

Re-**re**-thinking Minnesota Taxes

**Fairer for families and
better for business growth**

September 19, 2008

GROWTH & JUSTICE

Back in 2005, Growth & Justice founder Joel Kramer testified before the House Taxes Committee, and in a presentation called “Rethinking Minnesota Taxes,” he laid out a proposal that would make the tax system fairer for families and better for business.

I was covering that hearing as a reporter, and I remember Joel saying his plan was a strategy proposal to get people to think differently. He didn’t expect it to go anywhere in the Legislature that year.

He was right. It didn’t. But three-and-a-half years later, now as the organization’s president, I know Growth & Justice was right to start that conversation, and I thank the Commission for the invitation to speak here today as you advance the tax discussion in an important direction.

Today, I want to recap some of that proposal ... Call it **Re-re**-thinking Minnesota’s Taxes”... and convey a few reasons why it’s more important than ever to make reforms in the tax system that will be better for business and for Minnesota families.

3-1/2 Years Ago We Asked

1. **Can we make the tax system fairer?**
2. **Can we simultaneously make it better for economic growth?**

GROWTH & JUSTICE

Can we make the system more fair and also better for economic growth?

The answer is yes, and I think most people would agree those would be good things to do.

In fact, making the *tax system* better for business will *only* work if the reforms also support *public investment* that makes the economy better for everyone — by continuing our ability to ensure an adequate, well-educated workforce... by slowing the rate of congestion and improving our physical infrastructure... and by maintaining a quality of life that will retain and attract the best minds and managerial talent.

Why Tax Reform Now?

- **Losing our lead on social & economic indicators**
- **Below-average income, GDP & jobs growth**
- **Widening income gap, more regressive taxes & fees**
- **Politics limiting revenue & spending options**
- **Likely result — greater drag on economic growth**

GROWTH & JUSTICE

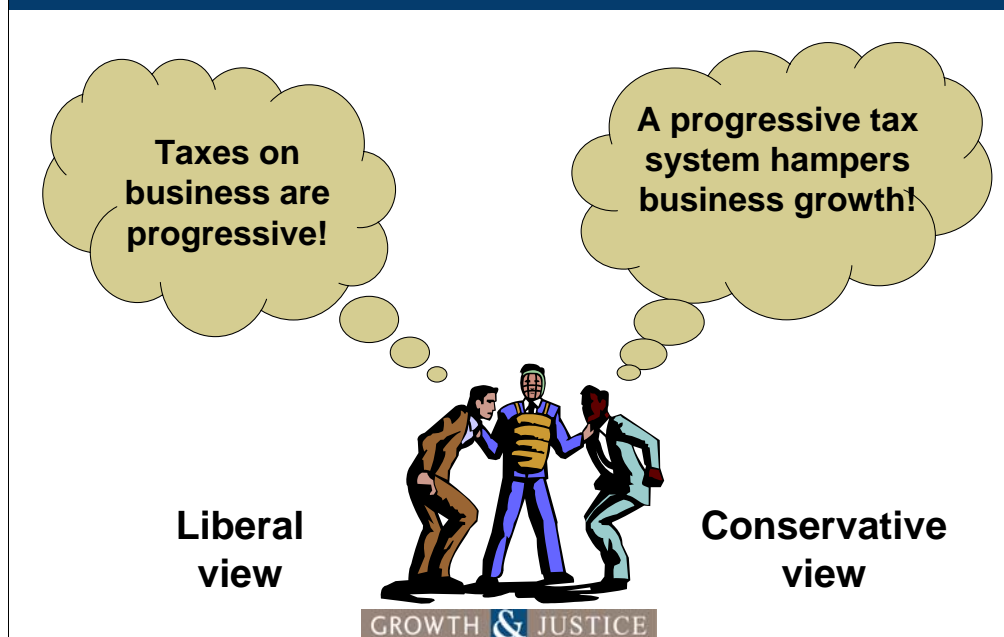
Since Growth & Justice made the case in 2005, we have seen Minnesota slip on a variety of leading indicators of social and economic well being. Tom Stinson and Tom Gillaspay recently painted that picture for you, so I won't belabor the points here, except to remind you that in this decade:

- We have gone from above-average to below average growth rates for income, GDP and job growth.
- The income gap that separates the top earners from rest of us has continued to widen — at an accelerating rate. Meanwhile, the wealthiest Minnesotans pay the lowest proportion of their income in state and local taxes.
- Even though we've found a majority of Minnesotans support wise investment in people and places to build the state's productive capacity, the political climate constrains our ability to raise taxes or to spend more where it can make a difference. No new taxes, by any name, has contributed to the state we find ourselves in.

And all of this, plus demographic changes over which we have little control, argues for a fresh look at how we raise revenues and invest in ourselves to encourage economic growth. It is past time to rethink taxes.

So why haven't we gotten anywhere yet on something that would clearly be in our best interests? Because first, we have to get past some cherished but erroneous beliefs about business taxes.

