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A TAX SYSTEM THAT MAKES SENSE FOR MINNESOTA:

VOLUME ONE - WHAT WE'VE HEARD

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Dear Fellow Minnesotan:

Last summer, the Ventura Administration embarked on a reform of Minnesota's tax laws as a part of the Governor's Big Plan. Instead of appointing a panel of experts and waiting for its report, we asked customers (the taxpayers) to tell us from their perspective what works and what doesn't in our tax system, and how we can make it better.

We are approaching reform of Minnesota's tax system as we would the redesign of any complex business system; through *Assessment* of the problem, particularly from the customer's perspective, through *Design* of alternative solutions around identified problems and challenges and through an *Implementation* plan, which will result in law changes and administrative changes to our tax system.

As part of the *Assessment* phase, we have solicited input through a variety of forums: the Citizen's Jury on Property Tax, Citizen Dialogues held around the state, interviews with legislators and other public policymakers, and input from citizens from a broad cross-section of Minnesota. Taxpayer organizations have been participating through public meetings, through our website at www.taxes.state.mn.us, through correspondence and email at taxreform@state.mn.us.

Throughout this process we asked taxpayers and others four basic questions:

- ◆ What is important to you about tax reform? What would a "good" tax system be like?
- ◆ In your view, what would make our tax system fairer?
- ◆ What kinds of things make the tax system complicated, confusing and hard to deal with for you as a taxpayer and a citizen?
- ◆ What kinds of changes would enable our tax system to serve us well in the future?

So what have we heard? The comments we've heard fall into four major themes:

- ◆ **Fairness:** It has many dimensions, but it is the most important goal for the vast majority of Minnesotans.
- ◆ **Complexity:** Taxpayers wonder if tax laws have to be so complicated to be fair.
- ◆ **Predictability:** Taxpayers want to be able to predict and plan for their tax obligations, and state and local government officials want to plan budgets wisely.
- ◆ **Economic prosperity:** Taxpayers want a tax system that best secures Minnesota's economic growth and competitiveness, yet provides revenues for needed government services.

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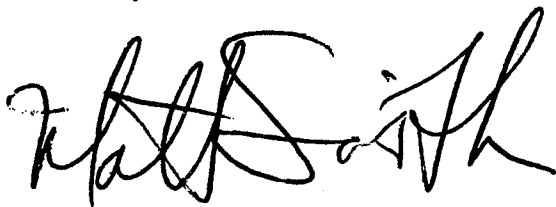
Comments from taxpayers and others on these issues are included in this report. These comments will help guide our work over the next several months to develop the tax reform package for the 2001 legislature.

What's next? We will take what we've heard and begin developing initial recommendations for public discussion this summer and fall. As we do this, one thing is certain: we cannot continue looking at each kind of tax or tax problem in isolation. For example, it's not enough to look at cutting property taxes without knowing how local governments will manage their budgets. It's not enough to grant piecemeal sales or income tax exemptions in hopes of spurring economic growth, when the very structure of business and viability of traditional taxes are being reshaped by an increasingly electronic and global economy. And, we should ask, have we incrementally (and largely accidentally) designed a set of tax laws that now benefit narrow groups of taxpayers at the expense of most?

So while there is not a financial crisis today, there are significant issues we need to address through reform of our state and local tax system. And now is the time to do it, when times are good and we have the opportunity and resources to be thoughtful and comprehensive in our efforts. Our current state economic and financial outlook means that we may have perhaps the best chance in a couple of decades to do this right.

We will continue to talk with taxpayers to get their suggestions and we will use what we've heard to develop specific options for the public and policymakers to review this summer and fall. We look forward to continue working with all of you to develop a tax system that makes sense for Minnesota.

Sincerely,

A handwritten signature in black ink, appearing to read 'Matt Smith', written in a cursive, flowing style.

Matthew G. Smith
Commissioner of Revenue

Why tax reform now? Tax reform again?

Since Minnesota first became a Territory in 1849, taxes have been a fact of life. But over the past 150 years, our state and local tax system has grown from a few paragraphs enacted by the territorial legislature to today's enormous complex of statutes, rules, instructions and forms. From a tax system originally based on the property tax and a few excise taxes, we've added a gas tax (1925), individual income taxes and corporate tax (1933), and a sales tax (1967)—just to name a few of the bigger ones. There are 30 different state taxes and numerous local taxes like local sales taxes and franchise fees, along with uncounted other fees and charges for various services. Over time new, overlapping layers of government have appeared, each serving different purposes and with their own taxing authority—up to a total of 6,000 different combinations of government levying taxes around Minnesota today.

Most of the changes in our tax system might have been well intentioned and designed to solve particular problems as they arose over time. In fact, many of these changes were heralded as major tax reforms when they were first enacted. The overall result, however, is that we have a state and local tax system that has not so much been designed as it has grown almost by accident. A 1954 "blue ribbon" commission of experts summed it up in words that could just as well have been written today:

It became obvious at the outset of the study that Minnesota's tax structure was not the result of systematic long-range planning. Rather, most of the changes and additions to our revenue laws seem to be the result of

moving from one crisis to another. To meet temporary emergencies, taxes have been piled upon taxes and few of them have been repealed.

In the almost half-century since those words were written, the tax laws have continued to change—not just by adding new taxes, but by adding special provisions or "tax expenditures," (sometimes referred to as "loopholes"), to reduce taxes on certain taxpayers or transactions. Year after year, public policymakers are inundated with requests for new exemptions, credits, and exceptions to the tax code, often responding to perceived cases of unfairness to individuals, groups, or industries. Each general addition and special subtraction adds to the complicated patchwork quilt of tax laws we find in Minnesota today. There are over 300 state-enacted "tax expenditures" in law as of January 2000.

Our state has also undertaken many studies on how to reform our tax system over the years. Since before statehood, Minnesotans have periodically asked, "Is our tax system meeting our needs? Is it still doing the job it is supposed to do?"

Tax reform is never "done" once and for all. It is a necessary and continuous process. We need to keep reforming our tax system as the economy changes and grows. Today, goods and services are produced and exchanged in ways that could scarcely be imagined twenty years ago. Our tax code has not kept pace with changes in the national and world economy—and it must if our state and citizens are to continue to prosper. That is why it is time to reform our tax system once again.

Tax relief and tax reform—can we have both?

To many people, tax reform and tax relief are the same thing—a “reform” is anything that reduces their tax burden. However, we must be clear about important distinctions between the two from the start:

- ◆ **Overall tax relief requires less government spending.** State and local governments in Minnesota are required to balance their budgets, and government cannot spend more than it takes. The overall level of government spending in Minnesota is an important topic for public discussion, and reductions in government spending (or at least its rate of growth) must occur for overall tax relief to be achieved.
- ◆ **Tax reform means changing the structure of our tax laws.** Our current tax laws were largely written for a property-based, physical transaction economy of the early 20th century. Tax reform will mean updating the tax laws to be flexible and accommodate further market and technology trends, while maintaining clarity and predictability for both taxpayers and government.
- ◆ **In tax reform, some taxes will go up and others will go down.** Changing the structure of the tax system means that even though overall tax revenues stay at a constant level, the mix of taxes and how they are imposed can change significantly. For any individual or business taxpayer, this will probably mean that while their overall tax burden may not change dramatically, the type of taxes and how much they pay in each separate tax may go up or down. In tax reform, we have to examine the fairness of taxes, individually and in total: who's paying and at what rates, and who's exempt. Tax reform may well mean that some taxpayers that are now exempt or favorably treated under the law will begin to be treated equally with others, so that the general base of taxpayers—who don't enjoy those special provisions—can benefit through lower rates.
- ◆ **Tax reform requires us to look at all taxes together—not just each in isolation.** Taxpayers' total tax burdens reflect all the taxes they pay. To develop the best possible tax system for Minnesota and its citizens, we cannot just look at “property tax reform” or selected sales tax or corporate tax provisions, or income tax reform in isolation. Real reform looks at the whole tax burden that a business or individual bears.
- ◆ **Tax reform requires us to look at policy and administration.** A tax system in operation is the combination of tax law and how the law is administered. To serve citizens well, a reformed tax system must be both well designed and well administered. Tax laws should be easy to learn about, and filing and paying should be simple and straightforward. A fair tax system should also minimize disputes between taxpayers and government. When those disputes occur, resolution should be as quick and easy as possible. Litigation should be an option of last resort. It can be a costly and time consuming process for both taxpayers and the state.

