Tax Strategies For A Strong Minnesota

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TAX STRATEGIES FOR A STRONG MINNESOTA

By nearly any measure, Minnesota's economy is strong. In fact, Minnesota has been one of the leading states in many of the most important economic and social indicators over the past fifteen years. The private and public sectors are collaborating to provide Minnesotans with employment, opportunity and relative prosperity. The tax system, perhaps more than any other single factor, defines the terms of this collaboration.

Minnesota's government taxes more and spends more than the governments of a majority of states. Minnesota has chosen a tax system that is less regressive than most states—offering a better deal for middle- and low-income families. And the share of taxes initially paid by Minnesota business is about at the national average.

Minnesota's Strong Economy

- **5th lowest unemployment rate nationally in 1996 (3.6 percent).**
- **4th highest increase in per capita personal income in the nation in 1996.**
- **The Minneapolis-St. Paul metro area had a unemployment rate of 2.4% in August 1997.**
- **From 1984 to 1996, Minnesota's median household income grew more than twice as fast as the national average.**

These choices have worked well for Minnesota. The investments represented by government spending appear to be paying off. At the same time, the state's methods of collecting taxes have not inhibited economic well-being.

Now, with the economy performing so well, the people of Minnesota have many options in choosing what they want their government to do and how they want to pay for it. Tax revenues have, as is to be expected, grown healthfully under current economic conditions. In fact, Minnesota's state tax revenues have brought in more than the government has budgeted to spend—resulting in surpluses.

In the euphoria that has accompanied these surpluses, cutting taxes is a very attractive option to elected officials, citizens and corporations. The state, however, should proceed with care not to undermine the structure which has served the people of Minnesota so well. In the haste to enjoy today's prosperity, tomorrow's prospects should not be jeopardized. The value of tax cuts must be balanced against the benefits of additional government spending and investments in the state's future. To the extent tax cuts are deemed best, one should first ask who needs them the most, even if they may not be the most influential or the most vocal in their demands.

In addition, prudence requires keeping in mind that the economy will not always be so strong. Cutting taxes could leave funding for vital government services vulnerable during an economic downturn. Further expansion of the budget reserve (the state's "rainy day fund") to secure Minnesota's future should be considered.

This report will examine Minnesota's major taxes, who pays these taxes, and how taxation has changed over time. The study will also examine Minnesota's economic and social indicators, and state and local spending trends. In addition, the study will address how well equipped Minnesota is to handle future needs. Finally, the study will address the merits and shortfalls of several tax reform options.

SUMMARY OF FINDINGS

Economic & Social Indicators

Over the past decade and a half, *income growth* in Minnesota has outpaced the national average. Per capita personal income rose from 17th highest in the nation in 1980 to 12th highest by 1996. Since 1980, 675,000 new jobs have been created in Minnesota—reflecting a growth rate higher than the national average.

The growth in jobs and the falling unemployment rate appear to have had a positive impact on wages in Minnesota. Average annual pay, however, is still slightly below the national average. The failure of pay levels to break this threshold may be due in part to a great increase in those available to work. The share of Minnesota's population that is working has grown rapidly—and faster than the national average. The increasing labor supply has probably kept wages down relative to what they would otherwise be.

As the share of adults working nears its maximum possible amount, there are important ramifications for Minnesota's economy. In the past, pay levels below the national average may have encouraged job and economic growth in Minnesota. But a tighter job market may push wages above the national average, which in turn may hamper job and economic growth *unless* the quality of labor and other assets in Minnesota improve.

Despite rapid job growth, falling unemployment, and rising average annual pay, the poverty rate in Minnesota has not declined. Although the poverty rate in Minnesota is substantially below the national average, it was higher in 1996 than it was in 1980. Thus, some 450,000 Minnesotans remain below the poverty line in spite of the state's economic accomplishments. And over the past year, the number of poor Minnesotans has risen.

Economic expansion has led to increased demands on Minnesota's infrastructure. Minnesota's infrastructure has not kept up with needs. Many of the state's highways and bridges need repair.

A well-educated workforce is important if Minnesota is to remain competitive, and in this area Minnesota is doing well. In 1996, Minnesota ranked 7th in the percentage of its adult population with a high school diploma or higher degree, up from 14th in 1980 (88 percent versus 73 percent). In addition, Minnesota's high school graduation rate of 89.1 percent in 1993 was the highest in the nation.

There is evidence that Minnesota is providing good quality K-12 education: Minnesotan student achievement in math and reading proficiency have been excellent in comparison with other states. But by some indicators, the state's commitment to education has been lagging: the pupil-teacher ratio, for example, has been increasing in recent years.

Minnesota has made considerable progress at the level of higher education. In 1996, Minnesota ranked 13th in the percent of its adult population with a college degree or higher, up from 20th in 1980 (26.3 percent, up from 17.4 percent). In some important areas of higher education, however, Minnesota's ranking has been declining.

Health conditions and availability of medical care are also important. Minnesota generally ranks well in health indicators. In several rankings, however, Minnesota has been slipping. Although the number of doctors in Minnesota per 100,000 people has remained steady since 1980, the percent of Minnesota residents without health insurance has been rising at a faster pace than for the country as a whole over the past five years.

Another important indicator is crime. The crime rate in Minnesota is well below the national average. In addition, the crime rate in Minnesota has decreased from its 1980 level and fallen faster in Minnesota than in the nation as a whole.

Overall, Minnesota ranks high on most measures of economic and social attainment, and has expanded its lead in many areas over the past 15 years. Minnesota has positioned itself as a relatively high-wage, high-skill economy. Whether this position is sustained and enhanced will depend in large part on the public policies that the people of Minnesota decide to follow in the future.

Public Spending in Minnesota

When measured as a share of personal income, Minnesota's public spending ranked 12th in the nation in 1980, and 11th in 1994. This commitment to strong public programs has led to high marks in education, health care, environmental quality and other areas —and helped the state's economy to flourish. For Minnesota to maintain its success, these investments must continue and improvements must be made in some areas.

Recent trends show a decline in state and local education spending relative to other states. Minnesota's ranking in expenditures per pupil dropped from 19th in 1980 to 22nd in 1994. When measured as a share of personal income, higher education spending experienced a slight decline from 1980 to 1994, slipping from 28th in the nation in 1980 (1.8 percent of personal income) to 30th in 1994 (1.7 percent of personal income). In addition, Minnesota spends slightly less (8.3 percent of total state and local spending) on higher education than the U.S. average (8.5 percent of total state and local spending).

While the state has recently boosted its *budget reserve*, or "rainy day fund," it is still not adequate to meet the state's potential needs. When and if an economic downturn occurs, revenue collections will fall while the demand for public services will likely increase. The state needs to be better prepared to deal with this eventuality.

Minnesota's Current Tax System

By any of the most commonly used measures, Minnesota ranks relatively high in government services, and thus in the taxes that support them:

On a per capita basis, state and local taxes in Minnesota rank 8th highest in the nation.

As a share of total personal income, state and local taxes in Minnesota rank 10th highest in the nation.

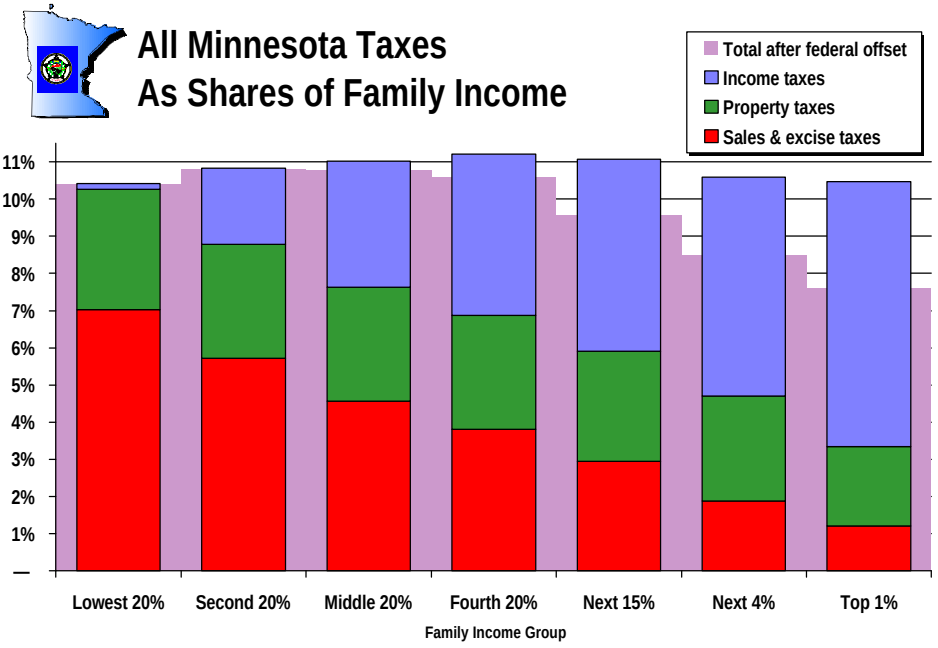
As a share of gross state product, Minnesota's taxes rank 7th in the nation.

Overall Distribution

The Minnesota tax system is slightly regressive. The wealthiest one-percent of taxpayers pay a lower percent of their income in Minnesota state and local taxes than do all except the lowest income group—which pays essentially the same share as the wealthy. The differences among income groups are not substantial, however, and the system is very close to flat.

The slightly regressive nature of the Minnesota tax system is the result of the offsetting impact of its major taxes. The state's sales and excise taxes are very regressive, but their impact is offset by the progressivity of the income taxes. Minnesota's property taxes are also regressive, although less so than the sales and excise taxes.

Although the underlying system is only slightly regressive, when its interaction with the federal



system is accounted for, the Minnesota system is starkly regressive. This is because the deductions for state and local taxes from the federal personal income tax are more beneficial to better-off taxpayers.

In recent years, Minnesota's regressive taxes have been on the rise relative to progressive taxes. Most dramatically, sales taxes are providing an increasingly large share of taxes while progressive taxes like the corporate income tax have declined. In addition, there has been a dramatic shift in the property tax burden from business to homeowners —a trend that has been exacerbated by recent legislation.

Trends in Specific Taxes

Minnesota *sales taxes* have increased substantially as a share of personal income since 1978. Minnesota ranked 40th in the nation in 1978, with general sales taxes taking 1.7 percent of personal income. In 1994, Minnesota placed 31st, with sales taxes amounting to 2.5 percent of personal income. This trend is disturbing because sales taxes are *regressive*—meaning that they take a larger share from those with less income than from those with more. Our findings show that:

- For the 20 percent of Minnesotans making less than $16,000, sales and excise taxes amount to 7 percent of total income.
- Minnesotans in the middle of the income spectrum (average income $34,100) pay 4.6% of their income in sales and excise taxes.
- But the best-off one percent of Minnesota residents, with average income of $730,000, pays an effective sales and excise tax rate of only 1.2 percent.

In other words, low-income Minnesotans pay sales and excise taxes at almost six times the effective rate that the wealthy pay. Middle-income families pay four and a half times as great a share of their income in sales and excise taxes as do the wealthy.

The overall level of *property taxes* has not changed much over the past two decades—in 1978, total property tax collections accounted for 3.8 percent of personal income; in 1993, total property tax collections equaled 3.9 percent of personal income. But there has been a significant shift in who pays the property tax burden. In 1990, businesses paid 56 percent of total Minnesota property taxes and homeowners paid 32 percent (residential rental property accounted for the rest). But by 1996, the business share of the property tax had fallen to 49 percent and the homeowner share had risen to 41. Recent legislative changes threaten to continue to increase homeowner share of the total property tax burden.

Corporate income taxes have declined markedly over the past two decades. As a share of Minnesota gross state product, corporate income taxes fell from 0.8 percent in the late seventies to less than 0.5 percent by 1994. Corporate income taxes also declined as a share of total tax revenue, from 7 percent in 1978 to 5 percent in 1996.

Personal income taxes have remained remarkably constant over the years. In 1978, personal income taxes equaled 3.4 percent of personal income and 27 percent of total Minnesota tax revenues; in 1996, personal income taxes amounted to 3.4 percent of personal income and 28 percent of total revenues.

The combination of sharp increases in regressive taxes (sales taxes and property taxes on homeowners), coupled with stable or declining progressive taxes (personal and corporate income taxes), threaten to make the overall Minnesota tax system more regressive than it was in the past.

Tax reform options

This report presents eighteen options for possible tax changes in Minnesota. Some increase revenues to pay for public services. Others would require reductions in government programs. And still others would shift taxes among income groups. Readers can evaluate these options based on their own notions of tax fairness.

Notes on Presentation

The distributional tables in this report were produced using the Institute on Taxation & Economic Policy Microsimulation Tax Model.[1] They look not only at Minnesota taxpayers by income levels, but when relevant, also at categories of Minnesota families, broken down by family type and age:

- Most of Minnesota's population—62 percent—live in non-elderly married-couple families. These families also earn 62 percent of Minnesota's total personal income.
- Unmarried non-elderly taxpayers, a group that includes single people with and without children, represent 25 percent of Minnesota's population and total personal income.
- Elderly Minnesota couples and individuals constitute 13 percent of Minnesota's population and total income.

When our distributional charts and tables divide the Minnesota taxpaying population by percentage groups (as in the chart on the previous page), we subdivide the top fifth of the taxpayers into three subgroups to aid our analysis. As the table to the right illustrates, the top 20 percent is both a very important and a very heterogenous group:

- Fifty-three percent of all personal income in Minnesota goes to the best-off fifth of all taxpayers.
- Taxpayers in the first 15 percentage points of the top fifth have average incomes of $84,000. In contrast, the average income of the top 1 percent is $730,000.

Finally, in our tables and analysis, we define "income" to include all cash earnings and transfers, including items (such as tax-exempt interest or most Social Security benefits) that are not included in "adjusted gross income" or other narrow tax-law-based income definitions.

Minnesota Family Demographics

	% of Adult Population	% of Total Population*	% of Total Income
Married non-elderly	54.0%	61.9%	62.3%
Unmarried non-elderly	27.6%	25.2%	24.6%
Elderly	18.4%	12.9%	13.0%
Addendum:			
Married, all	66.2%	70.4%	71.1%
Unmarried, all	33.8%	29.6%	28.9%

**Includes dependents.*

The Distribution of Income in Minnesota
All Families and Individuals in 1998

Income Group		Income Range	Average Income	Share of Total Inc.
Lowest 20%		Less than $16,000	$9,500	3.7%
Second 20%		$16,000 to $27,000	$22,000	8.7%
Middle 20%		$27,000 to $43,000	$34,100	13.5%
Fourth 20%		$43,000 to $66,000	$53,300	21.1%
TOP 20%	**Next 15%**	$66,000 to $122,000	$84,000	25.0%
	Next 4%	$122,000 to $287,000	$170,900	13.6%
	Top 1%	$287,000 or more	$730,000	14.4%

[1]The ITEP Model is described in Appendix C. For a more detailed description of the model and its methodologies, see ITEP's June 1996 report, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* or contact the Institute.

CHAPTER ONE

ECONOMIC AND SOCIAL INDICATORS

The economic and social well-being of a state is a function of many often interrelated and interdependent factors. Of course, precisely measuring the well-being of a state is difficult.[2] Nevertheless, chosen and evaluated carefully, economic and social indicators can paint a picture of how well a state economy is performing, allow state-by-state comparisons, and show trends over time. Most important, such an analysis can provide useful insights into what can be done to promote greater social and economic well-being in the future.

After reviewing hundreds of indicators, we selected a number of measures of economic and social well-being to help assess the state of Minnesota. These indicators are grouped into six categories: General Economic, Infrastructure, Health, Education, Environment, and Crime. The primary criterion for selecting these indicators was their ability to reflect economic and social well-being, but they were also chosen based on the availability of data over time and the ability to compare data across states. When possible we have compared Minnesota to the national average and to nearby states: North Dakota, South Dakota, Iowa, Wisconsin, Illinois and Michigan—and we have looked at trends over time.

Ideally, Minnesota would like to be at or near the top in the nation in quality of life and strength of its economy. At minimum, economic and social conditions in Minnesota should improve over time. Where Minnesota is above average, its lead should be increasing. In those areas where Minnesota lags behind the national averages, the gaps between Minnesota and the U.S. averages should be narrowing.

Our analysis finds that Minnesota ranks high on most measures of economic and social attainment. Moreover, over the past fifteen years, Minnesota has expanded its lead in many areas. We find that Minnesota is in the advanced stages of moving from an average-wage, average-skill economy to a high-wage, high-skill economy. Whether the process of transition stalls or continues will depend in part on the policies and strategies that the people of Minnesota and their elected representatives choose to pursue.

I. General Economic Indicators:

Over the last fifteen years Minnesota has experienced steady improvements in its economic well-being. In 1980, most indicators of economic well-being suggested that Minnesota ranked near the middle of all fifty states. Today, many indicators place Minnesota near the top of the fifty-state rankings.

Per Capita Personal Income in 1980 & 1996 (in constant dollars)

	1980 Per Capita Personal Income (1996 dollars)	RANK	1996 Per Capita Personal Income	RANK
Illinois	$ 20,730	9	$ 26,848	8
Iowa	17,840	28	22,306	31
Michigan	19,325	16	24,945	17
Minnesota	**19,060**	**17**	**25,663**	**12**
North Dakota	14,586	48	20,448	39
South Dakota	14,610	46	20,895	38
Wisconsin	18,654	25	23,320	23
US Average	**18,991**		**24,426**	

Source: Bureau of Economic Analysis, US Dept of Commerce

Per capita personal income is one of the most commonly used measures of the relative affluence of states. Since 1980, Minnesota's per capita personal income has grown rapidly. Its per capita personal income is now greater than the national average ($25,663 versus $24,426, in 1996) and

[2]First, all the data useful for such an analysis may not be available. Second, time constraints may oblige researchers to be selective in their analysis. Third, for data that are available and that are selected for analysis, judgments may have to be made as to how to interpret them and how to weigh their relative importance. For example, if Minnesota has a better educational system than Wisconsin while Wisconsin provides better medical services to its citizens, in which state are the citizens better off?

higher than those of all of its neighboring states. Minnesota ranks 12th in per capita income nationally (as opposed to 17th in 1980), and its per capita income is 5 percent greater than the U.S. average instead of equal to it as in 1980. As the figures above indicate, over the past 16 years per capita income in Minnesota has grown faster than it has in the nation as a whole (35 percent versus 29 percent).[3]

Employment growth is another important indicator of the relative health of an economy. The Minnesota economy has added more than 675,000 new jobs since 1980, a growth rate that is substantially above the U.S. average (36 percent versus 30 percent).[4] What is particularly impressive about this employment growth is that Minnesota has added more than 75,000 *manufacturing* jobs, up 22 percent since 1982 (one of the fastest growths in the nation). In contrast, manufacturing jobs declined 3 percent in the nation as a whole over that period.[5] Growth in manufacturing jobs can help economic vitality because such jobs tend to be higher paying than most. When manufacturing workers spend their relatively high salaries, sales and earnings are increased throughout the economy.

Although the number of manufacturing jobs has grown impressively in Minnesota relative to the nation, hourly earnings in manufacturing in Minnesota grew more slowly than the national average between 1980 and 1995. Minnesota manufacturing hourly earnings are now only 4 percent above the national average, down slightly from 5 percent above the average in 1980.

Minnesota's rapid job growth has had a notable and predictably salutary effect on its unemployment rate. The unemployment rate in Minnesota is below 4 percent, the lowest rate in more than twenty years and one of the lowest rates of any state.[6]

The growth in jobs since 1980 and the falling unemployment rate appear to have had a positive impact on average annual pay in Minnesota (in spite of the sluggishness in manufacturing pay). In 1981, annual pay in Minnesota was three percent below the national average. But, by 1996, inflation-adjusted average annual pay in Minnesota had grown by more than 10 percent (versus just 7 percent for the nation as a whole) and had almost caught up to the U.S. average. Although high-wage, high-population states at the top of the rankings held it slightly below the national average, Minnesota's 1996 average annual pay was the 14th highest (versus 24th in 1981). Minnesota's rising relative annual pay suggests that many of the new jobs created in Minnesota were "good" jobs; that is, they were high-paying, high-skilled jobs.

Average Annual Pay for All Workers, 1981 & 1996

	1981 Average Annual Pay (1996 dollars)	US RANK	1996 Average Annual Pay	US RANK
Illinois	$ 29,253	7	$ 31,285	9
Iowa	24,534	34	23,679	42
Michigan	31,290	3	31,522	8
Minnesota	**26,198**	**24**	**28,869**	**14**
North Dakota	23,778	40	21,242	49
South Dakota	20,884	51	20,724	51
Wisconsin	25,529	28	26,021	28
US Average	**27,080**		**28,945**	

Source: U.S. Bureau of Labor Statistics.

