota state tax system. In fiscal year 1991, almost $3 billion in net individual income taxes accounted for 43.2 percent of total state taxes and 30.2 percent of state and local taxes. The income tax is the most important tax in achieving the tax system objective of fairness, or vertical equity, in the distribution of state and local tax burdens.

Like most states, Minnesota's individual income tax is based heavily on the federal tax system. Federal tax reform in 1986 significantly improved the federal system by reducing the number of deductions and exclusions, reducing rates, and increasing the standard deduction and personal exemption. These improvements were sufficient to warrant basing our income tax on the federal system beginning in 1987. Use of the federal base greatly simplifies the Minnesota tax for taxpayers and for Department of Revenue processing and compliance activities. Because of the use of the federal tax base, only a small number of additional specifications are required for a model individual income tax system for Minnesota.

1. **The individual income tax should provide 25-30 percent of total state and local taxes. Individual income tax yield should be larger than the net property tax.**

   Minnesota's tradition has been to rely heavily on individual income tax, because it is most closely related to ability to pay. Reliance on the progressive income tax is necessary to meet our goal of avoiding regressivity in the overall state and local tax system. Because most economists estimate that consumers ultimately pay half or more of the corporate income tax and commercial and industrial property taxes, individual income tax is the only major state and local tax available to attain progressivity. The goal of having individual income tax yield larger than net property tax (after subtracting property tax refunds) will help to limit the reliance on the property tax, which becomes particularly unfair and unpopular if it reaches too high a level. However, the individual income tax should not rise above 30 percent of total state and local taxes, since this would decrease stability in the state and local revenue system and could hinder our ability to compete with other states.

2. **Federal taxable income should be retained as the starting point for the Minnesota individual income tax.**

   This provides maximum simplicity and makes the standard deduction and personal exemption as large as the federal system. Any other starting point, such as federal adjusted gross income, would immediately complicate our system and make it much easier for other complexities to creep back into the system. Conformity with federal taxable income should aid state legislators in protecting the income tax base from erosion due to specific exclusions from the base.

3. **Deductions, credits, checkoffs and adjustments to income should be minimized.**

   a. State deductions should usually be the same as federal deductions; in no case should state deductions be more generous than federal provisions.

      The present simplicity of the Minnesota income tax depends upon relying on the federal tax base and minimizing any adjustments. In addition to reducing simplicity, most adjustments reduce fairness by departing from the concept of horizontal equity (equal tax for people with equal income). We generally oppose federal tax changes that would reduce and complicate our tax base. We also oppose federal changes, such as the exclusion of a portion of long-term capital gains from the base, which would tax different income sources at different rates. This would violate both horizontal and vertical equity principles.

      In this version of the model income tax system, we are not recommending specific deviations from federal taxable income or changes in current state adjustments to income that would broaden the income tax base. Examples of the latter would be eliminating the state exemption for municipal bond interest paid by Minnesota governments or the school expense deduction. This conclusion will be reviewed in the future in response to federal tax base changes and state tax policy discussions.

   b. The effective tax rate on capital gains should be the same as that on other sources of income.

c. Special provisions should not be based on age.

Special tax breaks for senior citizens seem to arise from the fact that many senior citizens have low incomes. This reasoning is faulty, since senior citizens with low incomes will owe little or no tax, especially considering that social security is not taxed at low-income levels. Furthermore, at equal incomes, senior citizens may have lower living costs than non-seniors, who may have costs for children, new mortgages, and clothes and travel for work. The case for senior citizen tax breaks has been further weakened by recent developments that have significantly raised the living standards of seniors relative to non-seniors.

d. No additional checkoff provisions should be added to the current nongame wildlife fund checkoff.

e. The current Minnesota regular individual income tax form (M-1) provides all the required lines on one page, with most taxpayers not required to use other forms. We recommend that this situation be maintained.

4. Minnesota tax rates should:

a. be limited to three rates,

b. continuously rise with income,

c. be competitive with other states, especially surrounding states, and

d. be sufficiently progressive to achieve the desired degree of progressivity of the overall state and local tax system.

Minnesota currently has three income tax rates (6.0, 8.0 and 8.5 percent). In combination with the zero rate on the non-taxable first portion of income, three rates are sufficient to achieve any desired degree of progressivity. The top personal income tax rate, in particular, should be competitive with other states.

As reported in the department's *Minnesota Tax Incidence Study*, the regressivity of sales, excise and property taxes is offset by Minnesota's relatively heavy reliance on the progressive income tax. The combined distribution of these taxes is essentially proportional to income for all taxpayers except those in the bottom 10 percent of the money income distribution. In contrast, effective income tax rates rise from 0.3 percent of income for the lowest income groups (bottom 10 percent) to 5.6 percent for taxpayers in the highest income group (top 10 percent).

The top rate receives great scrutiny and should be kept competitive. On the other hand, the income tax is the main tool available to keep the overall state-local tax system from being regressive, and the income tax rate structure must provide progressivity. Where data is available, interstate income tax comparisons should be based on effective tax rates (taxes relative to comprehensive income), not statutory tax rates. Effective tax rates provide the necessary adjustments for differences in state tax bases.

