An Introduction to

Property Tax Reform in Minnesota

BACKGROUND ON THE PROPERTY TAX

HOW IS THE PROPERTY TAX CALCULATED?

GOALS OF PROPERTY TAX REFORM

Minnesota Budget Project

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About The Minnesota Budget Project

Ongoing public policy changes at the federal, state, and local levels of government have increased the need for policy-makers and community leaders to understand the implications of tax and budget decisions on our state's vulnerable populations. In the coming years, fiscal policy decisions made at the Legislature and at county courthouses and city halls across the state will influence Minnesotans' ability to successfully find livable wage jobs and secure access to affordable housing, education, health care, and other essential services.

The Minnesota Budget Project, an initiative of the Minnesota Council of Nonprofits, provides independent research, analysis, and outreach on state budget and tax policy issues, emphasizing issues affecting low and moderate-income persons and the organizations that serve them. Our mission is to provide interested citizens, elected officials, and community leaders with timely and accurate information so that they can become more active and effective participants in the public policy debate.

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An Introduction to Property Tax Reform in Minnesota

Table of Contents

EXECUTIVE SUMMARY

The property tax can be looked at from two points of view: as a revenue source for local units of government and as a piece of the total tax burden on taxpayers. As a revenue source, it provides a range of support, from 26.1% of revenues for school districts to 57.9% of revenue for towns. Local units of government use property tax revenues to pay for services including streets and roads, health programs, public safety, human services, recreation and park facilities, and sanitation. As taxpayers, most Minnesotans pay between 3% and 4% of their incomes in property taxes. In total, an estimated $4.6 billion in property taxes will be paid in Minnesota in 2000, compared to $5.1 billion in income taxes and $3.6 billion in sales taxes.

The Minnesota property tax is calculated based on the estimated market value of property. The legislature sets class rates, which determine how the property tax burden will be distributed among different kinds of property. Homes, farms, and cabins have fairly low class rates, while businesses and apartment buildings have higher class rates. This means a home, farm, or cabin will pay lower property taxes than a business or apartment building with the same value in the same taxing jurisdiction. Local units of government determine how much property tax revenue they need to collect, which is called the levy, and distribute that tax burden among the properties in their taxing jurisdiction.

Property tax reform is not a new idea, nor a one-time event. It is an ongoing process that has received renewed emphasis in recent years from both the legislature and the Governor. There is general agreement among decision-makers and analysts as to the main goals of property tax reform. They are:

1. Simplify the property tax system.
2. Reduce reliance on the local property tax.
3. Make government more accountable to taxpayers.
4. Provide more tax relief directly to taxpayers based on individual need.
5. Ensure that local taxing authorities have sufficient resources to provide an adequate level of public services.

Most past and current reform strategies can be judged in relation to these goals. Reform strategies that don't fit neatly under these goals are those that address whether the assessed market value of property is an appropriate starting point for calculating a tax. These strategies question the very premise of a property tax.

In order to **simplify** the property tax system, the state has sought in recent years to reduce the number of property classes. It has also undertaken rate compression, or the reduction of differences between class rates. The state has also made changes, mainly through the Truth-in-Taxation process, to make the property tax system more understandable to the taxpayer and to give the citizen a greater voice in the process.

The state has also pursued several strategies to **reduce reliance** on the local property tax. These include taking over more of the cost of certain services, especially schools and courts, and by imposing levy limits that restrict the amount that property tax collections by local units of government can grow from year to year. Another possible strategy to lower the property tax would be to allow local units of government to collect other kinds of revenues, such as local sales or income taxes.

Accountability means making sure the citizen knows what decisions change the level of taxation and who makes those decisions. The Truth-in-Taxation process, especially the use of public hearings and tax statements that outline the various components of the tax bill, have been used to increase accountability.

The property tax is based on the assessed market value of one's property, which historically was a good approximation of wealth. This is less true today than it was in the past, which makes it necessary to provide **tax relief based on individual need** when property taxes are excessive in relation to the taxpayer's ability to pay. The Property Tax Refund Program (also known as the circuit breaker or renter's credit) provides relief to individuals who pay a large of a percentage of their income for property taxes. The Senior Deferral Program allows seniors to limit their property tax payments and defer the rest of the taxes until a future date.

State aid has been the main mechanism to ensure that local units of government have **sufficient revenue to provide adequate public services**. State aids are used to make sure that areas of low property wealth can still provide adequate services and to ensure a similar quality of education in all school districts. Some criticize the state aid system for being too based on historical factors and not enough on current needs.

Some changes to the property tax system do not relate directly to these goals, and instead make adjustments to assessed market value as the basis for taxation. Our "Limited market value" law caps the amount by which a property's assessed value can grow, and currently is in place for homes, farms, and cabins. Some have suggested changing to an acquisition value system, under which property tax would be based on the purchase price of the property. Another idea is excluding the value of improvements from the assessed market value.

All changes to the system must be judged by the degree to which they alter how much different people pay and to what extent services are enhanced or restricted. Strategies that reduce the amount of tax one group pays often shift tax burdens on to others. Strategies that reduce the total amount of property tax collected in a jurisdiction require that other revenue sources be found or that spending be reduced.

Citizens are affected by the property tax both as they pay the tax and as they benefit from the services it funds. They therefore must take an active role in the reform process.

INTRODUCTION

Minnesota's state government has embarked on an 18-month journey to develop a package of property tax reform initiatives for consideration by the 2001 legislature. The first stage of the study process was the meeting in August 1999 of a "citizens jury." The jury received background information on the property tax system and made recommendations on the appropriate revenue mix for various levels of local government and how to improve the property tax system. The administration is also holding meetings around the state this fall and winter at which citizens can discuss tax reform.

Property tax reform is not a new idea or a one-time event. It is an ongoing process that has been a priority in recent years of the legislature and is now a priority of the Ventura administration.

Citizens are affected by the property tax both as they pay the tax and as they benefit from the services it funds. They therefore must take an active role in the reform process. This publication is intended to enable the public to become more informed participants in the tax reform debate.

The first section of this report provides an overview of the property tax, explaining its role both as a funding source for local units of government and discussing it as part of the overall tax burden. The next section is a step-by-step explanation of how the property tax is calculated.

The main part of the report provides the reader with a framework for evaluating various tax reform strategies. It describes these strategies in relation to five characteristics of a well-designed property tax system: simplicity, reduced reliance on the property tax, accountability, tax relief provided to individuals based on need, and ensuring local governments have sufficient resources to provide an adequate level of services.

