

March 31, 1981

STATEMENT ON BUDGET AND PROPERTY TAX ISSUES
FACING THE GOVERNOR AND LEGISLATURE IN 1981

Summary of Major Ideas

Process

1. The Governor and Legislature should see that steps are taken this year to avoid in 1983 and in subsequent legislative sessions the kind of "crisis" budgeting that is present this year.
2. The state is on a property tax relief rollercoaster. Property taxes on most homesteads have been declining rapidly. Unless the Governor and Legislature take corrective action, the rollercoaster ride will continue, with steep increases in property taxes in 1982, followed by pressure in 1983 for another round of reductions.

Substance

1. The uniform, mandatory statewide school mill rate should be increased as an alternative to non-uniform increases in city and county mill rates.
2. To avoid hidden property tax increases, the Legislature should stop reducing the valuation for taxpayers it wants to benefit. Instead, if the Legislature wants to help certain taxpayers, it should increase the valuation for all other taxpayers.
3. The Governor and Legislature should re-examine whether too much homestead credit is being given and whether the credit should be restructured so homeowners are more fully aware of the gross tax, before the credit is given.
4. If the Governor and Legislature were to allow units of government below the state level to impose general non-property taxes, they should make sure that within the Twin Cities metropolitan area such taxes would be allowed only if imposed on the entire seven-county area.

A. State Fiscal Crises Are Not Inevitable

The next several weeks are an extremely critical time for state and local government finance in Minnesota. The issues facing the Governor and the Legislature are intensely controversial and enormously complex. A great deal of work remains to be done before the state's budget for the two-year period beginning July 1, 1981 can be adopted. It is possible the Governor and Legislature will require a special session, after May 18, the constitutionally-prescribed limit for the end of the regular session.

The Governor and Legislature now are awaiting official revenue estimates from the Department of Finance -- expected by mid-April -- which are to be used as a basis for balancing the budget.

It is urgent that the Governor and Legislature commit themselves to a full, candid discussion of options and the possible consequences of different options. They need to think carefully about the following bienniums, not only the immediate upcoming biennium.

Nine years ago, following a legislative session during which far-reaching changes in state-local fiscal relationships were adopted, we urged several steps be taken to improve the ability of the Governor and the Legislature to (a) determine longer-term consequences of current policies, (b) analyze alternative courses, and (c) anticipate future problems. Those needs are every bit as urgent today, and that report's title, "State Fiscal Crises Are Not Inevitable," still is applicable. A major recommendation in that report, still not adopted, was that a Minnesota Governmental Policy Institute be established to identify and analyze long-term consequences of present actions.

B. The State Now is On a Property Tax Relief Rollercoaster

As we have examined the issues this year, it seems clear that many of the fiscal problems facing the Governor and the Legislature have their roots in property tax relief which was voted in previous sessions. In recent legislative sessions there was bipartisan support for the provision of extremely generous property tax relief, particularly for homeowners and farmers. These actions have produced a rollercoaster effect on the level of property taxes. Most homeowners in moderate and medium-priced homes have been enjoying large drops in their property tax statements over the last few years. These decreases have been in absolute dollars, even as the market values of their homes have been rising rapidly, and as the costs of local government services have been rising rapidly. Now, in 1981, these homeowners may find themselves at the bottom, and are facing steep increases in 1982 and beyond, unless there are significant cuts in spending. These steep increases may bring people back to levels where they were a few years ago, but they are likely to be just as abrupt in going up as the decreases were in going down.

Unless the Governor and Legislature take corrective action, it is likely that the rollercoaster ride will continue. Steep increases in property taxes in 1982 are likely to produce considerable pressure on the Legislature in 1983 to grant additional property tax relief, thereby bringing about another big swing downward.

The following graph shows the homestead property tax as a per cent of market value since 1968 for the community which was at the median in each of the Citizens League's annual surveys of homestead property taxes among metropolitan area communities over 2,500 population. The market value of a representative house in

Property tax relief usually is accomplished by shifting the burden to other types of taxes, not by cutting spending. Thus, a dollar of relief for the homestead property tax payer, for example, involves a dollar of higher burden for other taxpayers, either non-homestead property taxpayers or other types of taxpayers.

Traditionally, the main motivation for providing property tax relief has been to adjust for the fact that property taxes bear no relationship to an individual's income, meaning that lower income persons have been more heavily burdened. The Governor and Legislature have adopted one of the most ambitious circuit-breaker laws in the nation to attack this problem.

