

Exhibit B
Minnesota's Property Tax System and City Aids

Minnesota's property tax aids and credits ("PTAC") payable to local governments ("PTACLG") are not results oriented. They pour billions of dollars down the black hole of property tax relief.

Could the Legislature spend those billions of dollars so as to get better results for Minnesotans? One approach to answering this question is to ask: What is a reasonable amount to expect a Minnesota family to pay in local property taxes to support local governments?¹ If the answer is \$83.33-200 per month, local property taxes in the \$1,000-\$2,400 range would be reasonable. In many Minnesota communities, owners of average valued homes pay far less, and those small payments are made possible by property tax relief dollars flowing out of the crisis ridden state general fund.

Attachment B-1, City Aids and Property Taxes, shows population, local aids and property tax information for 496 cities.² Attachment B-2, Cities with High Per Capita Aids, drawn from Attachment B-1, shows the 60 cities with the highest per capita state aids and the property tax paid on an average valued home in each city.³

Attachment B-2 means: The Legislature sent general fund dollars to _____ equal to \$____ for every resident of _____ in order to hold the property tax payable on an average valued house in _____ down to about \$____, or \$____ per month for all (not just city) local government services. For example: The Legislature sent general fund dollars to Eveleth equal to \$841 for every resident of Eveleth to hold the property tax payable on an average valued house in Eveleth down to about \$325, or \$27 per month for all (not just city) local government services.

¹ Assume the family has the ability to pay whatever the amount is. If they do not, the homeowners' property tax refund ("HPTR") program exists to solve that problem.

² The cities examined are those in 14 of the League of Minnesota Cities' 15 cluster groups – all except small Greater Minnesota cities. (The analysis takes into account the merger of Elko and New Market and the switch from township to city status of Columbus and Scandia.) Aid numbers are from LMC's report on 2009 aid unallotments, but are the pre-unallotment amounts. Populations are 2007 estimates from the State Demographic Center. There are significant variations among cities within each of the areas except the two central cities. The cities are grouped using the Stinson/Gillaspy geographic division of the state into six plexes, but separating the seven county statutory Metro Area from the other 10 counties in the Metroplex. (Both property tax rates and aid levels in the six plexes are consistent with the Stinson/Gillaspy geographic division of the state.) Within the Metro 7, cities are grouped alphabetically in accordance with the LMC's cluster groups. Outside the Metro 7, cities are grouped in descending order of population.

³ Many of the 60 high aid cities are on the Iron Range, which is a consequence of two factors. First, the taconite companies pay the taconite production tax, but do not pay the property tax on their production facilities. The taconite production tax is distributed to local governments across the Range more or less in lieu of property taxes in accordance with legislatively enacted formulas, generally determined by the Range Delegation and ratified by the Legislature. Second, the taconite aids include the taconite homestead credit, which is on top of the market value homestead credit that applies state wide. The THC directly reduces the property taxes of homes on the Iron Range by up to 66% of the tax payable after other credits, to a maximum reduction of \$315.10. (In some instances, a slightly lower percentage and maximum apply. This analysis assumes that the higher percentage and maximum apply, so may slightly overstate the extent of the state aids in some instances.)

The lessons taught by Attachments B-1 and B-2 include:

- Neither local effort, frugality or the lack thereof nor anything else can be determined by comparing local property tax rates because so much depends on the property tax value per capita of the city (and other local jurisdictions). Consider, e.g., Browns Valley, with its 206.182% city and 273.494 total tax rates. These astronomical rates cause the owner of the average valued house in Browns Valley to pay only \$785 per year in property tax, because that house has a value of only \$33,595. Message: forget about using local tax rates as a meaningful indicator of anything.
- Notwithstanding \$2.4 billion being sent directly to local governments as property tax relief, the enormous variations in property taxes and property tax rates around the state establish that there is no standard for how high is too high. While there is no need for a state standard, the absence of a standard undermines the rationale for spending billions on controlling property taxes. There is no right answer to how high local property taxes should be.
- There is great variation in the relative size of the city only and total property tax burdens, with some cities having a city property tax less than 20% of the total, many in the 30-40% range, and some well over 50%. The latter group are the cities most likely to need a permanent LGA program. The lower the city tax is as a percentage of the total, the more likely that reducing school and county levies (an integral part of this proposal) would offset the elimination of city aids and the shift of local business taxes onto homes (as would happen with elimination of the class rate system, another feature of this proposal).
- Cities receiving large amounts of state aid have less incentive to find ways to economize than do those that do not receive such aid. This is a principal reason for recommending that the city aid programs be suspended for the next four years, save for transition provisions that prevent major property tax increases for residents, but also show those residents just what their potential future property tax burden could be. This could be done through the HPTR program in such a way that the amount is paid to the city, but shown to the homeowner.

