Citizens League Report

A First Class Property Tax System

public affairs
research and education
in the Minneapolis-Saint Paul
metropolitan area

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<u>A FIRST CLASS PROPERTY TAX SYSTEM</u>

Citizens League Property Tax Committee
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Approved by Citizens League Board of Directors
March 24, 1987

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INTRODUCTION

We challenge the 1987 Legislature to restructure Minnesota's state-local fiscal system. The urgency that the Legislature act, in this session, should not be obscured by debate over our recommendations or someone else's.

Today's system doesn't suffer from legislative inattention. Probably no topic has received more continuous legislative involvement over the last 20 years. In fact, some of today's problems might be attributed to too frequent legislative action.

The Legislature has had good objectives. It has concentrated on (a) keeping the overall level of the property tax reasonable, (b) giving local governments state aid in return for reduced property tax receipts, (c) adjusting for differences in income among property taxpayers, and (d) adjusting for differences in wealth among communities.

Other objectives need attention, too.

The Legislature needs to reduce vulnerability of the state-local fiscal system to a recession. The next recession could produce a shortfall of between $1.5 billion and $2.5 billion in the biennial state budget. In such an environment the state would have no way of honoring its "promises" of property tax relief.

Taxpayer confusion over how to hold state and local elected officials accountable for the property tax must end. If property taxes rise, whom does the voter hold accountable? The city council, which decides how much to spend? The Legislature, which decides how much property tax relief it will pay?

When changes are made, results should be predictable. From session to session the Legislature has made repeated changes in the property tax, so that the combination of credits, aids, refunds, and classifications is so mixed up that even persons who supposedly know how to unravel the system no longer are able to do so.

The time for change is right because money is tight. The Legislature must bring the system of escalating property tax relief payments under control if it is to balance the budget without further tax increases. If the state treasury were awash in money, it is unlikely the Legislature would even consider change. Instead it would be pressured to "buy" relief.

The time is right because the report of a prestigious state tax study commission lays out the rationale.

The time is right because the Governor has made an aggressive, comprehensive proposal for action, in this session.

The time is right because many groups are calling for change.

The time is right because the Legislature will be making major changes in state taxes, necessitated by federal tax reform.

Finally, the time is right because so many aspects of the current system cry out for change.

Does the property tax system have too many classes? Yes.

Does the system discriminate against rental housing? Yes.

Does the system give too much relief to some taxpayers who don't need the money? Yes.

Does the system give too much aid to cities based on what they received in the past instead of based on need? Yes.

Does the burden on comparable property vary more than the level of public services from one place to another? Yes.

Does the state budget suffer because too many dollars are distributed as open-ended entitlements instead of as fixed appropriations? Yes.

Does too much property escape taxation? Yes.

But agreement on problems doesn't guarantee action to correct them. Changes are immensely difficult -- regardless of their compelling logic -- because the Legislature can't hold everyone harmless. Such "grandfathers" are too expensive to support.

It can, however, make sure that shifts in burden are equitable and produce no extraordinary increase or decrease in any one year.

While change requires courage, the alternatives appear no easier. The existing property tax relief system constantly needs more money just like an addict needs more drugs. In the absence of reform, the state would have to increase state sales or income taxes to satisfy the existing system's demand.

Legislative debate probably will be more productive if legislators focus first on the policies behind proposed changes and refrain from "governance by printout." We have no doubt that computers can kick out rather quickly whatever analysis is desirable on an individual proposal, as they already have done with the Governor's and others' proposals, and as they might do with ours, too.

Every proposal for comprehensive reform lays itself open to analysis by printout. Printouts that illustrate the impact on individuals and government units are valuable research tools, but legislators ought to try to concentrate first on policy. We challenge the Legislature to postpone -- not throw out -- printout analysis. Start the debate at the policy level. Do the changes make sense? If so, how can they be brought about as fairly as possible to all taxpayers?

We expect our proposals might be every bit as controversial as those of the Governor, the Minnesota Tax Study Commission, and others. Our proposals represent our best thinking and we are confident that the state-local fiscal system would be vastly improved if they were adopted. But they are only proposals. They need to be analyzed carefully with all others. The end result will be measured not by whether our specific proposal or any others are enacted but by whether the Legislature accepts the responsibility to design its own comprehensive reform package, with whatever help it chooses to accept from outside proposals.

SUMMARY OF RECOMMENDATIONS

1. Eliminate the current multi-class assessment system and the property tax credit system while, simultaneously, taking other steps to preserve desirable differences in property tax burdens. These steps would establish:

- a new, targeted "resident refund" program that would provide the great majority of homeowners and renters with cash refunds on a portion of their property tax payments;
- a separate, targeted refund for farm operators; and
- a statewide property tax on commercial-industrial-utility property.

2. Enforce vigorously the equalization of property values.

3. Replace Local Government Aid (LGA) with two new programs of assistance to cities and counties. One program would distribute aid to cities based on need, without reference to spending levels. The other program would provide equalized property tax burdens among counties for income maintenance.

4. Eliminate levy limitations on cities and counties.

5. Broaden the property tax base to include currently exempt real property that the constitution does not prevent from being taxed.

6. Provide state assistance through limited appropriations, not open-ended entitlements.

7. Prepare tax records by separating land and improvement values so that the Legislature can make an informed analysis of the impacts of a site-value tax.

8. Provide a period of transition to the new system to avoid large decreases or increases in tax burden in any one year.

BACKGROUND ON THE PROPERTY TAX IN MINNESOTA

I. Introduction

A. Nature of the Fiscal System

The Minnesota Legislature is responsible for the entire state and local fiscal system. Local governments may levy local taxes only when granted this authority by the Legislature. The Legislature has allowed local units of government to levy property taxes and, except in special cases, retained other tax options exclusively for state use.

The system has evolved over time, beginning with the first separation of property into use classes for differential tax treatment in 1913. The sales tax was instituted in 1967 to pay for property tax relief and, subsequently, other features of the system evolved: removal of personal property from property taxation; the homestead credit; the circuit breaker refund for renters and senior homeowners. The Omnibus Tax Bill of 1971, which became known as the "Minnesota Miracle," instituted expanded state support for public education and aids for local jurisdictions. Later in the 1970s, the agricultural school credit was introduced, to replace an agricultural school mill differential, and adjustments were made to property classifications and credit programs.

Today, the State of Minnesota is strongly committed to providing relief for local property taxes and funding for locally provided services by substituting state-collected income and sales tax revenue for locally collected property taxes. As a consequence, Minnesota's rank among the states for net property tax collections per capita is relatively lower than for net income and sales tax collections. In 1985, Minnesota ranked 6th among all states and the District of Columbia in state and local total tax collections per capita, 4th in income taxes, and 20th in property tax.[1]

TABLE 1: MINNESOTA TAX PER CAPITA AND
RANK AMONG THE STATES AND DISTRICT OF COLUMBIA, FY 1985

	Collections Per Capita	Rank
State and Local Total Tax	$1,766.57	6
Property Tax	496.89	20
Individual Income Tax	532.67	4
Sales Tax	321.54	15
Corporate Income Tax	91.41	11

Source: Minnesota Taxpayers Association, HOW DOES MINNESOTA COMPARE?, Dec. 1986.

To manage the local fiscal system, the Legislature has structured a set of tax relief programs. These programs operate at both the state and local level and include four basic forms: classification, credits, aids, and targeted tax relief. Classification results in redistribution of property taxes locally. The other three approaches transfer state revenue for local uses and result in adjustment of net property tax obligations. For 1987, the credits, targeted tax relief in the circuit breaker, and aid in the Local Government Aid program will offer about $1.2 billion in state-raised revenue for local uses.[2]

B. Impact of Funding State Programs for Local Taxpayers and Local Governments

Transferring such large amounts of state money to the local level produces major consequences for both state and local budgets. At the state level, program funding may place extreme stress on the state budget when the economy next goes into recession; if the state reduces the funding on short notice, local budgets would also be in distress. These budgetary problems could arise because the state allocates a significant share of its budget to fund locally provided services. In some programs, the state's funding is committed before revenues can be forecast accurately. For some programs the amount drawn is not fixed but depends upon spending decisions at the local level. Therefore, the state budget is automatically subject to large and somewhat unpredictable draws even during periods when revenue from sales and income taxes is declining. This can produce unexpected shortages in the state budget, shortages that may be imposed abruptly upon local governments if the state is unable to meet its commitments.

At the local level, there is stimulus to increase local budgets resulting from the transfer of state funds. This is true regardless of the form in which the program funding is given, although some kinds of programs tend to be more stimulative than others. For credits, aids, and targeted tax relief, the potential dollar-for-dollar impact on demand is greatest with credits (a kind of matching grant) and least with targeted relief (a form of income supplement).

Credits are transfers of revenue from sales, income, and other state taxes to owners of some classes of property. With credits, owners may pay less than the total bill for extra taxes, because the state picks up part of the cost. In effect, the state matches local tax increases with additional state money under the limits set by the credit program. Because the price of extra public services is reduced, local taxpayers are likely to demand more of these services. Thus credits tend to increase the level of local services.

Aids are lump-sum transfers of state revenues to local jurisdictions to reduce property taxes on all classes of property or to increase local spending. Because the jurisdiction is better off after a transfer, there likely is an increase in demand for local services although the stimulus to demand is weaker than with the corresponding level of credits.

Targeted tax relief is provided in Minnesota primarily through the homeowners and renters "circuit breaker" that gives tax refunds to households with high property tax relative to their incomes. Because these refunds go directly to individual taxpayers, they stimulate little increase in local demand. Individuals may demand more public service, but they also increase their demand for private consumer goods.

Classification redistributes tax burdens locally and is a way of relieving the tax on some classes of property through higher tax burdens on other property. Because classification tends to reduce tax burdens on voters (households), classification may make it easier to raise revenue locally since non-voters (e.g., commercial and industrial property) bear a disproportionate share of the additional tax.

These arguments about the effects of different forms of government grants are consistent with economic studies [3] and with the findings of Bell and Bowman for the Minnesota Tax Study Commission [4]. In Minnesota, Local Government Aid stimulates demand, but less so than the stimulative effect of the Homestead Credit, according to the Bell and Bowman study.

