1986

Final Report of the Minnesota Tax Study Commission

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The Tax System and Intergovernmental Linkages*

For most states, a systematic examination of state and local tax structure can proceed with only a brief reference to the state-local intergovernmental system. A study of Minnesota taxes, however, requires an explicit recognition and examination of the interplay between state-to-local aid programs and the Minnesota method of taxing property. This is true for two reasons. First, the bulk of the state's general fund expenditures are, in fact, pass-throughs of state revenues to local governments. Second, these tax/state-aid linkages have important implications not only for the overall level of Minnesota's taxes but also for their incidence (equity) effects.

Accordingly, the primary purpose of this section is to make explicit these linkages among the state aid programs. This provides the background for discussions in subsequent chapters that specifically deal with the issues of fiscal accountability among levels of government and the equity effects for Minnesota taxpayers.

The remainder of this chapter is divided into two parts. First, a brief overview of the Minnesota intergovernmental system is presented with comparisons drawn to the U.S. state/local system as a whole. The text then concludes with a detailed examination of the linkages among Minnesota's property tax relief devices and state-to-local aid programs.

MINNESOTA AND THE U.S.[1]

Public services in the United States are provided by 82,688 governmental units, the vast majority of which are local. These units are distributed quite unevenly among the fifty states, with the number ranging from nineteen in Hawaii to about 6,464 in Illinois. Only five states have more units of government than Minnesota's 3,530.

Minnesota's above-average number of local governments does not necessarily imply an above-average reliance upon local government to finance local public services. In fact, this is not the case. Table 1 illustrates that local governments in Minnesota raised only 49% of their general

*This chapter was written by John Bartle, a consultant to the commission.

TABLE 1
Composition of State and Local Revenues
U.S. Aggregate and Minnesota, 1982-83

Revenue Component	U.S. Aggregate Total	U.S. Aggregate State	U.S. Aggregate Local	Minnesota Total	Minnesota State	Minnesota Local
	(Aggregate amounts in millions of dollars)					
Total revenue	593,586	357,637	338,070	12,635	8,074	7,277
General*	486,878	290,456	298,542	10,664	6,841	6,522
Intergovernmental	89,983	72,704	119,399	1,766	1,509	2,955
Own-source	396,895	217,752	179,143	8,899	5,332	3,567
Taxes	284,585	171,440	113,145	6,106	4,320	1,786
Property	89,254	3,281	85,973	1,712	4	1,708
General Sales	64,890	53,639	11,251	997	992	5
Income	69,387	62,941	6,446	2,232	2,232	—
Motor Fuel	10,943	10,793	149	262	262	—
Other	50,113	40,785	9,327	903	829	74
Current Charges	62,625	23,182	39,443	1,497	582	915
Miscellaneous	49,685	23,130	26,555	1,296	430	866
	(Percentage distributions by level of government)					
Total revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
General*	82.0	81.2	88.3	84.3	84.7	89.6
Intergovernmental	15.2	20.3	35.3	14.0	18.7	40.6
Own-source	66.9	60.9	53.0	70.3	66.0	49.0
Taxes	47.9	47.9	33.5	48.3	53.5	24.5
Property	15.0	0.9	25.4	13.5	*	23.5
General Sales	10.9	15.0	3.3	7.9	12.3	0.1
Income	11.7	17.6	1.9	17.6	27.6	—
Motor Fuel	1.8	3.0	*	2.1	3.2	—
Other	8.4	11.4	2.8	7.1	10.3	1.0
Current Charges	10.6	6.5	11.7	11.8	7.2	12.6
Miscellaneous	8.4	6.5	7.9	10.2	5.3	11.9

Source: Calculated from U.S. Bureau of the Census, *Governmental Finances in 1982-83* (Washington: Government Printing Office, October 1984). Table 5.

*Less than one-tenth of one percent.

revenue from own-sources in 1982-83. This compares with a 53% for local governments throughout the nation. In contrast, the local share of total state and local direct expenditures (which counts intergovernmental revenue as an expenditure of the recipient unit) is above average in Minnesota: 62.3% compared with the national average of 58.8%. The contrast between the local role in raising revenue and its role in spending for services is accounted for by three facts:

- A large percentage of total state government spending in Minnesota is for aid to localities (34.7% versus 29.8% nationally);
- Minnesota local governments derive no money from local income taxes and almost no money from local sales taxes, while local governments nationally raise 5.2% of their total revenue from these sources; and

- Property taxes account for 23.5% of local total tax revenue in Minnesota compared with 25.4% nationally.

