Understanding Tax Reform in Minnesota
Laura Kalambokidis

Minnesota is in the midst of a wave of interest in reforming the state tax system. In response to taxpayer input gathered at numerous public meetings, the Minnesota Department of Revenue (DOR) has developed proposals designed to make the tax system fairer, simpler, and more favorable to prosperity. Governor Ventura has proposed that the state 1) shifts K–12 education funding away from local property taxes to some other tax, 2) reduces income-tax rates, and 3) lowers the rate and broadens the base of the sales tax. The Citizens’ League has recommended that property-tax relief be more carefully targeted to low-income households. Finally, Minnesota has joined 38 other states in seeking to simplify general sales taxes and to adopt a model sales-tax system.

It seems that every major component of the state tax system is being considered for reform, including the sales tax, property tax, corporate franchise tax, and individual income tax. For each tax, numerous options are on the table. How are Minnesota taxpayers to understand and assess the array of possible outcomes of the reform process? This article will explain some of the options and provide some guidance for evaluating tax-reform proposals.

Why Reform the System?

The objectives of the current reform effort are consistent with the basic principles of tax reform: fairness, simplicity, and promoting prosperity by restricting the influence of taxes on individuals’ economic decisions. As with other major tax changes, reforming Minnesota’s system is complicated by tensions among these principles. For example, provisions that enhance fairness, such as Minnesota’s Working Family Credit for low-income families, also introduce complexity. In addition, the tax system is often used to pursue important social and economic goals such as home ownership and education. The resulting special deductions, credits, and rates can conflict with all three of the basic tax-reform principles. In any tax-reform effort, policymakers and citizens must consult their own values to balance these competing goals.

Reduce Complexity

Tax reform has risen to prominence in Minnesota for several reasons. First is a widespread perception that some parts of the state tax system have grown unnecessarily complex. Taxpayers complain that some Minnesota taxes—especially the property tax—are exceedingly hard to understand and ought to be simplified.

Indeed, simplifying taxes can have numerous benefits. A more understandable tax system reduces taxpayers’

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Wage Changes in the Pork Industry: How Did Minnesota Workers Fare?
Terrance Hurley and Pascal Elisabeth

The nation’s pork industry has experienced turbulent change over the past decade. Smaller operations that rely almost exclusively on family labor have largely been replaced by larger operations that hire skilled labor to take advantage of new technologies. The result is a market that provides new jobs for skilled workers in rural communities, while often leaving unskilled workers behind.

Understanding wages and wage growth in this emerging labor market is useful for producers, their employees, and rural communities. Producers can use wage information to determine whether they pay enough to attract and retain skilled employees, and whether their wages are too high to remain competitive. Current and prospective employees can determine whether their wages are fair, or whether it is better to seek employment elsewhere. And rural communities can determine whether hog-production facilities will help the local economy; for example, if wages in the pork industry are low and growth poor, communities may be better off looking to other industries for economic growth.

Wage Determinants

Why do some people working in the same jobs earn higher wages than do others? The answer depends on many factors, but four in particular seem to account for many of the observed wage differences.

First, the more people know, the more they earn. What people know is often referred to as a person’s “human capital”—and good indicators of what he or she knows are the numbers of years spent 1) in formal education, 2) in the world of work, and 3) at the same job with a specific employer. And just as a

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compliance costs and the government’s administrative costs. Under a simpler system, it is easier for taxpayers to predict what their taxes will be, which simplifies their financial planning. A simple, transparent tax system can also improve the perceived fairness of the system, as taxpayers wonder less about whether they are being treated differently than someone else. Despite these arguments, and despite nearly universal support for tax simplification in theory, simplification can be difficult for lawmakers to achieve in practice.

**Increase Taxpayers’ Sense of Fairness**

Related to taxpayers’ impatience with tax complexity is a concern that Minnesota’s tax system includes many special benefits (the state’s DOR has identified 292 of them) for particular taxpayers, and that those special benefits harm the system overall. Special deductions, rates, and credits are intended to enhance fairness or influence taxpayers’ decisions, steering them toward choices that are consistent with social and economic goals. For example, Minnesota allows tax deductions for charitable contributions and provides tax credits for families with certain types of educational expenses. Influencing taxpayer behavior, however, causes distortions in the economy that can limit economic growth. Preferential treatment for particular activities or taxpayers also increases tax complexity and narrows the tax base, requiring higher tax rates overall.

It is good practice to periodically examine preferential tax provisions to determine whether the social and economic benefits they provide exceed the costs to the efficient operation of the tax system and the economy. Eliminating special tax benefits, however, is rarely easy, as each provision is, or once was, justified by some policy goal or particular political interest. The current recipients of those benefits will surely resist change.

