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Minnesota Governor Proposes Poorly-Designed Tax "Reform"

By
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Minnesota Governor Mark Dayton (D) recently proposed his 2014-2015 biennial budget, which includes $2.1 billion in revenue increases.[1] Included are increased income taxes on high-income earners, a poorly designed expansion of the sales tax base, and a steep hike in cigarette excise taxes.

Higher Individual Income Tax

Table 1: Minnesota Individual Income Tax Brackets & Rates, Single Filers, 2013

Current Law		Governor's Recommendations	
Taxable income	Income Tax Rate	Taxable income	Income Tax Rate
$0-$24,270	5.35%	$0-$24,270	5.35%
$24,271-$79,730	7.05%	$24,271-$79,730	7.05%
≥$79,731	7.85%	$79,731-$149,999	7.85%
		≥$150,000	**9.85%**

Source: Minnesota Department of Revenue.[2] Taxable income is adjusted gross income minus deductions and personal exemptions.

The governor's tax package would make multiple changes to the individual income tax, with those changes resulting in a $300 million net decrease in biennial revenues.[3] The state currently has the ninth highest top rate in the nation. This budget, if implemented, would add a new top rate of 9.85 percent on single filers earning $150,000 or more. The measure would raise an estimated $1.1 billion over the next biennium[4] and push Minnesota's top rate to the fourth highest in the country. Theory suggests that progressive income taxes negatively affect economic growth.[5] Not only do they reduce the returns to education and the incentive to build human capital, but they also "undermine the factors that contribute most to economic growth: investment, risk-taking, entrepreneurship, and productivity."[6]

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[1] Office of Governor Mark Dayton, *Budget for a Better Minnesota*, http://www.mmb.state.mn.us/budget2013/doc/budget/bud-op/op14/gov-presentation.pdf [hereinafter *Dayton Budget*].

[2] Minnesota Department of Revenue, Minnesota Department of Revenue News Release, *Minnesota income tax brackets and rates*, Dec. 14, 2012, http://www.revenue.state.mn.us/newsroom/Documents/20121214%20income%20tax%20brackets.pdf.

[3] Office of Governor Mark Dayton, *Budget for a Better Minnesota Presentation*, http://www.mmb.state.mn.us/doc/budget/bud-op/op14/presentation.pdf [hereinafter *Dayton Budget Presentation*].

[4] Minnesota Management & Budget, *General Fund Balance Analysis—January 2013 Governor's Recommendations, Expenditures by Omnibus Bill—Summary* (Jan. 22, 2013), http://www.mmb.state.mn.us/doc/budget/report-fba/jan13-summary.pdf.

[5] William McBride, *What Is the Evidence on Taxes and Growth?*, TAX FOUNDATION SPECIAL REPORT NO. 207 (Dec. 18, 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.

[6] William McBride, *How to Judge a Tax Plan*, TAX FOUNDATION FISCAL FACT NO. 286 (Dec. 15, 2011), http://taxfoundation.org/article/how-judge-tax-plan.

Governor Dayton proposes swapping this new revenue with a $500 property tax rebate for homeowners, estimated to cost $1.4 billion.[7] Also included is the imposition of an additional $30 million in state income taxes on "snowbirds" (individuals residing in the state for only part of the year) by adding "a share of outstate income based on number of days spent in Minnesota" to existing tax liability.[8] This new provision will require taxpayers to keep detailed records of travel between states throughout the year.[9]

Sales Tax: Business Inputs and Tax Pyramiding

The largest portion of Governor Dayton's proposal is a sales tax base expansion and a rate reduction of 20 percent (from 6.875 to 5.5 percent), raising an additional $2.1 billion during the biennium.[10] In theory, positive sales tax reform includes both base broadening and rate reduction and if done correctly, the tax is applied to a larger base of goods and services and the rate can be lowered without any revenue implications.

However, the governor's proposal departs from tax reform principles. His sales tax base expansion would include the taxation of business inputs. If enacted, this would cause economic distortions by favoring different production processes based on the number of intermediate transactions. If inputs are not exempted, taxes are paid each time the product changes during production, compounding and leading to a highly variable effective tax rate. This tax pyramiding falls more heavily on goods with longer production chains and encourages businesses to vertically integrate (that is, "cut the number of production stages for products by absorbing suppliers")[11] even when it is not otherwise economically efficient to do so.

The Minnesota Department of Revenue published a list[12] of those items and services that would be included under the new sales tax:

- Personal and professional consumer services;
- Services purchased by businesses (examples include advertising, office administration, business support services, consulting services, and equipment maintenance);
- Certain goods, such as ready-to-eat meat and seafood, clothing items exceeding $100, admissions, memberships, over-the-counter drugs, publications, and digital goods.

