

Revenue-Raising Options to Address Minnesota's Budget Deficit

Minnesota is facing a severe budget deficit. For the 2004-05 biennium, the Forecast shows a \$4.2 billion deficit. The deficit represents approximately 14% of the state's 2004-05 general fund budget. Unlike past forecasts, expenditures are not adjusted for the impact of inflation. If inflation were included, the deficit would be \$1.1 billion larger.

Tough choices are ahead, but they can be smart choices. This document outlines several revenue-raising options, which are judged by the following principles:

- The state's budget-balancing decisions should not make the impact of the recession worse for those Minnesotans least able to weather the downturn, including low-income families, laid-off workers, and other vulnerable populations.
- The state should use a combination of the three primary budget-balancing tools available: raising revenue, using reserves, and cutting spending.
- Budget balancing should be informed by current need and past budget decisions, including how surpluses were divided between tax cuts and new spending, who benefited from recent tax cuts, and how certain programs were underfunded even in times of surplus.
- Federal actions impact the state's efforts to balance the budget. The state should work with federal decision-makers to promote revenue sharing, and to oppose federal tax cuts or stimulus plans that make it more difficult for the state to balance its budget.

This document presents a range of revenue-raising options, estimating how much revenue each could raise and weighing them against the principles listed above. It is not intended to endorse any particular proposal or provide an exhaustive list of all possibilities. More discussion and debate is needed to determine the appropriate amount of revenue to be raised as part of a budget-balancing solution and the best options for doing so.

The Case for Raising Revenues

One of the principles for budget balancing articulated above is that the state should use a combination of the three primary budget-balancing tools available: raising revenue, using reserves, and cutting spending. However, some have argued that tax increases are the "last thing" that should be done in a recession. There is no economic basis for this statement. As argued by Peter Orszag of the Brookings Institution and Joseph Stiglitz, recipient of the 2001 Nobel Prize in Economics, both spending cuts and tax increases take money out of the state economy. In a recession, the focus should be on consumption. While each \$1 cut in government spending immediately removes \$1 from the state economy, a \$1 tax increase is likely to be offset by a partial reduction of savings — for example, consumption may fall by 90¢ and savings reduced by 10¢. Therefore, a tax increase may be less of a drag on the economy than would be an expenditure cut of the same size.¹

A number of options for increasing state revenues are described below, along with their fiscal impact and the consequences for tax fairness. These options include:

- Enact an income tax surcharge or other income tax changes
- Close corporate tax loopholes
- Broaden the sales tax base

¹ Center on Budget and Policy Priorities, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?*, www.cbpp.org/10-30-01sfp.htm.

- Increase excise taxes
- Rethink past tax cuts
- Promote federal revenue sharing

Enact an Individual Income Tax Surcharge or Other Income Tax Changes

Most of the state's taxes are regressive, meaning they take a larger percentage of income from lower-income Minnesotans than from those with higher incomes. In contrast, the state's income tax is a progressive tax that takes a higher percentage of income from those with a greater ability to pay.

Income tax surcharges were used as a response to the state's deficits in the early 1980s. An income tax surcharge can raise revenue in a progressive way and without much complexity. When a surcharge is in place, taxpayers calculate their income taxes following the existing tax laws, but then add an additional surcharge amount, such as 10% of taxes owed. A surcharge is a flexible tool, as the amount of surcharge can be chosen depending on the amount of revenue needed — for example, a 10% surcharge would raise \$558 million in FY 2004 and \$647 million in FY 2005.² A surcharge could also be removed, or “blinked off,” when the additional revenue is no longer needed.

Another change that policymakers could consider is changing income tax rates. For example, income tax rates could be returned to their pre-1999 levels. This would mean increasing the current rates from 5.35%, 7.05%, and 7.85% to 6%, 8%, and 8.5%. This would raise \$671 million in FY 2004 and \$741 million in FY 2005.³

Table 1 shows the impact of each of these income tax proposals on sample families. In each case, the family is a family of four, consisting of a married couple and two dependents.

Additional Tax Owed in Tax Year 2004	Family #1	Family #2	Family #3
Adjusted Gross Income	\$25,000	\$60,000	\$100,000
10% Income Tax Surcharge	\$24	\$215	\$449
Increase Income Tax Rates	\$29	\$270	\$586

Source: House Research. Assumes Family #1 takes the standard deduction, Families #2 and #3 take itemized deductions equal to 17% of income. Examples do not take into account any tax credits, such as the Working Family Credit, for which families may qualify.