How the MVHC and THC Produce the Results They Do

The impacts of the market value homestead credit (“MVHC”) and the taconite homestead credit (“THC”), respectively are reflected in Attachment B-1. They work as described below.

The market value homestead credit is 0.4% of market value to a maximum credit of \$304, which occurs at \$76,000 of value. As the value rises above \$76,000, the MVHC drops at the rate of .09% of the excess over \$76,000, and zeroes out at \$413,778 in value. The MVHC perceptual distortion is demonstrated in the following table:

Value/Tax Rate	100%	150%	200%
\$50,000 value – Tax	500	750	1,000
MVHC	<u>200</u>	<u>200</u>	<u>200</u>

Tax payable	300	550	800
\$76,000	760 <u>304</u> 456	1,040 <u>304</u> 736	1,520 <u>304</u> 1,216
\$100,000	1,000 <u>282</u> 718	1,500 <u>282</u> 1,218	2,000 <u>282</u> 1,718
\$125,000	1,250 <u>260</u> 990	1,875 <u>260</u> 1,615	2,500 <u>260</u> 2,240
\$150,000	1,500 <u>237</u> 1,263	2,250 <u>237</u> 2,013	3,000 <u>237</u> 2,763
\$175,000	1,750 <u>215</u> 1,535	2,625 <u>215</u> 2,410	3,500 <u>215</u> 3,285
\$200,000	2,000 <u>192</u> 1,808	3,000 <u>192</u> 2,808	4,000 <u>192</u> 3,808
\$250,000	2,500 <u>147</u> 2,353	3,750 <u>147</u> 3,603	5,000 <u>147</u> 4,853
\$300,000	3,000 <u>102</u> 2,898	4,500 <u>102</u> 4,398	6,000 <u>102</u> 5,898
\$350,000	3,500 <u>57</u> 3,443	5,250 <u>57</u> 5,193	7,000 <u>57</u> 6,943
\$414,000	4,140	6,210	8,280

Assume a 200% tax rate (really, really high) and home value of \$76,000, \$100,000 or \$125,000. The tax actually payable would be \$1,216 or \$1,718 or \$2,240. That translates to a range of from \$100-\$187 per month for all local government services for the person or persons living in the house. Is this too much? If it is not, are the homeowners in Minnesota cities with local rates well under 200% (and house values in the \$76,000-150,000 range) getting a really good deal on their local government services? (State wide, 12 of the 496 cities examined have rates over 200%; 484 are below 200%.)

Compare these tax amounts to other value levels in the table: The 200% rate for a \$76,000 house is about the same as the 100% rate for a \$150,000 house. The 200% rate for a \$100,000 house is about the same as the 100% rate for a \$200,000 house. The 200% rate for a \$125,000 house is about the same as the 100% rate for a \$400,000 house. Thus, the actual dollar burden on an average homeowner where property values are high

is likely to be similar to the actual dollar burden on homeowners where property values are low if the rate in the latter community is double that in the former.

This means that one cannot conclude much of anything about actual property tax burdens from comparing property tax rates from one community to the next. One also needs to know the relative market values. This means that if a person looks at comparative property tax rates for cities in the Metroplex and cities in the ruralplexes, he or she should not conclude from much higher ruralplex rates that ruralplex homeowners have a much greater problem in paying their property taxes.

