

Redefining the State-Local Government Relationship and State-Local Fiscal System

One Minnesota, Many Communities and Results-Focused Government

“Change Minnesota”

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I. The Proposal

The Governor and Legislature should act as described below in 2009 to:

- Help balance the state general fund budget for FY 2010-11 and 2012-13
- Encourage local communities to reduce the cost and increase the quality of local government services, producing immediate results and steps along a path to greater future improvement
- Change systemic land use and development incentives to encourage better water and habitat quality, energy conservation and emissions reduction, protecting Minnesota’s iconic waters and working on climate change issues
- End Minnesotans’ risk of personal bankruptcy from health care financial catastrophe and begin the task of reining in out of control health care spending
- End the need for referenda to raise the money to run the schools
- Engage citizens in communities across the state in reconfiguring their local governments to fit the times

The proposal is to redefine Minnesota’s state-local government relationship (“SLGR”) and state-local fiscal system (“SLFS”)¹, implementing a new SLGR operating system,² supported by the SLFS redesign required to optimize SLGR performance to:

- Change SLGR strategy from state command and control to steering government service provision to improved results by:
 - Focusing governments on improving results at lower unit cost
 - Focusing state resources on investing in people by funding education and human services
 - Giving cities, counties and townships more autonomy on other functions
 - Ensuring that results are measured and accurately reported
 - Providing citizens opportunities to reconfigure their local governments based on knowledge of the true costs of the current configuration

¹ The “state-local government relationship” refers to the allocation of responsibilities for providing government services between the state government and the various local governments, how the state ensures that the locals provide the results the Legislature desires, and how local governments are funded. The “state-local fiscal system” refers to the state and local fund raising mechanisms – taxes, fees and charges – and the transfer payment systems between the state and local levels that deliver state-raised funds to the locals to provide services and charge one governmental unit for services provided by another (usually two local units; occasionally, local units paying the state for state government services). Fees and charges are beyond the scope of this analysis.

² Readily extendable at Legislature’s option to the entire state budget and the Legislative-Executive Branch relationship. Readily extendable at local option to 3,000+ local government units.

- Change state-provided property tax aids and credits (“PTAC”) to maximize budget savings, support the SLGR strategic change, and focus property tax relief on individuals, not governments, until such relief can be eliminated
- Make the SLFS changes required to accomplish the foregoing and desired to make Minnesota’s SLFS more fair, reliable, efficient, understandable and competitive, in structure and in operation, than it ever has been³

What SLGR and SLFS Redesign Can Do for Minnesota

Characteristic	Present Crisis, Bleak Future	Redesign: Resolve Crisis, Bright Future
General fund spending down property tax relief black hole	\$3.4 billion per biennium	0 within a couple of years
General fund savings	As agreed by Governor and Legislature	Same, but fewer service cuts & clear path to a brighter future
Land, water, energy, climate change	Inefficient land use + lack of care of the land = dropping water & habitat quality, wasteful energy use, high emissions	Development channeled to cities, growth without trashing the place, energy conserved, emissions reduced
Health care	Some uninsured, most one or two events away from personal financial catastrophe, runaway costs	Cover all Minnesotans by ending current subsidies and risk of financial catastrophe, get started on cost reduction ⁴
Schools	Near \$2 billion property tax per year, raise operating funds by referendum	No referenda, less property tax, none if use local income tax, measure and report results
Human services delivery	Organized through 87 counties, which levy hundreds of millions in property tax	9-14 regional boards, no more property tax dollars, counties can bid to produce services
Cities	Funding instability from LGA instability, levy limits, difficult access to crowded property tax	Property tax opened up for cities, no levy limits, greater local autonomy, little or no LGA, measure & report results
Counties	Human services major part of budget, hands tied by maintenance of effort mandates, difficult access to crowded property tax	With schools (nearly) off & human services off property tax, access to property tax eased, end MOE mandates, measure and report results, maybe more roads responsibility

³ Criteria articulated by the Department of Revenue in its Model Revenue System in the early 1990s.

⁴ Health care reform design beyond scope of this proposal, but potential use of SLFS in health care reform and contribution of health care reform to SLGR redesign are noted

SLFS reliability	Unreliable – Budget Trends Study Commission report	Improved: state ptax reduces shortfalls, broad based low rate sales tax, better budget reserve
Business location competitiveness	Governor and business community concerned – see 21 st Century Tax Reform Commission	Improved: eliminate giveaways and local negotiations, burdens more consistent across state, choice of burden shift to out of state businesses or continued high property & sales taxes
Farm taxation	Property tax important, sales tax exemptions for environmentally harmful chemicals. Land as an economic commodity with no regard for the environment.	Exempt from property tax – honor the land. Business activities tax like a severance tax. Stop pollution subsidies.
Tax system regressivity	Regressive and becoming more so	Governor and Legislature decide how regressive
Transportation funding	Gas tax, motor vehicle sales tax, license tabs, local sales & property tax	Don't need local sales tax. More from property tax. May turn over some state highways to counties.
State budget process and SLGR	Control inputs, command uses, provide property tax relief, results secondary	Results oriented, measure and report, state invests in human capital, more local autonomy
Measurement & reporting of results	Rare	The norm
Use service production alternatives for better, lower cost results	Comparatively rare	Common, but at local option
Local citizens decide to reconfigure local governments for better, lower cost results	Almost never	Opportunities abound
Twin Cities Metroplex	7 county statutory area plus Met Council, lots of governmental service producers per capita	Urban citizens decide whether to merge 7-17 county governments and Met Council into Metroplex Council; rural whether to attach to adjacent county or be in Metroplex rural division
Townships	Property tax reliant	Same, but can use money saving SLGR reform tools
Special Districts	Many levy property tax	No more – bill their local government customers

II. The Problems and the Bright Spots

Minnesota has 87 counties, 347 school districts, 855+ cities and 1,500+ townships, plus an assortment of other governmental entities, and a major metropolitan city region that covers seven counties in law and 17 in reality⁵. The geographically understated seven county statutory Metro Area includes 138 cities and 45 townships, as well as the counties. Minnesota no longer needs all these governmental units, and they cost a fortune, but there is no right answer to how many there should be, and it's difficult to reduce the numbers.