Another feature of income tax increases is that some of the cost is offset by federal deductibility. Minnesotans who itemize their deductions on their federal tax returns are able to deduct their state income taxes; therefore, any increase in state income taxes results in a decrease in federal income taxes. In the case of the 10% income tax surcharge, 22% of the total cost would be offset by lower federal taxes.⁴

Close Corporate Tax Loopholes

Given the budget situation, the state may want to close corporate tax loopholes. In particular, the state may want consider provisions that address the problem of multi-state corporations having a portion of their income untaxed. A good step in this direction would be a throwback rule, which for purposes of the corporate franchise tax, treats sales made in a state in which a

² Minnesota House of Representatives Research Department. This assumes that the surcharge would be implemented July 2003. A 5% income tax surcharge would be in place for the second half of the 2003 tax year, and a 10% income tax surcharge starting in 2004.

³ House Research. This assumes that the rate changes would be implemented July 2003. Rates for the second half of the 2003 tax year would be half way between the old and new rates, and the new rates would be fully in effect for 2004.

⁴ House Research.

corporation is not taxable as if they were made to customers in the state from which it was shipped.⁵ This provision would raise \$15 million in FY 2004.⁶ Of 46 states with corporate income taxes, 24 have a throwback rule and two have a similar “throw-out” rule.

Broaden the Sales Tax Base

There has been some discussion of expanding the sales tax base, and there are many ways this could be done. The sales tax is a regressive tax, so attention should be paid to the impact on tax fairness. Making the sales tax a larger portion of total taxes paid is likely to make the overall tax system more regressive.

Three options for base broadening are described below. The fiscal impacts listed provide an approximate amount of revenue to be raised in FY 2004.⁷

- Option 1: Eliminate exemption on clothing: \$434 million
- Option 2: Eliminate exemptions on many products and services (not including clothing) purchased by consumers and businesses: \$1.5 billion
- Option 3: Eliminate exemptions on products and services purchased mainly by consumers (not including clothing): \$479 million

The three options above illustrate the range of revenue that could be raised through base expansions. Option 1 simply applies the sales tax to one exempt category: clothing. Typically, legislation to tax clothing has exempted used clothing and sewing materials.

Option 2 takes a different approach, and rather than eliminate one exemption, taxes a wide range of goods and services that are purchased both by consumers and businesses. Items that would become taxable include publications, beauty and barber services, advertising, computer and data processing, legal services, accounting, and vehicle repair.⁸ Exemptions would remain on essentials including food, drugs and medicines, baby items, and funeral services. This option does *not* include removing the exemption on clothing.

The argument has been made that the sales tax should only be paid on final consumption, and that sales taxes on business inputs are passed on as a higher final price for a product. Option 3 takes this argument into account, and removes from Option 2 services purchased mainly by businesses.

Increase Excise Taxes

Excise taxes — such as those on alcohol, cigarettes, and motor fuels — do not keep up with inflation, because they are usually a flat amount rather than a percentage of the retail price. The alcohol excise tax was last increased in 1987, the gas tax in 1988, and tobacco taxes in 1992.

There are several legislative proposals to increase cigarette taxes by \$1 per pack, for a total of \$1.48. This increase, combined with increases in related tobacco taxes, is estimated to raise \$295 million in FY 2004.⁹

⁵ For more on this topic, see Center on Budget and Policy Priorities, *Closing Three Common Corporate Tax Loopholes Could Raise Additional Revenues for Many States*, www.cbpp.org/4-9-02sfp.htm.

⁶ Senate Office of Fiscal Policy Analysis, Analysis of SF 1504.

⁷ Minnesota Department of Revenue, *Tax Expenditure Budget Fiscal Years 2002-2005*, www.taxes.state.mn.us/reports/fiscal/teb2002.html.

⁸ A more detailed list of items that would be taxed under Options 2 and 3 is provided in Appendix 1.

⁹ Minnesota Revenue, fiscal note for HF 29/SF 114.

