

# Minnesota Budget Bites

## Fiscal and tax information in bite-sized pieces

December 2000

### Dept. of Revenue has Big Plans for Tax Reform

Over the past year, the Minnesota Department of Revenue has engaged in a tax reform process that has included a Citizen's Jury, Citizens Dialogues around the state, stakeholder meetings, and internal study teams. This fall, the Department presented to the public the reform options they are considering. The Department of Revenue is now designing a tax reform package for Governor Ventura's consideration. The Governor will determine which of these options will be part of the administration's tax legislation for the 2001 session.

The Department of Revenue has described four goals that have guided their tax reform process:

- ❖ Make the property tax smaller, simpler, fairer, and more local.
- ❖ Sort out state and local government roles so that taxpayers know why they are being taxed and where the money is going.
- ❖ Make the state tax system competitive in a global environment.
- ❖ Ensure the tax system is fair for taxpayers of all income levels.

Following are some of the options the Department of Revenue (abbreviated as "Revenue" from here on) is considering for the major tax type. Some areas, including corporate tax reform, are not discussed here.

#### **Property Tax**

The primary focus of the Ventura administration's tax reform process is the property tax. The Governor has already begun to publicly discuss his proposal for the state to pay directly for the state-determined general education levy.

Currently, Minnesota spends a total of \$7.3 billion on K-12 education. Only 25% of this spending - \$1.8 billion - comes from the property tax; direct state spending makes up 66%, and the remaining 9% comes from other sources. Of the \$1.8 billion in education spending that is raised through property taxes, 48%, or \$900 million, is the state-determined general education levy. This is the portion of school funding that the state *requires* local governments to raise through property taxes.

Under Governor Ventura's proposal, the \$900

million general education levy would be deleted from property tax collections. The state would need to replace those property taxes with other revenue sources. Some of the changes the state may pursue to fill the funding gap are a statewide property tax on business properties, expansion of the sales tax base, and/or cuts to a state funding program for cities and towns called HACA.

Revenue is also looking at classification reform. Minnesota is one of about 30 states that impose different property classification rates (class rates for short) based on a property's use. The class rate describes what percentage of the property's market value will be used to determine its property tax.

Differences in class rates mean properties of equal value but used for different purposes pay different amounts of tax. The major classifications are: Residential Homestead (owner-occupied homes), Residential Non-homestead, Market-rate Apartments, Low-Income Apartments, Commercial/Industrial/Public Utility, Seasonal Recreational Commercial (resorts), Seasonal Recreational Residential (cabins), and Agricultural.

Within some of these class rates, there are different tiers based on value. For example, the first \$76,000 of value (called the first tier) of a homestead has a class rate of 1%, but any value over \$76,000 (the second tier) has a class rate of 1.65%.

Revenue is considering combining some of these classes, so that all similar-use properties (such as homes, apartments, and cabins) are subject to the same class rate, and to eliminate or reduce tiers.

Overall, Revenue suggests that the state rely more on the Property Tax Refund program (known more commonly as the Circuit Breaker and Renters Credit components) to provide targeted tax relief, rather than providing general tax relief to whole categories of property through the classification system.

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## **Sales Tax**

In the sales tax area, broadening the base means expanding the sales tax to items not currently taxed. Currently, Minnesota has the 3rd highest sales tax rate, but only ranks 26th in terms of dollars raised by the sales tax. This is because Minnesota exempts many purchases from the sales tax. The Administration is particularly interested in extending the sales tax to services.

Some items that are unlikely to become taxed under a sales tax expansion include food, clothing, child care, medical services, and tuition. Instead, Revenue is looking at services that are taxable in neighboring states, which include accounting, legal services, repairs, landscaping, delivery, and beauty/barber services. A shift to taxing more services would reflect the fact that over time, services have made up a larger share of total consumer purchases. Making more purchases taxable could also mean that the sales tax rate itself could be lowered.

The sales tax is a regressive tax, meaning that it takes a larger share of income from lower-income taxpayers than from upper-income taxpayers. Whether changes in the sales tax make it more or less regressive depends on what items become taxable and what the sales tax rate will be.

## **Individual Income Tax**

Revenue has suggested changing the starting point for the Minnesota individual income tax. Currently, Minnesota income tax forms begin with federal taxable income (FTI), which is the measure of income *after* subtracting either itemized or standard deductions. Revenue has suggested that Minnesota income tax start instead with federal adjusted gross income (FAGI), a broader measure of income *before* taking deductions.