5. **The income tax should be indexed for inflation.**

Our use of federal taxable income picks up federal indexing of the standard deduction and personal exemption. Additional indexing of the Minnesota tax brackets will prevent "bracket creep," which would cause people to pay higher real taxes when their incomes just keep up with inflation. With full indexing, our income tax will still have an elasticity value greater than 1.0 due to the normal growth in real incomes. With an elasticity greater than 1.0, a one percent growth in personal income results in a greater than one percent increase in income taxes. However, it is important to note that, with income tax indexing, overall revenue growth needs to be protected by indexing the excise taxes and avoiding narrowing the tax base for all tax types.

CHAPTER 4
SALES AND USE TAX

Minnesota's sales and use tax, first adopted in 1967, is now the second-largest source of state taxes, yielding $1.96 billion in fiscal year 1991. In addition, the related motor vehicle excise tax yielded $232 million. Sales, use and motor vehicle excise tax collections were 22 percent of total state and local taxes in fiscal year 1991. This report uses the term "sales tax" to refer to sales, use and motor vehicle excise taxes.

The general sales tax is primarily a broad-based tax on consumer expenditures. The tax is imposed on the sale of tangible personal property or services to the final consumer and is collected by the seller. A number of exemptions reduce the size of the actual sales tax base. The current sales tax rate is 6.5 percent, which includes a 0.5 percent local option sales tax. In addition, different tax rates apply to several products, including farm machinery and alcoholic beverages.

1. **The sales tax, not counting excise taxes, should provide 20-25 percent of total state and local taxes.**

   The national literature generally recommends that income, sales, and property taxes each provide 20-30 percent of total state-local taxes. With Minnesota presently at about 22 percent sales taxes and our tradition of staying on the high side of the range on the income tax and the low side on the sales tax, we recommend the 20-25 percent range for the sales tax. Some increase in the sales tax share would relieve pressure on the income tax and property tax, which are both at or above the 30 percent maximum. Increasing the sales tax share by broadening the base would support the tax system objectives of reliability, fairness and efficiency.

2. **Final sales of tangible personal property to consumers should generally be taxed, with some exceptions noted below.**

   The reasons for this general rule are:

   - fairness among consumers who buy different mixes of products and less distortion of consumption choices between taxed and untaxed goods,
   - simplicity that assists in compliance, administration and taxpayer understanding,
   - stability of receipts over the economic cycle, and
   - sufficiency in terms of tax growth equal to the growth in personal income.

Minnesota has a long list of products that are exempt from sales tax, and these exemptions should be reduced to the major necessities. As the sales tax base is broadened, the tax rate could be reduced to achieve revenue neutrality. The exemption of prescription drugs should continue. National literature favors exemption of food, either by direct exemption or by a refundable income tax credit. We agree with the literature that a model revenue system should include taxation of the following products (where available, the number of states taxing the product is identified):

a. clothing (only five states exempt clothing, and the exemption creates numerous interpretive, compliance and audit problems. The sales tax would be less regressive with clothing taxed and a revenue-neutral reduction in the tax rate),

b. newspapers (taxed in 11 states),

c. gasoline (taxed in 8 states), and

d. other products, including textbooks, non-prescription analgesics and baby products.

3. **Services that are provided primarily to consumers, not to businesses, should be subject to the sales tax, except for specifically-listed exemptions.**

In most states, the sales tax began as a tax on sales of products, not services. Most states, including Minnesota, now tax a wide variety of consumer services, while exempting many others. Taxation of consumer services reduces regressivity and maintains revenues relative to personal income as services become a larger share of consumer spending and products become a smaller share.

A model revenue system, rather than listing which selected services are taxable, should specify that *all* consumer services are taxable, unless specifically exempted. The major category that should be exempted from the general sales tax is health services, to avoid regressivity and heavy impact on individuals in periods of serious illness.

Some of the major consumer services not now taxed that should be taxed in accordance with this position are the following:

a. vehicle repair and repair contracts (taxed in 44 states),

b. other repair and repair contracts (generally taxed in 23 states),

c. barber and beauty services (taxed in 6 states), and

d. artistic performances by tax-exempt organizations (taxed in 23 states).

4. **Services that are provided primarily to businesses, not to consumers, should be exempted from sales tax.**

Historically, many states tax a wide variety of consumer services, whereas only a few states tax professional services such as legal, accounting, advertising, and architectural. In addition to conformity with other states, there are sound tax policy reasons for not taxing professional services:

- Professional services are rendered to both businesses and consumers, but a majority of the services are rendered to businesses. Taxation of these services provided to businesses would create "pyramiding" or multiple taxation, with both the service and the final product taxed. With pyramiding, the effective tax rate on consumers could vary significantly by type of final product or service.

- Taxing services to businesses would encourage firms to hire their own professionals (e.g., lawyers) in which case sales tax would not be paid, whereas the same services from an outside firm would be taxed. This would create an inefficient use of resources by firms.