The share of Minnesota's adult population that is working has been growing rapidly—and faster than the national average. As jobs increased, unemployment fell. But equally important, the number of adults entering the workforce seeking employment grew very rapidly. This increasing supply of available labor is probably a significant reason that average annual pay is still below the national average.

The trend toward fuller employment in Minnesota is unlikely to continue at the pace of the last decade or so. As the share of adults working

[3]Median household income is another common measure of economic well-being. It measures the income of the typical household—the household in the middle of the income distribution. Between 1984 and 1996, Minnesota's median household income grew more than twice as fast as the national average (11% versus 5% in constant dollars). As a result, it rose to the 6th highest in the nation (up from 15th in 1984), nearly 16% above the national average ($40,991 versus $35,492).

[4]Bureau of Economic Analysis.

[5]Bureau of Labor Statistics, *Employment and Earnings.*

[6]Bureau of Labor Statistics, *Geographic Profile of Employment and Unemployment.*

nears its maximum possible amount, the growth in the employment/population rate must slow down. This fact has important implications for the nature of future economic growth in Minnesota.

Over the past fifteen years, Minnesota's below average annual pay may have helped encourage local employers to hire more workers and may have attracted employers from out of state. But given that Minnesota is well above the national average in its employment rates and given that the growth in Minnesota's employment/population rates must slow down, there is likely to be an increase in wages (relative to the national average) in response to further increases in the demand for labor. Indeed, this upward pressure on wages is already manifesting itself in the relative rise in average annual pay, as noted above. Just as pay below the national average may have encouraged job and economic growth in Minnesota, wages above the national average may hamper job and economic growth *unless* the quality of labor and other assets in Minnesota improve.

A rising quality of labor and other assets can both *encourage* employers to expand employment opportunities (despite Minnesota's wages rising relative to the U.S. average) and *enable* employers to pay higher wages. If this occurs, of course, workers and their families will be better off.

An analysis of economic and job expansion in Minnesota over the past fifteen years indicates that it has been spurred in part by business investments in new structures and equipment, especially for manufacturing plants and high technology industries. The jobs that have been created by these investments are, for the most part, high paying and high-skilled. If a healthy, well-educated and skilled labor force is available, these industries and others have the potential to generate thousands of additional good jobs in Minnesota. Thus a key challenge facing Minnesota policy-makers is how to insure an adequate and growing supply of appropriately skilled labor.[7]

Despite rapid job growth, falling unemployment, and rising average annual pay, the poverty rate in Minnesota has not declined. Although the poverty rate in Minnesota is substantially below the national average (9.8 percent versus 13.7 percent), it was higher in 1996 than it was in 1980 (8.7 percent).[8] In other words, despite the impressive achievements of the economy as a whole, some 450,000 Minnesotans are languishing in poverty. Worse still, the number of poor has been rising over the past year. So although the economy as a whole is performing strongly, there remains a sizeable job gap for entry-level workers at wages above the poverty level.

II. Infrastructure:

The physical infrastructure of an economy is fundamental to its health and growth potential. The infrastructure's role in the economy is similar to the role of the skeletal structure, the nervous system and the cardiovascular system in the human body. Each needs to be in good condition in order for a body to function well. Likewise the various components of the physical infrastructure (roads, bridges, sewage systems, telecommunication networks, etc.) need to be adequately developed and well maintained in order for an economy to grow rapidly and efficiently.

Infrastructure plays a key role in attracting and retaining business. In particular, the adequacy and quality of roads, bridges, and sewage systems are among the primary factors that businesses consider when making investment location decisions. Several indicators of Minnesota's physical infrastructure suggest that its condition is somewhat mixed.

Highway conditions are important to a state's economic health because highways serve as the major link between producers and purchasers of goods and services. Traffic on Minnesota's highways increased 80 percent between 1974 and 1996, but highway spending has not kept pace (up by 52 percent over the same period). Thirty percent of Minnesota's highways were rated in "fair" or "poor" condition in 1996, which ranked Minnesota

[7]If wages in Minnesota continue to rise relative to wages nationwide, then, to some extent, Minnesota can anticipate an in-migration of labor that will help to satisfy the need for skilled labor. Businesses are, however, more likely to locate and expand in areas that have the resources they need than to go where there are shortages and rely on in-migration.

[8]Bureau of the Census, *Current Population Survey.*

27th among the states[9]—a noticeable decline from a ranking of 14th in 1987. The Legislative Auditor has recommended that the Minnesota Department of Transportation increase the rate at which it resurfaces highways in order to prevent the deterioration of the state's highway system, since many of the state's roads are fairly old. The average pavement age increased from 32 to 40 years from 1985 to 1995.[10]

Minnesota bridges fare relatively better. The state ranked 6th best in the nation in bridge deficiency in 1994.[11] Despite this high ranking, over 21 percent of Minnesota's bridges were deemed deficient or structurally obsolete. This, however, was an improvement over the 28 percent of bridges deemed deficient in Minnesota in 1988. The Department of Transportation has warned that an increase in the number of bridges classified as being structurally deficient will require additional spending: 240 out of the 4,614 trunk highway bridges had structural deficiencies which would cost an estimated $100 million to correct, and an additional 116 bridges have functional problems.[12]

Finally, one measure of the adequacy of Minnesota's sewage system shows the state ranking 15th best in the United States in 1992, up from 31st in 1988.[13] Adequate wastewater treatment facilities are important for economic vitality because new and expanding businesses need such facilities.

Although these measures indicate the condition of some of the existing infrastructure, they do not indicate whether this infrastructure is sufficiently comprehensive. Unfortunately, no good statistics are available to provide that information.

III. Education:

Education is arguably the single most important factor determining long-term economic growth. The productivity and growth of an economy are directly related to the level of education and training of its workforce. For a state to maintain its economic competitiveness it must develop a workforce that has the skills needed by employers. The workforce, furthermore, must be able to adapt to ever changing economic circumstances. In light of the employment data discussed earlier, it is particularly important for Minnesota to improve the skills of its labor force if the transition to a high-pay, high-skill economy is to proceed smoothly.

Minnesota's overall record in the area of education is very good. There are, however, some troubling indicators that the state's commitment to educational excellence is ebbing.

Elementary and Secondary Education

Perhaps the broadest indicators of the skill levels of the workforce are measures of educational attainment. In today's economy, a minimum requirement for most jobs is a high school diploma. Minnesota's record in providing its citizens with this requirement is excellent.

In 1996, Minnesota ranked 7th in the percentage of its adult population with a high school diploma or higher degree, up from 14th in 1980 (88 percent versus 73 percent).[14] In addition, Minnesota's high school dropout rate (6.4 percent) was the second lowest in the nation and its high school graduation rate of 89.1 percent in 1993 was the highest in the nation.[15] These latter indicators bode well for Minnesota's future.

Of course, the fact that a growing percentage of Minnesota's population is getting high-school diplomas does not tell us much about the quality of the education that the citizens of Minnesota are receiving relative to other Americans. Although measuring the quality of education is extremely difficult, some data suggest that Minnesota's students are achieving at above average proficiency.

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[9]*Highway Spending*, Page xvi. Office of the Legislative Auditor. April 1997.

[10]*Highway Spending*, Page xvii. Office of the Legislative Auditor. April 1997.

[11]Twelfth Report of the Secretary of Transportation to the U.S. Congress, *The Status of the Nation's Highway Bridges.* GPO, June 1995.

[12]*Highway Spending*. Page xviii. April 1997. Minnesota Office of the Legislative Auditor.

[13]The U.S. Environmental Protection Agency, Office of Water, *1992 Needs Survey Report to Congress*.

[14]Bureau of the Census, *Current Population Survey.*

[15]U.S. Department of Education, National Center for Education Statistics.

Measurements of math proficiency for fourth and eighth graders in 1992 scored Minnesota's students well above average. These measurements ranked Minnesota 6th and 3rd, respectively, out of the 41 states surveyed. Likewise, a measurement of reading proficiency of fourth graders in 1994 showed Minnesota's students performing above average. Instead of ranking near the top, however, Minnesota ranked 14th out of the 39 states that participated in this reading proficiency study.[16]

Another indication of education quality is pupil-teacher ratios. Numerous studies have shown that students benefit from smaller class sizes and more individual attention from school staff.

Minnesota has, in recent years, seen its pupil-teacher ratio increase to worse than the national average. In 1989, the pupil-teacher ratio in Minnesota was slightly better than the national average. But, by 1994 the pupil-teacher ratio in Minnesota was worse than the national average and Minnesota's ranking had fallen from 31st to 37th.

Higher Education

Minnesota has made considerable progress in higher education. In 1996, Minnesota ranked 13th in the percent of its adult population with a college degree or higher, up from 20th in 1980 (26.3 percent, up from 17.4 percent).[17]

Without a further substantial increase in the percentage of its population with college degrees or better, however, Minnesota will experience difficulty in creating and attracting high-skilled, high-paying jobs in the future. Yet, highly trained local talent has been declining in Minnesota in recent years relative to the rest of the nation.

For example, the number of employed doctoral scientists and engineers per 1,000 workers in 1993 was lower in Minnesota than in twenty-five other states—down from a ranking of 16th in 1986. Nor are the prospects for developing a large cadre of locally trained highly-skilled scientists and engineers in the near future particularly good. In 1995, Minnesota ranked 38th in the number of science and engineering graduate students per one million population, down from 29th in 1989. Likewise, in 1995, Minnesota ranked 30th in research and development expenditures per capita at doctorate-granting institutions—down from 19th in 1989.[18]

The lack of a large, locally trained pool of highly skilled workers and the prospects of a continued lack of such workers for the foreseeable future is potentially a serious problem for Minnesota. Without improvements in the quality of Minnesota's future labor force, the current boom in the economy may be difficult to sustain. Existing businesses may experience difficulty in finding qualified job applicants. Studies of new business creation have found that many new companies are founded by locally educated and trained individuals. Without appropriately educated individuals, new businesses may fail to develop. By failing to train people locally, Minnesota is limiting the supply of skilled individuals it will need to be competitive in the future.

IV. Health:

Health conditions of a state's population and the availability of medical care have major effects on the quality of life. They influence decisions about where to live and where to start a business, and they affect the quality and productivity of labor. Hence, health is one of the keys to economic growth and development, as well as a significant measure of a society's general well-being.

Statistics on health and health care cover a wide variety of issues. We have selected indicators that reflect the average health of states' populations and the availability of care at the state level.

Health Conditions

Many indicators suggest that health conditions in Minnesota are well above the national average. To some extent this should be expected, given Minnesota's relatively high levels of economic development and educational attainment. In addition, most indicators of health suggest that conditions have been improving in Minnesota, although some suggest the opposite.

[16]U.S. Department of Education, National Center for Education Statistics, *National Assessment of Educational Progress.*

[17]Bureau of the Census, *Current Population Survey.*

[18]National Science Foundation.

Death rates due to heart disease and cancer, the two leading causes of death nationwide, are lower in Minnesota than in most other states. The rate of death due to heart disease has fallen faster in Minnesota than in the nation as a whole and the cancer death rate has risen slightly more slowly than the national average. As a consequence, Minnesota's ranking on avoiding heart disease deaths has improved from 18th in 1981 to 11th in 1995,[19] and its cancer death ranking has improved, too, from 19th to 12th.[20] The fact that Minnesota's population is slightly younger than the national average may explain part of this trend, but not all of it.

The infant mortality rate in Minnesota is about 15 percent below the national average, and fell by 38 percent from 1980 to 1996. The national rate, however, declined by 42 percent over the same period. Thus, despite a significant decline in Minnesota's infant mortality rate, Minnesota's national rank has fallen from 4th in 1980 to 12th in 1996.[21]

The percentage of babies with low birth weights is not only an indicator of current health conditions, but also a predictor of health in the future (since low-birth weight babies tend to have more health problems later on). Unfortunately, the percent of babies with low birth weights in Minnesota rose faster than the national average between 1980 and 1995 (16 percent versus 7 percent). In 1980, Minnesota ranked 4th best in avoiding low-birth-weight babies; in 1995 it ranked 9th.

Health Availability

An important determinant of health conditions is the availability of health care. Relative to the national average, Minnesota fares very well on health care availability. There are, however, some indications that health care is becoming less available in Minnesota.

One way to measure the availability of health care is to calculate the number of physicians per 100,000 population. In 1981, Minnesota ranked 12th in this measure, about 2 percent above the national average number of doctors per capita. By 1993, Minnesota ranked 11th, about 3 percent above the U.S.[22]

Health insurance coverage is another good measure of the availability of health services. Over the last five years, the number of Americans without health insurance has been rising rapidly. During the same period, the percent of Minnesota residents without insurance has risen at an even faster pace. Thus, Minnesota's health insurance coverage has declined (from 91.2 percent in 1992 to 89.8 percent in 1996) and its ranking among the states has fallen slightly, from 7th to 9th best. However, MinnesotaCARE, a state-administered agency, has improved efforts to bring health care coverage to low-income working families.

A third measure suggests that health care is better in Minnesota than nationwide but that it is also becoming less available. In 1996, less than 5 percent of Minnesota's population did not have ready access to primary health care. This ranked Minnesota 9th best in the nation. In 1989, however, less than 2 percent of Minnesota's population did not have ready access to primary health care and Minnesota ranked 3rd best.[23]

Percent of Persons Not Covered by Health Insurance

	90-92	RANK	1996	RANK
US Average	**14.2%**		**15.6%**	
Illinois	11.8%	21	11.3%	13
Iowa	9.0%	8	11.6%	18
Michigan	9.4%	9	8.9%	3
Minnesota	**8.8%**	**7**	**10.2%**	**9**
North Dakota	7.4%	2	9.8%	7
South Dakota	12.2%	24	9.5%	4
Wisconsin	7.9%	4	8.4%	1

Note: 1990 to 1992 is a three year average

SOURCE: U.S. Census Bureau, March 1997 Current Population Survey.

[19]National Center for Health Statistics.

[20]American Cancer Society.

[21]National Center for Health Statistics.

[22]American Medical Association.

[23]This indicator, in theory, measures the proportion of a state's population without primary health care services within ready economic or geographic reach. It should be used with caution, however, because a place is reviewed for designation as a health care shortage area only after an application is made on its behalf by a state or local government. *SOURCE: U.S. Dept. of Health & Human Services, Bureau of Primary Health Care, Division of Shortage Designation.*

V. Environment:

Environmental conditions, like health conditions, have an obvious impact on the quality of life of citizens. They also influence economic conditions, although their effects on economic conditions are more subtle than their impact on quality of life.

Businesses, like people, prefer safe, clean, stable communities. Indeed, many businesses require healthy environments in order to thrive. For example, much of the tourist industry could not survive with polluted rivers, lakes, oceans and streams. The old thinking that economic growth and environmental protection were incompatible is giving way to an understanding that they are often complementary—and that a healthy environment is important for long-term, sustainable economic growth.

As the relationship between environmental decay and community health has become clearer, the American public has demanded that its drinking waters be safe and the air it breathes be free of dangerous contaminants. It is now understood that the costs associated with maintaining a safe and clean environment in a community frequently pale in comparison to the costs of reestablishing a safe and clean environment. Indeed, the enormous cost of cleaning up the superfund dump sites is one of the most sobering reminders that it is often vastly cheaper to prevent pollution than it is to repair the damage caused by toxins.

Indicators of environmental quality reflect the general conditions of water, air and soil. These indicators suggest that the quality of Minnesota's air, water and soil ranges from about average to below average. Since statistics on environmental quality have been collected regularly only recently, it is very difficult to determine whether the quality of Minnesota's environment has been improving.

It should be kept in mind that some of the following statistics on pollution are not necessarily perfect indicators of the health risks from pollution in particular states. For example, the negative effects of toxic chemicals released in a state may not be felt in that state because the chemicals may be carried by wind or water to other states. Similarly, the amount of hazardous waste generated in a state does not convey the degree of toxicity of that waste, nor does it indicate how much of that waste escapes into the state's environment. Likewise, the number of dump sites in a state does not reflect the size and condition of each of those sites, although qualifying as superfund dump sites does suggest that the sites may be among the worst dump sites in the nation.

In 1996, Minnesota ranked 23rd in the proportion of its residents who lived in areas that exceeded national air quality standards for ozone or carbon monoxide—about the national median.[24] Water quality is a more serious concern. In 1996, 16 percent of Minnesota's surface water discharges were not in compliance with water quality standards, ranking Minnesota 42nd in the nation. This was even worse than the non-compliance rate in 1990, when 14 percent of Minnesota's water discharges were in noncompliance (also ranking 42nd in the nation).[25] Likewise, in terms of the miles of its rivers and streams that are polluted, Minnesota fares worse than the national average and ranks 37th among states. In 1992, more than 76 percent of all the miles of rivers and streams in Minnesota were unsafe for fishing and swimming compared to the national average of 44 percent.[26]

Adjusted for the size of its population, Minnesota had more than its share of the total number of superfund dump sites within its borders in 1995, and ranked 36th on this indicator of pollution.[27] On a brighter note, in 1993 Minnesota released a smaller amount of toxic chemicals into its air, water and soil than did 32 other states. Its per-capita release of toxic chemicals was about half of the national average.[28]

In sum, most measures of environmental quality suggest that Minnesota is at or below the national average. This stands out in contrast to the state's better than average conditions on most other indicators of economic and social well-being.

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[24]U.S. Environmental Protection Agency, Office of Air Quality Planning and Standards.

[25]U.S. Environmental Protection Agency, Compliance Evaluation Section.

[26]U.S. Environmental Protection Agency, *Water Quality Inventory.*

[27]U.S. Environmental Protection Agency, Office of Emergency and Remedial Response.

[28]U.S. Environmental Protection Agency, *1993 Toxics Release Inventory.*

VI. Crime:

Crime affects economic and social well-being. High crime rates discourage economic activity, contribute to community disintegration and cause businesses and families to flee.

The crime rate in Minnesota is well below the national average. It is now lower than its 1980 level, and has fallen faster than in the nation as a whole. In 1980, Minnesota had the 17th lowest violent crime rate in the country. By 1994, the state ranked 16th lowest, with a violent crime rate that was 81 percent of the national average. Minnesota's violent crime rate fell by nearly 10 percent over the period.[29]

VII. Summary

Over the past 15 years, Minnesota's economic and social conditions have improved significantly. To a large degree, these improvements have been a function of investments in the quantity and quality of Minnesota's productive resources—both public and private.

Improvements in a state's economic well-being are a function of "extensive" and "intensive" development. Extensive development refers to growth that results from increases in the *quantity* of various factors of production. In simple terms, this means that output generally expands in response to increases in employment, factories, machinery, tools, equipment and infrastructure. Intensive development refers to growth that results from improvements in the *quality* of the factors of production. Hence, intensive development refers to output growth in response to improvements in the health, education and training of workers, infrastructure enhancements, and technological innovations.

Some kinds of extensive development are by their very nature limited. For example, increases in employment are limited because as employment grows the pool of potential workers is gradually exhausted; that is, at any given moment there are only so many people available to work. Once full employment is achieved, output expansion due to employment growth proceeds only if population grows.

In contrast, there are no known limits to intensive development. The health, education and training of workers can always be improved. Technological advances and infrastructure enhancements have no apparent bounds.

Like all states, Minnesota has experienced both intensive and extensive development—although it has experienced both to a greater degree than most states. As a consequence, its social and economic conditions are superior to, and have been improving faster than, those of most states. One of the clearest examples of Minnesota's intensive development is the improvement in the educational attainment of its population. The most obvious manifestation of extensive development in Minnesota is the dramatic increase in the ratio of its population that is working. This surge in the portion of the population employed has increased Minnesota's per capita output, but at the same time may have kept wages from surpassing the national average.

With its unemployment rate relatively low, an employment/population ratio well above national norms, and the demand for labor strong, it is unlikely that Minnesota's wages will continue to lag behind U.S. average wages. Labor shortages are likely to develop and this will put upward pressure on wages. Indeed, as noted above, wages in Minnesota are rising faster than wages nationwide and have essentially caught up to the national average pay level. If the quality of the labor force and other critical factors do not continue to improve and average wages in Minnesota start to surpass the national average, employers may experience declining profits and they will have less of an incentive to expand employment opportunities. Job growth could slow down and the economic expansion of the past fifteen years may slow down. On the other hand, if the quality of the Minnesota labor force continues to improve, businesses will remain profitable and employers will be willing and able to pay higher wages and further expand employment opportunities. Minnesota's workers and families will be better off and the economic expansion may continue unabated.

