CITIZENS LEAGUE REPORT

No. 124

Proposed Legislation to Enable a Levy of a City Income Tax or Earnings Tax

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Citizens League
545 Mobil Oil Building
Minneapolis 2, Minnesota

APPROVED
BOARD OF DIRECTORS
DATE MAR 8 1961

RECOMMENDATIONS ON MINNEAPOLIS CITY COUNCIL'S PROPOSED LEGISLATION TO ENABLE LEVY OF A CITY INCOME TAX OR EARNINGS TAX

The Board of Directors of the Citizens League requested the Taxation and Finance Committee, James Pratt, chairman, to analyze the Minneapolis City Council's proposals for a City tax on earnings or income, and recommend a Citizens League position on the proposals. The Taxation and Finance Committee through a subcommittee under chairmanship of David R. Roberts presented an analysis of the Council's proposals and suggested conclusions and recommendations.

After consideration of the various conclusions and recommendations, the Board of Directors issues the following statement:

CONCLUSIONS AND RECOMMENDATIONS

1. The Citizens League commends the Minneapolis City Council for its action in seeking to find a way to provide major property tax relief for Minneapolis property owners with a broadly-based new local tax source.

2. The League finds, however, objections to a number of features of the City Council's current proposals for an income or earnings tax in their present form, including principally:

(a) <u>They Are Not Metropolitan Area Proposals.</u> The League believes such local income or earnings taxes should be on a metropolitan-area basis and should provide for returning the net proceeds to the local government of the taxpayer's residence.

(b) <u>Other City Taxing Units Are Not Considered.</u> Any major new tax source should be considered in the light of the revenue needs of all the taxing units of the City. The Council's proposals are directed only toward presenting the City Council's needs, and do not take into account the needs of the Park, Library, and School boards.

(c) <u>Tax Liability Is Not Clearly Defined.</u> The City Council's proposals are drawn as enabling acts, leaving to later Council ordinance the definition of important terms in the determination of individual and business tax liability. The League believes that statutory authority to levy such a broad new tax as a local income or earnings tax, when an income tax is already imposed on the State and Federal levels, should contain clear definitions of taxable income and a specific formula for allocation of income from sources inside and outside the taxing jurisdiction.

3. The Citizens League reiterates its support for a metropolitan area non-property tax capable of producing a substantial amount of revenue for the purpose of reducing or preventing a further increase in property taxes. We specifically recommend broadening the City Council's earnings tax proposal to include the following principal features, and would support the proposal as so changed:

(a) Imposition on a Metropolitan Basis -- by giving the metropolitan counties the option to levy the tax, with the net proceeds being returned to the place of residence of the taxpayer if the residence is in a county levying the tax. This very likely would result in most or all of the counties in the metropolitan area levying the tax.

(b) Consideration of Revenue Needs of Other Taxing Units -- by distributing net proceeds to the taxing units within the counties of residence according to a formula which would take account of the needs of more of the local taxing units.

(c) Clear Definition of Taxing Liability -- by drafting the legislation to provide sufficient detail so that those affected can fairly determine the tax's likely impact on them.

4. If, despite the urgency of the need, there is not favorable action at this session of the Minnesota State Legislature on a metropolitan area non-property tax to relieve the overdependence on the property tax, we consider it imperative that every possible effort be made to secure general agreement on a broadly-based source of income for the metropolitan area prior to the convening of the 1963 session of the Legislature. As a means of carrying out this objective we recommend either or both of the following:

(a) Establishment by the 1961 session of the State Legislature of an interim commission to review the tax situation in the Twin Cities Metropolitan Area and to report its findings and recommendations to the 1963 session.

(b) Formation of a Twin Cities Metropolitan Area Citizens Tax Study Committee with membership representing the various geographic and economic interests in the area, whose purpose would be to recommend ways of bringing about a more equitable tax structure for financing local government. We suggest the Twin Cities Metropolitan Planning Commission as the appointing authority for this citizens commission.

