Minnesota's Changing Business Property Taxes

Where We Are, How We Got There

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Analysis By Jeff Van Wychen, Tax Consultant
Commissioned by the Minnesota Rural Education Association

MREA
Voice For Greater Minnesota Education

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Executive Summary

The conventional wisdom—that business property taxes in Minnesota are higher than residential taxes—is correct. Residential property taxes are lowered—and business property taxes are raised—through Minnesota's property classification/class rate system, homestead market value exclusion, and other factors. However, these effects are partially reversed through Minnesota's personal property exemption, which has the effect of shifting taxes away from businesses and on to residential and other classes of property. All things considered, the average 2019 commercial effective tax rate (ETR) is approximately double that of the residential properties, while the average industrial ETR is approximately 40% higher.

Two approaches to examining Minnesota business property taxes relative to other states are examined in this report. The first—the *50-State Property Tax Comparison Study* from the Minnesota Center for Fiscal Excellence (MCFE)—indicates that business property taxes in Minnesota are generally high relative to other states, while the second—a comparison of business property taxes per capita and per private sector employee calculated using data from the annual Ernst & Young (EY) business tax report—indicates that they are low.

However, both approaches have limitations. The MCFE study benchmarks Minnesota urban and rural taxes to two cities that have atypically high tax rates relative to other urban and rural communities in the state. These two cities are compared to urban and rural cities in other states which may not be representative of other cities in those states. In addition, the study uses assumptions regarding the share of total commercial value that is personal that are below that estimated by the Minnesota Department of Revenue; this has the effect of understating the benefit that Minnesota commercial properties derive from the personal property tax exemption and overstating Minnesota business property taxes relative to other states.

Meanwhile, the measure of business property taxes used in the EY report includes taxes on residential rental property; insofar as many states—including Minnesota—tax rental property differently than other business properties, business property taxes per capita and per private sector employee calculated using this data become less representative of the property taxes paid by commercial and industrial properties.

Within the various subcategories of commercial and industrial property, there is tremendous variation in the share of total value that is comprised of personal property; these variations cause large variations in business property taxes among these subcategories, depending on state tax policy regarding the taxation of personal property. Any comparison that lumps all commercial or industrial property together under a narrow range of personal property assumptions is not likely to produce findings that are meaningful for many of the subcategories of commercial and industrial property.

The gap between business ETRs and residential ETRs has shrunk since 2000—and especially since 2002. Expressed another way, the degree of preferential tax treatment enjoyed by residential properties relative to business properties has declined over the course of the 21st century. The reasons for this include:

- *Increased dependence on referendum market value levies, driven largely by a decline in real (i.e., inflation-adjusted) per pupil state aid to school districts.* Per dollar of total value, referendum market value levies generally fall more heavily on residential properties than on commercial and industrial properties. Hence, the rapid growth in referendum market

value levies has caused residential property taxes to increase more rapidly than business property taxes.

- *Large business class rate reductions enacted in 2001.* Over the long-term, these class rate reductions have caused a larger share of local property tax increases resulting from real per capita state aid reductions to fall on residential and other classes of property and a smaller share to fall on business properties.
- *Caps on growth in the state business property tax.* The state business property tax was initially imposed to offset the large tax relief that businesses received through class rate reductions; the revenue generated from this tax would help to pay for increases in state aid to school districts and other state funding obligations. Because growth in this levy was capped at the rate of inflation—and later frozen entirely—businesses were partially insulated from the effects of aid reductions, population growth, and other factors that were pushing local property taxes upward.
- *The phase-out feature of the homestead market value credit (HMVC) and—later—the homestead market value exclusion*. These phase-outs caused the tax benefit of HMVC and market value exclusion to shrink as homestead values grew beyond $76,000. In concert with rising home values, these phase-outs contributed to reduced tax relief for homesteads and accelerated growth in homestead property taxes. As the portion of homestead value excluded from taxation declines, the share of local property taxes paid by homeowners increases and the share paid by business and other classes of property decreases, all other things being equal.

Other legislative efforts—most notably, the expansion of the homeowners and renters property tax refunds—offset a portion of the growth in residential property taxes. However, even after factoring in the impact of the expanded PTRs—residential property taxes per dollar of value have increased by 7% since 2002, while commercial and industrial property taxes per dollar of value have declined by 8% and 9% respectively.