Where to start: What is our approach to tax reform?

The Ventura tax reform initiative is part of and supports the BIG PLAN – the Governor's vision for a better Minnesota. The Big Plan has four strategic goals: *Healthy Vital Communities, Self-Sufficient People, Service not Systems, and Minnesota: World Competitor*. Many of the policy goals of the Big Plan may require changes to our tax laws. The task of the tax reform initiative is to identify changes in our tax code that align with sound tax policy principles and support the broader policy objectives of the Big Plan.

A systematic approach to tax reform looks broadly at all taxes, and approaches the task of tax policy reform like the redesign of any other complex system or process in business or government. Like any redesign, we involve the customers - in this case we ask taxpayers and public policymakers for their input.

Tax reform has three phases:

1. Assessment: understanding how the current tax system is performing and where it needs to improve. Asking the customers and stakeholders for their input is critical to reforming the tax system. We have had extensive discussions with a broad cross-section of taxpayers on what they want in a reformed tax system. This report summarizes this phase.

The assessment phase ran from August 1999 through March 2000.

2. Design: identifying and evaluating specific policy changes to improve the overall performance of the tax system. During the design phase, we will take what we have heard and develop alternative tax policies for public discussion and evaluation. The potential policy changes will be organized around *Taxes on Income, Taxes on Consumption, and Taxes on Property*.

We will continue to work closely with citizens, stakeholders, and policymakers to seek input and feedback via public meetings, focus groups, surveys, and partnerships on specific research or policy topics as recommendations are developed.

The design phase runs from May 2000 through November 2000.

3. Implementation: recommending and enacting tax reforms during the 2001 legislative session. Tax policy reform options will be prepared for the governor's consideration in coordination with the FY02/03 budget recommendations, and will be presented to the 2001 Legislature.

The implementation phase runs from November 2000 through May 2001.

Citizen and stakeholder input has been fundamental to the assessment phase:

A strong emphasis on citizen and stakeholder input has resulted in:

- The *Citizen's Jury on Property Tax Reform*, a week long focus group of 18 Minnesotans to discuss what works and what doesn't in Minnesota's Property Tax System, and to make recommendations for reform. (Appendix B)
- Further exploration of the relationship between increasing market values and property tax by the Minnesota Citizens League. Thirty citizens are convening and will report back in early fall of 2000 on their findings.
- Thirteen "Citizen Dialogues on Tax Reform" were held throughout the state – we heard from citizens on what they would like to have addressed in tax reform. The format included 15 minutes in overview using a Dialogue Guidebook, 80 minutes of audience

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participation and 20 minutes of "local opinion leader" comments. The average attendance was 55 people. Discussion topics ranged from property tax to taxation of the internet. Visit our website for transcripts of the meetings.

- Eight special focus groups on the property tax system to assess citizen knowledge about the property tax system. Eighty people participated in the focus groups, conducted in two outstate cities and one in the metro area. (Appendix C)
- Interviews were conducted with over 50 legislative leaders and other elected officials on what is important to them in tax reform. Interviews and conversations will continue throughout the design and implementation phases.
- Interviews with the Governor's Cabinet on what is important in tax reform to support the policy objectives of their agencies and the needs of their customers.
- Presentations to 20 business and trade associations and organizations to provide background and solicit comments on the tax reform initiative.
- Thousands of businesses were surveyed on our performance, and we also asked them what is important to them in a tax reform effort. We asked them which tax laws are the most frustrating, what they consider to be the key outcome of successful tax reform and asked them to provide us with additional comments or concerns. We heard from approximately 950 businesses. Simplicity, tax reductions and fairness ranked the highest among respondents as important elements in a

reformed tax system. Visit our website for summary of what businesses said about each tax.

- Fifteen public and stakeholder input meetings were held by seven tax policy study teams to facilitate input on what topics and issues should be considered in the tax reform effort. Over 800 stakeholders participated in the meetings, either electronically or in person. (Appendix D)
- An interactive website has been developed for people to stay updated on how the tax reform process is working and a linked email address to add their comments.
- We have reviewed and responded to the body of mail to Governor Ventura from citizens concerned about tax issues during the past year. That mail volume has been considerable: about 2,250 letters in 1999, as much as ten times more than the year before. The majority of the letters have been on property tax (700), income tax (415), gambling taxes (325) and health care taxes (109).

For more information and background on the citizen participation effort, please visit our website at www.taxes.state.mn.us or email us at taxreform@state.mn.us

The next section of this report summarizes what we have heard and learned during the assessment phase of tax reform and the conclusions we've drawn so far. In *Volume II: Design Guide for Tax Reform*, we identify the key policy questions we will consider during the design phase of reform, and the measurement and evaluation approaches we will use as we evaluate reform alternatives.

Assessment: What did we hear in public meetings and interviews?

From our conversations and communications over the past several months across Minnesota, what have we heard so far?

First, something obvious: We are not in a financial crisis in Minnesota today. The economy is good and there is no imminent tax crisis brewing in our state. Citizens understand that anything they get from government costs something, and they're willing to pay their fair share. In all of our meetings around the state, citizens and elected officials have turned out and held thoughtful discussions about what is best for our state and our communities. They've talked about what we have now, what's good and bad about it and how it could be better, and some of the trade-offs in reforming our tax system.

Second, we received a lot of caution about the effort itself, and some skepticism. Will this just be another study or result in real reform? Is the task too overwhelming? Will it be driven by special interests? How can any statewide reform be achieved given differing policy goals among various regions and levels of government? How can we best promote fairness and economic growth and competitiveness? One legislator summed up the perils by calling tax reform "treacherous work."

Does that mean that everything about our tax system is just the way citizens and public officials want it to be, or is it possible to improve our tax system? The economy is changing and there are wide concerns that our tax system is not working as well as it could or should. There are tremendous challenges and opportunities for improvement.

In this document we've attempted to capture the general sense of those conversations through some specific comments made to us. While some comments reported here may not be entirely accurate with respect to the tax laws, they do give a sense of Minnesotans' priorities for a reformed tax system.

Four main themes emerged from all of our conversations:

- Minnesotans want fairness in the tax system.
- Minnesotans are frustrated with the complexity of the tax and spending system.
- Minnesotans feel taxes and spending are unpredictable and out of their control.
- Minnesotans want to ensure economic prosperity across the state.

Fairness

Fairness is the goal for the tax system that citizens and policymakers and the Citizens Jury identified first when we asked what was important to them. As expected, fairness seemed to be largely in the eye of the beholder, but most people related fairness to ability to pay.

"Fairness should be based on ability to pay."

—citizen comment, Stillwater

"I think income is the only fair tax, based on ability to pay."

—citizen comment, Marshall

"Property tax should be based on ability to pay. In a modern economy, that break is getting wider and wider."

—citizen comment, Minneapolis

"Fairness is important. But we have struggled with balancing fairness with other issues. Taxing the ability to pay would be important."

—citizen comment, Bemidji

"A fair system, tying ability to pay with services received, is not always possible. Many county services are for those with the least ability to pay."

—county official, Mankato

Another frequently offered principle for a fair tax is that all taxpayers be treated as equally as possible.

"What is fair? Everyone has his or her own idea of what is fair, and in its most generic state, it's treating like-people similarly. If people don't feel they are singled out, they will think they are being treated fairly."

—citizen comment, St. Cloud

"I prefer consumption-like taxes—it's discretionary—it gives people choices."

—state legislator

"Make sure everyone pays their taxes and no one hides their income."

—response to DOR survey of business taxpayers

"Taxes like the provider tax fall heavily on one or two taxpayers. Is this fair?"

—state legislator

"I am not offended by the level of property taxation, I am offended by inequity and complexity."

—state legislator

There were a large number of specific examples that Minnesotans consider to be unfair about the current tax system.

"As an assessor, one of the biggest complaints (about the property tax) is that it doesn't reflect the ability to pay. There are some cases where it does, and some where it doesn't."

—local government tax administrator, Bemidji

"I spent yesterday with two people in their seventies—they own a cabin with a fixed income. Their valuation on their cabin has skyrocketed. They can't afford to pay it. We need to cap the valuation in relation to the ability to pay. It's not fair."