5. The League calls attention to the fact that a high degree of resistance to increases in the property tax exists in the community, and expresses the opinion that the probable result of failure to adopt a substantial non-property tax source at this session of the Legislature may be the failure to provide necessary funds for essential city services in the coming biennium.

MAJOR FEATURES OF THE CITY COUNCIL'S TWO TAX PROPOSALS

The City Council's two legislative proposals call for "an act authorizing the City of Minneapolis to impose a tax on earnings and profits by adopting an ordinance providing therefor and providing for the collection thereof." The proposed taxes are popularly being called an income tax and an earnings tax and will be referred to as such in this report. The only significant difference between the two is that the income tax provides personal exemptions.

The main features of the proposed enabling acts are:

1. Use of proceeds: The yield is to be used for general purposes of the Council and with not less than 75% of the net to go for property tax reduction.

2. Tax base: The tax is on earnings from:

   a. Salaries, wages, commissions, and other compensations earned by Minneapolis residents.

   b. Similar earnings of non-residents for work done or services performed in the City.

   c. The net profits of associations, business or other activities conducted by residents. "Net profits" are not defined and could mean all income after deducting cost of goods sold.

   d. Similar profits earned in the City by non-residents.

   e. The net profits earned by all corporations as the result of work done, services performed, or activities conducted in the City.

3. Maximum rate: $1\frac{1}{2}$% for income tax, 1% for earnings tax.

4. Special exemptions: These include income from pensions, insurance payments, dividends and interest, unemployment compensation, workmen's compensation, and public assistance grants.

5. General taxpayer's exemptions: For income tax: $600 per taxpayer or dependent, with a maximum of $2,400 per family. For earnings tax: no personal exemptions.

6. Property tax reduction: Not less than 75% of net proceeds, after deducting administrative expenses, would be used to reduce the tax levy on real and personal property.

7. Reciprocity: If any other municipality in Minnesota taxed earnings of Minneapolis residents in that municipality, the tax paid by the Minneapolis resident would be credited against the tax due Minneapolis. However, non-residents owing a tax to Minneapolis would not be granted a credit for their Minneapolis tax in their own community, nor would they be allowed a credit on their Minneapolis tax due for the tax paid to their own community.

8. State income tax credit: Income tax paid to Minneapolis would be allowable as a deduction in determining income subject to State tax.

9. Taxable net profits: To be determined by subtracting "cost of doing business", which is not defined in the bill.

10. Formula for allocation of income: Ordinance would prescribe the formula for allocating portion of individual and business income allocable to Minneapolis in the case of non-resident individuals and businesses doing business within and without the City.

11. Income information: The City would have access to records of State income tax division and state department of social security*, subject to keeping such information confidential. It is not required that returns made to the City be confidential.

12. Referendum: At the next City general election, occuring more than two years after the effective date of any ordinance enacted under the act, the issue of continuing the tax would be submitted to the voters. Approval of a majority of the voters voting on the issue would be required for continuing the tax. If a majority was not received, the tax would be discontinued on the following December 31.

SUMMARY AND CONCLUSIONS ON CITY COUNCIL'S INCOME AND EARNINGS TAX PROPOSALS

1. City Council's Need For Additional Revenue.

(a) 1961 Budget Outlook Shows Little or No Need For New Revenue: Latest estimates indicate that the City Council's general fund (Current Expense Fund) will not be nearly as pressed for additional revenue in 1961 as the Council estimated during the budget time. The Council probably will be able to operate in 1961 at or near the level contemplated by the original 1960 budget.

(b) Longer Range Needs' Unsettled: There does appear to be a need for additional funds to increase services above the planned 1960 level, specifically for police, fire, street lighting, and garbage collection functions. The Council estimated in September 1960 that about $1,200,000 would be needed to expand the services specified. Whether this much is needed will depend on the soundness of the Council's current estimates and its decisions on wages. Other expansions may be necessary, but the public is entitled to further documentation of such need.