But the property tax is based on value, so isn't it only fair to tax those with higher values a higher amount? Why? Isn't the tax paying for local government services? And don't people pay it out of their incomes, not out of their home values? This reasoning, of course, could lead one to advocate a head tax for local government services. But one need not go that far to conclude that a tax based purely on house value is just about as arbitrary as a per capita tax. In either case, it is important to take ability to pay into account, and that depends on the taxpayer's income, not on his or her house value.

Now, add the further complication, which applies only on the Iron Range, of the taconite homestead credit. The THC is 66% of the tax otherwise payable, to a maximum of \$315.10 (\$289.80 in some areas, a distinction which is ignored here). The following table shows property tax for Iron Range homeowners at various values and tax rates:

Value/Tax Rate	120%	160%	200%
\$50,000 value – Tax	600	800	1,000
MVHC	<u>200</u>	<u>200</u>	<u>200</u>
Tax before THC	400	600	800
THC	<u>264</u>	<u>315</u>	<u>315</u>
Tax payable	136	285	485
\$76,000	912	1,216	1,520
	<u>304</u>	<u>304</u>	<u>304</u>
	608	912	1,216
	<u>315</u>	<u>315</u>	<u>315</u>
	293	597	901
\$100,000	1,200	1,600	2,000
	<u>282</u>	<u>282</u>	<u>282</u>
	918	1,318	1,718
	<u>315</u>	<u>315</u>	<u>315</u>
	603	1,003	1,403
\$125,000	1,500	2,000	2,500
	<u>260</u>	<u>260</u>	<u>260</u>
	1,240	1,740	2,240
	<u>315</u>	<u>315</u>	<u>315</u>
	925	1,425	1,925
\$150,000	1,800	2,400	3,000

	<u>237</u> 1,563 <u>315</u> 1,248	<u>237</u> 2,163 <u>315</u> 1,848	<u>237</u> 2,763 <u>315</u> 2,448
\$175,000	2,100 <u>215</u> 1,885 <u>315</u> 1,570	2,800 <u>215</u> 2,585 <u>315</u> 2,270	3,500 <u>215</u> 3,285 <u>315</u> 2,970
\$200,000	2,400 <u>192</u> 2,208 <u>315</u> 1,893	3,200 <u>192</u> 3,008 <u>315</u> 2,693	4,000 <u>192</u> 3,808 <u>315</u> 3,493

The taconite homestead credit, operating on top of the tax break already provided homeowners by the market value homestead credit, causes the prices paid by many Iron Range homeowners for all their local government services to be amazingly low.

Business Property Taxation

Minnesota has long employed a class rate property tax system under which business property is taxed at a much higher rate than owner occupied homes. This means that the tax on each dollar of business property value is much higher than the tax on each dollar of home property value.

At the zenith of class rate discrimination, much business property was taxed at 5.25 times the rate of many homes. The legislature has reduced the degree of discrimination over the years, but it remains substantial (and well over 5.25x in some parts of the Iron Range). Now the base rates for homes are 1% on the first \$500,000 of value and 1.25% above that, and for business property 1.5% on the first \$150,000 of value and 2% above that. Thus, the base rate for most homes is 1% and for most business property of substantial value is 2%, for a typical 2:1 ratio at the margin.⁴ The bottom line multiple, though, generally exceeds 2:1.⁵

⁴ Throughout the remainder of this analysis, for purposes of simplicity the base business rate is assumed to be 2%; i.e., the lower 1.5% rate which applies to the first \$150,000 of business property is disregarded.

⁵ The MVHC and THC make the bottom line ratio considerably higher than 2:1, for they reduce the actual home tax payable to well below what the 1% base rate would produce. Assume a home value of \$76,000 and a 100% tax rate. The \$760 home tax is reduced by the MVHC to \$456, which is 0.6%. Business property taxed at 2% is paying more than three times the rate paid by homes.