- States that tax business services may have a competitive disadvantage compared to states that do not. This may become a significant interstate tax competition issue as states attempt to expand the sales tax base.

The combined effect of recommendations (3) and (4) is that services provided primarily to consumers would be taxed, even when they are used by businesses. For example, repairs to company cars would be taxed. Conversely, services provided primarily to businesses would be exempt, even when they are used by individuals. For example, the legal fees of an individual would be exempt.

5. **Items used in production should be exempted from sales tax.**

   a. Materials consumed in production should be exempt.

      These materials are currently exempted in Minnesota and most states, since sales tax will be collected on the final product.

   b. Materials that are major expenses in the provision of taxable services should be excluded from sales taxation.

      This recommendation parallels (a) above regarding the exemption of materials consumed in the production of products. However, for ease of compliance and administration, this exemption should be limited to materials used directly in the performance of the service itself, such as the soap of laundries and car washes, not their office paper and pencils.

   c. Manufacturing capital equipment, both for new facilities and for replacement of existing equipment, should be exempt from sales tax.

      This exemption is based on the same concept as (a), that sales tax will be collected on the final product. Our present system of exempting new and expansion equipment and taxing replacement equipment is difficult to administer regarding numerous borderline cases, and is unfair between different firms and different ways of providing plant capacity. This exemption should include equipment installed by contractors and other third parties. The exemption should also include capital equipment used directly in providing taxable services (a dry cleaning machine should be exempt; an office computer should be taxed). Exempt equipment should be exempt at the time of purchase, with no refund procedure required.

6. **There should be only one state sales tax rate.**

   A uniform sales tax rate should be applied to all taxable sales. Different rates for such products as farm machinery (2.5 percent) and alcoholic beverages (9.0 percent) should be eliminated.

7. **The Minnesota sales tax rate and taxable base should be competitive with other states, especially bordering states.**

8. **As base-broadening steps are adopted, the current sales tax rate should be reduced.**

   The general concept of the last three recommendations is a broader sales tax base and a lower rate. The recommended changes could be implemented on a revenue-neutral basis or with some net gain in state revenue within the target range. Their full adoption should be accompanied by a rate reduction, since the broader base at the current rate would push sales and use taxes as a percentage of total state and local taxes above the target range.

9. **These features should be included in the sales tax system for effective administration:**

   a. Taxpayers should not be required to make early sales, alcoholic beverage and cigarette excise tax payments in June.

   b. Sales tax rules should be current, and there should be a centralized library of all sales tax technical, legal, and policy statements, releases and decisions.

   c. Penalties should be sufficient to encourage compliance, be consistent and be reasonable.

   d. Exempt products should be exempt at the time of purchase, with no refund procedure required.

   e. All purchases of taxable products and services should be subject to sales tax.

   f. A threshold for the payment of use tax by consumers should be adopted. Above the threshold, use tax should be publicized and enforced.

10. **A local option sales tax should be one option for local revenue diversification.**

    The local option sales tax should have the following features:

    a. uniform rate applied to the state sales tax base,

    b. state administration of the tax,

    c. no separate use tax for local jurisdictions, and

    d. county-level tax to reduce geographic fiscal disparities in the sales tax base.

CHAPTER 5
EXCISE TAXES

Minnesota's major excise taxes are those on cigarettes, alcoholic beverages and motor fuels. Excise taxes on specific commodities complement the sales tax as a tax on consumption. In addition to being a general revenue source, excise taxes are often justified as benefit charges (e.g., motor fuel taxes) or as taxes that properly charge consumers for the negative effects their consumption imposes on others (e.g., cigarette and alcoholic beverage excise taxes). In fiscal year 1991, cigarette and tobacco tax collections were $153.5 million, alcoholic beverage collections were $55.8 million and motor fuel taxes raised $455.4 million. In total, excise tax revenues equal 30 percent of the revenue raised from the general sales tax.

The excise taxes on cigarettes, alcoholic beverages and motor fuels are expressed as a fixed tax per unit of product (e.g., cigarettes are taxed 48¢ per pack). Since consumption of these products is quite flat or even falling, tax receipts tend to stay flat or fall over time. In Chapter 3, we recommended full indexing of the individual income tax, as provided by current law. Given this major protection for taxpayers against inflation, it is also important that adequate funding for public services be protected by indexing the excise taxes for inflation. This is reflected in the recommendations that follow.

1. **The earmarking of specific excise taxes to fund particular spending programs should be avoided.**

   A growing tendency exists for state governments to consider an increasing array of excise taxes to fund specific expenditure programs. Recent examples in Minnesota include proposals for a wholesale paint tax to fund lead abatement programs; a wholesale soft drink tax to fund early learning education programs; and an excise tax on cable TV and records, discs and tapes to fund nonprofit arts programs.

   Except in the case where an excise tax is closely tied to the benefits taxpayers receive from government programs (e.g., motor fuel taxes), we oppose the adoption and earmarking of this type of tax for a limited expenditure purpose. These earmarked taxes have high administrative costs per dollar raised, create significant complexities in the tax system, impose substantial compliance costs and reduce accountability in the state budgeting process.