In light of the potential shortage of skilled workers in the future and the need to improve Minnesota's non-labor assets, certain trends are worrisome and worth repeating. An ebbing

[29]Federal Bureau of Investigation, *Crime in the United States.*

commitment to primary and secondary education and the eroding relative support for higher education could make it difficult to guarantee a highly trained workforce. The apparent decline in health care availability, as suggested by the rising percentage of Minnesota's population without health insurance and ready access to primary health care, combined with the rising percentage of low-birth-weight babies is likely to have a negative impact on the productivity of Minnesota's future workers. Minnesota's average, or below average, environmental conditions and the worsening conditions of its roads will not enhance Minnesota's future economic competitiveness and efficiency. And, of course, an increased poverty rate can exacerbate crime problems, impose burdens on agencies that care for the poor, and impose undue hardships on thousands of men, women, and children. In other words, while economic and social conditions in Minnesota over the past 15 years have been improving, potential obstacles to future growth and improvements in well-being exist and need to be addressed.

In short, if Minnesota is to continue its transition from an average-wage to a high-wage economy, it must continue to invest in its workforce and other assets to improve their quality. This means that further attention must be paid to improvements in health, education, safety, infrastructure and the environment.

CHAPTER TWO

STATE & LOCAL PUBLIC SPENDING TRENDS IN MINNESOTA

Compared to other states, Minnesota historically has provided and continues to provide relatively high levels of public services. When measured as a share of personal income, Minnesota's public spending ranked 12th in the nation in 1980, and 11th in 1994. Per capita public spending in Minnesota ranked 7th nationally both in 1980 and 1994.

These sustained high levels of public spending are one of the reasons why the state's economic indicators have been so solid. Without adequate government funding, the state would be unable to achieve such high marks in education, health care availability and infrastructure. And the state's economy has flourished with its strong public sector.

Several factors contribute to Minnesota's higher rates of spending relative to the national average. Better-off states like Minnesota face higher costs. And, with its higher standard of living, there is a high demand for quality public services.

State & Local Spending as a % of Personal Income, Fiscal 1980 & Fiscal 1994

	1980		1994	
	%	Rank	%	Rank
US Average	**17.2%**		**18.2%**	
Illinois	15.1%	45	15.3%	48
Iowa	18.2%	22	19.2%	21
Michigan	18.9%	20	17.5%	33
Minnesota	**19.8%**	**12**	**20.5%**	**11**
North Dakota	21.7%	5	21.9%	7
South Dakota	19.6%	14	19.0%	22
Wisconsin	19.1%	19	19.8%	17

SOURCES: Bureau of Economic Analysis; Bureau of the Census.

Education

The single largest portion of state and local spending goes for education—about one-third of the budget. Minnesota student achievements in K-12 education have been very good over the last decade and a half. Recent trends indicate, however, that Minnesota's state and local governments have been providing fewer of the resources needed to maintain these high levels of student achievement. Minnesota's ranking in *expenditures per pupil* has fallen dramatically from 1970 to 1994. Ranked 11th highest in the nation in the 1969-70 school year, Minnesota slipped to 22nd in 1993-94. Whereas Minnesota expenditures per pupil were 11 percent higher than the U.S. average in 1969-70, by the 1993-94 school year, the state had fallen one percent *below* the national average.

Shares of Minnesota State & Local Spending in FY 1994

Education	33.7%
K–12	23.9%
Higher education	8.2%
Other education	1.5%
Poverty programs	18.8%
Health & hospital	9.7%
Highways	7.8%
Interest on general debt	5.4%
Nat. resources, parks & rec.	3.4%
Police protection	2.7%
Housing and community dev.	1.7%
Corrections	1.7%
Sewerage	1.9%
Fire protection	0.9%
Other	12.4%
TOTAL	**100.0%**

When measured as a share of personal income, higher education spending experienced a slight decline from 1980 to 1994, slipping from 28th in the nation in 1980 (1.8 percent of personal income) to 30th in 1994 (1.7 percent of personal income).

The relative decline in spending on education may hamper Minnesota's ability to continue to provide an adequate workforce for the state's economy.

Total State & Local Higher Education Expenditures as Shares of Personal Income, FY 1980 & FY 1994

	1980		1994	
	%	Rank	%	Rank
US Average	**1.5%**		**1.6%**	
Illinois	1.2%	45	1.2%	43
Iowa	2.6%	13	2.2%	5
Michigan	2.0%	24	1.9%	19
Minnesota	**1.7%**	**28**	**1.8%**	**30**
North Dakota	3.3%	3	2.7%	1
South Dakota	1.7%	18	2.0%	29
Wisconsin	2.1%	10	2.3%	10

SOURCE: Bureau of the Census; Bureau of Economic Analysis

Expenditures Per Pupil in Constant 1992-93 Dollars

	1969-70	RANK	1993-94	RANK
Illinois	$3,520	9	$5,893	18
Iowa	3,267	19	5,288	29
Michigan	3,499	10	6,658	11
Minnesota	**3,498**	**11**	**5,720**	**22**
North Dakota	2,669	37	4,674	41
South Dakota	2,670	36	4,586	43
Wisconsin	3,417	14	6,717	10
US Average	**$3,158**		**$5,767**	

SOURCE: US Dept of Ed, Nat'l Center for Ed Stats

Poverty Programs

The second largest area of state and local spending in Minnesota is on poverty programs (about 19 percent). State and local spending on the two biggest poverty programs—Medicaid[30] and the Minnesota Family Investment Program (MFIP)—totaled more than $1.4 billion in 1997. The federal government picked up the rest of the tab—54 percent of the total cost—of these two programs.

Legislation enacted by Congress in 1996 significantly changed the way the federal government funds these programs. In the past, the federal government's share was tied to a formula which was based upon the number of recipients. Under the changes, the entitlement status of these programs ended, and the federal contribution is allocated under a block grant formula with funding linked to a base year—in Minnesota, the state will continue to receive funding tied to 1994 levels.

Although the new arrangement provides Minnesota with fewer restrictions on how it can use the federal money, there could be a catch. The federal contribution is no longer tied to the number of persons in need, but rather to a set dollar amount: therefore, if the number of persons in need were to increase (say, during a recession), the federal contribution would remain at the same level. This could place the increased burden upon Minnesota governments.

Transportation

Transportation spending has not kept up with demand. While traffic growth in Minnesota increased 80 percent between 1974 and 1996, transportation spending has been the slowest growing sector of state and local spending over that time period (growing by 52 percent[31]).

Natural Resources, Parks and Recreation

Expenditures on natural resources and parks and recreation also fell as a share of personal income, from 10th nationally in 1980 (0.9 percent of personal income) to 16th in 1994 (0.7 percent of personal income).

The Budget Reserve

The state has recently bolstered its *budget reserve* or "rainy day fund." The purpose of the budget reserve is to have funds available to continue to provide government services in the event of a

[30]Medicaid covers health expenses for low-income families and individuals, including the impoverished elderly. In federal fiscal year 1996, 39 percent of the state's total Medicaid funding was spent on the elderly. (Minnesota Dept. of Health & Human Services.)

[31]*Highway Spending*, Page xix. Office of the Legislative Auditor. April 1997.

revenue shortfall. This is most likely to happen during economic downturns, since revenue collections fall with the decline in economic activity. The demand for public services, however, does not decline proportionately. In fact, with greater unemployment, an economic downturn brings about greater demand for government assistance. Furthermore, there is no longer a guarantee of federal help with increased spending on poverty programs during hard times.

Minnesota's Council of Economic Advisors has recommended a budget reserve of 5 percent of total expenditures in order for the state to be adequately prepared for any future economic downturns.[32] As of the 1998-99 biennium, Minnesota's budget reserve is half that recommended amount—2.5 percent of total expenditures. It is worth noting that Minnesota's Department of Finance, which conducts revenue and expenditure forecasts, had an average absolute error of 5.2 percent on its biennial revenue projections from 1980 to 1995.[33]

Summary

Minnesota has a long history of providing high levels of public services. And although many of the state's rankings in economic and social indicators remain strong, certain trends—lower levels of attention to education and infrastructure, for example—could limit Minnesota's prospects for the future. Also, while the state has benefitted in the short run from federal changes in poverty programs, the advantages today may turn into liabilities tomorrow if the economy slows down or if the federal government fails to balance its budget and further budget cuts are required. Because the state's budget reserve is half of the recommended amount, Minnesota runs the risk of being underfunded in time of recession.

Minnesota has traditionally valued government investments in education, infrastructure and human capital. So in these times of surplus, it is important to keep in mind the value of such investments in the long-term needs of the people of Minnesota, as well as the immediate appeal of tax cuts.

[32]Minnesota Department of Finance, *1997 February Forecast*, Page 7.

[33]Minnesota Department of Finance, Unpublished data.

CHAPTER THREE

AN OVERVIEW OF THE CURRENT MINNESOTA TAX SYSTEM

This section examines Minnesota's current tax system. It looks at:

Overall taxes in Minnesota compared to other states, along with trends over the past two decades.

The distribution by income level of the Minnesota tax system.

Specific Minnesota state and local taxes.

The Overall Level of Taxation in Minnesota

By any of the most commonly used measures, Minnesota ranks relatively high in government services and thus taxes:[34]

As a share of total personal income, state and local taxes in Minnesota rank 10th highest in the nation.

On a per capita basis, state and local taxes in Minnesota rank 8th.

As a share of gross state product, Minnesota ranks 6th in state and local taxes.

Which measure is the most appropriate one? Actually, each is instructive, but each has its limitations. Minnesota's high *per capita taxes* ranking means relatively high per capita dollars available for public services. But to a significant degree, this ranking merely reflects the state's relatively high *per capita personal income* (12th nationally). Higher incomes in a state tend to make providing government services more expensive,

State & Local Taxes in 1994—Three Different Measures

	As Shares of Personal Income	RANK	Per Capita	RANK	As Shares of Gross State Product	RANK
Illinois	10.6%	36	$ 2,481	17	9.0%	31
Iowa	11.9%	11	2,300	23	10.0%	14
Michigan	11.5%	18	2,554	12	10.3%	9
Minnesota	**12.3%**	**10**	**2,746**	**8**	**10.4%**	**6**
North Dakota	11.5%	16	2,032	37	9.9%	16
South Dakota	9.9%	45	1,820	45	7.9%	45
Wisconsin	13.1%	5	2,709	9	11.3%	3
US Average	**11.2%**		**2,415**		**9.4%**	

[34]We focus here on total taxes raised by states and their local subdivisions. Because states vary widely and somewhat serendipitously in the proportion of their revenues raised at different government levels (i.e., state versus local), limiting our analysis to only state (or only local) revenues would greatly distort the relationships among the various states.

State and local taxes include all tax revenues raised by state and local governments, mostly from personal income taxes, corporate income taxes, property taxes and sales and excise taxes. Excluded from taxes are (1) offsetting receipts from user fees charged for government-provided services, gross interest income, and amounts paid into employee pension, workers' compensation and unemployment trust funds; (2) a small amount of miscellaneous non-tax revenues; and (3) funds from federal assistance.

Many state and local tax figures cited here are for fiscal 1993-94, the last year for which the U.S. Bureau of the Census has published data for combined state and local taxes for all states. It should be noted that Census' *state-only* tax data through fiscal 1995-96 show little or no change in the trend of Minnesota's taxes compared to national trends.

since, for example, government wages cannot be too far out of line with private earnings. Also, in relatively wealthy states such as Minnesota the public tends to demand better quality government services, which are paid for in higher taxes. Thus, Minnesota's high per-capita tax rating is neither surprising, nor terribly informative. It fails to tell us much about the level of taxation relative to the cost of providing government services or what the public demands and can afford.

For this reason, most analysts commonly use *taxes as a share of personal income* as a benchmark. Because it is widely accepted, generally valid and the data is readily available, this is the measure of taxes that we use most often in this report.[35]

But measuring taxes as a share of personal income also can produce anomalies, since some taxes do not immediately come out of the pockets of individuals, but instead are paid, at least initially, by businesses. For example, Alaska's total taxes in 1994 were equal to 14 percent of personal income in the state, the 2nd highest in the nation. Yet no one would think of Alaska as a high-tax state from the point of view of its residents. Instead, most of those "high taxes" in Alaska reflect taxes collected from the oil industry.

That brings us to a third measure we've used, taxes as a share of gross state product (GSP)[36] which addresses the "Alaska problem" to a large degree. As a share of gross state product, Alaska taxes, at 8 percent, ranked 41st in 1994—much, much lower than when ranked as a share of personal income. The same is true in other states that rely heavily on taxes on natural resources. For example, Wyoming is 6th highest nationally when measured by taxes as a share of personal income, but is a very low-tax state (46th) when it comes to taxes as a share of gross state product.

Looking at taxes as a share of gross state product, almost by definition, probably offers the best measure of a state's taxes on economic activity in a state. As Minnesota's example illustrates, a state can have high taxes as a share of economic activity and still have an economy that provides high incomes, job growth and low unemployment —indeed there is a plausible correlation. We use taxes as a share of GSP in this report in comparing state corporate taxes with one another.

It is important to note that small differences between states in their levels of taxation can significantly affect their relative rankings. Despite ranking 10th highest nationally in taxes as a share of personal income, Minnesota actually has a tax burden as a share of personal income much closer to the median (Kentucky) than to the highest ranked state (New York). Minnesota's state and local taxes as a share of personal income are 20 percent below New York's but only 10 percent above the national average.

[35]Estimates of personal income by state are published by the U.S. Commerce Department's Bureau of Economic Analysis (BEA) as part of the National Income and Product Accounts, and are released soon after the national figures for gross domestic product and personal income are published. The BEA definition of "personal income" is quite broad, including not only most cash income, but also many types of in-kind income, e.g., food stamps, employee fringe benefits such as health insurance and accrued pension benefits, as well as certain "imputed income, primarily the rental value of owner-occupied housing. Personal investment income includes a large amount for certain types of imputed investment income (included as part of "personal interest"), but excludes both realized and unrealized capital gains (which are supposedly reflected in the reported income from the corporate sector of the GDP). These disparities from the common notion of "personal income" are not thought to create any significant distortions in state-by-state comparisons.

In computing taxes as a share of personal income, some analysts mistakenly divide *fiscal year* revenues by personal income in the *calendar year* that begins (typically) half-way through a state's fiscal year. Of course, if all state economies grow at exactly the same rate, then this error would simply understate the computed percentages across the board by a few percent (i.e., a few tenths of a percentage point) without affecting the relative comparisons among states. But if states vary significantly in their economic growth rates (and they do, because of, among other things, varying population growth rates), then this error can sometimes change state rankings noticeably. In addition, because the BEA periodically revises its past estimates of state personal income, figures for taxes as a share of personal income can also change somewhat when the revisions are taken into account. The figures presented in this report for taxes as a share of personal income avoid these common errors, by dividing fiscal year tax receipts by the most recent estimates of *fiscal year* personal income in each state.

[36]Gross state product measures total economic output in a state. The concept is similar to the gross domestic product figures published by the BEA for the U.S. as a whole.

	State & Local Taxes as a % of Personal Income in 1994	U.S. RANK 1994	% points different from Minnesota
New York	15.1%	1	+2.8%
Minnesota	**12.3%**	**10**	**—**
Median (KY)	11.0%	26	–1.3%
US Average	**11.2%**		**–1.2%**

SOURCES: Government Finances, Bureau of the Census; U.S. Dept. of Commerce, Bureau of Economic Analysis.

None of these aggregate measures of tax burden—per-capita, as a share of GSP or as a share of personal income—tells us whether specific groups of taxpayers experience Minnesota as a low-tax, high-tax or average tax state. Taxes can affect specific taxpayers differently depending on amount of income, types of income, home ownership, family size, where they live in a state and a host of other factors. For any given taxpayer, the tax burden he or she would owe in another state might be higher or lower than in Minnesota—whatever that other state's *average* tax burden.

Furthermore, many low-tax states have low-performing economies. Thus, the idea that a well-paid Minnesotan would owe less tax in a relatively impoverished state is often a fanciful notion since most well-paid Minnesotans wouldn't be as well-paid if they lived in a less prosperous place.

Another problem with the aggregate tax measures is that they include all taxes collected in the state, whether the residents of the state pay those taxes or not. But a significant portion of taxes are paid by businesses, and may not be ultimately paid by citizens of the states to which the taxes are paid. For example, much of the Minnesota business tax burden ultimately comes out of the pockets of non-Minnesotans through higher prices on goods exported from Minnesota or lower returns for out-of-state investors in companies operating in Minnesota. Of course, Minnesotans also pay taxes imposed on companies by other states. Since, however, different states impose different burdens on business in different ways, it decidedly does not all balance out. Thus, the business tax component is another reason these aggregate statistics don't tell the whole story.

The opportunity to deduct state and local taxes on federal tax returns also affects the relative tax burdens among states. The more a state relies on taxes that are deductible—specifically, income and property taxes—the lower the federal taxes paid by its citizens. Thus, all things being equal, the citizens of states relying more heavily on deductible taxes have lower total tax burdens—state, local *and federal*—than the citizens of states relying more heavily on non-deductible taxes. Minnesotans pay $1.3 billion less in federal personal income taxes because the state imposes deductible personal income and property taxes instead of relying on non-deductible alternatives. This amounts to an offset of 18 percent of these taxes. Simply measuring taxes as a share of personal income does not capture this effect.

In the next section, we offer a distributional analysis of the Minnesota tax structure that shows the tax burden at different income levels and accounts for the exporting issues described above. Thus, this report will examine not only *how much* Minnesota taxes, but *who pays* the bill.

The Distribution by Income Level of Minnesota Taxes

Minnesota's overall tax system can be characterized as slightly regressive before taking account of federal income tax offsets. The burdens among income groups do not vary substantially, however, and the system is close to flat. After including federal offsets, high-income taxpayers pay considerably lower effective tax rates than the less well off.

Even the initial flatness of the Minnesota system is arguably problematic, because taking the same share of income from a middle- or low-income family than from a better-off family has vastly different consequences for each. Low-income families must spend all of their income just to pay for life's necessities. Even middle-income families spend most of what they earn to sustain a modest standard of living. A tax on these families can cut directly into their quality of life. In contrast, the same level of tax may hardly affect the lifestyles of better-off families. This fact is a central argument for a *progressive* tax structure, which takes a larger percentage of the income of the well-off than from those with lower incomes. A *regressive* tax system does exactly the reverse.

The fact that Minnesota's tax system before federal offsets is close to flat is the result of the offsetting impacts of the various taxes imposed in the state—some regressive and some progressive.

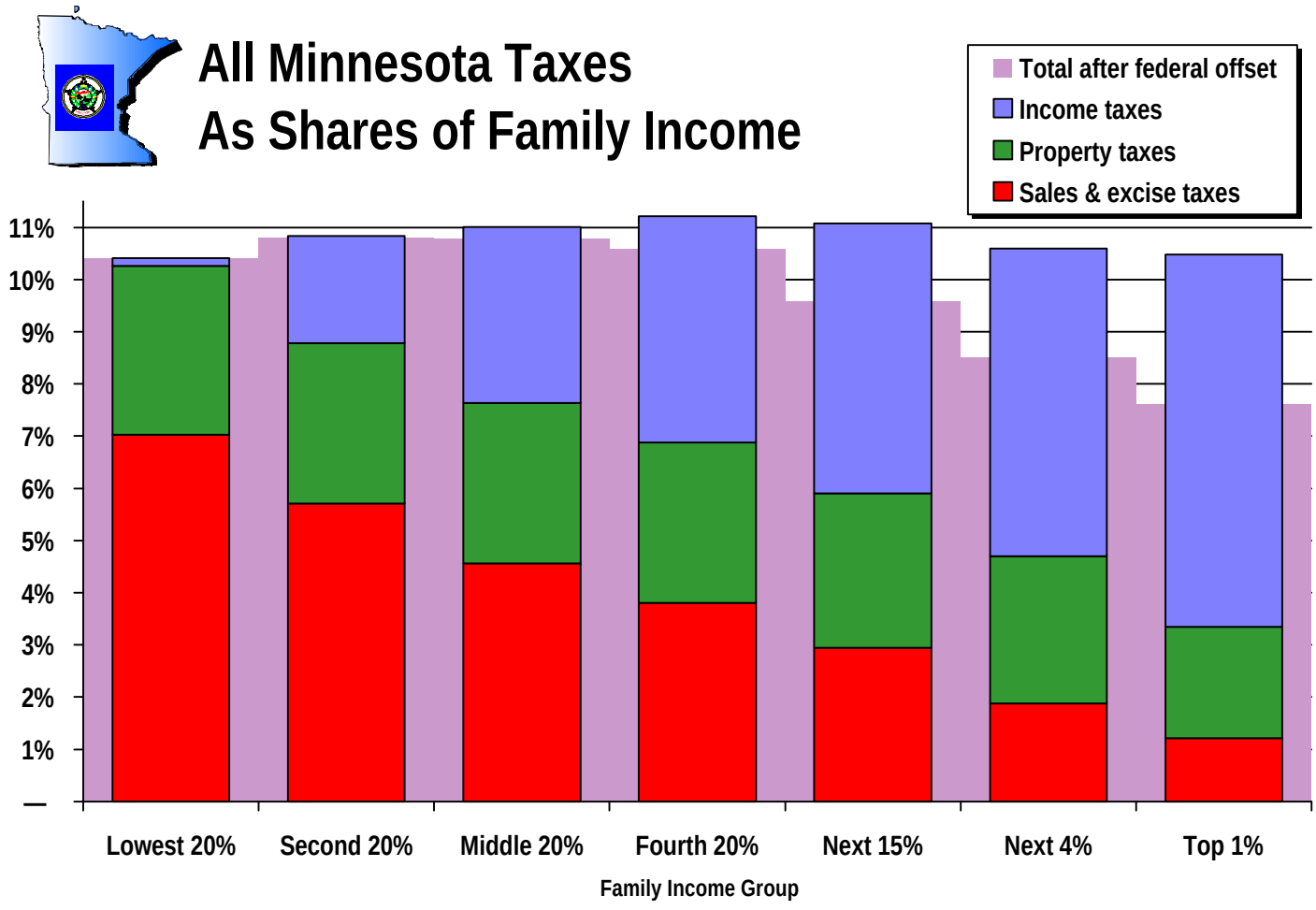
Sales, excise and gross receipts taxes (consumption taxes) are the most regressive class of the major taxes in Minnesota.