**Prevent Erosion of Tax Base**

Another reason for the growing interest in reforming state taxes—in particular, sales taxes—is the erosion of the sales-tax base. Over the last few decades, families have significantly increased the share of their total expenditures that goes to services, while reducing the share they spend on physical goods. Minnesota’s general sales tax, however, exempts most services, including financial, legal, and home-improvement services. For states like Minnesota, the trend toward a service economy has meant a steady wearing away of the sales-tax base. Consequently, Minnesota’s general sales-tax rate is one of the highest in the country, and is tied to one of the narrowest bases. This has prompted lawmakers to consider a variety of base-broadening measures.

Sales-tax bases have also been threatened by the growth of interstate sales, including sales made over the Internet. Sellers argue that the wide and varying assortment of state and local sales-tax rates, bases, and regulations make it impossible to accurately calculate and collect taxes on Internet sales. The potential loss of these sales taxes has prompted a coalition of 39 state governments, including Minnesota, to form the “Streamlined Sales Tax Project.” The goal of the project is to simplify and conform state tax systems in order to make collection of taxes on Internet and other interstate sales more feasible.

**Criteria for Evaluating Tax-Reform Proposals**

Evaluating a far-reaching tax reform can be daunting. Proposals are complex, their effects are unclear, and the evaluation criteria conflict with one another. A few guidelines can help us assess the net impact.

**Start With a Picture of the Current System**

In 2001 Minnesota’s combined state and local taxes will amount to an estimated $17.7 billion (figure 1). Of this total, the largest portions are the state-wide individual income tax (33 percent), local residential and commercial property taxes (30 percent), and statewide (and some local) general sales taxes (25 percent). It is easy to see that significant changes in any of these three taxes could have important effects.

**Is the Current System Fair?**

The notion of fairness is highly subjective, and there is no consensus among economists on how it should be defined or measured. A commonly used measure is the distribution of the tax burden among taxpayers at different income levels. Some people view a tax as fair if all households pay roughly the same percentage of income in taxes—regardless of their income—because all households are thereby treated equally. Such a tax is said to be flat, or proportional. Others feel that taxes should be imposed according to households’ ability to pay taxes. This argument suggests that a fair tax is one that requires high-income families to pay a larger share of their income in taxes than low-income families. Such a system is called progressive. A system is said to be regressive if the share of income paid in taxes falls as income rises.

Of course, income is not the only characteristic that differentiates households. Tax changes can shift burdens between homeowners and renters, workers and retirees, single people and families with children, and metro and rural households. But it is the income dimension that captures most of the public attention.

Not all of the $17.7 billion in 2001 taxes shown in figure 1 is paid by Minnesotans. An estimated 16 percent will come from individuals and businesses located outside Minnesota. And while some taxes are collected from businesses, all taxes are ultimately paid by individuals. Businesses may pass taxes to workers in the form of lower wages, to customers in the form of higher prices, or to investors in the form of lower rates of return. To estimate the distribution of the tax burden, therefore, we need to make assumptions about which households bear the final burden of taxes imposed on businesses, as well as about how much of the tax will be paid by non-Minnesotans.

**Minnesota’s Tax System Today Is Roughly Proportional**

In its 1999 *Minnesota Tax Incidence Study*, the DOR showed that for low- and middle-income households, the percentage of income paid in Minnesota state and local taxes tends to rise as income rises. For higher-income households (those with incomes over about $80,000), however, the share of income paid in state and local taxes falls as income rises. In other words, Minnesota’s tax system is progressive over much of the income distribution and regressive at higher income levels. Taken overall, however, Minnesota’s tax system is
Evaluating Tax Reforms as a Package

Major tax-reform proposals will likely include changes in more than one tax. The discussion of tax distributions highlights an important point about sweeping tax changes: different components of a tax proposal may have different effects. Even if a proposed reform were to leave the total tax burden the same, shifting revenue from one type of tax to another could affect the overall distribution of taxes among households of different income levels.

Different Taxes May Cancel Each Other Out

An increase in a family’s share of one tax might be mitigated by a change somewhere else, implying that the fairness of an entire tax package might be quite different than the fairness of a single component. In addition, cuts in one tax would have to be made up by increases in another, if revenue is to remain the same. Therefore, if a reform proposal includes several components that are likely to emerge intact from the legislature, the package should be evaluated in its entirety.