Recent proposals have suggested an increase of 5¢ per gallon in the state’s gas tax, which would raise \$164 million in FY 2004.¹⁰ The gas tax is different from the other revenue sources discussed in this document because gas tax revenues are dedicated to transportation. Therefore, an increase in the gas tax does not directly ease the general fund budget deficit. However, a gas tax increase would allow policymakers to dedicate a smaller portion of other taxes to transportation, such as motor vehicle sales taxes, and thereby make more of these other taxes available to the general fund.

Excise taxes, and tobacco taxes in particular, are more regressive than the general sales tax. Proponents of increased excise taxes argue that the positive social impacts of increasing excise taxes, such as a reduction of youth smoking, outweigh the impact on tax fairness, or that in the case of the gas tax, that they serve as a “user fee” by which those who use a service are the ones who pay for it. Nonetheless, policymakers should be careful not to become overly reliant on regressive taxes as a revenue source.

Rethink Past Tax Cuts

Since the deficit is largely due to lower revenues, it is reasonable to ask whether tax changes made in previous legislative sessions could be frozen or reversed in order to address the deficit.

The only significant part of the 2001 tax bill that has not yet been implemented is the elimination of the June Accelerated Sales Tax Payment, which is scheduled to be repealed on June 2004. Currently, merchants must remit 75% of their estimated sales tax collections for June in advance, which moves some of the sales tax revenues into the prior fiscal year. Delaying the repeal indefinitely, as is proposed in Governor Pawlenty’s 2004-05 budget, would provide \$155 million in one-time revenue in FY 2004.¹¹ This strategy is more appropriately described as a shift, rather than a way to raise new revenue.

Policymakers may wish to reconsider some of the tax reductions made in previous sessions. Permanent tax cuts were made in each of the five surplus years from 1997 to 2001. Property tax cuts were made in 1997, 1998, 1999, and 2001, income tax cuts in 1999 and 2000, and motor vehicle registration taxes (also known as “tabs”) were reduced in 1999. The total impact of permanent tax changes in the 2004-05 biennium is \$5.5 billion¹² — in other words, if Minnesota had in place the same tax system that existed in 1997, the state would have an additional \$5.5 billion in revenues.¹³

Promote Federal Revenue Sharing

In past recessions, the federal government provided financial assistance to states through revenue sharing. Revenue sharing can be provided quickly and with little administrative burden by channeling additional revenue to the states through existing programs. For example, one proposal under discussion is for the federal government to temporarily pay for a larger share of Medicaid, which is jointly funded by states and the federal government and provides health care for low-income families, seniors, and disabled persons. State policymakers should encourage implementation of federal revenue sharing.

¹⁰ Governor Jesse Ventura, *2002-03 Supplemental Budget Recommendations*.

¹¹ *State of Minnesota 2004-05 Biennial Budget*. In fact, the Governor’s proposal would also increase the June Accelerated Payment to 85% of estimated collections and would also apply it to excise taxes, which would raise an additional \$37.7 million in FY 2004.

¹² Minnesota House of Representatives Fiscal Analysis Department, *Tax Cuts and Rebates: The Fiscal Impact of Five Years of Tax Cuts (1997 - 2001)*, www.house.leg.state.mn.us/fiscal/files/02taxcuts.pdf.

¹³ Readers should not compare this \$5.5 billion in additional revenue to the \$4.2 billion deficit and conclude that there would be no deficit if tax cuts had not been made. What the state’s fiscal situation would be in the absence of these cuts depends on how the resources that went to tax cuts would have been allocated instead.

Policymakers should also be ready to make changes so that federal tax changes do not lead to additional shortfalls in revenues. Minnesota largely follows federal law definitions related to income and corporate taxes. This means that federal tax changes can reduce state tax revenues unless states act to avoid the loss. For example, conforming to the federal economic stimulus package enacted in March 2002 would have meant a loss of \$234 million of state revenue for 2002-03 and \$146 million in 2004-05. In the 2002 Legislative Session, policymakers agreed to conform to most of the items in the federal stimulus bill, but not the “bonus depreciation” provision, which accounted for most of the cost. The decision not to conform to such federal provisions strikes a balance between keeping things simple for taxpayers and avoiding a significant loss of state revenue.

