

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

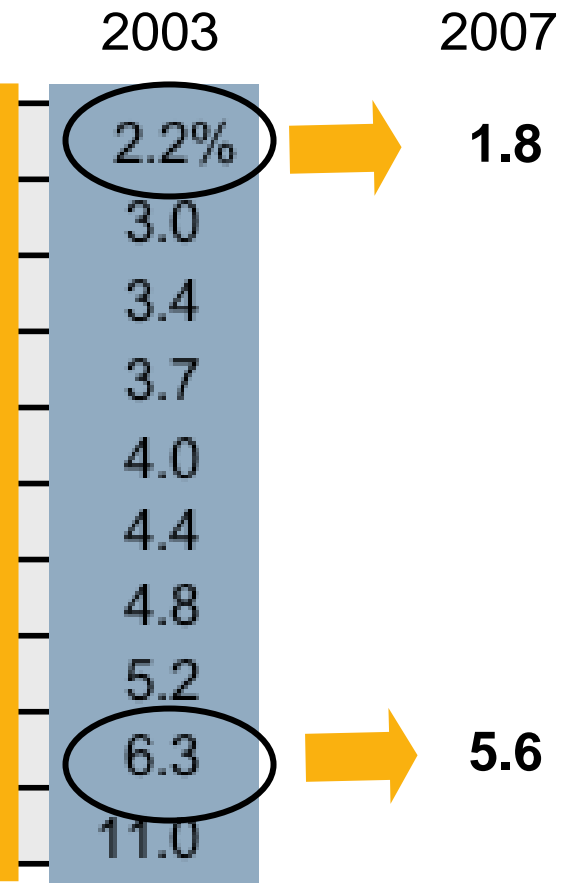
Source: MN Department of Revenue, Tax Incidence Study, 2003

Who Ends Up Paying Business Taxes?

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

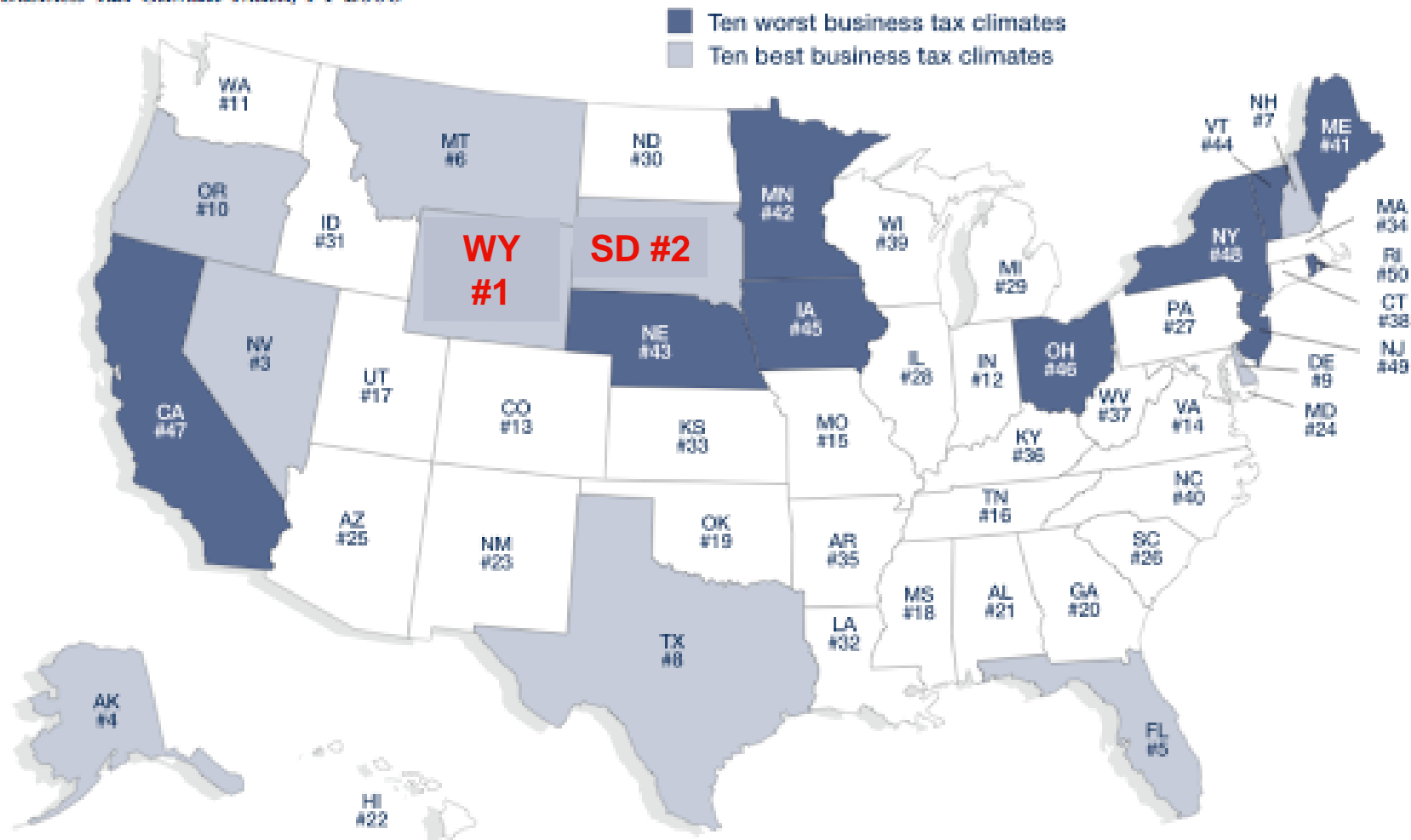
“The effective tax rate was 5.6 percent in the second decile; it fell steadily as income rose, reaching 1.8 percent in the tenth decile.”