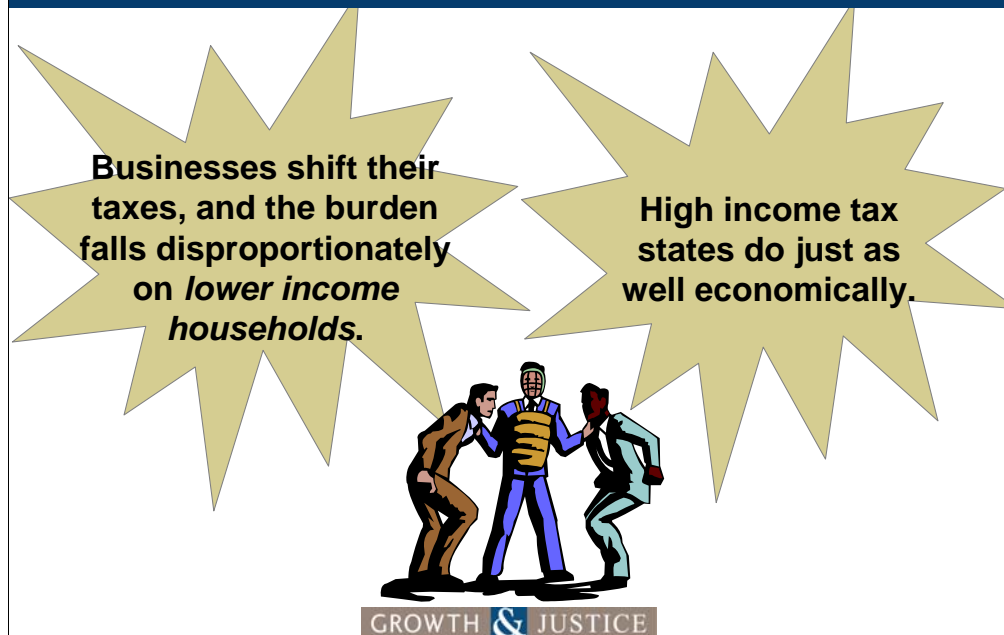
So Why Can't We Agree?



Liberals persist in believing that taxes on business are progressive — that they relieve the tax burden of the average working family and place it on corporations.

And conservatives tell us loudly and repeatedly that corporate taxes and higher income taxes — particularly for business owners and investors — hamper business growth.

Exploding Cherished Beliefs



But in fact, businesses have much greater ability than the average taxpayer to shift tax impact so the real burden falls disproportionately on lower income households. That may not be the intent of the companies or the tax system — but it is the effect.

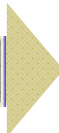
The Commission heard anecdotal testimony from the business groups last month that Minnesota's taxes were affecting local companies' decisions to expand in the state. I don't think we can ignore those concerns, but the research shows that high income tax states do just as well on economic measures— if not better — than low or no income tax states.

If we're going to make progress, we first have to scrap these beliefs.

Who Pays Business Taxes?

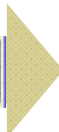
Businesses don't pay taxes — people do

**Business try to
shift tax costs
here...**



**Higher prices to
Consumers**

And here...



**Lower wages and benefits to
Workers**

**Only as a last
resort do the
costs shift here.**



**Reduced returns to
Investors**

GROWTH & JUSTICE

You're familiar with the fact that businesses don't pay taxes, people do.

And as taxes are shifted from business entities to individuals, the impact tends to fall on lower and moderate income earners before it falls on the owners of capital.

Who Ends Up Paying Business Taxes?

Over \$116,136	2.2%
\$84,343 - \$116,135	3.0
\$66,029 - \$84,342	3.4
\$52,134 - \$66,028	3.7
\$40,756 - \$52,133	4.0
\$31,749 - \$40,755	4.4
\$24,133 - \$31,748	4.8
\$17,110 - \$24,132	5.2
\$10,236 - \$17,109	6.3
Under \$10,235	11.0

After shifting to households, the effect of business taxes is highly regressive

Source: MN Department of Revenue, Tax Incidence Study, 2003

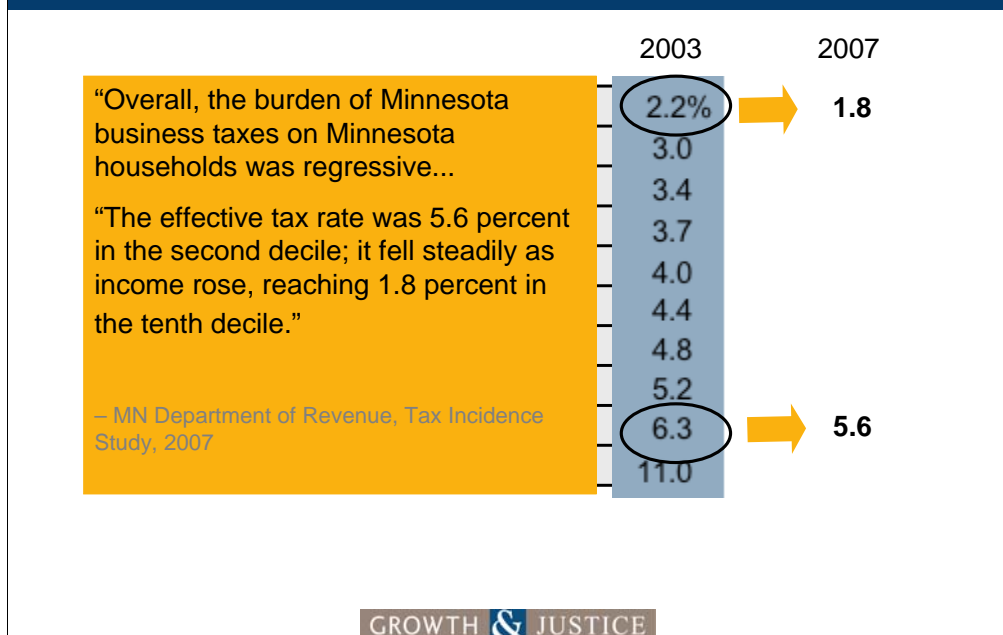
GROWTH & JUSTICE

The state tax incidence studies attempt to quantify this impact.

In the 2003 study, the state broke out the impact on different income deciles this way.

You can see that, after shifting, the top earners pay the smallest proportion of income in business taxes.