II. The Classification System

The function of Minnesota's classification system is to redistribute the property tax burden among local taxpayers. Some classes are assessed relatively high rates while other classes face lower effective tax rates. This happens because some classes are taxed on a higher fraction of market value than others. Certain types of real and personal property are exempt, and all other classes bear the entire burden of the amount not paid by exempt property.

Real property, including both land and improvements, is separated into various classes according to the type of land use. There are several classes for homesteads (owner-occupied homes), several more classes for agricultural lands, for commercial uses and industrial uses, for various types of rental residences and resorts, and a separate class for vacant land. Each class is assessed at a different fraction of its value for tax purposes; for example, timberland is assessed at 19 percent of market value and vacant land is assessed at 40 percent. In each class, land and improvements are assessed at the same rate. The estimation of market value is performed by county assessors with little supervision by the state. The law requires that the assessment fractions be a percentage of the fair market value of land and improvements. Further, according to law assessors must use standard data and view each site once every four years.

Property classification formally began in 1913 when four classes of property were created, each class to be taxed at a different fraction of market value. These classes were iron ore, household goods, unplatted rural real estate and business personal property, and all other property including urban real estate. Additional classes have been created over the intervening years and some classes have been exempted. The most recent change in classification occurred in 1986 with the creation of a separate category for manufactured homes not classified under any other provisions.

The classification system is shown in Table 2, on the following pages. Sixty-eight classes of property are incorporated under major categories such as homestead residential, agricultural land, non-homestead housing, disabled households, recreational property, commercial, industrial public utility, and the like. Exempt property, in effect, is a separate, undesignated class that includes most personal property, churches, schools, public land in public use, and property of non-profit organizations. The "split" classes for homesteads, agriculture, commercial, industrial, and other properties are classes within classes; splits have the effect of taxing the first portion of property value at a rate lower than the tax on remaining portions.

TABLE 2: REAL PROPERTY CLASSIFICATION PERCENTAGES BY PROPERTY TYPE
TAXES PAYABLE 1986 AND 1987

	1986		1987	
DESCRIPTION	Class	Percent	Class	Percent
BLIND/PARA VET/DISABLED HSTD.	3CC		1B	
BASE: AMOUNT-PERCENTAGE		$32,000- 5%		$32,500- 5%
EXCESS - AG: AMOUNT-PERCENTAGE		$32,000 TO $64,000-14%		$32,500 TO $65,000-14%
		OVER $64,000-18%		OVER $65,000-18%
NON-AG: AMOUNT-PERCENTAGE		$32,000 TO $64,000-18%		$32,500 TO $65,000-18%
		OVER $64,000-29%		OVER $65,000-28%
AGRICULTURAL HOMESTEAD	3B		2A	
BASE: AMOUNT-PERCENTAGE		$64,000-14%		$65,000-14%
EXCESS: PERCENTAGE		18%		18%
AGRICULTURAL NON-HOMESTEAD	3	18%	2C	18%
TIMBERLAND	3E	18%	2B	18%
SEASONAL RECREATIONAL RESIDENTIAL	3		6A	
A. COMMERCIAL, UNDER 200 DAYS		21%		21%
B. NON-COMMERCIAL		21%		21%
NON-PROFIT COMMUNITY SERVICE ORIENTED ORGANIZATIONS	NONE	21%	6B	21%
COMMERCIAL SEASONAL RECREATIONAL RESIDENTIAL, UNDER 200 DAYS AND INCLUDES OWNER'S HOMESTEAD	3A	12%	1C	12%
RESIDENTIAL HOMESTEAD	3C		1A	
BASE: AMOUNT-PERCENTAGE		1ST $64,000 - 18%		1ST $65,000 - 18%
EXCESS: PERCENTAGE		29%		28%
RESIDENTIAL NON-HOMESTEAD	3D		4A	
A. APTS. WITH 4 OR MORE UNITS NOT TITLE II		34%		34%
B. APARTMENT LAND *		34%		34%
RESIDENTIAL NON-HOMESTEAD 3 OR LESS UNITS	3DD	28%	5A	28%
TYPE I & II APTS. (STRUCTURES)	NONE		5B	
A. FOUR OR LESS STORIES		34%		34%
B. FIVE OR MORE STORIES		25%		25%
TITLE II NATIONAL HOUSING (STRUCTURES)	NONE	20%	7A	20%

DESCRIPTION	1986		1987	
FARM HOME ADMINISTRATION (MUNICIPALITIES UNDER 10,000 POPULATION-STRUCTURES)	NONE	10%	7C	10%
:CTION 8 (STRUCTURES)	NONE	20%	7B	20%
NEIGHBORHOOD REAL ESTATE TRUST	NONE	20%	7D	20%
COMMERCIAL-INDUSTRIAL	Class	Percent	Class	Percent
LAND AND BUILDINGS				
BASE: AMOUNT-PERCENTAGE	4C	1ST $60,000-28%	3A	1ST $60,000-28%
EXCESS: PERCENTAGE	4A	43%		43%
EMPLOYMENT PROPERTY	4D		3B	
COMPETITIVE CITY OR ZONE		1ST $50,000-20%		1ST $50,000-20%
		21.5%		21.5%
BORDER CITY		1ST $60,000-28%		1ST $60,000-28%
		38.5%		38.5%
VACANT LAND	4B	40%	3C	40%
PUBLIC UTILITY				
LAND AND BUILDINGS				
BASE: AMOUNT-PERCENTAGE	4C	1ST $60,000-28%	3A	1ST $60,000-28%
EXCESS: PERCENTAGE	4A	43%		43%
MACHINERY	3	33 1/3%	4B	33 1/3%
UNMINED IRON ORE	1	50%	9A	50%
"LOW RECOVERY" IRON ORE	1A	30-48 1/2%	9B	30-48 1/2%
ALL PROPERTY NOT INCLUDED IN ANY OTHER CLASS	4A	43%	10	43%

'OBILE HOMES ARE CLASSIFIED AS PERSONAL PROPERTY BUT RECEIVE THE SAME CLASSIFICATION ,ERCENTAGES THAT WOULD APPLY IF THEY WERE CLASSIFIED AS REAL PROPERTY.

* APARTMENT LAND INCLUDES LAND OF CLASSES 5B, 7A, 7C, AND 7B.

PREPARED BY: LOCAL GOVERNMENT AIDS AND ANALYSIS DIVISION
MINNESOTA DEPARTMENT OF REVENUE
OCTOBER 8, 1986
11b

The classification system shifts property tax burdens at the local level from homesteads to commercial, industrial, and apartment property. This result is shown by comparing columns 1 and 2 of Table 3. Table 3 shows the change in distribution of tax resulting from assessment. Column 1 shows the distribution if all property were taxed on full market value, where full market value is the market value as estimated by assessors and adjusted for differences in accuracy of the estimates. Column 2 calculates the tax share that results after the classification system is in place. Both columns assume that no additional tax relief measures are in place.[5]

TABLE 3: PERCENTAGE DISTRIBUTION OF MARKET VALUE AND PROPERTY TAX BY CLASS OF PROPERTY, payable 1986

	(Column 1)	(Column 2)
CLASSIFICATION	Percent of Full Market Value*	Percent of Gross Tax
Residential	50.45 %	45.47 %
Farm	22.01	13.85
Commercial	11.28	17.84
Apartments	4.54	6.25
Industrial	4.19	6.93
Utility	1.68	2.42
Seasonal Rec. Res.	2.80	2.03
Vacant	0.99	1.71
Other	0.19	0.41
Seasonal Rec. Comm.	0.17	0.10
Timber	0.21	0.18
Total Real Property	98.50	97.18
Total Real & Personal	100.00	100.00

*Full market value is the market value of property as estimated by assessors and adjusted for differences in the accuracy of estimates. Sales ratios for different classes of property, the ratios of estimated market value in the class to actual market value as shown by sales, are used to make the adjustments.

Source: Developed by the Citizens League from data supplied by the Minnesota Department of Revenue.

III. Credits for Direct Relief to Owners of Classes of Property

The credit programs involve transferring state funds, raised primarily through the general sales and income taxes, to local units of government to reduce the tax bill for owners of specific classes of properties. Credits come into play after the local levy is determined and assessed against local property. The ten credit programs provide direct tax relief to all owners of a class of property. These programs include the Homestead Credit, School Agricultural Credit, Taconite Homestead Credit, Native Prairie Credit, Wetlands Credit, Power Line Credit, Agricultural Preserves Credit, Disaster Credit, Enterprise Zone Credit, and Supplementary Homestead Credit. For taxes payable 1987 these programs are estimated to provide $727 million in tax relief. [6]

The Homestead Credit was first instituted in 1967; it offered 35 percent tax relief up to $250 on homesteads and it covered the first 80 acres of homestead farm property. The credit for 1986 provides direct reduction of tax for homesteads and all homestead farm land equal to 54 percent of the property tax bill up to a $700 maximum. Only the tax on the first $68,000 of home value is eligible.

The other major credit is the State Agricultural School Credit, begun in 1972. For 1986 the credit provides 36 percent tax reduction of the first 320 acres of homesteaded farmland (excluding the home, garage, and one acre), 26 percent on remaining homestead and all non-homesteaded farmland, and 15 percent reduction on recreational cabins. There is no limit on the credit for farms; cabins have a maximum of $100.

After credits, Minnesota's effective taxes on homes and farms are at or below the national average. Minnesota's effective tax on FHA-financed homesteads in 1984 was 0.99 percent, below the national average of 1.23 percent. Minnesota ranks 19th among the states, at 0.75 percent, in effective tax on farm property and 30th among the states for farm property taxes as a percent of total farm production expenses. [7]

There are few credits for commercial, industrial, or rental residential property and, generally, the classification system does not favor these properties. As a result, the share of the property tax assessed on these properties is about 50 percent higher than their respective shares of market value, as shown in Table 3. Also the overall effective tax rate on commercial and industrial property is greater in Minnesota than in the neighboring states of North Dakota, South Dakota, Iowa, Wisconsin, and Nebraska. [8]

However, because Minnesota no longer taxes the personal property of business, Minnesota's property tax on manufacturing is about average as compared to 16 selected states. The tax on other industrial, on commercial, and on rental residential appears to be higher in Minnesota than in the other states.

