CITIZENS LEAGUE
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STATEMENT TO TAX STUDY COMMISSION

BACKGROUND

The Citizens League has issued several reports and statements in the last several years on state-local fiscal matters, including a recommendation that the Legislature establish a tax study commission, followed by a statement to the Tax Study Commission shortly after it was formed. We urged the commission to develop proposals that would (a) support economic growth, (b) create an efficient and coherent intergovernmental tax and revenue system, and (c) be responsive to the need to redesign public services.

More recently we have been invited to offer specific suggestions concerning possible improvements in the state's budget process. This statement is a response to that invitation.

MAJOR PRINCIPLES

The Tax Study Commission cannot be neutral in its work. Its recommendations will significantly affect the state's budget. Thus it ought to be explicit on its assumptions. Among the principles likely to guide the commission's work, some need the greatest possible emphasis:

--The tax-spending system should be organized so that there is a direct connection between decisions to increase spending and the corresponding need to raise revenue to finance such spending. This will help restore fuller accountability for spending decisions by elected officials. Currently, some provisions of state law, including the homestead and agricultural property tax credits, insulate local taxpayers from feeling the full brunt of the last dollar of taxes levied. This happens because these credits are paid directly to units of local government so the taxpayers never are responsible for the total bill.

--Tax and spending policy should be sensitive both to (a) what is needed to spend and (b) what is prudent to tax. It is not realistic to decide what to spend without paying attention to the tax rates that would be required. Similarly, it makes no sense to decide what the tax rates will be and then spend what happens to be raised, irrespective of whether the revenue generated by these tax rates is needed. While the commission is not expected to concern itself with the details of spending, we believe that it should pay attention to the process by which overall spending levels are decided. If it fails to do so, there is a risk that Proposition 13-type spending limits will become more appealing to the electorate.

--In Minnesota a state tax or spending policy should not be considered independent of a local tax or spending policy. The two are so interconnected that an effort to deal with one and not the other would produce serious side effects.

The environment for the Tax Study Commission today is different from the late 1960s and early 1970s. At that time the Legislature made major changes in the state-local fiscal system, emphasizing the features of (a) the capacity of a system of taxes to raise sufficient revenue, (b) the equity of the burden among taxpayers, with a concern that low-income persons are protected, and (c) reduction in differences in levels of spending for essential services like education. Today another feature of the tax system is receiving considerable emphasis: how the system positions Minnesota in its competition with other states for economic development.

The Tax Study Commission needs to combine a sense of vision for the future of the state with practical proposals for meeting immediate needs. If it deals only with long-range concepts, its report may attract considerable academic attention but have little value for lawmakers. If it deals only with specific details of tax policy which it thinks will be on the Legislature's agenda in 1985, it will be failing to provide the leadership expected of it.

PROBLEM AREAS: THE PROCESS OF TAX POLICY

1. The commission should recommend that consideration of the overall tax and spending levels for the biennial budget begin much earlier than it does now. In late January or early February of the odd-numbered year the Governor presents his proposed biennial budget to the Legislature. But the executive branch of state government begins its work on a part of that budget several months earlier--before the November elections, before the campaigns, even before filings open for elective office--before May of the even-numbered year. In May the Governor submits an inch-thick set of budgetary guidelines to state agencies. The guidelines include the Governor's preliminary thoughts on how much spending by state agencies should change in the next biennium. For example, in May 1984 the Governor's guidelines called for a 14 percent increase in spending by state agencies in the biennium beginning July 1, 1985.

The agencies use these guidelines in developing their own proposed budgets for the Governor for the next biennium. The Governor in turn modifies these proposals as he deems desirable.

