

Finding a Way Forward
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To: Governor Tim Pawlenty, Commissioners Tom Hanson and Ward Einess, Budget Director Jim Showalter

Senator Larry Pogemiller, Senator Tom Bakk

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Here is a framework for creating a new Minnesota Miracle by (1) resolving the budget crisis; (2) focusing state resources on investing in people and focusing the people and their local officials on deciding how much local government they want and are willing to pay for; (3) making Minnesota a better location for business production, and solving the stadium for the Vikings problem; and (4) preserving and improving water and habitat quality, and encouraging more dense urban development to save billions on infrastructure costs.

More details on some of the following ideas are in the Change Minnesota reform package I delivered to you last March. Exhibit D thereof is attached, as it contains multiple options for improving how Minnesota governments operate, item (2) above.

I. Resolving the Budget Crisis

1. End the unallotment dispute.
 - Governor drops appeal of Judge Gearin's order
 - Governor unallots anew before the session begins, covering what he deems essential, and covering contingently the initial unallotments he includes in that category
 - Legislature and Governor ultimately reach an agreement that moots unallotments – some may be restored, others incorporated in Legislature's appropriations
 - Advantages: no time is lost to the spending faucet flowing until turned off; Governor can claim his approach worked and saved millions; future Governors will think twice before unalloting in the budget setting process because Judge Gearin's ruling still stands

2. Temporarily increase selected taxes and provide for future rollbacks.
 - Individual income tax

- Effective January 1, 2010, go back to the 1998 rates of 6%, 8% and 8.5% because the cuts in 1999 and 2000, plus the property tax cuts in 2001, converted the Minnesota Miracle to the Minnesota Debacle, with the state unable to meet its obligations because the cuts wrongly assumed that the high tech bubble would never burst. Current rates are 5.35%, 7.05% and 7.85%.
- To really make a difference, go to an FAGI or perhaps a federal gross income starting point, eliminate all deductions from FAGI and the municipal bond interest exclusion, provide income adjusted credits for charitable contributions and household maintenance, and the rates could be lower. If a bonding subsidy is deemed necessary, pay it to the local governments, with a threshold requirement based on responsible borrowing as evidenced by bond rating.
- The base broadening could include repeal of the AMT and incorporate appropriate portions of what it now reaches in the regular income tax base. This would help reduce the temporary rate increase and would be a welcome simplification.
- Make the base changes permanent, but provide that the rate goes back to today's equivalent share of the economy, or lower, on January 1, 2014.
- If the Governor is unwilling to correct the 1999-2000 rate cuts, which were based on grossly erroneous assumptions, the entire revenue burden could be met through sales tax base broadening.
- Sales tax
 - Effective July 1, 2010, vastly broaden the base and cut the rate from the current 6 7/8% to either 6% or 5%. May phase rate down further at dates set now. Because local sales taxes also could be repealed, the rate reduction on the sales tax could be dramatic.
 - Extend base to clothing, food, consumer services and health care. Consider repeal of existing health care taxes, but also extension of corporate income tax to health care corporations.
 - Low income people could be held harmless through debit card loading for food and clothing.
 - Sales tax base expansion and rate reduction may be the single most important improvement to be made in Minnesota's tax system. See Budget Trends Study Commission's work.
 - The sales tax probably has to provide a larger share of revenue than it does today if Minnesota's tax system is to become more reliable, which the BTSC work identifies as a serious need. This makes a future rate drop to the point that the sales tax takes no more of the economy than at present unwise.
 - Governor Pawlenty's concerns about not fueling a spending spree when the economy recovers could be taken into account in deciding now how far to drop the rate as of, say, July 1, 2013.