Lower ETRs for residential properties vis-à-vis businesses has been justified on the basis that housing is a necessity and thus the cost of housing should be reduced through preferential tax treatment, just as groceries are exempted from the sales tax. Another argument for preferential homestead tax treatment is that homeownership is associated with positive social outcomes, such as increased civic engagement, more stable neighborhoods, improved academic performance among children, and greater financial security. Furthermore, business properties often consume more public services per dollar of market value (e.g., increased traffic associated with retail businesses) or are associated with other negative externalities (e.g., noise or pollution associated with some industries) and thus should pay a higher ETR.

In 2019, owners of residential properties continue to enjoy lower effective tax rates than owners of business property. However, the preferential tax treatment afforded to residential property has eroded over the last twenty years in a way that has contributed to a decline in real per capita business property taxes and a reduced share of total statewide property taxes borne by businesses.

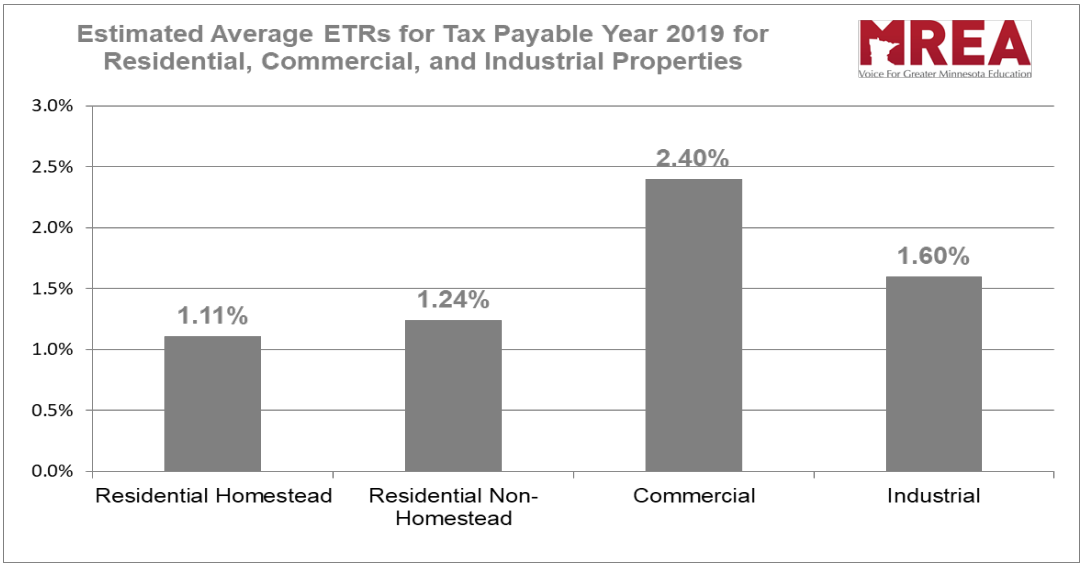
The findings presented in this paper do not point toward any single goal or objective. However, this empirically based perspective regarding the current level of business property taxes and the examination of the forces behind trends in business property taxes relative to other classes of property will hopefully contribute to a more informed debate over proposed changes to Minnesota's property tax system.

Part 1: Where We Are

Due to various provisions of state law, Minnesota businesses generally pay more property taxes per dollar of total value than do other classes of property. The following analysis will compare the aggregate effective tax rates of the two largest classes of business property—commercial and industrial—to the two largest classes of residential property—residential homestead and residential non-homestead.[1] In addition, business property taxes in Minnesota will be compared to other states using two different approaches.

Effective Tax Rates

The effective tax rate (ETR) is equal to the gross taxes paid by a property divided by the property's market value. The estimated average ETRs based on total property value—including both real (land and buildings) and personal (equipment, fixtures, and inventories) property—are shown below for residential homestead, residential non-homestead, commercial, and industrial properties. Tax levels for each category of property were calculated using levy information and preliminary real property value information for taxes payable in 2019 from the Minnesota Department of Revenue (MDOR). The personal value of each category of property was estimated based on data from MDOR and other sources.[2]



[1] Based on 2018 assessment data, these four categories of property comprise 67% of all taxable value in the state.