Minnesota property taxes are slightly regressive across most income ranges, with a notable drop-off at the very top of the income scale. The state's property tax relief mechanisms, as described later in this report, help to lessen the burden of property taxes on low- to middle-income families compared to what they would pay without these mechanisms.

The state's income taxes are progressive. The wealthiest one-percent of Minnesotans pay more than double the effective income tax rate that middle-income families pay. And low-income taxpayers pay hardly any state income tax.

The generally flat nature of Minnesota's tax system continues even when different demographic subgroups are examined. The tables and charts for non-elderly married couples, unmarried non-elderly people and the elderly, found in appendix A, illustrate this.

Minnesota's personal income tax and property taxes can be deducted in computing federal taxable income by Minnesotans who itemize deductions on their federal tax returns. This lowers federal tax liabilities substantially for itemizers. Hence, the *net* burden of the Minnesota personal income and property taxes, after offsetting the reduction in federal taxes, is lower than first appears. At the same time, because the benefits of itemized deductions go disproportionately to higher income people, the real burdens of Minnesota's taxes are actually more regressive than before the federal deductions. The chart on this page shows the burden, after the federal deduction offset, in the background shaded area.



Trends in Minnesota Taxes

Overall, Minnesota taxes are down as a share of personal income since 1978. In that year taxes took 12.7 percent of personal income, putting Minnesota 7th among all states. By 1994, Minnesota's taxes had dropped to 12.3 percent of personal income and its rank had dropped to 10th by this measure.

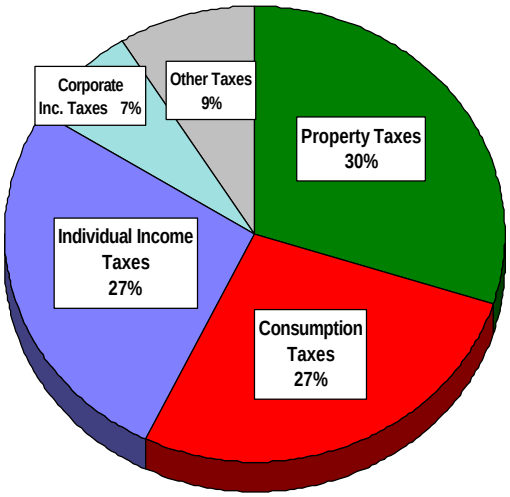
The portion of revenue that comes from various taxes and different taxpayers has been changing in recent years. The most noticeable trend from 1978 to 1996 has been the growth in consumption taxes, whose share of total revenues increased by almost a sixth, rising from 27 percent to 31 percent of total revenues. In contrast, corporate income taxes declined by a third—dropping from 7 percent of total revenues to only 5 percent.

The increase in consumption taxes since 1978 stems from the significant increase in the portion of revenue coming from the general sales tax. In 1994, the general sales tax equaled 2.5 percent of personal income in Minnesota, up from 1.7 percent in 1978. The general sales tax has grown as a share of total state and local taxes from 13 percent in 1978 to 20 percent in 1996. This is worrisome because the general sales tax, like all consumption taxes, is regressive. The sharply increased reliance upon sales taxes has caused middle- and lower-income Minnesotans to pay more as a share of their incomes for public services than they used to pay.

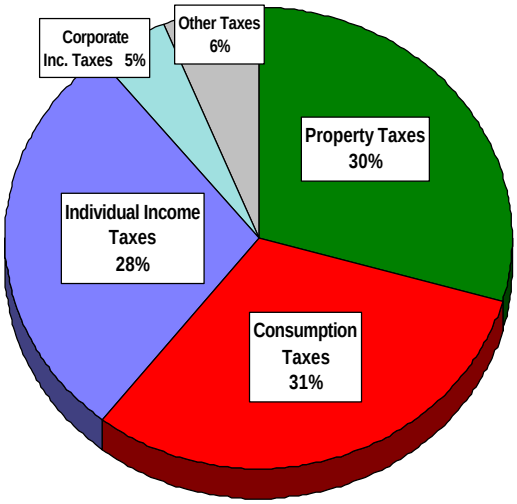
In contrast to the general sales tax, the corporate franchise tax (or corporate income tax, as it is also known) has declined markedly. In 1978, it comprised 0.8 percent of gross state product and 7 percent of all Minnesota state and local taxes. It fell sharply in the early-eighties, to less than 0.5 percent of gross state product, and has never recovered. In 1996, the corporate franchise tax equaled 5 percent of total Minnesota taxes. Thus, reliance upon a tax borne substantially by well-off, out-of-state shareholders in multi-state corporations has been reduced.

Minnesota's tax system now takes a lower share of the income of those in the highest income group than from most less well-off income groups. The Minnesota Department of Revenue, analyzing Minnesota taxes for 1994, found "that the tax system overall was very slightly regressive"[37] It should be noted, however, that most other states, according to our research, have tax systems that are considerably more regressive than Minnesota's.[38]

Shares of Total Minnesota State & Local Taxes, FY 1978 & FY 1996



1978



1996

Heavier reliance on sales taxes has also left Minnesotans as a group paying higher federal income taxes than they would owe if the system

[37] *1997 Minnesota Tax Incidence Study*. Minnesota Department of Revenue, page iii.

[38] *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States.* CTJ/ITEP (1996)

relied more on other taxes. That's because sales taxes are not deductible on the federal return. If the state was collecting more revenue from deductible personal income taxes or property taxes, instead of sales taxes, federal tax liability for Minnesotans would be lower.

As both a share of total revenue and as a share of personal income, Minnesota's property taxes and individual income taxes have not changed significantly over the past two decades. But homeowners bear a much larger share of the property tax burden than in the past, while the business share of the property tax has declined. Minnesota's continuing high reliance on the progressive and deductible income tax has served as a buffer against the state's increasing reliance on regressive, non-deductible taxes.

The Personal Income Tax

Minnesota's personal income tax was adopted in 1933. In 1996, 28 percent of Minnesota revenue was collected from the personal income tax. Compared to most other states, this represents a relatively high reliance on this tax (5th highest in 1994).

The personal income tax is progressive and is deductible on federal returns. It helps offset the regressivity of the other taxes that collect most of the revenue for state and local governments—resulting in the only slightly regressive Minnesota tax system.

- **Individual income taxes were the third largest source of tax revenue for Minnesota in 1996.**
- **The personal income tax is the most progressive tax on individuals in the state.**
- **Recent reforms have enhanced progressivity.**
- **Although the national trend has seen an increase, Minnesota's personal income tax, as a share of personal income, remained at the same level in 1994 as it was in 1978.**

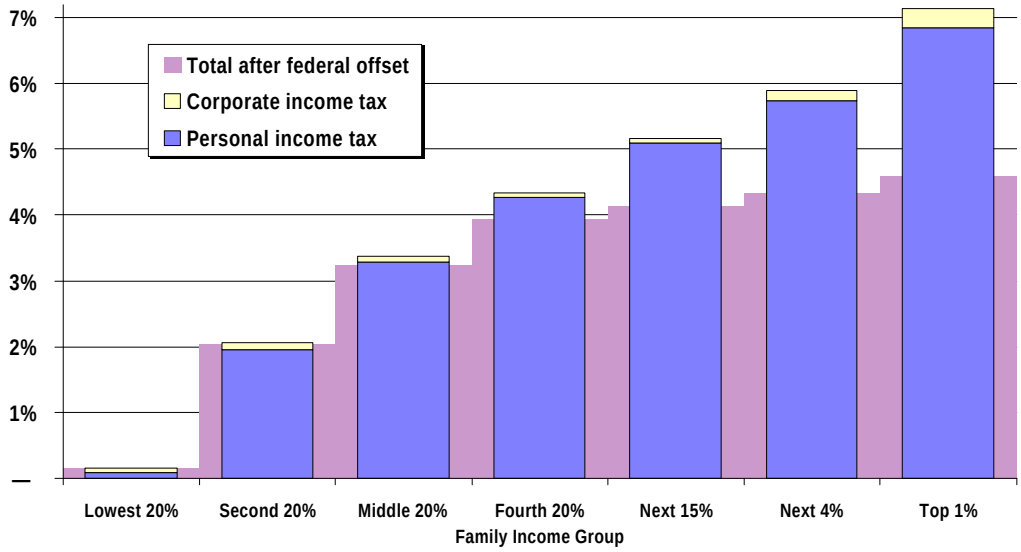
What Makes Minnesota's Personal Income Tax Progressive?

Minnesota has a graduated rate schedule—people with lower incomes pay lower tax rates than do people with higher incomes. The base of the Minnesota personal income tax is very similar to the federal personal income tax. Most of the same itemized deductions are allowed and Minnesota uses the federal standard deductions and personal exemptions.

Compared to other states, these are relatively generous allowances. Exempting a relatively large flat amount of income for all taxpayers makes the tax system more progressive. For instance, in 1998, a married-couple family of four that takes the standard deduction (instead of itemizing) will not pay income tax on its first $17,900 of income.

These kinds of exemptions are more valuable to lower-income families than to higher-income families. A family making $50,000 has more than 35 percent of its income exempted from income tax, while a family making $100,000 has only about 18 percent of its income exempted. Of course, at higher incomes families

Minnesota Income Taxes As Shares of Family Income



are more likely to take itemized deductions instead of the standard deduction. Nevertheless, Minnesota's relatively generous standard deduction and personal exemptions help make its personal income tax progressive.

By comparison, Illinois's income tax exempts only the first $4,000 of a family of four's income. Most states provide income tax exemptions between what Minnesota and Illinois allow.[39]

Also contributing to the progressivity of the Minnesota income tax is the graduated rate structure. The current rate structure, adopted in 1991, has marginal tax rates of 6 percent, 8 percent and 8.5 percent. This is not a *steeply* graduated system, with only two-and-a-half percentage points separating the bottom rate and the top rate. Nevertheless, it is more progressive than the single rate systems used in Illinois and Michigan.

Note that this is a *marginal* rate tax system and the brackets refer to *taxable* income. Thus, although the 8 percent rate starts at $24,800 in taxable income for a married couple, typically a couple will have total income, before deductions and exemptions, of more than $45,000 before the higher rate begins to apply. Also, the rate only applies to *marginal* income. Thus, the first $24,800 in taxable income will always be taxed at the 6 percent rate no matter what total income is. So, a married couple with total income of $50,000 and taxable income, after deductions, of $30,000, will pay 6 percent on $24,800 in taxable income and 8 percent on its remaining taxable income of $5,200 ($30,000 – $24,800), for a total tax bill of $1,904. That equals 6.3% of the family's taxable income and 3.8 percent of its total income.

1998 Minnesota Personal Income Tax
Marginal Tax Rates on Taxable Income

Married Couples	Single Parents	Single without children	Marginal Rate
Up to $24,800	Up to $20,890	Up to $16,960	6%
$24,800–$98,540	$20,890–$83,930	$16,960–$55,730	8%
$98,540+	$83,930+	$55,730+	8.5%

Taxable Income and Marginal Rates
A Minnesota Married Couple Example

	Income	Tax
Total Income	$ 50,000	
Taxable Income after deductions, etc.	30,000	
Taxable income in 6% bracket	24,800	
Tax at 6% rate		$ 1,488
Taxable income in 8% bracket	5,200	
Tax at 8% rate		416
Total Tax		$ 1,904

	1978		1994	
	Personal Income Taxes as a % of Personal Income	U.S. RANK	Personal Income Taxes as a % of Personal Income	U.S. RANK
Illinois	1.6%	25	1.8%	37
Iowa	2.2%	17	2.8%	12
Michigan	2.2%	18	2.6%	13
Minnesota	**3.4%**	**4**	**3.4%**	**7**
North Dakota	1.5%	28	1.2%	42
South Dakota	—	46	—	45
Wisconsin	3.7%	2	3.5%	4
United States	**1.7%**		**2.1%**	

SOURCE: Government Finances; Bureau of Economic Analysis

[39]Iowa is an example of a state that has a deduction that is much more generous to better-off taxpayers. In Iowa, a deduction is allowed for federal personal income tax paid. Since the federal personal income tax is progressive the benefits of deducting it are much greater at higher income levels. Minnesota briefly had their own version of this deduction. The legislature in 1985 gave filers the option of deducting their federal income taxes paid from their state income tax. Filers who chose this option had to pay at higher tax rates. The option, however, expired in 1987 and the legislature declined to renew it.

The Federal Deduction Offset to the Personal Income Tax

A notable advantage of state personal income taxes (shared by property taxes) is that part of their cost is, in effect, paid by the federal government. This is because many taxpayers are able to deduct their Minnesota income taxes on their federal tax return, lowering their federal

personal income tax liability. This has a far more significant impact than is sometimes appreciated. For individuals who itemize their deductions on their federal tax return, between 15 percent and 39.6 percent of state tax liability is offset by lower federal taxes.

The federal itemized deduction offset means that part of the personal income taxes used to pay for Minnesota's government imposes no direct cost to the state's private economy. Put another way, Minnesotan's pay about a billion dollars less in federal personal income taxes because the state imposes a deductible personal income tax instead of relying on a non-deductible tax in its stead. That is, in effect, about a 21 percent discount.

Trends in the Personal Income Tax

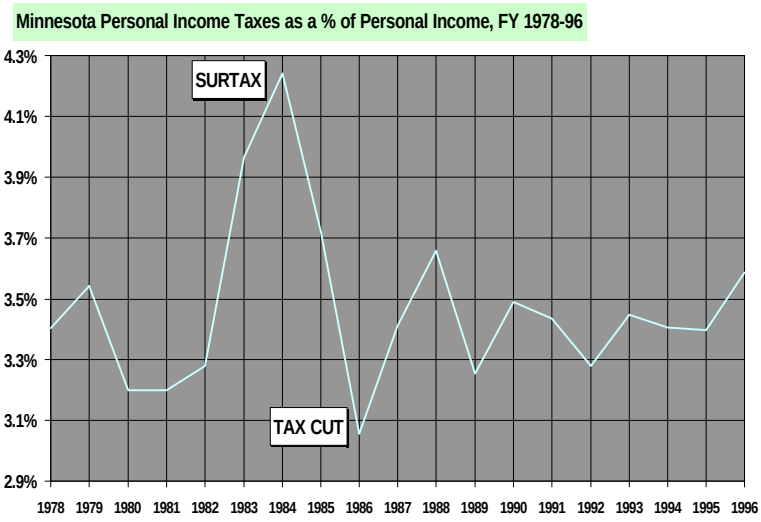
Recent reforms to Minnesota's personal income tax—most notably the expansion of the Working Family Credit (WFC)—have added to the progressivity of the system. Minnesota's WFC is built around the federal Earned Income Tax Credit (EITC) and is available to lower-income working families. Minnesota allows eligible taxpayers to subtract a percentage of the federal EITC from their state income tax liability. Eight other states have versions of the federal EITC—Iowa, Maryland, Massachusetts, New York, Oregon, Rhode Island, Vermont and Wisconsin. Minnesota's WFC was increased in 1997 for those with children, from 15 percent of the federal EITC to 25 percent.

Also in 1997, a credit for certain education expenses was created and an existing deduction for sending children to private elementary and secondary schools was expanded.

Families with household income not exceeding $33,500 with dependent children in public, private, or home schools may qualify for the *credit*. Starting with tax year 1998, the credit is a maximum of $1,000 per dependent, with a maximum of $2,000 per family. Up to these limits, the credit equals 100 percent of the costs of tutoring, academic summer camps, school transportation, and certain home computer equipment and software.

The private school deduction is a maximum of $1,625 for each dependent in grades K-6 and $2,500 for a dependent in grades 7-12. Because this is a deduction (rather than credit), its maximum value is $138 to 213 per child (depending on grade) for top-bracket families. There is no family income limit to qualify for the deduction. A person can claim both the deduction *and* the credit, so long as their income is under $33,500.

The chart below shows the relationship of personal income tax revenues to Minnesota's personal income. The dramatic rise from 1982-84 is attributable to a 7 percent surtax (raised to 10 percent in 1982) enacted by the legislature in response to revenue shortfalls caused by the recession. The surtax was repealed in 1984. The continuing decline in revenue from 1985 to 1986 is attributable to a $791.2 million income tax cut enacted for the 1985 biennium.[40] The tax cut was made possible largely by an upturn in the state economy that generated a $1 billion surplus in Minnesota's treasury. Other than these legislated changes, the growth of Minnesota's personal income tax has kept pace with the state's economic growth.



But personal income tax revenues have been responding very strongly to the state's recent economic boom. Indeed, 51 percent of the $1.3 billion 1998-99 surplus originates from higher-than-projected personal income tax revenues.

[40]St. Paul Pioneer Dispatch, 6/21/85

Property Taxes

Minnesota's property tax is the second largest source of tax revenue in the state—it comprised 30 percent of all state and local tax collections in 1996. Minnesota is near the national average both in the share of revenues from property taxes and in property taxes as a share of personal income. Within the region, only North Dakota is lower in these rankings.

- ☞ **Property taxes were the second largest source of tax revenue in Minnesota in 1996.**
- ☞ **Minnesota has a unique property tax system which limits regressivity through (1) a multi-tiered property tax rate structure arranged by market value; and (2) a progressive property tax refund system.**
- ☞ **Property tax revenue as a share of personal income, gross state product and total state and local taxes *decreased* from 1978 to 1994.**
- ☞ **Homeowners have been paying an increasing share of the Minnesota property tax burden, while the share for business has been declining.**
- ☞ **Both businesses and homeowners received significant property tax relief in the 1997 legislative session.**
- ☞ **Businesses receive priority for future property tax rate reductions.**

Minnesota's system of property taxation was introduced in 1913. Under this system, the state sets "class rates" for different types of property. The "tax capacity" for each property is arrived at by multiplying its market value by the applicable class rate. Final tax liability is computed by multiplying the tax capacity by the local tax rates.

Minnesota is unique among the states in having lower effective tax rates for less valuable property than higher value property. This is accomplished through the class rate system. In the case of homes, a lower class rate is applied to the first $75,000 of market value than on the value exceeding $75,000. (See the class rate table for tax year 1998 on page 29). This is a progressive feature of Minnesota's tax system since lower-income homeowners are more likely to have lower value homes.

It is important to note that when the state sets class rates, it is not determining the amount of property taxes to be collected. The class rates only determine how the burden is distributed among the different classes of property. If, for instance, the state were to lower the class rates for all property by the same ratio, property owners would not see a drop in their property tax bills. The local governments would simply apply a higher rate to the, now lower, tax capacity.

On the other hand, if just the class rate for industrial property were lowered then industrial property would see a tax cut and all other classes would see a tax increase. This is because the local government's rates would go up to offset the lower class rate (and tax capacity) on industrial property. Industrial property would see a net tax cut because its tax capacity would be lower due to the lower class rate. Taxes would go up on all other property, which would still have the same tax capacity, but face the higher local tax rate.

Property Tax Relief Mechanisms

In addition to the multi-tiered classification system, Minnesota has several types of property tax rebates.

Income-Based Circuit Breakers

Minnesota's income-based property tax rebates are of a type known as "circuit breakers." The state refunds to homeowners and renters the amount by which their property taxes exceed a percentage of their income, with certain conditions. For homeowners, the maximum refund in 1996 was $470, and only households with income below $65,450 were eligible. For renters, the maximum refund was $1,090, and only households with income below $38,170 were eligible. The refunds and brackets are adjusted annually for inflation.

Renters, of course, do not directly pay property taxes—their landlords do. Minnesota assumes for purposes of its circuit-breakers that property taxes represent 18 percent of rent.

Elderly property tax refund recipients are allowed to exclude a portion of their income when calculating the benefit. This has the effect of giving a greater break to the elderly.

In 1996, Minnesota paid circuit breaker refunds totaling $83.6 million to homeowners and $89.3 million to renters. Two-thirds of all circuit breaker recipients in 1993 had incomes under $20,000; those filers also claimed three-quarters of the refund dollars.