2. Estimated Yield of Taxes:

(a) Income Tax. The Council estimates its proposed income tax would yield $16,000,000 each year at the maximum rate of 1½%. Of this about $3,800,000 would be available to the City Council each year for new spending. Administrative costs are estimated by the City at $300,000 to $800,000, or 2% to 5% of the estimated yield.

(b) Earnings Tax. The Council's proposed earnings tax is estimated to yield $12,000,000 at the 1% maximum rate. Of this about $2,900,000 would be available to the City Council each year for new spending. Administrative costs are estimated by the City at $375,000.

3. Property Tax Reduction: The proposed allocation of 75% of the net proceeds of the taxes to property tax reduction lacks legal "teeth" to compel an actual reduction in the property tax, because it does not require a reduction in legal mill rate maximums nor in assessed value. Assuming that the City Council as a matter of

* (sic)

policy would desire to grant such reduction in property tax, at present rates and valuations this 75% reduction could produce from the 1½% income tax a decrease in property tax levy of about $11,600,000 or 28.5 mills per dollar of taxable valuation - about a 15% reduction; and from the 1% earnings tax a property tax decrease of about $8,725,000, or 21.5 mills - about a 11% reduction.

4. Relief for the Over-Used Property Tax. Whether or not the Council's proposals effected an actual reduction in property tax, it is likely that they would effect relief for the tax. This is because the availability of substantial additional revenue would offset the continued pressure on the property tax from expenditures needs. Recent experience shows that unless this pressure is offset by other revenues, there will be a steady, mill-by-mill increase in the use of the property tax.

5. Effect on Residential Property Owners: At the maximum rate and with the exemptions suggested by the Council a reduction of the property tax would give some tax relief to low income home owners living on pensions and investment earnings, and to employed homeowners in the lowest income groups. It would increase the net tax obligation of non-residents employed in Minneapolis and of the bulk of resident home owners who receive earned income.

6. Effect on Business Property Owners: In general, the language of the tax measures are too broad and vague with respect to the taxation of business income to enable a projection of their net effect on commercial and industrial property, even taking into account some possible reduction in property tax.

7. Inequitable Burden of Property Tax: The proposed reduction in the property tax levy does not basically affect existing inequities within the property tax structure, since these are caused chiefly by inequities in assessment practices.

8. Elements of a good tax: The proposed income and earnings taxes would have a good yield, and would be broadly-based. They would be relatively flexible and could be simple to administer, although other non-property tax alternatives recently discussed (local supplement to a state income tax or sales tax,garbage collection fee), are cheaper to administer. The administrative cost of the Minneapolis income or earnings tax would be considerably greater than the cost of increasing the property tax to raise the equivalent amount. However, against this must be weighed the possible benefits from reduction in the property tax.

9. Taxing Non-Residents; Not A Metropolitan Area Proposal: It is questionable, at the least, whether Minneapolis should have the right to tax non-residents to the extent proposed in these tax measures. On the other hand, exemption of non-residents, in a tax applying only to Minneapolis, would tend to encourage an exodus from the City. This effect might be avoided by having the tax levied on a county or multi-county basis, on all income earned within the county, with the receipts returned to the place of the taxpayer's residence; or by changing the Council's proposals to provide reciprocity for neighboring communities levying the tax on their residents, with the proceeds returned to the place of residence.

10. Popular Referendum: While the proposals have been generally publicized as requiring a popular referendum on their continuance or abandonment two years after enactment by Council ordinance, it appears that, in fact, under terms of the proposed legislation, the referendum could be as remote as almost four years after enactment.

11. Needs of Other Agencies within Minneapolis. The proposal is drawn in the light of the City Council's revenue needs, and not in the context of the total revenue needs of local governments in Minneapolis.

12. Tax Liability Is Not Clearly Defined. The City Council's proposals are drawn as enabling acts, leaving to later Council ordinance the definition of important terms in the determination of individual and business tax liability. For example, "net profits", "services performed", "necessary expenses of operation", "gross profits or earnings", are not defined. Also, capital gains from the sale of a residence or of investments may be taxed fully as "net profits of . . . other activities conducted by residents".