This may seem like a technical change, but it would reflect a shift away from trying to provide incentives for personal spending decisions in the tax code. By using FAGI as the starting point, the state would minimize the impact of all federal itemized deductions (such as charitable giving and the mortgage interest deduction) on the Minnesota income tax.

To further simplify the income tax, Revenue proposes eliminating most additions to and most subtractions from taxable income and some of the non-refundable credits. There are currently 5 additions and 11 subtractions, such as the non-itemizer charitable deduction and health insurance subtraction for the self-employed; in addition, there are several non-refundable credits, which include the long-term care insurance credit and credit for employer transit passes. The two check-offs would also be removed from the income tax form (state elections campaign checkoff and non-game wildlife fund checkoff). Revenue is not necessarily proposing eliminating the

programs funded through check-offs, but rather suggests that they be administered outside the income tax system.

Through this process of “base broadening,” the state could lower income tax rates to 5%, 6.5%, and 7.5%, yet still collect the same total amount of income tax. (The current rates are 5.35%, 7.05%, and 7.85%). Under this scenario, 70% of taxpayers would receive a tax cut and 30% would see a tax increase. Approximately 100,000 persons would no longer owe any Minnesota income tax. Our current income tax system is progressive, meaning that it takes a larger percentage of income in taxes from upper-income taxpayers than from lower-income taxpayers. Under this proposal, the income tax system would become slightly more progressive, although the change may not be statistically significant.

Part of this picture would also be an enhanced Working Family Credit (WFC), that would combine some or all of the state’s three refundable credits for low-income individuals and families. The Working Family Credit is a refundable credit for low-income taxpayers with earnings from work. For tax year 2000, a small WFC is available to taxpayers with no children up to an income of \$10,380. Larger WFCs are available to one-child families with incomes up to \$27,413 and families with two or more children up to \$31,152.

Under Revenue’s proposal, the existing K-12 education credit for low-income families would be eliminated, but families receiving the WFC would receive an additional \$100 credit for one child and \$200 for two children. It is not clear at this point whether Minnesota’s child and dependent care credit would also be rolled into the enhanced Working Family Credit. (This reform to “streamline” the refundable credits could also occur without the other changes in the income tax.)

## **Exempt Entities**

The Department of Revenue is also considering a number of changes to the treatment of organizations that are exempt from taxation. Exempt entities include governmental bodies and nonprofits, although not all governments or nonprofits are exempt from all taxes.

Under current law, Minnesota provides an exemption from the property tax for institutions of “purely public charity.” However, the law does not define this term, and therefore it has been determined over time through a series of court cases. The Department of Revenue is concerned about the lack of uniformity of how this term is defined across jurisdictions, and the difficulties faced by assessors in deciding whether a given property should be exempt. Revenue has not yet determined how the exemption would be defined, but has suggested they may define it very narrowly.

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# Food for Thought and Action: Research Reviews

In each edition of *Minnesota Budget Bites*, we describe research reports whose findings may be of interest to our readers. In this issue, we look at two reports addressing job quality and flexibility.

In his report, ***No Shortage of 'Nonstandard' Jobs***, Ken Hudson of the Economic Policy Institute looks at nonstandard jobs - sometimes called contingent work - including part-time (less than 35 hours a week), independent contracting, temping, on-call work, day labor, and self-employment. Among his key findings:

- ❖ In 1997, 28.7% of American workers were employed in nonstandard jobs. This is an issue of concern, since most types of nonstandard workers earn lower hourly wages on average than their counterparts with similar personal characteristics engaged in regular, full-time work.
- ❖ Compared to regular full-time jobs, nonstandard work is concentrated at the top and bottom of the wage scale, with few jobs in the middle. Nonstandard arrangements that pay higher hourly wages than standard jobs are independent contractor and contract company employment. However, only 37.2% of nonstandard workers are in these arrangements. The more common types of nonstandard work - temp agency, on-call, and part-time - mean lower hourly wages than similar regular, full-time jobs. Self-employment means above average hourly wages for men, but below average for women.
- ❖ There is a gender gap in nonstandard work: 33.7% of women have nonstandard jobs, while only 24.3% of men do. In addition, men are concentrated in the higher-paying kinds of nonstandard work: 62.4% of men in nonstandard work are in arrangements with higher average wages, but only 14% of women are.
- ❖ All types of nonstandard work mean a reduced chance of receiving employer-based health insurance or pension benefits. Only 13.6% of women and 9.3% of men with nonstandard work arrangements receive health insurance through their employer.