The circuit breaker can significantly reduce net property tax liability. In 1993, for example, before calculating the property tax refund, circuit breaker recipients with incomes under $20,000 paid 7.1 percent of their income in property tax. After subtracting the property tax refund, however, they paid only 4.1 percent. The circuit breaker also helped out those with incomes between $20,000 to $60,000. The refund reduced their property tax as a share of their income from 5.2 percent to 4.4 percent.[41]

The circuit breaker program thus greatly benefits lower-income homeowners and renters.

The Targeted Refund Program

The second type of property tax refund is the *targeted refund* program. Taxpayers are eligible if their property tax bill rises at least 12 percent and more than $100 in a given year (excluding tax increases due to improvements in the property). The state reimburses 60 percent of the increase, up to a maximum of $1,000. This program refunds much less than the circuit breaker. In 1996, Minnesota homeowners received $4.6 million in targeted refunds.

Education Homestead Credit

In 1997 the legislature passed the Education Homestead Credit. Under this law, the state refunds 32 percent of a portion of education-earmarked property taxes paid by homeowners up to a maximum of $225 (this amount is *not* indexed for inflation).

1997 Property Tax Rebate

The 1997 property tax rebate was a one-time rebate to Minnesota homeowners and renters, regardless of income. It was made possible by the large budget surpluses in 1997. Under this program homeowners can claim on their 1997 income tax return a rebate of 20 percent of their 1997 property tax payments and renters get back 3.6 percent of their rent. With continuing surpluses, another one-time rebate is likely to receive serious consideration.

Federal Deductibility of Property Taxes

As is the case with Minnesota's personal income tax, a portion of Minnesota's property taxes on individuals is offset by federal income tax deductions—resulting in a "discount" of about a seventh compared to a non-deductible tax.[42]

Minnesota Property Tax Refunds in 1993

Income Range	# of Returns	Property Tax Refunds ($millions)	% of Total Refunds (dollars)	Property Tax BEFORE Refund as a % of Income	Property Tax AFTER Refund as a % of Income
Up to $20,000	341,506	$ 110.4	74%	7.1%	4.1%
$20,000 – $60,000	156,397	38.7	26%	5.2%	4.4%

SOURCE: 1993 Property Tax Relief for Minnesotans, Minnesota Department of Revenue.

Property Tax Trends

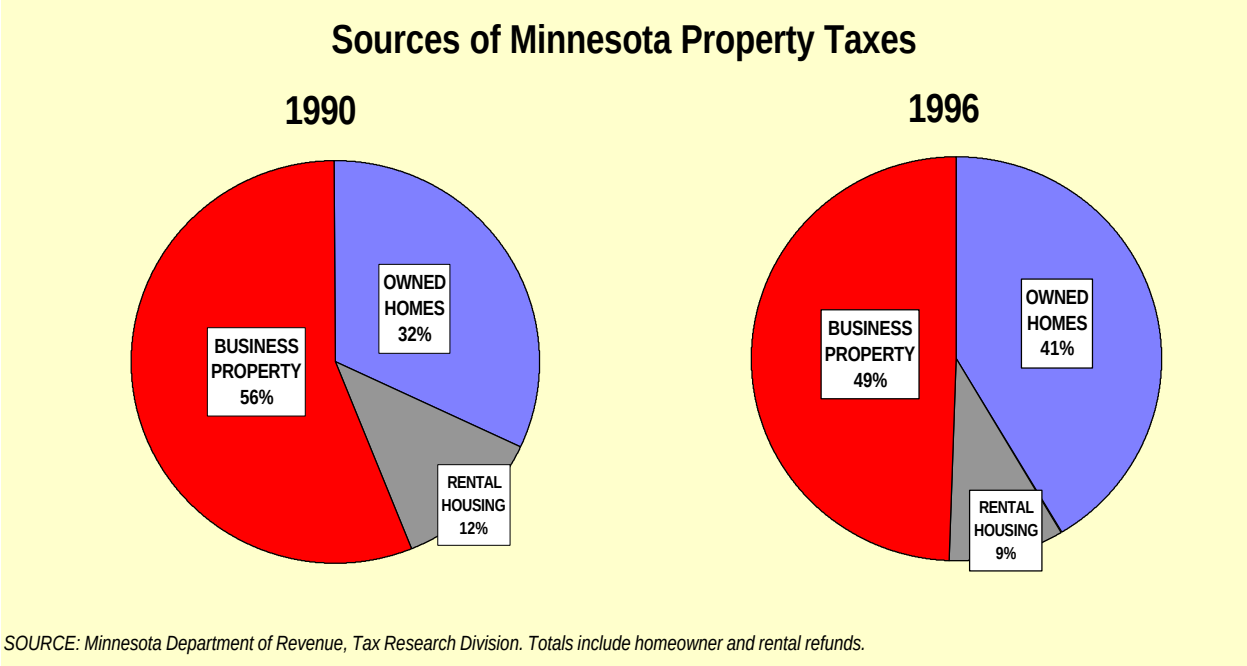
Minnesota's property tax revenues, as a share of personal income, grew only slightly from 1978 to 1994, from 3.8 percent of personal income in 1978 to 3.9 percent in 1994. Property taxes accounted for 30 percent of state and local tax revenue in both 1978 and 1996. But while the aggregate measures of property taxes changed little, there has been a significant shift in the distribution of property taxes—away from business and onto homeowners.

[41] *1993 Property Tax Relief for Minnesotans.* Minnesota Department of Revenue, Tax Research Division. August, 1996.

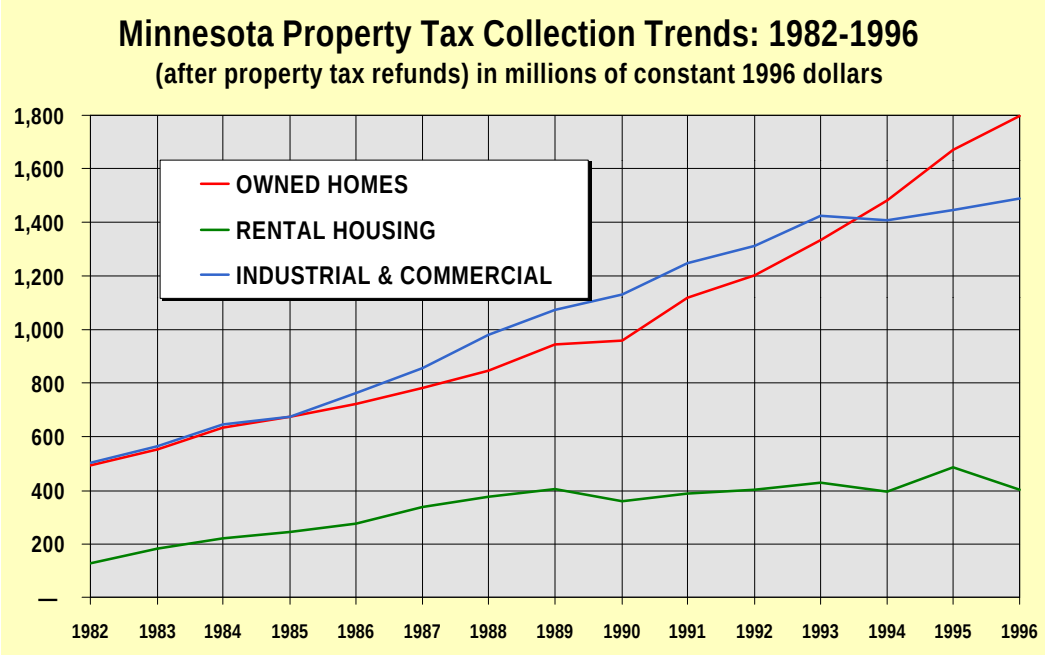
[42] The 14% federal-deduction "discount" on individual property taxes is less than the 21% discount on Minnesota personal income taxes because the income tax is progressive, and taxpayers with higher incomes are in higher federal income tax brackets.

In 1990, businesses paid 56 percent of total Minnesota property taxes, homeowners paid 32 percent and the remaining 12 percent was paid on rental housing. But by 1996, the business share of the property tax had fallen to 49 percent, while the homeowner share had jumped to 41 percent. The rental housing share fell to 9 percent.

As Minnesota's population and economy have grown, homeowner and business property tax collections have, as would be expected, grown as well. But what is notable is that business property tax collections have been flat over the past several years, leaving homeowners with an increased share of the property tax burden.



SOURCE: Minnesota Department of Revenue, Tax Research Division. Totals include homeowner and rental refunds.



Recent Property Tax Developments

In 1997 the legislature enacted substantial property tax cuts for businesses, homeowners and renters. Class rates were permanently lowered for businesses, rental housing, higher-valued homes and subsidized housing. The biggest class rate reductions were given to business and to rental housing. These reductions had the effect of further shifting property taxes to homeowners.

The rate cuts also were greater for higher value business property. The rate on business property value above $150,000 was reduced by 13%, while the rate cut on the first $100,000 of value was only 10%.

Homeowner class rates were not reduced at all on the first $72,000 of value. The rate on the next $3,000 of value was cut in half, but that has a very small impact. The rate on value above $75,000 was only reduced by 9.25 percent.

Changes in Minnesota Property "Class Rates"	1997	1998	"Target"
1a Residential Homestead			
Market value < $72,000	1.0%	1.0%	no target
$72,000 - $75,000	2.0%	1.0%	no target
$75,000+	2.0%	1.85%	no target
2a Agricultural Homestead			
House, garage and 1 acre	—— same as 1a ——		
Remaining Land:			
Market value < $115,000	0.5%	0.4%	no target
$115,000+ (< 320 acres)	1.0%	0.9%	no target
$115,000+ (320+ acres)	1.5%	1.4%	no target
3a Commercial, Industrial and Utility Property			
Market value < $100,000	3.0%	2.7%	2.5%
$100,000 - $150,000	4.6%	2.7%	2.5%
$150,000+	4.6%	4.0%	3.5%
4a Apartments (4+ units)	3.4%	2.9%	2.5%
4bb Single Family Rental Residential			
Market Value < $75,000	na	1.9%	1.3%
$75,000 +	na	2.1%	1.9%

Class rates are multiplied by assessed market value to produce the taxable amount by which property tax rates are multiplied to calculate property taxes due.

As described above, cuts in class rates do not translate into proportionate cuts in taxes because local rates are increased to offset the class rate reduction. Thus, reducing class rates more on businesses than on homes—and more on expensive homes than on less expensive homes—can mean that average homeowners end up paying higher property taxes.

Several measures were adopted to mitigate this shift. First, the state increased its share of school finance by five percent. This had the effect of lowering property taxes for all property, thus lessening what would have been, absent other measures, a tax increase for homeowners. More significantly, the 20 percent one-time rebate for homeowners described above was enacted, as was the education homestead credit.

Not counting the one-time homeowner rebate, businesses will save an average of 6.3 percent on their property tax bill; homeowners will save an average of 5.4 percent in 1998. The homeowner savings will, however, decline over time because of the cap on the education homestead credit. In addition, if state aid to schools fails to keep up with costs, homeowner savings may further erode. Thus, the end result could be higher homeowner property taxes and tax cuts for business—exacerbating the recent trend. At best, the likely long-run impact will be business property taxes declining more than homeowner property taxes.

As mentioned above, the changes in class rates were not uniform for all classes. The following table shows the preexisting class rates, the new class rates (including the new value ranges, where

Effects of 1997 Minnesota Property Tax Cuts On Homeowners and Businesses in 1998

	Average Tax Cut	% Tax Cut
Residential Homestead	$ –107	–5.4%
Commercial-Industrial	$ –102	–6.3%
On Homes with 1998 Market Value of:		
$62,265	$ –20	–2.6%
$93,398	$ –105	–7.3%
$124,530	$ –180	–8.2%
$186,795	$ –222	–6.0%

SOURCE: Minnesota Dept. of Revenue, Tax Research Division.

applicable), and the "target" rates for business taxes that were also adopted. Note that if the target rates are achieved, it will cause a further shift in property taxes from business to homeowners.

If the target class rates for business property are achieved, the rate cut for the first $100,000 of business property will be 17 percent and on value above $150,000, the cut will be 24 percent.

A mechanism for achieving these targets has been put in place. The legislation requires that 60 percent of state budget surpluses go into a property tax reduction fund. This fund is to be used to reduce class rates for business and residential rental property and for mitigating the shift to homeowners that would result. "Mitigate," it should be noted, does not mean "eliminate" and there is no time-frame for this requirement. If, as has been the case, the class rates for business are lowered permanently, while the homeowner property tax relief is temporary, or designed so that it becomes less valuable over time, this could result in continuing the overall shift of property taxes from business to homeowners.

After all, budget surpluses are unlikely to continue in perpetuity. The Minnesota Department of Finance, which estimates revenues and expenditures, had an annual average absolute error of 5.2 percent in its revenue projections from 1980 to 1995.[43] Recently, the Department's revenue projections have been lower than actual tax collections. That has not, however, always been the case. So it is probable that in the future, the Department will overestimate revenues and/or underestimate expenditures, particularly if the economy slows.[44] When and if that happens, it is unlikely that the state will be able to afford to continue temporary property tax relief programs. And the pressure will be on local governments to raise their rates due to their own revenue shortfalls. Thus, absent legislative action, the share of property taxes could shift even more dramatically onto homeowners.

[43]Minnesota Department of Finance.

[44]Note that there is no intention here to be critical of the Department of Finance. Revenue and expenditure projections are difficult to make as are the national, regional and state specific economic, demographic and behavioral phenomena on which they must be based.

Where do the Surpluses Come From And Where are They Going

Recent property tax cut programs are being financed by revenue surpluses. So it is worth examining the source of those surpluses.

Not surprisingly, the projected surpluses are generated by higher than expected revenues and lower than anticipated expenditures. Seventy-four percent of Minnesota's 1998-99 surplus of $1.348 billion is attributable to higher than expected tax revenues; 26 percent is due to lower than expected spending.[45] Of the higher than expected revenues, two-thirds came from greater than anticipated personal income tax collections.[46] On the expenditure side, most of the savings are in health care and education programs.

Sources of Minnesota's 1998-99 Projected Surplus

	$ Amount	% of Total Surplus
Higher Revenues	$1,000,635,000	74%
Lower Spending	347,923,000	26%
Total Surplus	**$1,348,558,000**	**100%**
Revenue Breakdown:		
Personal Income Tax Revenue	$ 684,251,000	51%
Corporate Income Tax Revenue	109,298,000	8%
Motor Vehicle Excise Tax Revenue	86,951,000	6%
Other	120,135,000	9%
Expenditure Savings Breakdown:		
Education/Children & Families	$ 28,443,000	2%
Health Care	270,881,000	20%
Family Support	38,393,000	3%
Other	10,206,000	1%

SOURCE: Minnesota Dept of Finance, November 1997 Forecast.

When you add it all up, more than four-fifths of the current budget surplus has come from either higher personal income taxes or less spending on government services for families and individuals. Only 8 percent of the surplus is clearly identifiable as coming from business.

[45]$364 million from the $2.3 billion 1996-97 surplus was carried over to the 1998-99 surplus

[46]Minnesota Department of Finance *November 1997*

Minnesotans are making more money and hence paying more in Minnesota personal income taxes. And the people of Minnesota are requiring less from some of the state's health care and education programs. Hence, the government has, literally, more money than it knows what to do with. But rather than returning these excess funds to the people who have paid the higher taxes or have foregone government services, a disproportionate share of this surplus is being used to benefit business.

It is also important to note that business property tax rate reductions are *permanent*—so when the surpluses are gone businesses will still be receiving their tax cuts and the state's other taxpayers will be paying for them in higher taxes or reduced government services.

Business Personal Property Taxes

Since 1971, Minnesota has not levied a property tax on a business' machinery, equipment, fixtures or inventories (so-called *personal property*[47]). Public utility personal property, however, *is* subject to taxation in Minnesota. Many other states continue to tax a broader base of business personal property.[48]

Some critics claim that not taxing personal property places certain types of businesses at a disadvantage. Businesses with a higher share of their total worth in land and buildings (real property), for example, may pay a higher property tax than businesses with more of their assets in equipment. Commercial businesses usually have more land and buildings, while industrial businesses tend to have large amounts of machinery. Commercial property accounted for half of all business property taxes in 1996; industrial property, for 19 percent; public utilities, for 16 percent; and farm business property, for 14 percent.

Since 22 percent of Minnesota's gross state product came from manufacturing in 1994,[49] it could be argued, for example, that since industrial properties (a broader category than manufacturing) pay only 19 percent of business property taxes, that industry is paying less than its fair share. When considering this argument, however, there are several points to keep in mind.

It is difficult to determine how to allocate businesses taxes fairly among different sectors. The portion of gross state product provided by a type of business tells little about how profitable the business is—i.e., how great of an ability to pay taxes it has. Furthermore, different businesses require different levels of service from government. The construction industry may put more wear on the roads, service industries may reap the benefits of the educational system, retail trade may require transportation infrastructure. Some argue that even less easily assessable costs should be included in the equation such as the price in poor health that industrial pollutants impose.

In addition to these factors, it is important to recognize that business property taxes are not the only taxes that businesses pay. The manufacturing sector, for example, pays 32 percent of the Minnesota corporate franchise tax—a higher percentage than its share of state GSP.

Finally, the argument that the failure to tax personal property is unfair would seem to be a case for simply *taxing* personal property and equalizing the burden on all types of business. But those who make this argument don't reach this conclusion. Instead, they argue that business property taxes should be lowered *in general* to make the distinctions less important. While this certainly is a more attractive solution within the business community, it can only be accomplished by further shifting the burden to families and individuals—a solution that not everyone would find acceptable.

[47]*Real Property* is land and buildings. *Personal Property* is property other than real estate (such as automobiles, inventories or machinery).

[48]*1997 All States Tax Handbook*, page 223. Research Institute of America. *State Tax Guide*, CCH. The *base* of a tax is defined as the total value of property that is included in calculating a tax.

[49]Bureau of Economic Analysis.

Sales and Excise Taxes

Sales, excise and gross receipts taxes account for about a third of total state and local tax revenues in Minnesota. These consumption taxes include the 6.5 percent general sales tax (with a separate, same-rate tax on car purchases), excise taxes on gasoline, tobacco and alcohol, and gross receipts taxes on insurance premiums, utilities (a local tax) and some medical products.

Because lower- and middle-income families spend more of their income on taxable items than do the wealthy, Minnesota's sales and excise taxes are regressive. In other words, although everyone pays the same nominal tax rates on their purchases, sales and excise taxes take a much higher proportion of the income of middle- and lower-income families than they take from better-off families. To be sure, sales tax exemptions for items such as groceries, clothing and home heating expenses do ease the regressivity of the sales tax somewhat. But even so:

- **Minnesota's sales and excise taxes are regressive—they hit middle- and lower-income taxpayers much harder than the wealthy.**
- **Sales tax exemptions for items such as groceries and clothing lessen the regressivity of the sale tax, but do not eliminate it.**
- **The sales tax has been an increasing share of total revenue in Minnesota, and has been one of the fastest growing sales taxes in the nation since 1978.**

For the 20 percent of Minnesotans making less than $16,000, sales and excise taxes amount to 7 percent of total income.

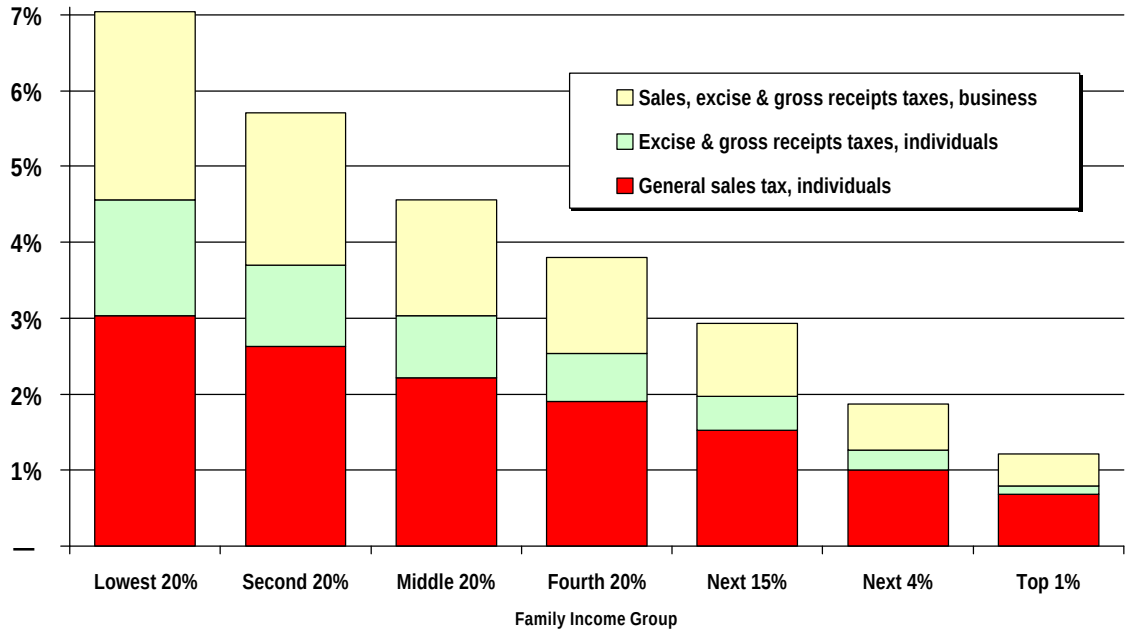
Minnesotans in the middle of the income spectrum (average income $34,100) pay 4.6% of their income in sales and excise taxes.