2. **Alcoholic beverages should be taxed at the same retail sales tax rate as other taxable goods and services.**

   As noted in Chapter 4, sales tax simplicity for vendors and tax administrators requires the use of one sales tax rate. During the 1982-83 state budget crises, the sales tax on both off-sale and on-sale alcoholic products was increased to 8.5 percent. The revenue that would be lost by reducing the rate to the general sales tax rate can be balanced by increases in the special excise tax rates on alcoholic beverages.

3. **Excise tax rates on beer and wine should be raised to levels comparable with most other states and with the tax rate on the alcohol content of "spirits."**

   Our excise tax rates on alcoholic beverages are about four times as high per unit of pure alcohol for spirits compared to beer and wine. Since the rationale for the high tax rates on alcoholic beverages stems from the problems associated with alcohol abuse, the tax rate on pure alcohol should be the same for all types of alcoholic beverages. Our beer and wine taxes are lower than most other states. Economic studies suggest that unusually low taxes on beer and wine may increase consumption of those beverages.

4. **The alcoholic beverage tax system should be indexed for inflation.**

   The system could be indexed, for example, by adjusting the excise tax rates for changes in the Consumer Price Index or by instituting a new system of tax rates based on a percentage of gross wholesale invoice prices. This change would provide inflationary growth in tax receipts and prevent the erosion in inflation-adjusted revenue over time. This reduction in real revenue can be significant; for example, beer excise tax collections fell 68 percent over the last two decades after adjusting for inflation.

5. **The cigarette tax rate should be indexed for inflation.**

   The cigarette tax rate was increased 5¢ per pack in June 1991 and an additional 5¢ per pack in July 1992. Even with the 10¢ increase in the cigarette tax rate in the last two years, the inflation-adjusted tax rate in 1992 is still lower than the rate in 1987 when the tax rate increased from 23¢ to 38¢ per pack. Indexing the rate would result in automatic, annual rate adjustments rather than infrequent, large legislative adjustments.

6. **The motor fuels tax rate should be indexed for inflation.**

CHAPTER 6
PROPERTY TAX SYSTEM

Property tax is almost the sole tax source for local governments in Minnesota. In fiscal year 1991, almost 96 percent of local taxes were from the property tax. Nationally, the property tax accounted for just under 75 percent of all local taxes in 1990. State tax policy in Minnesota has significantly restricted the use of local option taxes; any local sales or income taxes must be authorized by the legislature.

In fiscal year 1991, local governments raised $3.14 billion in net property taxes, which accounted for 31.1 percent of total state and local taxes. The level of local property taxes is partly determined by state fiscal policies, including levy limits, mandates, takeovers of local program costs, aids and credits paid to local governments and property tax refund payments to individual homeowners and renters. In fiscal year 1991, state-paid property tax relief (aids, credits and property tax refunds) totaled $3.4 billion, eight percent more than total net property taxes. In addition, legislative changes in property tax class rates also affect the distribution of property taxes across different classes of property. The property tax classification system currently has fifteen separate class rates applied to different classifications of property.

A. General Principles of State Role

1. **The model property tax system recognizes the importance of the state's extensive role in the local property tax system.**

   Specific state responsibilities include:

   - overseeing property tax administration and assessment practices;

   - defining a tax base that minimizes exclusions and fairly distributes the taxes across different property types;

   - ensuring access to basic government services through equalized state aid to local governments that recognizes both need and capacity;

   - reducing the regressivity of property tax though the property tax refund system, which targets relief to taxpayers with high tax burdens relative to their ability to pay;

- strengthening local accountability through oversight of the truth-in-taxation process; and

- increasing local budget flexibility by minimizing state program mandates and property tax limitations and by expanding local revenue options.

2. **Twenty-five to thirty percent of total state and local taxes should be obtained from property tax.**

   As with the other major taxes, the specific target percentage will be determined by the role of property tax in meeting the multiple objectives of a balanced state and local revenue system. As the local property tax pushes the upper end of the range, interstate tax competition and fiscal disparities among local units of government become significant fiscal issues. If the weight of property tax falls below 25 percent, there is a potential weakening of local government accountability. A lower property tax share could also introduce greater instability in state and local tax collections.

   Through its state aids, property tax relief programs, state mandates and other expenditure programs, the state has a responsibility to manage the overall level of local property taxes to achieve the targeted range for the utilization of property tax in the state and local revenue system.

3. **Levy limits should be eliminated for general purpose governments: cities, townships, and counties. Levy limits should continue for school districts.**

   Levy limits are a major entanglement of the state in local governing autonomy. Limits contribute to citizen confusion about the local responsibility for local spending decisions and resulting property tax levels. They also complicate the property tax and aid system. No clear proof exists that levy limits even work to hold down local spending over an extended period; in some cases, local governments may levy higher property taxes than needed in order to protect their levy limit base for future years. However, levy limits are needed for school districts to ensure an equitable distribution of educational resources.