Minnesota places 11th among 16 selected states in effective property tax on paper products and machinery manufacturing, 10th among the 16 in effective tax on fabricated metals and scientific instruments, and 6th of 16 in tax on food manufacturing and processing and on printing and publishing. The 15 other states are Alabama, California, Georgia, Illinois, Indiana, Iowa, Louisiana, Michigan, Mississippi, New York, North Carolina, Ohio, Tennessee, Texas, and Wisconsin. These results are contained in a study by the Wisconsin Department of Revenue. [9] A study by the Minnesota Senate Research Office produced similar results in comparing the tax in major Minnesota cities to other major cities. [10]

However, Minnesota's effective tax on non-manufacturing industries and commercial property appears to be above the median of other states. Minnesota is number one among the fifty states in property taxes per square foot on new construction of office buildings, according to the Minnesota Chamber of Commerce and Industry. The Minnesota Chamber also reports that Minneapolis ranked first, and St. Paul fifth, among 31 large cities around the nation in real estate tax on downtown buildings expressed as a percent of rental income per square foot. [11]

For businesses that have relatively little personal property, Minnesota's effective tax on the value of real-plus-personal business property is probably higher than in the other 15 selected states. This happens because Minnesota has a relatively high tax rate on real business property. Iowa, Illinois, and Minnesota each tax only real property. The effective tax per $1000 of market value is $24.67 in Iowa, $25.23 in Illinois, and $21.999 for the first $60,000 of market value in Minnesota with $33.78 on remaining value. Therefore, Minnesota taxes are higher than these states for higher valued business real estate. Ohio, Indiana, Michigan, and Wisconsin tax some or all personal property of business as well as real estate. The effective tax per $1000 is $14.685 in Ohio, $21.546 in Indiana, $21.71 in Wisconsin, and $26.83 in Michigan. Minnesota's tax rate on real property is higher than the rates in each of these states except for Michigan. These data come from the Wisconsin Department of Revenue study. [12]

The tax on rental residences is high in Minnesota. The effective tax rate on apartments is nearly twice as high as the overall effective tax rate on taxable property in Minnesota. And in a survey of 137 U.S. cities, those in Minnesota ranked highest in median taxes per square foot of apartments, according to the Institute of Real Estate Management. [13]

The net tax collected from rental residential property in Minnesota is considerably higher than the tax on similar owner-occupied residential property. For example, if two families each have $25,000 income and live in identical $50,000 homes in a community with a 110 mill tax rate, the tax bill on the rental property after all relief is paid is $836. The tax bill on the homestead after all relief is $455.

It is not clear who ultimately pays the tax on residential rental property and commercial and industrial properties. Part of the tax on rental units is passed to tenants as higher rents; if the market for rental housing is very tight, more of this tax is passed on. Similarly, the tax on commercial and industrial property is wholly or partly borne by consumers as higher prices. If demand for the product depends relatively little on the price charged, then a great deal of the commercial or industrial property tax will be borne by consumers. If taxes cannot be passed on to tenants and customers, then this could reduce market price when the property is next sold.

IV. Aids to Local Governments

Several major state programs provide funding for services that are locally administered and receive some support from local revenues. Mill rates on all property are lower because of state aid. The major programs sponsored in this way are Local Government Aid (LGA), school foundation aid, highway aid, and welfare aid. The amount of money transferred from the state level for all programs for 1986 was $2.15 billion, about the same amount as all net property taxes levied. 14

The 1971 Legislature created the LGA program to distribute general-purpose, lump-sum aid to local governments. For 1986, LGA totaled $288 million with 95 percent going to cities and townships and 5 percent to counties. 15

LGA was intended to serve two different yet complementary purposes: to keep local mill rates low by substituting state funds for a portion of potential local property tax revenues, and to reduce disparities among jurisdictions with regard to tax capacity. The state imposes levy limitations to attempt to guarantee that LGA will reduce local taxes rather than stimulate local spending. In this way, levy limits potentially protect the state/local tax system against greater taxation through regressive property tax and ensure more taxation through progressive income taxes. However, levies can exceed the limitations if approved by local voters and special levies can substitute for general levies; these along with other features lead analysts to believe that levy limits are not strongly binding. 16

Also, LGA has achieved only a modest degree of equalization among cities because the aid amount goes first to grandfather-in assistance levels that can date back to the circumstances in 1967 that were used to determine the original LGA allotments. Therefore, most of the aid is distributed independent of tax capacity of the jurisdiction.

The School Foundation Aid program is equalizing in that all school districts must levy the same mills, with the state funding the difference between the amount raised locally and the guaranteed amount. For 1986/87, all school districts levy 23.2 mills and are guaranteed the same foundation funding of $1,690 per pupil unit. School districts with little tax base per pupil unit receive a relatively high proportion of aid. A few school districts with large tax bases per pupil unit raise the entire foundation amount with the prescribed levy; these districts are said to be "off the formula."

School districts also can levy additional amounts and receive some equalizing assistance from the state. Several tiers of additional levy per pupil unit are permitted by the state and these receive equalizing assistance, although the percentage of assistance declines as the levies move through the tiers.

Beyond the allowable tiers, school districts can raise additional funds per pupil unit only if voters approve local referenda. Wealthier school districts are much more likely to have such referenda approved and these districts raise significantly more money than poorer districts. As of 1986, of the 50 school districts with the most property valuation per pupil unit, 88 percent had adopted referendum levies, with an average yield of $614 per pupil unit, according to the Minnesota Department of Education. By contrast, of the 54 districts with the least property value, only 11 percent have referendum levies, with the yield only $82 per pupil unit. 17

While state and federal money pays most of the cost of income maintenance welfare programs, counties must also bear part of the costs in Minnesota and counties raise these funds by levying property taxes. These county levies totaled $181 million in 1986 and were allocated for medical assistance, aid to families with dependent children, and general assistance programs. Differences by location in the concentration of individuals who receive welfare produces a wide variation in the relative burden on counties for their share of income maintenance programs. St. Louis County has the highest mill rate for program costs and the administration of income maintenance programs, 23.7 mills; the average mill rate for counties in the metropolitan area is almost identical to the statewide average of 6 mills. 18

V. Targeted Property Tax Relief

Two programs target tax relief to individual taxpayers, rather than to classes of property owners. These are the property tax refund program, referred to as the circuit breaker, that provided an estimated $162 million in relief to homeowners and renters in 1986, and the special property tax refund. 19

The phrase "circuit breaker" indicates a program of property tax relief that is triggered when property taxes become too large a portion of income. When that point is reached, the tax refund program kicks-in to break the circuit and prevent property tax overload on the taxpayer.

Minnesota's circuit breaker was created in 1967, offering aid to renters and senior citizen homeowners. Other homeowners were added to the program in 1975. The program really offers an income supplement to eligible applicants; the amount of the supplement is based on the relationship between actual property tax paid and total household income. Although both low and middle income households are eligible for the circuit breaker, less relief is offered to households with higher income and none to households with income over $40,000. When two households have the same income, the circuit breaker tends to give more tax relief to the household with more property wealth because more relief is offered to households with higher taxes.

GOALS FOR A PROPERTY TAX SYSTEM

The property tax is an appropriate local revenue source. It is well suited as a local tax because real estate is relatively immobile. In contrast, a local tax on sales or income can simply result in buyers going elsewhere or income earners living elsewhere, leaving the local government with services to provide but no stable source of revenue. Also property tax revenue pays for local services that benefit the property. And a tax on property is appropriate because it reaches a form of wealth that is not taxed under sales or income taxes, the other major revenue sources.

We have identified six goals for a property tax system.

1. THE PROPERTY TAX SHOULD BE USED TO PROVIDE THOSE LOCAL SERVICES IN WHICH THERE IS NO STATEWIDE INTEREST. These are local services for which the local government principally controls the level of service. The Committee seeks to preserve and increase the use of the property tax to fund local services in order to strengthen the relationship between local citizens and local public officials.

2. THE LOCAL PROPERTY TAX SHOULD BE SECONDARY TO STATE FUNDING FOR SERVICES WITH STATEWIDE EFFECTS EVEN THOUGH THEY ARE LOCALLY PROVIDED. The state should bear a share of the burden for financing fundamental levels of services that have statewide effects and are locally provided, such as primary and secondary education and welfare. The state share of the burden should reflect the share of benefits received on a statewide basis from the service.

3. THE PROPERTY TAX SHOULD BE VISIBLE AND UNDERSTANDABLE. The property tax system should be structured so that it is understandable and so that any change in the distribution of tax burden is visible to all.

4. THE PROPERTY TAX SHOULD BE USED SPARINGLY AS AN INSTRUMENT OF SOCIAL POLICY. Taxation in any form is inherently an implement of social policy. However, concentrating many policy objectives into the property tax system can dilute the effectiveness of the tax in its primary purpose of revenue raising. Rather, expenditure policy should be the primary tool for achieving social policy objectives.

5. THE PROPERTY TAX SYSTEM SHOULD TARGET TAX RELIEF TO INDIVIDUALS RATHER THAN TO CLASSES OF PROPERTY. Property tax relief can improve equity by reducing relative tax burdens for less well-off taxpayers and by according comparable tax treatment to similarly situated taxpayers. When property tax relief is needed to achieve equity, it should be targeted to individual taxpayers.

6. THE PROPERTY TAX SHOULD CONTRIBUTE TO OVERALL PROGRESSIVITY OF THE STATE/LOCAL TAX SYSTEM. The sales, income, and property taxes should <u>each</u> be structured so that, when taken jointly, taxpayers with greater ability-to-pay bear a greater share of the total tax burden.

FINDINGS AND CONCLUSIONS

I. FINDINGS AND CONCLUSION ON RESTRUCTURING THE OVERALL PROPERTY TAX SYSTEM

A. Findings:

Widespread concern is present today over the Minnesota property tax. -- In 1984, the Governor appointed a prestigious commission, the Minnesota Tax Study Commission, to review and evaluate Minnesota's state/local tax system. That commission recommended sweeping changes in the property tax as it is implemented in Minnesota. The Governor also recommended major changes in the property tax system. Other thoughtful and influential groups in the state have recommended broad-based restructuring of the property tax system.

Concern exists even though the property tax has been subject to continuous evaluation and modification for 20 years. -- Since 1967 the Legislature has sought to create a tax system that is both equitable and acceptable to taxpayers. The result is an interconnected approach to property taxation that includes

* multiple classes of property, each taxed at a different fraction of market value,
* a program of general aid to cities, townships, and counties and corresponding local levy limitations,
* a series of credits, paid to owners of various classes of property, and
* targeted tax-relief to eligible homeowners and renters.