Minnesota's SLFS raises a higher percentage of revenue at the state and spends a higher percentage at the local level than many other states. This was called the Minnesota Miracle due to extensive state support for K-12 education, but the system also features county performance of state-funded human services and a constitutionally mandated transfer of state gas tax revenues to local governments. The result is a massive transfer payment pipeline from the state to local governments.

Over half of combined state and local spending occurs directly or indirectly at the local level. The budget crisis is focused first on the state general fund (about 60% of state spending and 40% of combined state and local spending). The February forecast projected state general fund spending of \$35.506 billion in FY 2010-11 and revenues of about \$4.8 billion less:

K-12 Education	\$13.894
Health & Human Services	10.192
Property Tax Aids & Credits	<u>3.435</u>
Subtotal	\$27.521
Everything Else	<u>7.985</u>
Total	\$35.506

K-12 education funding is spent by the school districts. Most health and human services funding supports county-administered human services functions. The property tax aids and credits are to hold local property taxes down. So 77.5% of state general fund spending goes to three areas largely or entirely handled by local governments.

Positive aspects of the SLFS and the SLGR it supports include:

- The state raises revenue more efficiently than locals
- The income tax, the state's largest, is the fairest tax because it is based on ability to pay. Its progressivity reduces overall tax system regressivity
- Local communities should have spending discretion on local functions, given knowledge of local conditions and choices made by local citizens and officials.

⁵ State Economist Tom Stinson and State Demographer Tom Gillaspay collaboratively analyzed Minnesota from the economic and demographic perspectives and concluded that the state consists of one 17 county Metroplex and five multi-county Ruralplexes. See three articles in January 2006 Rural Minnesota Journal. They insightfully conceive of the Ruralplexes as "spatially separated neighborhoods."

The SLGR has fundamental problems, magnified by the budget crisis. Five SLGR problems impede governmental efforts to deliver better results to Minnesotans. Four are centered outside the SLFS structure, though affecting and affected by it.⁶ They are described in Exhibit A, Four Problems of the SLGR Affecting and Affected by the SLFS. The fifth is at the core of the SLFS and the SLGR - the property tax system is outdated, the system artificially impoverishes Greater Minnesota, and the state pays far too much attention to local property taxes, levy limits and property tax relief.

The state currently spends \$3.4 billion per biennium on property tax relief through 20+ programs, \$2.4 billion sent to local governments and \$1 billion to Minnesotans. This is 8-9% of the state general fund budget with respect to which the Legislature cannot influence the results Minnesota's governments deliver. Every local government lobbying and legislative minute spent on local property tax levels, levy limits and PTAC is a minute not spent on steering Minnesota government to better results.

The property tax system also:

- Misleads governors, legislators and the public into believing that cities throughout the state, both in Greater Minnesota and the Metro Area, are much less able to raise their own revenue than they really are;
- Pushes governments and the public toward a sprawling, expensive, wasteful land use pattern that diminishes the quality of Minnesota's streams, iconic 10,000 lakes and natural habitat;
- Discourages business production in Minnesota;
- Encourages over building in the retail sector, wasteful business tax subsidies and wasteful local government spending;
- Causes the Legislature to use the blunt tool of levy limits to constrain local governmental spending;
- Frustrates citizens;⁷ and
- Provides citizens with one easy outlet for that frustration – school district levy referenda, putting at risk Minnesota's ability to fund public education, an important factor in future quality of life and global competitiveness.

The property tax is a vital part of the SLFS, but as Minnesota has evolved over 150 years from the property tax being virtually the only tax to being one of three major and a host of minor taxes, the property tax system has become the major contributor to structural deficiency in the SLFS and the SLGR. Minnesota has evolved from a farm and natural resources-based economy with people spread all over the state to today's place in the global economy with people concentrated in urban areas. Minnesota's economy has evolved from farm and natural resources-based, through the dominance of manufacturing and into an economy increasingly based on services and information and entering a new era of energy, climate change and environmental concern. The property tax system has

⁶ Public employee health care program structure; human services delivery system structure; governmental unit structure; and the state budget process.

⁷ A very bad characteristic for a tax system, for the art of taxation is like that of plucking a goose, the objective being to get as many feathers as possible with a minimum of honking and biting.

not evolved to keep up, even though the SLFS has evolved to the point that the property tax is less significant size-wise in Minnesota than in most other states.⁸

Here is how the property tax system misleads Minnesotans into believing that cities need help from the state, and into acting upon that belief in grossly inefficient fashion:

- **Myth: Property taxes would be too high if** cities were more independent and could levy property taxes as they saw fit. **Reality: Cities would have plenty of property tax room if schools and counties levied less.** Change the state's SLGR strategy to focus state investments on human capital and this can happen.⁹
- **Myth: City aids are necessary to keep city homeowners' property taxes from being too high.** **Reality: Minnesota has no standard for how high is too high.** Property tax rates and burdens (not the same because the burden varies with property value as well as rate) vary dramatically from city to city. City aid programs ignore homeowner incomes, the true determinant of property tax affordability. And Minnesota has two property tax relief programs – the property tax refund programs for homeowners and renters – that do focus on the affordability of property taxes. Again, if schools and counties levied less, cities could levy more.
- **Myth: Many (or most) cities lack the economic viability** to serve their residents at a reasonable property tax cost without extensive state aid. **Reality: Minnesota's communities are falsely made to appear impoverished,** or more impoverished than they really are, because the property tax system requires them to tax business property at unreasonably high levels in order to tax homes at reasonable levels. Yet again: reduce school and county dependence on the property tax, and stop discriminating against business property at the local level and cities would have the economic viability to sustain themselves without “property tax relief” from the state.

