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INSIDE

An economist's take on tax shibboleths

Whether you view Minnesota as a high-tax or low-tax state depends on what you want for your money

by Paul A. Anton

Count the day won when, turning on its axis,
This earth imposes no additional taxes.

—Franklin P. Adams

Everyone seems to make complaints about taxes, some of them humorous and good natured and some not. Taxes are an important fact of economic life, to be sure. But many of the things I hear said about taxes, even the funny things, are discomforting to an economist like me because, so often, they seem to rest on a pretty shallow understanding of our tax system. I worry about how we can make informed, effective policy choices without a good general understanding of this important topic.

> You can use whichever statistic backs up the point you are trying to make, if you want. But if I were to respond to the statement that started this discussion, I would say, "We were a high-tax state. Now we are middle of the pack."

The Citizens League has similar concerns and a good deal more data to back up its opinion. After extensive polling for its Minnesota Anniversary Project (MAP 150), the Citizens League set as one of its four ongoing priorities to "remove the mystery" around how our taxes are raised and used.

I would like to address the first half of that challenge: how our taxes are raised. Rather than a long, dry theoretical discussion about Minnesota's tax structure, I'd like to talk about taxes by discussing some of the common statements one hears. Let's start.

Minnesota is a high-tax state.

This statement actually comes in two versions. The statement above might be referred to as the "red" version. The "blue" version says, "Minnesota is a high-tax, high-service state." Both versions say the same thing about the level of our taxation.

How does Minnesota actually stack up against other states? A recent *Star Tribune* story quoted some figures compiled by the Minnesota Center for Public Finance Research (MCPFR), part of the Minnesota Taxpayers Association (not to be confused with the Minnesota Taxpayers League.) The MCPFR is a nonprofit educational organization whose mission is "to provide objective research and analysis on state and local tax and spending issues in support of effective, efficient, and accountable government."

The figures, based on the Center's analysis of all state and local tax data across the country for the fiscal year 2005, showed Minnesota ranked 12th in total taxes collected per capita and 23rd in total taxes as a percent of personal income in the state. (The rankings differ because Minnesota is a relatively high-income state.) Both of these ranking are lower than in 2004 when we ranked 10th and 16th on these two measures, respectively. And both are lower than in 2000 when we ranked sixth and 12th.

"But wait," you say, "I heard we have the fourth highest state individual income tax." Yes, that's true, too. The MCPFR rankings combine all the different state and local taxes into one measure. And that's the correct way to compare states because different states raise revenues using different combinations of taxes.

continued on page 4

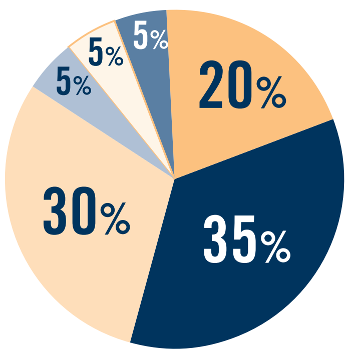
CONNECTIONS

Building a League of Citizens

Brett Campbell, Gayle Smaller, Shanaye Mitchell, and Annie Wood are four of our student commentators on the Citizens League's Students Speak Out website (www.StudentsSpeakOut.org). Visit the website to talk with them and other students, ask questions, and share ideas about education in Minneapolis.

May poll results

What motivated you most in high school?



Respondents: 20

- My parents and family.
- My school: good teachers, interesting classes, high expectations, etc.
- My goals: go to college, get a good job, etc.
- My friends: support, peer pressure, etc.
- My other activities: theater, sports, volunteering, etc.
- Something else.

Several of you told us about the teachers who mattered to you. Here are two examples:

"A great teacher who got me hooked on reading the work of great philosophers—Plato, Aristotle, Rousseau, etc. At first, I couldn't understand what I was reading, but did it because she thought that I was special and suggested it. I realize now that I've felt connected to the thoughts of sages across the centuries for 60 years!"

"Three teachers in particular—two demanding and one more lenient—all saw something special in me and encouraged me in different ways to develop it. I'm still grateful 40 years later. Academic competence is important, but adults who treat children as individuals with individual worth are the key to our school system."

New members, recruiters, and volunteers

New and rejoining members

Janet Cardle
Michael Chiodi
Karen Cole
Andrew Haug
Matthew Hunt
Janna King
Gretchen Musicant
Susan Nemitz
Joseph Plummer
Steve Ragaller
Tim Schuster
Dawn Sillars
Artika Tyner
Lauren and David Wrightsman

Firms and organizations

Best Buy Co. Inc.
Builders Association of the Twin Cities
City of South Saint Paul
COMCAST
CommonBond Communities
Community Action Partnership of Ramsey & Washington Counties
Continuing Professional Education
Designs for Learning
Faegre & Benson
Family Housing Fund
General Mills Foundation
GovDelivery, Inc.
League of Minnesota Cities
Lindquist & Vennum
Lutheran Social Service of Minnesota
Marquette Financial Companies
McKnight Foundation
Metropolitan State University
The Minneapolis Foundation
Minneapolis Public Housing Authority
Minnesota State Colleges and Universities
Otto Bremer Foundation
Robins, Kaplan, Miller & Ciresi
Saint Paul Riverfront Corporation
Taxpayers League Foundation
U.S. Bancorp Foundation
University of Minnesota
The Whitney Foundation
Wilder Foundation

Recruiters

Peter Eigenfeld
Kate Lundeen
Tim Penny

Volunteers

Janna Caywood
Dave Hutcheson

community connections calendar • point • click • engage

www.pointclickengage.org

Help us improve the Community Connections Calendar

Check out upcoming events from the Minnesota Council of Nonprofits, Africa Today, and other local organizations on the Community Connections Calendar—then go to www.citizensleague.org to take a short survey to help us improve the calendar.