In seeking the best system, the Legislature has adjusted the multiple features of the property tax many times. Each adjustment has led to further adjustments because the complex consequences are hard to forecast.

Concern also is present because the programs that transfer state funds to support local services pose a risk to the viability of the state/local fiscal system. -- For some programs like the homestead credit, the amount of state expenditure depends on local spending decisions. In other programs the state commits to expenditures for the next biennium, before revenue and other expenditures can be accurately forecast. Given these arrangements, both state and local governments can face abrupt, disruptive budgetary constraints if the economy goes into a downturn.

B. Conclusion:

Improvement through incremental change no longer seems effective; overhaul of the property tax system is needed. -- In the spirit of the tax restructuring efforts of 1967 and 1971, the Legislature again needs to make a bold effort to redesign the property tax system. Such a system can enhance the features of state responsibility, state support of education and welfare, and state commitment to citizens with less ability-to-pay. At the same time the tax system can be more visible and understandable to taxpayers and strengthen the relationship between local taxpayers and local spending decisions. By offering funding through fixed dollar appropriations rather than open-ended appropriations, the new system can reduce the vulnerability of the state to abrupt adjustments caused by unpredictable changes in the economy; this decreases the likelihood of correspondingly abrupt reductions in state funding for local programs.

Complexity makes the current system hard to work with (a) for legislators, who can't make changes in one part of the system without unexpected or undesired results elsewhere in the system, (b) for taxpayers, who can't understand the system and, consequently, don't know whom to hold accountable for their property taxes, and (c) for public officials who administer the system, because of innumerable complex adjustments they must make. Additional adjustments to the current property tax system, rather than overhauling it, can only add to the problems already present.

II. FINDINGS AND CONCLUSIONS ON THE LEVEL OF THE PROPERTY TAX

A. Findings:

The Legislature has been committed to working down the level of the property tax. -- The state's reliance on the property tax has been reduced significantly from 20 years ago. Property taxes were 6.0 percent of personal income in Minnesota in 1967 as compared to 3.1 percent for personal and corporate income taxes. By 1982 the situation was reversed, with 3.2 percent of personal income devoted to the property tax and 6.3 percent to income taxes. The property tax accounted for 49.6 percent of state-local tax collections in 1967. By 1984 the property tax share was down to 27.3 percent of those collections. 20

In 1983 the Legislative Auditor concluded that "Minnesota's property taxes are at an historically low level even after a sizeable upturn in 1982. Taxes on homesteaded property are especially low when compared to the past or in comparison to other states. Minnesota's property tax relief programs have succeeded to a degree perhaps not widely appreciated." 21

The concern today over property taxes does not feature a homeowners' revolt. -- There is no evidence of a revolt among homeowners such as helped stimulate legislative action in 1967.

The property tax is light on homeowners compared to other states and other classes of property. -- The tax amounts, on average, to slightly more than 1 percent of the value of the house. However, effective tax rates are higher on higher-valued homesteads and lower on lower-valued homes because of the split classification for homesteads and because lower-valued homes get relatively more tax relief.

Property taxes are low on farmland, averaging well under 1 percent on homesteaded farms. -- However, the declining value of farmland has created some concern that the effective tax rate may have to rise in order to provide a stable level of public services in rural areas. Agricultural assessed values declined about 25 percent between 1983 and 1985; under current tax programs this decline could result in a net tax increases on other property if current spending levels are maintained. The most serious problems will occur in school districts and counties and tax increases for non-agriculture owners could translate into about

$40 per capita. These data are developed by Tom Stinson, Agricultural Economist, in a study of declining value of farmland in Minnesota and neighboring states. [22]

The effective property tax rates on residential and farm property are lower than corresponding rates on commercial, apartment, and industrial property. -- For taxes payable in 1986, the effective tax rate on full market value (i.e., estimated market value corrected for the degree of assessment accuracy) of residential property was 1.33 percent, for farm property it was 0.85 percent, for apartments 3.24 percent, for commercial 3.72 percent, and for industrial 3.89 percent. [23] Also, the tax rates on the latter three categories for 1981 were higher relative to the rates on farms and residences than they were in 1974. In 1986, the gap remained greater than in 1974 but less than in 1981. It is not known exactly who bears the ultimate burden of commercial, industrial, and apartment property taxes since some of the tax is passed on to customers and tenants.

B. Conclusions:

As the Legislature restructures the property tax, there is no immediate urgency to work down the overall level of the property tax. -- Especially for homesteads and farms, the current level of Minnesota property taxes is one of the striking features of the tax system.

However, the restructured program might have to attend to tax relief for agricultural areas if the effective property tax rate on farmland is not going to rise appreciably in the future as the value of farmland falls.

And a restructured system should reduce the growing gap between homes and farmland, on the one hand, and commercial and industrial property on the other.

III. FINDINGS AND CONCLUSION ON PROGRESSIVITY.

A. Findings:

Several state programs reduce the regressivity of the property tax. -- A tax is regressive if lower-income taxpayers pay a larger fraction of their income than higher-income taxpayers; if the fraction paid by lower income taxpayers is smaller, then the tax is progressive.

If it is assumed that the burden of the residential property tax is paid by the property owner, then the regressivity of the property tax is reduced by state programs. However, it is difficult to tell who actually pays the residential property tax. Part of the tax on rental property can be passed forward to tenants and customers. For all classes of property, some of the tax may be passed backward to materials suppliers and builders. And the differences in property taxes between jurisdictions may be capitalized as differences in property values. To the extent that homeowners and renters do bear the property tax, the distribution of this tax burden is somewhat regressive on their incomes.

Federal and state deductibility of the property tax adds substantially to its regressivity, according to a study for the Tax Study Commission by Stinson and Vanderwall. However, this impact is more than offset by the combined effects of the classification system, the homestead credit, and the circuit-breaker. The net effect is that the distribution of the property tax on homeowners remains slightly regressive, but less so than if there were no state credit and refund programs. The measurement of "gressivity" is done using a number called the Gini coefficient. If this number is 0, the tax is proportionately distributed and all taxpayers pay the same percent of their income as tax. The largest possible Gini coefficient is 1, indicating that the highest income taxpayer pays all the tax; a positive number implies some degree of progressivity. A number of -1 indicates the lowest income taxpayer pays all the tax; any negative number implies some degree of regressivity. The Gini coefficient for the property tax is about -.20, indicating slight regressivity. 24

Sales, income, and property taxes, in combination, are about proportionately distributed on income in Minnesota. -- The slight regressivity of the property tax is matched by a comparable degree of regressivity in the sales tax. However, Minnesota's income tax is sufficiently progressive that, in total, the state system is just slightly better than a proportionate distribution. The Gini coefficient for Minnesota's three major taxes in 1984 is measured to be 0.04 to 0.08. 25

B. Conclusions:

State policy is sensitive to relieving the regressivity of the property tax and, in comprehensive reform, the Legislature should assure that the property tax does not become more regressive. -- Further efforts to make the property tax progressive by itself won't work very well, since much of the regressivity is driven by the deductibility of property taxes from income taxes. Indeed, state and federal income tax reforms will decrease the regressivity of the property tax by reducing the marginal amount that is deductible for higher income owners. Other efforts to make the property tax progressive usually assume a common level of ability to pay by owners of comparable property. But, in reality, incomes will vary even though properties have the same value. Consequently, relief based on property value gives some owners more relief than they need and others, not enough.

Progressivity can best be achieved in the cumulative state/local burden of property, sales, and income taxes on the taxpayer. -- Progressivity as it is used here relates to the distribution of the property tax on income, although the property tax is levied on property wealth. Thus there is a reasonable limit in how far to go in trying to make the property tax, per se, progressive.

IV. FINDINGS AND CONCLUSION ON COMPETITIVENESS

A. Findings:

The evidence is mixed regarding the impact of taxes on Minnesota's competitiveness as a location for business. -- For 1980, Minnesota's property taxes on business were 27.3 percent of total state and local taxes as compared to 31.4 percent for the U.S. as a whole and 27.1 percent on average for the seven plains states, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. 26

For 1985, Minnesota ranks 6th in state and local tax collections per capita and 5th in expenditures per capita. 27

Technical studies indicate that taxes negatively affect competitiveness while expenditures for education and other public services have a positive effect. 28 Taxes contribute to business costs and public services can reduce these costs, so that both tax and expenditures can play a role in location decisions. However, access to inputs (for example, labor and natural resources) and markets are the major determinants of location. If a state has taxes too high relative to the public service base it offers, businesses can have less incentive to locate there. Similarly, if a state has low taxes but offers too few beneficial services, this can deter business location.

One disdvantage of using unusually high taxes to support high levels of service is that the tax can "stick out like a sore thumb" in comparison to other states and perceptions, rather than real impacts, discourage new business locations. -- This argument is offered by John Shannon, Director, Advisory Commission on Intergovernmental Relations. 29 Over time Minnesota has been a high-tax, high-service state. High levels of public services continue to be in demand by business; for example, the Minnesota Business Partnership is working to reform K-12 education. However, business also has been concerned with the high level of individual income taxes. And income tax levels are strongly correlated to property tax policy, since state grants for property tax assistance account for almost half of the state income tax collections.

Recent evidence suggests that the property tax in Minnesota is not high on manufacturing property relative to other states. -- Personal property, as well as real estate, is taxed in many states but not taxed in Minnesota; therefore, businesses such as manufacturing which may have a good deal of personal property face a lower net property tax here. For businesses with relatively little personal property, the tax in Minnesota might be higher. 30

B. Conclusion:

New business location could be discouraged by taxes that are both significantly higher than taxes of other states and out-of-line for the level of public services provided. -- In Minnesota, taxes are high and the level of public service per capita also is high. While the state government does spend a significant share of its revenue on payments for local purposes, most of these payments are received at the local level and spent on public services there. In the absence of providing extensive public services, Minnesota's taxes would certainly detract on the margin from the state's ability to compete for new business. In restructuring the property tax system, the Legislature needs to focus carefully on the use of local revenue for local services and state revenue for services with statewide impacts. This will protect the balance between taxation and services that is necessary for competitiveness.