Exhibit B, Minnesota's Property Tax System and City Aids, shines some light on Minnesota's virtually indecipherable property tax and local aids program interactions and demonstrates what a problem it is for Greater Minnesota, notwithstanding generous local aid payments from the state general fund.¹⁰ Some findings:

⁸ Minnesota's home property taxes are not high by national standards. According to the Minnesota Taxpayers' Association's 50 State Property Tax Comparison Study, in 2007 Minneapolis' home property taxes ranked 34th among largest cities in the states at \$150,000 in value, and 27th at \$300,000 in value; Glencoe, considered typical of Greater Minnesota cities, ranked 31st at \$70,000 in value, 27th at \$150,000 and 23rd at \$300,000 among typical rural cities in the 50 states. By comparison, Minnesota's rank in taxes per \$1,000 of personal income was 6th on individual income tax, 25th on state sales tax and 35th on property tax in 2007. And on overall state and local taxes, Minnesota ranked 20th in 2006.

⁹ In 2005 (2004 for special districts), tax revenues (mostly property tax) were \$1.9 billion for counties, \$1.7 billion for cities, \$1.2 billion for school districts, \$151 million for townships and \$139 million for special districts. State wide, county property tax levies for human services, which would be eliminated in the redesign, appear to exceed LGA to cities.

¹⁰ See Exhibit B, note 2, for what Exhibit B does and does not cover. It is sufficiently comprehensive to bring interesting, if not disturbing, facts to light.

- Business property tax rates in Greater Minnesota generally are considerably higher than in the Metroplex, and range up to three or more times as high, gravely damaging the potential for business investment in much of Greater Minnesota
- In the 22 cities for which state aids paid annually to the cities exceed \$500 per capita, the amounts of annual property tax on the average valued home payable to all local governments ranges from \$262 to \$934, raising the question: Should scarce state dollars be spent to reduce the cost of local government paid by the average local household down to \$22-78 per month?
- In the seven county statutory Metro Area, the highest per capita annual state subsidy is the \$317 paid to Osseo, where the owner of the average valued home pays \$1,913 in property tax to all local governments, and the average state subsidy is \$80 per capita outside Minneapolis and St. Paul, which average \$236
- In the 10 other counties in the 17 county Metroplex, the average annual state subsidy is \$138 per capita and the highest the \$358 paid to Paynesville, where the average valued home pays \$1,054 in property tax to local governments.
- In the five Ruralplexes, the annual per capita state subsidies vary dramatically from city to city, but tend to be much higher than in the Metroplex. The Ruralplex averages are:

○ Central Lakes	\$244
○ Northwest Valley	299
○ Southeast River Valley	301
○ Southwest Corn Belt	347
○ Up North	428
- In the five Ruralplexes, 38 cities receive annual subsidies from \$400-\$499 per capita. The 2008 property tax burden for the average valued houses in those cities – including property taxes for all local governments, not just cities – ranged from \$292 to \$1,589, raising the question: Should Minnesota homeowners who can afford to pay taxes expect to pay some specific amount – say \$83.33-\$200 per month (\$1,000-\$2,400 per year) – for their local government services before looking to the state for help?

Exhibit C, Implications of Life in the “Energy-Climate Era” for Minnesota’s SLGR and SLFS: Urban and Rural - Minnesota Compared with China and India, draws some parallels between Minnesota and China and India, and highlights the need for change now for the sake of Minnesota’s water and habitat quality, Minnesota’s ability to cope in the Energy-Climate Era, and Greater Minnesota’s attractiveness for business investment.

Minnesota’s dire fiscal situation includes two other serious SLFS problems:

- Minnesota’s revenues and expenditures are out of balance and trending ever more out of balance, due to rapidly escalating health care costs, demographic changes which promise to make that worse and systematically reduce the revenue produced by Minnesota’s tax system, and the 10% permanent cut in Minnesota’s individual income tax made in 1999-2000 at the height of the high tech bubble.
- Minnesota is experiencing the worst state general fund budget crisis in decades, if not in history, and the structure and magnitude of the SLGR both makes it hard to

deal with that crisis without simply cutting services and imperative to look for alternatives with both short and long term benefit.

The State Budget Trends Study Commission's findings on the SLFS's problems were:

- Minnesota has a long term structural budget problem, with long term expenditure growth likely to outpace revenue growth
- Health care growth will become the most important factor in controlling rising state expenditures
- State revenue volatility makes long term budget instability more difficult to manage
- Minnesota's general fund tax base has grown more volatile in the past decade
- Shifting consumption patterns have reduced Minnesota's sales tax base
- Minnesota's statutory budget reserve ceiling has not grown to an appropriate level to adequately manage the underlying risks in Minnesota's tax system over time
- Achieving long term balance of state revenues and expenditures will require reductions in spending growth or increases in revenue growth, and possibly both

As if the foregoing were not trouble enough, the Governor's 21st Century Tax Reform Commission looked at Minnesota's tax system from an economic development perspective and concluded that Minnesota should substantially reduce the business tax burden. Minnesota's taxation of business discourages production in Minnesota through high property taxes, a high sales tax rate and narrow sales tax exemptions for business inputs. Minnesota's corporate income tax does not discriminate against businesses except by employing a rate (9.8%) higher than the highest individual income tax rate (7.85%). One of the Commission's major recommendations was that the corporate income tax, which brings in close to \$1 billion per year, be scrapped, notwithstanding the multibillion dollar state general fund budget shortfall.

The immediate problem to which the Minnesota Constitution mandates a solution be found is the projected state general fund budget shortfall for the FY 2010-11 biennium. The Legislature just passed and the Governor signed a new law requiring that the 2009 projections for the FY 2012-13 biennium also be balanced. The SLFS as historically constituted cannot deliver. Given that the federal stimulus money and one shot budget gimmicks appear insufficient to solve the problem, the pure political question is whether the rest of the solution will come just from spending cuts or from a combination of spending cuts and revenue increases.

The state spends \$3.4 billion per biennium on property tax relief. What is it accomplishing? How much relief is too much relief? Would Minnesotans be better off if the Legislature focused its efforts on human capital and getting better results instead of focusing on keeping property taxes "under control"? Would Minnesotans get more efficient and effective local government if local citizens were knowledgeable about and on the hook for its cost?

Perhaps 2009 could be the year for serious SLGR and SLFS improvement.

