

# Re-**re**thinking Minnesota Taxes

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

September 19, 2008

# 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?**

# 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**

# So Why Can't We Agree?

**Taxes on  
business are  
progressive!**

**A progressive tax  
system hampers  
business growth!**

**Liberal  
view**



**Conservative  
view**

# Exploding Cherished Beliefs

**Businesses shift their taxes, and the burden falls disproportionately on *lower income households*.**

**High income tax states do just as well economically.**



# 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**

# 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**

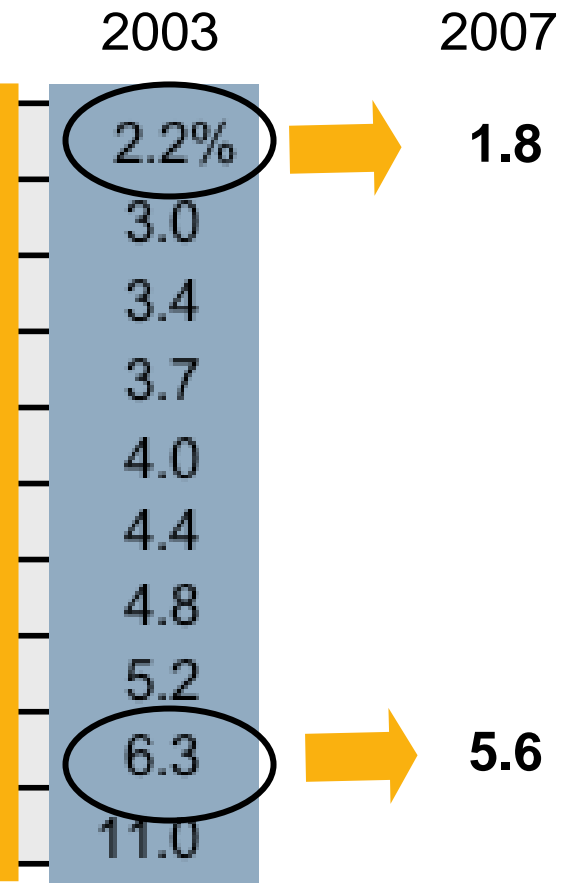
Source: MN Department of Revenue, Tax Incidence Study, 2003

# Who Ends Up Paying Business Taxes?

“Overall, the burden of Minnesota business taxes on Minnesota households was regressive...