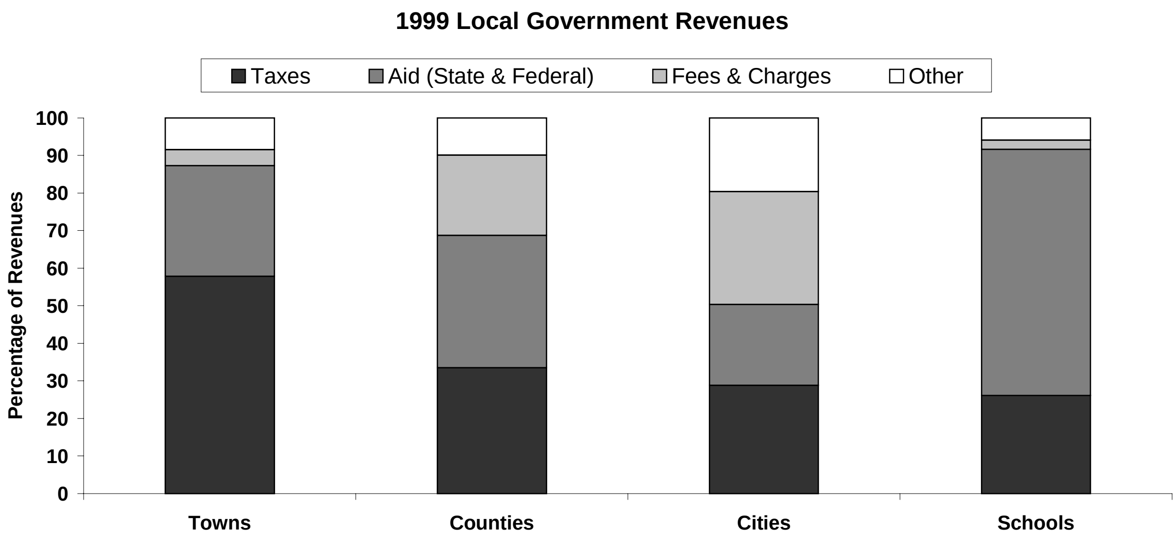
All terms shown in ***bold italic*** type are defined in the Glossary of Terms in Appendix 2.

BACKGROUND ON THE PROPERTY TAX

The property tax can be looked at from two points of view: as a revenue source for local governments and as a piece of the total tax burden on taxpayers.

The Property Tax as a Local Government Revenue Source

The property tax funds local units of government: counties, cities, towns, and school districts.[1] It is an important revenue source for all local units of government, ranging from 26.1% of total income for school districts to 57.9% of total income for towns. The chart below presents the relative importance of the major revenue sources of local governments. It is important to note that the chart presents the state average — each local unit of government has a different mix of revenues.[2]



Why do local units of government need to collect tax revenues and what do they spend their money on? Counties provide many services, such as health and welfare programs, under rules prescribed by the state. The state does not always provide full funding for the services it requires local units to provide (these are called ***unfunded mandates***), and therefore local units of government must raise other revenues to cover the cost. Counties also provide services to meet local demands, such as public safety and sanitation. The services provided by cities and towns vary based on the municipality's location, size, age, and demographics and are more locally determined.

State average expenses in 1996 for different units of government are listed below.

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[1] The information in this section comes from the State of Minnesota Office of the Legislative Auditor, Program Evaluation Division, presentation to the Citizens Jury on Property Tax Reform, August 3, 1999.
[2] In this chart, "taxes" means almost exclusively property taxes. The only exception is a relatively small amount of city sales tax revenue.

Average Expenditures by Local Units of Government (1996)			
Type of Expenditure	**County**	**City**	**Township**
Human Services	28.9%		
Streets & Highways/Roads & Bridges	15.1%	16%	52.8%
Health Programs	15%	7.8%	
General Government	13.3%	8.3%	18.7%
Public Safety	13%	15.9%	11.8%
Sanitation/Water & Sewer	3.6%	8%	3.6%
Debt Service	3.6%	16.8%	7.1%
Recreation	2.7%		
Culture		9.5%	
Housing		8.4%	
Capital Outlay		3.3%	
Other	4.8%	6.1%	6.1%
Total	**100%**	**100%**	**100%**

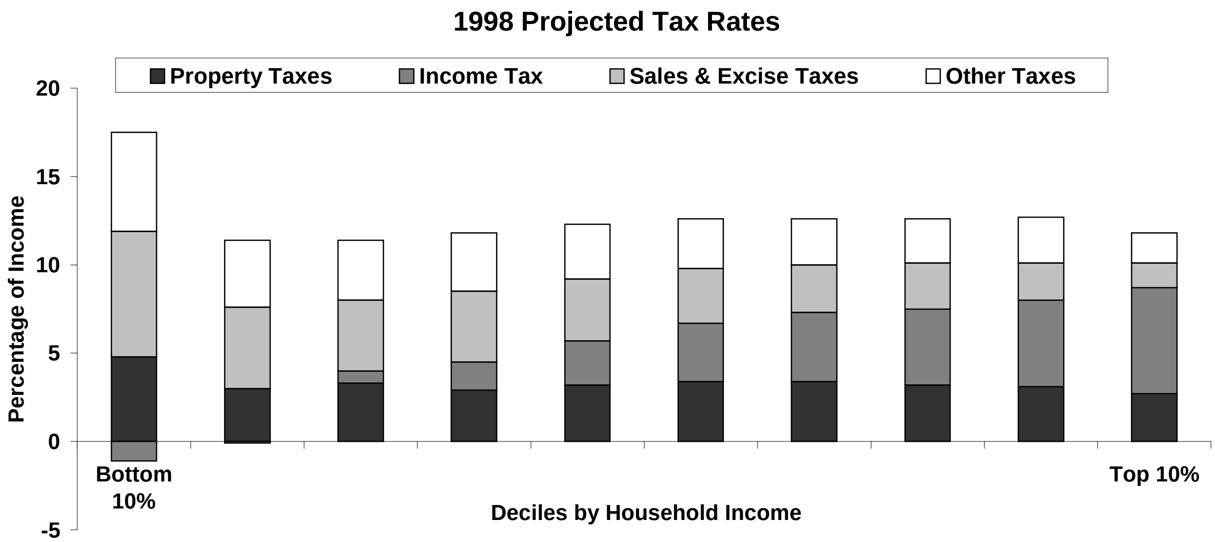
School districts provide very different kinds of services. They spend an average of 61.3% of their operating expenditures on instruction, 13.9% on student services, 10.9% on operations and maintenance, 9.3% on administration, and 4.6% on other operations.