[2] Because personal property in Minnesota is not taxable, there is no precise accounting of the total value of personal property in the state. The value of commercial and industrial personal property used here was estimated using information compiled by MDOR in preparation of the 2019 Minnesota Tax Incidence Study; according to these MDOR estimates, 70.4% of all commercial value is real and 29.6% is personal, while 46.6% of all industrial value is real and 53.4% is personal. For residential properties, it is estimated that 87.5% of value is real and 12.5% is personal; this estimate is based upon the 2002 *50-State Property Tax Comparison Study* published by the Minnesota Taxpayers Association. (While no states currently tax residential personal property, it is necessary to include it in this analysis to get an apples-to-apples comparison to commercial and industrial ETRs that include personal value.) Total value for each property type (used in calculating the average ETR) was calculated by dividing real value by the real value percentage. For each category of property, it is assumed that the real and personal property percentages are uniform throughout the state.

The two classes of business property—commercial and industrial—have higher average ETRs than the two classes of residential property. The average commercial ETR is approximately double that of the residential properties, while the average industrial ETR is approximately 40% higher.

There are several reasons why residential properties have lower estimated ETRs than commercial and industrial properties. First, residential "tax capacity"—the tax base against which most property taxes are levied—is considerably lower per dollar of taxable market value for residential properties than for commercial and industrial properties.[3] Second, a portion of the residential homestead value is excluded from tax capacity levies due to the homestead market value exclusion.[4] Third, unlike commercial and industrial properties, residential property does not pay the state business property tax.[5]

The advantages that residential properties derive from these features are partially offset by the fact that—unlike most other states—personal property in Minnesota is not subject to local property taxes. For most types of commercial and industrial property, the portion of total value that is personal is much greater than it is for residential properties.[6] Thus, the exemption of personal property shifts property taxes away from commercial and industrial properties and on to residential properties, effectively negating a portion of the benefits that residential properties derive from the property classification/tax capacity system and the homestead market value exclusion. ETRs calculated based on taxable (as opposed to total) value overlook the advantages that commercial and industrial properties derive from the exclusion of personal property, thereby overstating average commercial and industrial ETRs relative to residential properties.

There is tremendous variation within the various types of commercial and industrial properties in terms of the real versus personal property mix. For example, for real estate businesses, MDOR estimates that the percentage of total property value that is personal to be 4%—well below the 29.6% average for all commercial property. Meanwhile, for wholesale trade, 66% of total property value is personal—more than double the commercial property average. For this reason, average commercial and industrial ETRs frequently are not representative of the ETRs for specific subcategories of commercial and industrial property. In fact, some subcategories of commercial and industrial property with extremely high percentages of personal value have ETRs below the residential average.

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[3] The tax capacity of residential homestead and non-homestead 1-3 unit rental properties equals 1.0% of the first $500,000 of taxable value and 1.25% of taxable value in excess of $500,000. The tax capacity of commercial and industrial properties equals 1.5% of the first $150,000 of taxable value and 2.0% of taxable value in excess of $150,000. The percentage by which a property's taxable value is multiplied by in order to get its tax capacity is referred to as its "class rate" (e.g., the class rates for residential homesteads are 1.0% and 1.25% and the class rates for commercial and industrial properties are 1.5% and 2.0%).

[4] Forty percent of the first $76,000 of taxable homestead value is excluded from tax capacity levies; the exclusion phases out at the rate of 9 cents per dollar of taxable value in excess of $76,000, so that the exclusion is zero for homes with a taxable value of $413,778 and above. The homestead market value exclusion does not apply to referendum market value levies.

[5] For tax payable year 2019, commercial, industrial, and other designated business properties pay a state property tax equal to 42.416% of tax capacity.

[6] See footnote 2 for estimates of personal property value as a percentage of total value for commercial, industrial, and residential properties.

Advocates have advanced several reasons why residential properties should have lower ETRs than businesses. For example, it is argued that housing is a necessity and thus the cost of housing should be reduced by providing preferential tax treatment, just as we exempt food from the sales tax. Also, it has been argued that homeownership is associated with positive social outcomes, such as increased civic engagement and political participation, more stable neighborhoods, improved academic performance among children, and greater financial security for families.[7] In addition, it is argued that business properties often consume more public services per dollar of market value (e.g., increased traffic associated with retail businesses) or are associated with other negative externalities (e.g., noise or pollution associated with some industries) and thus should pay a higher ETR.

Business Property Tax Rankings

This section will consider two approaches to measuring the level of Minnesota business property taxes relative to business property taxes in other states. The first of these is a comparison of ETRs for hypothetical business properties in each state as calculated by the Minnesota Center for Fiscal Excellence (MCFE). The second is a comparison of aggregate business property taxes per capita and per private sector employee, derived from data contained in a report published annually by Ernst & Young in conjunction with the Council on State Taxation and the State Tax Research Institute.