Questions Families Should Ask About Any Tax Reforms

First, a taxpayer may want to decide whether a proposal would be sound policy by asking whether it is consistent with the basic tax-reform principles discussed above. Would the proposed change make the tax system more or less fair, more or less complex, and would the change enhance or hinder economic growth?

Second, a taxpayer may want to predict how the change will affect his or her own family. To get at this question, a taxpayer should identify what household characteristics determine the family’s tax burden. For example, in what part of the state does the family live? Are home- stead property taxes relatively high in the region? Does the family own a vacation home? What is the family’s income level? Does the family benefit from the Working Family Credit, the K–12 Education Credit, or the Child and Dependent Care Tax Credit? Does the family own a business? Are the costs of complying with business taxes onerous? Does the family plan to make any large purchases in the near future? Does the family purchase tobacco products, use a lot of gas for business, or go on frequent vacations? The answers to these questions can help determine how a particular tax change will affect an individual household.

What Options Are on the Tax-Reform Table?

Policymakers are discussing changes to nearly every Minnesota tax. Below are some of the more prominent options for sales, property, and income taxes. Table 1 shows some of the options that are under consideration.

Sales-Tax Reforms

The current sales-tax reform effort in Minnesota focuses on broadening the base, lowering the tax rate, and conforming to the recommendations of the Streamlined Sales Tax Project mentioned earlier.

To broaden the base, the sales tax could be extended to cover purchases of many types of consumer services that are currently excluded. These could include financial and legal services, but the governor’s proposed plan would continue to exempt sales of real property, medical services, prescription drugs, private-school tuition, and motor fuel. At the same time, the current multiple sales tax rates (which vary by location and by type of product) could be replaced with a single, flat rate.

Broadening the tax base by including services would allow the rate to be lowered without a loss of revenue, bringing it more in line with the tax rates in nearby states. Taxing a broader range of purchases at a uniform rate could also reduce the influence of taxes on households’ spending decisions and simplify the system. On the other hand, the change would require many more businesses—such as law firms—to collect the tax, thereby increasing tax-compliance costs. Taxpayers who purchase a lot of goods and services that are currently exempt may believe such base-broadening proposals unfairly single them out.

The state’s participation in the Streamlined Sales Tax Project probably means that the legislature will be asked to adopt the model sales-tax legislation proposed by this group of states. The recently published model legislation includes uniform definitions of different goods and services—to which states can refer when choosing which items to in-

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Taxes from page 3

...however, reducing the rate to ensure that total revenue remains the same), however, households. The effect of broadening the sales-tax base (while simultaneously portionately burden lower-income state on sales-tax revenue could dispro-

The distributional effects of sales-tax simplification and reform are also not clear. Because sales taxes are generally regressive, an increased reliance by the state on sales-tax revenue could disproportionately burden lower-income households. The effect of broadening the sales-tax base (while simultaneously reducing the rate to ensure that total revenue remains the same), however, depends on which types of goods and services are included in the base—and on which families purchase them.

Property-Tax Reform and Simplification

The governor would like to eliminate that portion of the K–12 general education levy that is currently mandated by the state. Under his proposal, the state would cover the mandated spending that local governments currently cover through property taxes. Local districts would continue to use the property tax, through local referenda, to supplement the state-mandated funding levels. The governor’s proposal would cut the share of total education costs financed by local property taxes from 25 percent to around 12 percent. Because a good educational system is thought to produce benefits for the entire state, the governor argues that the state—and not individual communities—should bear the burden of financing K–12 education.

The estimated revenue shift is about $900 million per year, which the state will have to fund from new or existing sources. This would probably not result in a $900 million tax cut but, rather, in a shift of $900 million from local property taxes to one of the other state taxes. Because the different taxes have different economic and distributional effects, it is impossible to evaluate the effect of this proposal until the specific source of state funding is identified, which has yet to be done.

The administration, responding to complaints that the property tax is far too complex and unpredictable, has also suggested repealing provisions that now provide preferential treatment for certain types of property or taxpayers. As with income and sales taxes, imposing the property tax more uniformly can simplify the administration of the tax and improve its efficiency. Even with this, the state will probably need to support education programs to help taxpayers understand what will surely remain a complicated tax.

The Minnesota property tax includes numerous provisions, such as the education homestead credit, the senior citizens’ property-tax deferral program, and the “circuit breaker” property-tax refund, that are meant to keep homestead property taxes low relative to household income. In a recent report, however, the Citizens’ League argued that programs targeted to households with tax bills that are high relative to family incomes account for only 10 percent of total homeowner property-tax relief. The other 90 percent of relief goes to taxpayers regardless of their ability to pay. To make the tax fairer, the Citizens’ League recommends placing greater emphasis on relief that is targeted to those taxpayers with the greatest need.