But the best-off one percent of Minnesota residents, with average income of $730,000, pays an effective sales and excise tax rate of only 1.2 percent.

In other words, low-income Minnesotans pay sales and excise taxes at almost six times the effective rate that the wealthy pay. Middle-income families pay four and a half times as great a share of their income in sales and excise taxes as do the wealthy.

Excise taxes are the most regressive part of the sales and excise tax system. Low-income families pay 15 times the effective excise tax rate that the wealthy pay, and middle-income families pay eight times the wealthy's effective rate.

Minnesota Sales & Excise Taxes As Shares of Family Income



Hardly anyone would propose an *income* tax that looks like this—the main reason the harsh distributional pattern of sales and excise taxes is tolerated is that the amount families pay is hidden in the many purchases made throughout the year.

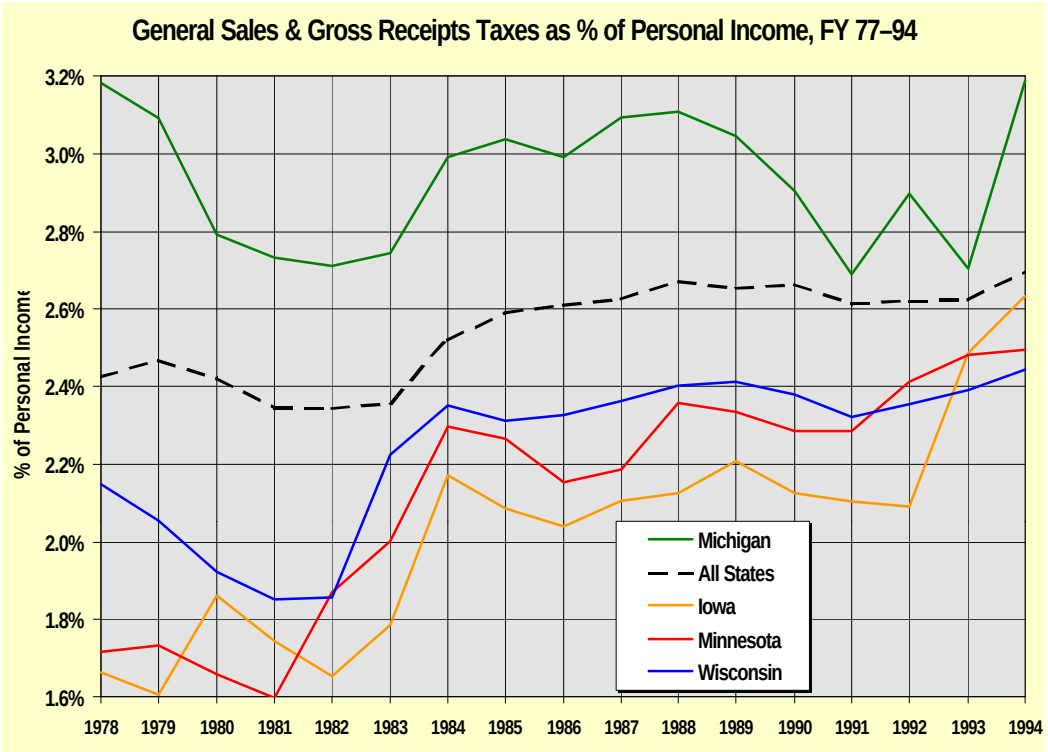
A small portion of Minnesota's sales and excise taxes are paid by visitors from out of state. And a considerable share of the sales and excise taxes initially paid by businesses on their purchases are passed on to out-of-staters in higher prices for Minnesota products. Overall, we estimate that about 23 percent of total Minnesota sales and excise taxes are "exported" in these ways. But that figure compares unfavorably to the percentages for income taxes (27 percent) and property taxes (44 percent) that are either exported or offset by lower federal income tax payments.

Minnesotans who itemize deductions on their federal income tax returns can deduct their Minnesota income and property taxes, but not their sales and excise taxes. So with sales and excise taxes, every dollar paid directly by Minnesota residents is a dollar out of their pockets.

Trends in Consumption Taxes

The general sales tax is a relative newcomer to Minnesota's tax system—it was enacted in 1967 at a rate of 3 percent. It was raised successively to 4 percent in 1971; to 5 percent in 1981; and to 6 percent in 1983. In 1996, the local option sales tax of 0.5 percent was incorporated into the state rate. As of 1998, the state has a general sales tax rate of 6.5 percent. Minnesota's sales tax had the 6th highest rate of growth in the nation from 1978 to 1994. The portion of Minnesota's total tax revenue coming from the sales tax grew from 13.5 percent to 20.3 percent over that time period—a 50 percent increase.

Minnesota's sales and gross receipts taxes (excluding excise taxes) remain lower than the national average as a share of personal income, but only slightly. This is a major change over the past two decades.



The Corporate Franchise Tax

The corporate franchise tax was established at the same time as the personal income tax (1933), when it imposed rates ranging from 1 to 5 percent. Now a flat rate of 9.8 percent is in effect.

The corporate franchise tax is a tax on corporate profits. Minnesota, however, does not tax all corporate profits. A substantial amount goes untaxed because the Minnesota system relies heavily on flawed federal corporate income tax definitions of profits.[50]

The corporate franchise tax is really three taxes. First, there is the 9.8 percent tax on profits. This portion of the tax is responsible for well over 90 percent of the revenue.[51]

In addition to the profits tax there is the "Minimum Fee." This fee ranges from $100 to $5,000 and is paid whether or not tax is owed under the profits tax.[52] It applies to businesses that have total of sales, property and payroll of more than $500,000.

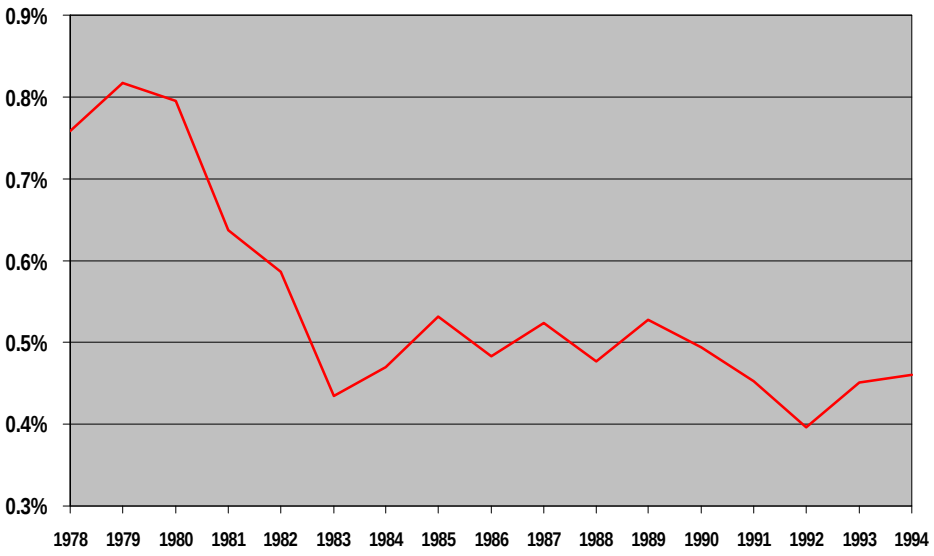
Finally, there is the Alternative Minimum Tax. The purpose of the "AMT" is to assure that profitable companies pay at least some tax notwithstanding their ability to take advantage of tax-reducing provisions in the federal and state tax codes. Profits for AMT purposes are calculated without the benefit of these provisions. Then the AMT tax rate of 5.8 percent is applied to these profits. If the AMT is greater than the tax owed under the regular tax, at its 9.8 percent rate, then the AMT is paid. Otherwise the regular profits tax is paid. Companies are not denied the full benefit of their tax breaks, because they do get to pay at the lower AMT rate. But they are not supposed to escape income taxes completely.

Corporate Income Tax Trends

Minnesota's corporate franchise tax has been a declining source of revenue in the last twenty years. After peaking at 0.8 percent of GSP in 1979, it sank to less than 0.5 percent in the early eighties (largely as a result of federal tax changes), where it has since remained. The corporate income tax comprised 5 percent of all Minnesota tax revenue in 1996, down from 7 percent in the late seventies.

Minnesota's corporate franchise tax is a progressive form of revenue, taxing the profits of corporations, who generally pass it on to their shareholders. Because most of the corporate income tax is paid by multistate corporations, most of whose shareholders live outside of Minnesota, most of the corporate income tax (about four-fifths, we estimate) is "exported" to citizens of other states.

Minnesota Corporate Income Taxes as a Share of Minnesota Gross State Product, FY 1978 to 1994



[50] *The Hidden Entitlements*, ITEP (1996)

[51] 1993 Minnesota Corporate Income Tax Bulletin. Minnesota Department of Revenue, Tax Research Division. February 1997. Page 5.

[52] The minimum fee also applies to large Subchapter S Corporations, whose profits are otherwise not subject to corporate taxation, but instead to the personal income tax.

Tax Expenditures

Tax expenditures are spending programs implemented through the tax code—programs which cost Minnesota over $5 *billion* in 1997.[53] Tax expenditures are similar to regular spending programs in that they are designed to accomplish a goal unrelated to equitable tax collection. Instead of the government sending out a check to the recipient, however, the recipient pays less in taxes.

An example of a tax expenditure is the Research and Development Credit in the Minnesota Corporate Franchise Tax. The function of this credit is to have the Minnesota government subsidize companies that do research in Minnesota.

Instead of Minnesota writing a check to the corporations involved, however, the corporations pay less in corporate income tax. The loss of funds available for other government programs is, of course, the same whether the state writes a check or lowers a company's tax liability. And the benefit to the recipient corporations is also the same either way.

Tax expenditures can be controversial for several reasons. First, they are sometimes used as a means of hiding a government subsidy. Although the costs may be the same, it is often deemed politically desirable to cast a "subsidy" as a "tax reduction."

Also, unlike most spending programs, tax expenditures are usually like permanent entitlement programs. Spending programs typically must be reviewed and re-approved as part of the budget process each and every budget cycle. In contrast, tax expenditures remain in the state's tax code until they are repealed.

Also like entitlement programs, all those who meet the eligibility criteria for a tax expenditure receive the subsidy. Spending programs usually involve some state agency oversight or detailed contractual arrangements. Tax expenditures are generally unsupervised and rarely assessed for their performance. Thus, there is rarely a clear sense of whether they are achieving their stated goals or merely providing a windfall for recipients.

Corporate tax expenditures tend to be the most controversial. Corporate tax subsidies are hidden because they appear on corporate tax returns that most people never see. In addition, corporate subsidies raise more concerns than do broad-based benefits going to a large portion of the population —the mortgage interest deduction on the personal income tax, for example.

One way to partially address the problems associated with tax expenditures would be to subject them to periodic review like ordinary spending. Then spending provisions that find their way into the tax code would be examined to determine if they are serving the purpose for which they were intended and whether that purpose represents the best use of public resources. In addition, information-reporting requirements for those who receive tax expenditures can be a way to ensure that data is available to make meaningful evaluation of tax expenditures possible.

[53] *FY 1995-1997 Tax Expenditure Budget*. Minnesota Department of Revenue, Tax Research Division.

CHAPTER FOUR

SOME TAX OPTIONS FOR MINNESOTA

There are many possible ways to change the Minnesota tax system. This section looks at a number of them. We include tax-increase options, tax-cut options and revenue-neutral options. We examine some options that have been already proposed with much fanfare and others that are less well-known or talked about.

In some cases, if a combination of options were adopted, there would be interactions that would affect the net revenue estimate. If, for example, a property tax cut that costs $100 million on its own were paired with an income tax proposal that raises $100 million on its own, the net result would raise revenue. That's because the property tax cut would reduce the amount of property tax deductions from the state income tax and result in more than a $100 million income tax hike. For several options, we have shown what the combined effect would be.

Arguments for, or against, some of these options may be made on economic grounds—particularly where the options involve changing the taxes on the well-off or corporations. But the economic issues are far from cut and dry. For one thing, there is little evidence that overall levels of taxation play a significant role in a state's economic well-being. In Minnesota's case, higher taxes have been accompanied by strong economic performances.

Also, the impacts of tax changes have many facets. Where relevant, we have indicated the total change in the federal tax liability of Minnesotans. When a state tax change causes more state and local taxes to be deducted on federal tax returns, there can be substantial benefits to the state. Lower federal taxes mean more money staying in the state instead of flowing into federal coffers. For example, the first revenue-raising option described below raises Minnesota state taxes by $140 million, but causes federal taxes paid by Minnesotans to be $50 million lower. That leaves $50 million more to be spent and invested by the people of Minnesota. Hypothetically, if that $50 million were spent directly on employing people, it could create 1,250 jobs paying $40,000 per-year. An economic development proposal that succeeded that well would undoubtably be viewed as a significant boon to the economy.

Conversely, tax cut plans that raise federal tax liability cause a net outflow of tax dollars from the state.

Most of the options presented here do not change the tax burden at any income level by more than half of a percent of income. Only one of these options changes the tax burden more than one percent of income for any group. When these changes are weighed against the federal top personal income tax rate of close to 40 percent and the other components of the overall tax burden, it would appear that the cries often heard in response to proposals involving higher taxes on the well-off and corporations are somewhat in excess of an appropriate level of concern.

Although the debate on the economic impact of taxes has been centered on taxes on the well-off and businesses in recent years, it is important to note that consumption taxes can have adverse economic impacts. Shifting tax burdens to middle-income consumers means they have less to spend at retail establishments in the state. Furthermore, a high sales tax rate can hurt retailers' and other businesses' positions relative to competitors from other states.

This is not to say that taxes can never adversely affect the economy, nor that reasonable minds do not differ on these issues. But, all in all, consideration of the likely economic impacts of tax proposals should be kept in perspective.

The charts accompanying the text show tax changes as a percent of income by income group. The solid portion of each bar represents the tax changes after offset for change in federal tax liability. The light lines on the charts show the tax changes without taking account of federal tax increases or decreases.

We have presented our data in this way because for those who itemize deductions on their federal tax return, changes in state income tax or property

taxes can produce substantial changes in federal tax liability.

For instance, if an itemizing couple in the 28 percent federal tax bracket gets a $1,000 cut in property taxes, their federal itemized deductions will fall by $1,000. That will require them to pay tax on $1,000 more of their income and increase their federal tax liability by $280. Thus, their net tax cut would be $720, not $1,000.

The charts are generally for all families and individuals. Where specific groups are affected in substantially different ways, we include charts showing this.

Earlier sections of this report, plus appendix A, show the incomes and current tax information that underlie these charts.

All sales tax revenue estimates and distributions are for calendar year 1998. Property tax estimates and distributions are for taxes paid in calendar year 1998. Personal income tax estimates and distributions are for tax year 1998.

TABLE OF CONTENTS FOR OPTIONS

Revenue-Raising Options

In this section we offer several revenue-raising tax reform options. A primary value to the public of these proposals is that they increase available funds for pubic services. The primary objections to any of these proposals is that those paying more in taxes will have lower after-tax incomes and that higher taxes may have an adverse impact on economic growth.

It is important to note that there is little evidence that higher state taxes have significant adverse economic impacts. The benefits of well-funded public services appear to play at least as significant a role in a state's economic well-being.

1. Raise the Top Personal Income Tax Rate

Principal Features

- # Revenue increase of $140 million.
- # Tax increase only at higher incomes.
- # Federal taxes drop by $50 million.
- # Top marginal tax rate increased from 8.5 percent to 9.5 percent.

Under current law, the top marginal tax rate applies at taxable incomes exceeding $98,540 for married couples filing jointly, $55,730 for single individuals and $83,930 for heads-of-households.[54] The current tax rate above these incomes is 8.5 percent. This option raises that rate to 9.5 percent.

This tax increase would only meaningfully impact on the richest 5 percent of Minnesotans. Note that the brackets described in the preceding paragraph are based on *taxable* income. This is income after deducting all of the exemptions and deductions. Thus, for example, single tax filers in Minnesota with taxable incomes of $55,730 typically have total incomes exceeding $70,000. Married couples typically would not be effected by this increase until their incomes exceeded $130,000.

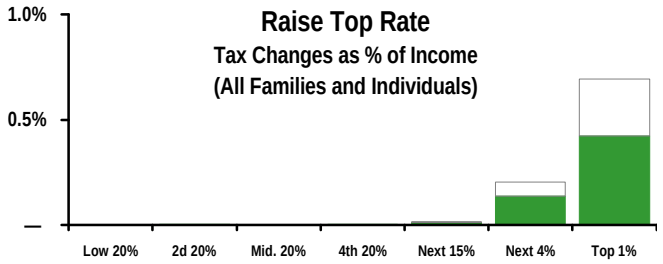
It is also important to note that the Minnesota income tax system uses marginal tax rates. The rate increase described here applies only to the marginal income above the bracket cutoff. A married couple, with $150,000 in total income and $115,000 in taxable income would only see a tax rate increase on $16,460 of their income (the amount by which their taxable income exceeds the top tax bracket $98,540). In this case, the tax increase would be only $164. Only at extremely high incomes do the tax increases begin to approach one percent of income.

Tax increases that affect only higher income taxpayers are offset to a large degree by lower federal income taxes. High-income taxpayers are in high federal tax brackets, which makes the value of increased deductions for state income taxes greater. For example, a married couple with a million dollars in total income, $800,000 of it taxable income, would pay an additional $7,014 under this

[54] "Head of Household" is the term used in the personal income tax to describe a single person supporting a dependent, such as a child. Elsewhere in this report the phrase "single parent" is used as shorthand for this term.

option. At the same time this couple would get $7,014 more in deductions on their federal return. This would cut their federal income tax by approximately $2,778. Thus, the net tax increase on this couple is $4,236 (about 0.4 percent of their income).

In total, federal personal income tax paid by Minnesotans would go down by $50 million under this option—offsetting 35 percent of the tax increase.



2. Uniform Increase in Personal Income Tax Rates

Principal Features

- # Raises over $250 million in additional revenue.
- # All rates increased in a proportional way.
- # Progressive tax increase.
- # Federal tax liability reduced by $60 million.

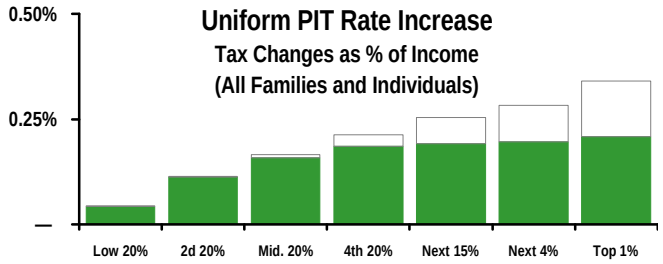
MN Marginal Tax Rates on Taxable Income in 1998

Married Couples	Single Parents	Single w/o children	Marginal Rates	
			Now	+5%
Up to $24,800	Up to $20,890	Up to $16,960	6%	6.30%
$24,800–98,540	$20,890–83,930	$16,960–55,730	8%	8.40%
$98,540+	$83,930+	$55,730+	8.5%	8.93%

This option raises $250 million to provide additional public services. Although the proportionate rate change is the same for each bracket (an increase of 1/20th), the overall result is a progressive tax increase. This is because the underlying tax is progressive. An "across-the-board" increase in a progressive tax is a progressive tax increase.

Minnesota's federal personal income tax liability would decrease by $60 million under this option because of the increase in the deduction for state personal income tax paid.

This option can be criticized for increasing the burden on lower and middle-income families (albeit less than their better-off compatriots).



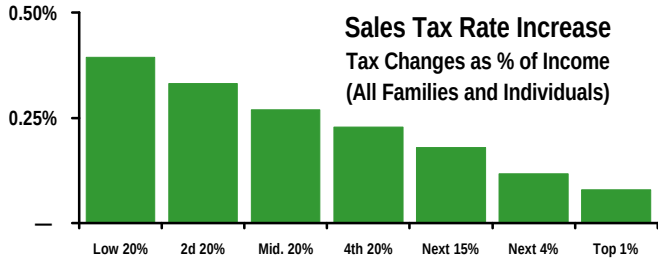
3. Sales Tax Rate Increase

Principal Features

- # Raises $290 million in additional revenue.
- # Tax rate from 6.5 percent to 7 percent.
- # Impact of tax increase greatest for low- and middle-income taxpayers.