The Property Tax as Part of the Total Burden on Taxpayers

Another way to consider the property tax is as part of the total tax burden on individuals.[3] Every two years, the Minnesota Department of Revenue releases a comprehensive ***tax incidence*** study in order to answer the question of who pays Minnesota's taxes. Determining tax incidence identifies where the tax burden really falls, regardless of who is legally required to pay the tax. For example, although the owner of an apartment building is required to pay the tax on that property, a significant portion of the tax is passed on to renters in the form of higher rents. Likewise, taxes on businesses may be shifted onto workers in the form of lower wages or onto consumers as higher prices.

The tax incidence study divides the population by income level into ten groups of equal size called ***deciles***. For example, the bottom decile contains the 10% of Minnesotans with the lowest incomes. The study looks at actual taxes paid and calculates what percentage of income each decile spends on taxes. The most current study analyzes taxes from 1996 and projects tax incidence for 1998. It finds that Minnesotans of all income levels pay around the same percentage of their incomes in total state and local taxes, between 11% and 12%. However, lower-income people tend to pay more of their tax burden in sales tax and middle- and upper-income people pay more of their tax burden in income taxes. Most Minnesotans will pay between 3% and 4% of their income for property taxes (including business property taxes passed on to them.) The projected tax incidence for 1998 is shown below (not including 1998 rebate).

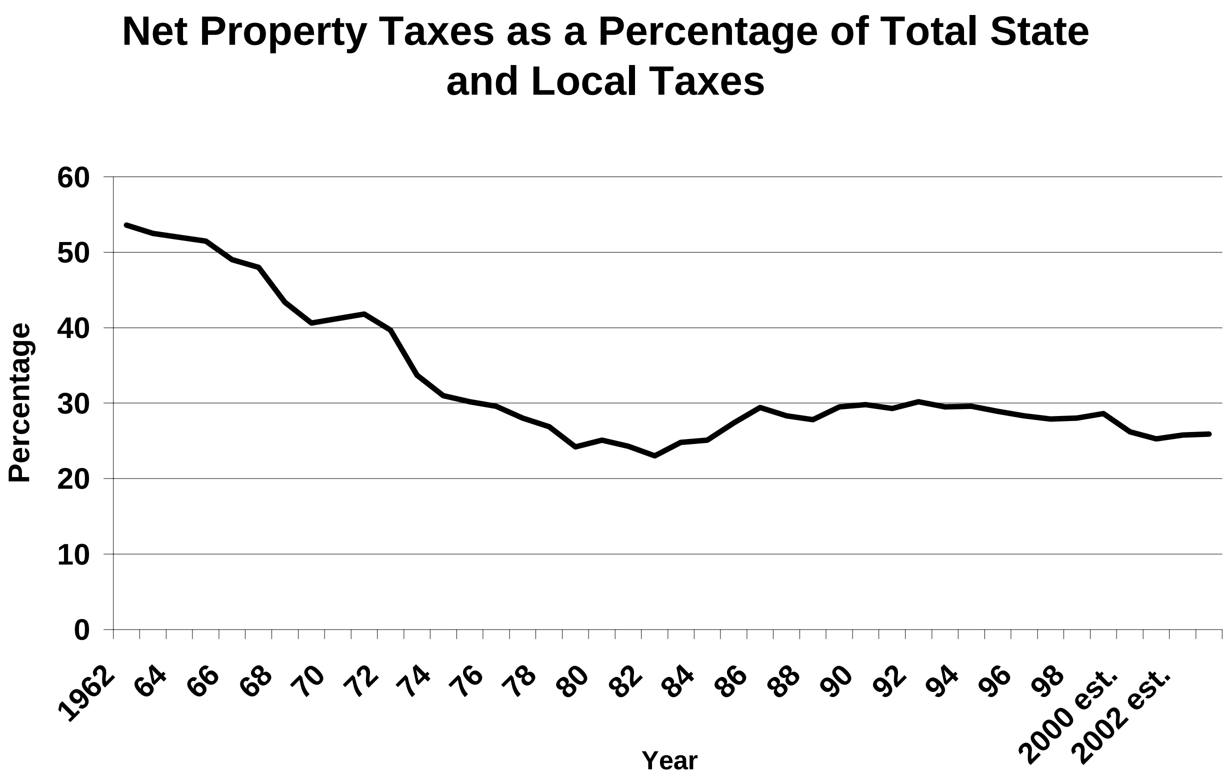
[3] The information in this section comes from the Minnesota Department of Revenue, *1999 Minnesota Tax Incidence Study*.



Another way that taxes can be described is in terms of their regressivity or progressivity. If lower-income persons pay a higher percentage of their income on a tax than upper-income people do, the tax is said to be ***regressive***. If lower-income people pay a smaller percentage of their income for a tax than upper-income people do, the tax is ***progressive***. If all income levels pay the same percentage of income, the tax is said to be ***proportional*** or flat. For the 1996 tax year, the overall Minnesota tax system was slightly regressive, with a progressive income tax system being largely offset by the regressivity of other taxes. Minnesota is unusual in the degree to which it relies on the income tax, but this is also what makes our state's tax system much less regressive than is found in other states. The property tax (including both taxes paid directly by homeowners and renters and the portion of business taxes that is passed on to consumers) is mildly regressive.

Finally, taxes can be looked at in relation to each other. The property tax is just one of several taxes that citizens pay. In Minnesota, $5.1 billion in income taxes are projected to be collected in 2000, $4.6 billion in property taxes, $3.6 billion in sales tax, and $3.5 billion in other taxes (including corporate income taxes, vehicle license and excise taxes, and motor fuel taxes).[4] Over time, the balance of taxes has changed. In 1962, the property tax was the largest piece of the tax burden on taxpayers, making up 53% of taxes collected. In 1968, the sales tax was introduced and income taxes were restructured so they became a larger part of total taxes. Property taxes today are 28% of total taxes — nearly half what they once were as a percentage of the total.[5] The change over time is shown in the graph below.

[4] Peggy Ingison, State Budget Director, *Overview of State and Local Revenues*, presentation to the Citizens Jury on Property Tax Reform, August 2, 1999.
[5] Department of Revenue data.


Net Property Taxes as a Percentage of Total State and Local Taxes
60
50
40
30
20
10
0
Percentage
1962
64
66
68
70
72
74
76
78
80
82
84
86
88
90
92
94
96
98
2000 est.
2002 est.
Year

HOW IS THE PROPERTY TAX CALCULATED?

The historic basis of the property tax is that the value of one's property is an approximation of one's wealth. To tax property, its value must be determined, then the amount of tax can be calculated. Both the state and local units of government play a role in determining how much each taxpayer will pay. Some aspects of the process, including class rates and formulas for credits, change from year to year. The description below is for property taxes to be paid in 2000.

The starting point for calculating the property tax on a property is the ***assessed taxable market value*** as determined by local property assessors. The assessed value of residential property is based on sale prices of comparable property in the same taxing jurisdiction, and the assessed value of commercial property is based on the revenue stream generated by the property.