Who Ends Up Paying Business Taxes?

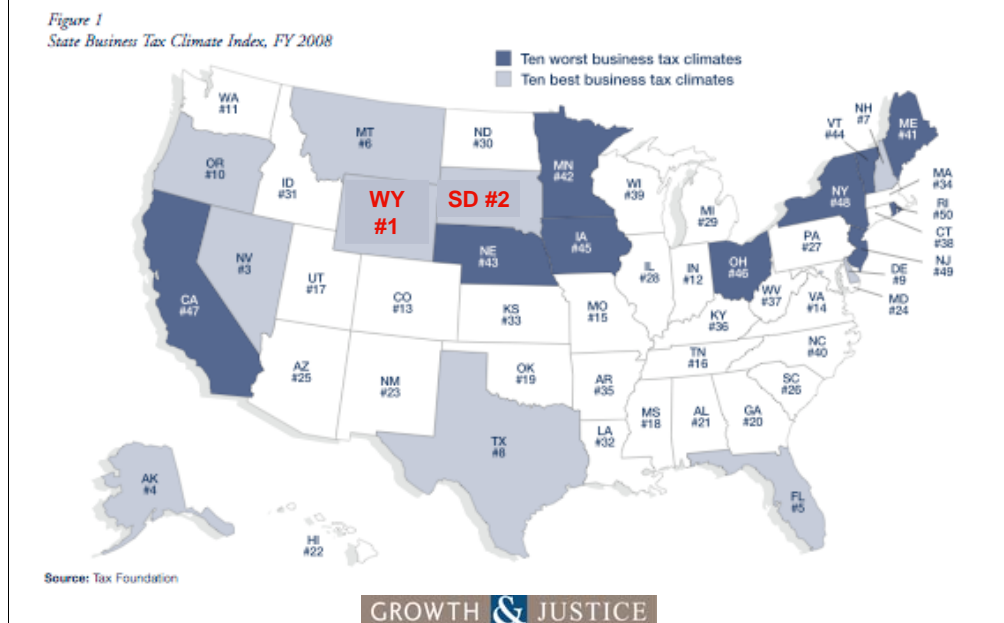


Four years later, the 2007 tax incidence study summarized the impact of business taxes with these words.

The relative overall burden from business taxes had dropped somewhat, but a substantially regressive gap is still there.

Liberals who think business taxes are progressive need to look at this chart.

Best Business Tax Perception



On the other hand, conservative organizations like the Tax Foundation feed the notion that a healthy business climate depends on low business taxes.

By its rankings, Minnesota, California and New York are among the worst states for business, with number-1 Wyoming and number-2 South Dakota being the best.

If the business tax climate really worked that way...

Business Climate is More than Tax



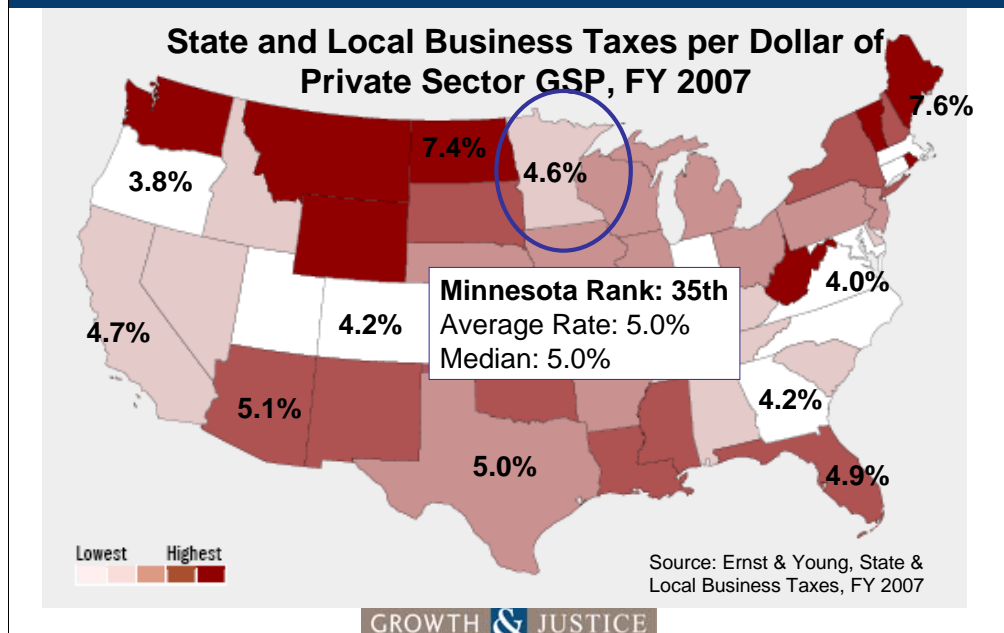
Silicon Valley would be in Casper and South Dakota tourists would be heading for Wall Street instead of Wall Drug.

We constantly hear that states like Nevada, Texas and Florida are proof that job growth follows low taxes.

Low-tax states have had a hundred years to prove their policies will result in higher rates of economic growth and higher standards of living.

If it were going to happen, we should've seen much clearer evidence by now.

What's the Business Tax Reality?



Here's one more comparison. When Ernst & Young looked at business taxes for FY 2003, Minnesota ranked 35th among the states when measured per dollar of private sector economic activity. While some states have moved up or down since then, and the average rate crept up from 4.8% to 5.0%, Minnesota held steady in its ranking and its percentage of 4.6%.

In other words, based on the relative prosperity Minnesota's economy produces, businesses in the state are not doing so badly. Certainly not as badly as some would like us to think.