III. The Redesign

The redesign has three sets of elements – SLGR redesign, state general fund budget savings from the combination of SLGR and SLFS redesign, and SLFS redesign.¹¹

A. State-Local Government Relationship Redesign

One hundred fifty years of transportation and communications advances, plus migration from rural to urban areas and especially the Twin Cities City Region, make Minnesota more one community today than ever before. Programs for increasing individual well being should have state wide standards, for each Minnesotan is principally a Minnesotan, not a resident of x city or township in y school district and z county. Equally important, human capital will determine Minnesota’s ability to compete in the global economy and affect the quality of life of all Minnesotans. The development of that human capital – the human potential of each Minnesotan – is a state wide concern.

Each Minnesotan, though, lives in a specific community within the state that is separate from other Minnesota communities. Within broad limits, each community’s citizens should have the right to shape their community as they collectively determine.

These differences – the predominant state interest in human capital and the predominant local interest in matters involving community character and operations – suggest that the levels of state involvement and concern should vary greatly with different governmental functions. Education and human services delivery are state wide concerns in which state funding should play a major role.¹² Local community concerns, such as those in operating townships, cities and counties (excepting human services) are inherently local, should be of less state wide concern and are appropriate for largely or exclusively local funding.

Minnesota’s SLGR and SLFS do not reflect these differences as well as they could:

- Schools, though mainly funded by the state, must increasingly resort to the local property tax
- Counties collectively spend \$3.2 billion per biennium on human services, of which hundreds of millions of dollars come from local property taxes
- Cities face competition from counties and schools for the property tax base and many depend, some very heavily, on state aids.

This multiplicity of local uses for the property tax keeps the state focused on keeping local property taxes “under control,” with the result being \$3.4 billion of biennial general

¹¹ Political judgments generally are left to the Governor and Legislature. An exception is the suggestion that the public be consulted directly through a series of referenda on some of the SLGR changes. The redesign is neutral on what the appropriate long term levels of taxing and spending in Minnesota should be, but does take the position that temporary revenue increases to fund some up front investments that have tremendous long term savings potential would be appropriate, and identify potential sources for such increases.

¹² Education is a constitutionally prescribed state government responsibility.

fund spending going into the black hole of property tax relief, without regard to what results the spending at either the state or the local levels produces.

This SLGR redesign, supported by the SLFS redesign, is aimed at:

- Investing state resources in people by funding education and human services
- Giving cities, counties and townships more autonomy on other functions
- Focusing state and local governments on improving results at lower unit cost
- Ensuring that results are measured and accurately reported
- Engaging citizens in deciding whether and when to reconfigure their local governments to reduce the cost of government

Under the new SLGR design, local property tax levels will be the natural outcome of the state investing more heavily in human capital, so that the locals need not do so, and by the locals making their own choices on property tax, based on what they want for their communities and how interested they are in using the tools available to cut the costs of their governments.

Exhibit D, Changing the SLGR to Solve Minnesota's Too Many Governmental Service Producers Problem, describes some of what could be done to implement this new SLGR design, to replace the historical legislative command and control strategy, and to engage citizens across the state in deciding exactly how to reconfigure Minnesota's local governments to get better results for less cost. The Exhibit D options all involve the SLFS. Exhibit D describes changes that would:

- Redesign the rickety 87 county human services delivery system
- Require measurement and reporting of results by local governments in exchange for repealing maintenance of effort mandates on counties and school districts; reducing county and school district need to levy property taxes and increasing availability of the property tax base to cities
- Encourage use of proven tools for providing lower cost, higher quality services, leading to township boards, city councils and county boards across the state considering contracting with others to produce the services they provide, as an alternative to producing the services with their own employees
- Allow citizens across the state, community by community, to decide whether to keep the status quo in local governmental units or change the local governmental landscape, perhaps dramatically
- Allow urban citizens of the Twin Cities Metroplex to decide whether they want to compete aggressively with city regions around the world or continue with a vast number of inefficient local governmental service producers
- Channel future development into existing cities, to the everlasting benefit of Minnesota governmental budgets, taxpayer pocketbooks, and the quality of Minnesota's waters and natural habitat.

Exhibit E, SLFS, SLGR and Health Care Reform, describes ways to deploy the SLFS and SLGR redesign in health care reform with the goals of ending the risk of personal bankruptcy from health care expense catastrophes and gradually achieving multibillion dollar annual budget savings, lower health care costs and healthier Minnesotans.

Some of the changes in Exhibit D have been designed and are ready for legislative consideration. Others in Exhibit D and those in Exhibit E require more work. Minnesota's creative thinkers have or will come up with still more possibilities for 2009 legislative consideration.

Most important here are the possibilities for combining SLGR and SLFS redesign. The combined potential is spectacular.

The SLFS changes laid out below could be enacted in 2009. They are fiscally feasible and could dramatically improve SLFS functioning on all the criteria that matter – fairness, reliability, understandability, efficiency and competitiveness.

B. State General Fund Budget Savings from the Combination of State-Local Government Relationship Redesign and State-Local Fiscal System Redesign

1. General Fund Budget Savings from SLGR Redesign

Vast long term savings in state and local spending can result from SLGR redesign. While not all savings accrue to the state general fund because local governments have multiple revenue sources, the long term potential general fund savings are huge. With fast implementation of SLGR redesign, there could be a material impact on the FY 2012-13 budget problem, projected in February to be \$5 billion plus.

Savings from SLGR redesign require behavior changes by many local governments, so achieving savings for the FY 2010-11 biennium is difficult. Estimating attainable savings, cutting general fund appropriations accordingly and hoping that the savings materialize from enthusiastic embrace of SLGR redesign is one approach to minimizing service cuts.

Budget cuts of one kind, however, have two safety valves in addition to SLGR redesign tools to mitigate service cuts. This unique cut is to property tax aids and credits ("PTAC") payable to local governments ("PTACLG"). Like with any other cut, the service-providing local units can employ SLGR redesign tools to become more efficient. The first safety valve to minimize service cuts is for local governments to raise property taxes. Such increases are a reasonable response because Minnesota's home property taxes are so low relative to other states.¹³ The second safety valve is that the Legislature can prevent the resulting increases in property taxes on housing from being unduly onerous through its property tax refund ("PTR") programs.¹⁴

¹³ See note 8 above. Business property taxes, however, are high compared to other states. This problem would worsen by cutting PTACLG, unless something else were done. This design solves that problem in the best variant, but leaves it in the marginal variant and mitigates it a little in the good variant.