- Alternatively, enact budget reserve reform including triggers for tax rate cuts and increases, described below
- Governor's guarantee of static or reduced state government share of the economy
 - Consider using the state's share of the price of government to trigger future tax rate cuts. E.g., enact now a provision calling for proportional rate cuts in the individual income and/or sales taxes as of January 1 of any year following the end of a state fiscal year in which the state's share of the price of government exceeded whatever percentage of Minnesota personal income you select.
 - Consider enacting now a provision that would bill counties for a share of human services costs and/or bill all entities a greater share of the health care costs of their employees (assuming in each case the reform suggested below is made) as of January 1 or July 1 (whichever works better for operational purposes of affected entities) of any year following the end of a state fiscal year in which the state's share of the price of government exceeded whatever percentage of Minnesota personal income you select.
 - Consider making these provisions effective January 1, 2014 – after the next biennium, which presently appears to present an unprecedented fiscal challenge to the state.
 - This would provide Governor Pawlenty with protection against the charge that he had failed to be fiscally responsible by allowing a temporary tax increase to help resolve the biggest budget crisis in Minnesota history. It would make explicit what is now implicit in the Governor's fiscal policies – that he prefers local property taxation to state taxation. And it would write into law an unprecedented degree of fiscal conservatism. Such a provision could be repealed later, but that would be easier said than done.

3. Permanently cut state spending.

- At your joint discretion.
- Include immediate or gradual complete elimination of property tax aids and credits, using the property tax refund program at the individual level as the sole means of providing property tax relief. See below for better ways to spend this money to get improved results. The results produced by the current system are simply indefensible – property taxes vary all over the lot, which is fine because it is a local tax, but the state pours \$2 billion plus per biennium into property tax aids and credits, holding property taxes to very low levels in some cities (many, but by no means all, on the Iron Range, where the taconite homestead credit, which should be repealed, makes the situation ridiculous). Paying subsidies of \$800+ per capita to hold the property tax on an average house in a city to less than \$400 per year cannot be justified, especially in a time of fiscal crisis. The impact of repeals can be feathered in through the property tax refund program.

- If necessary, consider across the board cuts to education, but with local discretion as to what to cut, coupled with improved reporting of student outcomes.
 - The changes in this package would substantially reduce the cost of administering the state/local fiscal system. Due to transition costs, that might not help solve the current crisis, but would help in the long run.
4. Consolidate funds.
- Review all state funds
 - Consider dropping some programs and transferring funds to general fund
 - Consider consolidating funds to take balance to help solve the general fund problem, with appropriate changes in the program to deal with suspension of activities and restoration of activities and/or funds over time
5. Consider extending the shift concept to all local governments.
- This would require changing the fiscal year for cities, counties and townships to the June 30 FYE used by the state and schools.
 - There would be a transition “year” that could be either 6 months or 18 months in length. The latter probably would be better.
 - When implemented, local governments would set property tax levies in the fall and the taxes would be levied in late winter and paid in May and October as at present, but the norm for the May payment would be to apply to the FYE beginning the next July 1 to the extent determined by the local government. The Legislature then could, by fiat as at present with schools, mandate that the May payment count in whatever percentage it chose against the current year ending June 30.
 - Whether this would work at all would require review not only of state aid payments to local governments, which are a far lower percentage of local government budgets than is state school aid, but also of the mechanics of making the property tax changes noted below.
 - While such arbitrary shifts are questionable policy, if they help get through the crisis and are coupled with other positive reforms such as those listed here, the overall impact could be hugely positive.
6. Mitigate the intensity of future budget crises through budget reserve reform
- Set budget reserve target at 5% of biennial budget
 - Consider tying tax rate cuts to exceeding that level
 - Consider tying temporary tax rate increases to slippage below, say, 2%
 - Could help maintain high bond rating
 - Would materially reduce the chances of recurrence of the budget difficulties of the past eight years
 - A major improvement in fiscal responsibility

II. Focusing State Resources on Investing in People
and
Focusing the People and Local Officials on Deciding How Much Local Government
They Want and Are Willing to Pay For

A. The State Invests in People

1. State share of K-12 spending increases, funded by state tax on business replacing local business property taxes cut by class rate system change set forth below
2. Reconfigure the funding of human services so that local property taxes are substantially or entirely eliminated. Initially may just provide that the counties continue to provide as they have, with capitated funding. But transition rapidly away from the existing 19th century vintage system to one of 9-14 regional purchasers of human services. See Change MN, Ex. D, Section I.
3. If fiscally feasible, a portion of the eliminated property tax aids and credits goes to the state picking up a share of all governmental entities' health care costs. This would provide the state with the opportunity to do health care reform on a base of 338,000 governmental employees (as of June 30, 2008), plus their dependents, enough to create major state wide impact as well as improving results and cutting costs for government .
4. If the numbers work, cut prison time and use longer parole, coupled with GPS tracking of parolees, and rent freed up prison space to other states.