Proponents of business property tax relief contend that Minnesota business property taxes are high relative to other states. The *50-State Property Tax Com parison Study* from the MCFE is frequently cited in support of this claim. This report compares commercial and industrial property taxes for hypothetical businesses in two Minnesota cities to businesses of identical value located in designated cities in other states. Specifically, Minneapolis is compared to the largest city in other states,[8] while Glencoe—the seat of McLeod County—is compared to a "rural city" selected from other states. The rankings of Minneapolis and Glencoe based on the MCFE study for tax payable year 2016 are presented below.

Property Type; Total Value;[9] % of value personal	**Minneapolis ranking[8]**	**Glencoe ranking**
Commercial: $120,000 total value; 16.67% personal value	17	6
Commercial: $1.2 million total value; 16.67% personal value	9	2

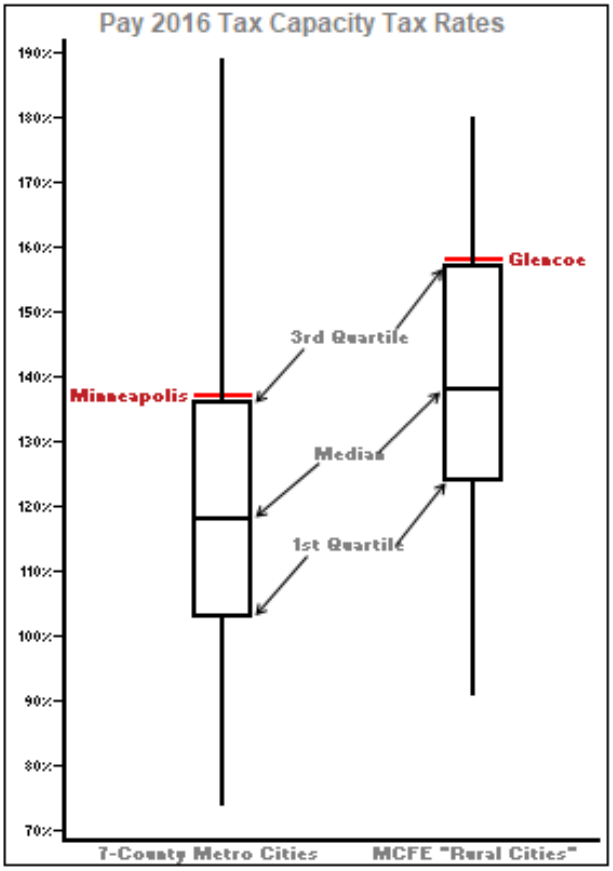
[7] Some of these claims have been disputed in the aftermath of the bursting of the housing bubble, especially claims associating homeownership with greater financial security. However, research indicates that as the housing crisis recedes, societal attitudes regarding the merits of homeownership are rebounding,

[8] In the MCFE study, two cities in Illinois and New York are included in the rankings. In addition to the largest city in these two states, two other cities are included because the tax systems in the largest cities "are significantly different from the rest of the state." If only the largest city in each state were included in the ranking, Minneapolis' rank would increase by two places for the $120,000 commercial property (from 17th to 15th), the $200,000 industrial property with 50% personal value (from 26th to 24th), and the $250,000 industrial property with 60% personal value (from 31st to 29th). For the other six commercial and industrial properties examined in the MCFE study, Minneapolis' rank would increase by one place.

[9] The MCFE study presents the real (i.e., land and buildings) value of the properties examined, along with the personal property as a percentage of real value. In this table, the equivalent total (i.e., real and personal) value is listed, along with the percentage of total value that is personal. In most states, commercial and industrial property taxes are levied against total value, not just real value.

Commercial: $30 million total value; 16.67% personal value	9	2
Industrial: $200,000 total value; 50% personal value	26	13
Industrial: $2 million total value; 50% personal value	18	7
Industrial: $50 million total value; 50% personal value	18	7
Industrial: $250,000 total value; 60% personal value	31	15
Industrial: $2.5 million total value; 60% personal value	25	12
Industrial: $62.5 million total value; 60% personal value	22	13

Tax levels for Minneapolis are frequently cited as the basis for Minnesota's urban ranking, while tax levels for Glencoe are cited as the basis for Minnesota's rural ranking. However, property tax rates in Minneapolis are generally higher than property tax rates for other urban communities in Minnesota; similarly, property tax rates in Glencoe are generally higher than those of other rural communities in the state. The box and whisker chart below shows the distribution of pay 2016 local tax capacity tax rates among urban communities—defined as cities in the seven-county metropolitan area—and rural communities—defined using criteria set by the MCFE in the Property Tax Comparison Study.[10] In tax payable year 2016, most of the property taxes paid by Minnesota businesses were generated via the local tax capacity tax rate.