VIEWPOINT

Voices In My Head

Re-thinking the role of experts and citizens in public policy

How will our democracy survive the information overload of this Information Age?

by Sean Kershaw

American democracy was conceived in the Age of Enlightenment and born at the dawn of the Industrial Age. A question before us now is how this democracy—the way in which we solve public policy problems—can thrive in the Information Age.

We live in a 24/7/networked/mass-customized/Googled-and-YouTubed world, where the pace and volume of information increases exponentially. This is old news. But the cacophony created by this changing environment robs us of the chance to reflect on *how* things are changing—or in the case of public policy outcomes, how they are *not* changing.

This column began as an argument about the need to provide citizens with better information to build their capacity to become better decision-makers on important policy choices. While providing information is certainly an essential function for policy leaders (and an essential role for the Citizens League), the lack of useful, objective, and easy to discern information may be a symptom of a larger problem.

In the chaos of this new era, we've lost the ability to distinguish between information and knowledge, and set up an elaborate structure of public policy that rewards "experts" but effectively excludes the *expertise* that all citizens have in helping to solve policy issues. As a consequence, we've gotten good at studying public policy problems, but we've lost the ability to develop and implement effective solutions.

Knowledge vs. information

Webster's defines knowledge as "the fact or condition of knowing something *with familiarity gained through experience or association*." Information is "the *communication* or *reception* of knowledge or intelligence," and does not depend on who created it, their role, or for what purpose it was created (emphasis added).

Knowledge has meaning in context. Each of us creates knowledge all the time, in the places and institutions where we spend time. We also have the ability to do something with this knowledge—but our role often depends on our power and position within the world.

We've inadvertently created a new and unhelpful civic caste system of experts and citizens.

For example, it became clear to me through the work of the Minnesota Mental Health Action Group, convened by the Citizens League, that people with mental illness often have the best knowledge about what treatments work best for them. And these people have both the capacity and a role to play in their own treatment and wellness. But it also became clear to me that the reams of information and white papers on mental health policy reform did not sufficiently connect this knowledge and capacity with treatments and outcomes.

This approach to policy-making tends to become dominated by experts and doesn't create the solutions we need.

The role of experts in public policy

As a means of managing and valuing our current flood of information, we've professionalized it. We've increased the role of experts, and made everyone else more passive in the process. On almost every important public policy issue, we've inadvertently created a new and unhelpful civic caste system of experts and citizens, using experts to manage the conversation and the action, and downgrading the role of citizens—everyone else—to passive participants in this charade.

The evolution of this distinction is understandable, but it is corrosive to democracy and it keeps us from solving the policy issues that confront us. It excludes both the knowledge and expertise that all citizens have about what works for them, and eliminates their role in making policy solutions work.

In the case of mental health reform, the dozens of white paper recommendations (including our own) provided too much information from experts and outsiders, and not enough practical involvement from a diverse group of stakeholders. Too few recommendations were ever put into practice. The Minnesota Mental Health Action group deliberately changed this dynamic, bringing together all of the parties involved in mental health and using their knowledge and expertise to develop implementable and effective solutions.

And it worked. Despite a legislative session that was frustrating on almost every front, the Legislature and governor took real leadership on mental health, supporting the recommendations of our action group, reforming the system significantly, and providing more than $30 million in desperately needed new funding.

In the Information Age, a system of public policy that is based on active-experts informing passive-citizens about what works *doesn't work*. Public policy solutions (the information that groups like the Citizens League produce), must be based on the knowledge and expertise that is created by all citizens in the places where they spend time, and citizens must have an active role in implementing these solutions.

Knowledge and democracy

In order to move from information to knowledge and from experts to expertise, we'll need to develop new generations of active civic leaders. Building on the knowledge and expertise of citizens requires that these citizens have the civic identity, principles, and skills necessary to govern for the common good.

We have an opportunity to create a new Civic Age that combines Information Age technology tools and the real interest that Minnesotans have in solving problems to create the new leadership and institutions that our democracy demands. ●

Sean Kershaw is the Executive Director of the Citizens League. He can be reached at skershaw@citizensleague.org. You can comment on this Viewpoint at: www.citizensleague.org/blogs/sean.

An economist's take

continued from page 1

In 2005, Minnesota ranked fourth in individual income tax, 28th in general state sales tax, and 35th in local property taxes. (I will resist the temptation to tell you where we ranked in local sales taxes, corporate income taxes, excise taxes, motor vehicle taxes and health impact fees. Oops, those aren't taxes.)

So what's the bottom line? You can use whichever statistic backs up the point you are trying to make, if you want. But if I were to respond to the statement that started this discussion, I would say, "We were a high-tax state. Now we are middle of the pack."