V. FINDING AND CONCLUSIONS ON THE RELATIONSHIP BETWEEN PROPERTY TAXES AND PUBLIC K-12 EDUCATION

A. Finding:

The Legislature has long held that all children deserve a comparable opportunity for public K-12 education, regardless of where they live in the state.

Public K-12 education is funded through a three phase, state/local approach.

* The first phase is the Foundation Levy: each district is required by the state to assess the same number of mills and is guaranteed by the state the same amount of revenue per pupil unit. This revenue will consist of the part actually raised by the uniform mill levy and the additional aid paid by the state to reach the foundation amount.

* The second phase is revenue raised through additional tiers of levies that are permitted by the state and are accompanied by declining amounts of equalized state assistance.

* The third phase of funding is raised through local levies that must be approved by local referenda. These levies are above the foundation and tier amounts and receive no equalizing aid. School districts with larger tax bases use these levies more often and to raise more revenue than other school districts.

B. Conclusions:

The foundation aid program is fair in that it offers equal foundation funding per pupil unit for equal property tax effort in all school districts. -- Given the uniform local levy of 23.2 mills, all districts are guaranteed the uniform foundation of $1690 per pupil unit for 1986/87.

Revenue raised above the foundation base is not equalized. -- In addition to revenue raised by the districts in the uniform mill levy, the state provides funding from sales and income tax revenues for the "equalized" portions of the foundation levy and the tiers. However, local districts must rely on referenda and revenue that is raised, unassisted, for any additional school funding. Better-off school districts raise this revenue more often and in larger amounts, suggesting that other districts have less opportunity to provide comparable educational opportunity.

VI. FINDING AND CONCLUSIONS ON THE RELATIONSHIP BETWEEN THE PROPERTY TAX AND INCOME MAINTENANCE PROGRAMS

A. Finding:

The Legislature has long held that public income maintenance programs benefit taxpayers statewide as well as those in the county that administers the state-mandated welfare services. -- For 1986 the state provided about $500 million to counties to fund locally administered programs of medical assistance, general assistance, AFDC, and Minnesota supplemental aid.

However, counties also raise revenue through the property tax to pay for programs and for the costs of administering the programs, and the tax burden is heavier in those counties with greater case loads and less property tax base. Counties offer the same level of income maintenance services, as directed by the state.

B. Conclusion:

Although the tax burden for welfare programs is largely a federal and state responsibility, the property tax burden of the counties can vary because of income maintenance programs and for reasons largely outside the control of local officials. -- Property taxes for state-mandated programs vary according to the size of the case load and the wealth of different counties even though county governments have no voice in determining eligibility or levels of payments. The result is that some counties pay very high mill rates for welfare and other counties pay very low rates.

VII. FINDINGS AND CONCLUSIONS ON FUNDING FOR LOCAL SERVICES

A. Findings:

Local city services and some county services have largely local benefits that do not significantly spill over to other residents of the state.

Some local governments have less ability to support local services for reasons largely beyond their control. -- This happens because one jurisdiction may have a low property value per capita than other jurisdictions.

B. Conclusions:

Services should be funded by the unit of government that represents the taxpayers benefited by the service. -- By raising revenue locally, taxpayers retain control and responsibility for the spending for public services.

Cities' property tax levies should vary if some cities want higher levels of services than others. But taxpayers should not be required to pay excessively high rates for comparable services for reasons outside their control. -- Paying for local city services is a local responsibility and the burden should fall to the local property tax. However, some localities are favored because they have large tax bases for reasons wholly outside their influence.

In jurisdictions with immobile populations, the level of taxation and expenditure may be higher than is demanded by many local taxpayers. -- In areas with a concentration of relatively immobile households, the tax burden may be unduly large. This circumstance may arise because of decline in the local economy, because of a concentration of elderly or minorities or persons who have restricted housing options, or simply because moving is expensive relative to paying the undesired extra taxes.

VIII. FINDINGS AND CONCLUSIONS ON THE CLASSIFICATION SYSTEM

The state currently uses four methods of reducing the burdens on different properties: the classification system, credits to classes of property owners, refunds to individual taxpayers, and aid to local governments.

A. Findings:

Classification has been a popular, long standing technique for redistributing the property tax burden locally. Classification started with a few classes but has experienced many and frequent changes. As a result, the impacts of the classification are now many:

* Classification shifts the tax burdens among classes of property. -- In a one class system, residential property would bear 50.45 percent of the gross property tax in Minnesota, agricultural 22.01 percent, apartments 4.54 percent, seasonal property 2.80 percent, and commercial/industrial 15.47 percent for payable 1986. These data are based on full market value of property, with adjustments as necessary for differences in assessment accuracy. Classification redistributes these burdens so that actual gross tax levies are 44.5 percent for residential, 16.6 percent agricultural, 6.0 percent apartment, 1.8 percent seasonal, and 30.8 percent commercial/industrial.

* The impact of the classification system on tax burdens varies, depending upon the mix of property in a community. -- If a community is made up predominantly of homes or farms, for example, a reduction in the homestead or farm classification won't appreciably reduce taxes on these properties because there is so little property to which the burden can be shifted.

* These shifts in tax burden are largely invisible. -- When the assessment fraction on a class of property is changed, it is very difficult, perhaps impossible, to tell how the impact will be distributed to other classes of property and across jurisdictions.

* The subsidies that result from classification require no direct appropriations. -- Burdens can be shifted without state appropriations because classifications do not increase or decrease property taxes in total. Instead burdens are shifted among classes of property.

* Split classification is really the creation of additional sub-classes of property where the separation is based on both property use and property value. -- Split classes allow the first portion of value of homesteads, agricultural land, commercial property, and industrial property to be taxed at a lower rate than remaining value in the property.

* The classification system in Minnesota does not distinguish between land and improvement values. -- Because the owner has less influence over the value of land than over the value of improvements on the land, a tax on structures may create disincentives to develop and maintain property. Two separate property taxes, one for land and one for improvements, has been in use in Pittsburgh for about fifty years and recently has been instituted in several other Pennsylvania cities.

* Exempt property is another class where the property is assessed at zero percent of market value. -- In Minnesota, "churches, houses of worship, and property solely used for educational purposes by academies, colleges, universities and seminaries of learning" are exempted in such a way that these properties cannot be taxed without a constitutional amendment. Exemptions that could be removed by legislative action include: hospitals, burying grounds, charitable institutions, other property owned by churches, public property exclusively used for any public purpose, real and personal property used primarily for abatement and control of pollution, native prairie land, and wetlands. 31 If hospitals, charitable institutions, and cemetaries had been included in the tax base for 1986, these properties would have paid taxes of $76 million which is now paid by other types of property. 32

B. Conclusions:

The property tax classification system has so many classes of property that any shifts of tax burdens are not visible or well understood. -- In contrast to a system with one or a few classes, the current system has many dozens of classes and it is impossible to tell how changes in taxation of any one class impact the net taxes of others.

A separate, lower classification for agricultural land is an attempt to treat all business property in a comparable fashion. -- This occurs because, in Minnesota, the personal property of capital-intensive businesses is not subject to the property tax; a relatively larger share of the property of land-intensive businesses, like agriculture, is subject to the property tax. In the absence of a lower classification, land-intensive business would bear a relatively higher tax.

Classification contributes to the differential tax treatment of similar properties in different jurisdictions and, therefore, can produce inequities. -- Two identically valued properties, eg. homesteads, face different tax rates in different jurisdictions for several reasons. One reason is that one community assesses relatively more tax in order to provide more services; in this case tax differentials are equitable. However, tax differences are inequitable when an identical home or farm pays more tax in one area than another because there is less commercial, industrial, or other property to bear the tax burden in the first jurisdiction.

Like other classes, split classes and exemptions result in shifts in tax burden that are not visible or well understood.

Taxation of land at a higher rate than improvements may reduce the interference of the property tax with private decisions about the use of land.

IX. FINDINGS AND CONCLUSIONS ON CREDITS TO CLASSES OF PROPERTY

A. Findings:

The Legislature has sought for 20 years to provide property tax relief to taxpayers who need relief. -- These taxpayers have been identified through classes of households and their relationship to land-use. For example, programs designed by the Legislature are directed to homeowners, renters, and farm households.

In an effort to assist those who need tax relief, the Legislature also has provided assistance to well-off taxpayers. -- The homestead credit and agricultural school credit are directed to all homeowners and farmers, regardless of ability-to-pay. Thus some property owners who cannot readily afford to bear taxes receive relief; other better-off owners also receive relief.

Because the $700 cap on the homestead credit results in abrupt tax increases as homeowners' taxes pass the $700 threshold, the Legislature is under constant pressure to increase the cap on the homestead credit. -- A $100 increase in taxes costs the homeowner who has not reached the $700 cap only $46, even less if the circuit breaker also is available. Beyond the cap, the increase in cost to the homeowner is the full $100, more than twice as much. The Legislature can prevent many homeowners from hitting the limit by frequent increases in the cap, and pressure to provide these increases arises in every legislative session.

If the Legislature passes an increase in the cap on the homestead credit, owners beyond the cap get the amount of the increase as a direct decrease in property tax obligations. -- For example, the cap was $650 for payable 1985 and $700 for payable 1986 taxes. Owners receiving the maximum for 1985 got the equivalent of a $50 free reduction in tax obligations for 1986. It's not just that their taxes fell by 54 percent on the margin; for these, owners taxes fell $50 for the last $50 of tax assessed.

The amount of state expenditure on the homestead and agricultural credits is determined in part by local tax levies and, therefore, state liability is hard to limit or predict. -- The credits are a kind of open-ended appropriation where state liability is determined a year or two after the credit expenditure is adopted.

The homestead credit and agricultural school credit reduce the marginal tax price of additional local services, in the manner of a matching grant. -- For each program, when local taxes rise, part of the additional tax bill of a class of property owners is matched by the state so that the "price" of extra spending for public services is reduced. Economists argue that matching grants stimulate the demand for public services so that more taxing and spending are brought about. 33

B. Conclusions:

Credits are a costly instrument for providing tax relief to less-well-off property owners. -- These owners do indeed get relief from credits so that the regressivity of the overall tax is reduced. However, better-off owners also get relief so that the system provides more relief overall than is necessary and is thus unduly costly to the state.

The Legislature has an incentive to increase the upper limit of the homestead credit frequently, so that homeowners do not experience abrupt and unpopular jumps in their marginal property taxes and because homeowners at the maximum credit receive a "free-ride" on their property tax bills. This contributes to the unpredictability of the cost of the homestead credit to the state budget.