Revenue Increases Should Not Hit Low-Income Families the Hardest

Whatever revenue increases may be implemented, attention must be paid to the effect on tax fairness. The combination of tax increases during the recession of the early 1990s and the tax cuts enacted in the better economic times that followed have led to tax systems in most states that are more regressive.¹⁴ Many of the options discussed above would hit low-income taxpayers the hardest. Fortunately, there are several strategies that can be used in combination with the options listed above to ensure that budget-balancing decisions are not overly burdensome on the state’s low-income taxpayers:

- Expand existing refundable tax credits for low-income families such as the Working Family Credit or Property Tax Refund.
- Reduce the sales tax rate. Some base broadening options bring in a large amount of revenue at the current 6.5% rate, and therefore the rate could be lowered while still having a net increase in sales taxes.¹⁵
- Provide a sales tax credit to low- and moderate-income taxpayers to offset sales tax base broadening. One possible mechanism would be an automatic sales tax credit, similar to the sales tax rebate, but targeted to specific income groups.

Taxes Versus Fees

In determining what options for raising revenues makes most sense to address the state’s budget situation, policymakers will undoubtedly take a second look at the state’s many fees.

Policymakers may want to look at areas where fees have not keep up for inflation. For example, in 2002, Governor Ventura proposed adjusting the minimum fee paid by businesses (which have not been increased since 1990) and increasing the minimum fee from \$0 to \$50. This proposal was projected to bring in \$25.5 million in FY 2004.¹⁶

However, decision-makers must be careful of the unintended consequences of using fees instead of taxes to raise revenues for general purposes. Minnesotans who itemize their deductions on their federal forms may deduct their state income taxes and portions of their auto tabs, but most fees are not deductible. Low- and moderate-income taxpayers may receive income tax credits to offset their overall tax burden, but it is more difficult to offset the burden of fees.

Similarly, on the local level, a city or county may consider increasing assessments (a fee) but not raising property taxes. Again, taxpayers who itemize on their federal income taxes can deduct their property taxes, but not all assessments are deductible. In addition, low- and middle-

¹⁴ Center on Budget and Policy Priorities, *The Rising Regressivity of State Taxes*, www.cbpp.org/1-15-02sfp.pdf.

¹⁵ If this approach is used, the revenue estimates of the base expansions above should be reduced to take into account the lower rate.

¹⁶ Governor Jesse Ventura, *2002-03 Supplemental Budget Recommendations*.

income persons with high property tax burdens are provided some relief through the Circuit Breaker and Renter's Credit, but there is no relief provided when the burden comes from fees.

Fees often do not take into account ability to pay. If government is highly reliant on fees, struggling families might be unable to afford the "price of admission" to libraries, school activities, or higher education.

Conclusion

There is no question that difficult choices are ahead for Minnesota's decision-makers. However, by using responsible fiscal decision-making, looking at the full range of options available, and considering the impact of their decisions on vulnerable Minnesotans, policymakers can make budget-balancing decisions that put the state on the right track while not increasing the recession's burden on those who are hurting most.

Appendix 1: Sales Tax Base Broadening Options

Option 2: Eliminate exemptions on products and services purchased by consumers and businesses: \$1.5 billion for FY 2004

Feminine hygiene items, publications, textbooks, computers for school use, residential heating fuels, residential water services, sewer services, used manufactured homes	\$190 million
Personal services: beauty/barber, shoe and leather repair, tax preparation, diet and weight reduction, miscellaneous	\$59 million
Business services: advertising and public relations, consumer credit reporting, collection agencies, office administrative services, computer system design and related, other	\$383 million
Other services: legal, engineering, accounting, research & testing, management & PR, scientific consulting, auto repair, misc. repair	\$886 million
Miscellaneous: Television commercials, advertising materials, horses	\$10 million
TOTAL:	\$1.5 billion

Option 3: Eliminate exemptions on products and services purchased mainly by consumers: \$479 million for FY 2004

Feminine hygiene items, publications, textbooks, computers for school use, residential heating fuels, residential water services, sewer services, used manufactured homes	\$190 million
Personal services: beauty/barber, shoe and leather repair, tax preparation, diet and weight reduction, miscellaneous	\$59 million
Other services: auto repair, misc. repair	\$229 million
Miscellaneous: Horses	\$1 million
TOTAL:	\$479 million