Many believe that people are attracted to nonstandard jobs due to the flexibility they provide. However, whether a nonstandard worker prefers his/her current arrangement over a regular full-time job depends on the quality of the job. Hudson finds that the majority of temps and on-call workers say they would rather have a standard job, while the majority of independent contractors and self-employed workers prefer their existing arrangement.

Another belief about nonstandard jobs is that they appeal particularly to students, who will then go on to find better employment after they complete their education. However, only 12% of nonstandard workers are students.

If nonstandard work arrangements on the whole mean a trade off of job quality in exchange for perceived flexibility, what other chances do American workers have to attain flexible work schedules? ***The Time Bandit: What U.S. workers surrender to get greater flexibility in work schedules***, an issue brief by Lonnie Golden for the Economic Policy Institute, argues that a more family-friendly work environment can arise when workers have more work-hour flexibility and less work-schedule volatility.

Golden finds that in 1998, 46% of workers spent more than 40 hours a week on the job, and 18% worked more than 50 hours per week.

Over time, the percentage of full-time workers with flexibility (the ability to adjust the length or timing of their work week), has increased from 12.4% in 1985 to 27.6% in 1997. However, there seems to be a gap between availability and usage: the proportion of firms who say they offer flextime is two or three times higher than the proportion of workers who say they have such flexibility.

Access to flexible work schedules is not evenly available - flexibility is less common among non-whites, women, unmarried workers, those with little education, and in low-skilled occupations. Workers are most likely to have access to flexible work schedules if they work either 50 or more hours per week or fewer than 20 hours a week, or are self-employed. The flexibility that is currently available is unlikely to help workers balance their work and family responsibilities, as they must sacrifice income to work part-time or work unusually long hours.

Another aspect of work scheduling affecting workers is volatility, or the degree to which the length or schedule of work hours varies at the employer's discretion. Volatility tends to be strongly associated with flexible daily schedules, especially among part-time workers. This means that workers with more flexibility also face less stability in work hours, which also has negative implications for work/family balance.

The paper concludes with a call for coordinated policy changes to enhance scheduling flexibility for more American workers. By being able to customize and individualize their work hours, employees can achieve the number of work hours most beneficial to them and their families. It could also help transfer some work hours from the over-employed to the underemployed.

***No Shortage of 'Nonstandard' Jobs*** is available online at [www.epinet.org/briefingpapers/hudson/hudson.html](http://www.epinet.org/briefingpapers/hudson/hudson.html), and ***The Time Bandit*** at [www.epinet.org/Issuebriefs/ib146.html](http://www.epinet.org/Issuebriefs/ib146.html).

More information about advocacy efforts to improve the rights and job quality of nonstandard workers is available at [www.fairjobs.org](http://www.fairjobs.org).

# Dept. of Revenue has Big Plans for Tax Reform, continued

Another proposal would allow local governments to require nonprofits who own property to make "payments in lieu of taxes" or some other kind of service fee, whether exempt from the property tax or not. This proposal responds to complaints from local governments about the percentage of properties that are exempt from the property tax. However, only 15% of all property in Minnesota is exempt, and the majority of exempt land is owned by government.

Some exempt entities already enter into voluntary agreements with local governments to make payments in lieu of taxes. Another approach under consideration is for the state to take on an oversight role and develop guidelines that such voluntary agreements should follow.

## **Other Taxes**

The health care provider tax, which funds the MinnesotaCare program, has received a lot of attention from the legislature in recent years, and the House and Senate Republican caucuses have made it a priority to repeal the tax. Revenue has considered the issue of the MinnesotaCare tax, but appears to prefer reform, perhaps looking at a reduction of the rate.

Revenue also is looking at the excise tax on cigarettes. Minnesota has a relatively low tax on cigarettes and the funds raised are used for general purposes. One possibility is to increase the tax on cigarettes and devote at least some of the proceeds to health care.

Excise taxes are regressive taxes, meaning they take a bigger percentage of income from lower-income taxpayers than from those with higher incomes. The cigarette tax is one regressive tax that Revenue may be willing to raise, despite the fact that such an increase would hit low-income people hardest.

Overall, Revenue is attempting to make sure the effect of the total tax system after reform will be much as it is now, where taxpayers of all income levels are paying about the same total percentage of income in state and local taxes.

*Readers wishing a more comprehensive outline of reform options are directed to our **Overview of Department of Revenue Tax Reform Options**, available at [www.mncn.org/bp/overview.htm](http://www.mncn.org/bp/overview.htm). The Department of Revenue's briefing papers addressing all proposals in more detail are available at [www.taxes.state.mn.us/reform/brpap2000.html](http://www.taxes.state.mn.us/reform/brpap2000.html).*

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