– MN Department of Revenue, Tax Incidence Study, 2007



Best Business Tax Perception

Figure 1
State Business Tax Climate Index, FY 2008



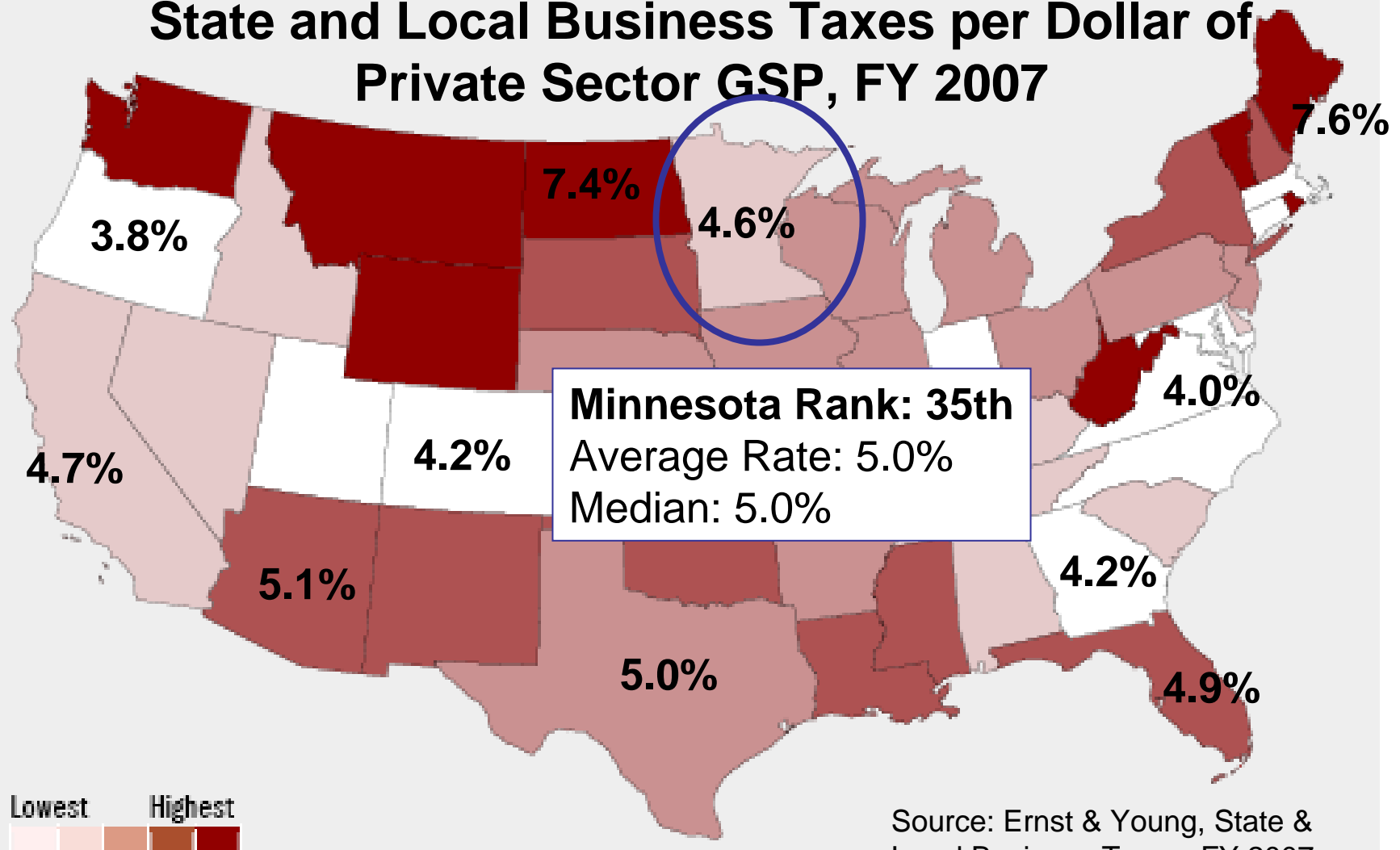
Source: Tax Foundation

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
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