LINKAGES AMONG STATE AID PROGRAMS

In Minnesota there are several state aid programs to local governments, many of which interact with each other. Table 2 summarizes the discussion of this section, demonstrating how various programs are linked.

These linkages are of concern for four reasons. First, outlay reductions in one program that cause outlay increases in another make it harder to cut state spending. Second, there is a potential for certain state programs to work against each other. This will waste money and frustrate the accomplishment of the goals of each of the affected programs. Third, under current state property tax relief arrangements, certain types of property will receive large total credits. This will initially reduce the property tax burden on such property from what it would be without these credits. And fourth, the present system creates incentives for higher local public spending.

This discussion identifies two general types of interaction—automatic linkages and optional linkages. An automatic linkage means that a change in one program directly causes a change in the cost of another. In short, the two programs are inherently related. An optional linkage means that a change in one aid program may result in a decision by local officials, which in turn changes the cost of another aid program.

AUTOMATIC LINKAGES

Several aid programs are related so that a change in the funding of one program will automatically cause a funding change in another program. There are three basic categories of these relationships: linkages among property tax relief programs; linkages among school foundation aid and classification ratios; and linkages between local government aid and levy limits.

PROPERTY TAX RELIEF PROGRAMS

There are seven major programs that reduce a property-owner's tax. Five of these are credits which are subtracted from the tax bill a property owner receives. These include:

- *Agricultural School Credit (ASC).* Reduces the tax bill by between 10% and 29% for owners of agricultural homestead and nonhomestead property, timberland, and seasonal recreational property.

TABLE 2
Minnesota Linkages Among State Aid Programs - 1984

PROGRAMS	INTERACTION	RESULT
Automatic Linkages		
1. THC and HC	Both affect taconite households.	Change in THC causes an opposing change in HC.
2. ASC and HC	Both affect agricultural homesteads of greater than one acre.	Change in ASC causes an opposing change in HC.
3. THC, HC, and ASC	All affect taconite agricultural homesteads greater than one acre.	Change in ASC causes an opposing change in both THC and HC; change in THC causes and opposing change in HC.
4. NPC, WC, and ASC, HC.	NPC and WC reduces credits on other land.	Change in NP or WC may cause an opposing change in HC; change in ASC may cause an opposing change in NP or WC.
5. HC and CB	HC subtracted from CB calculated.	Change in HC causes an opposing change in CB.
6. TR and other credits	Credits affect net tax; TR is triggered by increases of over 28% in net tax.	Decreases in credits that are large enough can increase TR outlays.
7. Foundation aid basic allowance/levy and property tax relief	Basic allowance and levy affect state aid share of school district revenue. Remainder is financed by school property tax levies, part of which are paid by property tax relief programs.	Change in the basic allowance levy change the division of school district revenue between foundation aid and local property taxes. Property tax relief outlays change with property tax changes.
8. Classification ratios and foundation aid	Classification ratios partially determine local tax base which influences state foundation aid.	Change in classification ratio changes school district tax bases which cause an opposing change in foundation aid.
9. Clasification ratios and property tax relief	Classification ratios determine taxable portion of property market value; property tax relief pays part of property tax.	Changes in classification ratios change property taxes which change property tax relief for certain types of property.
10. LGA and levy limits	LGA received is subtracted from allowed levy limit.	Changes in LGA cause opposing changes in levy limits.
Optional linkages		
1. Levy limits and property tax relief programs	Levy limits control local levies; property tax relief programs pay part of local levies.	Changes in levy limits may affect local levies which will change property tax relief outlays.
2. Direct aid to localities unrelated to levy limits (i.e., highway aid, welfare aid) and property tax relief.	Direct aids fund certain locally-administered programs; property tax relief programs pay part of local levies.	Changes in state aids may affect local levies which will change property tax relief outlays.

Source: Minnesota Tax Study Commission (1984).