—citizen comment, Minneapolis

"Property tax is thought of as a tax on wealth—but often property is separated from wealth. It's hard to identify the increasing gap between property and wealth."

—citizen comment, Mankato

"Retired income levels are not reflected when being taxed."

—citizen comment, St. Paul

Some property owners expressed doubt that property valuations (and thus taxes) are fair and accurate, or can be corrected easily when in error.

"We just found out in our neighborhood that there is a home that has three to four times the value and pays one-third the tax that we do. It's our direct neighbor. What is happening? I would like to know!"

—citizen comment, Bloomington

"Comparable properties don't reflect each other's values. It's a lousy system. Change to a square foot basis, or square footage of the lot, or both."

—citizen comment, Bloomington

"Get away from the appraised value as a base for taxation. We are being taxed out of our home due to inflation in values in our suburban area."

—citizen comment, St. Paul

"People are very suspicious of assessors."

—state legislator

"The homeowner property tax assessment system is flawed. There is excessively high property valuation by assessors to maintain structured inflation taxation rather than the actual selling price at the time the property is viewed. The method being used is unfair. I have no confidence in the appeals process."

—citizen comment, St. Paul

Owners of seasonal recreational property, typically cabins, told us that they bear an unfairly high share of the total local tax burden.

"I own lake property and the tax on my home is far less than on the lake place, but the value is more.... Lake property owners have taxation without representation. I sometimes feel like I'm in a different country."

—citizen comment, Bloomington

"Real estate taxes are much too complicated and unfair. For example, why should seasonal property owners pay more while using less services, particularly schools?"

—response to DOR survey of business taxpayers

"...(if) a school district needs a new building, but if it has the majority of property in lakeshore, should local people and non-residents be pitted against each other to make these decisions?"

—state legislator

"We are working people—two weeks vacation—and we spend limited time at our lake. Now the taxes are going up. So what do lake residents really get for their money? We rarely use the roads, etc., and we spend money in town."

—citizen comment, Bloomington

People talked about special tax breaks or exemptions, especially those that benefit only a few taxpayers, and questioned the fairness of those laws.

"We also need to be looking at tax expenditures—taxes we don't collect. These are things that are exempt from tax like food and clothing. This might be good, but there are many that aren't clear or we aren't sure if they are just loopholes for special interests."

—citizen comment, Anoka

"Both property tax and income tax would be better without all the different exemptions and deductions. If we had less of those then it might be more fair."

—citizen comment, Marshall

"Close loopholes and tax the rich, give low income folks a tax break."

—response to DOR survey of business taxpayers

"End tax breaks for large companies with political influence."

—response to DOR survey of business taxpayers

"The income tax has seen marked improvements in the form, as well as the rate coming down. But what hasn't been good are federal changes and subsequently state changes in marriage credits,

child tax credits. It creates imbalances between married with children and singles/seniors. When you balance out all the credits, and compare it to different income levels, it doesn't treat people fairly. We should not always adopt federal changes."

—citizen comment, Bemidji

"Exemptions represent the legislature's decision not to continue with bad tax policy. Not all exemptions have accountability ties, but some do."

—stakeholder,
Utility Tax Reform Meeting

A variety of concerns were raised about mismatches between the amounts of the tax paid and the value of government services received.

"People buy right outside the city limits yet take advantage of services. A fair share isn't always paid by non-city residents yet they take advantage of services."

—city official, Moorhead

"Twenty-eight percent of property in Winona is tax-exempt and they all have services."

—citizen comment, Winona

"We continue to erode our tax base with properties with no carrying costs yet those exempt properties still require services."

—county official, Moorhead

"Eliminate MNCare. I pay the tax, but I'm not eligible to see patients under the program."

—response to DOR survey of business taxpayers

Several people told us that facing a higher tax or the possibility of a higher tax—when they fix up an old property or reclaim abandoned or dirty sites seems unfair to them.

"We have a system that if the property runs down, you get lower taxes. If you improve it, your taxes go up. You teach your dog to fetch and when he comes back you kick him."

—citizen comment, Stillwater

Others cautioned that there are limits to how much the tax system can or should create equity.

"Tax reform often means we pay too much attention to those in the lower income brackets. It needs to be balanced."

—state legislator

"Stop wealth redistribution as part of the tax code."

—response to DOR survey of business taxpayers

A lot of discussion focused on what is a fair use of the general property tax versus fees and charges for specific services.

"Property tax should just reflect basic costs. It doesn't cost more to remove snow from a \$100,000 house than a \$50,000 house."

—citizen comment, Bloomington

"Let local governments bill their citizens for services. People get these benefits, not property."

—state legislator

"I like user fees, but will people understand it?"

—state legislator

Advocates for low-income people pointed out that Minnesota's current overall mix of taxes and rates results in a more proportional, "flat" tax burden across income groups than most or all other states, and want to see that preserved.

"Don't lose sight of the whole picture. Everyone pays nearly the same percentage of their income in total taxes. Not all states are this fair—keep this in mind when reforming. We can't be overly concerned with rankings for one particular tax."

—nonprofit representative, St. Paul

"Successful tax reform is a system that helps minimize the distance between rich and poor."

—response to DOR survey of business taxpayers

Finally, many recognize that "fair" tax reductions for some may in turn create "unfair" burdens on others.

"Property tax reform proposals should not shift taxes onto homeowners—they are the bottom of the pecking order."

—local government official, Anoka

"It seems to me that we are talking about whose ox is being gored. Like if seniors get the break, who pays?"

—citizen comment, Bloomington

Particularly among public officials, there is broad recognition that fairness and simplicity are sometimes opposed, and in the balance most opt for fairness.

"We need to recognize that simple doesn't mean fair. As complicated as the property tax system is, there have been many attempts to create fairness through complications. We may have to put up with this."

—county commissioner, Moorhead

"Fairness is more important to me than 'reform'. Simple doesn't go hand in hand with fair."

—state legislator

"Tax reform has to be comprehensive and we need to be objectively informed. Simplification is not an end unto itself. Fair trumps simple."

—state legislator

"There is a relationship between complexity and fairness. Some think the more complex the more fair. It has become so complicated it is perceived as not fair... Increasingly over the past years we have tried to obtain many social goals that have nothing to do with raising revenues and nothing to do with fairness."

—state legislator

Complexity

A second general concern is the **complexity** of our current tax system. Whether it is individuals trying to decipher their tax bill, a business trying to comply with tax laws or a public policymaker trying to manage the tax and spending relationship, it was cited in almost every conversation as a problem. Frustration with complexity was expressed from a variety of perspectives.

First, many find the tax laws themselves complicated—often (it seems to them) unnecessarily.

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

—citizen comment, Hibbing

"Complicated regulations require us to hire a tax professional."

—response to DOR survey of business taxpayers

"I would also propose we simplify the tax code—with all the loopholes. Who knows what the Alternative Minimum Tax is? I am getting to the point where I want the flat tax—and I never would have thought I'd hear myself say that."

—citizen comment, Bloomington

"I'm a retired grocer/retailer and I know the complexity of the sales tax. Chocolate chips used for baking are not taxable—sold one-by-one, they are. It's really complicated."

—citizen comment, Marshall

(sales) tax, you pay the tax and then file for a refund. It takes about six months. It seems like an exercise in futility."

—citizen comment, Mankato

"It was decided a few years ago to tax local government purchases. It doesn't make any sense—it raises the property tax."

—county official, Moorhead

"Complex partnership rules can drive one to drink."

—response to DOR survey of business taxpayers

"If you pay capital equipment

Even fewer taxpayers are confident that they understand where and how their tax dollars are used.

"I don't know of anyone who doesn't think they should contribute, but people don't really know what is happening to their money. We need to fix A before we fix B."

—citizen comment, Stillwater

"My pet peeve is that people don't know what's going on."

—state legislator

"How does the average citizen learn where the tax dollars go?"

—business owner, Minneapolis

The complexity of the tax system makes it difficult for government officials to explain the tax laws and their effects to citizens, and even to understand and change the tax laws themselves.

"...when we have people coming up to the counter (at the courthouse) and we try to explain why their (property) taxes are high, especially when they don't like it in the first place, it is very difficult. Class system, market value, sales ratio determinations—if people could understand, it might put them at ease. If you can explain it to that person who is writing out a check twice a year that would help."