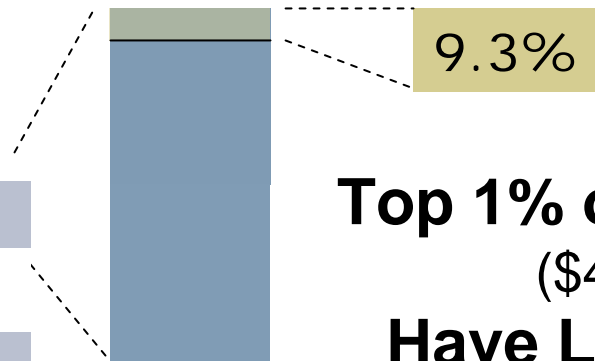
High Income Tax States Do Well

- **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**

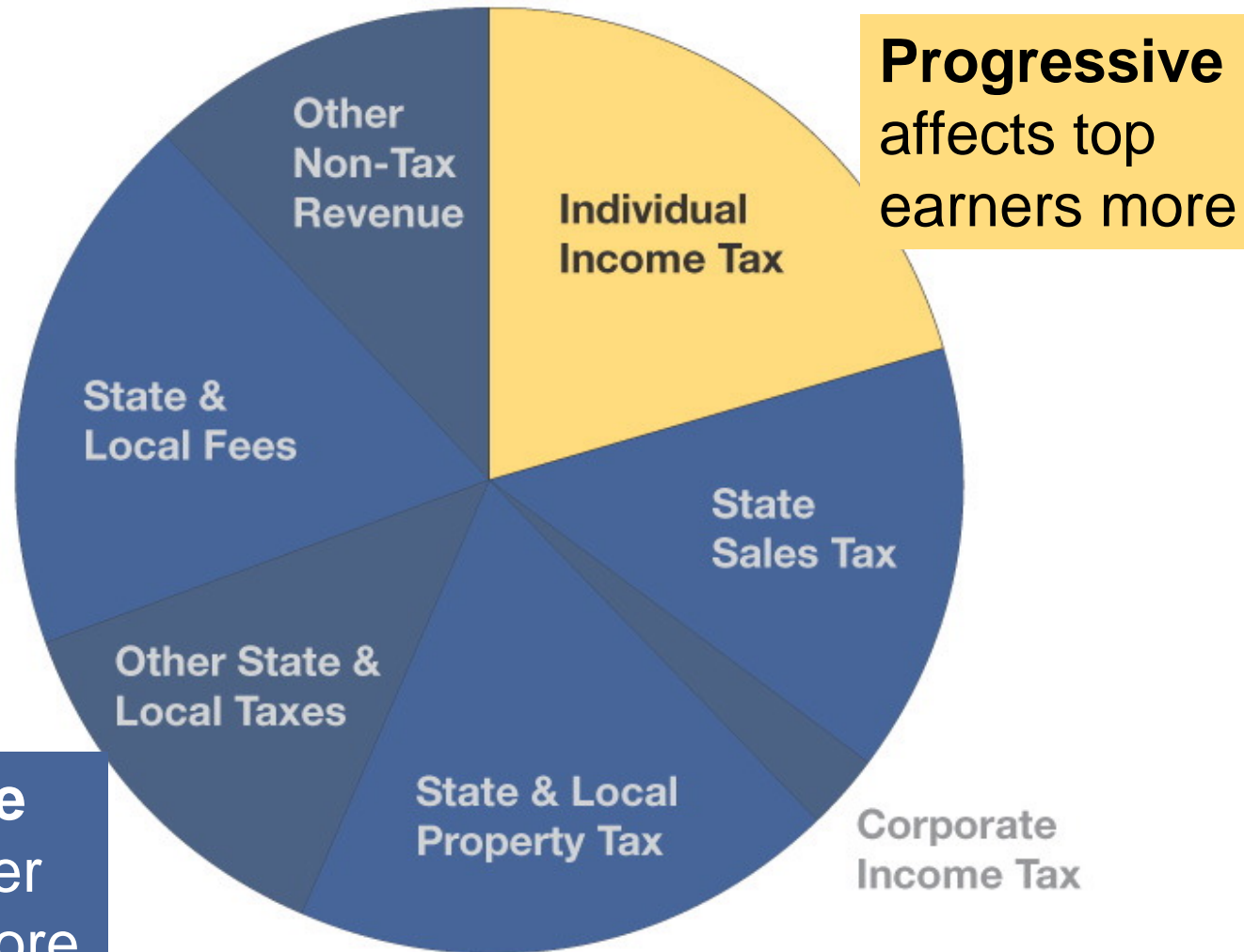
Better compliance and efficiency

Prosperity Building