B. Administration and Assessment

1. **The property tax system should be uniformly administered by local governments with the oversight of the Department of Revenue.**

   The uniformity of local property tax administration has two major dimensions:

   - Classification

     Assigning individual properties to a particular use class (such as residential, commercial or agricultural) is the critical first administrative step in Minnesota's classified property tax system. In practice, uniform classification means that properties used in the same manner should be given the same property tax classification, no matter where they are located.

     Classification uniformity can be promoted by legislation enacting fewer, broader property tax classes based upon obvious differences in use, and by reducing the comparative tax differentials among classes that give major tax consequences to relatively minor differences in use. As outlined below, the model property tax system recommends not more than three classes of property.

   - Valuation

     Accurately estimating the market value of individual properties is crucial to the uniform administration of the property tax system. More accurate property valuation can be promoted by policies basing taxes for all types of property on their estimated market value rather than on income-capitalization or other formulas. Market valuation provides a consistent, precise basis for measuring assessment accuracy and uniformity by comparing assessments against actual selling prices in sales ratio studies.

2. **The accuracy and uniformity of property valuation can be measured by several statistical indicators of assessment quality:**

   a. The statewide median sales ratio and all local sales ratios should be 90 to 105 percent, after any decisions by all boards of review and equalization.

b. Average intra-county coefficient of dispersion should be less than 20 percent.

c. Average inter-county coefficient of dispersion should be less than eight percent.

d. Assessment levels should be neutral with respect to the values of the properties being assessed.

The median sales ratio in (a) measures the typical level of assessment by comparing estimates of market value to actual market sales prices. The coefficient of dispersion is the average absolute deviation of the individual sales ratios from the median ratio, expressed as a percentage of the median. For indicators (b) and (c) above, the coefficient of dispersion measures how greatly individual sales ratios vary from the overall median.

The neutrality of assessment levels in relation to market value in (d) means that high- and low-valued properties are assessed at the same percentage of market value. This may be judged using several indicators, among them indices of regressivity, sales ratio studies stratified by market value, and other more complex statistical procedures. In using the above statistics to evaluate year-to-year changes in the effectiveness of property tax administration, any available information of the statistical reliability of these individual measures should be considered.

C. Treatment of Different Types of Property

One of the most important property tax roles for state government is to define the property tax base. The state does this in two important ways. First, it determines which types of property (e.g., real vs. personal property) should be taxable and which should be fully exempt. Second, the state also has a responsibility to determine what percentage of full market value should be taxable for different types of property. The following recommendations outline the model revenue system principles for treating different types of property differently.

1. **Properties that are currently constitutionally exempt, including public lands owned by state, local and federal governments and church affiliated properties, should remain fully exempt from the property tax base. However, tax exempt property that is not constitutionally exempt should pay a fee equal to the city or township levy for police and fire protection and streets in lieu of property taxes.**

2. **All property should be assessed at 100 percent of full market value.**

The most common property tax system in other states is a "one-class system," where the same local property tax rate is applied to the market value of all types of property. However, most states with such a system actually make several distinctions between different types of property in determining the property tax base, such as these:

- Business equipment is taxed, adding about 50 percent to the commercial and industrial tax base compared to Minnesota's tax exemption of equipment.

- In some states, farmland is valued based on income potential, compared to Minnesota's valuation based on selling prices.

- Residential values are reduced by a partial exemption.

The extent of these distinctions is indicated by the representative tax system, published by the U.S. Advisory Commission on Intergovernmental Relations. To calculate "representative" property taxes for each state, the representative tax system assumes a standard property tax with a residential taxable value almost double that of farmland, and a commercial and industrial rate 2.5 times that of farmland, with a commercial and industrial tax base of realty, equipment and inventories. Thus, "one class" property tax systems do not usually assess all types of property uniformly. However, Minnesota departs much further from a strict "one class" system than most states, with taxable value distinctions ranging from 0.45 percent to 4.75 percent of market value (for taxes paid in 1992).

Our basic goal is to achieve property tax results similar to those obtained with the representative tax system and the more common "one class" systems of other states. We are so different from such a system at present that the most desirable methods for treating some types of property cannot be completely spelled out at this time. However, the general directions needed are clear.

3. The local tax rates applied to market values of different types of property should be related as follows:

a. Commercial and industrial property should be taxed at 100 percent of the local tax rate.

b. Residential homesteads and rental housing should both be taxed at 50 percent of the local tax rate.

No justifiable reason exists to differentiate between different types of residential property, especially considering that renters tend to have lower incomes than homeowners and do not benefit from the mortgage interest deduction that homeowners receive on their income taxes. While there is concern about whether lower rental housing property taxes benefit landlords or renters, we believe that, in the long run, lower property taxes do benefit renters in the form of lower rents, better maintenance, and greater availability of high-quality rental units.

c. Farmland should be taxed at 25 percent of the local tax rate.

The present method for valuation of farmland based on sales, not income capitalization, should be continued. Farmland selling prices are definite known quantities, whereas income valuation depends on the assumption of a capitalization rate and other judgmental factors. However, farmland values are usually much higher by the selling price method compared to the income method. The lower local tax rate applied to farmland values should be used as the method to reduce the relative farmland property tax rate.