Business Climate Reality

Correlation between Tax Progressivity and State Performance

State	State Progressivity Ranking (1 = most progressive; 50 = most regressive)	1 = best performing state; 50 = worst performing state					
		2004 DRC Performance	2004 DRC Business Vitality	2004 DRC Development Capacity	Beacon Hill State Competitiveness Index	2005 State Policy Report Camelot Index	2005 Morgan Quitno Most Livable State
Alabama	42	33	23	43	47	45	39
Alaska	16	38	36	40	27	23	27
Arizona	37	39	45	45	32	35	36
Arkansas	25	45	12	44	45	44	48
California	2	31	5	20	22	33	35
Colorado	34	21	1	11	5	15	16
Connecticut	38	7	9	7	15	7	14
Delaware	1	6	15	3	18	23	17
Florida	49	37	32	36	29	38	37
Georgia	29	30	26	24	25	42	38
Massachusetts	27	16	6	9	1	13	7
Michigan	36	24	20	21	24	27	28
Minnesota	11	2	13	1	4	3	2
Mississippi	31	48	50	50	50	49	50
Missouri	19	15	39	25	20	26	22

SOURCE: MN2020

GROWTH & JUSTICE

Finally, from our friends at Minnesota 2020, here's a chart from their study on the correlation between tax progressivity and state economic performance.

Basically, it shows that Minnesota, with the 11th highest progressivity ranking among the states, performs exceptionally well on a number of reputable indexes of economic health, competitiveness and business vitality.

We heard the concerns of the business groups who testified here last month, and we appreciate that perception is reality. But the real question to consider is whether the perception influences the behavior of businesses in general. Despite the anecdotes and interviews, a behavior change is so far very difficult to detect from the research.

High Income Tax States Do Well

- **Institute for Taxation & Economic Policy:**
 - States with high income taxes grew personal income faster 1980-98
- **Statistical studies:**
 - Dueling results
 - **But best evidence: progressivity does no harm**

GROWTH & JUSTICE

In fact, the most we can say is that higher taxes, at the rates we've seen in the U.S. over the last thirty years, don't appear to suppress growth — and lower taxes don't turn backwaters into economic powerhouses.

Meanwhile, as Minnesota has lowered its relative overall tax rankings, our relative economic performance has also dropped. So drawing correlations in either direction is very dicey.

Inequity at the Top

Tax Incidence by Income

Over \$129,880	10.8%
\$93,488 - \$129,879	12.4%
\$73,428 - \$93,487	12.4%
\$58,510 - \$73,427	12.3%
\$45,528 - \$58,509	12.4%
\$35,544 - \$45,581	12.6%
\$27,505 - \$35,543	12.0%
\$19,737 - \$27,504	10.9%
\$12,260 - \$19,736	11.4%
\$12,259 & under	19.3%

9.3%

**Top 1% of Earners
(\$457K+)
Have Lowest Tax
Incidence**

Source: MN Department of Revenue,
Tax Incidence Study, 2007

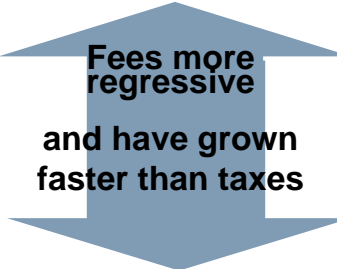
GROWTH & JUSTICE

As I said, there's little evidence that state economic performance is harmed by progressivity — basically, by having a progressive personal income tax.

When we look at tax incidence for Minnesota's households, the inequity between the top earners and the rest of Minnesotans remains. In fact, it's opened a little wider since we noted this gap in 2005, and incomes at the top have been growing faster than in the middle and lower deciles.

The top 1% of earners have the lowest tax incidence of all, and the top decile's rate is more than 1 and a half points lower than for middle income earners.

A Wide Gap

<u>Household Income</u>	<u>State & Local Taxes</u>	<u>Fees Not Included</u>
\$ 45K	12.6%	 <p>Fees more regressive and have grown faster than taxes</p>
\$450K	9.3%	

GROWTH & JUSTICE

The tax incidence report actually understates the impact of the system on Minnesota families because it does not include fees and tuition, which have grown faster than taxes — and which fall disproportionately on middle and lower income households.

Four Considerations

1. **Fairness**
2. **Sufficiency**
3. **Simplicity**
4. **Prosperity building**

Consider the revenue system, not just the tax

GROWTH & JUSTICE

With that background, we revisited four considerations for rethinking business taxes. Three of these four points — fairness, sufficiency of revenue and simplicity — are pretty standard tax policy guidelines.

The fourth — prosperity building — asks “can we make changes that will grow the economy in a way that benefits all Minnesotans?”

This is the goal of this commission in looking at business taxes.

We can probably make improvements in the other three without having any direct, measurable impact on prosperity, so it’s a question worth asking as you look at potential policy changes...

Will this change lead to increased wealth-creating capacity in *society*? Or will it only help widen an income and opportunity gap that is already growing of its own accord?

Fairness

- **Reflects cost of benefits received**
- **Comprehensive — reaches all sectors**
- **Does not pick winners**
- **Transparent: Minimizes tax shifting**

Proportionate with ability to pay

GROWTH & JUSTICE

These points on fairness may be obvious to you all, but they're worth stating because fairness underlies acceptance and support of the tax system. At Growth & Justice, we believe fairness means proportionate with the ability to pay, but we recognize others believe it means proportional with services received.

Ability to pay is more easily measured than benefits received, and income can serve as an imperfect proxy for those benefits. Those espousing the benefits principle like to count streets and sewers, but they discount the value of education and court systems.