Credits add to the unpredictability of the state budget because of the open-ended nature of the commitment to state spending.

Credits tend to loosen the link of responsibility between local property owners and their local officials. -- This happens because the "matching grant" feature of credits reduces the price of local services, stimulating spending above levels that would otherwise be provided.

X. FINDINGS AND CONCLUSIONS ON LOCAL GOVERNMENT AID

A. Findings:

The legislative intent for LGA was to allow local governments to fund local services without undue or inequitable local tax burdens. -- LGA was created by the Legislature to relieve the demand by cities for local option taxes and as part of a conscious strategy to hold down local property taxes.

LGA was designed to reduce local levies while allowing for the original level of local spending. -- However, lump-sum grants to local governments will both augment and substitute for local revenue sources. LGA, therefore, may contribute somewhat to increased spending on local services.

LGA is intended to equalize differences in local tax base. -- However, the degree of equalization that actually occurs is very small because most cities are grandfathered-in to funding levels that reflect conditions as far back as 1967. Thus, relatively little of the aid actually goes for equalization.

Levy limits reflect the acknowledgement of the Legislature that LGA can tend to increase local expenditures. -- The levy limitation for a city is figured by taking the Levy Limit Base (determined based on adjustments to the amount of local property tax revenue raised in 1971) and subtracting the amount of the LGA grant. The remaining sum is the amount of general purpose levy allowed to the city.

B. Conclusions:

As currently structured, the LGA program fails to meet its original goals of equalizing for tax base differences and substituting for local property tax collections.

Levy limitation has not been particularly effective in holding back the growth in local taxes. -- Because levy limits have often been amended, are binding on only part of local levies, apply only to some jurisdictions, and are frequently eased by local referenda, it is doubtful that they are a strong constraint on local tax/expenditure growth.

Levy limitation gets in the way of spotlighting the responsibility for local expenditures. -- Because levy limits exist, they can appear to strongly impact the extent of local spending. However, because the limits also are rather elastic, there is only an appearance of constraint and the appearance can interfere with a more visible examination of local expenditure patterns.

XI. FINDINGS AND CONCLUSIONS ON REFUNDS TO INDIVIDUAL TAXPAYERS

A. Findings:

A majority of Minnesotans have incomes that make them eligible to apply for the circuit breaker. -- The Legislature intended to offer circuit breaker relief on an ability-to-pay basis not only to "poor" taxpayers, but also to middle and upper-middle income taxpayers for whom the property tax bill is a large share of income.

The circuit breaker is targeted specifically to taxpayers with incomes below $40,000. -- Both renters and homeowners can receive this relief under the circuit breaker with a larger percentage of the tax bill paid for those with lower income.

The circuit breaker can give more assistance to those with higher home values. -- This happens, for example, if two taxpayers with equal income are assessed the same mill rate. Assuming that both receive a circuit breaker refund, the taxpayer with the higher valued home will get a bigger refund. This is true even when one owner has a $30,000 house and another has a $120,000 house.

The circuit breaker is more popular with recipients than with the Legislature. -- Recipients actually receive a check from the state, after paying the property tax bill, and can spend this check in any way they choose. Legislators feel that taxpayers make little connection between the check and the amount of the property tax paid months earlier; therefore, the state gets little credit for having provided tax relief.

There are numerous administrative problems involved in granting property tax relief to renters through the current circuit breaker formula. -- This is true because the program ties the refund payment to amount of property tax assessed against the unit occupied by the renter. But this tax is in fact assessed against the property owner and passed on, in part or in total, to all the renters who occupy the property during the tax year. Thus, the state is involved in a complex process of figuring out who paid how much rent on the property and how much tax is attributable to that property. The frequency of errors and/or abuse in this procedure is quite high. 34 As currently administered, the Department of Revenue estimates that errors in the refund program to renters results in about 10 percent overpayment.

2. Conclusions:

By targeting relief to individual, lower-income taxpayers, the circuit breaker conserves on scarce state resources and, at the same time, improves on equity by helping those who are less able to pay.

The circuit breaker contributes to progressivity based on income but, because those with higher home values can get more circuit breaker assistance, it detracts from progressivity as based on wealth.

The circuit breaker program works better for homeowners than for renters because, as currently formulated, the renter portion is very difficult to administer and enforce.

A targeted tax relief program is needed for renters because, without such a program, renters have no protection from property taxes that place undue burdens on them. -- On the whole, renters are less well-off than homeowners of comparable income because renters do not have wealth in the form of residential real estate.

A program like the circuit breaker, that makes payments for property tax relief in cash to households, stimulates less local spending for public services than other kinds of programs.

XII. FINDINGS AND CONCLUSION ON IMPLEMENTATION OF THE PROPERTY TAX SYSTEM

A. Findings:

There is public concern because assessment levels continue to vary considerably within the metropolitan area and statewide. -- The State Department of Revenue compares selling prices of property with the values as assigned by assessors. With such information the Department calculates, for each class of property, a sales ratio that is the ratio of estimated market value to actual market value of property in the class.

Sales ratios vary considerably across jurisdictions by class of property. For example, for the period October 1984 through September 1985, the commercial ratio was 48.3 percent in Big Stone County; 75.3 in Dakota County, and 106.1 percent in Mower County. And within an individual jurisdiction, ratios among the classes also can vary considerably. For example, in Scott County, the mean sales ratio for residential was 89.7 percent, for apartments was 87.6 percent, seasonal recreational was 74.3 percent, agricultural was 114.9 percent, and commercial properties had a sales ration of 87.6 percent.[35]

Finally, ratios can vary within a class of property in a single jurisdiction. Especially with residential property, it typically happens that the average sales ratio for property falls as property value rises.[36] Therefore, higher-valued homes are assessed somewhat less, relative to lower-valued homes, than is indicated by the classification.

B. Conclusion:

Assessment of property accurately and in a timely manner is essential to the efficiency, acceptability, and equity of the property tax. -- Variations in the sales ratios across jurisdictions and within classes of property demonstrate that the Minnesota assessments need to be improved. In the absence of consistent performance in assessment, there can be enormous variations in the burden of the property tax within classes of property and across jurisdictions.

RECOMMENDATIONS ON THE MINNESOTA PROPERTY TAX

Following many years of adjustments and revisions to improve its functioning, the Minnesota property tax system needs to be overhauled. The inner-workings of the system are now obscured and it is difficult to know who actually pays for local services. Because of the great number of assessment classes, the system is riddled with hidden subsidies that cause property taxes to be lower on some properties and higher on others. The property tax does not treat similarly situated taxpayers in a comparable manner, it does not link local services closely to local taxing decisions, and it cannot protect the state budget from local spending decisions. Because the funding for state-paid property tax relief is partly open-ended and increases with local levies, property tax programs can exacerbate the problems of adjusting to declining revenues from sales and income taxes during a recession. In sum, there is need for comprehensive restructuring of the property tax system.

The Citizens League recommends developing an open property tax system in which all property is treated uniformly and property tax relief is visibly targeted to individuals and cities based on need. Any undesired shift in property tax burden would be handled through an up-front tax on business property, with revenue distributed to homes and farms. Such a system would enhance equity, encourage a strong link between local spending and local taxpayers, and remove open-ended reliance on state revenues to finance local spending. The Citizens League offers a comprehensive system to achieve visibility, fairness, and local responsibility in property taxation.

1. <u>The Legislature should replace the existing multi-class fractional assessment system with (1) local property taxation based on uniform assessment of all property at full market value and (2) a statewide property tax on commercial-industrial-utility property</u>.

A system that taxes all property uniformly, commonly referred to as a one-class system, would be visible and equitable in the treatment of different property owners. Under the current fractional assessment system, some property bears higher taxes to reduce tax on other property and much of this tax shifting is hidden. Also, the actual amount of shifting of tax burden depends on the mix of property in each jurisdiction. In a jurisdiction that has a significant proportion of favored property, e.g. homes and farms, very little tax relief is afforded because there is so little other property to bear the added burden. Under this recommendation, all property would be treated equally and visibly as a base for local taxes, regardless of the class of the property and regardless of the jurisdiction.

Although all property should be assessed uniformly, some class distinctions should be retained. These distinctions are necessary to preserve the right of the Commissioner of Revenue to adjust assessments, by class, to bring assessments up to full market value.

The move to taxing all property at its full market value, without any other changes in the law, causes significant shifts in the tax burdens on various kinds of property. The tax burden on commercial, industrial, and utility would be lowered while the burden on homesteads and farms would increase. The tax burdens shifts should not, in themselves, be alarming and should not prevent the Legislature from taking this very important step to uniform assessment.

However, a statewide property tax on commercial-industrial-utility property would allow the Legislature to mitigate these shifts. Such a tax is a very direct, visible, uniform method of preserving the historic commitment to reduction in tax burdens on homes and farms. Historically, this commitment has been carried out, in part, through the multiple-class system, but that system operates very unevenly and affords tax reduction to homes and farms only if there is a great deal of business property in the same jurisdiction. If not, as in areas that are predominantly farms or in cities made up largely of homes, homes and farms may pay very high effective taxes. A statewide property tax on business would tax businesses evenly and provide for tax relief to homes and farms evenly, regardless of location and of the mix of property in the area.

The implications of this tax for the state and for business are favorable. The net impact on the state's budget is zero. Businesses would pay no more tax and perhaps less than currently, and the property tax burdens on business would be more evenly distributed across the state. The Legislature would be highly accountable for any increases in the statewide tax on business property because efforts to increase rates would be quite visible; currently rates can be subtly increased by reducing assessment fractions on other classes of property. Such a tax, in combination with uniform assessment, would give the Legislature enough tools to effectively and fairly distribute tax burdens among different types of property, and to do this through equitable, up-front methods.

A statewide property tax on business could be designed in several alternative ways. Two options are

(1) for the state to collect revenue from a statewide mill rate on commercial-industrial-utility property and return this revenue through targeted refund programs to residents and farms. Recommendation 3, below, lays out two new programs that could be used for distributing the refunds from such a tax.

(2) for the state to modify the existing, state-mandated, equalized school mill rate that is part of the foundation aid formula. Under a modified formula, business property would pay a mill rate that is higher than the current rate while other property would pay another, lower rate. The number of dollars raised statewide would not be changed.

