

Revisiting the “Three-Legged Stool” Is Good Tax Policy Dead?

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About MCFE



“Fiscal Excellence” consists of three simple yet fundamental ideas:

1. Revenue collection should reflect the principles of sound tax policy
2. Government spending should be efficient, transparent and accountable
3. Spending outcomes should be measured and evaluated

The mission of the Minnesota Center for Fiscal Excellence (formerly known as the Minnesota Taxpayers Association) is to make these ideas the foundation of Minnesota state and local government. MCFE pursues this mission by:

- Educating and informing Minnesotans about sound fiscal policy
- Providing state and local policy makers with objective, non-partisan research about the impacts of tax and spending policies
- Advocating for the adoption of policies reflecting principles of fiscal excellence

First...an Introductory Quiz



Polling Question

This picture represents:

- A. One of the most clever policy marketing campaigns in state history
- B. A highly misleading portrayal of the state tax system
- C. Both of the above



Background

- Dayton Administration “tax reform listening sessions”
- “3-legged stool” symbolized the state’s three principal revenue sources
 - Individual income taxes
 - Sales/use taxes
 - Property taxes
- The “stool” actually misrepresented the financial and fiscal situation, and the context, at the time



Tax Policy Implications of Using the “Stool”

- Concept of equal “balance” among key revenue sources is illusory
- Impact of other state revenue sources
- Allocation of/access to particular revenue sources differs among state/local governments
- Reliability, predictability and short-term economic dislocations of collections skews data, analyses

But it does raise an important tax policy question

- Just how reliable and able is our tax system to support government expenditures as our economy evolves and cycles?
- Tax diversity is important, but **how** we tax that diversity is no less important

A Look at the State of the “Big 3”

- “Vital Statistics”
- Structural Issues
- Policy Considerations
- Conclusions

Individual Income Tax

Individual Income Tax Statistics: More Reliant on the Tax than Ever Before

- 24.7% above national average in collections (6th in nation)
- 44.1% more reliant than the national average to fund state and local operations
- Comprises 52.5% of all general fund resources (all-time high)
- Over the last 10 years, average annual growth in collections is 15.4% greater than average annual general expenditure growth

Individual Income Tax: Structural Considerations

Progressivity as a Defining Feature

- Increasing reliance on the tax is correlated with increasing reliance on highest income earners
- Share of collections from top 5% of income earners
 - Twenty years ago 40.9%
 - Ten years ago: 43.2%
 - Now: 47.1%
- In contrast with other highly progressive income tax states, collections found to be generally in synch with GDP changes and recovered twice as fast than national average from economic shocks (1967- 2012)

Individual Income Tax: Policy Issues

1. The Push for Even More Progressivity

- Income tax base is currently twice as volatile as the general sales tax base and about five times more volatile than the property tax
- Volatility from more progressivity comes from two sources:
 - Income composition exposed to tax
 - Behavioral responses -- individual and business

2. Push for New Tax Base Exemptions

- About a half dozen bills introduced last session to exempt larger amounts of government and private retirement income
- Retirement income now constitutes 11% of state AGI and growing at 6% per year

Polling Question

What is the most common behavioral response you have seen in response to a push for more progressive individual income taxation?

- A. Residency changes
- B. Employee requests to work remotely from lower tax jurisdictions
- C. Business location changes or expansions into lower tax jurisdictions
- D. Accelerating transactions/big income events in advance of rate increases
- E. None

Sales and Use Tax

Sales Tax Statistics: Slower Growth, Declining Reliance

- Total state and local collections 9.8% below national average (largely due to comparatively less local government use)
- 19% less reliant than the national average to fund state operations. MN reliance on sales tax has shrunk 22% in last twenty years. Only two states have reduced their reliance on sales taxation more over that period.
- Over the past 10 years, average annual sales tax growth has been 45% slower than income tax growth, 36% slower than the growth in all other general fund tax revenues combined and over 1/3rd slower than average annual general fund expenditure growth.