“Comprehensive” means every sector of the economy and the population contribute, and the system does not discriminate against certain types of businesses or favor some companies over others within a sector.

“Transparency” is also a dimension of fairness. In fact, business taxes lack transparency, because, as we've noted, taxpayers may not see how they bear the ultimate costs — and as a result, may be acquiescing to level of taxation they might not otherwise approve.

Sufficiency

- **Consistently funds needed services**
- **Reduces volatility in the system**
- **Allows capacity-building investment**

Stability over the long term

GROWTH & JUSTICE

The tax system should also be able to consistently produce sufficient revenue without constant tinkering through business cycles or as needs evolve.

Considering how much revenue the state should raise isn't the commission's focus, but I will argue that sufficiency is important to business — not just to pay for direct services like roads and police and fire, but to invest enough in the two largest investments made by state and local government — education and public health and welfare.

Investing adequately in education that leads to greater post-secondary attainment increases the skills and expands number of people in the workforce. An adequate health and welfare system helps more children be ready to learn — and provides a safety net for employees of low-wage businesses.

Since our future economy depends on educating and preparing for work a greater proportion of students from low-income households, these benefits should not be discounted.

Simplicity

- **Consistent & predictable for business**
- **Easy to understand, comply & administer**

Better compliance and efficiency

GROWTH & JUSTICE

The tax system is complex for business in particular. Simplicity contributes to efficiency, both for government and business.

Establishing simplicity is a constant struggle as initial reforms are inevitably re-complicated — from legislated efforts to reduce tax impacts, motivate or discourage behavior, and respond to changing conditions.

Good luck!

Prosperity Building

- **Sustains public assets, not just “services”**
- **Mitigates costs to employers**
- **Encourages employment**
- **Overall competitive with other states**

Encourages business to come, stay, invest and grow.

GROWTH & JUSTICE

To keep Minnesota competitive, business tax reform must do more than lower taxes. It should enable investment that supports growth and prosperity.

Based on the research, states do better long-term if they invest in public assets beyond the minimal police, streets and utility services called for by the free market types.

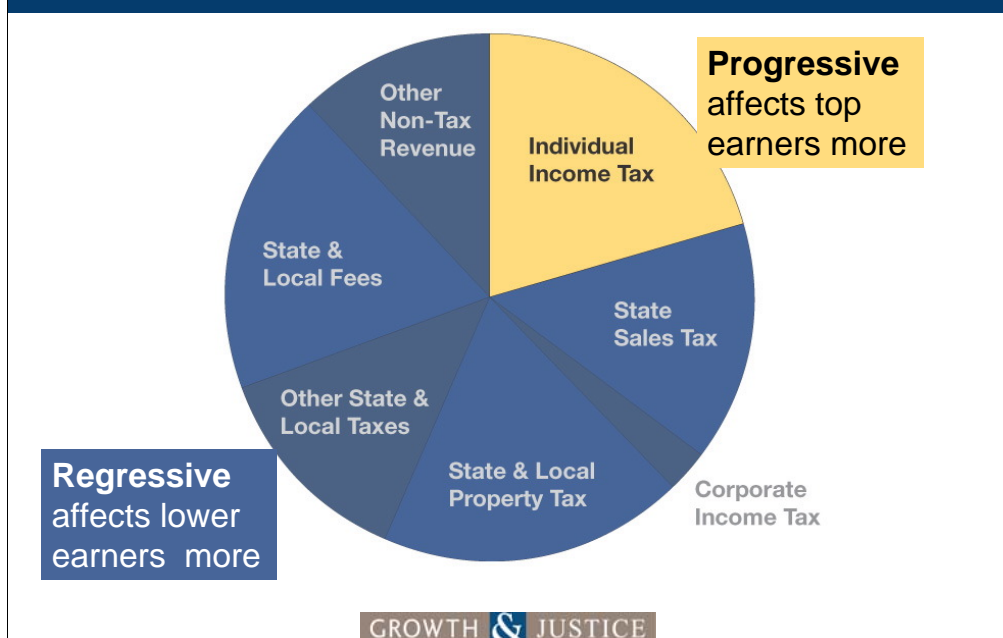
In particular, that’s education, transportation and health care. If government does not make capacity-building investments in its people and places, employers either pay the price themselves or they go where the human capital and infrastructure are better organized to create value.

Considering how much revenue the state should raise isn’t the commission’s focus, but I will argue that sufficiency is important to business — not just to pay for direct services, but to invest wisely in the two largest investments made by state and local government — education and public health and welfare.

Investing in education to increase post-secondary attainment increases the skills and expands number of people in the workforce. An adequate health and welfare system helps more children be ready to learn — and it provides a safety net for employees of low-wage businesses.

Since our future economy depends on educating and preparing for work a greater proportion of students from low-income households, these benefits should not be discounted.

Overall Tax System is Regressive



If we're going to have sufficient revenue, raised fairly, and without burdening business competitiveness, we should not make our tax system more regressive. That means looking to revenue sources that are more progressive.