[10] In the MCFE study, rural cities generally must meet three criteria: (1) have a population between 2,500 and 10,000; (2) be the seat of their county; and (3) be located in a non-metro county with a population between 2,500 and 19,999, as determined by the U.S. Department of Agriculture. In Minnesota, 27 cities meet this definition of "rural."

The pay 2016 tax capacity tax rate was 136.82% for Minneapolis and 158.26% for Glencoe. The rates for both cities were significantly above the median for their respective groups (118.43% for 7-county metro cities and 138.08% for MCFE "rural cities"). In fact, tax rates for both cities fall within the fourth—or highest—quartile, meaning that 75% of the cities in each group have tax rates below the Minneapolis and Glencoe tax rates. Minneapolis and Glencoe tax capacity tax rates are significantly above the tax rates of other cities in their respective groups, even if we use alternative definitions of "urban" and "rural."[11]

Given that local property taxes as a percent of value are significantly higher in Minneapolis and Glencoe than in other cities in their respective regions, it is plausible to argue that these two cities are not representative of "urban" and "rural" property taxes in Minnesota generally. The MCFE study compares two relatively high tax Minnesota cities to cities in other states with property tax levels which may or may not be representative of tax levels of other urban and rural communities in those states.

The MCFE acknowledges that "…caution is needed when extrapolating findings for a single city to an entire state." This admonition is especially applicable when the cities being examined are not representative of other cities in the state. Caution should be exercised when making generalizations about Minnesota property taxes based on this sort of information.

Assumptions regarding the mix of total value between real and personal property have a significant impact upon how states rank in terms of commercial and industrial property tax levels. According to MDOR data, 46.6% of industrial value is real and 53.4% is personal; the MCFE calculates industrial property taxes using two different personal property assumptions. The first assumption (50% personal) modestly understates the personal property percentage relative to the MDOR estimate, while the second (60% personal) modestly overstates it; combined the two industrial scenarios presented by the MCFE adequately frame the average industrial personal property percentage as estimated by MDOR.

As noted above, 70.4% of commercial value is real and 29.6% is personal, based on MDOR estimates; even if we ignore inventories (i.e., include only equipment), the average commercial property percentage based on MDOR data is 23.1%. Both percentages are modestly to significantly above the 16.67% personal commercial value assumption used by the MCFE in the *50-State Property Tax Comparison Study.*