This recommendation creates differences in effective tax rates for different classes of property through differences in the local tax rates applied to a property's market value. The state determines the relative rates, but local government decisions determine the level of property taxes. By comparing the effective local tax rates for different types of property, local residents and businesses will have a clearer understanding of the relative tax burdens on different types of property. By comparing effective local tax rates between units of governments, taxpayers will better understand differences in the level of local property taxes. This simplification should increase understandability and accountability in the local property tax system.

4. **The overall taxation of commercial and industrial property should be reduced to be competitive with other states, especially bordering states. The exact methods and class rate to be used need study, but phased movement to the appropriate classification rate is strongly recommended.**

   The taxation of commercial and industrial property involves dealing with Minnesota's exemption of business equipment compared to its taxation by most states. We need more studies and discussions with policymakers and business people to decide on the best approach. We do not want to copy most states, because business equipment is difficult and expensive to assess and is typically under-assessed.

   We could continue our present approach of including only commercial and industrial real estate in the property tax base, with a higher tax rate to compensate for the exemption of equipment. It appears that a 3.8 percent effective tax rate — property taxes divided by market value — would be competitive (about 11th among the states) with this approach. The disadvantage of this approach is that even 3.8 percent is still very high for commercial and industrial property that has little equipment. As this issue is examined more thoroughly, consideration should be given to the problems created by different ratios of real to personal property for different types of business.

5. **A gradual phase-in should be adopted to achieve the basic goal of property tax results similar to those obtained with the representative tax system and the more common "one class" systems of other states.**

   Immediate adoption of the ultimate goal would cause severe problems in immediate large tax increases for some taxpayers, inability of the state to accurately establish new formulas and cost estimates for programs such as education aids, local government aid, property tax refunds, and difficulties for local governments in coping with radically different tax bases, aids and tax incidence. A gradual phase-in of the proposed local tax rate structure would also result in more gradual changes in property values which could reflect capitalization of tax rate changes.

   During the phase-in period, the focus should be kept on the basic goal, as stated above. The relative shares of taxes for the various types of property are much more important than the exact structure, such as the number of classes.

D. State Aid and Property Tax Relief

A clear distinction should be made between state expenditures for property tax relief for individual taxpayers and state expenditures for local government aids. State paid property tax relief should be targeted to taxpayers and not to local governments. The primary objective of these expenditures is to directly reduce property tax burdens for individual taxpayers with relatively high property tax burdens.

The primary objective of state aid to local governments (including school districts) should be to subsidize local government funding for basic or state mandated programs and services. These expenditures should be targeted to local governments based on expenditure needs and revenue-raising capacity. A secondary objective is to equalize property tax burdens across local governments for financing basic programs.

1. Property Tax Relief

a. The state's only major program for direct property tax relief should be the property tax refund program for homeowners and renters.

   Following Minnesota tradition, property tax refunds should be targeted to taxpayers with high property tax burdens relative to their income (i.e., their ability to pay). The role of the property tax refund program in providing direct property tax relief should be increased relative to other programs providing indirect relief through state aid payments to local governments.

   When all housing is subject to the same tax rate, there should be only one property tax refund schedule for all homeowners and renters. Special provisions for cabins, mobile homes, part-year homeowners and renters, and nursing home residents should be eliminated.

b. The special "targeting" refund program should be eliminated.

   Targeting refunds provides property tax relief to homeowners with large percentage increases in annual property taxes. Because refunds are unrelated to household incomes, targeting is not a cost-effective program for providing property tax relief.

c. Homestead and agricultural credit aid (HACA), which is the state's current major policy to provide property tax relief, should be gradually converted to other more efficient property tax relief and aid programs.

The first priority should be to use HACA dollars to fund a new and expanded property tax refund program. The remaining HACA should be used to fund better targeted local government aid formulas (including school aid).

2. State Aid to School Districts

The state aid share of school district operating funds (all funds except capital and debt service) should be targeted at approximately 70 percent.

This would provide full tax base equalization for basic educational costs and concentrate state aid in program areas with significant state mandates. The 30 percent local share should be maintained for addressing local control and revenue diversification concerns.

To the extent the state provides its relative share of aid, incorporates appropriate cost equalizing factors in the allocation formulas, and maintains adequate funding growth in the general aid program, there will be less need for school districts to seek referendum levies to support basic school operations. School general operation referendum levies should reflect a school district's choice to spend above the basic funding level and, therefore, should not be subsidized by the state.