Assume this situation is on the Iron Range. The \$456 actual home tax that would apply anywhere else in the state is further reduced by 66% (\$301), so the actual home tax on the Range is \$155, which is 0.2%. Business property taxed at 2% is paying 10 times the rate paid by \$76,000 homes on the Range.

These higher (3x or 10x) multiples diminish as rates and values increase because the MVHC and THC are capped at specific amounts. Also, the MVHC phases out from \$76,000 to \$413,778 in home value. At the

Business property is taxed at 2% where the local tax rate is exactly 100%. A lower local rate means a lower effective tax rate, and a higher local rate means a higher effective tax rate. Review of the local tax rates on Attachment B-1 thus shows which cities are more and less attractive for business investment, things other than taxes being equal. Most cities have total tax rates well over 100%, so businesses in most Minnesota cities pay well over 2% of property value in property taxes.

Of greatest concern, the local tax rates in the five Ruralplexes tend to be higher than those in the Metroplex. At the extreme, the tax rate on high value business property in Brown's Valley is 5.46988% of value. By contrast, the rate in Edina is 1.7179% of value. So, where business investment is most needed to boost the local economy, Minnesota's property tax system charges business more than three times as much in property tax than it does where the investment is just about least needed. And, a system designed by liberal Democrats to soak the rich, and especially businesses over homeowners, operates on the ground to promote the rich getting richer.

Minnesota's property tax and local aids system thus is bad for Minnesota's Ruralplexes, making it very difficult for them to compete for business investment.⁶ This is a tragedy, for information technology today means that businesses can locate anywhere and do business world wide. See Exhibit C and understand the comparison between Greater Minnesota and rural India and China. Minnesota's Ruralplexes have a lot to offer, but when one component of the offer is property taxes that are up to three times as high as property taxes in favorable Metroplex locations (which are also on the high side by national standards, though not as high as they used to be), the Ruralplexes have been shot in the foot by their well meaning supporters at the Legislature.

Here is how to fix the problem of too high business property taxes in Minnesota's Ruralplexes:

- End the class rate system discrimination against business property by taxing both homes and businesses at the same rate
- Protect homeowners from too high property taxes resulting from the first change by whatever combination of the following is politically feasible:
 - Homeowner's property tax refund program that limits property taxes to an acceptable percentage of income and/or to no more than whatever rate of annual increase is acceptable
 - Make the SLFS changes needed to reduce reliance on the property tax by the counties for funding human services and by the schools

margin at higher rates and values, the multiple is 2x. But the bottom line multiple would always be slightly more than 2:1 (except, in areas outside the Iron Range, when home value is at least \$413,778). Thus, it is fair to say that the business:home tax multiple generally exceeds 2:1.

⁶ The gubernatorial and legislative response to this problem is the JOBZ Program. The author believes JOBZ to be inefficient, unfair and unconstitutional, but those issues are beyond the scope of this analysis. Why not eliminate the need for JOBZ, and perhaps TIF and even Fiscal Disparities, by fixing the underlying system?

- Avoid giving businesses a windfall from the first change by shifting business taxation from the local to the state level by whatever combination of the following is politically feasible:
 - A business activities tax to end discrimination against production in Minnesota and shift business tax burden from businesses producing in Minnesota to businesses selling into Minnesota, many of which are located out of state; or
 - A state level business property tax, which would spread the burden state wide, going easier on businesses in high tax rate communities and getting a little more from those in lower tax rate communities

These changes would also support the strategic shift of state focus from property tax control to investment in Minnesota's human capital and a focus on results recommended in this proposal. The situation is win-win-win-win-win:

- Fix the problem of high Ruralplex business property taxes
- Use substantial amounts of the \$3.4 billion in property tax aids and credits in the budget solution
- Focus Minnesota governments on improving results per dollar spent
- Focus state efforts on Minnesotans' well being
- Give local governments and citizens more flexibility in how they operate

In sum, Minnesota's property tax and local aids system is bad for the state and perhaps most bad for those who superficially seem to benefit most from high local aids, because the state can never pour in enough money to make up for the lack of economic activity that is promoted by this irrational system.