Minnesota is one of about 30 states that imposes different ***property classification rates*** (***class rates*** for short) based on a property's classification. The class rate describes what percentage of the property's market value will be used to determine its property tax. Classes are described by the legislature and are based on a property's use. Different class rates means properties of equal value but different usage will pay different amounts of tax. Part of the assessor's job is to determine the appropriate class for each property. 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)
- Agricultural land and buildings

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%.

Class rates are set by the legislature and have changed frequently in the past. For property taxes due in the year 2000, class rates range from 0.35% on the first tier (up to $115,000) of an agricultural homestead to 3.4% on the second tier (over $150,000) of commercial/industrial property. Class rates are listed in Appendix 1.[6]

A property's ***tax capacity*** is simply the value of the property multiplied by the appropriate class rate. Despite what the word "capacity" implies, the tax capacity is not

[6] It is difficult to make a specific count of the number of classes, because there is no consensus on what constitutes a class. The list above gives eight, but if you count the tiers within these classes, as is shown in Appendix 1, there are 18. If you look at the Abstract of Assessment used by assessors of special exemptions given to various types of property based on location and usage, the count goes higher.

an upper limit on how much tax can be collected or a measure of how much the taxpayer can afford to pay. The tax capacity of a property can change from year to year if the property's value or class rate has changed.

The ***local tax rate*** is determined largely by local units of government. To determine the local tax rate, a local unit of government will look at its projected budget for the year and see how much revenue can be expected from other sources (state aid, fees and charges, etc.). The amount that is left is the amount that must be raised from property taxes, which is called the ***levy***. Dividing the levy by the total tax capacity of all property in that taxing jurisdiction will determine the local tax rate. Because a property is located in multiple jurisdictions (county, city, school district, special taxing district[7]), the local tax rates for each jurisdiction are added together to get the ***total local tax rate***. As a formula, this can be written as:

County levy
÷ Total county tax capacity
= County local tax rate

County local tax rate
\+ municipal local tax rate
\+ school district local tax rate
\+ special district tax rate
Total local tax rate

The table below shows the average statewide local tax rates projected for taxes payable in 2000 for different levels of local government.[8]

Local Unit of Government	Average Local Tax Rate
County	40.27%
Municipality (City/Town)	25.60%
School District	55.24%
Special District	4.77%
Total Local Tax Rate	**125.88%**

Finally, ***property tax credits*** are subtracted to get the final amount of tax owed.[9] All homesteads are eligible for the ***Education Homestead Credit***, which is a portion of the education levy that the state pays to the school district on the behalf of the taxpayer. The Education Homestead Credit is equal to 83% of the property's general education tax, up to a maximum of $390. The ***Education Agricultural Credit*** is similar to the

[7] Special districts are areas that cross several jurisdictions or cover only a portion of a jurisdiction and that have the authority to levy a tax. Examples include watershed districts and the Metropolitan Council.
[8] House Research Property Tax Simulation Data. There can be a large range of values behind these averages — for example, in 1999, county tax rates ranged from 28.24% in Dakota County to 118.182% in Mahnomen.
[9] These credits are different from those based on ability to pay, such as the circuit breaker or renter's credit, which are administered through the income tax system, and from the property tax rebates administered in 1997 and 1998.

education homestead credit but applies to agricultural properties. It is equal to 54% of general education taxes for homesteads and 50% for non-homesteads.

An Example

Take a homestead valued at $125,000. Its class rate is 1% on the first $76,000 of value and 1.65% on the rest of the value ($49,000). Multiplying the value by the class rate in each tier and adding them together gives a tax capacity for this home of $1,569. Assuming that this home is taxed using the state's average total local tax rate and that the only credit it receives is the education homestead credit, this home would pay $1,587 in property taxes. As a formula, this can be expressed as:

Assessed Taxable Market Value	**Tier One**	**Tier Two**
X Property Classification Rate	$ 76,000	$ 49,000
= Tax Capacity	X 1%	X 1.65%
	= $ 760	$ 809
	Total (both tiers)	
	$ 760	
	+ $ 809	
	= $ 1,569	
Tax Capacity	$ 1,569	
X Total Local Tax Rate	X 126%	
= Gross Property Tax	= $1,977	
Gross Property Tax	$ 1,976	
- Property Tax Credits	- $390	
= Net Property Tax	= $ 1,587	

Some taxes collected on the property tax bill do not follow this formula. For ***referendum levies***, which are levies approved directly by the voters, the starting point is not assessed taxable market value but referendum market value. For most homesteads this is the same as assessed market value, but not for all. Referendum class rates also are different from ordinary class rates. Referendum levies mainly are used to finance public schools. Likewise, some property tax owners will find ***special assessments*** on their tax bills. These are not based on property value, but to what extent the property benefits from the project to be funded by the special assessment (measured by such characteristics of the property as street frontage), and are usually only applied in a portion of the taxing jurisdiction.

GOALS OF PROPERTY TAX REFORM AND PROGRESS TO DATE

As difficult as property tax reform is to achieve, there is a general consensus among policy-makers and analysts on the broad policy goals that a reformed property tax system would address. These goals are:

1. Simplify the property tax system.
2. Reduce reliance on the property tax.
3. Make government more accountable to taxpayers.
4. Provide more tax relief directly to taxpayers based on individual need.
5. Ensure that local taxing authorities have sufficient resources to provide an adequate level of public services.

Each of these goals will be addressed below, with a description of strategies that have been used in ongoing property tax reform efforts. New strategies that could be tried are also described.

It is sometimes difficult to distinguish between changes made in the property tax system for the purpose of ***property tax reform*** (changing the system) and ***property tax relief*** (reducing the amount of tax). Advocates for changes usually claim both reform and relief will be achieved. When describing change strategies, this report will identify whether they alter the total amount of property taxes to be collected or whether they simply change the relative burdens among taxpayers.

Goal One: Simplify the property tax system

A. Simplify the classification system

One of the main strategies advocated to reform the property tax system is to reduce the number of property classifications. For example, in 1997 a number of low-income housing classifications were combined into a single class. Not all states use a classification system; instead, property is taxed solely on its value.

A classification system can be a tool to provide tax relief. The legislature can use the class rate structure to alter the relative tax burden among various classes of property. This can be seen as either positive or negative. It is positive if one agrees with the idea of different tax rates for different kinds of property (for example, treating residential properties differently from revenue-raising properties). However, one can also see this as an unnecessary complication of the system or a way that certain property owners avoid paying their “fair share” of taxes.