—county tax administrator,
St. Cloud

"It's hard to explain how property values keep increasing even though a person may not do anything to their home. As an elected official, we take heat on these issues, not the state."

—small town mayor, Moorhead

"When it takes four lawyers to get up and explain what should be a fairly simple bill, it's a sign that things are getting out of hand."

—state legislator

"We need to get education off the property tax. There are only about two or three senators who can explain this."

—citizen comment, Minneapolis

"Very few legislators feel they understand enough to participate in decision making."

—state legislator

Another contributor to the complexity of the tax system is that the tax laws seemingly change every year—sometimes dramatically.

"I've been doing (property tax administration) for twenty-one years and never done it the same way twice. Can the legislature leave it alone for a little while?"

—county tax administrator,
St. Cloud

"The culture of the institution is that every year we need a 400-page tax bill."

—state legislator

Unpredictable and out of control

Another general area of concern is **uncertainty** about future tax burdens and a sense that the system is beyond the control of taxpayers and governments.

Taxpayers find it hard to predict their future bills, and some worry that taxes will increase faster than their ability to pay them.

"The property tax system is flawed to the point of being ludicrous. I own a lake home—the estimated market value went up from 72 to 103 percent over the last three years. Your estimated market value and taxes are brand new every year—every year you are messed up."

—citizen comment, Anoka

"I am concerned with year-to-year increases in market value. My income has not kept up with the cost of taxes."

—citizen comment, Bloomington

"I have lived on the East Side of St. Paul since 1947. I've paid taxes ever since I came to this country. Now I am older and my nest egg got smaller. I cannot pay my taxes."

—citizen comment, St. Paul

"For people who have been in their homes for a long time, it becomes a big part of the cost of living."

—citizen comment, Bloomington

Citizens observed that many taxpayers don't know much about how much it costs government to provide the services they use.

"I think there is only one way to lower cost of government and that is to educate people that everything comes out of their pocket."

"As consumers of benefits, most us don't know what we are using. If we knew the taxes on cookies as well as gasoline, we'd all be better consumers of government services."

—citizen comments, Winona

"There is a cost for good services. I don't know if we can talk about taxes without talking spending. Maybe a usage tax or being made accountable for what we use. Then maybe people won't complain so much—they will know how much they are getting for services."

—citizen comment, Minneapolis

Many taxpayers in general express a lack of confidence in that they can effectively control government spending decisions that affect their taxes.

"I look at a property tax bill, and there are meetings stated where you can go to talk about the taxes being changed. The meetings are for the little numbers. The big numbers have no meeting for discussion."

"We have a system that is difficult for average citizens to understand. Truth-in-Taxation hearings act to inflame rather than inform."

—citizen comments, Minneapolis

Many government officials at the state and local levels express frustration that taxpayers are not engaged effectively in the spending decisions that will lead to future tax consequences.

"...we have a swimming pool that needs to be repaired and those who use it are lobbying heavily and those who don't use it don't say anything. When we spend the money someone's taxes will go up and then we'll hear about it."

—local government official,
St. Cloud

"Property tax is hard for everyone to understand and if we could make sure it is stable and understandable it would be great. We need people to help—no one (taxpayers) showed up when the county commissioners set their (property tax) levy proposals."

—state legislator

"I wish this room was packed. I don't often get enough phone calls—we need people more involved."

—state legislator

Local government officials themselves say they don't feel fully in control of their own budgets and taxing decisions—they're asked to explain things to taxpayers that are caused by some other level of government or economic changes halfway across the state.

"For county commissioners, this system is hard for us to manage. The state mandates so many services that the county must provide and 80 percent of our budget is already predetermined by state and federal government."

—county official, Bloomington

Citizens and state and local officials commented about the importance of maintaining similar levels of service throughout the state, regardless of the wealth of the community—but this also turns into mandated spending, and tax increases.

"The legislature is trying to help people, but it is expanding and creating unfunded mandates and creates protections. If people voted on them, they might not vote the same way as the legislature."

—citizen comment, Winona

"If you focus taxes at local levels, not every county board might have the same concern for some groups that are disenfranchised."

—nonprofit representative, Mankato

"Mandates aren't fair because local governments can't opt out."

—state legislator

"I agree with concerns about mandates. HACA (a state aid program) was designed to pay for mandates—and out of home placements—if the state mandates this they should pay for this. But the trade-off is less property tax and more state spending. It will come out as more spending somewhere else."

—state legislator

"The nonprofit sector ends up picking up the greater end of the burden of government changes—especially welfare to work. A lot of money is being saved and we are asked to do some services that government is cutting back on."

—nonprofit representative,
Marshall

Government officials and citizens raised concerns about how best to maintain reliable and predictable revenue streams to meet statewide responsibilities.

"When we put together a tax system, we need a system that is reliable from year to year. Income tax brings progressivity, property tax brings stability and prevents wild fluctuations—we need balance between sales, income, and property taxes."

—state legislator

"Keep many kinds of taxes. Do not rely solely on one type of tax alone. Share the burden of paying taxes among several sources."

—citizen comment, St. Paul

"If we reduce certain taxes, what flexibility do we have for the future?"

—state legislator

"One of the reasons the property tax is coveted (by governments) is its reliability. When you call 911 you expect police, fire, etc. Those things have to be there, and the only sure way to pay for it is through property tax."

—county official, Stillwater

Local government officials express concerns that if they are going to make more budget and tax decisions locally, they face unequally distributed taxing authorities and resources that make this difficult.

"The city doesn't enjoy the surpluses that the state does. I have to go to the property tax to pay for everything. So we need to diversify our revenue sources."

—city mayor

"We need the ability to pay for essential services and mandated services. We must maintain the ability to deliver and look to less reliance on the property tax system."

—county official, Mankato

"A lot of land is being put into DNR conservation—it's not all bad, but it takes away from the tax base and we tax them at three-quarters of 1 percent of assessed value and it's eroding our tax base with the same amount of infrastructure. Fifteen years down the road, this could really be a problem."

—citizen comment, Marshall

"From a local government standpoint, I look at taxes like a portfolio: diversity is good. One type of income (only) would be bad....Local option taxes like sales tax is a good asset to have."

—city government official, St. Cloud

"I am against any new taxes for local governments before we look at our spending."

—citizen comment, Minneapolis

At the state level, there is acknowledgment of the need for state aid transfers to local governments, but uncertainty over the fairness and effectiveness of the distribution formulas, and what it does to the responsibility for spending decisions.

"I'm unsure there is accountability. We seem to be bailing out local governments with aids. We use levy limits to try to wean them off the spending cycle."

—state legislator

"Transfers between state and local government clouds the issue."

—state legislator

As a consequence of unevenly distributed tax bases, limited local government taxing authority, and state mandates for services, state aid payments to local governments consume a lot of attention at both the state and local levels.

"(State aid to local governments) ensures that a basic level of services is in place. There are varying levels of tax bases, and aids help even out that variation."

—city government official, St. Cloud

"All too often property tax reform discussions involve discussion of reducing state aids to local governments. We should emphasize the relationship between the state and local services—especially in property poor areas. This includes tax exempt properties that still require services."

—local government representative, Hibbing

Others prefer to keep spending and taxing decisions as close to the local level as possible.

"I believe locally we are frugal in Winona compared to, say, Edina. So it's really up to us and people in Edina to determine what basic services are for them."

—citizen comment, Winona

"The only way to reform the tax system is to have local people do the taxing."

—state legislator

The net result is a lot of frustration over a seeming inability to predict and control tax burdens and spending at the taxpayer, local government, and state levels.

"When we got our (local) tax increase, they told us they had no power on how much the tax would be—they blamed the legislature."

—citizen comment, Anoka

"Property taxes across the board are down—especially for the school districts—but there is a budget shortfall in the school. No one understands the legislature's intention to subsidize schools and then schools close."

—citizen comment, Anoka

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

—state legislator

As a result of years of tugging back and forth over issues of state versus local authority and responsibility for taxing and spending decisions, state and local government officials have developed a significant degree of distrust on these issues.

"I am increasingly cynical about property tax reform. The legislature does one thing, and local governments respond and get around the changes."