This option raises $290 million to provide for additional public services.

This option raises taxes regressively. Raising the sales tax does not lead to lower federal income tax payments by Minnesotans.



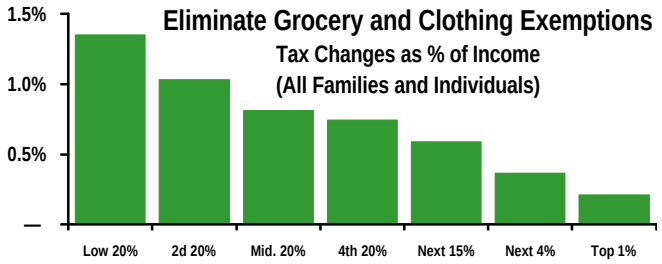
4. Eliminate Sales Tax Exemptions For Groceries and Clothing

Principal Features

- # Raises $710 million in additional revenue.
- # Extends sales tax to currently exempt groceries and clothing.
- # Impact of tax increase greatest for low- and middle-income taxpayers.

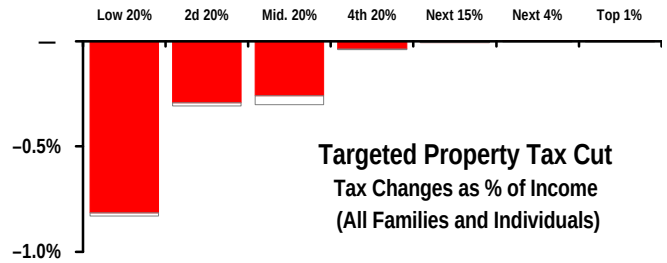
This tax increase would hit hardest on those for

whom food and clothing is the largest part of their household budget. That is, lower income families who spend a substantial portion of their income on these necessities. Raising the sales tax does not lead to lower federal income tax payments by Minnesotans.



Revenue-Reducing Options

In this section we offer several revenue-losing tax reform options. The primary value to the public of these proposals is that they increase their after-tax income. The primary objection to any of these proposals is that they reduce funds available for providing desired government services.



5. Targeted Property Tax Reduction

Principal Features

- # Revenue loss of $130 million.
- # Provides progressive property tax relief.
- # Federal taxes go up by $10 million.

This property tax refund option would reduce revenues by $130 million. It would offer an alternative to the current property tax refund system, allowing homeowners and renters to choose the highest refund of the two. The option would offer greater tax reductions to some low-income households and extend benefits to higher incomes. The income brackets would be adjusted annually for inflation.

Property Tax Refund Alternative

HOMEOWNER **Household Income**	***RENTER*** **Household Income**	Property tax refunded above this % of income:
< $10,000	< $10,000	2%
$10,001–$20,000	$10,001–$20,000	3%
$20,001–$30,000	$20,001–$30,000	4%
$30,001–$40,000	$30,001–$40,000	5%
$40,001–$69,350	$40,001–$40,450	6%
$69,350+	$40,450+	*no refund*

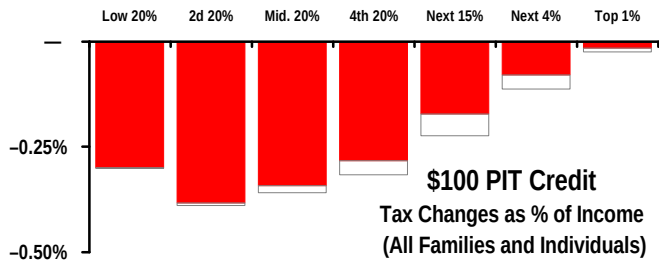
6. Personal Credit on the Income Tax

Principal Features

- # Reduces revenues by $250 million.
- # $100 non-refundable credit per taxpayer.
- # Impact of tax cut greatest for middle- and moderate-income taxpayers.
- # Federal taxes go up by $30 million.

This plan reduces personal income taxes by $100 for each tax filer. Couples receive $200. The tax cut has its greatest impact for moderate- and middle-income taxpayers. The lowest income group would see its already modest tax liability reduced to zero. Wealthier taxpayers would receive the full $100 credit, but this represents a small amount to them relative to their income and tax liability under the personal income tax.

About $30 million of the $250 million in state tax cuts would be offset by increased federal taxes.



7. Cut the Bottom Personal Income Tax Rate To 5 percent From 6 percent

Principal Features

- # Reduces revenues by $300 million.
- # Bottom tax bracket tax rate lowered.
- # Impact of tax cut greatest for middle-income taxpayers.
- # Federal taxes go up by $40 million.

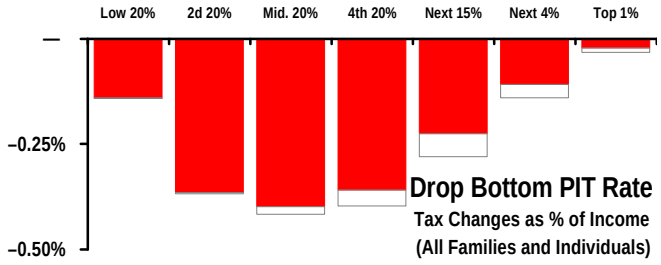
This option cuts the current bottom bracket tax rate from 6 percent to 5 percent. The bottom bracket applies to the first $24,800 of taxable income for married couples filing jointly, $16,690 for single individuals and $20,890 for heads of households.

Reduce Lowest Tax Rate from 6% to 5%

	Income for Maximum Tax Cut	Maximum Tax Cut
Married Filing Jointly	$ 24,800	$ 248
Single	16,690	167
Head of Household	20,890	209

This provides tax cuts to all taxpayers owing personal income tax. The maximum possible tax reduction shown in the table is the benefit realized for those with incomes above the lowest taxable income bracket. Taxpayers with incomes below the bottom bracket see a tax reduction equal to one-percent of their taxable income. This option benefits middle-income taxpayers the most. Lower income taxpayers do not currently pay enough personal income tax under Minnesota's system for it to be of substantial benefit to them (they pay more under Minnesota's other taxes). The wealthy receive the maximum benefit, but this represents a small amount to them relative to their income.

Forty million dollars of the $300 million in state tax cuts would be offset by increased federal taxes.

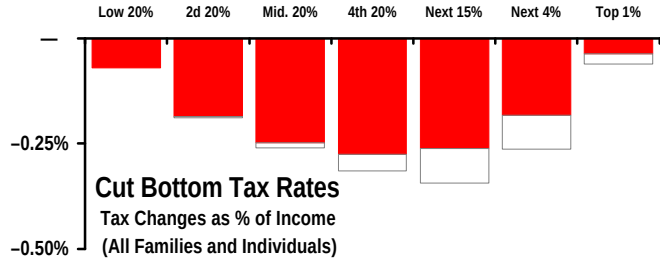


8. Lower Bottom Two Personal Income Tax Rates

Principal Features

- # Reduces revenues by $270 million.
- # Six percent rate dropped to 5.5 percent. Eight percent rate dropped to 7.5 percent.
- # Impact of tax cut greatest for middle- and upper-middle-income taxpayers.
- # Federal taxes go up by $50 million.

This tax cut proposal would reduce revenue by $270 million, giving the biggest tax cut to middle- and upper-middle-income taxpayers. All taxpayers owing personal income tax would, however, get a tax reduction under this proposal. Fifty million dollars of the $270 million would be offset with increased federal taxes.



9. New Bottom Income Tax Bracket At 3 percent Rate

Principal Features

- # Reduces revenues by $195 million.
- # Bottom tax bracket with 3 percent rate.
- # Impact of tax cut greatest for middle- and moderate-income taxpayers.
- # Federal taxes go up by $20 million.

New 3% Bottom Income Tax Rate

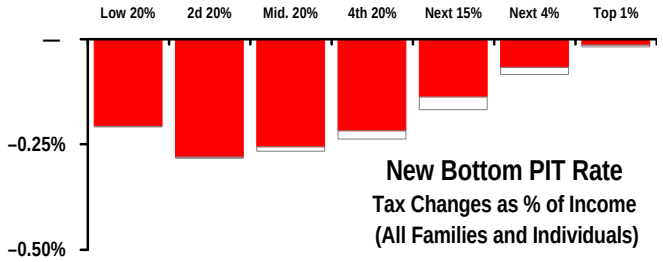
Married Couples	Single Parents	Single w/o children	Marginal Rate
Up to $5,000	Up to $2,500	Up to $2,500	3%
$5,000–$24,800	$2,500–$20,890	$2,500–$16,960	6%
$24,800–98,540	$20,890–83,930	$16,960–55,730	8%
$98,540+	$83,930+	$55,730+	8.5%

This option creates a new bottom bracket with a rate of 3 percent. The new bracket goes up to taxable income of $5,000 for married couples filing

jointly and to $2,500 for single people. The maximum possible tax cut for married couples filing jointly is $150. The maximum possible cut for all others is $75.

This provides tax relief to all taxpayers owing personal income tax. This option benefits middle- and moderate-income taxpayers the most. The lowest income taxpayers do not benefit more because they pay relatively little in personal income tax already. The wealthy receive the maximum benefit, but this represents a very small amount to them relative to their income.

Twenty million dollars of the $195 million in state tax cuts would be offset by increased federal personal income tax payments.



10. Eliminate Rate Table Marriage Penalty and Increase Single Brackets

Principal Features

- # Reduces revenues by $205 million.
- # Increases the single brackets to match the head-of-household brackets.
- # Married tax brackets made double new single and head-of-household brackets.
- # Greatest tax breaks for middle- and upper-middle-income taxpayers.
- # Federal taxes go up by $40 million.

Under some circumstances, the current Minnesota rate structure results in higher taxes when two single people marry. The cause of this "marriage penalty" is that the tax brackets for married couples are less than double the brackets for singles. Thus, for example, two single people with taxable incomes of $16,000, just below the bracket for the 8 percent tax rate, would have all of their taxable income taxed at the 6 percent rate. If they were to get married, however, $7,200 of their combined taxable income would be taxed at the 8 percent rate. Thus, instead of a tax of $1,920, they would pay $2,064.

The marriage penalty can affect single parents who decide to get married to an even greater degree. That's because the head of household tax rules are even more favorable compared to the joint-filing rules than are the single rules.

1998 Minnesota Personal Income Tax Marginal Tax Rates on Taxable Income Now

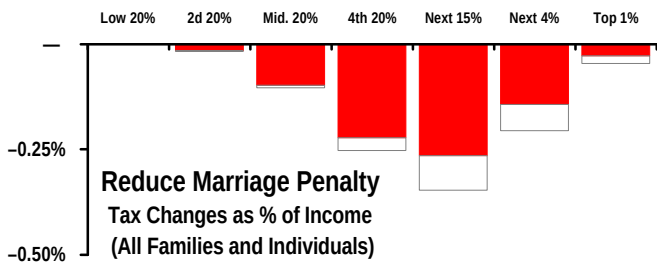
Married Couples	Single Parents	Single w/o children	Marginal Rate
Up to $24,800	Up to $20,890	Up to $16,960	6%
$24,800–98,540	$20,890–83,930	$16,960–55,730	8%
$98,540+	$83,930+	$55,730+	8.5%

Eliminate most of the marriage penalty and increase single brackets

Married Couples	Single Parents	Single w/o children	Marginal Rate
Up to $41,780	*NO*	Up to $20,890	6%
$41,780–111,460	*CHANGE*	$20,890–55,730	8%
$111,460 +	*FROM 1998*	$55,730 +	8.5%

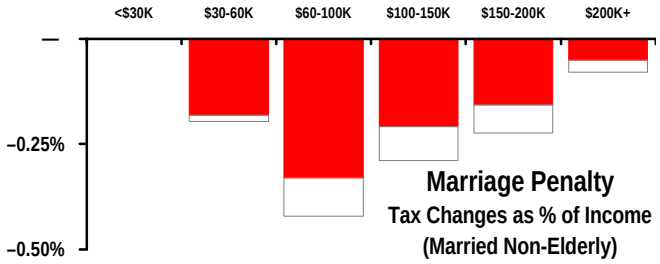
This option eliminates the rate bracket marriage penalty by making the married brackets double the head-of-household brackets and increasing the single brackets to the head-of-household brackets. This latter step is necessary to avoid creation of a "singles penalty." If the married brackets were allowed to be more than double the singles brackets, two single people would pay more in tax than a married couple with the same combined income.

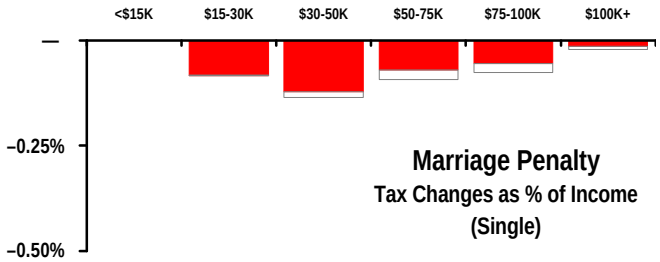
Because this proposal affects only couples and singles with income above the first tax bracket, the benefits of eliminating the penalty help middle- and upper-middle-income households the most. The

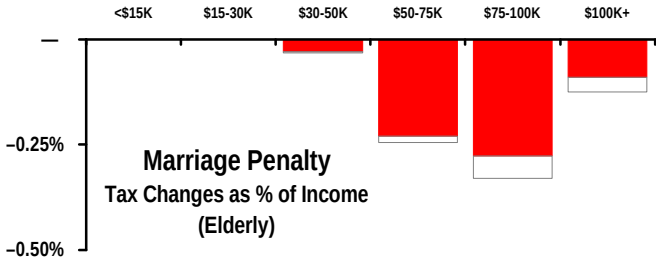


wealthy have most of their income in the top tax bracket anyway so the impact on them is relatively modest.

This option would leave other marriage penalties intact. The federal standard deduction that Minnesota uses is more beneficial to an unmarried couple than a married couple.





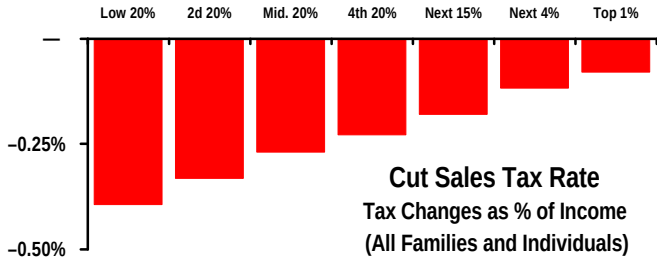


11. Sales Tax Rate Cut

Principal Features

- Revenue loss of $290 million.
- Rate cut from 6.5 percent to 6 percent.
- Tax cut greater for lower-income families.

This plan provides progressive tax relief. But it requires a substantial reduction in state and local government services to pay for it.



Revenue-Neutral Options

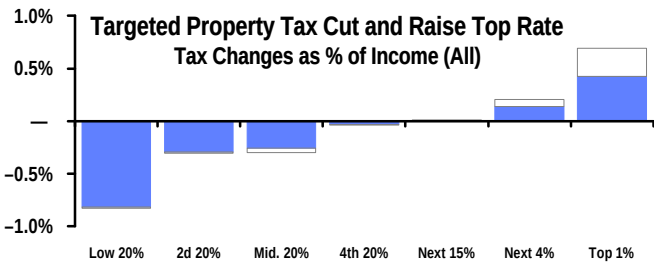
In this section we offer several tax reforms that have little or no impact on total tax collections but significant effects on who pays the taxes. The amount of federal taxes paid by Minnesotans is also changed by several of these options.

12. Targeted Property Tax Cut and Higher Top Personal Income Tax Rate

Principal Features

- Progressive property tax cut and income tax increase.
- Top personal income tax rate increased to 9.5 percent.
- Federal taxes paid by Minnesotans reduced by $40 million.

This option is a combination of options 5 and 1. It has the benefit of providing property tax relief to those who need it most. This is revenue neutral with respect to Minnesota government. It is a net tax cut for Minnesotans however because federal taxes would go down. Wealthier taxpayers get a greater benefit from federal deductions for state and local taxes than do middle- and low-income families. Hence, shifting deductible tax burdens to those at higher incomes causes less money to be sent out of the state in federal tax payments.



13. Targeted Property Tax Cut & New Statewide Business Property Tax

Principal Features

- # Progressive property tax cut paid for by a state business property tax.
- # Improves regional equity in property taxation.

This option incorporates option 5. In addition, a statewide tax is imposed on all commercial and industrial property. This would modestly lessen the trend of increasing the homeowner share of property taxes and decreasing the business share. Also, by taxing business property at the state level, inequities between communities in the availability of a business tax base would be moderated.

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14. Eliminate Much of Marriage Penalty and Raise Top Income Tax Rate

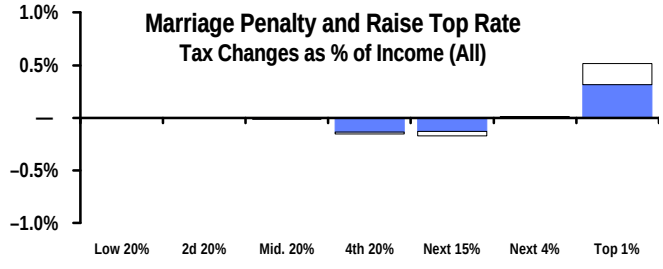
Principal Features

- # This plan would cut taxes for upper-middle-income married taxpayers and raise taxes on the wealthy.
- # Top personal income tax rate increased to 9.5 percent.
- # Federal taxes paid by Minnesotans reduced by $15 million.

This plan combines option 1 with a reduction in the marriage penalty.

This marriage penalty reduction is similar in principle to option 10. The married brackets are, however, only increased to double the single brackets. The single and head-of-household brackets are left unchanged.

Thus, the penalty resulting from the special head-of-household brackets would be lessened, but not eliminated. There would still be a marriage penalty for heads-of-households that got married.



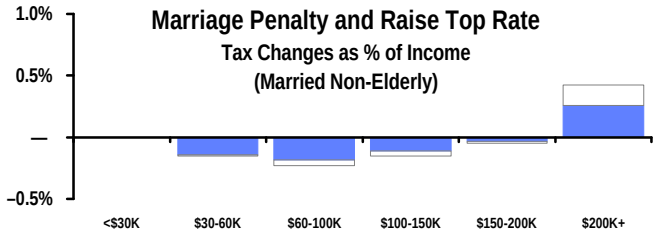
This is an inevitable consequence of the current tax breaks for heads of households—if a single parent marries, the couple will pay higher combined taxes.

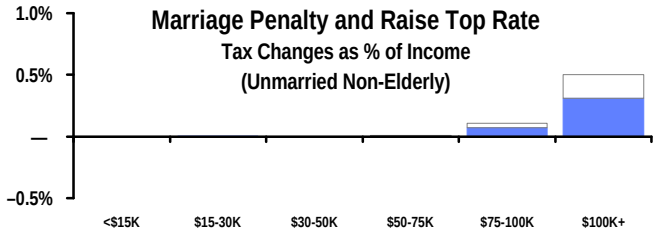
1998 Minnesota Personal Income Tax
Marginal Tax Rates on Taxable Income Now

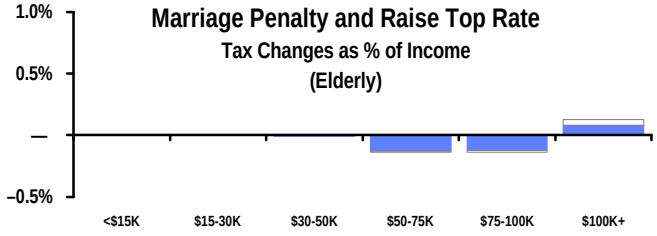
Married Couples	Single Parents	Single w/o children	Marginal Rate
Up to $24,800	Up to $20,890	Up to $16,960	6%
$24,800–98,540	$20,890–83,930	$16,960–55,730	8%
$98,540+	$83,930+	$55,730+	8.5%

Eliminate Much of the Marriage Penalty
And Raise the Top Rate

Married Couples	Single Parents	Single w/o children	Marginal Rate
Up to $33,920	Up to $20,890	Up to $16,960	6%
$33,920–111,460	$20,890–83,930	$16,960–55,730	8%
$111,460+	$83,930+	$55,730+	9.3%





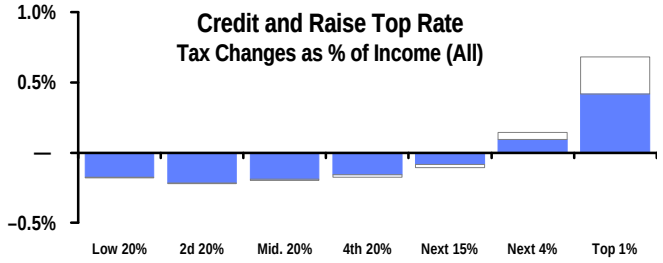


15. Personal Credit on the Income Tax and Raise Top Income Rate

Principal Features

- # Lowers taxes for all income groups except the best-off 5 percent of Minnesotans.
- # Non-refundable credit of $55 for each tax filer combined with increasing the top tax rate to 9.5 percent.
- # Federal taxes paid by Minnesotans reduced by $30 million.