No mention has been made by the governor regarding concerns over the taxation of business-to-business transactions and the issues associated with doing so. In fact, if the services classified as purely business-to-business are excluded from the governor's estimates, the expected 2014-2015 biennium revenue from sales tax measures drops from $2.1 billion to only $760 million.

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[7] If the homeowner's property tax bill was less than $500 last year, the rebate will be equal to that amount. Tom Nehil, Kaeti Hink, & Alan Palazzolo, *Budget 101: A graphic primer to Dayton's budget proposal*," MINNPOST, Jan. 31, 2013, http://www.minnpost.com/data/2013/01/budget-101-graphic-primer-daytons-budget-proposal.

[8] *Id.*

[9] Tom Scheck, *Dayton's snowbird tax plan may be hard to enforce*, MPR NEWS, Mar. 15, 2011, http://minnesota.publicradio.org/display/web/2011/03/08/dayton-state-budget-snowbird-tax-plan.

[10] *Dayton Budget Presentation, supra* note 2.

[11] Andrew Chamberlain & Patrick Fleenor, *Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes*, TAX FOUNDATION SPECIAL REPORT NO. 147 (Dec. 2006), http://taxfoundation.org/article/tax-pyramiding-economic-consequences-gross-receipts-taxes.

[12] Minnesota Department of Revenue, *Sales Tax Base Broadening* (Jan. 25, 2013), http://www.revenue.state.mn.us/tax_reform/Documents/Sales%20Tax%20Base%20Broadening.pdf.

Cigarette Tax Hike

Minnesota currently taxes cigarettes at $1.23 per pack. Part of Governor Dayton's plan would increase this to $2.17 per pack—skyrocketing Minnesota to the 10th highest in the nation[13] and raising $370 million in revenue over the next biennium.[14] Minnesota's cigarette taxes are already higher than nearly all of its neighbors (except Wisconsin) and this measure would make taxes one of the highest in the area. Cigarette tax differentials across state lines can create lucrative business opportunities for smugglers who transport cigarettes from high-tax states to low-tax states.[15]

Corporate Rate Cut

A positive portion of Governor Dayton's proposal is his cut to state corporate income tax rates, which he notes is the "largest reduction of [the] corporate tax rate in 26 years."[16] By expanding the corporate tax base, the governor aims to cut the rate by 14 percent, moving Minnesota down from the third highest in the nation. The new rate would move to 8.4 from 9.8 percent.[17] The $319 million reduction in revenue from the rate drop will be offset by the elimination tax provisions for foreign operation companies (FOCs) and "foreign royalty subtraction for some businesses."[18] The net result is an increase in revenue by $5 million over the next biennium. Research suggests that high corporate rates can be detrimental to economic growth[19] and reductions in the corporate rate make states more attractive for investment and competitive with their neighbors.[20]

Conclusion

On the revenue side, Governor Dayton's budget proposal leaves much to be desired. Our research suggests that the plan will do more than simply raise taxes by $2.1 billion over the next two years. Taxing business inputs and implementing increasingly progressive income taxation can harm economic growth for years to come. The plan is an example of a state operating under the facade of positive and pro-growth reform while failing to understand the relationship between a state's tax structure and its ability to attract business.

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[13] Tom Nehil, Kaeti Hink, & Alan Palazzolo, *Budget 101: A graphic primer to Dayton's budget proposal*," MINNPOST, Jan. 31, 2013, http://www.minnpost.com/data/2013/01/budget-101-graphic-primer-daytons-budget-proposal.

[14] Minnesota Management & Budget, *General Fund—Fund Balance Analysis—January 2013 Governor's Recommendations* (Jan. 22, 2013), http://www.mmb.state.mn.us/doc/budget/report-fba/jan13-detail.pdf.

[15] Joseph Henchman & Scott Drenkard, *Cigarette Taxes and Cigarette Smuggling by State*, TAX FOUNDATION FISCAL FACT NO. 351 (Jan. 10, 2013), http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state.

[16] *Dayton Budget*, *supra* note 1.

[17] Note: these rankings are based on the 2012 edition of our booklet *Facts & Figures: How Does Your State Compare?*, available at http://taxfoundation.org/article/facts-figures-handbook-how-does-your-state-compare-0.

[18] *Dayton Budget*, *supra* note 1.

[19] William McBride, *What Is the Evidence on Taxes and Growth?*, TAX FOUNDATION SPECIAL REPORT NO. 207 (Dec. 18, 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.

[20] William McBride, *How to Judge a Tax Plan*, TAX FOUNDATION FISCAL FACT NO. 286 (Dec. 15, 2011), http://taxfoundation.org/article/how-judge-tax-plan.