The pie charts below show how the property tax burden is distributed under our property classification system for taxes to be paid in 2000 and how they would be distributed without a classification system.[10]

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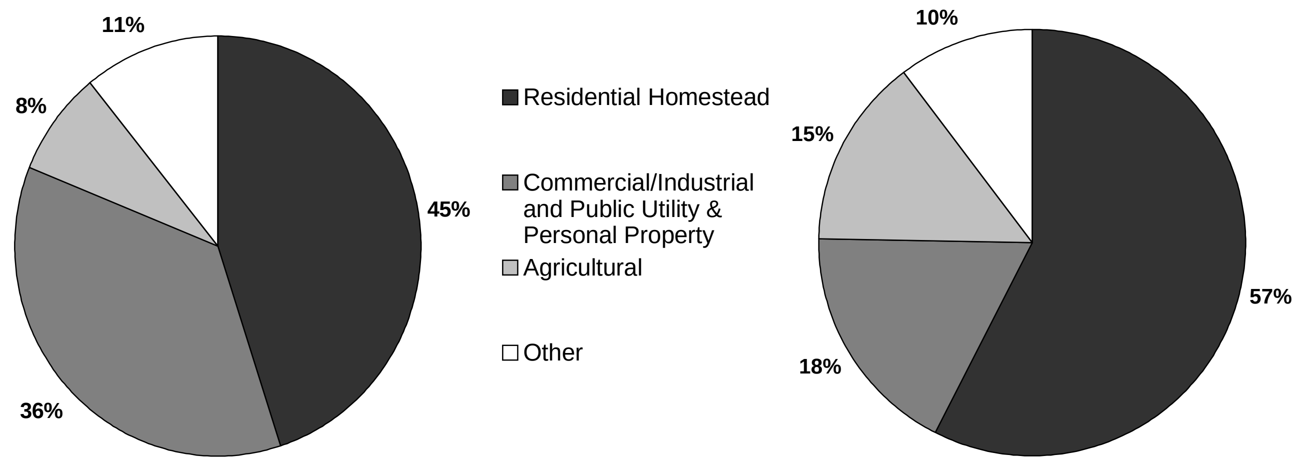
[10] House Research Property Tax Simulation Data.

Percentage of Tax Paid Under Current System | **Percentage of Tax That Would Be Paid in a One Class System**



The property classes that benefit most from the current class system are those with the lowest class rates: residential homestead, agricultural, and seasonal recreational property. Homesteads as a whole pay $576 million less in property tax than they would under a one-class system. Those who pay more are other residential properties, commercial/industrial, and public utility properties. Commercial/Industrial properties pay $707 million more in property tax than they would under a one-class system.

B. Compress property class rates

Rather than reduce the number of classes, rate compression reduces the difference among them. It can be debated whether this is a substantial change of the system (tax reform) or a means to provide tax relief to high class rate properties. For taxes payable in 1997, the relationship between commercial/industrial properties and residential properties was 3.3 to 1. In the 1997 and 1998 legislative sessions, all class rates were reduced except for low value residential homesteads. As a result of this compression, the range is now 2.6 to 1 for taxes payable in 2000 — a 21% reduction since 1997.[11] Appendix 1 shows how class rates have changed from 1997 through 2000.

One feature of rate compression is that it shifts taxes onto other types of property — since the total amount of tax money to be raised does not change, the reduction of taxes on one group necessarily means another group must pay more. The recent rate compression was designed so that all shifting would be on to the first tier of homesteads (the first $75,000 in home value). To largely offset the additional taxes that homesteads would otherwise have to pay, the Education Homestead Credit was introduced. Although class compression advocates claim it simplifies the tax system, in this case a further complication arose in the form of the Education Homestead Credit. This illustrates how tax relief and tax reform can be in conflict with each other.

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[11] When talking about rate compression, what are often compared are the class rates of the top tier of commercial/industrial property and the bottom tier of residential property. The ratios used here compare the weighted average tax rate of commercial/industrial and homestead properties. This takes into account both tiers and the relative share of market value of these types of properties.

C. Make the system more understandable to the taxpayer

One of the most difficult parts of the property tax system for the taxpayer to understand is why his or her property tax changes from year to year. Among the contributing factors are:

- The market value of the property may change.
- The market value of other properties in the taxing district may change, shifting taxes from one property to another.
- The budget and levy of the county, city, town, school district, or special district may change. Changes can result from local spending decisions, voter approval of a referendum, changes to federal or state mandates, or changes to federal or state aid.
- The state legislature may have changed class rates.
- Special assessments may have been added to the tax bill.
- Changes in law may adjust the tax base.
- Any combination of the above.[12]

Truth-in-Taxation was enacted by the legislature in 1988 to increase public understanding of the property tax system and enhance public participation in the local budget process and setting spending priorities. Truth-in-Taxation has four components: public advertisements on the budget and levy of taxing jurisdictions, notices sent to property owners, public hearings, and information on property tax statements.

Property tax statements were redesigned as part of the Truth-in-Taxation process to increase understanding by taxpayers and the accountability of local units of government. Notices identify the factors contributing to changes in the owner's property taxes, isolating changes due to spending, changes due to other factors (such as an increase in the property's value), the local government's tax base growth, state aid changes, and classification system changes.

Goal Two: Reduce reliance on the local property tax

A. Reduce the amount of money local units of government need to raise

Many of the services provided by local units of government, especially counties and schools, are mandated by the state. The state recently has begun to bear more of the cost of some of these services, thereby alleviating the burden on local property taxpayers. The most significant initiative has been to increase the state's share of public education funding (thereby replacing local property taxes with state income and sales tax revenues). This has contributed to an 18% decrease in the amount of property tax

[12] This list is based on the document *Why Property Taxes Vary From Year to Year* from the Association of Minnesota Counties.

dollars going to schools from 1997 to 2000. In contrast, property tax collections for cities and towns increased 13% over this time period and increased 9% for counties.[13]

The state has also been assuming more of the costs of the judicial system. In 1990, the state assumed all court costs in the 8th Judicial District, and starting July 2000, the state will take over all costs for the 5th, 7th, and 9th Judicial Districts and certain court costs for the remaining judicial districts.

One caution with this strategy is that it reforms the system but it does not guarantee tax relief. When the state takes over the cost of services, it usually reduces aids to local governments by an equal amount, so it does not free up any additional resources for local units of government to use for other purposes, including property tax relief.

B. Restrict the amount of money local units of government can raise (levy limits)

Counties and cities with populations over 2,500 are subject to ***levy limits***, which were enacted by the state to limit the total growth in a local government's combined property tax levy and state aids.