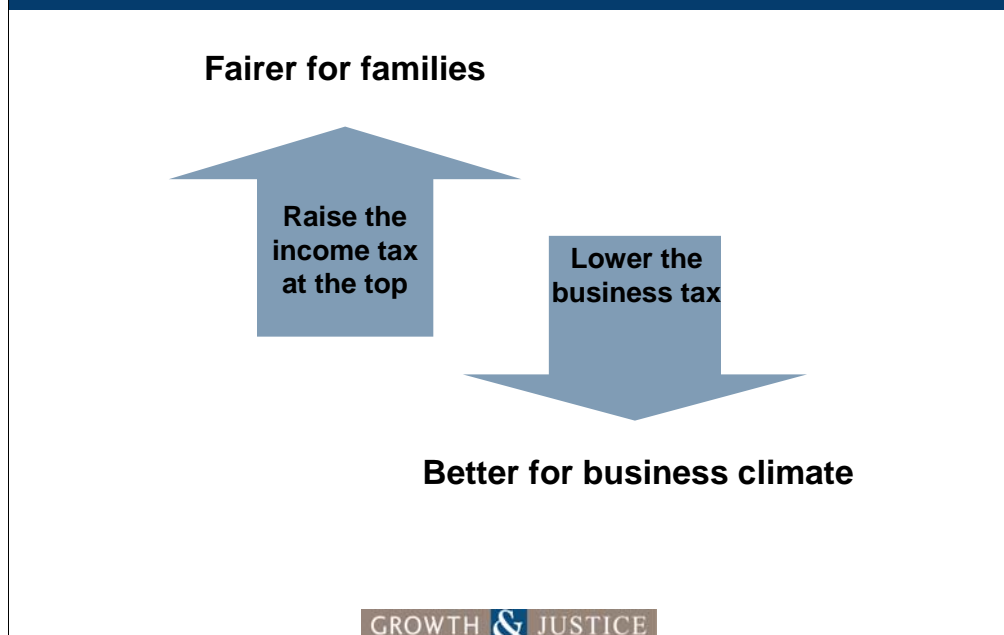
Now, free market advocates will tell you that fairness or tax equity is not synonymous with progressivity or regressivity. They consider a progressive tax as penalizing productivity. In their book, taxes should reflect the level of government services received by the taxpayer.

In a perfect world, that makes perfect sense. But in the real world, it has undesirable side-effects and is virtually impossible to implement. A well-designed tax system will still look something like this — with a variety of revenue sources that are more or less fair for individuals.

It's overall fairness that matters.

For all of us who would like to see greater fairness and proportionality in the tax system, it seems there's one change we might be able to support.

Why Not a Swap?



Why not swap a lower business tax for raising the income tax at the top?

Eliminating business taxes altogether — more radical than anyone is proposing — would leave nearly a \$1 billion hole in the state general fund. So we'd propose a more politically palatable trade — significantly lower some business taxes in exchange for new top marginal income tax rate.

Cut Business Taxes?



- **Lower business taxes broadly**
 - Improve perception of business climate
 - Reduces regressive impact of shifting
- **Cut back on exemptions by industry or ZIP, and “taxation by negotiation”**
 - Level playing field is good tax policy and good selling point
- **Take the opportunity to market Minnesota**
 - Low business taxes, getting lower
 - We let business do business

GROWTH & JUSTICE

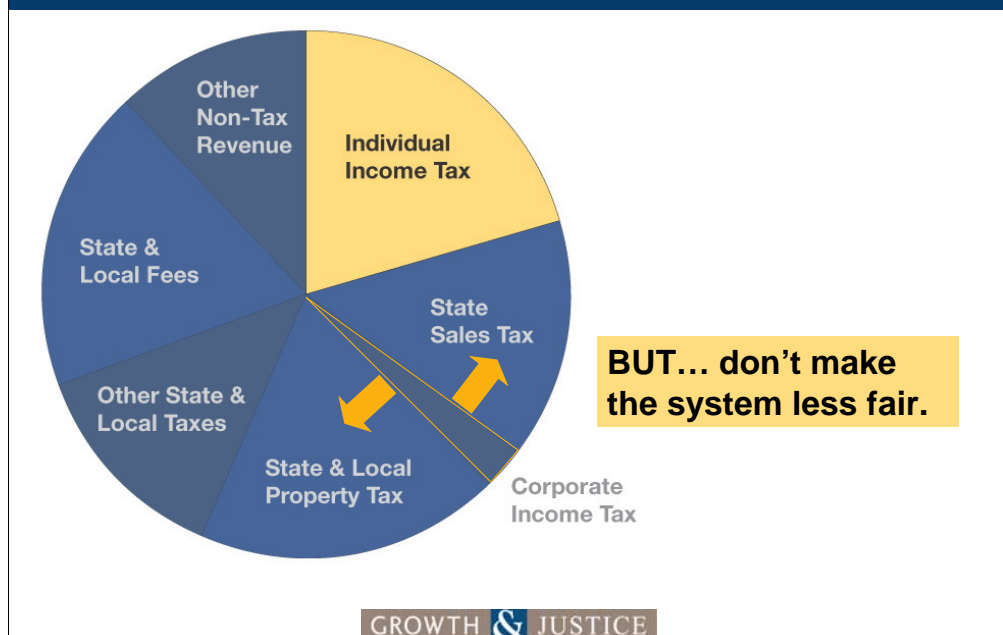
Reducing and simplifying business taxes on business would have a number of positive impacts, including:

- Improving the state and nation perceptions of our business climate and our commitment to maintaining our competitiveness
- and reducing regressivity

This should enable the state to create a more level playing field for all businesses, by cutting back on subsidies and tax exemptions.

And, it sends a good, strong signal — especially if the reforms come with bipartisan support — that Minnesota is serious about remaining a great state for businesses.

Drop the Corporate Income Tax?