B. The People and Local Officials Decide How Much Local Government
They Want and Are Willing to Pay For

1. Repeal levy limits. Home property taxes remain comparatively low, so can appropriately be increased if local governments and citizens are willing to do so. Relief based on ability to pay can be delivered via property tax refund program.
2. Repeal or suspend maintenance of effort mandates. Allow local discretion as to where to cut and whether to raise property taxes to avoid cutting. We have more government than Governor Pawlenty is willing to pay for, and programs legislative leaders think important and do not want to cut. If valuable programs must be reduced, it would be wise to maximize the role of local officials in prioritizing based on local conditions in this time of crisis.
3. Repeal the referendum requirement for school board taxing decisions, except perhaps for new buildings. School districts should not be disadvantaged vis a vis other governments in raising the money they need to operate, especially given the widespread hatred of the property tax.

4. Minnesota's property tax system is both incomprehensible and full of perverse incentives for communities, businesses and citizens. The property tax should be reconfigured with respect to its users, its uses and how it applies to different classes of property. Exactly what changes to make will vary with your interest in making Minnesota a better location for business production and in improving water and habitat quality and saving billions in future infrastructure costs.
 - Property tax users and uses
 - Cities and townships rely much more on the property tax
 - Schools are taken off the local property tax, perhaps except for discretionary funding
 - County human services levies are cut way back or eliminated, but counties use it more for general government purposes
 - Transportation may be funded more through the property tax
 - Property taxation of differing properties
 - Residential and business property taxed locally at the same rate
 - Farms either continue taxed at a lower rate or exempted from the property tax except for townships and county rural roads
 - Habitat property – that which is not residential, farm or designated for development – follows farms
5. Repeal all local sales taxes, though perhaps gradually.
6. Ideally, have school districts use an equalized local individual income tax, instead of the property tax, for discretionary funding. If this would be too much of a change, continue using property tax for this purpose. That would be simpler.
7. With the foregoing changes, Minnesotans would be well positioned to understand the costs of local governments, and both local officials and their constituents could make intelligent decisions on what local government they want.
8. Eliminate the election of sheriffs, effective immediately. This would open up possibilities for locally generated consolidation of law enforcement functions around the state.
9. See Change Minnesota, Exhibit D, for how to go about changing the state-local government relationship to solve Minnesota's too many local government service producers problem. The Legislature could well make changes in 2010 that would facilitate prompt action by citizens and local governments to find ways to provide government services more efficiently, or in some instances launch studies of specific changes that have particular promise. Many helpful changes already are legally possible through joint powers agreements. There is nothing but lack of will to change preventing major improvements in public service delivery. You could consider a number of incentives to promote change. And you could consider creating one or more commissions to study whether various consolidations should be imposed.