¹⁴ Using the PTR programs reduces the general fund savings. But because they pay out after June 30 annually, the payout bulge for local property tax increases caused by state budget cuts affecting the FY

Clearly then, PTAC payable to local governments (PTACLG) should be examined for budget cut opportunities before directly cutting state paid services.

2. Eliminate Up to \$2.4 Billion in Property Tax Aids and Credits Payable to Local Governments¹⁵

The February forecast projects PTACLG as follows for the next two biennia:

Item (\$ in thousands)	FY 2010-11	FY 2012-13
City Aid	\$1,062,979	\$1,116,436
MVHC	578,086	558,717
County Program Aid	460,218	483,346
Disparity Reduction Aid	38,920	38,982
Police and Fire Aid	179,188	191,564
PERA Pension Aid	28,862	28,862
Replace Taconite Production Tax Reduction	17,004	17,004
Other Taconite Aids	11,711	11,923
Border City Disparity Credit	12,541	13,834
All Other PTACLG	20,813	19,881
Total PTACLG	\$2,410,322	\$2,480,549

- The SLFS redesign creates eight possibilities for disposition of the \$2.4 billion presently projected for PTACLG in each of the next two biennia:
 - Elimination to balance budget, probably totaling at least the \$466 million requested by the Governor and limited primarily by extent of consensus at the Capitol on the acceptable level of local property tax increases
 - Elimination to pay health insurance costs of local government employees, replacing local property tax
 - Elimination to fund human services delivery, which could be coupled with replacing county property tax from another revenue source

2010-11 biennium, would be half deferred into FY 2012 for homeowners and fully deferred for renters. The 2009 Form M-1PR, which would be filed in the spring and summer of 2010, will reference renters' rent paid in calendar 2009 and homeowners' property taxes payable in 2010. Thus, renters refunds ("RPTR") will not reflect property tax increases in response to the cuts and homeowners' refunds ("HPTR") will. The forms filed in 2011 will reflect property tax increases, but they will not pay out of the state general fund until FY 2012. Thus, half the increases in the HPTR and none of those for the RPTR will hit in the FY 2010-11 biennium. The temporary savings could exceed \$100 million.

¹⁵ The property tax system redesign ("PTSR") set forth below comes in three variants – marginal ("Marginal PTSR"), good ("Good PTSR") and best ("Best PTSR"). Whether Marginal PTSR on the one hand, or either Good PTSR or Best PTSR on the other is adopted will have a major impact on the extent to which PTACLG can be eliminated. It could be done with difficulty under Marginal PTSR; it could be done more easily under Good PTSR; and it could be done very easily under Best PTSR.

- Elimination to invest in an innovation fund of up to tens of millions of dollars to issue grants to engage local governments in the SLGR redesign described in Exhibit D
- Elimination by shifting amounts now sent to cities and other local units of government via LGA and other relief programs to amounts sent to school districts to reduce their levies
- Elimination to enhance the HPTR and RPTR to protect homeowners and renters against property tax increases resulting from state aid cuts
- Elimination to fund transitional property tax relief program that winds down over a period of years
- Existing property tax relief programs in current or modified form
- Mix depends on technical issues and political response to design elements.
- Clearest targets are the first four items, which total over \$2.1 billion per biennium, and the taconite homestead credit (“THC”), which adds a little bit more.
- Market value homestead credit (“MVHC”) repeal part of repeal of class rate property tax system, as to which see below
- County program aid (“CPA”) repeal part of state taking over more of human services delivery system costs, which could cut county property tax needs by more than the amount of the CPA reduction
- City LGA repeal would not abandon the equitable intent of LGA – no city’s residents would be abandoned to face harmful consequences
 - Important to focus cities and citizens on city government costs, so they can choose wisely from the options shown in Exhibit D and have maximum incentive to operate more efficiently. Under status quo, everyone is clueless due to property tax system distortions.
 - Repeal difficult under Marginal PTSR, easier under Good and Best
 - Unknown whether a city LGA program will be needed after transition to the redesigned SLGR. Think of repeal now as a suspension lasting through the FY 2012-13 biennium, at which point consideration should be given to whether an LGA program is still necessary.
- THC repeal would put homeowners across the state on the same system, rather than having a special program that reduces Iron Range homeowners’ property taxes by an additional \$289-\$315 per year, often to very low levels. See Exhibit B and Attachments B-1 and B-2. The current level of subsidy is questionable alongside the cuts in services to low income Minnesotans that will otherwise be made. Consistency on the system for homeowners would improve tax system fairness. Resulting increases could be phased in through the HPTR and perhaps eliminated by aggressive use of SLGR redesign tools by Iron Range communities. The Iron Range could use Iron Range Resources funds to become a leader in using the cost saving options shown in Exhibit D.
- Some aids might be retained, as they deal with specific issues, not general property tax relief
- How could such change be politically feasible? See Exhibit B. Looking at three property tax relief programs – LGA, taconite aid and market value homestead credit - payable to cities for 496 Minnesota cities, arrayed in the Stinson/Gillaspy geographical groupings of five ruralplexes and one 17 county metroplex, shows

the following average annual per capita city aids (dollars per city resident) and the following 2007 county or “plex” populations:

Metro 7 outside Minneapolis and St. Paul – 138 cities	\$ 80	2,172,994
Metro 10 nonstatutory metroplex counties – 76 cities	\$139	<u>763,261</u>
Low subsidy areas population		2,936,255
Minneapolis-St. Paul - 2 cities	\$237	676,009
Central Lakes - 47 cities	244	<u>292,129</u>
Medium subsidy areas population		968,138
Northwest Valley – 43 cities	\$299	289,396
Southeast River Valley – 112 cities	301	549,035
Southwest Corn Belt – 41 cities	346	164,535
Up North – 37 cities	428	<u>356,134</u>
High subsidy areas population		1,359,100

(Disregard taconite aids and the per capita numbers drop to \$236 for Central Lakes and \$386 for Up North.) Under this proposal, cities would have greatly eased access to the property tax because schools and counties would levy less; no city or its residents would be punished; all cities would be treated similarly, which would greatly incentivize attempts to operate more efficiently; all Minnesotans would be protected to the same degree against too high property taxes; the need for LGA would be reexamined four years out; and Greater Minnesota cities would no longer be priced out of the competition for business expansion by ridiculously high business property taxes (as to which see Exhibits B and C). The votes could be there.