One more complication to throw out before we move on—the states are relatively tightly bunched together with respect to the percentage of income they tax through all state and local sources. So in 2005, Minnesota ranked 23rd by taxing a total of 11.4 percent of personal income. If we had lowered the overall tax rate by one percent, to 10.4 percent, we would have fallen to 43rd in the rankings. So it doesn't take much of a change to move down (or up) in those state rankings.

In Minnesota, we are not undertaxed.

I hear this statement a lot, especially during election years. It seems to draw an instant crowd response as though it is self-evident. And, in a sense, I suppose it is. All of us would like to pay less rather than more for the same item. So if you just consider the question, "Would I like taxes to be higher or lower?" the answer is obvious—lower.

But from an economist's point of view, I would have to say that the statement and the question are both meaningless because neither discusses what you get for the taxes you pay. And, to me, a concept like being "undertaxed" or "overtaxed" only really make sense when you consider what public services you are purchasing with those tax dollars.

By analogy, say I find a guy who will sell me a new Mercedes SLK 280 Roadster for $30,000 when the list price is $44,000. Though I paid a lot, I certainly wouldn't feel as though I had overpaid. On the other hand, if I spent $10,000 on a used car (let's leave out the make and model) and it fell apart on the way home, I certainly wouldn't feel as though I had underpaid even though

continued on page 6

Is Minnesota a high-tax state?

by Bob DeBoer

During interviews for the Citizens League's Minnesota Anniversary Project (MAP 150) one of the things we heard was that Minnesotans want to demystify how our taxes are raised and spent. One of the research products that helps frame this "mystery" is the annual review of state tax and expenditure data by the Minnesota Taxpayers Association (MTA), "How Does Minnesota Compare?" The MTA just released the 2005 data in June and the results beg the question, is Minnesota a high-tax state?

The Minnesota Taxpayers Association offers us the data in two different ways, per capita and per $1,000 of income. On a per capita basis, Minnesota ranked 12th in 2005 (dropping from 10th in 2004). By this straightforward measure, Minnesota is still in the top 25 percent in taxes when compared with other states. The other measure provided by the MTA compares states by the amount of state and local taxes per $1,000 of personal income. By taking into account personal income, this measure more accurately ranks a state relative to its ability to pay taxes (i.e. how burdensome is the tax "burden").

Minnesotans pay $114 in state and local taxes per $1,000 of income, a statistic which dropped us to the middle of the pack in 2005 (from 16th to 23rd). In fact, we almost hit the national average exactly at 100.6 percent (see Table 1).

Table 1: Minnesota state and local tax collections (2005)

	Per $1,000 of income rank	Taxes per $1,000 of income	Percent of national average
Individual income tax (state and local)	7	$34	115.5
Property tax (state and local)	35	$28	82.4
Sales tax (state and local)	37	$23	83.6
Excise tax (state)	16	$13	129.8
Corporate income tax (state)	8	$5	113.6
Total rank	**23**	**$114**	**100.6**

In general, Minnesota depends more on income taxes (7th) and excise taxes (16th), and less on sales (37th) and property taxes (35th) than other states. These are policy choices that have been developed over several decades, but should not preclude Minnesotans from considering shifts in sources of revenue. (See Figure 1)

If we agree that it is good to be a state that is relatively high in personal income (Minnesota ranked 11th in 2005), then a good comparison beyond the national numbers might be to look at other states with high personal income. Table 2 includes all the states that are above average for personal income in the U.S. (the top 20). Although Florida and Wisconsin had personal income just below the national average in 2005, they have been added to round out the top 20, since two of the states (Alaska and Wyoming) are considered special states in terms of data analysis (see footnote on Table 2).

The framework provided by the MTA can help us to start looking at what choices have been made by other states. But what works for other states may not work for Minnesota. Before concluding that we ought to be more like Colorado or more like Maryland, for example, a much more detailed analysis of those states economies and sources of revenue would be needed. If Minnesotans want a different tax system (higher taxes, lower taxes, or a different mix of taxes) other states can only help us so much.

The question: Is Minnesota a high-tax state?

The answer: Currently (as of 2005), Minnesota is still significantly above the national average in total taxes on a per capita basis (by about $400), but is just as significantly below the highest six states in the nation (about $400 or more), making us a medium-high tax state on a per capita basis. Based on our ability to pay as a state (per $1,000 of personal income), Minnesota is clearly a medium-tax state, relatively high in income and excise taxes and relatively low in sales and property taxes.

For more analysis (including expenditure data) and to link to the Minnesota Taxpayers Association report "How Does Minnesota Compare," visit the Citizens League website at www.citizensleague.org.