Notes:
HC - Homestead Credit
THC - Taconite Homestead Credit
NPC - Native Prairie Credit
TR - Targeted Relief
ASC - Agricultural School Credit
CB - Circuit Breaker
WC - Wetlands Credit
LGA - Local Government Aid

- *Homestead Credit (HC).* Reduces total property tax paid on owner-occupied homestead property by 54% up to a $650 maximum.
- *Taconite Homestead Credit (THC).* Reduces total property taxes on owner-occupied homesteads in "taconite relief areas" by either 66% up to $475, or by 57% up to $420.
- *Wetlands Credit (WC).* Provides a direct credit to qualifying wetlands on all property owned (since wetlands are also tax-exempt). The credit equals .005 of the average market value of an equal acreage of tillable land in that jurisdiction.
- *Native Prairie Credit (NPC).* Operates in the same manner as the wetlands credit. The credit equals .015 of the market value of tillable land.

These credits are subtracted from the gross tax bill in this order: ASC, NPC, WC, THC, and HC. The remainder is the net tax paid by the property owner. It is highly unlikely that a landholder could receive all of these credits. Most will only receive one.

There are two other types of property tax relief: the property tax refund (also known as the *circuit breaker*) and targeted relief. Both of these are granted in the form of a tax refund. These operate as follows:

- *Circuit Breaker (CB).* Homeowners and renters may receive a refund for a portion of the property tax paid. The refund is primarily determined by income level, net property taxes (which, in turn, depend on the amount of the homestead credit), and
- *Targeted Relief (TR).* Homeowners with increases of more than 20% in their 1985 net property tax may receive a refund for 100% of the net tax increase above 20%. This refund is phased out between income levels of $40,000 and $50,000. All homeowners in 1984 may receive a refund of 50% of the net tax increase above 10% if their net taxes exceed 2.25% of property market value. For taxes payable in 1985, TR will equal 50% of increases above 12.5% up to a $400 maximum, with no income restriction.

Linkages between these programs will have important budgetary and equity implications. Six linkages among property tax relief programs can be identified:

- Homesteads in taconite areas can receive both the THC and the HC. An increase in the HC directly reduces THC payments. At the current rates, $1 increase in the HC results in a decrease in the THC between 57 and 66 cents, subject to the credit maximum.
- The agricultural school credit (ASC) and the homestead credit (HC) in certain instances can both be credited against taxes on agricultural homesteads. The ASC applies to all qualifying land and property on an agricultural homestead except the dwelling, a garage, and one surrounding acre. The HC now applies to the entire acreage of qualifying

agricultural homesteads. Therefore only the HC applies to the dwelling and the first acre, but the ASC and the HC may then both apply to the same property on the rest of the land classified as a homestead. As a result, on agricultural homesteads larger than one acre, a decrease in the ASC will increase outlays for the HC, subject to the credit's limits. The actual increase in HC outlays will depend on the HC percentage and the portion of these households at the HC maximum. For every $1 decrease in the ASC that affects the HC, it is estimated that HC outlays will increase 28 cents.[2]

- For qualifying taconite agricultural homesteads, the ASC, THC, and HC can all apply. The linkage between the ASC and the THC is the same as that described for the HC and ASC. The reactions between the THC and the HC is explained above.
- The native prairie credit (NPC) and the wetlands credit must be applied against other property that is taxable. On the tax statement, these two credits are subtracted before the HC, so if either of these credits is applied against taxes on homestead property, they will reduce the amount available for the HC (and in taconite areas, the THC). The ASC is subtracted before the NPC and WC and will affect NPC and WC outlays when the full amount of these two credits cannot be taken.
- In using the circuit breaker, a taxpayer subtracts the homestead credit received before calculating the circuit breaker. Therefore, increases in the HC will automatically decrease the amount available for the CB. Between 1978 and 1981, outlays attributable to the homeowner's portion of the circuit breaker fell from $123.4 million to $54.1 million, partly due to increases in the HC.[3]
- Targeted relief (TR) is also tied to property tax credits. Outlays for TR may increase if other credits are reduced significantly. This will automatically occur, but only when the resulting increases in net property taxes exceed 20%. Therefore, the magnitude of the linkage depends on the particular change.

This discussion leads to three conclusions: (1) Outlays for these credit programs are determined in part by the order in which they are taken on tax statements; (2) A change in outlays for one credit may automatically cause an opposing change in outlays for other credits. This linkage is unlikely to cause the credits to work at odds with each other, but an attempt to reduce outlays in one program may be partially offset by increased outlays for another program; (3) As a result of the overlaps among these credits, certain property owners in particular situations will receive large total credits and may pay net property taxes that are substantially lower than those paid by other property owners.