3. Could the Governor and Legislature Think About Eliminating the \$1 Billion Biennial Property Tax Refunds Payable to Homeowners and Renters?

- No under Marginal PTSR, for cities, counties and schools all rely heavily on the property tax, which will increase, so HPTR and RPTR still needed
- Maybe under Good PTSR, if accompanied by individual income tax base change from FTI to FAGI and development of income-adjusted household credit, but probably need for a while to smooth transition to redesigned SLGR and SLFS
- Yes under Best PTSR, with foregoing individual income tax change and transition

C. State-Local Fiscal System Redesign

1. Property Tax System Redesign – Three Variants with Common Elements

- Common elements
 - **End levy limits**
 - **End requirement for school districts to hold referenda** to get operating money. Puts school districts on same footing as other governmental entities – school board members answer to the public for their decisions at the next election. Optional whether continue to require for new buildings
 - **Leave townships** reliant on the property tax.
 - **Met Council stops levying property tax**, instead billing cities and townships on combination of area and population to encourages more urban development, reducing future infrastructure costs, making public transit more affordable, and reducing energy consumption
 - Other **special districts continue reliant on property tax**, but probably through billing local government customers, not levies

- **Marginal Property Tax System Redesign**
 - Repeal as much of the \$2.4 billion per biennium PTACLG as practicable, using HPTR and RPTR to offset excessive property tax increases
 - State partially takes over local employee health insurance expense unless that negatively affects health care reform, as alternative to PTACLG
 - State shifts county program aid to regional boards in new health care delivery system, if it helps make new system work

- **Good Property Tax System Redesign**
 - Changes are Marginal PTSR+, so eliminate more PTACLG
 - **Change governmental property tax use**
 - **Take schools off the property tax**, except perhaps as stabilizer when revenue forecasts are missed (state could fund this) and for building construction. Made feasible by shift of business taxation from local property tax to the state and by a local individual income tax, equalized by the state, for discretionary school revenue raising. **Reduces local property taxes by \$1.5-2 billion per year.** Could keep discretionary local spending on the property tax, but that means higher home property taxes than taking it off.
 - **Decrease county property tax use by transfer of human services delivery system responsibility to regional boards. Reduces county property taxation by several hundred million dollars annually** (\$300 million plus in Hennepin plus Ramsey alone). Counties may still deliver human services, but it would be by contract with a regional board, for which they would be paid by the board. State and federal money flows through the boards to the

- service providers, which may or may not be counties. Elimination of County Program Aid helps fund boards.
- **Increase city reliance on the property tax**, with LGA and other property tax relief programs and perhaps local sales taxes repealed. LGA repeal increases property taxes by \$400 million plus per year. Largely offset by schools going off property tax and reduction in county use of property tax for human services. Reduce city tax burden by a state takeover of employee health care costs, either directly or through reimbursement.
 - **Change property tax incidence**
 - **Class rate system ended**, except for farm land, shifting local burden from business property to homes and other classes. Business does not get a tax cut and homes do not get an increase, due to other changes.
 - **State property tax** on business and seasonal recreational residential property **repealed**.
 - **New state property tax on business property state wide with levy spread based on market value**. Evens out business tax burdens across the state.
 - **Developed property outside cities subject to additional property tax** at rate needed **to equalize the local rate with that in an appropriate nearby city – the urban development encourager (“UDE”)**. Making cities more dependent and schools and counties less dependent on property tax would otherwise push development outside cities. UDE would neutralize this or, if the Legislature so decided in the interest of protecting habitat land and water quality, minimizing public infrastructure costs, conserving energy and fighting climate change, make it more expensive, property tax-wise, to develop outside cities.
 - **Best Property Tax System Redesign**
 - Changes are Good PTSR+, so get better results, including complete elimination of PTACLG (\$2.4 billion in general fund spending) and perhaps of HPTR and RPTR (\$1 billion in general fund spending), over one or two biennia, in neither case all counting as budget savings, but in each completely eliminating undirected spending in favor of results-focused spending
 - **Change governmental property tax use**
 - **State uses state wide property tax levy to make up for revenue not meeting forecast. Property tax used more locally and regionally for transportation infrastructure**, with level available from time to time dependent to some extent on whether forecasts are met. Good uses for property tax: its stability can help stabilize

the SLFS and transportation infrastructure should not be built if it does not increase property values.¹⁶

- Optional whether school districts use property tax to make up for shortfalls in local income tax revenue or whether this comes from state, which issued the forecasts. Latter much simpler.
 - Locals use property tax more and special assessments less, increasing federal subsidy for capital improvements by making the payments deductible for federal income tax purposes
 - **If taking schools off property tax for local discretionary funding is unacceptable**, they could continue to use it, but this would put more pressure on the property tax
- **Change property tax incidence**
 - **Farm land off the property tax except** township levies and county rural road levies. **Farmers pay new business activities tax (“BAT”)** when they sell their products. Like a severance tax. Farm land also subject to undeveloped land appreciation tax (“ULAT”) when sold for development – a special capital gains tax.
 - **Habitat property** (vacant land outside cities) **exempt** from property tax, but subject to ULAT when sold.
 - **Change property tax base from value to area**, enacting now for implementation about 2-3 years out.
 - Best PTSR may not be feasible unless state revenue augmented at least temporarily. Other SLFS redesign measures would further improve SLFS.
- The property tax redesign is fiscally feasible
 - Back of the envelope calculations show PTACLG could be eliminated for FY 2010-11, subject to need to transition changes
 - Transition not yet analyzed, but plainly poses no insuperable difficulties.
 - HPTR would prevent any homeowner from being hard hit.
 - Refining the design requires participation by legislative staffs and Department of Revenue with their property tax models
 - Analysis to date available upon request

¹⁶ Among the potential advantages: the state turning lesser used portions of the state highway network over to the counties, possibly resulting in more efficient use of constitutionally dedicated gas tax revenues and competitive bids from county highway departments to maintain portions of the state and interstate highway networks.