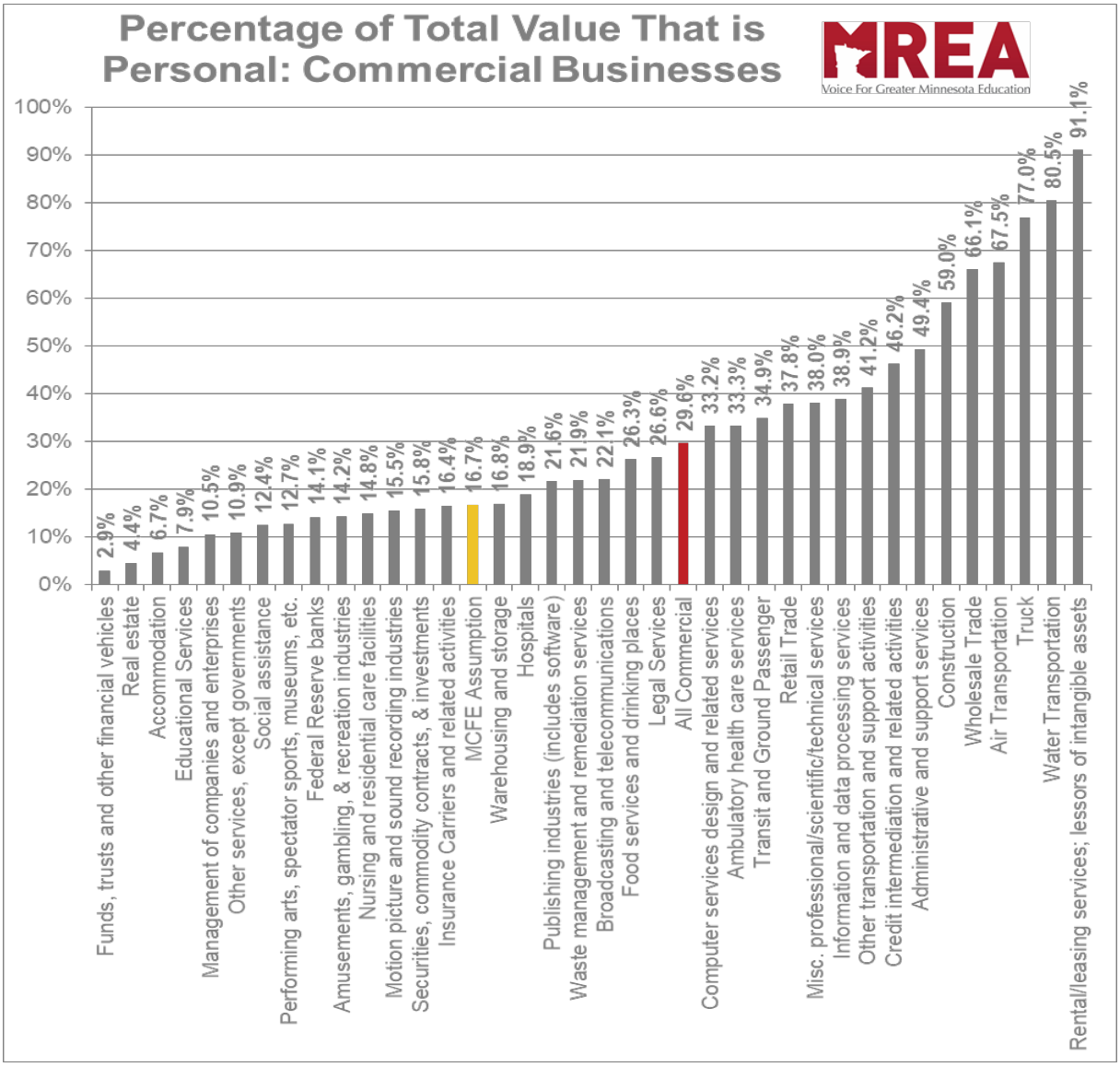
Minnesota is one of 13 states that do not tax business personal property. Interstate comparisons of commercial property tax levels that understate the percentage of total value that is personal will understate the tax benefit that businesses derive from the personal property exemption and overstate commercial property taxes in the 13 states where personal property is exempt relative to the 37 states where it is not. Thus, insofar as the commercial personal property percentage used in the MCFE study is below the average for commercial properties generally, the findings in the study will overstate commercial property taxes in Minnesota relative to the majority of states where personal property is taxable.

A close examination of data compiled by MDOR reveals that subcategories of commercial and industrial property vary tremendously in terms of the percentage of total value that is personal.

[11] For example, if we define "urban" as cities of the first or second class (i.e., all cities with a population over 20,000) or as communities within a metropolitan statistical area, the resulting average pay 2016 tax capacity tax rate of each group (124.71% and 114.68% respectively) is still significantly below the Minneapolis' tax capacity tax rate.

For example, real estate businesses derive little advantage from Minnesota's personal property tax exemption, since—as noted above—only 4% of real estate business value is personal; by using a 16.67% estimate, the *50 State Property Tax Comparison Study* overstates property taxes on real estate businesses in Minnesota relative to other states. On the other hand, 66% of the value of wholesale trade businesses is personal, according to MDOR estimates; these properties derive a large advantage from Minnesota's personal property exemption. Calculation of commercial property taxes using a 16.67% estimate will overstate wholesale trade property taxes in Minnesota relative to other states.

The following chart shows the average percentage of total value that is personal for various subcategories of commercial businesses based on MDOR data. Fewer than half of the 37 subcategories of commercial property examined by MDOR are within 10 percentage points of the commercial personal property percentage used in the MCFE study (i.e., from 6.67% to 26.67%), while fewer than a third are within five percentage points (i.e., from 11.67% to 21.67%). Thus, for many types of commercial property, rankings based on the 16.67% assumption are not particularly relevant.



The issue is not whether the MCFE rankings are accurate. They likely are accurate reflections of commercial and industrial property tax rankings *under the methods and assumptions stated in the MCFE study.* The issue is whether the methods and assumptions produce meaningful interstate comparisons of urban and rural property taxes generally. For example, Minnesota's urban and rural ranking would drop (i.e., business property levels relative to other states would diminish) if they were based on communities that were more representative of property taxes in other urban and rural communities. For commercial properties, Minnesota's ranking would drop if the personal property percentage used were closer to the average calculated by MDOR.