SCHOOL FOUNDATION AID AND CLASSIFICATION RATIOS

Foundation aid is a state aid program that ensures that school districts will have a basic revenue amount per pupil[4] ($1,475 for school year 1984-85) for a common basic tax levy (24 mills). Therefore, regardless of property wealth, districts receive a similar basic amount for a given tax levy, with the exception of districts "off the formula." Above the foundation aid basic amount, school districts may raise more revenue from a combination of local property tax levies and state aids.

There are three automatic linkages among school foundation aid, classification ratios, and property tax relief. They are as follows:

- Changes in foundation aid's basic revenue allowance and the basic tax levy both automatically affect property tax relief outlays. For instance, a decrease in the basic levy will reduce property taxes, and so reduce certain property tax relief outlays. In addition, such a change will also shift part of the burden of school finance from local property taxes to state aids. Similar shifts happen with changes in the basic revenue allowance amount. Because the foundation aid program mandates the division of a district's revenues between property taxes and state aids at any given level of a district spending, this linkage is automatic. It has been estimated that a $1 change in the basic levy induces an opposite change in state property tax credits equal to between 13 and 13.8 cents.[5]
- Classification ratios set the portion of a property's market value which is subject to taxation. In Minnesota there are several classification ratios for different types of property (chapters 16 and 17). Changes in classification ratios change a local government's base of taxable property. Since foundation aid is determined in part by district property tax base, such a change will affect the level of state aid to school districts. This linkage is automatic, although districts may react to these changes and set into motion other optional linkages.
- Changes in classification ratios on property receiving tax relief also create an automatic linkage. For example, lowering the classification ratio on homestead property will lower taxes on homesteads and so reduce outlays for homestead tax relief programs (HC, THC, TR, and CB). This impact may be reduced if local governments allow their mill rates to increase to compensate for the reduction in tax base. However, even if localities increase mill rates to compensate fully for the decreased taxable base, total taxes on homesteads will still be lower because the tax burden has been partially shifted to nonhomestead property.

LINKAGES BETWEEN LEVY LIMITS AND LGA[6]

The overall state levy limitation applies to all counties and to cities with populations over 5,000, and limits the total property tax that can be levied. Certain levies can be excluded from the limitation. Local government aid (LGA) provides formula-determined grants to most cities, counties, and some towns in order to reduce property taxes. In calculating a jurisdiction's levy limit, the full amount of LGA received, a part of the taconite aids, and native prairie and wetlands reimbursements to counties are subtracted from the maximum allowable levy. To illustrate, a decrease in LGA of $1 directly results in a $1 increase in the levy limit. Whether or not changes in the levy limit translate into changes in levies depends on local action. That is an optional linkage and is discussed in the following section.

OPTIONAL LINKAGES

Optional linkages among state aid programs result when changes in outlays for an aid program cause a local fiscal response which in turn induces a change in another state program. Unlike automatic linkages, optional linkages do not always cause changes in outlays for other programs.

For instance, a decrease in state welfare aid to a county will cause an increase in county property taxes, if the county decides to make up all or part of the reduction in program expenditures. In turn, this levy increase will cause an increase in state property tax relief. The end result is that state welfare aid has decreased, the county's tax levy is higher, and state property tax relief outlays also have increased. The net savings to the state is lower than the welfare aid reduction would indicate, as the cut has induced a rise in other state outlays. Of course, this is only one possible result. County officials could choose not to increase taxes and instead absorb the full amount of the aid decrease. In this case, property tax relief outlays will be unaffected and the reduction in welfare aid represents the net savings to the state.

This illustrates the difference between automatic and optional linkages among state aids. Automatic interactions happen directly and with certainty—no other party must act for the result to occur. An optional linkage requires action by some other party and so may not happen. As such, the impact of these linkages are much harder to identify because of the uncertainty involved. Further, different local units may react in much different ways. However, it is clear that such influences are an important factor in determining the net impacts of changes in state aid policies.

Two state programs are related in this way to the property tax relief programs: levy limits and direct state aids to localities.

LEVY LIMITS[7]

Levy limits set the maximum permissible property tax levy for counties and cities. A local decision to increase property taxes in response to a levy limit increase will increase outlays for property tax credits and refunds except in the unlikely instance where all affected taxpayers are at their credit and refund maximums. If, on the other hand, local taxes do not change in response to levy limits, there will be no change in property tax relief outlays with other factors the same.