2. Individual Income Tax Redesign to Broaden the Base, Eliminate the AMT and Facilitate Both Health Care Reform and Cutting \$1 Billion in Homeowner and Renter Property Tax Refunds

- Current base begins with federal taxable income. Broader base could use either federal adjusted gross income, or Line 28, Form 1040.
- Major elimination of “tax expenditures” – exempted income and various deductions and credits – could produce \$1 billion+ in revenue per biennium without raising rates, or permit a 6-8+% rate reduction without revenue loss
- Broadened base allows replacing exemptions and standard deduction with income adjusted household credit, which could also eliminate the HPTR and RPTR, resulting in elimination of another \$1 billion in general fund spending
- Because Minnesota relies heavily on income tax (6th highest of the states in FY 2007 in individual income tax as a percentage of income, per Minnesota Taxpayers Association) and high nominal rates attract more negative publicity than a broad base, should maintain as broad a base as practicable
- BTSC report affirms this, stating at p. 29: “Taxes should be assessed on the broadest base possible with the lowest rates possible and avoid special exemptions.”
- If alternative minimum tax eliminated, administration simpler and cheaper for taxpayers and state
- Numerous health care-related tax breaks that, if eliminated or moderated, might fund health care reform to protect all Minnesotans against risk of personal bankruptcy from family health care disaster, if legislators can agree on program to do so as significant step in health care reform. See Exhibit E, SLFS, SLGR and Health Care Reform
- Possibilities for base broadening and AMT elimination, and magnitude of existing health care and other tax breaks discussed in Exhibit F, Minnesota Individual Income Tax System Redesign (prepared upon request).

3. Business Taxation Redesign for a More Competitive Minnesota

- Discriminatory, high property taxation and high sales tax rate coupled with narrow business input exemptions the two biggest business tax problems
- Redesigned property tax could work with either retention of high business property taxation, with elimination of local discriminatory taxation plus addition of major state business property tax, or elimination of the high property tax problem through a new business activities tax (“BAT”) on apportioned gross margin
- BAT should result in equalizing business and residential property taxation, equalizing the corporate income tax rate and the top individual rate, and exempting most business inputs from sales taxation.
- Redesign results:
 - End discrimination against business production in Minnesota

- Simplify corporate income tax to conform to federal
- Shift significant business tax burden off businesses producing in Minnesota and on to businesses selling into Minnesota
- Eliminate business tax giveaways
- Business tax redesign is discussed in Exhibit G, Minnesota Business Tax Redesign (prepared upon request).

4. Farm Taxation Redesign to Honor the Land

- Best Property Tax System Redesign calls for redesign of farming taxation
- Exempting farm land from most property tax honors the land, acknowledging status of land as foundation of the ecosystem, including feeding humans, as well as economic commodity
- Stunning contrast with current system - Christmas 2008 Minneapolis Star Tribune story on 2008 Green Acres program change causing cash-strapped farmers all over the state to cut down trees to avoid property tax increase
- Not a free ride for farmers. BAT applies to sales of Minnesota farm products. Farm land taxed just like other property for township governance and the rural roads that are largely for farmers' benefit.
- Farmers could also be taxed for using pollution-causing chemicals, by removing the sales tax exemptions for purchases of such chemicals, and perhaps applying a higher rate of tax to such chemicals.
- One element of the systemic change required for the public endorsement of importance of Minnesota's waters and wildlife habitat expressed through approval of the dedicated sales tax constitutional amendment to be turned into reality
- Farm tax redesign discussed in Exhibit H, Minnesota Farm Tax Redesign (prepared upon request).

5. Sales Tax Redesign to Broaden the Base, Cut the Rate and Make the SLFS More Reliable

- BTSC finding and recommendation
 - Shifting consumption patterns have reduced Minnesota's sales tax base
 - Taxes should be assessed on the broadest base possible with lowest rates possible and avoid special exemptions
- Revelation from Department of Revenue's Tax Expenditure Budget: the "tax expenditures" from the sales tax; i.e., exemptions from the sales tax base, would produce more revenue if taxed than the items that are now taxed.
- The revelation means Minnesota could either more than double its sales tax revenue or cut the rate by more than half – to something under 4% - and raise the same amount of revenue, or do something in between
- Addresses two BTSC concerns – SLFS instability and coming problems as the population ages and older people have lower incomes and fewer purchases of what currently is taxable
- Also part of business tax redesign – broadening the base with respect to general consumption, but cutting with respect to business capital expenditure inputs

- Look at whether sales tax exemptions should be narrowed in light of fiscal crisis
- Base broadening and rate cutting options discussed in Exhibit I, Minnesota Sales Tax Redesign (prepared upon request)

6. State-Local Fiscal System Redesign for Greater Reliability

- Reliability includes revenue system sufficiency, stability and certainty.
Sufficiency: Is enough revenues produced to cover service delivery obligations?
Stability: How stable (volatile) is the revenue stream? Certainty: Can taxpayers plan with confidence in how economic activity will be taxed?
- Minnesota's SLFS is flunking on sufficiency and stability. That's what led to formation of Budget Trends Study Commission.
- Stability could be enhanced by
 - Use of property tax at the state level to make up for forecast shortfalls
 - Broadening sales tax base to virtually all consumer purchases
 - Retaining the corporate income tax, which, though notoriously unstable on its own, is countercyclical to other major taxes, so actually makes the overall system more stable according to BTSC. Governor's 21st Century Tax Reform Commission, by contrast, would repeal corporate income tax.
- Sufficiency could be enhanced by broadening sales tax base to virtually all consumer purchases, countering the drop off in tax revenues that is coming as the population ages, has less income to tax and makes fewer purchases of the high value goods that are the bulk of Minnesota's current sales tax base.
- Stability also enhanced by enlarged and improved budget reserve
- SLFS reliability discussed in Exhibit J, Redesigning the Minnesota SLFS for Greater Reliability (prepared upon request)