This is a combination of a scaled back version of option 6 combined with option 1.



16. Value-Added Tax (VAT) & Corporate Income Tax Reduction

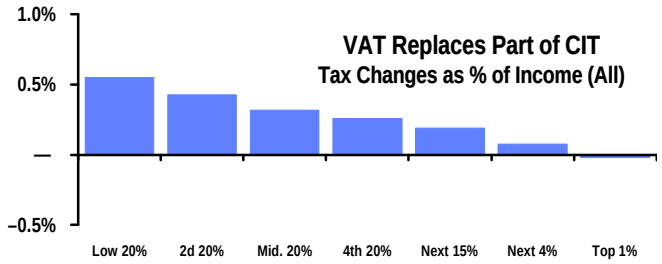
Principal Features

- # Value-added tax imposed. Revenues raised ($300 million) used to reduce corporate franchise tax rate by four percentage points.

Appendix B briefly discusses the nature of state value-added taxes (VATs) and the "Business Activities Tax" proposal analyzed here. Adopting such a tax in Minnesota would increase total consumption taxation in the state. This would make the tax system more regressive. Lowering the Corporate Income Tax would lower the tax on business profits and, hence, on generally better-off shareholders.

The reason a VAT with a rate of under one percent can reduce the Corporate Franchise Tax by about four percentage points is that the VAT has a much broader base. The VAT analyzed here taxes the price of virtually everything sold in Minnesota. The Corporate Franchise Tax, however, only applies to the *profits* received from those sales and only to the extent those profits are actually allocable to Minnesota.

The reason this revenue neutral proposal looks like a tax increase to Minnesotans is that the VAT is allocated by sales in Minnesota, hence putting the bulk of its burden in state. The Corporate Franchise Tax, on the other hand, is partially paid by stockholders in companies doing business in Minnesota. Those stockholders are spread throughout the United States and the world. Thus, by lowering the Corporate Franchise Tax this option lowers taxes on non-Minnesotans while the VAT raises taxes on Minnesotans. The chart shows only the impact on Minnesotans.



17. Adjust Property Class Rates To Shift Property Tax Burden From Homes to Business Property

Principal Features

- # Would partially reverse the shift of property tax burden from business to homeowners.

As discussed above, there has been a shift of the Minnesota property tax burden from business to homeowners. This shift is reminiscent of situations in other states where such shifts have caused substantial taxpayer dissatisfaction. California's infamous Proposition 13 was a response not so much to major increases in taxes in general, but to a shift in the property tax burden away from business and onto homeowners. Similar situations have occurred in Oregon and Massachusetts.

Class rates could be restored to their pre-1998 levels, or greater adjustment could be made to offset some of the shift to homeowners that has occurred in recent years.

18. Increase Gas Tax, Provide Tax Credit.

Principal Features

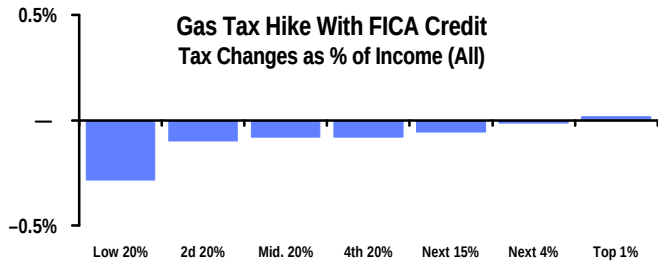
- # Increase gas tax by 10 cents.
- # Refundable personal income tax credit equal to the first $100 of federal FICA tax liability.

It is argued by some that raising taxes on the causes of pollution can be an effective way to improve environmental conditions. An objection to this approach is, however, that taxes on energy consumption are regressive. This option attempts to ameliorate the regressivity of higher gas taxes by using the revenue to provide tax relief targeted at those income groups most severely impacted.

Although progressive, the impact of this option would be uneven. Those who pay more gas tax because they drive more, or use automobiles that consume more gasoline, would end up with their net tax burden increasing. Also, those who do not pay the FICA payroll tax would get no benefit from the credit.

A more sophisticated approach that would impose a broader carbon tax could also be adopted. It could treat different polluting fuels evenhandedly instead of targeting just gasoline.

Because some of the business portion of the gas tax is exported to customers and owners of businesses who reside out-of-state, this option gives a net tax cut to Minnesotans.



CHAPTER 5

CONCLUSION

In preparing this report, information was collected from a wide range of sources on Minnesota's economic and social conditions and its government tax and expenditure policies. The data show that Minnesota ranks in the middle to the top in national comparisons for most major indicators. Perhaps most illuminating is the fact that Minnesota has recorded strong, robust economic growth under a state and local government structure with relatively high levels of revenues and expenditures.

Historically, Minnesota has taken great efforts to try to pay for its public expenditures fairly. But the state's increasing reliance on sales taxes and a shift in the property tax burden away from business and on to homeowners threaten the equity of the tax structure that has served the citizens and businesses of Minnesota so well for so many years.

As the state continues to enjoy economic and budgetary successes, the citizens of Minnesota must determine what direction they want their state government to take in the future. We hope the information in this report will help them make informed and wise decisions.

Minnesota Taxes in 1998
As Shares of Family Income for All Taxpayers

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20%		
					Next 15%	Next 4%	Top 1%
Average Income in Group	$9,500	$22,000	$34,100	$53,300	$84,000	$170,900	$730,000
Income Range	Less than $16,000	$16,000 – $27,000	$27,000 – $43,000	$43,000 – $66,000	$66,000 – $122,000	$122,000 – $287,000	$287,000 or more
Sales, excise & gross receipts taxes	**7.0%**	**5.7%**	**4.6%**	**3.8%**	**2.9%**	**1.9%**	**1.2%**
General sales tax, individuals	3.0%	2.6%	2.2%	1.9%	1.5%	1.0%	0.7%
Excise & gross receipts taxes, individuals	1.5%	1.1%	0.8%	0.6%	0.5%	0.3%	0.1%
Sales, excise & gross receipts taxes, business	2.5%	2.0%	1.5%	1.3%	1.0%	0.6%	0.4%
Property taxes	**3.2%**	**3.1%**	**3.1%**	**3.1%**	**3.0%**	**2.8%**	**2.1%**
Property taxes on families	2.8%	2.5%	2.5%	2.5%	2.4%	2.0%	0.9%
Business property taxes	0.4%	0.6%	0.6%	0.6%	0.6%	0.8%	1.2%
Income taxes	**0.2%**	**2.1%**	**3.4%**	**4.3%**	**5.2%**	**5.9%**	**7.1%**
Personal income tax	0.1%	2.0%	3.3%	4.3%	5.1%	5.7%	6.8%
Corporate income tax	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.3%
Total Before Federal Offset	**10.4%**	**10.8%**	**11.0%**	**11.2%**	**11.1%**	**10.6%**	**10.5%**
Federal Itemized Deduction Offset	–0.0%	–0.0%	–0.2%	–0.6%	–1.5%	–2.1%	–2.9%
Net after Federal Offset	**10.4%**	**10.8%**	**10.8%**	**10.6%**	**9.6%**	**8.5%**	**7.6%**

Minnesota Taxes in 1998
As Shares of Family Income for Married, Non-Elderly Taxpayers

Income Range	Less than $30,000	$30,000 – $60,000	$60,000 – $100,000	$100,000 – $200,000	$200,000 or more
% of couples in group	15.6%	34.0%	35.1%	10.8%	3.8%
Average Income in Group	$21,000	$46,400	$75,200	$131,700	$487,000
Sales, excise & gross receipts taxes	**6.7%**	**4.5%**	**3.2%**	**2.1%**	**1.4%**
General sales tax, individuals	3.0%	2.2%	1.7%	1.1%	0.8%
Excise & gross receipts taxes, individuals	1.4%	0.8%	0.5%	0.3%	0.1%
Sales, excise & gross receipts taxes, business	2.2%	1.5%	1.1%	0.7%	0.5%
Property taxes	**4.5%**	**3.2%**	**2.9%**	**2.8%**	**2.1%**
Property taxes on families	4.0%	2.7%	2.4%	2.2%	1.1%
Business property taxes	0.5%	0.5%	0.5%	0.6%	1.0%
Income taxes	**0.5%**	**3.6%**	**5.0%**	**5.6%**	**6.9%**
Personal income tax	0.4%	3.5%	5.0%	5.6%	6.7%
Corporate income tax	0.1%	0.1%	0.0%	0.1%	0.2%
Total Before Federal Offset	**11.6%**	**11.2%**	**11.1%**	**10.5%**	**10.4%**
Federal Itemized Deduction Offset	–0.0%	–0.3%	–1.3%	–2.0%	–2.8%
Net after Federal Offset	**11.6%**	**10.9%**	**9.8%**	**8.6%**	**7.7%**

Minnesota Taxes in 1998
As Shares of Income for Unmarried, Non-Elderly Taxpayers

Income Range	Less than $15,000	$15,000 – $30,000	$30,000 – $50,000	$50,000 – $100,000	$100,000 or more
% of taxpayers in group	28.9%	37.6%	22.2%	8.9%	1.4%
Average Income in Group	$8,700	$23,200	$39,500	$64,000	$320,000
Sales, excise & gross receipts taxes	**7.1%**	**5.3%**	**3.8%**	**2.8%**	**1.4%**
General sales tax, individuals	3.1%	2.4%	1.9%	1.4%	0.8%
Excise & gross receipts taxes, individuals	1.5%	1.0%	0.6%	0.4%	0.1%
Sales, excise & gross receipts taxes, business	2.5%	1.8%	1.3%	0.9%	0.5%
Property taxes	**2.1%**	**1.8%**	**2.6%**	**2.5%**	**2.4%**
Property taxes on families	1.7%	1.5%	2.2%	2.0%	1.0%
Business property taxes	0.4%	0.4%	0.4%	0.5%	1.4%
Income taxes	**0.6%**	**3.4%**	**4.6%**	**5.6%**	**7.1%**
Personal income tax	0.5%	3.4%	4.6%	5.5%	6.7%
Corporate income tax	0.0%	0.0%	0.0%	0.1%	0.3%
Total Before Federal Offset	**9.8%**	**10.5%**	**11.0%**	**10.8%**	**10.8%**
Federal Itemized Deduction Offset	–0.0%	–0.0%	–0.6%	–1.5%	–2.7%
Net after Federal Offset	**9.8%**	**10.4%**	**10.4%**	**9.3%**	**8.2%**

Minnesota Taxes in 1998
As Shares of Family Income for Elderly Taxpayers

Income Range	Less than $15,000	$15,000 – $30,000	$30,000 – $50,000	$50,000 – $100,000	$100,000 or more
% of taxpayers in group	27.1%	34.6%	21.0%	11.6%	4.9%
Average Income in Group	$9,500	$22,100	$39,300	$66,200	$196,000
Sales, excise & gross receipts taxes	**6.5%**	**5.4%**	**4.0%**	**2.9%**	**1.5%**
General sales tax, individuals	2.8%	2.5%	2.0%	1.5%	0.8%
Excise & gross receipts taxes, individuals	1.3%	1.0%	0.7%	0.4%	0.2%
Sales, excise & gross receipts taxes, business	2.4%	1.9%	1.4%	1.0%	0.5%
Property taxes	**4.9%**	**4.7%**	**4.8%**	**4.6%**	**3.6%**
Property taxes on families	4.4%	3.6%	3.5%	3.1%	1.6%
Business property taxes	0.5%	1.0%	1.3%	1.5%	2.0%
Income taxes	**0.2%**	**0.8%**	**2.2%**	**4.6%**	**5.4%**
Personal income tax	0.0%	0.5%	1.9%	4.2%	4.9%
Corporate income tax	0.1%	0.3%	0.3%	0.4%	0.5%
Total Before Federal Offset	**11.5%**	**10.8%**	**11.1%**	**12.0%**	**10.5%**
Federal Itemized Deduction Offset	—	–0.0%	–0.1%	–0.5%	–1.7%
Net after Federal Offset	**11.5%**	**10.8%**	**11.0%**	**11.6%**	**8.8%**

APPENDIX B: WHAT'S A VAT?

A value-added tax is a tax levied at each stage of the production and sale of goods and services. It applies to the "value added" at each stage—so the ultimate tax base is the final retail price of products and services.

Because a VAT is usually not itemized on receipts to consumers (unlike a regular sales tax, where one can always look at the receipt and see just how much one paid in tax), some advocates of the VAT characterize it as a tax on business. But virtually everyone who has seriously analyzed a VAT agrees that it is "equivalent to a retail sales tax," except for "differences in methods of collection."[55] The U.S. Congressional Budget Office pointed out that "a value-added tax is a form of general sales tax . . . [O]nly sales to consumers end up being taxed."[56] Hence, a VAT would end up regressively taxing consumers, just as a sales tax does. So how is a VAT collected, and how does this differ from (or how is it similar to) the general sales tax?

VATs are most commonly found in Europe, where they were instituted for the most part in the late 1960's and early 1970's to replace cascading, multi-level gross receipts taxes. But they are also found in two U.S. states: Michigan and New Hampshire (the federal government does not implement any type of VAT). Some VATs being discussed in Minnesota are closely modeled on Michigan's VAT, called the "Single Business Tax". Michigan's VAT works like this:

- First, raw materials suppliers collect the VAT when they sell materials to manufacturers.
- Second, manufacturers subtract the cost of the raw materials from the cost of the manufactured products. The manufacturers then collect the VAT on the difference when they sell to wholesalers.
- Third, wholesalers subtract the amount paid to the manufacturers from the wholesale selling price before collecting the VAT from retailers.
- Finally, retailers subtract the amount paid to wholesalers from the retail price before charging the VAT to consumers.

So, businesses at the various stages of production and distribution, who pay tax at each stage, pass the full added cost of the VAT on to consumers.

Why go through all this trouble to collect what basically amounts to a retail sales tax? In Europe, one main reason was that a VAT merely replaced pre-existing multi-stage sales taxes. Going to a VAT maintained the existing tax structure.

In Michigan, the primary reason for adopting a VAT was to stabilize tax revenues from the state's dominant business sector, the auto industry. The auto industry experienced volatile periods of profits and losses, which accounted for Michigan's erratic corporate income tax collections. So a VAT, based on sales instead of profits, was adopted to stabilize revenues. But to successfully tax the auto industry, Michigan's VAT does not exempt goods shipped out of state (unlike most sales taxes or most European VATS). Thus, Michigan uses its VAT to tax out-of-state car buyers—and, as a result, cars made in Michigan will be more expensive—or perhaps less profitable—than cars made elsewhere. To the extent it taxes exports, some portion of the Michigan VAT is probably ultimately paid by owners or workers, not end consumers. Nevertheless, its total impact is regressive.

A 5% Michigan-Style VAT

	Price	Taxable	Tax
Raw Materials	$40	$40	$2
Manufactured Product	140	100 (140–40)	5
Wholesale Sale	200	60 (200–140)	3
Retail Sale	300	100 (300–200)	5
TOTAL		**$300**	**$15**

The VAT introduced in the Minnesota Senate in 1997 (called the "Business Activities Tax"), however, does not tax exports (although it does exempt imports).[57] Thus, it would be borne almost entirely by Minnesota consumers.

Preliminary estimates show that the Minnesota VAT proposed in 1997 would raise approximately $300 million. It has been suggested that this revenue could be used to lower the state's corporate franchise tax rate. The corporate franchise tax raised $700 million in 1996 from the *profits* of Minnesota's corporations. Since the franchise tax taxes profits, the cost is largely passed on to *shareholders*, not *consumers*. So replacing a progressive tax (like the franchise tax) with a regressive one (like the VAT) would not serve the consumers of Minnesota very well.

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[55]Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, (JCS-6-91), May 30, 1991.

[56]Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, February 1992.

[57]The Minnesota VAT proposal would be implemented gradually—beginning at 0.45% in 1998, and increasing to 0.55% in 1999 and thereafter. An exemption of $500,000 and a capital acquisition deduction would be granted. The tax base would be computed on a unitary basis and would be apportioned to Minnesota using a single sales factor. The tax base would be calculated using federal taxable income increased by depreciation deductions taken, royalties paid, interest expense paid, and compensation paid. The base would then be decreased by taxable dividends, interest income, and royalty income received. Casual transactions were not included in the tax base.

APPENDIX C: METHODOLOGY AND COMPARISON WITH OTHER ANALYSES

About the Institute on Taxation and Economic Policy & the ITEP Microsimulation Tax Model

THE INSTITUTE ON TAXATION & ECONOMIC POLICY has engaged in research on tax issues since 1980, with a focus on the distributional consequences of both current law and proposed changes. ITEP's research has often been used by other private groups in their work, and ITEP is frequently consulted by government estimators in performing their official analyses. Over the past several years, ITEP has built a microsimulation model of the tax systems of the U.S. government and of all 50 states and the District of Columbia.

What the ITEP Model Does

The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the presence of children and age.

In computing its estimates, the ITEP model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to three quarters of a million records. To forecast revenues and incidence, the model relies on government or other widely respected economic projections.

The ITEP model's federal tax calculations are very similar to those produced by the congressional Joint Committee on Taxation, the U.S. Treasury Department and the Congressional Budget Office (although each of these four models differs in varying degrees as to how the results are presented). The ITEP model, however, adds state-by-state estimating capabilities not found in those government models.

Below is an outline of each area of the ITEP model and what its capabilities are:

The Personal Income Tax Model analyzes the revenue and incidence of current federal and state personal income taxes and amendment options including changes in:

- rates—including special rates on capital gains,
- inclusion or exclusion of various types of income,
- inclusion or exclusion of all federal and state adjustments,
- exemption amounts and a broad variety of exemption types and, if relevant, phase-out methods,
- standard deduction amounts and a broad variety of standard deduction types and phase-outs,
- itemized deductions and deduction phase-outs, and
- credits, such as earned-income and child-care credits.

The Consumption Tax Model analyzes the revenue and incidence of current sales and excise taxes. It also has the capacity to analyze the revenue and incidence implications of a broad range of base and rate changes in general sales taxes, special sales taxes, gasoline excise taxes and tobacco excise taxes. There are more than 250 base items available to amend in the model, reflecting, for example, sales tax base differences among states and most possible changes that might occur.

The Property Tax Model analyzes revenue and incidence of current state and local property taxes. It can also analyze the revenue and incidence impacts of statewide policy changes in property tax—including the effect of circuit breakers, homestead exemptions, and rate and assessment caps.

The Corporate Income Tax Model analyzes revenue and incidence of current corporate income tax law, possible rate changes and certain base changes.

Local taxes: The model can analyze the statewide revenue and incidence of aggregate local taxes (not, however, broken down by individual localities).

Addendum: Data Sources

The ITEP model is a "microsimulation model." That is, it works on a very large stratified sample of tax returns and other data, aged to the year being analyzed. This is the same kind of tax model used by the U.S. Treasury Department. the congressional Joint Committee on Taxation and the Congressional Budget Office. The ITEP model uses the following micro-data sets and aggregate data:

Micro-Data Sets:
IRS 1988 Individual Public Use Tax File, Level III Sample
IRS 1990 Individual Public Use Tax File
Current Population Survey: 1988-93
Consumer Expenditure Survey, 1988-90 and 1992-93
U.S. Census, 1990

Aggregated Data Sources:
Miscellaneous IRS data.
Congressional Budget Office and Joint Committee on Taxation forecasts.
Other economic date (Commerce Department, WEFA, etc.)
State tax department data.
Data on overall levels of consumption for specific goods (Commerce Department, Census of Services, etc.).
State specific consumption and consumption tax data (Census data on Government Finances, etc.).

State specific property tax data (Govt. Finances, etc.).
American Housing Survey 1990
1990 Census of Population Housing

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For More Information:
For a complete, detailed explanation of the methodology underlying the ITEP Model, *see Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (ITEP, 1996).

COMPARISON WITH MINNESOTA DEPARTMENT OF REVENUE DISTRIBUTIONAL ANALYSES.

The methodologies used by the Minnesota Department of Revenue are similar to that used by ITEP although data sources and some assumptions regarding the ultimate incidence of business taxes differ.[58]

Generally DOR shows a higher burden distributed by income level in a similar pattern. The higher burden shown by DOR apparently reflects differing assumptions regarding the portion of business taxes exported to residents of other states.

The similarity in results despite different data sources and different business tax assumptions shows that the shared overall conclusions are robust.

[58] *1997 Minnesota Tax Incidence Study*. Minnesota Department of Revenue.