III. Making Minnesota a Better Location for Business Production and Solving the Stadium for the Vikings Problem

1. Changes should (1) shift the emphasis of business taxation off production in Minnesota and on to exploitation of the Minnesota market; (2) facilitate shifting tax burden from Minnesota-based to out of state businesses; and (3) promote fairness and acceptance of Minnesota's tax system in the business community by discriminating less against businesses in taxation. The changes set forth below would do this and make Minnesota a better place in which to locate a business.
2. Taxing businesses like homes under the local property tax (item II.B.4.) means businesses' local property taxes would drop precipitously. A windfall tax reduction would be avoided by either a state wide business property tax or a business activities tax. Whichever was adopted would fund much greater state funding of schools and human services, which, with the other property tax system changes, would avoid major property tax increases for homes.
3. Eliminating the local discrimination against business property would mitigate the absurdity of the current system, under which business property is taxed at far higher rates in property poor than in property rich communities. The current system, presumably designed to soak the rich, in fact operates to promote the rich getting richer. For example, the business property tax rate in the property poor city of Browns Valley is three times the rate in Edina. Such systemic discrimination against property poor communities, coupled with the inherent discrimination against business property in the class rate structure, is indefensible. See Change Minnesota, Exhibit B at 5-7. A state wide business property tax would be much more based on ability to pay than the current distribution of local business taxes, and reduce the discrimination against property poor communities.
4. Better would be to repeal the existing state wide business property tax instead of adding to it, and enact a state wide business activities tax ("BAT") based on gross margin apportioned on a single factor sales basis and taxed at a fairly low rate, perhaps 2%.
5. The BAT would also permit expanding the business capital equipment sales tax exemption and exempting many business to business services from sales tax.
6. By materially reducing the property tax and sales tax burdens of businesses producing in Minnesota, the BAT would be a major boon to business investment in Minnesota and shift substantial tax burden to businesses selling into Minnesota from outside the state. The BAT would also end the now near century old discrimination against business property under the property tax. BAT details provided upon request.

7. What about the corporate franchise (income) tax?
 - The BAT could fund its repeal, but that seems like a bad idea because
 - Owners of LLCs, partnerships and S corporations are taxed, so it would be incongruous to exempt C corporations (the ones that pay the corporate income tax)
 - So long as the feds have a corporate income tax, a state tax is an efficient way to raise tax revenue
 - We are in a budget crisis
 - The corporate income tax should be harmonized with the individual tax:
 - The corporate rate (now 9.8%) and the top individual rate (now 7.85%) should be the same. Base broadening changes in both taxes could keep rates low, making Minnesota look good.
 - Dividends might be made deductible, or a credit against the shareholder's tax might be provided to avoid double taxation
 - The corporate income tax could be improved in other respects. Details provided upon request.
8. These changes would also make it reasonable to consider repealing Fiscal Disparities, TIF and the JOBZ Program and other business subsidies. Repeal of Fiscal Disparities would improve local governments' and citizens' ability to focus in on what they want and are willing to pay for, leading to local choices to make Minnesota government more efficient. See item II.B.9.
9. These changes could leave businesses' share of total Minnesota taxes the same, or increase or decrease it slightly, all depending upon your collective judgment. But even if there is a slight increase overall, the share paid by businesses located in Minnesota could be reduced, with the increase attributable overall to businesses selling into Minnesota from out of state, many of which now underpay the taxes they should be paying to Minnesota.
10. The revenue from out of state businesses would be enhanced by the fact that the BAT would not be subject to federal Public Law 86-272, which exempts many out of state businesses from paying corporate income tax. And compliance by out of state businesses with their obligation to collect Minnesota sales or use tax could be enhanced by providing a lower BAT rate for businesses that collect that tax. This could lead to a major increase in sales and use tax collections, reducing people's ability to avoid them by buying over the Internet or otherwise from out of state vendors. This currently is a huge loophole in the sales tax, probably amounting to hundreds of millions of dollars per year in lost Minnesota revenue.
11. The problem of providing a stadium for the Vikings could be solved by taxing the entire enterprises of professional team sports – not just the local teams, but the entire leagues.
 - Application of the BAT to these organized enterprises would suffice, or a separate gross receipts tax could be deployed.

- The base could be as broad as total revenues of teams and league, or as narrow as the total of payments to the league for national television rights.
- The rate could be just set at a low level (bearing in mind that lots of other states would be interested) or at Minnesota's share (based on percentage of national population or percentage of the league represented by one team) of a higher rate.
- Either way, the revenue could be dedicated to providing facilities and supporting youth sports and culture, or could just be general fund revenue.
- The theory is that professional team sports are not purely private enterprises because they depend on, benefit from and exploit people's sense of community. It is a very large advantage to teams in the largest cities to have teams in other cities around the country with whom they can have rivalries and which cause the entire country to be the accessible market for the advertisers who provide much of the funding.
- This would be fought vigorously by the pro sports leagues and team owners, who might threaten to pull out. For this reason, such a tax probably should be designed not to apply until a number of other states had enacted similar taxes. Given today's economic circumstances, that might not take long. A legal challenge could also be expected, and it might involve a trip to the U.S. Supreme Court, which probably would be won by the state.
- The question is, why should the public, whose governments are broke and whose members are staggering under the burden of a down economy, excessive debt and the burst housing bubble, pay for sports palaces which support enterprises whose players and owners make millions? That money comes from exploiting the markets made up of the general public, the national market is what makes the financial success of the enterprise possible, and there is no reason why a portion of the money flowing through these enterprises should not be tapped to fund both the stadiums and the programs that can lead to the development of future players and enhanced quality of life for the fans.
- The current fiscal condition of governments across the country combines with the urgency of the Vikings' situation to make 2010 the perfect time to test this concept out by enacting such a tax.

