

## **James Proposal Post-Unallotment Rejection**

Legislators and Governor Pawlenty should not assume that the state can legally borrow money and then pay it back with a constitutionally-mandated state property tax. Minnesota Constitution Article XI, Section 6 requires such a tax, but only following certificates of indebtedness having been issued “in anticipation of the collection of taxes levied for and other revenues appropriated to any fund of the state for expenditure during that biennium”, which cannot be the case in the current biennium because Governor Pawlenty and the Legislature failed to enact a balanced budget in the first place. The argument for requiring a government shutdown would be far stronger under the Constitution and statutes than was Governor Pawlenty’s attempted unallotment.

In crisis lies opportunity. Minnesota’s budget crisis could be ended for FY 2010-11 and reduced for FY 2012-13 by a combination of spending cuts; tax increases; a shadow budget to demonstrate the impact of gubernatorial intransigence; and structural changes in the state-local government relationship and fiscal system.

**Spending cuts.** Programs will have to shrink or disappear, and some payments may be deferred. The Legislature may ratify some of Governor Pawlenty’s unallotments, and probably will cut other spending.

Since most governmental spending is on salaries, modest pay cuts or salary freezes could be considered. If necessary to secure agreement, the salary reductions could be deferrals, with payment moved beyond June 30, 2011. Agreements to amend local contracts could be encouraged by financial incentives to local governments.

The obvious major spending cut, which fuels the obvious major tax increase, is to reduce or eliminate property tax aids and credits, switching reliance for property tax relief to the property tax refund program. Since property tax refunds are paid out after the June 30 fiscal year end, the change would be doubly helpful in balancing the FY 2010-11 budget

This cut would reduce the indefensible subsidies of local government costs that occur on a patchy basis in various cities around the state. The owners of average valued homes in some Minnesota cities pay less than \$50 per month for all of their local government – city, school, county and special district – services combined. There is no excuse for this.

**Tax increases.** Minnesotans pay a lower percentage of our income for state and local government today than at almost all times since the state began keeping track in 1990. Minnesota’s home property taxes remain relatively low compared to other states.

The obvious tax to increase is the local property tax. Local governments in touch with local citizens could decide how much local government they want and are willing to pay for, now that the state has no choice but to drastically reduce the level of state support for local government services. Levy limits should be repealed so each community can decide which services it will continue with increased property taxes and which it will cut.

A considerable portion of the state deficit could be covered, and services maintained, by increasing local property taxes to replace reduced state aids. Governor Pawlenty's consistent refusal to consider state tax increases implicitly favors local governments funding a greater portion of their operations by levying higher property taxes.

Temporary increases in the state income and sales taxes should be enacted. Rollbacks effective no later than January 1, 2014, could be written into the law. Minnesota is in the midst of perhaps its worst fiscal crisis. Temporary state tax increases to help resolve a fiscal crisis without drastic service cuts seemingly would be part of, not in violation of, a principled conservative approach to fiscal management.

The obvious change for the state income tax is to go back to the pre-1999 rates of 6%, 8% and 8.5%, up from the current rates of 5.35%, 7.05% and 7.85%. The rate cuts in 1999 and 2000 were made at the peak of the high tech bubble, and leave Minnesota still operating on the assumption that that bubble, not to speak of the housing bubble, never burst. This probably would increase income tax revenues by about 10%, far from enough to solve the problem, but enough to make a dent in it. The mistaken reliance on a popped bubble affects all income taxpaying Minnesotans. Just soaking the rich is not a solution.

The state sales tax is a strong candidate for a temporary revenue increase because it badly needs a broader base in order to make Minnesota's tax system more reliable. Minnesota now has a high rate (6.875%, and higher in many cities and counties) on a narrow base. The base should be broadened to make the system better, and the rate cut, to no higher than 5%, with the rate cut done in stages over time to help solve the budget crisis. Everything should be on the table – clothing, personal services, food and health care. The broader the base and the lower the rate, the better off all Minnesotans will be. Problems for low income people can be solved with debit cards. There is no excuse for continuing the status quo. The rollback a few years out should be a rate reduction, leaving the broadened base in place.

Legislators and the Governor could choose to forego any income tax change and make up the difference with the sales tax revenue increase. The choice is purely political, and if the Governor will budge on the sales tax, but not the income tax, the Legislature should accommodate him.

**Shadow budget.** Governor Pawlenty steadfastly resists state tax increases (but not local ones virtually forced by state actions that he advocates). The situation now may be stark enough for legislators to have a chance at public opinion convincing the Governor that a compromise involving spending cuts, local property tax increases and temporary state income and sales tax increases would be better than relying exclusively on spending cuts and local property tax increases. Negotiations could proceed as follows.

First, pass bills with a mix of solutions to solve the problem. Make substantial cuts, but include temporary sales and income tax increases, and publish the impact of the changes on tax system regressivity and the price of government.

Second, if Governor Pawlenty vetoes the first solution, try to over ride the veto and, if that fails, drop the temporary income tax increase, make the temporary sales tax increase larger, and publish the impact of this change on tax system regressivity. It will show that the poor and the middle class pay more, and the rich less, than under the more balanced approach. This could then be a campaign issue.

Third, if Governor Pawlenty vetoes the second solution, try again to over ride and, if the attempt fails, make even greater cuts in aids to local governments, which are sure to push property taxes up, and make enough additional cuts to balance the budget. Then publish the cuts in detail along with the impact on the price of government and local property taxes. The shadow budget that could have been can then be compared with what the tax cost to produce it would have been, and the question of whether the services would have been worth the taxes could be a campaign issue.

**Structural changes.** Two structural improvements to Minnesota's state-local fiscal system are suggested above – reduced reliance on property tax aids and credits, with the property tax refund program becoming a more important source of relief to those whose taxes would otherwise be too high; and a massive broadening of the sales tax base, coupled with a significant cut in the rate. Additional ideas can be found in James Proposals Light, Medium and Jumbo. Some require study, some might be too complex to consider now, but some could be incorporated into the budget crisis solution, and all have the potential for getting more value from the public spending dollar in the long run.