IV. Pros and Cons of Each Property Tax System Redesign Variant

A. Marginal Property Tax System Redesign

- Pros
 - Better relates property tax relief to ability to pay
 - Clarifies cost of operating each city
 - Energizes city use of SLGR opportunities
 - Sets stage for future determination of need for LGA
 - May save \$500 million+ plus in FY 2010-11 with minimal harm
 - If want local property tax increases to cope with crisis, this delivers
 - Substantial reform with minimal SLFS change
- Cons
 - Hits business property, already highly taxed, hard
 - Ability to cut PTACLG restricted by other local governments' continued heavy property tax usage
 - No help for other SLFS structural problems, blowing reform opportunity

B. Good Property Tax System Redesign

- Pros
 - Does as well or better on first five Marginal PTSR pros
 - Significantly reduced school and county property taxes leaves cities room
 - Nearly eliminating class rate system saves money, simplifies
 - Seasonal recreational residential property tax burden eased
 - Urban development encourager channels development to cities, saves on infrastructure costs and energy, helps water and habitat quality, and is one element of systemic change required for public endorsement of importance of Minnesota's waters and wildlife habitat through approval of dedicated sales tax constitutional amendment to be turned into reality
 - Ending local business property tax discrimination ends impetus for excessive retail construction, moderates citizen demand for local services, pushes cities to use SLGR opportunities to increase efficiency, and improves economic development prospects in Greater Minnesota
- Cons
 - Transferring business property tax burden to state an improvement, but problematic due to heavy taxation of business property
 - Ability to fully eliminate PTACLG may be compromised by still just working within property tax system

C. Best Property Tax System Redesign

- Pros
 - All pros of Good PTSR are replicated or improved
 - Complete elimination of PTACLG (subject to reexamination of LGA in four years). All \$2.4 billion either eliminated or converted to results-focused spending, effective immediately
 - If change individual income tax base, may be able to eliminate the \$1 billion in PTAC paid to individuals through the HPTR and RPTR

- State property tax as stabilizer major improvement in SLFS reliability
- Exempting farm and habitat land from most property taxation and changing from value to area base for property tax produces major positive ongoing consequences
 - Perhaps \$100 million per year tax administration savings
 - Virtually eliminates property tax disputes, beginning with those about to occur because homes now valued for tax purposes higher than current market values
 - Systemic incentives to use land efficiently, maximize buildings' value, and replace old, dilapidated, inefficient structures
 - Encourages urban redevelopment – recycling real property – shrinks areas of run down property and concentrated poverty, reduces tendency to sprawl, minimizes infrastructure costs and energy usage, and makes public transit a better deal
 - Preserves habitat and water quality
 - Ends problem of seasonal recreational residential property owners being forced to sell by skyrocketing property taxes
 - One element of the systemic change required for the public endorsement of importance of Minnesota's waters and wildlife habitat expressed through approval of the dedicated sales tax constitutional amendment to be turned into reality
 - This is a **new approach to thinking about property tax – from property as pure economic commodity to that plus ecosystem foundation**¹⁷
- Look at whether property tax exemptions should be narrowed, perhaps to the constitutionally required ones, in light of fiscal crisis
- Cons
 - Probably requires some additional state revenue for maximum impact. Could be immediately revenue neutral, revenue neutral long term with transitional revenue gains to help transition to redesigned SLGR, or permanently increase revenue
 - Change is difficult

¹⁷ Now is the time for this change in thinking. See T.L. Friedman, Hot, Flat, and Crowded (Farrar, Strous and Giroux 2008) at 47: “All five of these key problems – energy supply and demand, petropolitics, climate change, energy poverty, and biodiversity loss – have been building for years. But they all reached a critical mass sometime shortly after the year 2000. Two thousand years ago, the world went from B.C.E. to C.E. ... December 31, 1999, was not simply the end of a century, not simply the end of a millennium, but the end of the period we called the common era – and ... January 1, 2000, was actually the first day of a new era... the Energy-Climate Era ... 1 E.C.E.

VI. The Results - Assuming Best Property Tax System Redesign

- Lets legislators and Governor cut \$2-3.4 billion of biennial general fund PTAC spending not targeted to results, some to help close the budget gap, the rest transformed into results oriented spending
- Move toward general fund balance in FY 2012-13, another big challenge given that the February forecast projects it to be out of balance by about \$5 billion (15%) and new law requiring that FY 2012-13 project out now to be in balance
- Change budget discussions from mandates, maintenance of spending effort and property tax relief to improving results for the price taxpayers pay, as steering for results by Minnesota's state and local governments becomes central to budgeting
 - SLFS changes energize SLGR redesign utilization
 - Citizens across the state participate in reconfiguring Minnesota's local governments for the 21st century
 - Positions state officials to improve the budget process and focus both state and local governments on steering government for better results
- Best Property Tax System Redesign produces the pros noted in Section IV above
- Encourage efficient land use (urban and rural), improved water and natural habitat quality, and channeling of development into cities, reversing current incentives
- Business tax reform reduces tax burden on Minnesota based businesses and improves Minnesota's competitiveness, concerns of the 2009 Governor's 21st Century Tax Commission Report, while eliminating giveaways instead of increasing them as recommended by the Commission
- Redesigned SLFS
 - Interferes less in private and governmental decision making
 - Saves on tax administration expense
 - Increases SLFS reliability (the major concern of the 2009 Budget Trends Study Commission Report), as well as fairness, understandability, efficiency and competitiveness
- Four potential sources of broad public support for SLFS redesign
 - Unhappiness with subsidy patterns of existing city aids
 - Happiness at eliminating disputes over home property values, especially with outdated high values now affecting taxes currently payable
 - Happiness with ending risk of personal bankruptcy from health care costs
 - Happiness with emphasis on care for Minnesota's water and land, channeling of development to cities and facilitation of energy conservation of the Best Property Tax System Redesign – the public voted in November to increase taxes to help the environment, and people increasingly recognize that we are, in Tom Friedman's words, living in a "hot, flat and crowded" world

Stopping short of the Best Property Tax System Redesign would compromise the results.