Sales Tax:

Structural Considerations – All about the Base

- Reputation for having a significantly constrained sales tax base compared to other states not justified
- Breadth of sales tax base has shrunk dramatically – and Minnesota is absolutely not alone
 - Growth of the service economy
 - Impact and role of technology in modern economy (e.g., sharing economy, new goods and services blurring traditional statutory classifications, etc.)

Polling Question

What is your biggest concern with sales tax base expansion?

- A. Taxing and sourcing sales of services
- B. Failing to exempt business inputs
- C. Resulting compliance burdens
- D. Regressivity

Sales Tax: Policy Issues

1. Challenges of Doing Base Expansion “Correctly”

- Political and administrative challenges of exempting business inputs
- General administrative and enforcement considerations

2. Dealing with sales tax regressivity – Three sources of “nuance”

- Progressivity enhancements in base expansion
- Income vs consumption incidence
- Progressivity of spending supported by regressive taxation

3. Keeping up with sources of GDP Growth

- The issues behind the provider tax kerfuffle will not be going away any time soon

Property Tax

Property Tax Statistics

- Property tax collections are 6% below the national average (23rd in the nation)
- State and local own source revenues are 13.9% less dependent on property taxation to fund government operations than the national average
- Property taxation provides schools and other local units of government with 51.2% of their own source revenues, essentially unchanged over the last 10 years
- Statewide median homestead property tax burden (post refunds) is 2.5% of household income versus 2.8% ten years ago

Property Tax Structural Considerations – Complexity as a "Tax"

- As a levy driven system, the property tax is largely immune from the productivity and reliability challenges sales and income taxes face
- However, the property tax's role in revenue dependability introduces the immensely complicated issue of state intergovernmental finance relationships
- In addition, local reliance on the tax is influenced by its political acceptability and the sheer complexity of the Minnesota property system inflicts a "tax" on public understanding and acceptance

Property Tax Policy Issues

1. Whether or not to restore the property tax to being a true local tax

- The State General Tax is a tax in limbo
- Is the modicum of diversification and stability it offers worth the state's intrusion on local governments' primary tax base and resulting levy setting impacts?

2. Making Progress on the 2012 Property Tax Working Group Recommendations

3. Transparency Initiatives

- Splitting up market vs. levy impacts on bills
- Demonstrate math behind levy (tax of “last resort”)
- Local government consolidation investigations?

Conclusion

Polling Question

Is good tax policy dead?

- A. Yes
- B. No

Conclusions: Is Good Tax Policy Dead? No. More Likely in a Coma

- States cannot deviate too far from federal structure and until the federal government addresses some of the same structural challenges (e.g., join the rest of the planet enacting a VAT?) states are going to be somewhat limited in their efforts
- Challenge is compounded by partisan mindsets:
 - DFL: Ever-greater progressivity is an essential condition for raising revenue
 - Republicans: No rate or base changes that could raise revenue, in any context or for any systemic purpose, period.
- Signs of awakening: Tax Expenditure Review Commission
- The polarity of these two mindsets offers very little opportunity to gear Minnesota's tax system for the future

MCFE Upcoming Events and Publications

- **95th Annual Meeting Policy Forum, Tuesday, November 9 (FREE, virtual)**
 - 9:00-10:15 Federal Action, State Reaction: National and International Tax Developments and the Implications for Minnesota Tax Policy, Featuring Joe Crosby, Harley Duncan, Karl Frieden
 - 10:30-11:45 Government Human Capital Reform: Transforming Human Resource Systems to Meet the Needs of 21st Century Government, Featuring Dr. Howard Rishner, Dr. Ronald Sanders, Kristin Batson
 - Register Here: <https://www.fiscalexcellence.org/assets/documents/2021registration-form.pdf>
- **Policy Reports, Education, Guides, Analysis, Commentary**
 - View Here: <https://www.fiscalexcellence.org/policy.html>
- **Fiscal Focus**
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