These effects will be strongest for cities or counties at their levy limits. In such a case, a levy limit decrease may force a locality to reduce its levy. This will then decrease property tax relief outlays. In the other direction, a levy limit increase may provide an opportunity to increase local revenues, and if so, would increase property tax relief outlays.

DIRECT STATE AIDS TO LOCALITIES

Unlike LGA, some aid programs are not included in the levy limit. Two such programs are welfare aids and highway and street aids. In both cases, the aid is tied to local conditions like "approved highway aids" and "reimbursable costs" for welfare aids. However, changes in funding patterns may affect local property tax levies and, in turn, property tax relief outlays. This is an optional linkage since a local decision must occur for property tax relief outlays to be affected.

CONCLUDING COMMENT

Four general conclusions can be drawn from this examination:

- None of the linkages described prevent any of the aid programs from achieving their stated objectives.
- The linkages are likely to frustrate the efforts of the budget cutters since a decrease in outlays for many of these programs will either directly or indirectly increase outlays for other programs. There is no case where these effects can be expected to overwhelm the initial budget cut; however, in many cases the compensating increases are significant.
- Property owners of certain types of property are likely to pay much less property tax than other owners of like-valued property. Whether or not the particular circumstances causing this result are justified is a policy question.
- A fourth conclusion—which is only suggested here, but for which, empirical evidence will be presented below (chapter 15)—is that the state "property tax relief" aids actually have the economic effect of stimulating a higher level of local government spending than would otherwise occur. Thus, the Minnesota system of linkages among state-to-local-aid programs and the tax system not only results in overly complex and

uncertain intergovernmental arrangements, but over time actually thwarts the basic goals that it was ostensibly intended to achieve.

ENDNOTES

1. This discussion utilizes U.S. Bureau of the Census definitions of "revenue," "expenditure," and "intergovernmental aid." Thus, the numbers presented here will vary somewhat from data in the remainder of this and subsequent chapters that draw on Minnesota state sources. See U.S. Bureau of the Census, *Governmental Finances in 1982-83,* (Washington: Government Printing Office, October 1984), Tables 5, 13, and 17.

2. This was estimated as follows: for taxes payable in 1983, 52.4% of agricultural homesteads receiving the HC were not receiving the $650 maximum. Therefore, for every decrease in the ASC that affected the HC, 52.4% of agricultural homesteads would receive an increase in the HC equal to 54% of the change. The other 47.6% are already at the $650 maximum, and so will receive no more. The net effect in outlays then is 52.4% x 54% = 28.3%. This estimate is slightly overstated because the HC increase will push some homeowners to the $650 maximum, and only part of their increase will receive the 54% credit. The same method for the state as a whole gives an increase of 23.0% in HC outlays for decreases in other credits affecting the HC. For nonagricultural homesteads, this figure is 22.7%. Differences result from portions of households at the credit maximum. The source for HC payment distribution was: Minnesota Department of Revenue, *Property Taxes Levied in Minnesota (Taxes Payable in 1983),* pp. 196 and 203.

3. Legislative Auditor, *Evaluation of Direct Property Tax Relief Programs* (February 1983), pp. 84-85. These are actually figures that are also influenced by other factors. It is likely that the "pure" effect of the HC on the CB is greater than indicated since other factors, such as increased tax levies, were at the same time exerting an upward influence on outlays.

4. A district's pupil units are calculated as follows: nonhandicapped kindergarten students are weighted as 0.5 pupil units, handicapped kindergarten students and students in grades 1-6 are weighted as 1.0 pupil unit, students in grades 7-12 are counted as 1.4 pupil units, and an additional 0.5 pupil units are added for each pupil whose family receives AFDC.

5. Alan Hopeman, Legislative Analyst, Minnesota House of Representatives Research Department. Letter to Representative John Tomlinson, March 29, 1984.

6. The Minnesota Local Government Aid (LGA) program is analyzed by Michael E. Bell, "Minnesota's Local Government Aids Program," in *Staff Papers,* vol. 2 of the *Final Report of the Minnesota Tax Study Commission,* ed. Robert D. Ebel and Therese J. McGuire (St. Paul: Butterworth Legal Publishers, 1985).

7. Levy limits are discussed in chapter 17 of this volume.