—state legislator

"Local units of government seem to have a negative impression. We are not the bad guys. We provide good services for a moderate cost."

—local government official, St. Paul

"I'm very concerned about distrust by St. Paul of local governments. It's all our money and decisions are usually better made locally. Trust school boards, townships, counties and cities."

—comment, Worthington Chamber of Commerce member

Economic Prosperity

The last general area of concern is **economic prosperity and competitiveness** and whether Minnesota's tax structure will support continued prosperity across the state.

Everyone acknowledges the social and economic transformations that are being driven by rapid changes in technology, and some express apprehension about the future.

"We live in a very unique time and we don't realize it. There are fundamental changes in the economy—one thing I worry about is that we are very smug about our quality of life and headquarters companies. MPR had a series about Minnesota in the "dot

com" age, and the reality is Minnesota is not in the game anymore. We need to realize what is going on in the economy and try to position ourselves so people want to come here."

—citizen comment, Minneapolis

"Changing shifts in demographics and the economy will change the whole landscape."

—state legislator

"More and more we will be living inside the machine."

—state legislator

As the economy and technology change, the tax laws will be under increasing pressure to change as well.

"Technology is driving changes in taxes, such as electric deregulation, and our tax structure will have to be changed as well. That could potentially make it more complex or shift burden onto people less able to pay for it. We have to be careful."

—state legislator

"Looking to the future, the sales tax might not be as reliable because of the internet sales tax exemption."

—citizen comment, Marshall

"The property tax is so arcane. We need to look at a more modern system."

—citizen comment, Minneapolis

"There are three technologies that can deliver the same product – wireless, cable and land line telephone. The marketplace should decide which method is most efficient rather than make a determination based on pricing. Sales tax applies in some but not all cases."

—taxpayer representative

State policymakers acknowledge that state tax policy can make a difference for economic growth of competitiveness.

"We are all sensitive to national rankings."

—state legislator

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

—state legislator

Owners of business properties pointed out that they have to pay property tax at a much higher rate per dollar of market value than other kinds of properties within Minnesota, and higher than businesses in most other states.

"Commercial-industrial property taxes are third highest in the nation, and it does hurt Minnesota businesses because it makes it more expensive to produce products and compete."

—citizen comment, Anoka

"Fairness segues into competitiveness—we need to stay competitive. Taxes on CI property have to change—they bear the largest burden."

—citizen comment, Minneapolis

"We are taxing our businesses at a much higher rate than neighboring states. Go to Fargo or Hudson and you will see the expansion of business that could be here."

—citizen comment, Bloomington

High property taxes on apartments and other rental housing were cited as raising rents, limiting new investments, and curtailing economic growth.

"One of our biggest problems with economic development is housing and the property tax on rental housing. Property tax on rental housing is higher than the average home. What we have are beginning wages trying to find a place to live. Homeowners might pay more taxes—but you would see more fairness and more housing because the tax change would help the cash flow."

*—citizen comment,
Worthington Chamber of Commerce discussion*

"Businesses need educated and well-trained workers and with low unemployment it is difficult to find skilled labor and good housing. Apartment taxes are preventing new units from being built."

—citizen comment, Minneapolis

"We end up discriminating among housing choices—we penalize the choice to rent."

—state legislator

A number of people questioned some of the recent or proposed business tax changes to know if tax breaks given in the name of economic development actually result in real economic impact.

"Property tax is inequitable. With TIF and exemptions, the rest of us have been footing the bill for "gifts" from local governments and taxpayers. I hear it's economic development, but really it just moves jobs around."

—citizen comment, Mankato

"We hear mostly what is prepared for us by special interests. I think there is a much better way to tax business."

—state legislator

"Was there a measurable impact on economic development of the recent capital equipment exemptions?"

—state legislator

"I'm uncertain whether class rate reductions for apartments will actually reach tenants."

—state legislator

There is broad support to ensure all regions of the state prosper, but mixed views on which areas win and lose under the current system.

"Kids are moving to the cities and that area is growing. We don't want to become a one-community state. Things are built thinking outstate people will come, but outstate people are subsidizing the cities' growth."

—citizen comment, Moorhead

"Hennepin County is exporting more than they get."
—local official

"It is important that we have a means of equalizing of raising revenues. In our community we are less than the statewide average of property tax wealth. With equalization that helps; without it we would see big tax increases."

—city mayor, Moorhead

"About 35 percent of Bloomington's commercial-industrial property taxes go to the state and are redistributed around the metro area. This drives taxes here. You wind up giving money to 'have not' communities."

—citizen comment, Bloomington

"I don't think we want to give up local control. We don't need St. Paul or Washington D.C. telling us what we need."

—citizen comment, Marshall

"Cities compare and compete. But each of you selected where you live for a specific reason. Each community has a unique identity. We have an excellent school system here—that's why many people live here."

—city mayor, Anoka

"We need to be mindful of declining school enrollment. Per pupil aid will reflect this, but just because there are less pupils doesn't make it less expensive....Tax reform must include a discussion of school expenditures and declining enrollment."

—state legislator

"Education is mandated to provide each child with equal education around the state. This should not depend on the property wealth of any given community. Is it more appropriate that these services be paid by something other than property tax?"

—local government official, St. Paul

Summary

This report gives you a glimpse of what we've heard from citizens around the state on what's important to them in tax reform. We want to thank all of the citizens, legislators, public officials, taxpayer organizations and our staff for spending the time and effort in sharing with us their perspectives on our current tax system and how it can be improved.

In *Volume II: The Design Guide* we will outline more specific parameters for tax reform and lay out a workplan for developing and evaluating alternative tax law and administration. A critical element will be to design an analytical framework to evaluate the overall impact of changes to the tax system on individuals, nonresidents, and in- and out-state businesses. It is important to make sure we understand the cumulative effects of changes to all the tax laws on taxpayers, communities, and

businesses, not just what each individual change would do. And of course, any future tax system will still have to add up in the end to balance state and local budgets.

Above all, we will continue to do what we have done for the past eight months: talk to taxpayers and state and local government leaders and officials about these problems and how to solve them, and the pros and cons of the alternatives.

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

Reform Taxes
c/o Commissioner Matt Smith
600 North Robert Street
St. Paul, MN 55146

Or call us at 651-297-1577 for more information.

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Appendix A: History of Tax Reform in Minnesota

Minnesota has debated reforming our tax system almost since statehood. Starting in 1902, here's a history of significant efforts to reform our tax system.

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Appendix B: The Citizens Jury on Minnesota's Property Tax

The Citizens Jury on Minnesota's Property Tax, hosted by the Department of Revenue and the Jefferson Center, met August 2-6, 1999. While the Jury was not asked to solve the entire state budget challenge, they were asked to respond to two specific questions about Minnesota's property tax system:

Question 1: What role should the property tax play in financing local government?

Question 2: What should be done to improve the property tax system (i.e., how can the property tax be a better tax?)

In answer to question 1, the Jury examined the revenue "mix" for each level of government. The jury recommended that:

- There be less reliance on property taxes across the board and minimal changes in the use of local sales taxes
- NOT to create a new tax in the form of local income tax to replace property tax
- State aid should play a greater role in funding schools
- More reliance on fees and charges across the board
- Recognize and increase state aid to local governments due to increasing state mandates
- There should be a direct connection between fees and charges from local government and services provided

In answer to question 2, the Jury recommended the following changes or further study:

- Decrease and simplify the number of classes and subclasses, without going to a single class system for property (17 for to 0 against)
- Re-evaluate current property tax credits and exemptions and eliminate special credits and exemptions that are no longer valid (17-0)
- Increase public education about the property tax system (17-0)
- Examine the possibility of each county setting their own classifications and rates for all properties (17-0)
- Study the cost to collect one dollar of property tax (cost-benefit analysis) (17-0)
- Establish a process to hold assessors accountable (16-1)
- Eliminate penalties for home improvements (15-2)
- Address problems of tenant's burden of property tax (16-1)
- Examine other methods of property taxation based on site, value and land consumption (16-1)
- Recommend an imposition of a cap on annual property valuation increases using the Consumer Price Index (9-8)

For a copy of the complete report, go online to www.taxes.state.mn.us or www.jefferson-center.org

Appendix C: Property Tax Reform Focus Groups

Description and Summaries

March 2000

We invited homeowners, agricultural homestead owners and business property owners from the metro area, the counties around Morrison County and the counties around Blue Earth County to talk with us about how they, as property tax payers, receive information to help them understand the property tax system.