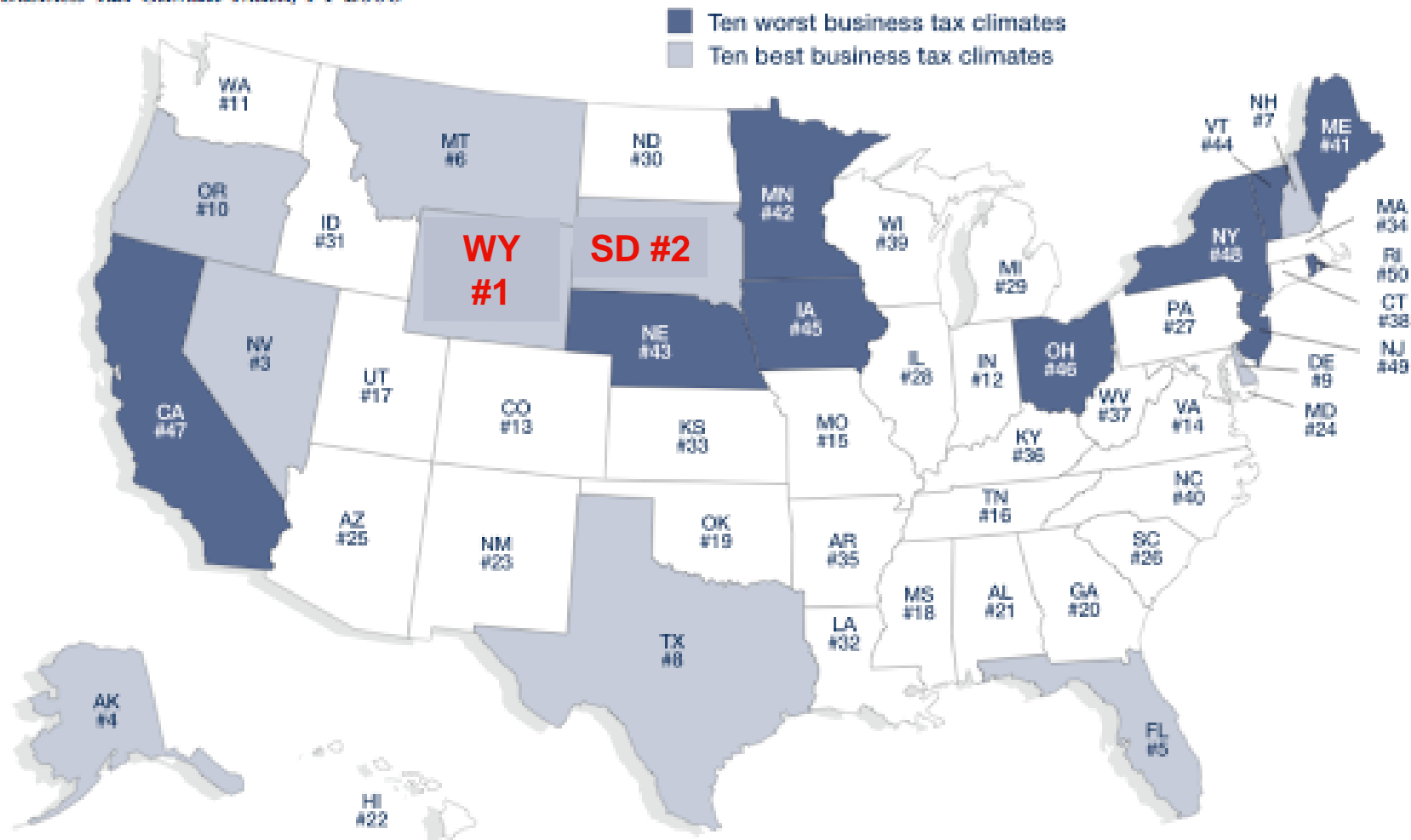
“The effective tax rate was 5.6 percent in the second decile; it fell steadily as income rose, reaching 1.8 percent in the tenth decile.”