3. State Aid to Cities and Townships

The state should continue to provide general support aid to cities and townships, but the state's role in the fiscal partnership should change in the following ways:

a. Because cities and townships provide those goods and services that tend to have primarily local benefits, state policy should encourage a greater reliance on own-source revenue for cities and townships. Policies supporting this objective include the removal of levy limits and increased local option revenue sources. These policies would make local budgets less susceptible to state budgetary cycles and more accountable to local taxpayers.

b. The primary purpose of ongoing state general aid to cities and townships should be to equalize funding for a basic level of services with a statewide interest. The formula for distributing this aid should be based on both fiscal need and capacity. Aid amounts should be independent of local spending decisions, simple to understand; and all cities and townships should receive their formula amounts with no limits or grandfather provisions.

c. The state's fiscal responsibilities to cities and townships should recognize possible differences by type of city in the fiscal partnership with the state. Large cities like Minneapolis, St. Paul, and Duluth have unique economic needs relative to fiscal capacities. A different formula may be needed to recognize this situation. It also suggests that these larger cities could receive less general aid but more categorical or block grant aid than smaller, more homogeneous cities. In contrast, smaller cities and townships may only require a basic amount of per capita tax base equalizing aid.

d. Tax increment financing (TIF) should continue to be available to cities for the elimination of blight, housing needs not otherwise being met, and economic development. Since TIF does involve government spending and taxing and has the potential to export city taxes to the state and other local governments, effective state controls should exist to limit its use to projects with sufficient overall benefits to the state. The statewide percent of TIF captured value to total property value should not increase (new captured value should be balanced by properties being decertified).

4. State Aid to Counties

In many respects, county governments are an extension of the state. Counties are primarily responsible for providing programs for health, income assistance, social services and corrections. Although there is some degree of local discretion in delivering these programs, service levels and eligibility standards are, to a great extent, determined by state and federal mandates.

The escalating costs of these programs have put increasing pressure on the property tax. County property taxes to support these programs have recently increased in excess of 10 percent annually.

In order to address this problem:

a. The state should, where possible, institute cost controls and work with counties to develop a more efficient and targeted delivery system.

b. The state should continue its efforts to sort out program responsibilities with county governments and provide 100 percent funding for those programs that are primarily a state function. Examples of these include income maintenance benefits and public defender costs.

c. The state should provide a greater amount of state aid in those programs where it shares responsibilities with county governments. For example, state aid should be increased for social service, health and corrections block grants. This type of aid would help counties fund programs that have a statewide interest, help to equalize service levels and alleviate fiscal pressures on the local property tax. Effective cost controls should also be developed for these programs.

5. **State Dedicated Revenues**

The state should not dedicate revenues for property tax relief or local government aids.

The dedication of state revenues may be warranted if there is a reasonable linkage between program costs (i.e., the tax source that is dedicated) and benefits received. However, where such a linkage does not exist, the dedication of revenues undermines legislative accountability by removing the revenue and expenditures from the biennial budget review process. Continuing adjustments in the scope of programs funded or the amount of dedicated revenues will, in practice, be needed to reduce these budget inefficiencies.

E. State and Local Relationships

1. **The state should support the operation of a state and local advisory commission to provide the executive branch, the legislature and the public a neutral forum for sorting out the responsibilities for delivery and funding of state and local services, and the control and funding of state mandates. The commission should have statutory authority and an adequate budget for staff studies.**

2. An effective monitoring and reporting system should exist for local fiscal information and trends. Local accounting should be required on a uniform basis. State agencies should cooperate in the publication of annual information on local fiscal data, trends and issues.

CHAPTER 7
BUSINESS TAXATION

A. Introduction

The business tax structure in Minnesota is a complex system of a number of separate taxes, some of which also apply to individuals. The separate business taxes apply to different tax bases including property, profits and gross receipts. Minnesota's major state and local taxes with an initial impact on businesses are approximately as follows (fiscal year 1990 except as noted):

Business Taxes	Million
Commercial and industrial property taxes (payable 1990)	$1,125
Utility property taxes (payable 1990)	246
Sales and use tax (estimated 30 percent paid by businesses)	560
Motor vehicle excise tax (estimated 30 percent paid by businesses)	78
Corporate income tax, including alternative minimum tax	444
Business minimum fees ($100 to $5,000, adopted in 1990)	27
Telephone gross earnings tax (phased out by 1992)	47
Insurance premiums taxes	134

Under the heading "business taxation," one tends to think primarily about the corporate income tax. However, as these numbers show, business property taxes and sales and use taxes are actually the largest business taxes. Therefore, it is important to include these taxes in a consideration of total business taxes. In addition to the taxes listed, Minnesota employers make annual payments for unemployment compensation ($375 million in 1989) and workers' compensation ($1,039 million in 1989).

Because of the number of taxes involved, the complexities of business activities and the unsettled state of basic principles, the model revenue system for business taxes is the most difficult to specify. For example, the ability-to-pay equity concepts are difficult to apply to businesses. What is the proper base for measuring taxpaying ability? Possibilities include profits, sales, value added, property and net worth. The issue of fairness is further complicated by the uncertain resting place, or final incidence, of taxes imposed on businesses. In response to a tax, a firm may alter output and input levels and shift the tax forward to consumers through higher output prices or backward to factors of production through lower input prices.

Another reason why the business tax structure is more complex than the structure of taxes affecting individuals is that some business taxes apply only to certain types of businesses (e.g., insurance and utility property taxes) or to certain forms of business (e.g., corporate franchise tax). This nonuniform treatment can create significant distortions or inefficiencies in a state's economy.