During 8 focus groups, about 80 people gathered to discuss their opinions about these questions:

1. How have you been involved with or participated in any parts of the property tax system in the past?
 2. How do you currently get the information you need about the property tax? This question was followed with a discussion about the use and contents of the valuation notice, the Truth-in-Taxation statement and the property tax billing statement and about what other information they would like to receive.
 3. In what ways do you think you can influence your property tax?
 4. Do you think the property tax system is broken? What needs to be fixed?
- Taxpayers took these focus groups as an opportunity to share their concerns about many general "government" programs; however, we have summarized just the property tax issues below. We will use what we learned in these focus groups to help us construct a meaningful survey of property tax payers throughout the state to be conducted later in 2000.
- Issue #1: Communications Instruments (Valuation Notice, TNT Statement, and Billing Statement)**
1. Many taxpayers just pay the tax when the statement comes, or they have even fewer interactions with the property tax system when they pay the tax through escrow accounts. They have **no choice** but to pay the tax. The property tax statement is the document that meant the most to them.
 2. They glance cursorily at their TNT statements, which they call the "proposed" statement. Rarely did anyone refer to it as "Truth in Taxation" notice.
 3. Almost unanimously, they do not remember seeing their own valuation notices.
 4. Hardly anyone understood the **timing** of these three documents.
 5. After they had a chance to look at the documents more carefully, they had many questions about specific items that they didn't understand. Sometimes the answers were right on the form, but most times there was no answer and no understanding available. They would like explanations of some of those concepts or the detail should not be included on the form.
 6. Everyone wants to know **why** assessed values change. They also want to know how much it went up without having to look at last year's statement; they need at least two years of information on the valuation notice.
 7. Most did not feel the need for all three documents, but that sentiment could be tied to the fact that they did not understand the timing of them. They suggested some consolidation.

8. Taxpayers were ambivalent about the amount of information they want on these communications.
 - a. Many wanted the forms to be **simpler** with just the "bottom line" and then easy access to more detail if they were interested.
 - b. Others warned against giving any less information than they get now.
 - c. Others wanted even more information (school district and county budgets in readable formats, a breakdown of the house and lot value, a summary of recent law changes, a "rule book," the taxes of other people around them, etc.) However, they didn't want more information if it was going to cost much more to make it available.
 - d. Having consistent information on the internet was suggested often.

Issue #2: Where do Taxpayers go for Questions and Appeals:

1. Most understood that they could appeal "something," but they were **confused** by the instructions on the forms. Those who had appealed (and there were many of them) had received their information about how to appeal from a variety of sources.
2. Business representatives were very comfortable with the appeals process and with their access to information about property taxes.
3. There were some who had successfully appealed and some whose appeal had been denied, so there were varying degrees of trust in the appeals process. It was very easy for some and very difficult for others, especially those who had appealed through several levels. Residential non-ag property owners were more experienced in successful appeals. Agricultural property owners

were less positive about the influence they could have on their property values.

4. Those who had not appealed cited reasons as varied as "hopelessness about someone listening," "unwillingness to take on the government" and "fear of having to speak about their issue at a public meeting."
5. There were some communications that did not include a local taxing district phone number for taxpayers' questions. That should be a requirement for any notice sent to taxpayers.

Issue #3: Comments about the Property Tax System in General:

1. Many were **generally satisfied** that the system worked well. They didn't understand it but they didn't feel the need to understand it; it worked to collect the money that the local governments needed to offer the government services the taxpayers generally expect.
2. There were others who were very dissatisfied because they **could not understand** it, because they thought it was **unfair**, because they had no control over what they paid nor about how it was spent. **Powerlessness** was a common theme.
3. They would like more **consistency** about assessment practices, assessors' training, reporting from the counties, education funding, etc.
4. There were many concerns about understanding why the state pays for some of the property taxes. They would prefer that the system were more **straightforward**; instead it seems like a shell game to collect money from other taxes to buy down the property taxes.
5. There is plenty of room for **simplification** of the property tax system.

6. There is a general "us versus them" attitude coming from the non-metro taxpayers. They perceive that "metro" money is coming into their community and raising the value of property so that their taxes go up.
7. Even though the State of Minnesota might not have an understandable property tax system, there was some sentiment for our learning better ways to "do" property tax from other states. Who does it better?
8. It's too **hard to predict** the property tax, and it's too hard to see why it's going up. It's much easier to see consequences in other taxes; we consume (sales tax) or we earn money (income tax), and we know the consequences of that. We do not know the consequences of improving our property, of nearby property sales, of increased local government spending, etc., until we get our proposed bill, and then we don't know which event or combination of events made the taxes go up or down.
9. There was a great concern about school funding. The schools are always asking for money and are not able to offer the same services as other more fully funded schools; is there a way to achieve **equity** in the offerings of K-12 education?
10. Farmers were very passionate about how much property tax they pay to give **more than their share** of support to local governments and schools. This attitude was evident in many "us versus them" statements about differences between agricultural and non-agricultural taxpayers.
11. As expected, business representatives were mostly concerned about the **unfair** property tax burdens they have in relation to most other taxpayers.
12. Everyone was very pleased that the "state" was willing to listen to them; these focus groups helped to combat the distrust they have of "government."

Appendix D: Summary of Stakeholder Meetings by Topic

In order to begin a constructive dialogue with stakeholder groups on tax reform, the Department of Revenue hosted a series of meetings, asking for comments on a broad spectrum of tax topics. The meetings were organized around property tax, sales tax, corporate taxes, dedicated and excise taxes, income taxes and two special issue areas - utility and health care taxes. All meetings were open to the public. Teams were constituted by those citizens/stakeholders who participated in the meetings. Over 2,500 stakeholders were invited to participate and over 800 taxpayers signed up to receive notification of meetings. All agendas and minutes can be found on our website www.taxes.state.mn.us.

We used the following tax reform topics to guide discussion at public meetings:

- **Is the tax understandable?** *Do taxpayers understand how and why they pay the tax and what it is used for? Is the tax unnecessarily complex? Do they know how to appeal the tax? Is the tax predictable?*
- **Does the tax make sense?** *Is the tax simple? Does the tax or tax exemption accomplish its intended purpose? Is there an issue with compliance?*
- **Is the tax fair?** *Does the tax reflect the taxpayers' ability to pay in relationship to the services they consume?*
- **Is the tax modern?** *Is the tax in sync with the changing economy and changing technology?*

Property Tax Reform

In property tax reform, we are looking at changes that benefit the taxpayers as well as sort out the tangle of financial relationships between state and local governments to fund government provided services such as education, transportation, housing and other local services.

A number of methods were used to obtain taxpayer input into the process:

- The initial work to organize information for public comment is being prepared by four subgroups with a total of over 300 stakeholders signed up to receive information. The Citizens Jury, the Citizen Dialogues (13 around the state) and the Citizens League study on the role of market increases in the property tax, as well as eight property tax focus groups, have gathered countless comments and suggestions on ways to better reform the property tax system.

Focus groups were conducted to learn more from taxpayers on these topics. [See Appendix C]

Major issues identified for discussion of reforming property include:

- **Property assessment and classification.** Topics for study during the next few months will include examining factors that cause accelerating property tax burdens associated with valuation increases, and evaluating assessment practices and quality. Changes to the property tax classification system, which address issues of simplification and fairness, will also be examined. To date, assessors and property tax staff have been meeting to develop proposals to determine assessment "best practices" and proposed classification policy recommendations to be discussed this summer and fall.

- **Taxpayer understandability.** This was an area of concern identified by the 1999 Citizen Jury on Property Tax Reform. While the jury recognized many areas of reform, there was a strong recommendation to enhance taxpayer understanding of the system through better education and information. We will examine ways to simplify and improve the property tax statement, the Truth-in-Taxation statement and the process to make information more meaningful and understandable to the taxpayer.
- **Administrative burdens** of the property tax system. A comprehensive description of how the current system works from point of assessment to tax collection has been developed. It is important to examine who does what and when, what information is collected, how the information is processed, who uses the information, and an estimate of how much it costs to administer the property tax system. Policy reform initiatives will examine ways in which modern

technologies can be applied in order to make the system more efficient and less burdensome to administer and ways to make it more flexible and adaptive to legislative changes and taxpayer needs.