– MN Department of Revenue, Tax Incidence Study, 2007



# Best Business Tax Perception

Figure 1  
State Business Tax Climate Index, FY 2008



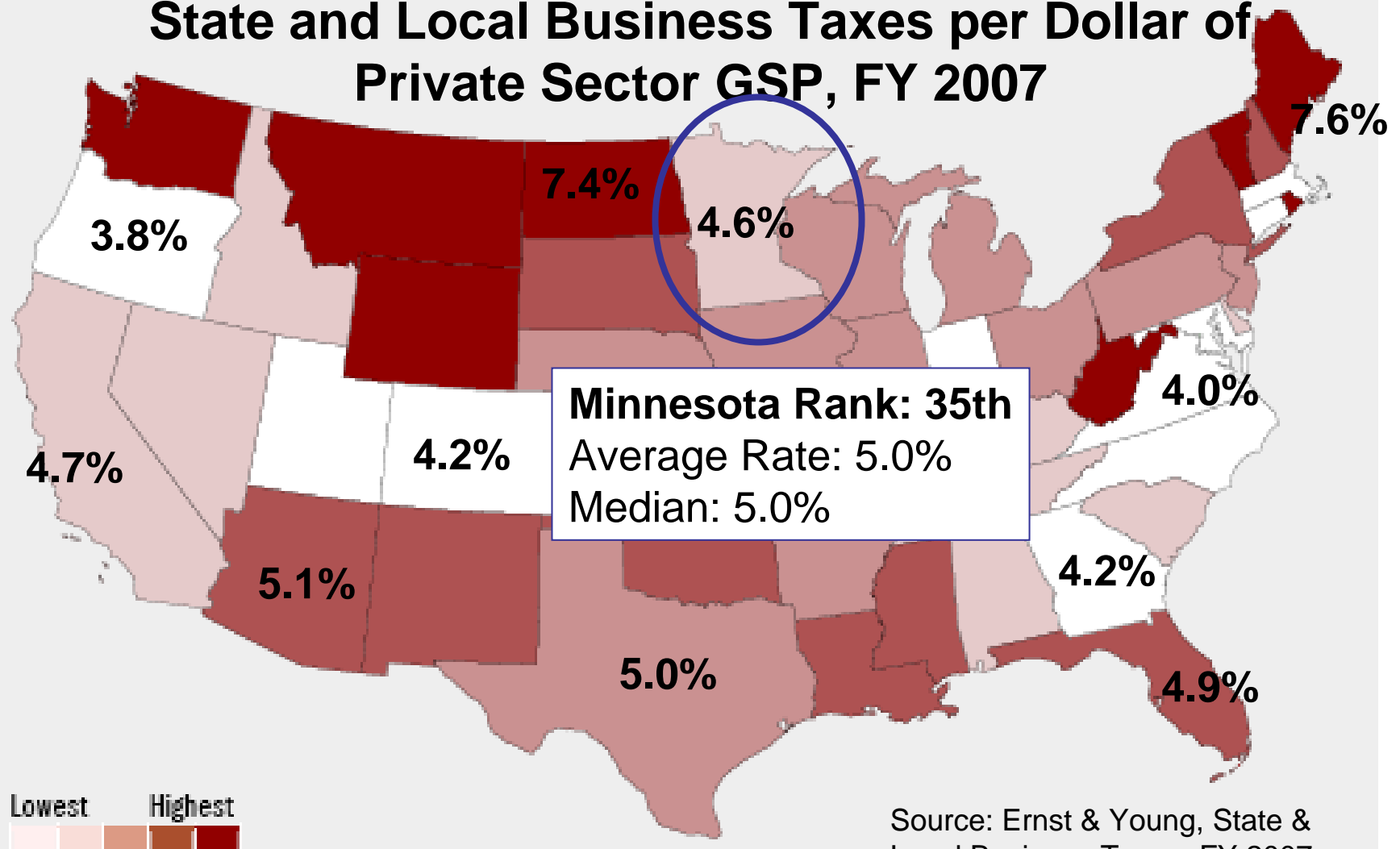
Source: Tax Foundation

# Business Climate is More than Tax



# What's the Business Tax Reality?

## State and Local Business Taxes per Dollar of Private Sector GSP, FY 2007



Source: Ernst & Young, State & Local Business Taxes, FY 2007

# Business Climate Reality

## Correlation between Tax Progressivity and State Performance

1 = best performing state; 50 = worst performing state

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
<b>Minnesota</b>	<b>11</b>	<b>2</b>	<b>13</b>	<b>1</b>	<b>4</b>	<b>3</b>	<b>2</b>
Mississippi	31	48	50	50	50	49	50
Missouri	19	15	39	25	20	26	22