The guidelines encompass only a small portion of the biennial budget, because they do not include policy direction for property tax relief, school aids, local government aids, medical assistance and welfare, which dwarf spending by state agencies. They are not legally binding. Moreover, the incumbent Governor who issued the guidelines may not even be in office the following year when the budget is presented to the Legislature. Nevertheless, the guidelines are immensely important because they set the tone for budget discussions which follow and influence the expectations of all recipients of funds from the biennial budget. Because the guidelines have such a significant impact on the

Governor's proposed budget they also, indirectly, have a significant impact on the budget as finally adopted by the Legislature. Usually legislatures do not depart much from the overall budget figure recommended by the Governor, although they may make major changes in the way the funds are appropriated.

We urge the Tax Study Commission to suggest steps that will bring more public and legislative attention to overall tax and spending issues much earlier than now. This should be done by urging the following changes in the way the budgetary guidelines are issued and discussed:

--The Governor should spell out his projections about the growth(or shrinkage) in all areas of the budget, not just the state agency amounts, when he issues the guidelines. Total spending by agencies covered by the guidelines amounts to less than 25 percent of the state's budget. The Governor should state what he expects the state's obligations in property tax relief, local government aid, school aid, medical assistance and welfare will be. Where obligations are fixed by law, the Governor may need only to lay out projected levels of expenditure for the next biennium. He probably can defer policy judgment on whether those obligations should be changed. In other cases the Governor should indicate whether the non-state agency portions of the budget should be expected to increase at a percentage rate higher, lower or the same as the rate applicable to the state agencies.

The Governor's budgetary guidelines are important in that they can prompt broad public discussion, early, of the alternatives that ought to be explored. They are an important signal about how much the budget will change. They also offer the opportunity to discuss appropriate spending levels separate from revenue estimates.

Perhaps the most difficult problem with state budget-making today is that the question of appropriate spending levels almost always is related to how much money is being generated by existing taxes. It would be beneficial to have some discussion of appropriate budgetary levels absent the question of revenue generation. The presentation of the budgetary guidelines affords that opportunity because they are issued well in advance of the time of revenue-forecasting that will relate directly to the submission of the budget.

--The Governor should indicate clearly what portion of the overall increase is designed to cover expenses above the rate of inflation. This year, for example, the Governor at the time of the announcement of the guidelines would have indicated how much of the increase is attributable to anticipated inflation and how much goes beyond, as well as the assumptions behind the inflation forecast. According to officials of the State Department of Finance, the Governor has since instructed state agencies to assume an inflation factor of 5.5 percent in each year of the biennium, or a total of 11 percent (ignoring the compounding effect). This means that the 14 percent increase in spending the Governor has forecast over the two year period is based on a gubernatorial decision that spending in each year should be 1.5 percent above the anticipated rate of inflation.

--The Governor should include an estimate of how taxes as a percent of personal income and spending per capita will change--in absolute terms and relative to the other states, including assumptions on what kind of change, if any, would be occurring in the other states--if the percentage increases contemplated by the guidelines are ultimately incorporated in the budget adopted by the Legislature.

--The Governor should submit the guidelines formally to the leadership of the House and Senate and the Appropriations/Finance and Tax Committees. Issuance of the guidelines comes after the Legislature has adjourned. But the committees of the House and Senate still are active. The appropriate committees of the House and Senate, separately or together, should hold post-adjournment public hearings on the guidelines. Such hearings would provide public education and probably would help focus issues for upcoming elections to the House (every biennium) and the Senate and Governor (every other biennium).

--The Minnesota Horizons project, an effort to broaden legislators' perspective on state issues, should be rescheduled so that it occurs in the middle of the even-numbered year, just as election campaigns are getting under way, but after submission of the budgetary guidelines. This will help stimulate more direct campaign attention to the issues which the guidelines present.

--Private organizations which follow state-local budget issues should contribute to the educational process by sponsoring public forums where state office-holders could discuss the issues in the budgetary guidelines.