C. Proposals Which Could Help the Governor and Legislature in Property Tax Relief Issues

As we examined our existing positions and the problems facing the Governor and Legislature this year, we identified four areas where new ideas seemed helpful.

1. The uniform, mandatory statewide school mill rate should be increased as an alternative to non-uniform increases in city and county mill rates.

We have documented in previous years the wide differences in net property taxes on homesteads between the metropolitan area and outstate counties. These wide differences are readily apparent in the preliminary data for 1981 taxes now becoming available in the Department of Revenue. For example, for the first 30 outstate counties sending in their tax reports for this year, the figures reveal that almost two-thirds of all homeowners in those 30 counties, farm and urban combined, are paying less than \$253 in net property taxes in 1981 (after deducting the homestead credit, but not the circuit-breaker). By way of contrast, fewer than one-tenth of Ramsey County homeowners are paying less than \$253. At the other end of the scale, the figures reveal that two-thirds of Ramsey County homeowners are paying more than \$362, with only one-fifth of the 30 outstate counties' homeowners falling in this category.

DISTRIBUTION OF NET HOMESTEAD PROPERTY TAXES
1981

(After deducting homestead credit, but without deducting circuit-breaker credit.)

	<u>Less than \$145</u>	<u>\$145- 253</u>	<u>\$253- 362</u>	<u>\$362- 471</u>	<u>Over \$471</u>	<u>Total</u>
Minneapolis	1.5%	11.1%	26.5%	27.8%	33.2%	100.1%
Suburban Henn. County	1.4	3.6	15.1	28.9	51.0	100.0
Saint Paul	.1	9.5	34.1	31.0	25.1	99.8
Suburban Ramsey County	3.1	3.4	12.5	29.6	51.4	100.0
Carver County	3.3	12.2	20.7	20.7	43.1	100.0
Dakota County	2.4	11.5	29.4	25.0	31.7	100.0
30 non-metro counties*	37.4	25.7	16.8	7.8	12.3	100.0

* The 30 non-metropolitan counties are Aitkin, Big Stone, Brown, Clearwater, Cook, Douglas, Goodhue, Houston, Hubbard, Itasca, Jackson, Kittson, Koochiching, Lac Qui Parle, Lake of the Woods, Lincoln, Lyon, Mahnomen, Mower, Murray, Nicollet, Nobles, Otter Tail, Pennington, Pipestone, Redwood, Renville, Rice, Traverse and Waseca.

Source: County Finance Officers and Department of Revenue

It seems apparent that the Governor and Legislature will allow property taxes to rise in 1982. The question, therefore, is not so much whether, but where. If property taxes rise mainly in county governments and municipalities, this means that the increases in property taxes will be greatest where municipal and county costs are the highest, which is predominantly the metropolitan counties. Implicit in the Governor's budget is an assumption that county and municipal property taxes will make up for lack of state aid. If this occurs, it is likely that the differences in property taxes between metropolitan and outstate areas will increase in 1982, beyond the differences which exist today.

RECOMMENDATION: We recommend a different approach. The uniform, mandatory statewide school mill rate should be increased. This would enable property taxes to rise more uniformly statewide. It doesn't reduce differences which already exist, but it helps keep the differences from widening.

The uniform rate now is at 21 mills. A decade ago it was 30 mills. If the Legislature were to increase the rate, then schools would need less aid from the state general revenue fund. Thus it would be possible to take some of the money now earmarked for schools in the state budget and shift that to municipalities or counties to reduce the extent these units of government would have to increase property taxes.

This approach would make possible more state aid to cities and/or counties than was proposed in the Governor's budget in January, without increasing the total amount of the Governor's budget.

We are aware this idea could be misinterpreted. It has been widely assumed that it is unfair to use the property tax for schools, because the amount of money available for a child's education should not be dependent upon the property tax wealth of the local school district. What is unfair, however, is the use of the local tax base for schools, not the tax base of the entire state. Our proposal would treat all districts and students alike.

In no way would this proposal affect the amount of money which school districts would have to spend. They would receive the same amount, except that less would be coming from state aid and more from the uniform property tax.

We have previously recommended (in a 1978 report, Local Discipline Not State Prohibition) that the state itself levy the mandatory school mill rate with the revenues flowing directly into the general fund with sales and income taxes and other revenues. The effect on school finance would be the same, except school districts would receive all funds for essential operating expenses directly from the state.