SOURCE: MN2020

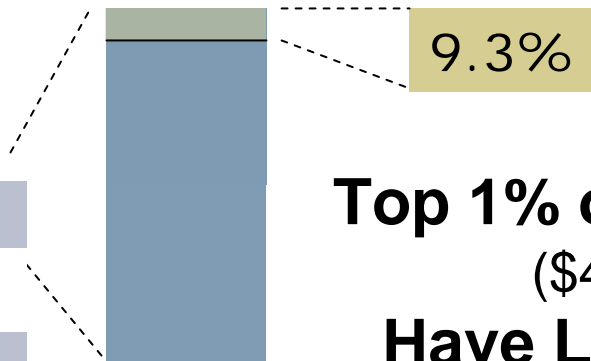
# High Income Tax States Do Well

- **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

# 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%



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

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

# A Wide Gap

**Household  
Income**

**\$ 45K**

**\$450K**

**State & Local  
Taxes**

**12.6%**

**9.3%**

**Fees Not  
Included**

**Fees more  
regressive**

**and have grown  
faster than taxes**

# Four Considerations

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

**Consider the revenue system, not just the tax**

# Fairness

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

**Proportionate with ability to pay**

# Sufficiency

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

**Stability over the long term**

# Simplicity

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

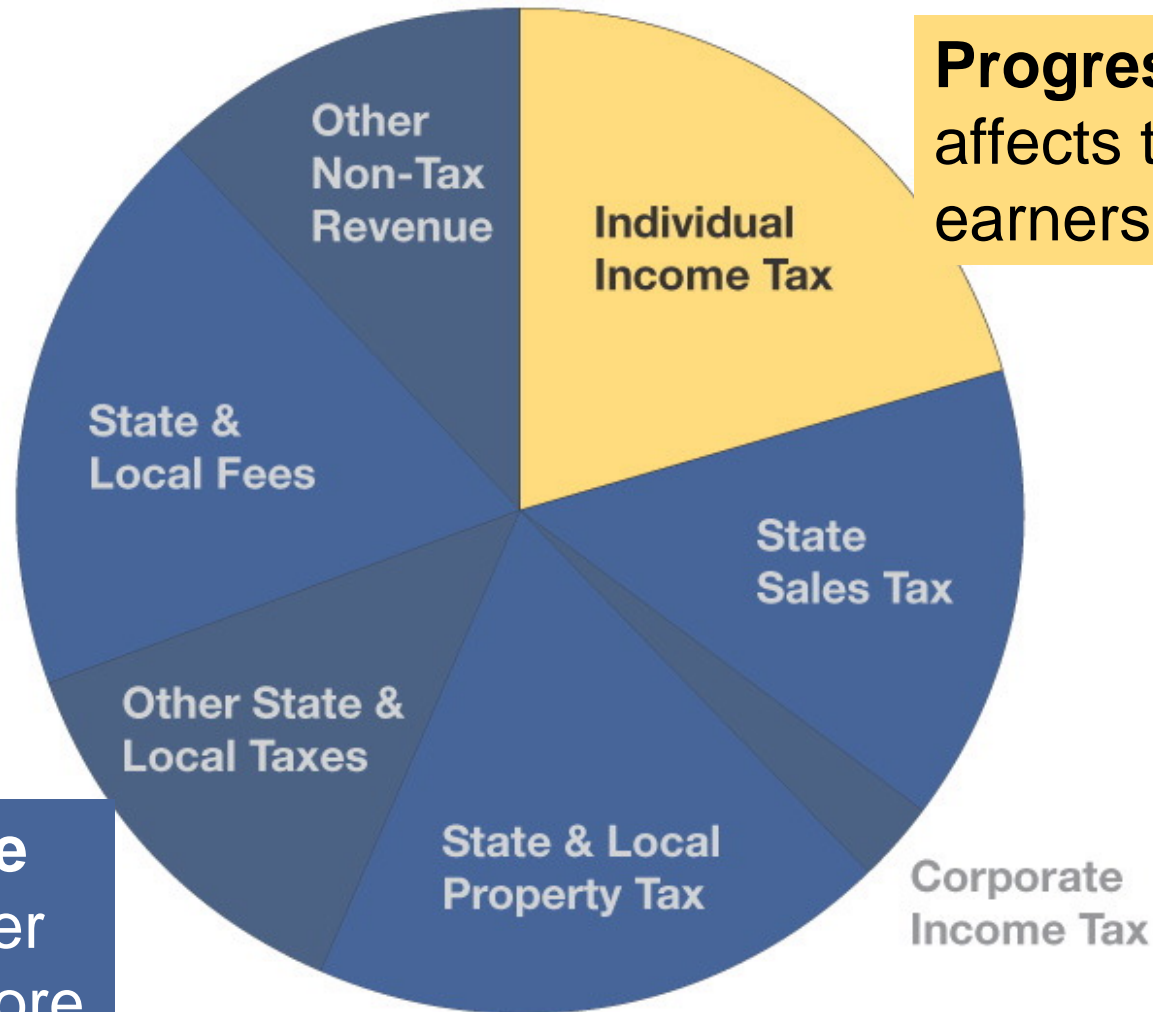
**Better compliance and efficiency**

# 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.**

# Overall Tax System is Regressive

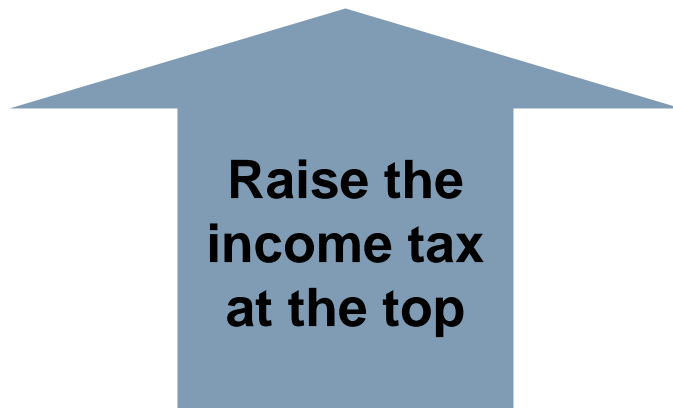


**Regressive**  
affects lower  
earners more

**Progressive**  
affects top  
earners more

# Why Not a Swap?

**Fairer for families**



**Lower the  
business tax**

**Better for business climate**

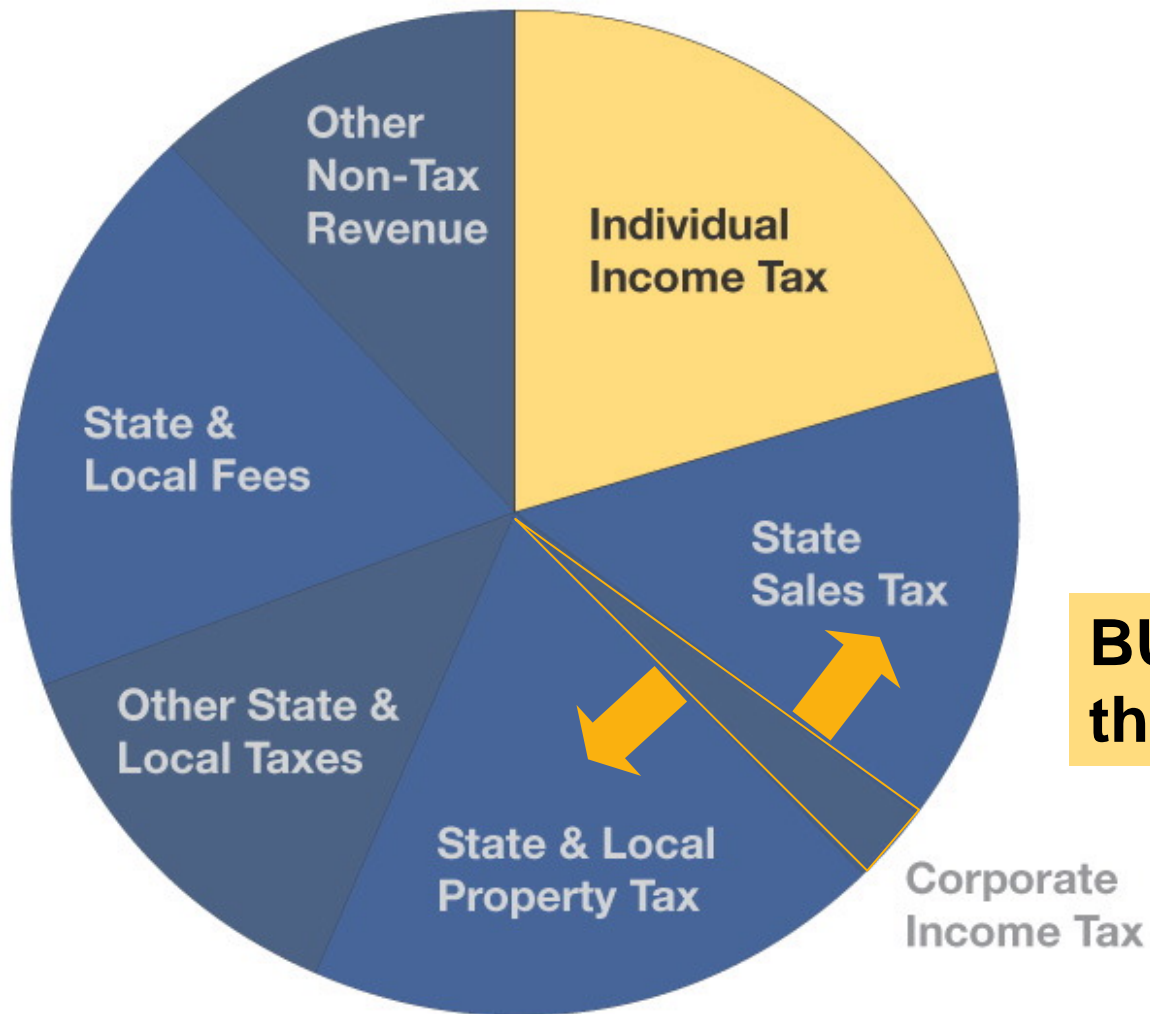
# Cut Business Taxes?