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Figure 1: Sources of revenue

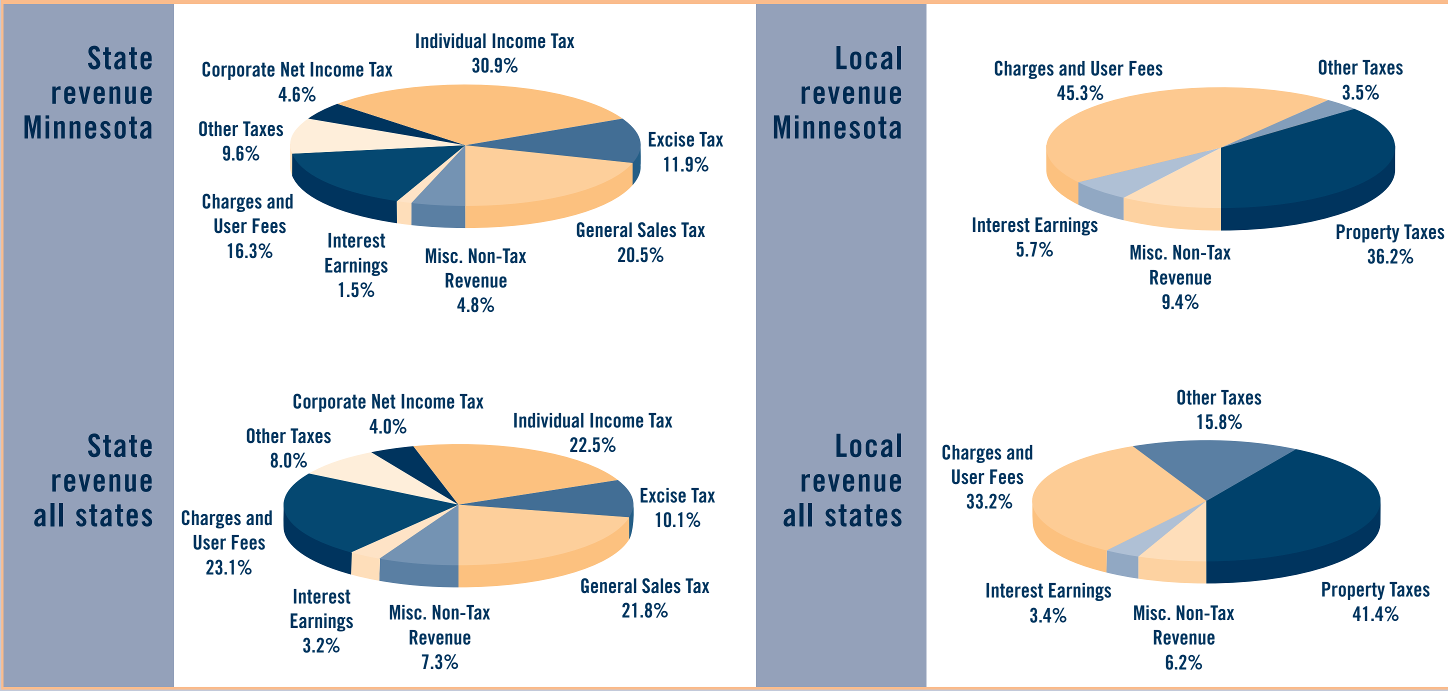

Table 2: Tax comparison of states with the highest personal income

State	2005 Personal income	2005 Personal income rank	Taxes per $1,000 income	Per $1,000 total tax rank	Per $1,000 income tax rank	Per $1,000 property tax rank	Per$1,000 sales tax rank	Per $1,000 excise tax rank	Per $1,000 corporate tax rank
Wyoming*	$37,305	10	$151	1	---	5	9	46	---
New York	$39,967	6	$150	2	1	7	22	45	24
Washington D.C.	$52,811	1	$147	3	4	16	20	---	---
Hawaii	$34,489	20	$134	4	10	46	1	7	35
Alaska*	$35,564	16	$133	6	---	14	47	37	1
Rhode Island	$35,324	18	$123	8	22	6	38	10	34
Wisconsin	$33,278	22	$121	10	13	9	32	30	14
Connecticut	$47,388	2	$119	12	13	8	39	21	27
New Jersey	$43,831	3	$117	16	34	4	42	29	6
California	$36,936	13	$116	17	8	39	15	50	5
Nevada	$35,744	15	$114	20	---	34	8	3	---
Minnesota	**$37,290**	**11**	**$114**	**23**	**7**	**35**	**37**	**16**	**8**
Pennsylvania	$34,937	19	$111	25	19	25	40	17	18
Delaware	$37,088	12	$111	26	14	50	---	14	4
Illinois	$36,264	14	$111	27	39	11	41	12	11
Maryland	$41,972	5	$108	33	3	41	46	27	26
Massachusetts	$43,501	4	$107	35	6	17	45	44	10
Washington	$35,479	17	$107	36	---	30	2	24	---
Florida	$34,001	21	$106	39	---	21	11	25	32
Virginia	$37,503	9	$104	42	15	27	44	38	40
Colorado	$37,510	8	$95	47	33	33	26	47	44
New Hampshire	$37,768	7	$91	50	43	1	---	8	3
U.S. Average	$34,471		$113						

* = Three states in particular—Alaska, Montana and Wyoming— have unusually high tax and/or spending numbers which affect their rankings but do not accurately reflect the tax load on their residents. Alaska—because of its oil reserves fund—annually makes payments to its residents of about $1,000 per person. Wyoming and Montana tax their coal industries very heavily, thus shielding the average taxpayer from the cost of higher than average spending. All Alaska data and primarily spending data for Wyoming and Montana should be considered with this in mind.

All data provided by the Minnesota Taxpayers Association

An economist's take

continued from page 4

I paid less than in the Mercedes example.