IV. Preserving and Improving Water and Habitat Quality and Encouraging More Dense Urban Development to Save Billions on Infrastructure Costs

1. The changes here have twin goals – recognize that land is part of the foundation of the ecosystem, not just an economic commodity, and save billions of dollars in future infrastructure costs. The former would dramatically reverse current tax system incentives to degrade the land and the water. The changes set forth below are a fraction of what could be done. Minnesota could change its tax system to get incentives right for fighting global warming, pollution and waste, and minimizing infrastructure costs.

2. The shift in emphasis on property tax use to cities and away from schools and counties would cause city property taxes to be even higher than rural property taxes than they now are, which would encourage development out in the country - unless something is done to prevent that. The something is matching rural property taxes up to an appropriate nearby city. This is the “Urban Development Encourager.” The tax would be levied and collected by the county and could be used for general county purposes. The UDE would eliminate the property tax advantage of locating outside of cities, which would help concentrate development in cities, which would be good for keeping infrastructure costs down and water and habitat quality up. The UDE arguably should make development in the country taxed higher than in cities, because it not only degrades the environment and water and habitat quality, but adds unnecessarily to infrastructure costs.

2. Enactment of a BAT would permit immediate repeal of the state wide cabin property tax. It presently serves to push cabin owners to sell out to developers, undermining a Minnesota way of life and tending to bring a more urbanized atmosphere to the north woods.

3. Special districts, including the Met Council, should be stripped of property taxation power and required to bill their constituent cities and townships for their services.
 - This would simplify the property tax system and interest city and township officials in being well informed on what the special districts are doing. Citizens are hopelessly unable to hold them accountable because they lack the time to pay attention.
 - Requiring the Met Council to bill for sewage and transportation services based on a combination of area and population would encourage more dense urban development, which would be good for water and habitat quality and help keep infrastructure costs down.

4. The foregoing changes easily could be enacted in 2010 and implemented immediately. The following two major conceptual changes in Minnesota’s approach to property taxation arguably should be enacted now, but with implementation deferred to work out some details. At the very least, the foregoing changes should be enacted, and the following ones subjected to study, including solicitation of specific proposals and publicity to develop ideas for how to tie the tax system to environmental concerns, including energy related concerns as well as pollution and loss of habitat.

5. Farm land and habitat property – land that is other than residential, business or farm land, and has not been designated for development – should be exempted from the property tax, except perhaps for township taxes and rural county roads.
 - Farming would be subject to the BAT.
 - Once such land was sold for development there could be a special capital gains tax – an “undeveloped land appreciation tax (ULAT)”. It could be

at a fairly substantial rate, reflecting that nothing is done to earn the gain and that the sale represents a permanent loss of a valuable resource.

- Exemption from sales tax for purchases of chemicals that cause water quality problems might be ended
- Property tax exemption might be tied to using the land so as to minimize erosion and runoff issues
- Timber taxation should also be covered by a specific proposal

6. The property tax could be changed from a value base to an area base, with different rates for land area and building area. This possibility was explored in a study by 1000 Friends of Minnesota in 2000 (Taxing Our Strengths: How Minnesota's Property Tax System Weakens Our Communities), resulting in a report and proposal to convert the property tax to an area based "land and structures tax" (LAST). The LAST appears to be feasible. It would:
- Dramatically reduce the cost of property tax administration
 - Encourage more efficient use of land, meaning less loss of habitat and less pressure on water quality
 - Reward the creation and maintenance of value, and tax consumption