The structure of levy limits has changed several times in past years. At some points of time, one year's levy limit was based on the previous year's levy — if a local unit of government had a low levy one year, it could not make it up in the next year by having a significantly higher levy. Local units of government, therefore, sometimes feel they should "levy up to the limit" in case the levy limit rules are changed once again to be based on the previous year's levy. Another disadvantage of levy limits is that it can create problems of accountability. Local officials can claim that spending cuts are caused by levy limits, although local spending decisions may be a large contributing factor. The current levy limit law is set to expire for taxes payable in 2001, but it has been repeatedly extended by the legislature over the last few years.

C. Use other forms of revenue

A third method to reduce reliance on the property tax is to replace it with other funding sources. This can be done either by the state sharing more of the revenues coming from income and sales taxes, as it does through state aids, or by allowing local units of governments themselves to raise other kinds of revenue.

Currently, the most significant additional revenue source collected directly by local governments is ***fees and charges***, which are payments made in exchange for goods or services that are provided by government. These make up an average of 21.4% of revenues for counties and 30% for cities. They make up less than 5% of revenues for towns and schools.[14] Although it may make sense to use fees and charges for specific services, such as garbage collection or waste water treatment, it is more problematic to

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[13] Calculated from data in Gordon Folkman, Minnesota Department of Revenue, *Overview of Minnesota's Property Tax System: How Does It Work?*, presented to Citizens Jury on Property Tax Reform, August 4, 1999.
[14] Peggy Ingison, State Budget Director, *Overview of State and Local Revenues*, presentation to the Citizens Jury on Property Tax Reform, August 2, 1999.

use them to raise general revenues. In the case of schools, the use of fees on a more widespread basis is generally seen as unfair and inconsistent with our tradition of public education.

Another revenue option is a ***local sales tax***. Nine Minnesota cities and one county have a local sales tax of 0.5% or 1%,[15] and some have taxes on lodging, restaurant food and beverages, liquor and beer, event admissions, or motor vehicle retail sales. Such sales taxes must be approved by the legislature. Because people from neighboring jurisdictions end up paying some of a local sales tax, the legislature usually only allows local sales taxes to pay for projects of a regional nature, such as a convention or community center or tourism activities. A greater use of local sales taxes would only be feasible in areas with sufficient retail activity. Such a change would add complexity to our sales tax system, and might lead consumers to shop in cities without local sales taxes. In addition, the sales tax is more regressive than the property tax, and would place more of a burden on low-income people.

A third revenue option that is not currently used in Minnesota is a ***local income tax***. Advocates argue that the income tax is a fairer tax, since it relates directly to one's ability to pay. Opponents feel that use of a local income tax could lead the majority of the population who pay relatively low income taxes to seek additional services that more wealthy citizens would then pay for. In addition, poorer jurisdictions would have difficulty raising sufficient funds for basic needs through a local income tax.

Goal Three: Make government more accountable to taxpayers

A. Compress tax rates

In addition to its role in simplifying the tax system, rate compression is also advocated to increase accountability. Advocates of rate compression argue that the current system lacks accountability, because those who receive services are not held accountable for the full cost of providing services. They argue that homeowners (whose property class rate is lower than the commercial/industrial class rate) can demand additional public services because some of the cost will be shifted onto business. Critics of this assertion note that homeowners generally do not perceive their property taxes as being low, and that the business community is well organized to make its opinions known to decision-makers.

B. Truth-in-Taxation

When talking about accountability, usually what is meant is that citizens should be able to determine what decisions affect their taxes and who makes these decisions. It is hoped that through public advertisements and hearings as part of Truth-in-Taxation, the public will better understand how spending decisions affect their local property taxes and can participate in direct discussions with their elected officials about spending priorities. The process is also intended to clarify which decisions are made by the state and which are made by local officials.

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[15] They are Cook County, Duluth, Hermantown, Mankato, Minneapolis, Rochester, St. Paul, Two Harbors, Willmar, and Winona.

Goal Four: Provide tax relief directly to taxpayers based on need

The historic basis of the property tax is that the value of one's property can be used as a measure of one's wealth. This was truer in the past than it is today. When the value of property has little relation to ability to pay, the state provides tax relief to individual Minnesotans through the property tax refund, special targeted refund, and the senior tax deferral program.[16] The advantage of these programs is relief is targeted to those in need; these programs are frequently adjusted to ensure relief goes to those who need it. On the negative side, it could be argued that these programs allow local units of government to increase taxes, since the state will pay part of the tax bills of those who are unable to pay.

The ***Property Tax Refund Program for Homeowners and Renters*** (called the PTR, circuit breaker, or renter's credit) provides relief for persons whose property taxes exceed a certain percentage of income. Homeowners with incomes up to $69,860 and renters with incomes up to $40,740 can be eligible for the PTR if their property taxes are sufficiently high. Approximately 18% of homeowners and 47% of renters who file income taxes receive PTRs. The PTR is calculated by taking the amount of tax that exceeds a certain percentage of income and subtracting a co-payment that the PTR recipient must pay. The property tax burden for renters is 19% of rent paid.[17] The average credit in 1997 was $323 for homeowners and $342 for renters. An estimated $195 million in PTRs will be paid in 2000. This is the only property tax relief that goes directly to renters.

The ***Property Tax Special Targeted Refund for Homeowners*** provides relief to those whose property taxes increase significantly over one year. Homeowners are eligible, regardless of income, if their property taxes increase by more than 12% in one year and the increase is $100 or more. The refund is equal to 60% of either 12% of the prior year's tax or $100, whichever is greater. The average refund in 1997 was $79. In 2000, approximately $1.8 million in targeted refunds will be distributed to 12,000 homeowners (1% of all homeowners). Both the targeted refund and PTR are administered through the income tax system.

The ***Senior Property Tax Deferral Program*** allows seniors to limit their property tax payments to 3% of household income, with the remaining amount deferred. The state pays the deferred portion of tax to local governments. The program works like a reverse mortgage, but the loan is from the state rather than a lending institution. Once program participation is terminated (because the homeowner leaves the program, sells the home, or dies), the deferred tax plus interest must be repaid. Seniors with household incomes of $60,000 or less can participate. Very few people have taken advantage of the program since it was enacted in 1997.

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[16] The information in this section comes from House Research Department, *Property Tax Division New Member Briefing*, January 1999; and Gordon Folkman, Minnesota Department of Revenue, *Overview of Minnesota's Property Tax System: How Does It Work*, presented to Citizens Jury on Property Tax Reform, August 4, 1999.

[17] Previously, property owners had to calculate what percentage of the property tax each renter was estimated to have paid, based on their share of total rent. A set percentage was enacted in 1997 as a simplification measure.

Critics of the current property tax system argue that only a small portion of property tax relief is distributed to individuals based on need. For example, in the 1999 fiscal year, the state paid $182 million in property tax refunds for homeowners and renters but $891 million in the two main state aid programs to local units of government for general tax relief.[18] These funds for property tax relief might be better spent if more of the total was targeted to low-income individuals, rather than local governments.