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

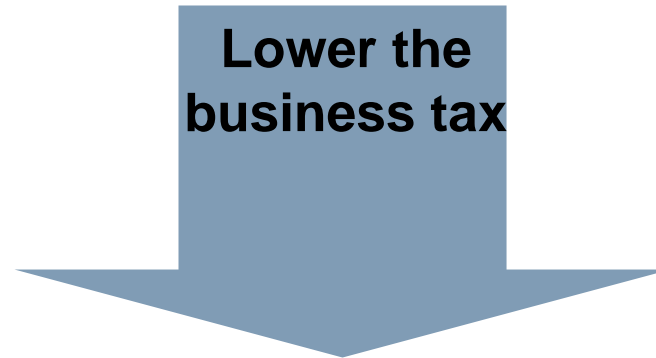
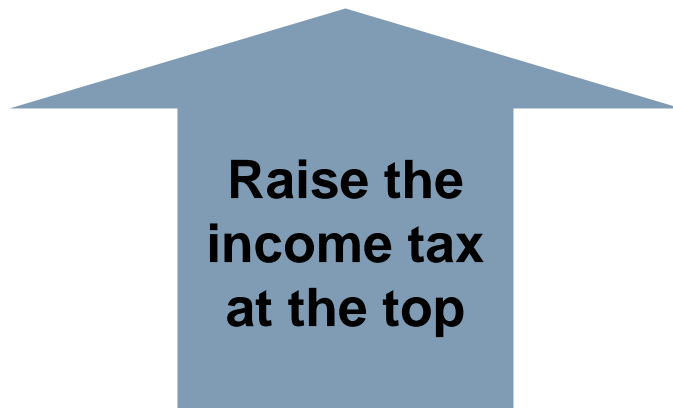
Encourages business to come, stay, invest and grow.

Overall Tax System is Regressive



Why Not a Swap?