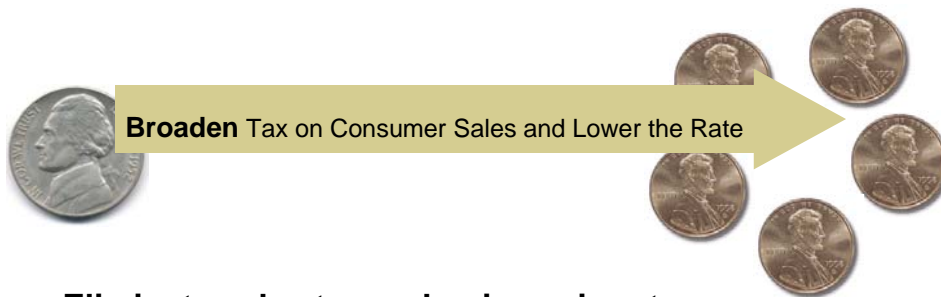


Specifically, eliminating or drastically lowering the state's corporate income tax could make the tax system more fair... unless the burden were to shift to an even more regressive tax — sales taxes or property taxes.

Making this change would send an important signal to corporations by cutting their tax bill by about 10 percent; and it would certainly create some attention.

Imagine Minnesota standing alongside Texas, Wyoming and Nevada as the only four corporate income tax havens in the U.S.!

Broaden Sales Tax?



- **Eliminate sales tax on business inputs**
 - Keep sales tax on consumption
- **Broaden to more goods & services at lower rate**
 - Revenue keeps better pace with overall economic growth

GROWTH & JUSTICE

The sales tax is another potential area for reform.

For example, the sales tax on business inputs ends up getting passed along to consumers. The state could eliminate this sales tax, perhaps reducing complexity and the pyramiding effect of taxes built into product prices.

To keep this change at least revenue-neutral, reduce the overall sales tax rate, and broaden the sales tax to more goods and services, which are the faster-growing part of the economy.

Moving to a broader base may also lessen the negative revenue impacts of internet sales and nexus disputes.

Sales Tax Changes Impact



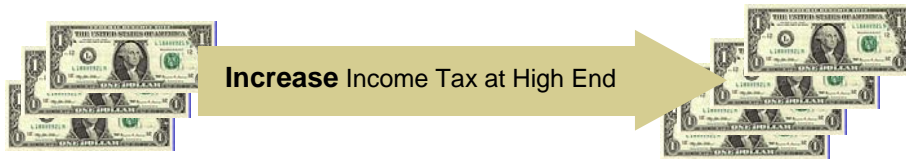
Revenue:
Neutral to positive
(with expansion & swap)

Equity:
Positive for business
Slightly less regressive

GROWTH & JUSTICE

Overall, these changes in corporate and consumer sales taxes could be kept revenue-neutral, or, with an accompanying increase in the personal income tax, could provide more revenue — especially as more revenue is captured from services growth.

Personal Income Tax



- **Focus mainly on top 5% of earners**
 - Keep top rate under 10%
- **Reduce deductions and exclusions**
 - Broadens the base
- **Lower taxes on low earners if possible**

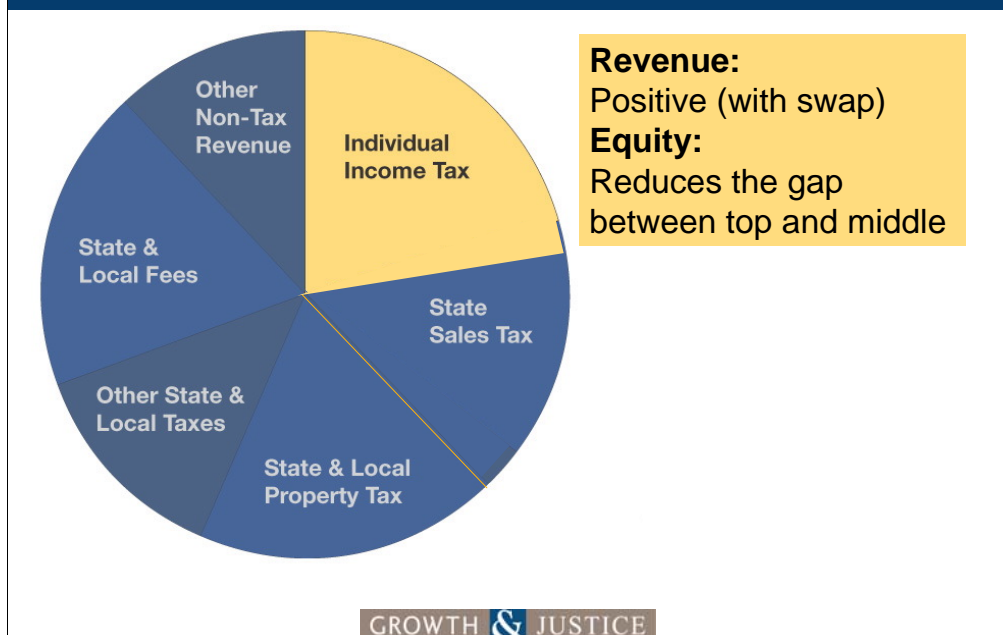
**Contributes more total revenue —
and revenues will grow faster**

GROWTH & JUSTICE

I've saved the most controversial for last — increasing the income tax at the top end, where income growth is fastest. This makes the other changes possible fiscally... and politically.

Earlier, Growth & Justice suggested that about a penny increase per dollar of income on average would restore the price of government to the level it was at during the Carlson years. Most taxpayers would less than a penny or no increase at all. And those at the top would pay more.

Personal Income Tax Impact



This would provide an additional \$1 billion in revenue to state and local governments, and it would close the tax incidence gap between high earners and middle income households.

Impact on Small Businesses

Percent of federal filers with “small business income”

Top two marginal tax rates:	1.9%
In bottom bracket or below:	33.7%
Claim the EITC:	14.5%

Most “small business owners” would pay little or no income tax with a new, higher bracket.

Tax Policy Center estimate, as of August 1, 2008.