Goal Five: Ensure local governments have sufficient resources

A. Revise the state aid formula to better reflect need

All local governments rely on state support to ensure that an adequate level of services can be provided without exorbitant local property tax rates. Intergovernmental aids make up 21.6% of all revenues for cities, 35.2% for counties, and 65.6% for schools.[19]

State aid is provided for several reasons. One is equalization. Spending needs and the ability to raise revenues vary widely among different local governments. School funding, in particular, requires some state equalization of financing in order to provide similar levels of education across the state. Another reason for state aid is to pay for unfunded mandates — those services and regulations that the state requires governments to provide but for which it does not dedicate sufficient state funding. A third reason for state aid is revenue sharing. Local governments rely on the property tax, which is the slowest growing form of revenue, whereas the state receives income and sales taxes, which grow much more rapidly in a strong economy. By providing state aid, the state can share some of these increased revenues with local governments, who are less able to benefit from economic growth. The table below shows state spending for major aid programs:[20]

Aid Amounts for Property Taxes Payable in 1999 in millions

	Counties	Cities	Towns	School Districts[21]	Special Districts	TOTAL
Homestead & Agricultural Credit Aid	197.1	196.2	28.1	35.9	27.6	$484.9
Local Government Aid		380.6	3.5			$384.1
Education Homestead Credit				296.7		$296.7
Disparity Reduction Aid	13.5		.9	11.6		$26
Local Performance Aid	5.4	4.7				$10.1
Criminal Justice Aid	28.7					$28.7
Family Preservation Aid	1.7					$1.7
TOTAL	**$246.4**	**$581.5**	**$32.5**	**$344.2**	**$27.6**	**$1,232.2**

[18] The total here for "main state aids" is combined HACA and LGA. House Research Department, *Property Tax Division New Member Briefing*, January 1999.
[19] These percentages include federal aid, but the majority of aid received comes from the state. Data from the State of Minnesota Office of the Legislative Auditor, Program Evaluation Division, presentation to the Citizens Jury on Property Tax Reform, August 3, 1999.
[20] House Research Department, *Property Tax Division New Member Briefing*, January 1999.
[21] Schools receive an additional $3.6 billion in other state funding.

Homestead and Agricultural Credit Aid (HACA) began in 1990, replacing the homestead credit and agricultural credit programs. HACA is the largest state aid program and goes to all local units of government. The basic funding formula is to take the previous year's HACA for that local unit of government and adjust by population growth (for counties only) and tax base lost from certain class rate reductions. The state increases HACA to make up for tax base lost through state changes in class rates and reduces HACA when the state takes over the funding for services provided by counties (such as education, parts of the judicial system, etc.) HACA has also been reduced at times to make up for revenue shortfalls at the state level.

Local Government Aid (LGA) is intended to ensure an adequate funding level for cities and towns. The LGA formula is designed to reflect the need and revenue raising capacity of the municipality. The current LGA calculation is based on a historical portion and a formula. The historical portion is largely based on the amount of state aids received by the municipality in 1993. The formula is based on the municipality's spending needs as measured by demographic factors and by its revenue-raising capacity as measured by tax capacity. In 1999, $321 million of LGA was based on the historical factor and $60 million was based on the formula. Under current law, the amount of LGA based on formula increases but the historical portion does not.

Disparity Reduction Aid goes to counties, school districts, and towns. It is used to reduce local tax rates that otherwise would be quite high for their area.

In addition to these general aid programs, there are several state aid programs that provide funding to counties for specific services, based on the county's population and share of the relevant state caseload. These include County Criminal Justice Aid and Family Preservation Aid. Local Performance Aid was folded into HACA and LGA in the 1999 legislative session.

Critics note that much state aid is allocated based on historic spending patterns, rather than on a measure of need. State aids are also criticized as leading to reduced accountability for local units of government, as it is harder for the public to understand where the money is coming from and who makes decisions about it.

Reforms Related to Assessed Value

One category of property tax changes that is difficult to ascribe to any of the above goals are those that deal with the assessment process. These changes reduce the assessed value of a property for the purposes of determining the property tax. These strategies are often advocated because of the lack of a strong relationship between market value and ability to pay, especially when values increase rapidly, as is seen in hot real estate markets. However, these strategies are sometimes promoted because increases in market value are perceived as artificial changes for the purpose of raising increased tax revenue. This belief is based on a misunderstanding of the division of labor between assessors, who assess a property's market value, and local units of government, who determine how much tax to levy.

Rapid increases in value do not necessarily correspond to an increased ability to pay on the part of the property owner. One strategy to address this problem is ***limited market value***. Unlike the targeted property tax relief program, which addresses increased property taxes regardless of cause, limited market value only deals with increases in value. For taxes payable in 2000, market value increases are limited to 8.5% over the property's market value in the previous assessment year or 15% of the increase in valuation, whichever is greater. Limited market value applies only to agricultural, residential, and cabin properties. For taxes payable in 1999, the amount of value that was limited equaled 1.92% of the total tax base.[22] Limited market value has been in effect since 1993, and was also in effect from 1973 to 1979. The current limited market value law is set to expire after tax year 2002.

Although often advocated to address the problem of tax affordability, limited market value does not take into account ability to pay, as it does not consider the property owner's income. It also ignores the fact that the value of the property owner's asset *has* increased, from which the owner will benefit when the property is sold. Another problem with limited market value is that it shifts tax increases onto other properties — those in classifications not covered by limited market value and those properties whose values are not rapidly increasing. It is difficult to argue that someone whose home value is increasing should pay less tax and that someone whose home is losing value should pay more. Limited market value leads to a situation where some taxpayers are paying based on assessed value while others are not — the tax no longer has a consistent foundation.

Similar to limited market value is ***acquisition value***, where the property tax is based on the actual purchase price of a piece of property, which is not assessed again until sold or major improvements are made. It is advocated for many of the same reasons as limited market value. Acquisition value is also promoted because the assessment process is perceived as penalizing those who maintain or improve the condition of their property by increasing their property taxes, while those who let the value of their property decline will in return see a reduction in property taxes. One way the state has tried to address this issue is through the ***This Old House*** program. This Old House allows taxpayers to exclude the increased value related to home improvements for ten years, then add it back gradually over five years. A home must be at least 45 years old with a value of $400,000 or less to qualify for the program. There is a similar program for older business properties and properties damaged by the 1997 floods.

There have also been proposals to disregard increases in assessed value based on improvements. These proposals have the same problem as limited market value, in that it creates a system in which some properties are paying taxes based on their market value and others are not.