While these changes would lower Minnesota's urban and rural tax ranking, it is still unclear if they would result in an overall ranking that is truly useful, for two reasons. First, we do not know if the urban and rural cities selected from other states are representative of other urban and rural cities in those states. Second, given the tremendous variation among different types of commercial and industrial property in terms of the percentage of total value that is personal, it is doubtful that a tax ranking based on the average personal property percentage would be meaningful for most categories.

The MCFE approach to interstate comparison of business property taxes is based on a hypothetical property in specific communities in each state. An alternative approach would be to compare the sum of all business property taxes in each state relative to the state's population or the number of private sector employees.[12] Total business property taxes in each state and the number of private sector employees[13] is available from the annual *Total State and Local Business Taxes* report, prepared annually by Ernst & Young (EY) LLP in conjunction with the Council on State Taxation and the State Tax Research Institute; the most current report is based on fiscal year (FY) 2017 data. Population data from each state is available from the U.S. Census Bureau.[14] By combining data from these two sources, it is possible to develop an alternative approach to comparing business property taxes in the fifty states.

State and local business property taxes per capita range from a high of $1,760 in Vermont to a low of $410 in Alaska. Minnesota's 2017 business property taxes per capita were $790, 10% less than the national average of $880. Relative to the other fifty states, Minnesota ranks 25th in 2017 business property taxes per capita.[15]

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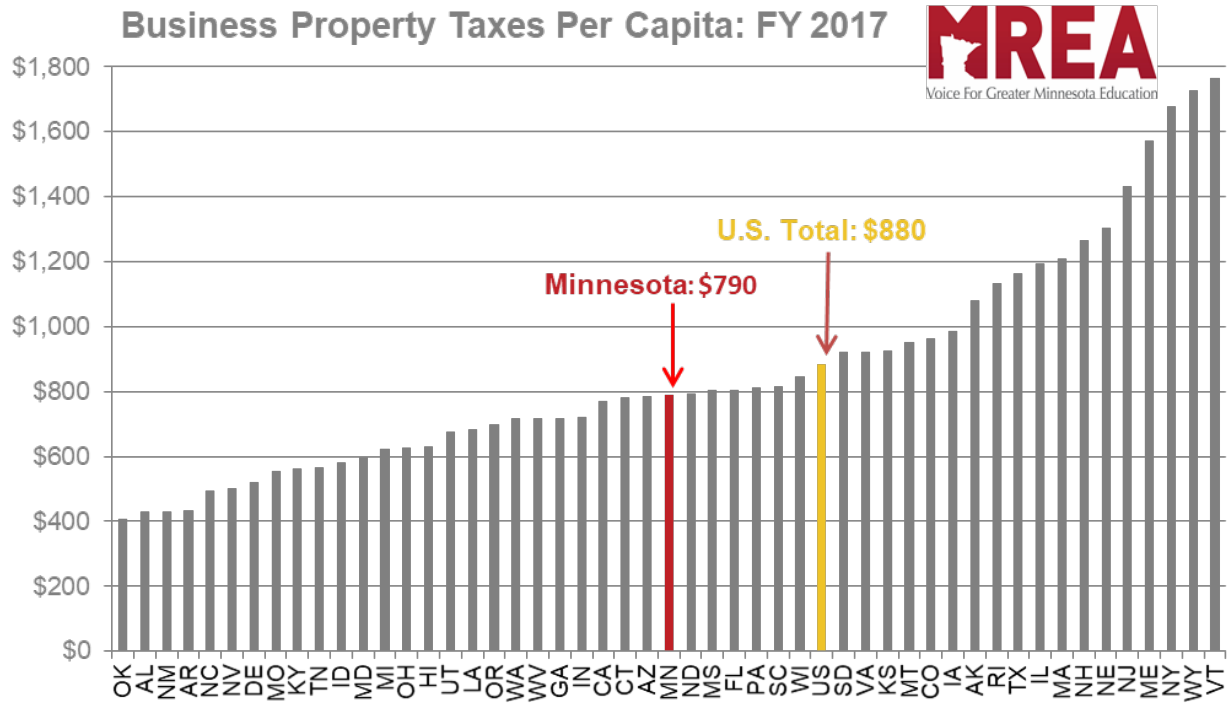
[12] It would be useful to calculate an aggregate business effective tax rate by dividing (1) total business property taxes by (2) the market value of total real and personal business property in each state. However, we could not locate total business market value amounts for each state.