- Finally, we will examine the **role of the property tax in funding selected government services.** We will look at the role of the property tax to fund K-12 education, and implications to the system on funding services in the areas of family support, health, transportation, housing and corrections. The effort will involve the assistance from appropriate state agencies and representatives of local governments. Of particular interest is the examination of policy options to best address the issue of state-to-local mandates. We will also examine the role of several state aid programs and other non-property tax revenues to fund local services, and possible fiscal implications of policy reforms affecting fiscal disparities, tax increment financing, and the distribution of taconite production fund revenues.

Sales and Use Tax Reform

In reforming the sales and use tax, we have begun our work by identifying, with stakeholders, the policy issues in our current system that are not aligned with the goals for a reformed tax system. Several national and multi-state sales and use tax reform and simplification efforts have identified many of the same issues in recent years.

A number of methods were used to obtain taxpayer input into the process:

- Questionnaires were sent to over 228,000 taxpayers registered for sales or use tax filing, 680 tax practitioners, 100 internal stakeholders including public policy-makers, other state and local governments.

- A survey was sent to 250 randomly selected businesses registered for sales and use tax. See a summary available on our website.
- Two public meetings were held, inviting over 225 stakeholders from a representative sample of businesses and their accountants. The issues discussed at that meeting were the identification of issues needed to be addressed by tax reform; sharing ideas for making the sales and use tax system more fair, understandable, easy to administer and modern; and prioritization of issues important to taxpayers.

- Focus groups with the Chamber of Commerce, held in conjunction with the team looking at Corporate Tax Reform at five locations around the state.

Major issues identified for discussion include:

- The **impact of electronic commerce**, the shift from a local economy to a global economy and the shift from a manufacturing economy to a service economy on our current sales and use tax system.
- The increased **burden on taxpayers to comply with and administer the sales and use tax law** because of an increased number of exemptions to administer, uncertainty about what is and is not taxable, expansion of local taxes, outdated rules and unclear definitions.
- **Taxation of telecommunications services.** Minnesota sales and use tax law currently does not contain a definition of "telecommunications" and only applies to a limited number of telephone services. As the technology for providing two-way voice, video and data services converge, it will become increasingly important to know what services are subject to tax.
- Changes to the **capital equipment exemption** including moving to an upfront exemption and expansion to service providers.
- The elimination of the **June estimated payment.** The June estimated payment scheme is complicated and burdensome for both businesses and the department.

What have we heard so far? When asked to rank the issues in order of importance, the taxpayers placed the issues in the following order:

- Capital equipment (upfront exemption, expansion).
- Elimination of the June estimated payment requirement.
- The impact of electronic commerce.
- Increased burden on taxpayers to comply because of complications and exemptions in the law.
- Taxation changes in the telecommunications sector.
- Governments taxing to pay sales and use tax on their purchases.
- Timing of electronic funds transfer payments.
- How to treat "mixed" transactions that include both taxable and exempt items.
- Exempting business inputs.
- Developing a consistent standard of taxation between manufacturing and services.

Minutes of the meetings can be found on the Sales and Use Tax Reform Team page of our website at www.taxes.state.mn.us.

Corporate Franchise Tax Reform Team

Currently, Minnesota's corporate franchise tax has one of highest rates in the nation. Approximately 10 percent of the taxpayers pay 95 percent of the tax. The system is antiquated and in need of reform to meet the needs of both taxpayers from an administrative and competitive standpoint and the needs of the state to fairly and consistently administer a tax on corporate

income. In reforming taxation of corporate income, we are exploring potential alternatives by examining the current corporate franchise tax to determine whether it meets the overall criteria for a good tax system. If it does not, proposals will be developed with potential recommendations to change the corporate franchise tax system; or potential alternative

tax structures (e.g., gross receipts tax, business activities tax, etc.) will be evaluated to determine their strengths and weaknesses in comparison with the existing corporate franchise tax.

A number of methods were used to obtain taxpayer input into the process:

- A survey was sent to 1,000 randomly selected businesses. See a summary available on our website at www.taxes.state.mn.us.
- Five public meetings with over 150 stakeholders participating from a representative sample of business and other stakeholders.
- Focus groups with the Chamber of Commerce, held in conjunction with the team looking at Sales Tax Reform at five locations around the state.

Major issues identified for discussion include:

- General issues of tax reform - fairness/ simplicity /modern/understandability.
- Corporate tax base/deductions/tax credits. The Minnesota corporate franchise tax starts with federal taxable income and makes 30 different Minnesota modifications to determine Minnesota net income. Does this make sense?
- How do we apportion income? Currently, Minnesota uses a three-factor test to apportion income: Property (15%), Payroll (15%) Sales (70%). The legislature has moved toward a single sales factor. Is this a move in the right direction? We will discuss this and other general provisions for attributing services/ financial institution apportionment.
- Discussion of unitary taxation. Minnesota currently uses domestic unitary combination. This means we limit the unitary combination to those corporations organized in the United

States. What are the implications of this practice in a global economy?

- Tax credits and deductions taken by business. There are numerous deductions and credits that have made Minnesota's corporate franchise return complex. Have these credits and deductions been evaluated for their effectiveness?
- Other issues will include: what factors should be used to determine whether a corporation is required to pay Minnesota tax, taxation of partnerships, S corporations and limited liability companies, cooperatives and other tax administration issues associated with business income taxes.

What have we heard so far? Stakeholders attending the meetings have told us to:

- Simplify the corporate tax system
- Make Minnesota companies more competitive
- Lower the corporate tax rate to eliminate the disparity between corporations, S corporations, and partnerships
- Repeal the Alternative Minimum Tax
- Retain federal conformity as much as possible
- Move to a single sales factor method of apportionment
- Adopt federal depreciation; eliminate ACRS/MACRS timing differences
- Eliminate the disparity between how we tax insurance companies and other corporations
- Avoid the Business Activities Tax
- Acknowledge that business taxes are passed on to consumers – evaluate the incidence of business taxes

Minutes of the meetings can be found on our website at www.taxes.state.mn.us on the Corporate Tax Reform Policy Team page.

Special Taxes Reform

Minnesota's tax system is extremely complex, with 48 different taxes and countless fees and charges. There are larger excise and dedicated taxes, which we call "special taxes" such as the cigarette tax, alcohol and gambling taxes and others administered by the department. Many of the "special taxes" rarely receive scrutiny as to their impact (if any) on the social policy goals they were created to achieve. We will be examining many of the "special taxes" for their efficiency and effectiveness in funding the policy purpose for which they were created:

- Cigarette tax/tobacco tax/Unfair Cigarette Sales Act
- Mortgage and registration tax/contamination tax
- Lawful gambling/liquor/wine and beer tax/unrelated business income tax/controlled substance tax/lawful gambling annual audits/profit carryover/bank reconciliation
- Insurance taxes and surcharges
- Environmental taxes and fees
- Petroleum taxes

A number of methods were used to obtain taxpayer input into the process:

- A survey was sent to taxpayers collecting and remitting cigarette, alcohol, and

environmental and gambling taxes. A copy of the report is available on our website at www.taxes.state.mn.us.

- Six public meetings with various stakeholder groups were held to date with participation by over 130 stakeholders.

What have we heard so far?

- Stakeholders are interested in investing in technology to improve remittance and compliance of the taxes. Examples include cigarette stamping methods, improvements in the documentation and administration of the mortgage and deed taxes, and e-filing for the unrelated business income tax.
- Stakeholders cited several laws that no longer make sense in a more modern economy. Examples include a penny per bottle tax on liquor, the "shrinkage" discount on taxes owed on petroleum products, changes in lawful gambling and the corporate insurance income tax.
- Stakeholders cited several dedicated taxes where the cost to collect a dollar of tax equaled or exceeded the amounts collected.

Minutes from these meetings can be found on the Special Taxes page of our website at www.taxes.state.mn.us.