[22] Minnesota Department of Revenue, *Presentation on the Limited Market Value Report*, February 1999.

CONCLUSION

In understanding property tax reform, one must look at it from two points of view: as a revenue source for local units of government and as part of the total tax burden on citizens.

As a revenue source, property taxes fund many important services at the local level, including schools, public safety, parks, health, and human services. If the intention is to lower the total amount of property taxes paid, then either other sources of must be found or some services will have to be funded at a lower level. In making either kind of change, we must ask who will pay more or less taxes than they do currently, and who will receive more or fewer services, and what these changes will mean for the overall quality of life in Minnesota. The impact of changes in taxes and services must be analyzed by both looking at different income groups and different geographic regions of the state.

Society generally agrees on the goals of property tax reform: simplicity, less reliance on the property tax, accountability, tax relief based on individual need, and an adequate level of funding for public services. Any strategy to reform the system can be judged in relation to these goals. Reform strategies must be distinguished from those that provide relief. Changes that provide tax relief for one group often shift taxes on to others.

If we are to have a property tax, we need to accept it for what it is: a tax based on the value of one's property. However, strategies like limited market value and acquisition value attack the very premise of a tax based on a property's value, and lead to a situation where some taxpayers pay according to assessed value and others do not. Under limited market value, the property tax system lacks consistency. It seems more appropriate to address the problem of rapid property tax increases through credits to individuals, such as the targeted property tax or property tax refund. However, if there is public agreement that assessed market value is not a valid starting point for the assessment of a tax, then we should move away from the property tax, and replace it with other sources of revenue.

Citizens are affected by the property tax in both of its forms, as they pay it and as they benefit from the services it provides. It is important that we all participate in discussions on how to make it work better.

APPENDIX 1: CLASS RATE SCHEDULE

Property Type	Payable 1997	Payable 1998	Payable 1999	Payable 2000
Residential Homestead:				
< $76,000[1]	1.00%	1.00%	1.00%	1.00%
> $76,000	2.00%	1.85%	1.70%	1.65%
Residential Non-homestead:				
Single unit:				
<$76,000[1]	2.30	1.90	1.25	1.20
>$76,000	2.30	2.10	1.70	1.65
2-3 unit and undeveloped land	2.30	2.10	1.70	1.65
Market-rate Apartments:				
Regular	3.40	2.90	2.50	2.40
Small city	2.30	2.30	2.15	2.15
Low-income Apartments:				
Title II	2.30	2.00	-	-
Farmer's Home Administration	2.00	1.90	-	-
New Class 4d	-	-	1.00	1.00
Commercial/Industrial/Public Utility:				
<$150,000[2]	3.00	2.70	2.45	2.40
>$150,000	4.60	4.00	3.50	3.40
Seasonal Recreational Commercial:				
Homestead resorts (1c)	1.00	1.00	1.00	1.00
Seasonal resorts (4c)	2.30	2.10	1.80	1.65
Seasonal Recreational Residential:				
<$76,000[1]	1.75	1.40	1.25	1.20
>$76,000	2.50	2.50	2.20	1.65
Agricultural Land & Buildings:				
Homestead:				
<$115,000	0.45	0.40	0.35	0.35
$115,000-$600,000:				
<320 acres	1.00	0.90	0.80	0.80
>320 acres	1.50	1.40	1.25	0.80
> $600,000:				
<320 acres	1.00	0.90	0.80	1.20
>320 acres	1.50	1.40	1.25	1.20
Non-homestead	1.50	1.40	1.25	1.20
Education Homestead Credit:				
Rate	-	32%	66.2%	83%
Maximum	-	$225	$320	$390
Education Agricultural Credit:				
Homestead	-	-	-	54%
Nonhomestead	-	-	-	50%

[1] First tier limit was $72,000 for payable 1997, $75,000 for 1998 and 1999.

[2] First tier limit was $100,000 for 1997.

APPENDIX 2: GLOSSARY OF TERMS

Acquisition Value: Basing the property tax on a property's purchase price.

Assessed taxable market value: The value of a property as determined by local property assessors.

Decile: A group containing one-tenth of the total.

Education Homestead Credit and **Education Agricultural Credit:** A portion of the education levy that the state pays to the school district on the behalf of the taxpayer.

Fees and charges: Payments for goods or services provided by government.

Homestead and Agricultural Credit Aid (HACA): The largest state intergovernmental aid program; HACA goes to all local units of government.

Levy limit: The maximum amount of property tax a local unit of government may impose.

Limited Market Value: A law which limits the maximum amount that a property's assessed taxable market value can increase each year; it only applies to homesteads, farms, and cabins.

Local Government Aid (LGA): A state general aid program that goes to cities and townships.

Local income tax: A tax collected on income; it can be collected from all residents of a local area and/or those who work in that local jurisdiction.

Local sales tax: A tax collected on purchases of goods and certain services within a local jurisdiction.

Local tax rate: The percentage by which a property's tax capacity is multiplied to determine its property tax due to that local taxing jurisdiction.

Progressive tax: A tax for which lower-income people pay a smaller percentage of income than upper-income people do.

Property classification rate (class rate): The percentage of a property's market value that will be used in determining its tax.

Property Tax Credit: A subtraction from the amount of property tax owed.

Property Tax Refund Program for Homeowners and Renters (PTR, renter's credit, or **circuit breaker):** A tax relief program administered through the income tax system for persons whose property taxes exceed a certain percentage of their income.

Property Tax Special Targeted Refund for Homeowners: A tax relief program administered through the income tax system for homeowners whose property taxes increase significantly from one year to the next.

Proportional tax (flat tax): A tax for which people of all income levels pay the same percentage of income.

Referendum levy: A levy that is approved directly by the voters.

Regressive tax: A tax for which lower-income people pay a larger percentage of income than upper-income people do.

Senior Property Tax Deferral Program: A tax relief program that allows seniors to limit their property tax payments to 3% of their income, with the remaining amount deferred.

Special Assessments: Taxes levied for a specific purpose; usually based on some measure of how much the property will benefit from the project.

Tax capacity: The value of a property multiplied by its class rate.

Tax incidence: Where the burden of a tax falls, regardless of who is legally responsible for paying the tax.

Tax reform: Changing the tax system.

Tax relief: Reducing the amount of tax collected.

This Old House: A tax relief program that rewards improvements to older homes.

Tier: A portion of a property's value to which a class rate is applied. The first tier of residential homestead property the first $76,000 of value.

Truth-in-Taxation: A process to encourage public participation in local tax and spending decisions by providing information and the opportunity for public discussion.

Unfunded mandates: Services or regulations that the state requires local units of government to provide or enforce, but for which the state does not provide full funding.

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