Fairer for families



Better for business climate

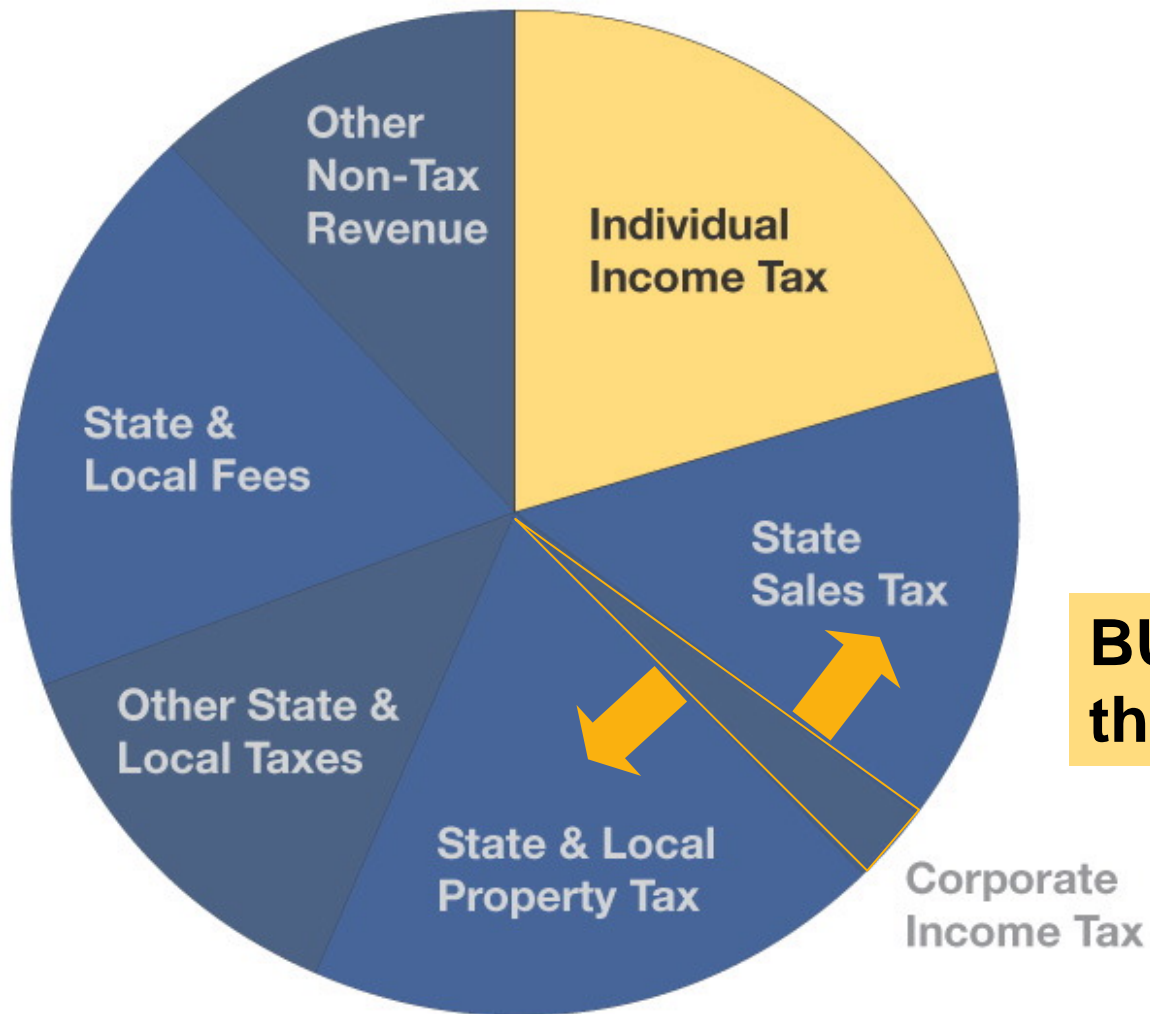
Cut Business Taxes?