2. <u>The Tax Study Commission should recommend a way to end the Legislature's practice of making expenditure commitments for school aid, local government aid and property tax relief for a period beyond the upcoming biennium.</u> Currently, the timing of property tax collections makes it hard for the Legislature to restrict its aid and property tax relief commitments to the upcoming biennium. Consequently, a Governor and Legislature are spending the money of the next elected Governor and Legislature. In the case of school aids, the commitments run a full 12 months beyond the expiration of the biennium. With city and county aids and property tax relief payments the commitments extend six months beyond the biennium.

To correct this problem the commission should recommend that the Legislature modify the budget years of local governments. Under such an approach, local units of government, including school districts, would receive their state aid, property tax relief payments, and property tax revenues during the same 12-month period which coincides with their fiscal years. One possible calendar would have the local government fiscal year begin sometime in August. Perhaps even the state's own biennial budget year could commence the same time. Then all units of government in Minnesota would be on the same budget year. State aids and property tax relief payments for that fiscal year would have been appropriated by the Legislature the previous May. Between May and the beginning of the fiscal year local governments would have decided their property tax levies for the fiscal year.

PROBLEM AREAS: THE SUBSTANCE OF TAX POLICY

1. The commission should recommend that the Legislature change the system of providing property tax relief so that taxpayers are responsible for the full amount of the taxes due on their properties--not only a part as now is the case for many taxpayers. Under such a change, state property tax relief payments such as homestead and agricultural credits would be made directly to the taxpayers, not to local units of government. Local government aid and school aid would continue to be paid directly to the units of government. The principal advantage of this change is that officials of local units of government--counties, school districts, cities and townships--would be more directly accountable to their voters for their decisions to increase property taxes. Today the state government intercedes on behalf of most property taxpayers and pays--using state funds--a portion of the property tax bill, before the bill is sent to the property taxpayer. Consequently, the taxpayer never is responsible for--and often not aware of--the full amount of the bill. The system should be changed so that every dollar levied by local government on a parcel of property would be payable by the owner of that property. Such a changed system need not modify any existing practices on ultimate distribution of the tax burden. If the Legislature wants to help certain taxpayers, that can be accomplished by separate payments made directly to taxpayers themselves. One form of property tax relief, the income-adjusted credit, also known as the circuit-breaker, already is paid in this fashion.

Under our proposal the Legislature would make all property tax relief payments that way. Such payments undoubtedly would be used by taxpayers to help them meet their property tax obligations, but the individual taxpayers would be responsible for remitting to local government the total amount of their property tax liability.

A further advantage of such a change is that the Legislature could adopt a much more targeted approach to property tax relief than is possible now. If it so desired, it could relate every property tax relief payment to the income of the property owner. The new system, of course, would make much more obvious exactly who is receiving how much assistance.

2. The commission should recommend that the Legislature reduce the number of property tax classifications. Sometimes the Legislature tries to give property tax relief to some categories of taxpayers by exempting more of their property value from taxation. Such an approach shifts property taxes to other property owners; it doesn't reduce taxes. It only creates an illusion that taxes are being reduced. It has the same consequence as the current system of providing property tax relief, outlined above: the Legislature is using indirect methods of providing relief, thereby shielding some taxpayers from the full impact of spending decisions. Moreover, some taxpayers who need the relief don't get it, and others receive relief even though they don't need it. The number of classifications should be reduced. If the Legislature wants to ease the burden on certain taxpayers, it should use the same method as we recommended above for providing property tax relief, a state rebate to offset what are deemed to be excessive property taxes. Such an approach makes it possible to direct property tax relief more effectively than is possible through changes in the classification system.

3. The commission should recommend that the Legislature broaden, not narrow, the base of taxes. The broader the base of a tax, the more people have an interest in its level, which will promote accountability. A broad-based tax, with income-related credits, will make it possible to target assistance to people who really need it. It would be fairer to all because certain types of property wealth, purchases and income would not automatically be excluded from taxation. The recommendations of this commission should combine the understandable concerns for revenue productivity, and our tradition for fairness, with a new sensitivity to how our tax practices affect our competitive position.