**Reduce and Simplify** Taxes on Business

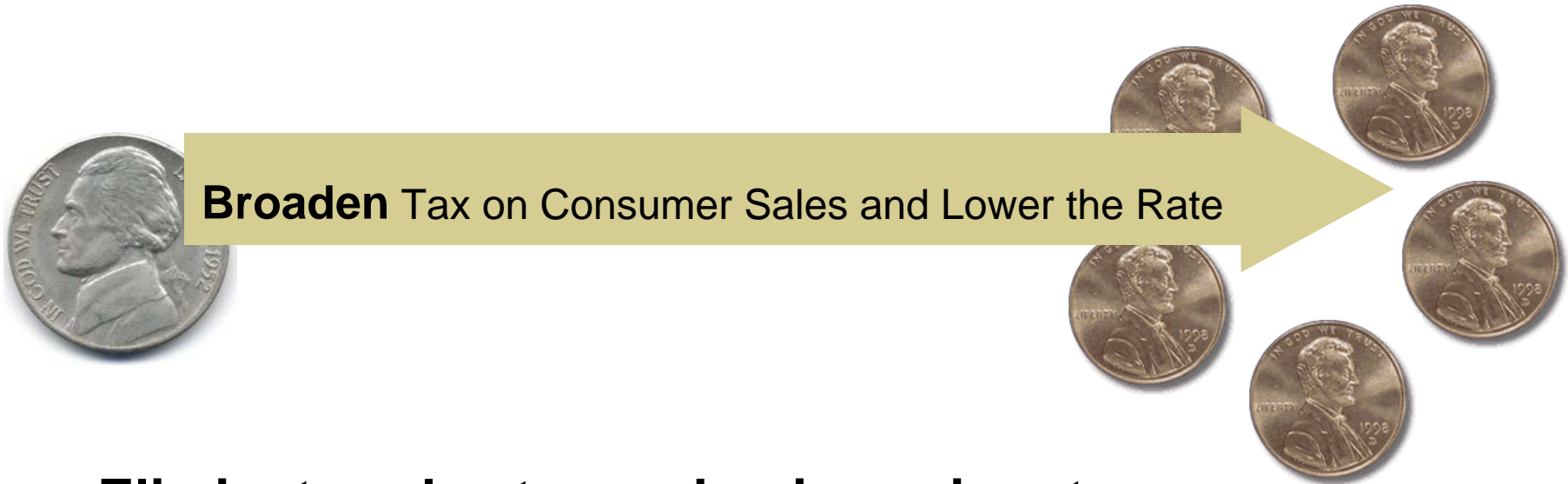
- **Lower business taxes broadly**
  - Improve perception of business climate
  - Reduces regressive impact of shifting
- **Cut back on exemptions by industry or ZIP, and “taxation by negotiation”**
  - Level playing field is good tax policy and good selling point
- **Take the opportunity to market Minnesota**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