Reduce and Simplify Taxes on Business

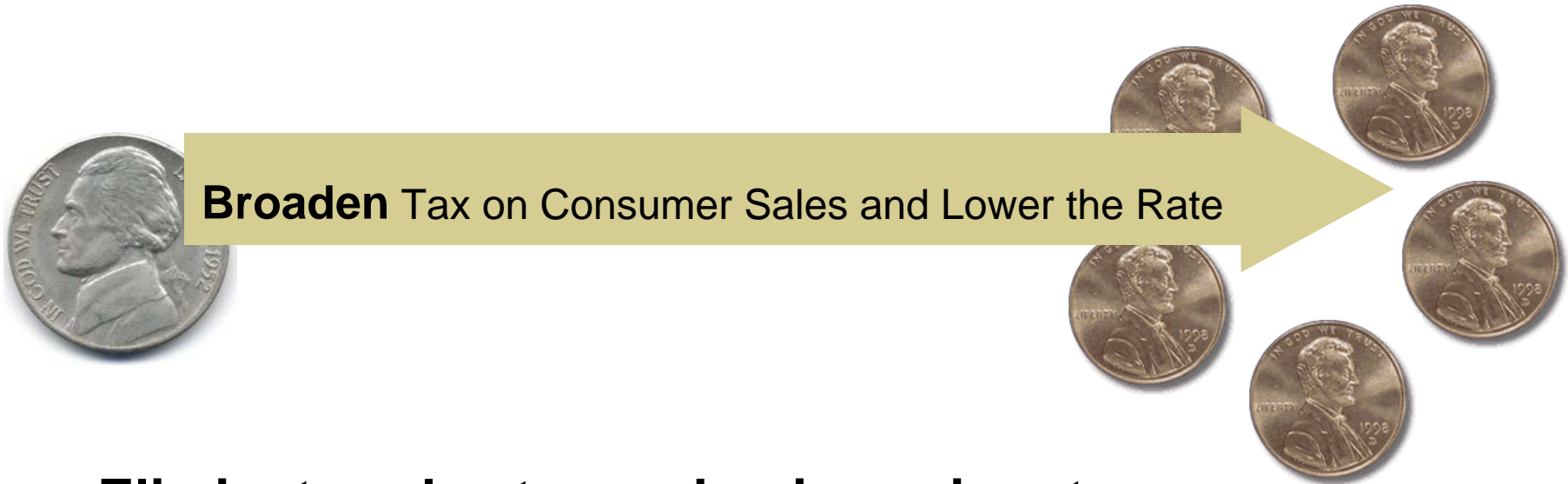
- **Lower business taxes broadly**
 - Improve perception of business climate
 - Reduces regressive impact of shifting
- **Cut back on exemptions by industry or ZIP, and “taxation by negotiation”**
 - Level playing field is good tax policy and good selling point
- **Take the opportunity to market Minnesota**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

Drop the Corporate Income Tax?



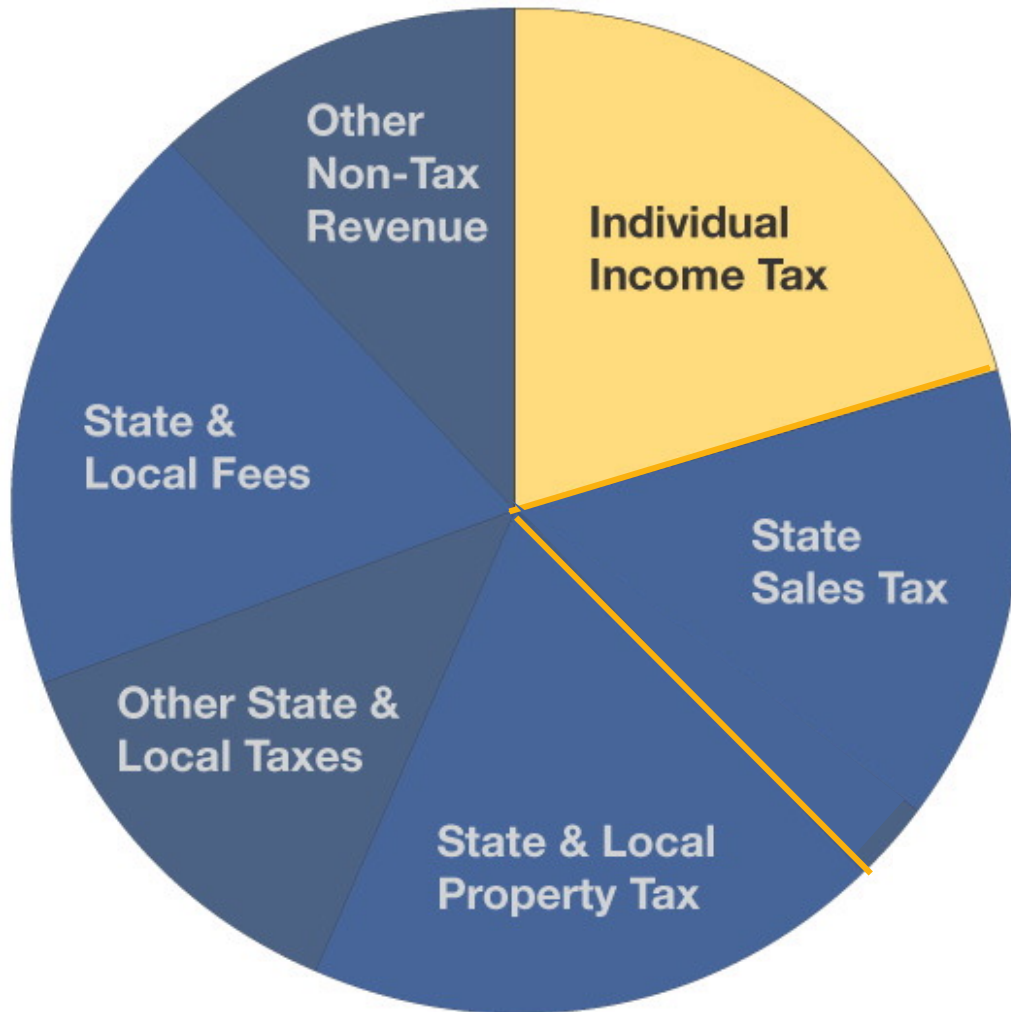
BUT... don't make the system less fair.