Maintaining the present system constrains the extent to which the state can

rely on the uniform mill rate. Some school districts with very low enrollment and high property values receive no state aid because all of the revenues necessary are raised by the mandatory mill rate. School districts in this situation continue to urge the Legislature to reduce the mill rate so they can receive some state aid. As we noted above, if the state takes over the mill rate, then all districts would get aid from the state. The state has not levied a property tax directly since 1967.

2. To avoid hidden property tax increases, the Legislature should stop reducing the valuation for taxpayers it wants to benefit. Instead, if the Legislature wants to help certain taxpayers, it should increase the valuation for all other taxpayers.

Several legitimate concerns over the property tax burden are coming to the attention of the Governor and Legislature in 1981. One proposal is to grant a tax break to small town businesses. In recent years, small town businesses have assumed a larger share of the total burden as the Legislature has reduced the share paid by homeowners and farmers. Another proposal comes from apartment owners and tenants who feel they are asked to assume a disproportionate share of the total burden relative to owner-occupied dwellings. Moreover, within rental property, there is a wide difference in the method by which different kinds of rental property are taxed. A third proposal being evaluated is whether to "index" the homestead classifications. This would mean that, as property values rise, the per cent of a homestead which bears the lower classification amounts would not decrease.

Changing the classification of a piece of property does not reduce taxes, it shifts taxes. The classification system is a way of determining the relative proportion of the total property tax that will be shared by different kinds of property. It has nothing to do with how much taxes actually are levied.

In the last 10 years the Legislature has made several changes in the classification system. A major reason for these changes has been to compensate for the fact that the market values of some properties -- particularly homesteads and farms -- have been rising much faster than others. The Legislature has feared that by not taking action, too much of the tax burden would have shifted from commercial and industrial property to homes and farms.

Changing the classification system has been popular, too, because benefits can be given to some taxpayers without a state appropriation. Whenever the valuation of one type of property is reduced, other taxpayers end up paying proportionately more.

We are generally opposed to these changes. We believe that the Legislature should work to reduce the number of classifications. This has not happened. Last year, for example, we cautioned the Legislature against further reductions in the homestead classification (subsequently, the Legislature did reduce the homestead classifications), because of four major reasons:

First, we believe that changing the classification system is a crude approach to relief, because its impact is not felt the same from locality to locality, but depends upon the exact mix of property in each location.

Second, we believe that changing the classification system frequently produces instability in the overall distribution of the tax burden, which, in turn, could affect the development of the state's economy.

Third, particularly when homestead classifications are reduced, we believe that this could reduce some of the accountability which has been inherent in the property tax when a significant amount of the tax falls on homesteads. If the proportion which homesteads bear becomes very small, then the accountability element in the property tax will diminish, too.

Fourth, we believe that changes in the classification system tend to hide the impact of a shift in burden.

RECOMMENDATION: To assure more enlightened debate and to reduce the likelihood of frequent changes in classifications, the Legislature should refuse to lower the valuation of any class of property. If the Legislature decides certain property taxpayers are paying more than their share, the Legislature should increase valuation on other classes. Such an action would make the shift in burden explicit.

3. The Governor and Legislature should re-examine whether too much homestead credit is being given and whether the credit should be restructured so homeowners are more fully aware of the gross tax, before the credit is given.

Under the provisions of the homestead credit, the state now is committed to pay substantially more than one-half (58 per cent, to be exact) of homeowners' property taxes until a total of \$650 in relief has been granted to each homeowner. Until this maximum is reached, the state will be paying 58¢ out of every dollar of increase in the homestead property tax. There is a great distance yet to go before the maximum is reached for most homeowners in this state. For example, 37.4 per cent of homeowners in the 30 outstate counties first to send in their reports to the Department of Revenue this year are receiving less than \$200 in homestead credit. They have a long way to go before they receive \$650. At the other end of the scale, only 12.3 per cent of the homeowners in those counties are at the \$650 maximum. Even in parts of the metropolitan area, a clear majority of the people are below the \$650 maximum. In Minneapolis, two-thirds of the homeowners are below the maximum; in Saint Paul, three-fourths. When the homestead credit was first imposed, in 1967, the payment was 35 per cent of the non-debt portion of the tax, to a total of \$250. As recently as 1979, it was 45 per cent, to a maximum of \$325. The homestead credit is costing the state about \$600 million in the current biennium. The state could pay about \$900 million in homestead credit in the next biennium, according to the Governor's budget. Ultimately, the figure could reach \$1.3 billion, if and as every homestead in the state were paid the maximum \$650 credit.