So I would say we are undertaxed if we are not getting the quality of schools, roads, healthcare, and public services that we want in this state. And we are overtaxed if we are getting public services that are better than what we want and are willing to pay for.

So, are we really undertaxed? I don't know. That's up to each individual to decide. But I do think that in order to answer that question you need to compare what we spend as a society to what we get. As in my car example, if you want to spend less for public services, you need to be prepared to see the quality decline.

> So are we really undertaxed? I don't know. That's up to each individual to decide. But I do think that in order to answer that question you need to compare what we spend as a society to what we get.

The fairest tax is a flat tax.

Soak the rich, that's always what they try to do.

Let's take these two statements together, since the response to both is so similar. An economist's answer to both is that the fairest tax is a progressive tax, one that taxes the rich more than proportionately. (Not be confused with the political term, "Progressive," which most people take to mean someone who would have been called "Liberal" before that became a pejorative term.)

By a progressive tax, economists mean one which taxes a higher proportion of higher incomes. This is viewed as fairer than a flat-rate tax because it comes closer to producing equality of sacrifice than taxing everyone at a fixed percentage rate. I don't know what Bill Gates or Warren Buffett made last year but let's just say they each made a billion dollars. If they paid a 10 percent tax rate, $100 million, it might affect their lifestyles marginally. On the other hand, take $2,000 in taxes from a family making $20,000 a year and their lives would be dramatically affected. That's the concept.

So how does Minnesota do with regard to tax fairness? Well better than most states but still our overall tax system is not even as fair as a flat tax. True, Minnesota's individual income tax is a mildly progressive tax, but, as in our earlier discussion about state rankings, we need to look at all taxes to get a clear sense of how the tax burden is distributed.

Minnesota actually produces a study every two years to calculate how much in taxes people at different income levels pay. Minnesota is the only state that I am aware of that does such a tax incidence study on a regular basis. In the latest study, released in March, researchers divided all Minnesotans into 10 equal groups from lowest to highest income. Then they calculated the amount of each different type of tax that would be paid by members of each income group, including the share of business taxes that get passed on in the prices of the goods. Finally, they added up the tax bills and calculated the effective overall tax rate for each group.

The figures showed that the highest income households pay a smaller percentage of their incomes in taxes than middle-income families. Households in the fifth decile, those with annual incomes of between $30,000 and $38,000, paid an estimated 11.9 percent of their income in taxes in 2004. Households in the top tenth of the income distribution, those with annual incomes of more than $105,000, paid an estimated 10.9 percent. And households in the top one percent, those with annual incomes over $354,000, paid 9.6 percent of their income in state and local taxes.

While that may not sound terribly fair, Minnesota's overall tax system is more progressive than most. Since we rely more heavily on the personal income tax than most states do, I feel pretty sure of that. Unfortunately, there are no detailed rankings of the progressivity of state tax systems. But to test my belief, I called Robert McIntyre, research director at the Institute for Taxation and Economic Policy (ITEP) in Washington, D.C. and lead author of a study that calculated tax incidence for all 50 states. The ITEP study did not include a formal state-by-state ranking but it did identify two groups, the four most progressive states and the 10 least progressive. Minnesota was not in either group. But after McIntyre scanned his data base, he opined that we were probably in the "top third but not the top quarter" of the state systems.

So is the Minnesota tax system fair? It is fairer than most state tax systems. That's the highest praise I can give it at this time.

In summary, for any tax system there are two basic questions:

How much money (in total) do we want to raise?

Who is going to pay how much?

On the first question, Minnesota chooses to collect more per capita than most other states but the percentage of our income collected in taxes is pretty much middle of the pack these days.

On the second question, Minnesota does a better job of distributing the tax burden across different income levels than most states, but the wealthiest Minnesotans still pay a smaller share of their income in taxes than the middle class.

And what are some quotes on taxes that I like? Here are two of my two favorites:

I like to pay taxes. With them I buy civilization.

—Oliver Wendell Holmes, Jr.

I'm proud to pay taxes in the United States; the only thing is, I could be just as proud for half the money.

—Arthur Godfrey

Paul Anton is Chief Economist for Wilder Research, part of the Wilder Foundation in St. Paul. He has served as a member of the Council of Economic Advisors for the state of Minnesota since the Council's founding in 1985.

Put the cost of increased transportation funding where it belongs—on users

Extending the state sales tax to gasoline would induce us to use both gasoline and road capacity more judiciously

by Steve Elkins

Every month you receive a water bill from your city based upon the amount of water you use. While your city could eliminate your water bill and just add the cost of providing water to your property tax statement, you probably accept that it's fairer to bill people based on how much they use. More importantly, under the "user pays" method we're all more judicious in our water use because we can save money by using less. Because we use water more wisely, it costs our city less money to provide it and our overall tax burden is lower.

So it would probably strike you as odd if you received a notice from your city announcing:

> "Because of an increase in the cost of materials used to treat water, the city will be increasing the sales tax on toothpaste and implementing a new sales tax on pants."

Yet this is just how some people are proposing that we finance our need for an increase in transportation funding.