# Drop the Corporate Income Tax?



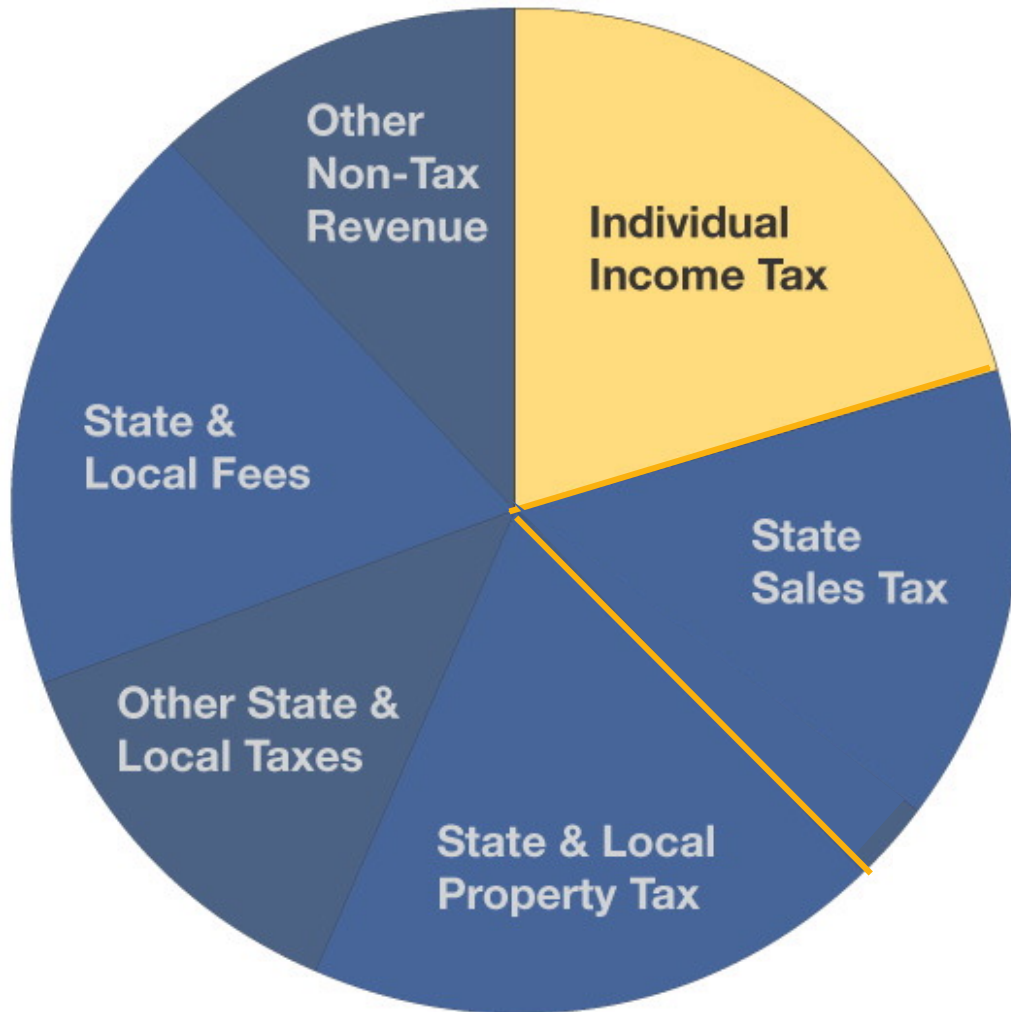
**BUT... don't make the system less fair.**

# 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

# Sales Tax Changes Impact



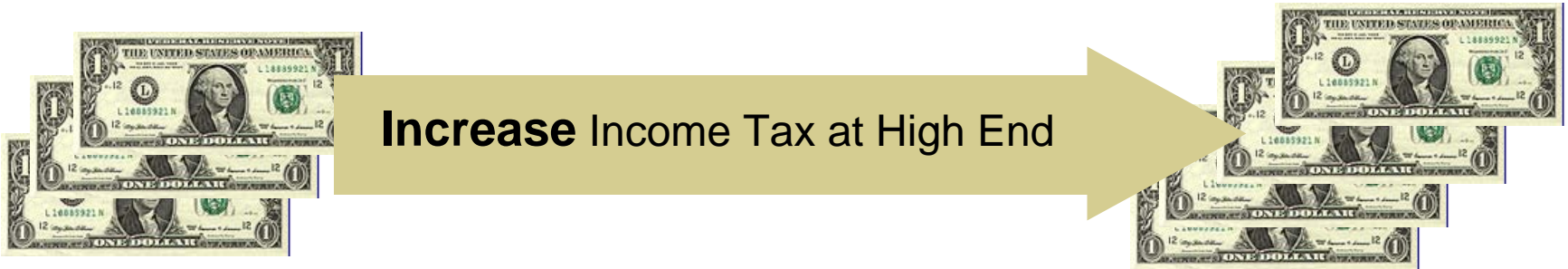
## Revenue:

Neutral to positive  
(with expansion & swap)