In either of these options the statewide tax need not be assessed against all business real property. Specifically, the Legislature may wish to establish a threshold level of property value such as $60,000 or $100,000. In that case, only business property in excess of this value would bear the statewide tax.

2. <u>The Commissioner of Revenue should vigorously enforce equalization of property values.</u>

A uniform assessment system requires consistent, high performance in the determination of true market value of taxable property. When the correct value of a class of property is not consistently estimated, a <u>de facto</u> fractional system can evolve, taxing some classes at different fractions of market value than other classes. To prevent the development of such a <u>de facto</u> system, the Commissioner of Revenue should be particularly diligent to adjust for differences in assessment accuracy under a uniform assessment system and the Legislature should monitor the adjustment process closely.

Currently, to ensure that all property is comparably represented in the tax base, the Commissioner of Revenue can adjust for differences caused by under-estimating market values in one assessment district as compared to other districts. The adjustment process, referred to as "equalization," uses the sales ratios (the ratio of estimated market value to true market value as shown by sales) for various classes in the different districts. Equalization can encourage all assessors to assess property at full market value and to improve the consistency of assessment practices within districts and across classes. Equalization must be strictly adhered to in order to protect the benefits of a uniform assessment system.

3. <u>The Legislature should use targeted tax relief to provide assistance to homes and farms by replacing existing property tax credits -- including the homestead credit, agricultural credit, and the circuit breaker -- with two new programs targeted to residents and to farm operators based on need.</u>

Under one program, all residents including renters, homeowners, and the home portion of homesteaded farms, would receive relief based on relative income and property wealth. An additional program would provide targeted relief to farm operators.

A. <u>Resident Refund</u>

Under the Resident Refund program, homeowners would receive refunds from the state for a percentage of their property tax payment. For each homeowner, the percent paid by the state would be inversely related both to income and to the value of the home. When two owners have the same income, the one with the lower-valued home would get a larger fraction of relief. When two owners have the same value home, the one with the lower-income would get a larger fraction of relief. 37 Refunds would be a percentage of the rent paid by renters, where the proportion is higher for lower-income renters. Most homeowners and renters would be eligible for a refund.

A Resident Refund program could be designed in many ways. One possible approach is for residents to apply for the refund in conjunction with filing their state income tax returns. For example, a resident would apply on his/her 1987 income tax return for relief from property tax levied in 1987, payable in 1988. The actual refund payment would be mailed to homeowners and renters in the form of a check, and separate from the income tax refund check.

The timing for issuing payments would be important in the Resident Refund program. While many options are available, the following pattern of timing illustrates how such a program could work. Under the program, the property tax bills for homeowners would be issued so that the first payment, due on May 15, would be smaller than the second payment, due in October. Residents would receive their refunds in July or August, after the beginning of each new fiscal year. Residents then would have the refund to meet the larger, second payment. Local governments would receive revenue in a pattern similar to the current pattern. Currently, some property tax revenue comes-in in May, but the homestead and other credit portions are not paid by the state until after July 1, and then the remainder of tax revenue is received in the fall. The state would continue to make outlays for credits after the beginning of each fiscal year.

The Resident Refund program would target tax relief and provide visibility in the property tax system. Currently, Minnesota has a complicated set of classes, credits, and targeted aids that favors homeowners, renters, and lower-income households in a very uneven manner. Resident Refund in combination with uniform assessment and the statewide tax on business property is consistent in favoring homeowners and renters and in concentrating relief for those less able to pay. In the current system, the amount of relief received by a "favored" property depends on numerous programs and the mix of property in the owner's jurisdiction; as a result, favored groups can receive quite different amounts of relief. In the proposed system, the relief is clearly and consistently targeted to those households that the Legislature wants to help.

The Resident Refund program would go to most residents and be targeted so that less well-off residents get relatively more relief. Such a refund would not increase and could improve upon the regressivity that results from the distribution of the property tax on residents.

The Resident Refund would tend to be less stimulative on local spending than the current system of credits. Taxpayers would be responsible for payment of all of their property tax; the cash refund that offsets part of the tax also could be used for all other purchases. These two factors would encourage greater awareness of the level of local taxes on the part of local residents.

B. <u>Farm Operator Refund</u>

The Farm Operator Refund would target relief to offset taxes on land in agricultural use with the percentage of state-paid relief in inverse relationship to net farm income.

The program would apply only to farm acreage; farmers would be eligible to apply for the separate Resident Refund on the residential part of farm. To qualify for the refund on farm acreage, the farmer would have to verify that she or he has farming as a principal occupation and is farming the acreage covered by the application. Both tenant-farmers and owner-farmers may apply for relief under this program. To verify farm income, the farmer would have to submit a balance sheet using a standardized format such as the one developed by the Minnesota Farm Business Management Program. The amount of refund received by any farmer would be a percentage of gross property tax due, and the percentage would decline as net farm income increases. There should be no acreage limitation or maximum credit.

4. The Legislature should replace Local Government Aid (LGA) with two new programs of assistance to cities and counties. One program would distribute aid to cities based on need, without reference to local spending levels. The other program would provide equalized property tax burdens among counties for income maintenance.

A. Targeted Aid to Cities

Under the new program, aid would be targeted to cities based on need. The amount paid to cities would bear no relationship to current LGA and there would be no grandfathering of current aid levels. Rather, need would be determined by wealth and income in the city; need would not depend on the level of local expenditures or the local levy.

A reasonable formulation of a targeted aid program, for example, would be to grant a specific dollar payment per household to eligible cities; the amount of the payment would vary inversely with median household income and with market value per household (i.e., total market value in the city divided by the number of households). Cities would be eligible only if median household income falls below a certain level.

Because the new program would be targeted to needy cities, it would allow these cities to provide local services at less local expense. Further, cities with relatively less fiscal capacity would have a supplementary source of revenue without turning to local option taxes. However, the aid program should not be used to soften incentives for other cost-cutting measures in providing city services.

B. Equalized Aid to Counties

Under a new program of equalized aid to counties, a statewide uniform mill levy would pay each county's share of program and administrative costs attributable to medical assistance, general assistance, AFDC, and Minnesota supplemental aid programs. The difference between the revenue collected by the uniform levy and service costs would be covered by the state for these "income maintenance" programs.

The purpose of the levy would be to allow counties to levy a uniform mill rate for state and federally mandated income maintenance services. Currently, the amount of the county levy depends upon local case loads and the local tax base and some counties must levy substantially above the state average. Equalizing the local responsibility and providing greater state assistance is in keeping with the statewide responsibility for general income maintenance programs.

5. The Legislature should eliminate levy limitations on cities and counties.

The recommendations in this report remove any automatic appropriation by the state whenever local property taxes happen to be increased. Also, aid to cities provided through the targeted aid program is intended in part to improve the ability of cities to provide local services. Further, levy limitations potentially interfere in the relationship between the demand for services by local taxpayers and the actions of local officials.

6. <u>The Legislature should broaden the property tax base to include currently exempt real property that the constitution does not prevent from being taxed.</u>

The constitution exempts churches, houses of worship, and property solely used for education purposes of academies, colleges, universities and seminaries of learning. Other non-public properties, however, are exempt by state statute and should be added to the tax rolls. These exemptions include hospitals, burying grounds, charitable institutions, other property owned by churches, real property used primarily for abatement and control of pollution, native prairie land and wetlands.

Local property that is subject to tax bears the burden of tax exempt real estate. Not only is the shifting of property tax burdens due to exemption hidden, but the relative tax burden of local property owners depends upon how much exempt property is located in their jurisdiction. By making exempt properties subject to tax, the state could still choose to subsidize them visibly by making payments in lieu of tax for the property to the local jurisdiction. And such subsidies would be equitable in that other local property would pay tax only for local services and not to pay for state-mandated exemptions.

7. <u>The Legislature should provide state assistance through fixed appropriations, not open-ended entitlements.</u>

The use of direct appropriations would link local spending decisions tightly to the raising of local revenue because state tax relief payments would be fixed, rather than variable with the level of local spending. Also, there would be less unpredictability in state budgeting because state expenditures will not rise automatically with local expenditures. And the Legislature would be directly responsible for the amount of money granted to local taxpayers and cities; if state appropriations rise too quickly and accommodate excessive local spending, the Legislature would be accountable for the action and could reverse it.

8. <u>The Legislature should require counties to prepare tax records by separating land and improvement values so that the Legislature can make an informed analysis of the impacts of a site-value tax.</u>

Advocates of the site-value tax argue that a higher tax rate on land than on structures would improve the efficiency of property taxation by interfering less with decisions about the development of land. Some cities in Pennsylvania do use a site-value tax and Pittsburgh has retained its use for more than half a century. In Minnesota, separate estimates are made by assessors of the land value and the market value of real estate but the tax on each is not separated. After records have been kept individually for tax on land and on improvements, the Legislature will be in a position to evaluate the impact of a site-value tax in Minnesota.

9. <u>The Legislature should provide a period of transition to the new system to avoid large decreases or increases in tax burden in any one year.</u>

Under the Citizens League recommendations, the state would make no additional appropriations from non-property tax revenues to fund expenditures for the property tax system. Total appropriations for the

Resident Refund, Farm Operator Refund, Aid to Cities, and equalized aid to counties for income maintenance programs would equal the total current amount of funding for credits, targeted relief, and LGA, augmented, if appropriate, with revenue from the statewide property tax on business. The recommendations do not envision any additional state funding to maintain historic levels of support for the programs that would be eliminated.

True restructuring of the property tax system can result only from eliminating current programs and substituting for them a visible and equitable tax system. To have a new system necessarily implies that the Legislature must not grandfather-in current levels of aids, credits, or targeted relief. Such grandfathering would simply encumber the "new" system with undesirable features of the old one while tying-up most of the available funds which could be used for desirable new programs. However, in moving to a new system there can be substantial changes in the distribution of property tax burdens on individuals, classes of property, and jurisdictions. To minimize these impacts, the new system should be phased-in over a period of a few years, so that changes in burden are felt gradually.

The design of a phase-in program should be simple so that it can be implemented with relative ease. Among the alternatives for a phase-in program are:

* a taxpayer's bill would not be allowed to increase or to decrease from the previous year by more than a specified percentage;
* the funding for the current credits, circuit breaker, and aids would be phased-out over the period and funding for the new refund and aid programs correspondingly phased-in; and
* the taxpayer would receive a composite tax bill in each year of the phase-in period, consisting of a percentage of the tax due under the current system and a percentage of the tax due under the revised tax system.