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



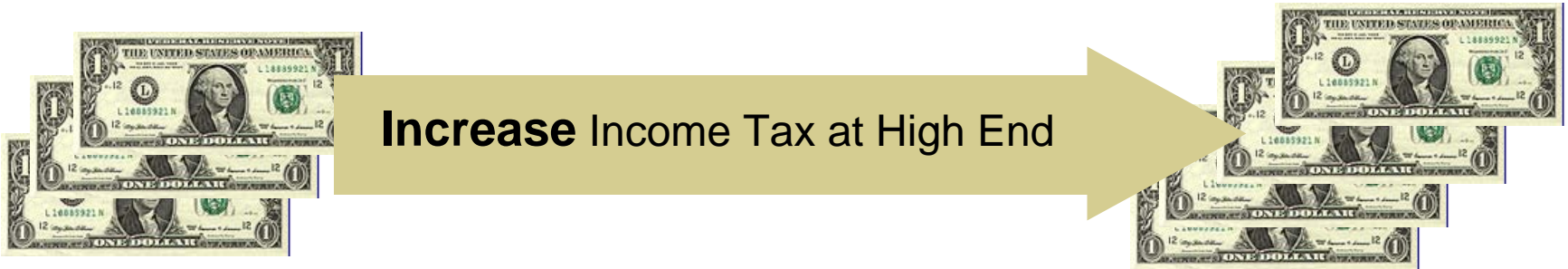
Revenue:

Neutral to positive
(with expansion & swap)

Equity:

Positive for business
Slightly less regressive

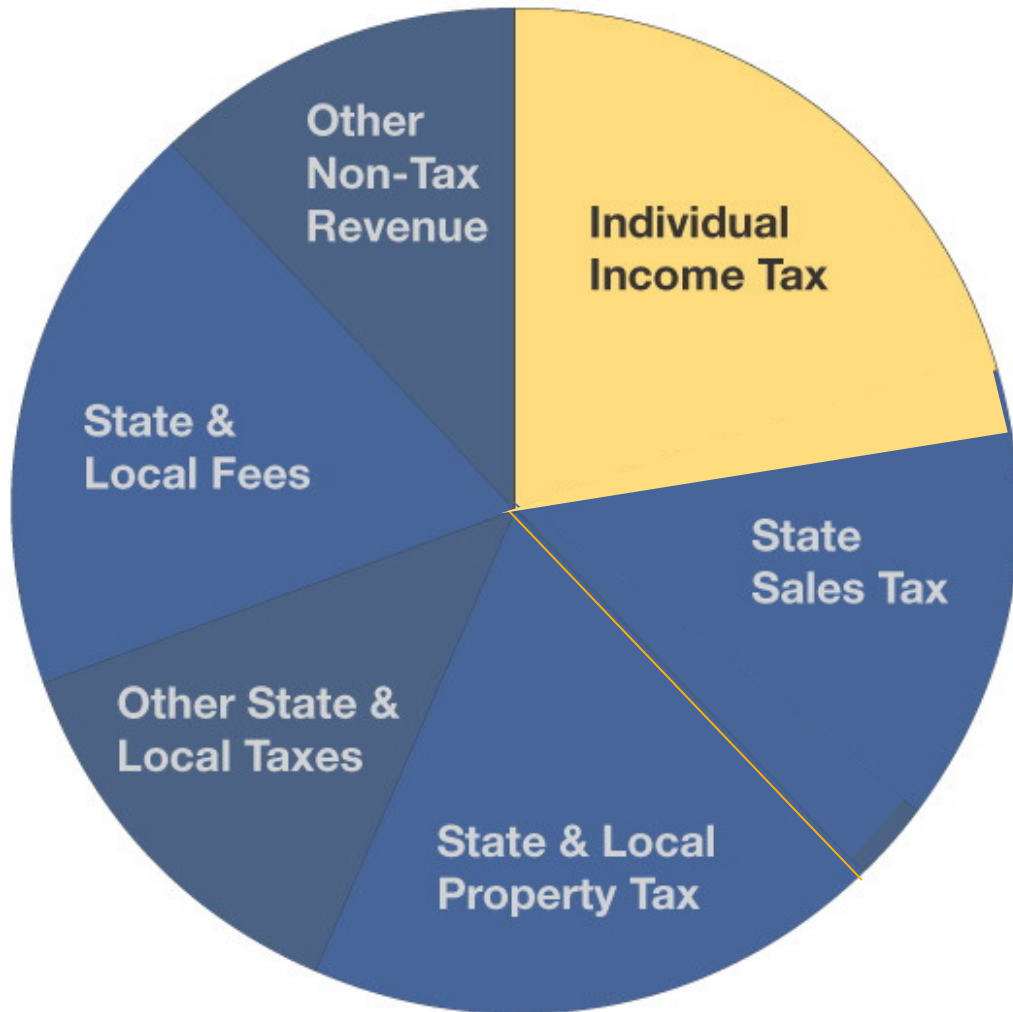
Personal Income Tax



- **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

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

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

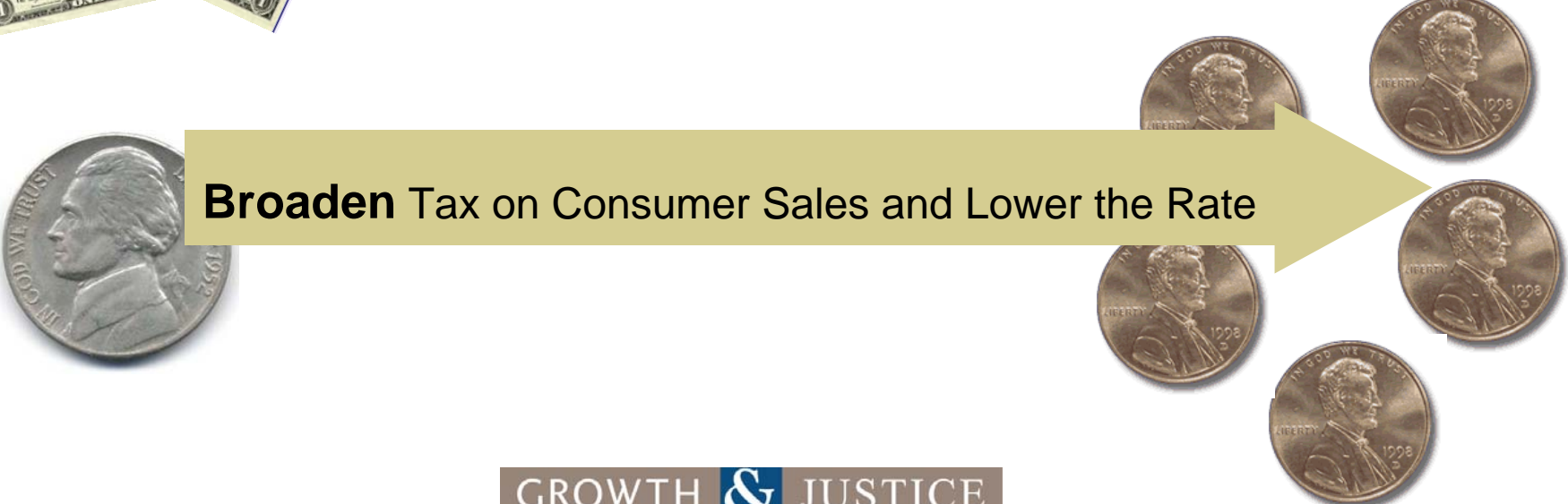
A Better Way to Raise Revenue



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