I disagree. Like your municipal water works, our transportation system is a taxpayer-financed public utility that can and should be paid for by the people who benefit from it. If you're a typical Twin Cities taxpayer, you probably already think that the costs of building and maintaining the region's roads are defrayed mostly or entirely by the gas tax you pay at the pump. You would be wrong. The truth is that you probably pay more in property taxes to maintain your city streets and county roads than you pay in state gas taxes to support regional highways. If all of the costs of building and maintaining Twin Cities' roads were covered by the gas tax your local property taxes could be reduced significantly. The fact is the percentage of regional road costs covered by the state gasoline excise tax is lower even than the percentage of transit operating costs paid by user fares (about one-third).

As a result, we're not as judicious in the use of either gasoline or road capacity as we would be if we had to pay all of the public costs of our driving through user fees. The consequence is that our dependence on foreign oil grows and our roads are more congested than they would be if we were truly observing the "user pays" principal. When the price of gasoline rose to more than $3 a gallon recently the number of vehicle miles driven actually fell for the first time in decades, fuel efficient cars once again came into vogue, and transit ridership rose to levels not seen in more than 20 years.

If you're a typical Twin Cities taxpayer, you probably already think that the costs of building and maintaining the region's roads are defrayed mostly or entirely by the gas tax you pay at the pump. You would be wrong.

So why are policy-makers looking to close the gap in transportation funding through a general sales tax surcharge or by extending of the current general sales tax to clothing? An extension of the 6.5 percent sales tax to gasoline would increase tax revenues by about the same amount as a half-percent increase in the sales tax on everything except gasoline—the latter only sounds like a smaller tax increase. However, an extension of the sales tax to gasoline would honor the user pays principle and induce us to use both gasoline and road capacity more judiciously. An increase in the sales tax on everything except gasoline would further subsidize driving and exacerbate our over consumption of both of these scarce resources.

Unlike an increase in the current 20 cent per gallon excise tax on gasoline, a 6.5 percent sales tax on gasoline could be used to fund any mode of transportation. Furthermore, the combination of the per gallon gasoline excise tax and a sales tax on gasoline would provide a more stable revenue source than either tax alone: when gas prices go up excise tax revenues would decline with gasoline sales volumes; however, gasoline sales tax revenues would go up with the increase in price (and vice-versa).

Are there other transportation user fees that we could tap to help plug the transportation funding gap? Yes. We can and should make greater use of direct user fees like the free-flow pricing paid by MNPASS users on Interstate 394. The "mileage fees" proposed by the governor will, in fact, be the best way to recover transportation system costs—in 10 years. In the meantime, increased fuel taxes are the only way to raise the additional $1 billion plus per year that all informed observers agree is what's needed to provide congestion relief in the Twin Cites—while simultaneously reducing the amount of driving and commensurately reducing the overall need to spend tax dollars on additional road capacity (as well as reducing our dependence on foreign oil).

As public policy-makers, we ought to devote less energy to finding tax structures that force other people to pay for the public services we demand and more attention to finding tax structures that actually reduce the cost of government by rewarding us for using government-provided services wisely. ●

Steve Elkins is a member of the Bloomington City Council and a participant in a number of transportation policy and advocacy groups. He is a member of the Citizens League and served on the 2004 transportation study committee.

After 30 years in the field, state financing for schools has become more complex than ever

Our state and schools could benefit from a simplified finance system and better accountability

by Alan Hopeman

This fall I will celebrate a significant anniversary. In November it will be 30 years from the day I accepted a new assignment as a nonpartisan legislative research analyst and first got my hands dirty with Minnesota's school finance formulas. I was both energized and nearly scared off by the many people who said "Oh, you're going to be one of the three people in the state who understand the school aid formula."

In the intervening 30 years, during which I have worked not only as a legislative analyst but also as the chief financial officer for three different metro-area school districts, Minnesota's school finance world has evolved, regressed, shrunk, grown—sometimes all at once. The school finance formula is seemingly in constant flux. The ever evolving nature of the formula has made it more and more difficult to understand. There are, however, several significant things about this complex system that every informed citizen should know.

The first thing to understand is how school districts receive funding from the state. Funding from the state flows on a per pupil basis. Along with an allotment for each student enrolled, additional dollars flow to districts to serve the needs of students who are poor, disabled, or whose home language is not English. The purpose, of course, is to deliver the dollars to places that have the greatest need in terms of the numbers of students served and the complexity of the challenges those students bring.

I am often asked to identify the most significant finance issues currently facing Minnesota school districts. The answer is simple: health care, health care, and health care. Energy costs continue to rise, but we spend only a third as much on energy as on employee health insurance. Schools are labor-intensive organizations and about 85 percent of most school district operating budgets are dedicated to salaries and benefits. Health insurance is the most significant cost driver we face. In addition to coping with double-digit health care cost trends throughout this decade, school districts must now also prepare to implement "GASB 45"—a new Government Accounting Standards Board rule requiring the disclosure and funding of the costs of retiree health coverage. While some districts have done better than others at managing health care costs, I do not believe the solution is a single statewide plan for all school employees.

> I am often asked to identify the most significant finance issues currently facing Minnesota school districts. The answer is simple: health care, health care, and health care.

Accountability should be a two-way street

School districts are often criticized for poor performance and lack of accountabilty. My perception of this differs from that of, say, the governor and chairs of legislative education committees, but I can agree that we must be accountable. However, accountability goes both ways. In addition to holding school districts accountable for student performance, safety, and prudent use of taxpayer funds, can we also expect some accountability from our state (and federal) governments? I suggest that their responsibility is to provide resources for education that are stable and adequate; that promises made are promises kept; that requirements imposed on schools are sensible and, if expensive, are funded.

