FISCAL FEDERALISM AND MINNESOTA TAX POLICY

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One of my favorite bumper stickers reads, "Are we having fun yet?" It's a question you might ask state and local officials who deal with budgetary affairs in this age of "New Federalism."

New Federalism is now ten years old. Five years ago at this conference, John Shannon from the Advisory Commission on Intergovernmental Relations examined the growth and subsequent decline in federal support for domestic (nondefense) public services. From the end of the Korean War to the late 1970s, federal aid to state and local governments and direct federal provision of domestic services grew rapidly. That period of fiscal history ended during the Carter administration and the downturn has accelerated under President Reagan.

Federal cutbacks have forced state and local governments to assume a larger role in providing—and financing—domestic services. The budgets of state and local governments were ravaged in the early 1980s by a combination of recession and inflation. And economic distress in rural communities compounded the fiscal problems of states like Minnesota. States coped with budget shortfalls. State and local taxes increased and budgets were cut.

Federal Tax Reform and the End of Revenue Sharing

Three aspects of federal tax reform were of paramount concern to state and local officials. First, as initially proposed by the administration, the tax plan would have eliminated the deductibility of all state and local taxes on federal tax returns. As finally enacted, only the deduction of sales taxes was eliminated. Second, changes in the tax code significantly cut the federal subsidy given to state and local governments through tax preferences for municipal bonds. Finally, tax reform was intended to combine a broadening of the tax base (by closing "tax loopholes") with a reduction in income tax rates. For states that conform closely to the federal definition of taxable income, as Minnesota does, this meant an automatic increase in state income tax collections unless specific action was taken by the states to "return" this windfall (or at least a portion of it) to state taxpayers.

Congress also allowed the federal general revenue sharing program to expire in 1986. In its final year the program distributed about $4 billion to 39,000 local governments. Revenue sharing never represented more than a small fraction of federal aid to state and local governments, but for many smaller governmental units it was their only direct source of federal financial assistance. In Minnesota, for example, revenue sharing payments went to approximately 1,800 township governments.

Reforming State Tax Systems

Even before federal tax reform became law, the clamor for tax reform swept from the halls of Congress to state capitols across the country. State tax reform was a subject tackled by the National Conference of State Legislatures in 1985 (Gold). In Minnesota, a comprehensive plan for tax reform was the centerpiece of our governor's 1987 legislative package. At the heart of the plan was a pledge to return the potential windfall from federal income tax changes to state taxpayers. Other features of the plan were to cut corporation income tax rates (but to provide a new minimum tax for corporations), broaden the sales tax base and simplify the property tax system. A host of other tax law changes were also proposed. The stated objectives of the tax reform package were to make Minnesota more competitive with other states, stabilize the state's revenue system, simplify the tax system and improve accountability between state and local governments and taxpayers. All of this to be accomplished without increasing taxes, the governor pledged during his reelection campaign in the fall of 1986.

Tax Reform in Minnesota

In the end, the governor got most of what he asked of the 1987 Minnesota legislature. But the road to a final tax bill was arduous—perhaps partly because the governor's own Democratic-Farmer-Labor party controlled both houses of the legislature by sizable margins. Intra-party compromise can be a tricky business.

Minnesota's individual income tax system was simplified by closely adhering to the new federal tax law. Minnesota taxpayers will now begin calculation of their state tax liability by using federal taxable income (not adjusted gross income) as a starting point. The potential windfall from the expansion of the tax base was indeed returned to state taxpayers by reducing tax rates and the number of tax brackets. A sizable number of low-income taxpayers will be dropped from the tax roles, but for higher income taxpayers the progressivity of the tax has been lessened.

We did not, however, hold the line on taxes. For the 1988–89 biennium, state tax increases are estimated at around $700 million—an increase of more than 7 percent. This increase is the result of a new minimum tax on corporations (although corporation income tax rates were reduced), a broadening of the sales tax base and higher excise taxes.

The major unanswered question is what will happen to local property tax levels? For the time being, they will rise only modestly because of a temporary tightening of local levy limitations. After that the answer will depend on future legislative decisions. The Minnesota property tax system and attempts to reform it require a little elaboration.

Minnesota's Property Tax System

For years the principal tax policy issue in Minnesota was concerned with attempts to de-emphasize property taxes. The objective was to provide "property tax relief." The way chosen to accomplish this goal was to provide increased amounts of state-paid property tax credits to local taxpayers and more state aid to units of local government and school districts. The line of reasoning was clear: if the amount of state aid provided to local governments and the proportion of local property tax bills paid by the state in the form of property tax credits were increased, we then could reduce our reliance on the property tax as a source of local revenue.

The plan worked. In the mid-1960s more than 50 percent of all local expenditures in Minnesota was financed by property taxes. By 1974 this figure had dropped below 30 percent as larger and larger amounts of state (and federal) aid and direct property tax relief flowed to local governments and school districts. The property tax was indeed de-emphasized.

In the process of de-emphasizing property taxes, however, we added to the complexity of our property classification system and developed an intricate set of property tax credits. Much of the dissatisfaction with our property tax system stems from this complexity. Minnesota's property tax system is difficult to understand, hard to administer and almost impossible to explain. Taxpayers (and probably most politicians) don't understand how their tax bill is determined, and they don't know who to blame if their taxes go up or who to thank if they go down. Property tax reform was a key element of the governor's 1987 legislative proposals. Unfortunately, little progress was made.

To would-be property tax reformers, four sets of objectives are mentioned frequently. They include: (1) simplification of the property tax system, (2) better targeting of property tax relief measures, (3) avoiding large increases in property tax levels, and (4) making local officials more accountable for local spending decisions.

Minnesota has a complex, classified property tax system. Different classes of property are assessed at different percentages of market value, and state-paid property tax credits reduce the tax liability of some property owners. For taxes payable this year, Minnesota had sixty-eight different property classifications and ten different property tax credits. The property tax system was revamped by the 1987 legislature, but little was done to simplify it or make it easier to administer.

Some Concerns about New Federalism

I have several concerns about what has happened to intergovernmental fiscal relations and the response of the states to federal tax reform and added state responsibility for financing domestic public services. I shall mention only two.

First, in many respects the new federal tax law represents a giant improvement, in my judgment, in our tax system. And to the extent that the states follow the federal government's lead, state tax systems may be significantly improved. However, to the extent that economic competition between states distorts state tax policy decisions, results may be mixed. Bill Schreiber, minority leader of the Minnesota House of Representatives, once observed, "Good tax policy is not always good politics." But perhaps the situation is no different in state legislatures than in Congress.

Second, state spending may not adequately reflect our national interest in some public services. I am thinking in particular of social services and education and job training. Some states are richer than others and therefore can afford to do more. Both questions of equity and efficiency are involved.

These concerns, of course, involve what has and will happen to state tax and spending decisions and personal value judgments. I am often reminded of something that Senator Russell B. Long once said: "Tax reform means, don't tax you, don't tax me, tax that fellow behind the tree."

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