## Equity:

Positive for business  
Slightly less regressive

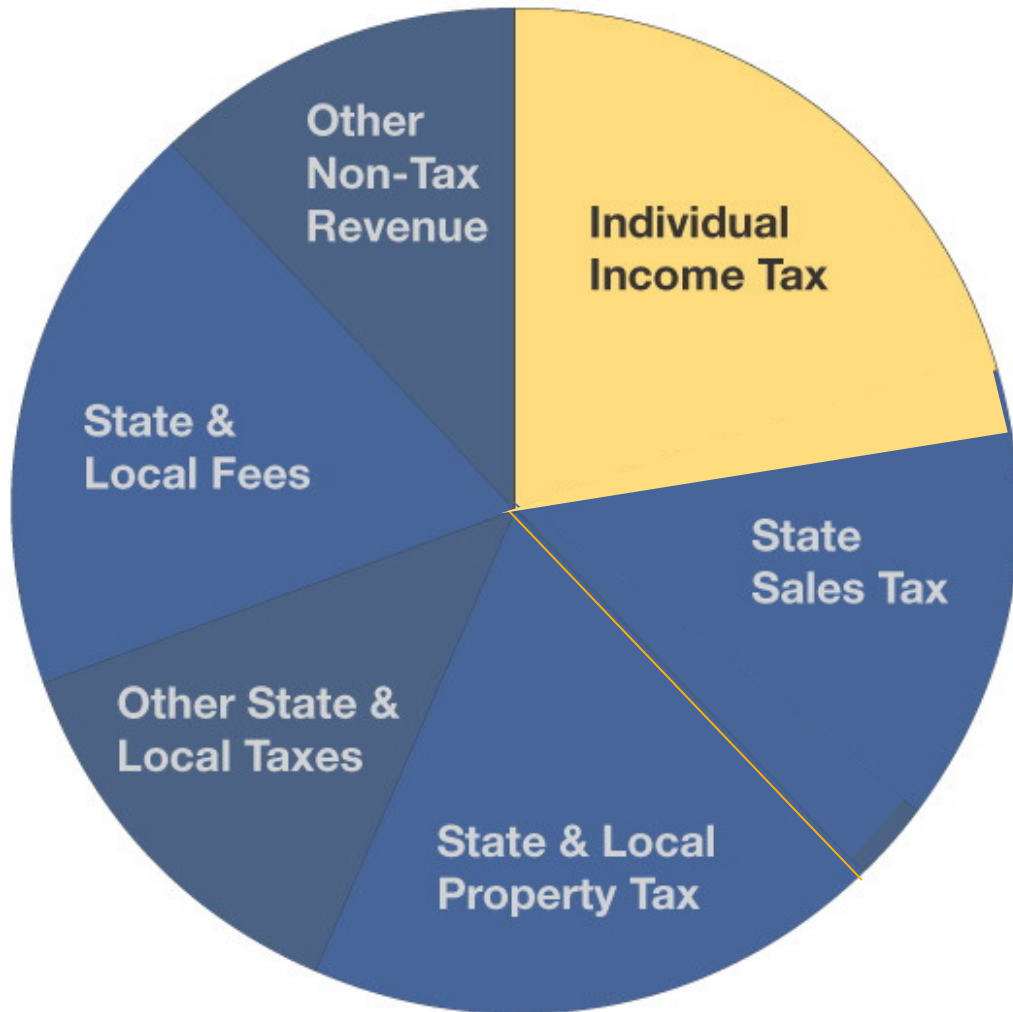
# Personal Income Tax



- **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**

# Personal Income Tax Impact



## Revenue:

Positive (with swap)

## Equity:

Reduces the gap between top and middle

# 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.

# Minnesota Jobs by Company Size

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

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

# A Better Way to Raise Revenue



**Increase** Income Tax at High End



**Reduce and Simplify** Taxes on Business



**Broaden** Tax on Consumer Sales and Lower the Rate



# Applying the Strategy: Three Models

## Revenue-Neutral

## \$1 B More Revenue

### Restructuring

Higher earners pay more income tax than today and lower earners pay less

Dramatic change in structure of business taxes — fewer, broader, lower

### Rebalancing

Minimizes number who pay more income tax, but no one pays less

Less dramatic change in business tax, but no losers

### Reinvesting

More aggressive in the income tax, with an income surtax option for local government

Less dramatic for business