A good example is special education funding. Both state and federal law impose requirements for the provision of special education services. The requirements are extensive and expensive, but of late neither the state nor the federal governments have managed to fully fund these programs. The 2007 Legislature made huge progress with respect to this problem, but the major special education aid appropriation for 2007-08 will still fund only 89 percent of the aid the formula promises. This has changed during my career. In the 1980's, when I worked on the K-12 finance bills at the legislature, a large deficiency would have been scrutinized and, usually, funded with a deficiency appropriation. Since 2000, the special education aid deficiency has become a way to balance the state budget.

Costs shifted to schools

School districts are a critical link in the support system for disabled individuals in our society. Many of the services school districts deliver were formerly provided by state and county agencies. This is one of the main reasons school district budgets and the state education appropriations have grown. Thirty years ago Minnesota had 16,500 state hospital beds, many of them occupied by lifelong residents who had been placed there as children. Today Minnesota has fewer than 2,500 state beds, and very few are occupied by children. Severely disabled children are now served in home and community settings, and I think we are all the better for it. I am proud of the services school districts provide to these students and their families, but these services are expensive and nearly every district spends much more on special education than it receives.

A word about complexity. State aid to school districts, charter schools, nonpublic schools, and other institutions involved in educating our kids now comprises more than 40 percent of the state budget. In order to distribute such a large amount of money in a fair manner, some complexity is essential and is no big surprise. But complexity gets in the way of efficiency.

Accounting and reporting requirements have gotten so onerous that we can hardly keep up. Most years more requirements are added, and never are as many taken away. The education code in the state statutes exceeds 550 pages. The state-mandated school district accounting system has many thousands of budget line items, and it grows in complexity every year. Special reserve accounts must be maintained for at least 29 different program areas, each requiring extra data and calculations to compute, and each complicating—and obfuscating—the system. School business managers will work awfully hard sometimes to save a thousand dollars, and we have lots of ideas for ways to do that, but we can't when we spend so much of our time counting beans. And there are more than a few cases where school districts have gotten into financial trouble simply because someone misunderstood the funding stream or accounting requirements; the system is too complex, even for the professionals.

More stable funding sources

The state holds almost all the cards when it comes to school funding in Minnesota. Even the local property tax is tightly controlled by the legislature, so going to the voters for approval of an increased referendum levy is difficult and, sometimes, impossible. Referendum "caps" place limits on the amount that districts can collect, regardless of whether the voters are willing to pay more.

One of the things that school districts are looking for from the school finance system is stability. We need to work on ways to limit the fluctuations in resources allocated for education. As a result of a major change in funding advocated by former Gov. Jesse Ventura, the property tax was much reduced as a revenue source for school districts, and school funding depends more than ever on sales and income taxes. These revenue sources are much more vulnerable to economic variations.

Public education is perhaps the single most important ingredient for a strong economic future for our state. In America we have the strongest economy in the history of the world, and most of our workforce was educated in the public schools.

Further, the referendum levy has become an essential component of school funding in Minnesota and this source of funding can disappear if the voters don't approve a renewal, required at least every 10 years. Today 300 of 343 Minnesota school districts have referendum levies in place. Virtually all metro-area districts have such levies, and some depend on the referendum for 15 percent or more of their operating revenue.

If not renewed—whether due to educational issues, local or national politics, local economic distress, or something else—the results can be nearly catastrophic for a school district. School districts are at particular risk, because school referenda and bond issues are among the very few chances citizens get to vote on an issue. Voters upset about a new professional sports stadium or a new city hall aren't likely to have had a chance to directly express their displeasure at the ballot box, and the school ballot question becomes a convenient target for voter frustration.

Public education is perhaps the single most important ingredient for a strong economic future for our state. In America we have the strongest economy in the history of the world, and most of our workforce was educated in the public schools. As the baby boomers head into retirement, we will need to replace them with a work force that is both skilled and adaptable. Ninety percent of our students attend public schools; if we don't support these institutions with our dollars and our hearts, our future as a state and a nation will not be as bright. ●

Alan Hopeman is Executive Director of Finance and Business for Wayzata Public Schools

POLICY REDUX

Sometimes it seems as if policy recommendations are made in one year and gone the next, replaced by a new set of discussions and policy priorities. But many of the reports and recommendations by Citizens League study committees have built on the work of previous committees. In this month's Policy Redux feature, we take a look at the Citizens League work on taxing and spending.

Preserving metropolitan tax-base sharing: A

This report was prepared in response to a proposal by the City of Bloomington that it be exempt from the tax-base sharing law in order to help finance the megamall. Additionally, both Bloomington and Minneapolis suggested that some of the regional pool of money from fiscal disparities be used to underwrite the operation of a new convention center. The Citizens League found that the legislature should reject both proposals because to exempt them from the law would result in raising taxes throughout the seven-county metropolitan area and the exemption would produce wide differences in property tax increases among metropolitan area cities.

The report is divided into three sections:

Section I discusses the fundamental flaws in using tax-base sharing to finance the megamall in Bloomington and proposes more equitable ways of providing regional assistance.