Many other phase-in approaches can be designed and the Legislature should adopt some approach to prevent abrupt changes in tax bills and to preclude the use of grandfathering.

FOOTNOTES

1. Minnesota Taxpayers Association, "How Does Minnesota Compare?, 1985 State-by-State Ranking of State and Local Taxes per Capita and per $1000 Personal Income and State and Local Expenditures," December 1986.

2. Minnesota Department of Revenue, "Minnesota's Property Tax System," February 3, 1987.

3. Stutzer, Michael, "Intergovernmental Revenue: Its Effects on Recipient Government Spending," manuscript prepared for the Citizens League, March 1987. Stutzer reviews the literature on intergovernmental grants to find strong agreement that matching grants are more stimulative than lump sum grants and that virtually all of a dollar grant paid as an increase in personal income is privately spent. Literature cited includes:

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4. Bell, Michael and John Bowman, "Property Tax Differences Among Minnesota Cities: The Effect of Property Tax Relief Programs," in Ebel and McQuire, eds., Final Report of the Minnesota Tax Study Commission, V. 2, (Butterworth, St. Paul) 1986.

5. Compiled by the Citizens League from data in Minnesota Department of Revenue, Property Taxes Levied in Minnesota, 1985 Assessments, Taxes Payable in 1986; Property Tax Bulletin No. 15.

6. Ibid.

7. U. S. Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1985-86.

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12. Wisconsin Department of Revenue, op. cit.

13. Testimony of John G. Horner, General Counsel, Minnesota Multi Housing Association, submitted to Property Tax Committee, Citizens League, on January 8, 1987. Also, Minnesota Department of Revenue, Bulletin No. 15, op. cit.

14. Minnesota Department of Revenue, Minnesota's Property Tax System, op. cit.

15. Ibid.

16. Ebel, Robert and T. J. McGuire, eds., "Levy Limitations," Final Report of the Minnesota Tax Study Commission, V. 1, Findings and Recommendations.

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18. Data supplied by the Minnesota Department of Revenue, March 4, 1986.

19. Minnesota Department of Revenue, Minnesota's Property Tax System, op. cit.

20. U.S. Advisory Commission on Intergovernmental Relations, op. cit.

21. Office of the Legislative Auditor, State of Minnesota, Evaluation of Direct Property Tax Relief Programs, February 1983, p. xi.

22. Testimoney of Tom Stinson at the October 7, 1986, meeting of the Property Tax Committee, based on Stinson, Tom. et. al, Governing the Heartlands: Can Rural Communities Survive the Farm Crisis, report prepared for the U.S. Senate Subcommittee on Intergovernmental Relations, May 1986.

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29. Shannon, John, Characteristics of a Balanced State-Local System, remarks before the National Conference of State Legislatures, Denver, Colorado, October 10, 1985.

30. Wisconsin Department of Revenue, op. cit., and Minnesota Senate Research, op. cit.

31. Minnesota Department of Revenue, Local Government Aids and Analysis Division, 1986 Exempt Property Values, February 3, 1987.

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33. Bell, Michael and John Bowman, op. cit. and Stutzer, Michael op. cit.

34. Office of the Legislative Auditor, State of Minnesota, The Administration of Direct Property Tax Relief Programs, an Evaluation, March 1983.

35. Minnesota Department of Revenue, 1985 Assessment Sales Ratio Study, Sales Analysis for the Minnesota Tax Court with Adjustments for Terms and Time, October 10, 1986.

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WORK OF THE COMMITTEE

Charge to the Committee:

The Property Tax Committee worked in response to the following charge from the Citizens League Board of Directors:

THE FUTURE OF THE PROPERTY TAX IN MINNESOTA

Major changes in the property tax are likely to be proposed to the 1987 Legislature. The State Department of Revenue is developing proposals. The Minnesota Tax Study Commission recommendations will be in front of the Legislature. Moreover, property tax issues have become more and more important each year as the Legislature finds it increasingly difficult to finance property tax relief.

The committee will have the broad charge of determining how real property should be taxed in Minnesota and for what purposes the revenue should be used.

The committee could give consideration to:

--examining the principles of property taxation and determining whether such wealth should be subject to higher or lower levels of taxation, including the question of whether land and buildings should be taxed alike.

--determining criteria for a good property tax system.

--comparing how city, township, county, and school governments rely on the property tax today with their reliance in previous years, both in Minnesota and in other states.

--examining Minnesota's system for determining value of property for tax purposes.

--reviewing Minnesota's property tax classifications and state-paid credits that adjust the burden among taxpayers.

--examining the interrelationship of property taxes with programs of state aids and levy limits for local governments and school districts.

--evaluating distribution of the property tax burden among different types of property, including farm, business, and residential, and among farms and businesses of different sizes and value and among persons of different incomes. The committee should pay particular attention to property taxation in rural areas, in light of current economic conditions.

--examining how property tax burdens have changed and are likely to change in those parts of the state where property values are declining.

--determining the capacity of local governments in rural and urban Minnesota to continue to provide services traditionally paid for by property tax revenues.

--examining the system for determining market value of property that might fluctuate considerably in value over time. For example, the value of rural land soared in the late 1970s and has declined considerably in the past few years. The committee should look particularly at the amount of time between when value is set by the assessor and when the tax bill is due and the impact of such an interval on taxpayers' ability to pay and their incentives to hold, purchase, or sell property.

--evaluating proposals for valuing property at its "production" value, instead of the value set in the open market, and the likely impact of such a system on different sizes of the same type of property and on other types of properties within a local taxing jurisdiction.

--comparing the experience of fluctuating property values in different parts of the state. Are there similarities, for example, in the experience of businesses on declining strip commercial areas in big cities?

The committee should make specific recommendations on central features of the Minnesota property tax, including its size relative to other state and local taxes, the classification system, homestead and agricultural credits, the circuit-breaker, the assessment system, and the distribution of net burden among and within the major classes of property: residential, commercial-industrial, and farm.

Committee Membership:

A total of 39 committee members, led by Chair Allen Saeks and Vice-Chair Dana Schroeder, took an active part in the work of the committee. They are:

Allen Saeks, Chair
Dana Schroeder, Vice-Chair
Charles Backstrom
Bill Betzler
John Burger
Curtis Carlson
Larry Chiat
Gary Cohen
Neil Dieterich
Ron Dody
Bright Dornblaser
Maurice Dorton
Phil Duff
Doug Easterling
Janet Green
Martha Grierson
Tom Howell
Orvil Johnson
Terrence Kayser
Bill Kelly
Sharon Koll
Maryann Kozlak
Georganne Krause
Scheffer Lang
Mary Ann McCoy
Malcolm McDonald
William D. Miller
John Moon
Verla Nelson
Patrick O'Leary
Jerry Pahl
Betty Radcliffe
Betsy Rice
Linda Schutz
Michael Stutzer
Peter Vanderpoel
Constance Waterous
Norman Werner
Bonnie Wilkins

A minority report from Kelly, Vanderpoel, Werner, Johnson and Green recommended a three-class system. A separate minority report from Waterous also recommended a three-class system. A minority report from John Burger recommended that land be taxed at higher rates than buildings. A minority report from Duff opposed the recommendations on farmland relief, on a special tax on commercial-industrial property, and on tax-exempt property.

* * * * *

The report as adopted by the Board of Directors of the Citizens League is more explicit in its recommendation for a statewide property tax on commercial-industrial property than the report as approved by the committee. The committee report suggested that such a tax might be needed if shifts in burden were too great. The Board amended the committee report to recommend the tax specifically.

<u>Committee Meetings/Resource Speakers</u>:

The committee met for the first time on September 16, 1986 and concluded its deliberations on March 17, 1987. During its 25 meetings the committee studied a wide variety of printed materials and heard from the following resource speakers. (Titles reflect positions held by resource persons at time they met with committee.)

Duke Addicks, legislative liaison, City of Minneapolis
Mark S. Anderson, general counsel, Minnesota Chamber of Commerce and Industry
Morrie Anderson, executive director, Association of Minnesota Counties
Karen Baker, legislative analyst, House Research, Minnesota House of Representatives
Bill Blazar, tax policy consultant
Julie Bleyhl, director of legislative services, Minnesota Farmers Union
Representative John Burger, committee member and member, Minnesota House of Representatives
Wayne Cox, Citizens for Tax Justice
Robert Dolan, manager of property taxes, Northern States Power Company
Glen Dorfman, Tax Reform in Minnesota (TRIM)
Dennis Erno, assistant commissioner, Minnesota Department of Revenue
Gary Farland, director of education aids and levies, Minnesota Department of Education
Gordon Folkman, director of tax, credit, and aid analysis, Minnesota Department of Finance
J. Fonkert, policy planner, State Planning Agency
John E. Haynes, assistant commissioner, Minnesota Department of Revenue
Rose Hermodson, director of legislation, Minnesota Federation of Teachers
Joel Jamnik, legislative counsel, League of Minnesota Cities
Carl Johnson, director of legislative services, Minnesota School Boards Association
Senator Douglas Johnson, chair, Senate Tax Committee
Joel Michael, legislative analyst, House Research, Minnesota House of Representatives
Herb Mocol, mayor of Mankato, representing the Coalition of Outstate Cities
Don Monk, director of assessments, Hennepin County
Glenn Nelson, state economist, State of Minnesota

Jerry Pahl, committee member and manager, administrative support division, Hennepin County Department of Property Taxation
Leonard Peterson, property tax review division, Minnesota Department of Revenue
Representative William Schreiber, former chair, Minnesota House Tax Committee
Tom Stinson, professor, University of Minnesota Department of Agriculture and Applied Economics
John Taft, chair, mayor's working group on government finance, City of St. Paul
John Tomlinson, former member and chair, Minnesota House Tax Committee
Representative Gordon Voss, chair, Minnesota House Tax Committee
Charles Weaver, representing Tax Reform in Minnesota (TRIM)

Staff Support:

The committee was assisted in its work by Julia Friedman, on sabbatical leave from her position as assistant professor of economics at Macalester College, and by Paul Gilje, Jody Hauer, Nancy Jones, and Joann Latulippe of the Citizens League staff.

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