Corporate and Individual Income Taxes

Proposed changes to the state corporate and individual income taxes generally follow the basic reform strategy of broadening the bases of the taxes to make them simpler and less distorting to the economy.

For the corporate franchise tax, the state is evaluating ways to improve the performance of some credits, such as the Credit for Increasing Research Activities.

<table>
<thead>
<tr>
<th>Some Reform Options</th>
<th>Types of Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broaden tax base and lower tax rates</td>
<td>Sales</td>
</tr>
<tr>
<td>Flatten rate structure (reduce number of tax rates)</td>
<td>x</td>
</tr>
<tr>
<td>Simplify the tax</td>
<td>x</td>
</tr>
<tr>
<td>Shift tax from localities to state</td>
<td>-</td>
</tr>
<tr>
<td>Conform to other states’ taxes</td>
<td>x</td>
</tr>
<tr>
<td>Provide more targeted tax relief</td>
<td>-</td>
</tr>
<tr>
<td>Increase tax to pay for property tax shift</td>
<td>x</td>
</tr>
</tbody>
</table>

* Includes a statewide tax on business property

Table 1. Proposed reform options for various Minnesota taxes
As a simplification measure, the state is also considering repealing the corporate Alternative Minimum Tax and the corporate minimum fee. For individuals, the primary focus is on eliminating special tax benefits, lowering tax rates, and basing the tax on federal-adjusted gross income instead of federal taxable income. In an additional simplification effort, the state could merge all of the refundable state credits now targeted to the same low-income population into a single credit.

Conclusion
The kinds of changes to state taxes I have described in this article probably would indeed make the tax system easier to administer, easier for taxpayers to comply with, and more efficient. It will be difficult, however, for the legislature to eliminate tax provisions for which there is strong political support without providing substitute spending programs. Legislators will confront some tough choices: should they reduce old taxes that have worked reasonably well in the past? or enact new tax legislation?—legislation that alters the way vital government services—such as education—are funded in Minnesota.

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Table 2. Individual wage differences in 2000 compared to 1995

<table>
<thead>
<tr>
<th>Parameters</th>
<th>Average Wage Difference (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Education</strong></td>
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<tr>
<td>High-school diploma vs. high-school dropout</td>
<td>11.4</td>
</tr>
<tr>
<td>Two-year college degree vs. high-school graduate</td>
<td>11.4</td>
</tr>
<tr>
<td>Four-year college degree vs. two-year college degree</td>
<td>12.8</td>
</tr>
<tr>
<td>Four-year college degree vs. high-school graduate</td>
<td>24.2</td>
</tr>
<tr>
<td><strong>Years of Experience and Tenure</strong></td>
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<tr>
<td>One more year of experience vs. average experience</td>
<td>0.7</td>
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<tr>
<td>One more year of tenure vs. average tenure</td>
<td>0.2</td>
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<tr>
<td><strong>Gender</strong></td>
<td></td>
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<tr>
<td>Women vs. men</td>
<td>-23.8</td>
</tr>
<tr>
<td><strong>Operation Size</strong></td>
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<tr>
<td>One more full-time employee vs. average number of full-time employees</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Annual Hog Production</strong></td>
<td></td>
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<tr>
<td>1,000–10,000 vs. 1000</td>
<td>-5.3</td>
</tr>
<tr>
<td>Over 10,000 vs. 1,000–10,000</td>
<td>21.6</td>
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<tr>
<td>Over 10,000 vs. 1000</td>
<td>16.4</td>
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<tr>
<td><strong>Region of Employment</strong></td>
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<tr>
<td>Northeast vs. Midwest</td>
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<tr>
<td>Southeast vs. Midwest</td>
<td>6.4</td>
</tr>
<tr>
<td>West vs. Midwest</td>
<td>-12.2</td>
</tr>
</tbody>
</table>

**Notes**

Midwest region: IA, IL, IN, MN, MO, ND, NE, OH, SD, and WI.
Northeast region: CT, MD, ME, MI, NJ, NY, and PA.
Southeast region: AL, FL, GA, KY, LA, MS, NC, SC, TN, VA, and WV.
West region: AK, AR, AZ, CA, CO, HI, ID, KS, MT, OK, OR, TX, UT, WA, and WY.

(Wages from page 5)

**Gender: Women Still Earn Less**

As in other industries, women working in the pork industry in 2000 earned 23.8 less than men—even after adjusting for education, job experience and tenure, size of operation, and location. For women, this represents an improvement over 1990 when they earned 30.9 less than men, but is a step backwards from 1995, when women earned only 17.5 percent less.