This chapter repeats the model revenue system principles applicable to businesses which have already been identified in previous chapters, and introduces new principles that are specific to a model business tax structure. These recommendations should help Minnesota to maintain a favorable business tax climate.

B. General Characteristics (Chapter 2 Summary)

1. Minimize efforts to pick winners and losers in tax system design.

2. Use broad based taxes with uniform rates to reduce economic distortions; keep the number of separate business taxes to a minimum to reduce the costs of compliance and administration.

3. Provide any state business subsidies for economic development directly by appropriations, not indirectly by tax expenditures.

4. Coordinate state taxes on business payrolls (e.g., withholding and unemployment taxes) to reduce taxpayer compliance burdens and state administrative costs.

C. Property Taxes (Chapter 6 Summary)

1. Commercial and industrial property should be assessed at 100 percent of market value and taxed at 100 percent of the local tax rate. The effective tax rate should be reduced to be competitive with other states.

2. The state should continue to exempt commercial and industrial personal property from the property tax base, and to tax the personal property of regulated public utilities.

D. Sales And Use Taxes (Chapter 4 Summary)

The business tax structure should avoid multiple taxation of business inputs and be neutral regarding various methods of producing a final product. The multiple taxation of business inputs will become a more severe problem as the sales tax base is expanded to include services. The model offers a workable compromise between the theoretically desirable base of no sales tax on business inputs and the practical needs for sales tax revenues:

1. Exempt materials consumed in production and in the provision of taxable services.

2. Exempt manufacturing capital equipment, both for expansion and replacement. The exemption should also include capital equipment used directly in providing taxable services. This would provide a significant investment tax incentive for both new and existing businesses in Minnesota.

E. Corporate Income Tax

1. **Minimize the use of credits, deductions and adjustments to income, following the structure of federal corporate income taxes.**

   Use of the federal tax base provides simplicity for taxpayers and tax administrators. Most adjustments to the federal tax base create inefficiencies by taxing similar economic activities at different tax rates. In addition, the federal government generally maintains compatible rules for their individual and corporate income taxes, since large numbers of competing businesses pay taxes on both the individual and corporate income tax bases. This makes it important for Minnesota to generally conform to federal rules on both individual and corporate income taxes.

2. **Continue to use the three-factor formula (sales, property and payroll) for the apportionment of profits to Minnesota.**

   The three-factor apportionment formula is used to identify corporate income that can be attributed to economic activity within Minnesota. The three-factor formula is a constitutionally acceptable method for apportioning a multistate firm's activities among the individual states. The allocation percentage is a weighted average of the shares of a firm's payroll, property and sales in the state. In Minnesota the weights are 70, 15 and 15 percent for sales, property and payroll respectively. The equally-weighted, three-factor formula is used in 31 states and is recommended by the Multistate Tax Compact. However, the recent trend is for more states to move to a sales factor weight of 50 percent and weights of 25 percent each for property and payroll.

We do not recommend a change in the Minnesota apportionment formula at this time for several reasons. A firm's payroll and property reflect production activities that benefit directly from state and local services. The destination sales factor allows the state to tax a portion of the income of firms operating in other states but selling in Minnesota. An increase in the weight given to sales would reduce state revenue and give too little weight to the benefit-related components of the formula. While a reduction in the weight on sales would increase state revenues, it could have a negative impact on multistate firms producing in Minnesota and selling nationwide. These firms may be particularly sensitive to interstate tax differentials.

3. **The corporate franchise tax rate should be competitive with other states.**

   In comparing corporate tax rates across states, any reduction in overall tax rates provided by unequal weighting in the apportionment formula, such as Minnesota's current 70 percent sales, 15 percent payroll and 15 percent property weighting, should be considered.

4. **The corporate alternative minimum tax (AMT) adopted in the 1990 session should be maintained, using the federal AMT tax base and the federal proportion of AMT rate to regular rate.**

   The corporate AMT ensures that corporations making an economic profit pay some tax. It also reduces the volatility of corporate income tax collections. These benefits, however, come at a cost of increased complexity in the tax system. Attention should be given to changes that simplify the AMT structure.

5. **The combination of the corporate income tax, corporate AMT and the $100 to $5,000 business minimum fee should continue to provide the recent share of about seven percent of state and local taxes.**

   This recommendation provides a measurable target for the desired balance between the corporate franchise tax and other state and local taxes. The various components (corporate franchise tax, minimum fees and AMT) can be adjusted to maintain this target.

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The *Model Revenue System for Minnesota* was prepared by the Tax Research Division of the Minnesota Department of Revenue with the assistance of many department employees and numerous individuals and organizations outside the department.

This first edition of the *Model Revenue System for Minnesota* is dedicated to the memory of John Tomlinson, former assistant commissioner of tax policy for the Department of Revenue.

Please send your comments or requests for additional copies of this report to:

MINNESOTA Department of Revenue

Model Revenue System
Mail Station 6670
St. Paul, MN 55146-6670