GROWTH & JUSTICE

We hear a lot of concern about whether this would represent a tax on small business owners whose business income is taxed at personal income tax rates.

Growth & Justice has been looking into this. Although we don't yet have a definitive answer for Minnesota, we can suggest a couple areas worth researching.

First, the impact is probably being overstated. At the federal level, less than 2% of filers reporting small business income are taxed at the top two marginal rates. Most small businesses are indeed small, and Minnesota data seems to reflect this, with less than 3% of households earning more than \$400,000 reporting some small business income. It's unclear how much of the total income reported actually comes from actively operating a business — nearly 60% of filers earning more than \$100,000 reported salary as well as small business income.

Minnesota Jobs by Company Size

Company size	Jobs (‘000s)
Sole proprietor	361.1
2 - 99	490.6
100 - 499	378.4
500 +	1,152.07
<hr/> Total	<hr/> 2,382.18

Estimates based on U.S. Dept. of Commerce,
Census Bureau data, 2003-04

GROWTH & JUSTICE

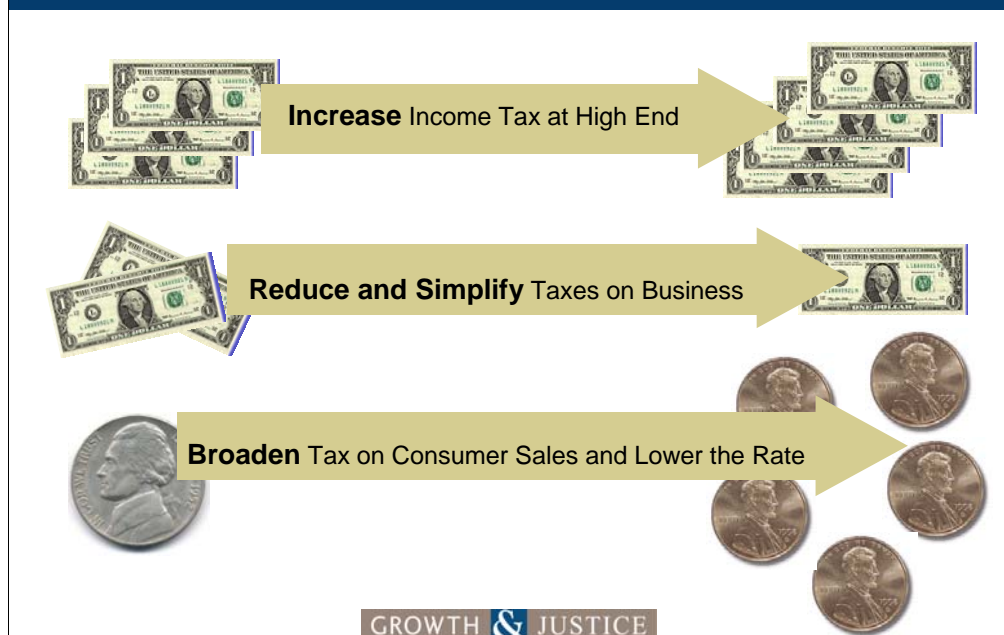
Second, nearly three quarters of small businesses in Minnesota — those employing fewer than 500 people — do not have employees. If the state is interested in tax policy that encourages job creation and economic growth, it should look more deeply at where sustained job growth really occurs — both in terms of company size and form of corporate organization.

Standard ways of reporting aggregated company data don't make this easy to extract.

Is most of the so-called new job creation in Minnesota simply an artifact of new sole proprietorships being created that will never add another employee? Would the state be best served by tax policy that favors companies in the 20-200 employee range, which are more likely profitable and have markets and business structures capable of more growth? What is the quality of new jobs being created in terms of pay, benefits and sustainability?

This is worth finding out before we make too many assumptions about how tax policy will affect the state's economic growth.

A Better Way to Raise Revenue



To summarize, a better way to raise revenue would combine increasing the personal income tax on the high end, reducing and simplifying taxes on business and broadening taxes on consumer sales — including services — while lowering the overall rate.

It has been easy for states facing budget shortfalls to see business tax changes as a way to raise revenue with fewer political consequences. But in a world of global competition, ongoing deregulation, the increased role of knowledge versus tangible assets in value creation, and the mobility of labor and capital, we can't ignore the economic consequences.

We must view business taxes in this larger context.

Back in 2003, we suggested several scenarios for reforming the system that would be revenue-neutral or could be used to generate more revenue that could be used to build the state's productive capacity.

Applying the Strategy: Three Models

Revenue-Neutral		\$1 B More Revenue
<p>Restructuring</p> <p>Higher earners pay more income tax than today and lower earners pay less</p> <p>Dramatic change in structure of business taxes — fewer, broader, lower</p>	<p>Rebalancing</p> <p>Minimizes number who pay more income tax, but no one pays less</p> <p>Less dramatic change in business tax, but no losers</p>	<p>Reinvesting</p> <p>More aggressive in the income tax, with an income surtax option for local government</p> <p>Less dramatic for business</p>

GROWTH & JUSTICE

Here’s a summary of the three models we proposed that would all fulfill a tax strategy that would be better for business and fairer for families.

From a purely business perspective, “Restructuring” was the more dramatic scenario that created a \$375 million reduction in business taxes and “Reinvesting” involved the least change in business taxes.

Going into the details is more than I want to do here, but I have included in the slides some of the background on how Growth & Justice arrived at these models back in 2005.

I think these approaches are still sound. What’s more clear than ever as we look to 2020 and beyond is that improving Minnesota’s business competitiveness and economic growth must be a combination of smart tax policy and smart investment in the people and places that will provide the basis for that growth.

Thank you.