Findings:

Proposals to use the tax-base sharing system for financing development are proposals to raise property taxes throughout the seven-county metropolitan area. If property taxes are an appropriate source of support for these projects, exempting projects from tax-base sharing is the worst way to proceed; it raises taxes in precisely those communities with the least fiscal capacity. It's unfair to the other communities because it pushes the burden of financing the Bloomington project mostly toward communities with the least commercial development of their own. While the exemption creates an illusion of a cost-free contribution, it really amounts to an open-ended subsidy from the regional tax base.

Remaking the Minnesota Miracle (1990)

In 1990, 17 years after the Minnesota Miracle, approximately 65 percent of the monies collected by state government was redistributed to local units of government in the form of aid and property tax relief. As a result of an increasing state role, the link in local decision-making between spending and taxing has diminished and thus, the accountability of local units of government to their constituents suffered. Additionally, the system is complex, confusing, and difficult for most taxpayers to understand. In such a system, it is not clear who to hold responsible for public policy, or how to enforce accountability.

Four principles that should be used to guide changes to the system are 1) accountability; 2) effectiveness; 3) economy; and 4) equity. Because it is not possible to equally achieve each of these principles the goal should be to structure a system that *optimizes* each of these principles.

Recommendations:

- **Accountability:** Responsibility for services should be assigned to the entity that is accountable to the electorate, the recipient of the service, and the governmental unit or persons paying for the service.

report to the Minnesota Legislature (1985)

Further, granting an exemption for one city would unravel the thread of collective support for the tax-base sharing law. If we lose tax-base sharing, the result will be precisely those wide disparities in wealth that plague so many metropolitan areas around the country; the Twin Cities metro area is widely admired for a system that mitigates those disparities.

Recommendations for other possible ways to raise revenues:

- A direct, metropolitan-wide tax levy.
- The Legislature could establish a metropolitan redevelopment fund.
- A sales tax that is spread uniformly throughout the metropolitan area.

Section II is a table comparing the property tax impact on metropolitan area cities from using a uniform metropolitan mill rate and from using the exemption from tax-base sharing law as proposed by Bloomington.

Findings:

See the report at www.citizensleague.org

Section III discusses what the tax-base sharing law is, its history, and how Bloomington's proposal to change it would affect the Twin Cities area.

Findings:

Fiscal disparities or tax-base sharing is a Minnesota law that guarantees every unit of government in the metropolitan area a share in the growth of the region's commercial-industrial (C-I) tax base. The law passed in 1971 and was intended to reduce wide differences in C-I valuation among metropolitan communities. It is a way for local governments to share in the resources generated by growth in the region, without dismantling their ability to make their own policy decisions on levying property taxes or expending public dollars. It does this by adjusting the property tax burden communities pay by pooling the taxes and redistributing the pool among communities on a per capita basis, which is adjusted by the market value of a city's property.

The law has withstood two constitutional challenges that it violated both the Uniformity and the Equal Protection clauses. The law is recognized nationally and has been copied in other metropolitan areas of the country. There's widespread support (84 percent of Minnesotans), to not approve the Bloomington proposal.

Legislative reasons for passing tax-base sharing:

- Addresses widespread concern over the large disparity among tax bases.
- Addresses the fiscal competition between communities which motivated cities to refuse low-revenue generating projects such as parks or low-income housing, and to compromise aesthetic and environmental development standards for the sake of maximizing tax base.
- Fears that the recently established Met Council might stimulate land development only in those parts of the region with high potential for C-I growth.
- The siting of a power plant along the St. Croix River raised land-use and tax base concerns.

> Eliminate local government aid and other state provided aid because local jurisdictions should rely on their own resources for services that are truly local in nature.
> Remove levy limits because they interfere in local officials' decisions regarding demand for local services.
> The Legislature should eliminate the opportunity for school districts to seek additional state dollars to go beyond their budgeted expenditures. District boards should have to go to voters to request additional dollars.

- **Effectiveness:** Responsibility for services should be assigned to the entity, public or private, that gets the job done well and measures for results.

> To be effective a provider must set standards of performance, measure the performance and identify satisfactory/unsatisfactory results, and use these measures to redirect the delivery of service.
> The state ought to avoid centralized micromanagement of elementary-secondary educational policy, even as it continues its substantial role in financing education.

- **Economy:** Responsibility for services should be assigned to the entity, public or private, that can supply the service at the lowest possible cost.

> Local governments should make efforts toward, and the state should facilitate, restructuring where necessary in order to provide public services in the most effective and economic way.

- **Equity:** Responsibility for services should be assigned to the entities that can finance the service equitably, and ensure equity in the delivery of services to all persons.

> This principle has received greater attention in Minnesota and thus the state must bring the other three principles into better balance with equity.
> The state ought to be fully responsible for financing courts and public defense costs, income maintenance programs and a base level of social services.

10/24

Citizens League Annual Meeting

Save the date for our biggest event of the year. It's your chance to reconnect with old friends, honor active citizens and other civic leaders, and check in on the work of the Citizens League.

Nominations for Citizens League Board of Directors

The Citizens League is currently accepting nominations for our Board of Directors. Go to www.citizensleague.org/nominations for more information, or to nominate someone to serve on the Board—or nominate yourself!

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