Health Care Tax Reform

In reforming health care taxes, we need to assess the efficiency, fairness, understandability and stability of each health care related tax, fee, surcharge and other methods of funding health care programs in Minnesota, and its relationship to the program(s) it finances. Minnesota offers many different programs for the uninsured, underinsured and hard to insure. These programs are financed through a variety of sources, including federal funds, the general fund and dedicated taxes:

- **Provider Tax** - This is a tax of 1.5% on the gross revenues from patient services provided by health care providers and hospitals. The tax also applies to wholesale drug distributors' sales of prescription drugs. The taxes collected go into the health care access fund.
- **Hospital Surcharge** - This is a tax of 1.56% on the net patient revenues of each Minnesota hospital. The taxes collected go into the general fund.
- **Nursing Home Surcharge** - Each nursing home in Minnesota is required to pay an annual tax of \$625 per licensed bed. This tax is deposited into the general fund.
- **Health Maintenance Organization (HMO) and Integrated Service Network (ISN) Surcharge** - This is a tax of 0.6% of the total premium revenues. The taxes collected go into the general fund.
- **Gross Premiums Tax** - This is a tax of 1% of the premiums received by nonprofit health plans, HMOs, and ISNs. The taxes collected go into the health care access fund. Due to the surplus in the health care access fund, this tax is currently not being assessed.

- **Minnesota Comprehensive Health Association (MCHA)** - MCHA provides health insurance for individuals who have been denied coverage due to pre-existing conditions. Each insurer writing health coverage, HMOs, ISNs, fraternal benefit societies offering health care coverage, are by law members of the association. To the extent that program expenses exceed enrollees' premium payments, the members are assessed for the shortfall.

We are also working with the Governor's Health Care cabinet to identify health care policy goals (e.g. universal coverage for children) to determine where there are gaps, overlaps, and conflicting goals in the current health care financing system and how they might be rectified. The overall objective is to propose a funding mechanism for the health care programs that is in sync with the tenets of sound tax policy and closely linked with the *Big Plan* goals for a viable health system.

A number of methods were used to obtain taxpayer input into the process:

- A survey was sent to 70 taxpayers on the Minnesota Care tax. See our website at www.taxes.state.mn.us for a summary of the report
- Participation by over 150 stakeholders at two public meetings to discuss:
 - the Minnesota Care Tax/MCHA/Medicaid Surcharge/Premiums tax on HMOs and Community ISNs
 - Minnesota health care taxes and surcharges and how they should be reformed – a focus on hospitals
- Focus group meetings with the Minnesota Medical Association,

Minnesota Dental Association and other health care, insurance and advocacy groups.

- Review of Health Care Taxes in Minnesota: An analysis, issued February 2000 by the Minnesota Taxpayers Association

Major issues identified for discussion include:

- Unpredictability of tax rate tied to health care access fund balance
- Tax incidence on consumers of health care service
- Tax equity between payers of health care taxes including exemptions
- Potential consolidation of various health care taxes
- Issues regarding imposition of the tax and provider's patient base
- Relationship of tax insurance companies and health care
- Overall financing mechanisms for health care programs

What have we heard so far?

- Taxpayers are opposed to the current

method of taxation (specifically MinnesotaCare) and seemed reluctant to explore any restructuring of that tax and other taxes.

- The medical assistance surcharge and overall tax compliance burden (including withholding, sales and use, unemployment insurance, etc.) generated little interest among the hospitals and providers at the meetings.
- The Minnesota Taxpayers Association identified their findings to include: a greater disparity of the tax burden depending on the provider's patient base; like services taxed differently depending on the source of the payments; insurance taxes, direct or indirect, fall unequally on different medical service purchasers; and the finding that health care taxes are regressive in their ultimate economic impact.

The minutes from these meetings can be found on the tax reform website at www.taxes.state.mn.us on the Health Care Tax Reform Policy Team page.

Utility Tax Reform Team

As part of the 1999 Omnibus Tax Bill, we were directed to study the taxation of utilities in Minnesota. Utility deregulation will be a major policy discussion over the next few years, and is part of the *Big Plan* goal for a Healthy, Vital Communities. We will examine issues related to the personal property tax paid on generation equipment and other tax issues related to the potential deregulation of the electric utility industry.

Outcomes for the project will be recommendations on changes in utility taxation that are based on legal, sound tax policy principles and that will create the least disruption to consumers, shareholders and local governments.

How have we solicited taxpayer input into the process?

The Utility Team has nearly 250 stakeholders on its mail list and has scheduled nine public meetings.

The following public meetings were scheduled around specific issues:

- October 29, 1999 - Overview of deregulation issues: Discussion of topics regarding reliability and future restructuring issues, as outlined in law.
- November 19, 1999 - Overview of utility taxation in Minnesota: Real and personal (including costs of deregulating personal property for generation, transmission and distribution).
- January 7, 2000 - Personal property tax: Current definitions, case law, exemptions, and administrative issues.
- January 28, 2000 - Competitiveness issues: Overview of utility taxation in sample of other states.
- February 25, 2000 - Non-property tax utility tax issues: Nexus issues, capital equipment, intangible/ tangible.
- March 31, 2000 - Assessment/valuation issues.

- April 28, 2000 - Environmental and other relevant issues.
- May 25, 2000 - State/Local financing relationships and utility properties.
- June 30, 2000 - Replacement revenues: Viability of alternative revenue sources.

The final meeting will be followed by a public comment period. A draft of the final report will be finished by the end of October 2001.

What have we heard so far?

- "Host" communities with utility plants are concerned about potential loss of revenue derived from the personal property tax paid by utilities.
- Counties and cities are concerned about how utility property is valued and assessed.
- Utilities are concerned with the competitive disadvantage they face paying a personal property tax in Minnesota that their competitors in other states do not face.
- Utilities are concerned about tax disparities among providers of electricity – both within and outside of Minnesota.
- There are other issues that will impact taxation of utilities in a deregulated environment, such as "nexus" or tax treatment of non-Minnesota utilities selling power into the state, issues on what is defined as "capital equipment" for the generation of electricity, and defining electricity as a tangible or intangible product.
- Advocacy groups are concerned about the environmental impacts of utility deregulation and potential for using the tax code to influence environmentally cleaner technology.
- Concern over how consumers will ultimately pay for electricity.

Minutes from the public meetings can be found on the Utility Tax Reform Policy Team on our website at www.taxes.state.mn.us.

Income Tax Reform

While Minnesota has attempted to simplify the income tax over the years, recently Minnesota's income tax has become increasingly complicated with numerous subtractions, credits and additions. As the Department of Revenue looks at "reengineering" the income tax system to make filing and paying more accessible for the taxpayers, we also need to look at tax policy objectives for the income tax. Some of the issues identified for discussion include:

- Examination of the base we use to calculate Minnesota tax – federal taxable income or federally adjusted gross income
- Balancing fairness in the system with the use of subtractions, additions and credits with simplicity
- In relation to that discussion, there are several credits, both refundable and non-refundable aimed at low-income populations. Is there a public policy argument for combining those credits?
- Capital gains issues
- Alternative Minimum Tax issues

A number of methods have been used to solicit taxpayer input:

- Input from citizens during recent focus groups and surveys
- Department of Revenue re-engineering recommendations
- Discussions with tax practitioners regarding policy changes

- Feedback from 13 Citizen Dialogues on tax reform held last fall
- We are also gathering data about current usage of individual income tax features as we plan to summarize the outcome of the issues discussions and request feedback from interested parties.

What have we heard so far?

- Don't change things so much. They like to use their last year's returns as a guide to help them get this year's return done correctly.
- Keep the link to the federal tax base for ease in filing.
- Keep filing and paying processes as simple as possible.
- Don't make them attach a copy of their federal return.
- Offer free, easy, and quick electronic ways to file and pay.
- Lower the rates.
- Keep up the good service with the forms, phone response, and education.
- Get the tax cheaters and non-filers.
- People using tax practitioners don't care much about whether the income tax is simple or easy; they know their tax preparer will take care of it for them.

Information about income tax reform can be found on the Income Tax Reform page of our website at www.taxes.state.mn.us.

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

Reform Taxes
c/o Commissioner Matt Smith
600 North Robert Street
St. Paul, MN 55146

Or call us at (651) 297-1577 for more information. For persons with hearing impairments, call TTY (651) 297-2196 or toll-free through the Minnesota Relay Service 1-800-627-3529 (ask for 1-800-652-9094).