**Size of Operation**

Larger operations pay higher wages. On average in 2000, the addition of one full-time employee to a firm’s payroll increases the wages of all workers by 0.4 percent—a result that has not changed much from 1990 to 2000.

The relationship between operation size and average wages, however, was not linear. Workers in small operations (producing fewer than 1,000 hogs per year) earned 5.3 percent more than those working in medium-sized operations (producing between 1,000 and 10,000 hogs per year). Similarly, workers in small operations earned 16.4 percent less than those working in large operations (producing more than 10,000 hogs per year). It is interesting to note that between 1990 and 2000, the wages paid by large operations decreased relative to small operations, but increased relative to medium-sized operations.

**Regional Differences**

Regional differences are also apparent in our survey data. In comparison to the Midwest region, workers in the Northeast and West are paid less, whereas workers in the Southeast are paid more. From 1990 to 2000, wages in the Midwest increased in comparison to the Northeast and West, but decreased in comparison to the Southeast.

**Relative Pork-Industry Wages**

The NPPC-NHF surveys also allow us to look at how wages in Minnesota’s pork industry compare to the national pork-industry average, and how the national average wage in the pork industry compares with other U.S. industries. Figure 2 shows average pork-industry wages in Minnesota and nationally for 1990–2000, as well as the average wage of civilian workers for the economy as a whole (as reported by the U.S. Bureau of Labor Statistics).

In 1990, the average national wage in the pork industry was only $18,900, and pork-industry wages in Minnesota—at $17,500—were even lower. The national wage was 18 percent lower than the average civilian wage of $23,000. Moreover, in 1990 Minnesota’s pork-industry wages were 7 percent less than the national average, and 24 percent lower than the average civilian wage.

Between 1990 and 2000, the wage gap between the Minnesota and national pork industries closed—as did the gap between the national pork industry and the average civilian wage. The average wage in the pork industry has risen to within 1 percent of the average civilian wage. Similarly, the average wage in the Minnesota pork industry was only 3 per-
cent less than the national pork-industry average, and only 4 percent less than the average civilian wage.

Why Do Minnesota Pork-Industry Wages Still Trail?

Figure 2 shows that wages in the Minnesota pork industry have persistently lagged behind the industry as a whole—but also shows that, during the past 10 years, this gap has been closing. What is responsible for the persistence of lower-than-average wages in Minnesota, and why has this gap been closing?

Figure 3 shows that the educational attainment of employees in the Minnesota pork industry lags behind the national average. About 43 percent of Minnesota and, indeed, 43 percent of all pork-industry workers have only a high-school education. Most workers in Minnesota who extended their education beyond high school obtained a two-year college degree, whereas most workers outside Minnesota obtained a four-year college degree. Similarly, the average worker in Minnesota’s pork industry has significantly less job experience and tenure (12 months and seven months, respectively) than the average pork-industry worker in the U.S. Finally, a larger percentage of workers in Minnesota’s pork industry are women—13.8 as compared to 11.1 percent nationally. In summary, wages in Minnesota’s pork industry are lower than the national average because the state’s workforce is less educated, less experienced and tenured, and there are, proportionally, more women compared to the rest of the nation.

Industry Expansion and Worker Education Boosted Wages

Pork-industry wages in 1990 were low in comparison to other industries, but strong wage growth between 1990 and 2000 made pork-industry wages more comparable with other industries. What accounted for this growth? An in-depth analysis of the survey data reveals that the reasons for the observed—and vigorous—growth in the early and late 1990s was powered by different factors.

In 1990, low wages in the pork industry made it hard to attract and retain the skilled employees the industry needed to grow bigger and introduce new technologies. To bring pork-industry wages more in line with other industries, there was a general increase in wages for workers throughout the industry. From 1990 to 1995, the wages of all pork-industry workers increased roughly $5,000—regardless of the workers’ education, job experience and tenure, size of operation where he or she worked, and employment location.

While strong growth continued from 1995 to 2000, not all employees benefited equally from a further overall boost in wages of roughly $5,000. Instead, a worker’s wages increased only if he or she returned to school for more education or went to work for a larger operation.

Future Trends

Today, the pork industry offers competitive wages and attracts skilled workers to well-paid jobs throughout Minnesota. No one, however, should expect pork-industry wages to outpace the economy as a whole, because the industry has achieved near parity with the average national civilian wage. Nonetheless, individuals in the pork industry can still increase their wages in the coming years by becoming more educated, acquiring more on-the-job experience, and accumulating more years of tenure on the job.

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