The homestead credit is paid by the state directly to the local units of government. Therefore, the homeowner becomes responsible only for the remaining portion of the property tax bill.

RECOMMENDATION: The Governor and Legislature should re-examine whether too much homestead credit is being given and whether the credit should be restructured so homeowners are more fully aware of the gross tax, before the credit is given.

Last year, before the Governor and Legislature approved the latest increase in the homestead credit, we said that the evidence did not support further property tax relief. We also opposed provisions of the property tax which enable local officials to increase tax levies without the impact being felt by local taxpayers.

One question which needs to be re-examined is whether the state should share in

all types of property tax increases, irrespective of the purposes for which the increases occur or the size of the increases. For example, the state could provide that the homestead credit would not apply to that portion of an increase that is more than the state feels is warranted.

Another question is whether the homeowner should be made responsible for the entire amount of the property tax bill, with the state then paying the homeowner a refund in the amount of the homestead credit. This approach wouldn't increase property taxes, nor would it reduce the amount of state payment, but it would mean that the homeowner would be more sensitive to the level of the total bill than now might be the case.

4. If the Governor and Legislature were to allow units of government below the state level to impose general non-property taxes, they should make sure that within the Twin Cities metropolitan area such taxes would be allowed only if imposed on the entire seven-county area.

Some discussion has been under way in the 1981 Legislature over whether local non-property taxes should be allowed. For the last 10 years the Legislature has prohibited sales and income taxes from being levied at the sub-state level. Some persons are advocating that the prohibition be lifted. They argue that if state aids to local units of government are to be cut back, these local governments shouldn't be left only with the options of cutting spending or increasing property taxes.

RECOMMENDATION: The Legislature should not allow non-property taxes within the Twin Cities metropolitan area on less than a full seven-county basis, even though it might allow individual cities or counties to impose such taxes elsewhere in the state.

We have consistently opposed the use of metropolitan non-property taxes on less than an areawide basis. We have been opposed for two major reasons. First, from the standpoint of imposition of a tax within the metropolitan area, we oppose the creation of "islands" of tax and non-tax areas, because of the ease with which people can purchase goods or move their residences from place to place. Second, from a standpoint of distribution of the tax, we believe revenues should not just go to the place of collection, but should be related to the needs of units of government. Returning revenues to place of collection could mean that some communities would get bonanzas and other communities would be starved.

We have previously recommended a metropolitan sales tax with the revenues to be used to reduce property tax levies on regional services such as transit and parks. This would make it possible to grant a uniform reduction on property taxes throughout the metropolitan area, without getting into the complications of a statewide approach to property tax relief.

In the early years of its existence the Metropolitan Council provided some leadership on the issue of non-property revenues for local government in the metropolitan area. For example, in 1971, the Legislature adopted a formula for distribution of non-property revenues within the metropolitan area, as requested by the Council. That formula still is law, but no money ever has been made available for distribution.

As we have pointed out in previous statements, the Metropolitan Council needs to return to a position of leadership on metropolitan finance issues. For example, adoption of municipal-option non-property taxes could have severe impact on urban development in the Twin Cities metropolitan area. Will the Council remain silent if the Legislature begins to debate this issue? Might the Council have the capacity to design a proposal that would enable municipal-option taxes to be levied in the metropolitan area in such a way that avoids disparities in collection and distribution?

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This statement ~~was~~ prepared by the Tax and Finance Task Force of the Citizens League, which has been reviewing state budget-related issues since last fall. The Task Force previously issued two other statements on the budget.

Over the last 15 years we have paid close attention to the parts of the state budget which relate to property taxes. These invariably are the parts of the budget which deal with local government finance. In 1965, we issued a major report concerning property tax assessment reform. In 1967, we advocated a state sales tax, with a substantial portion of the revenues dedicated to local government. In 1971, we recommended a change in the property tax relief provisions which had been enacted four years before, plus substantial reform in the method by which state aid is distributed to schools and cities. In 1975 and 1978, we issued additional reports concerning **property tax classifications and state aid formulas. On several occasions we have submitted additional statements to the Legislature as follow-up to these major reports. Most recently, in March 1980, we cautioned the Legislature about proposals then under consideration to make further changes in the property tax.**