[13] *Total State and Local Business Taxes* does not list the total number of private sector employees in each state, but this amount can be estimated for each state using other data provided in the report.

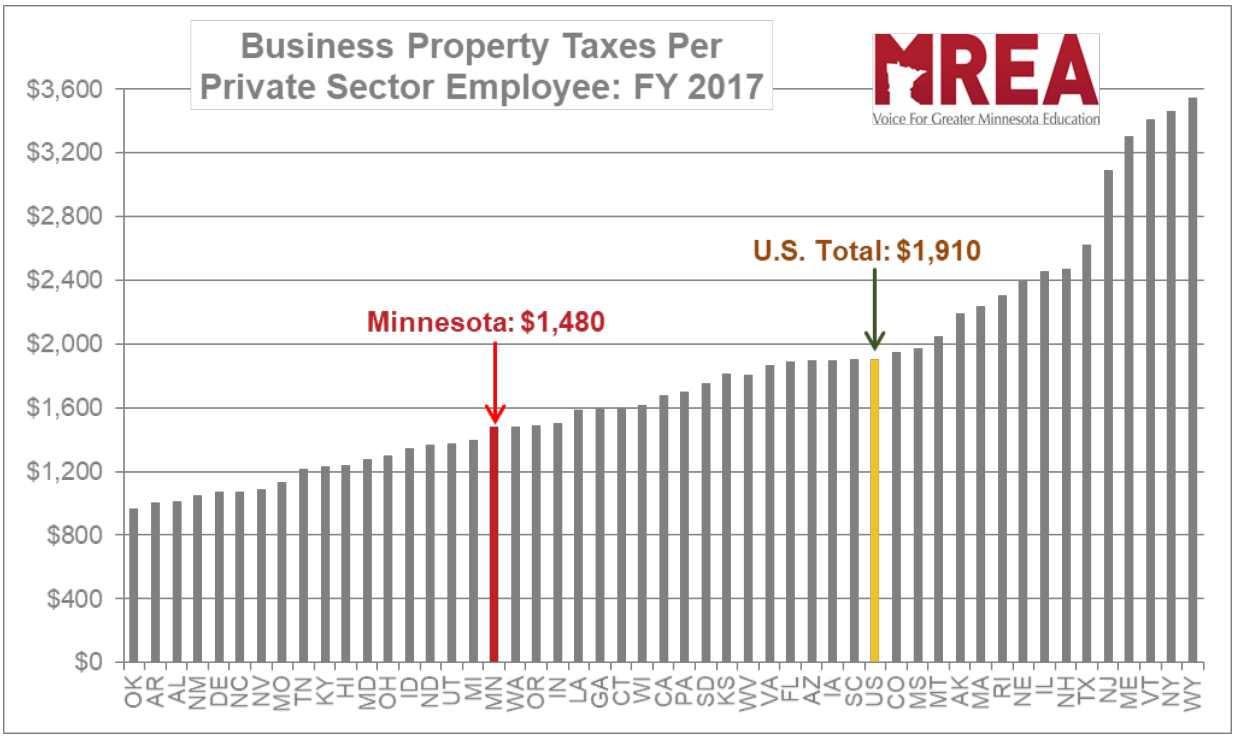
[14] Census Bureau population estimates as of July 1, 2017 were used to calculate business property taxes per capita in each state.

[15] The rounding of amounts reported in EY's *Total State and Local Business Taxes* results in some imprecision in calculating business property taxes per capita; this imprecision is greatest for smaller states with relatively low total business property taxes. The amounts reported here for each state represent the midpoint of a range of possible values. For example, Minnesota's business property taxes per capita could range from a low of $780 to a high of $800 and its rank relative to other states could range anywhere from 23rd to 27th.



Business property taxes per capita should be lower in states with relatively low business activity or that have a relatively large percentage of people who are not employed (e.g., retirees). An arguably better approach would be to examine business property taxes relative to the number of people actually employed by businesses. State and local business property taxes per private sector employee range from a high of $3,550 in Wyoming to a low of $970 in Oklahoma. Minnesota's 2017 business property taxes per private sector employee were $1,480, 23% less than the national average of $1,910. Relative to the other fifty states, Minnesota ranks 33rd (i.e., 32 states had higher business property taxes per private sector employee, while 17 states had lower taxes).[16]

[16] The rounding of amounts reported in EY's *Total State and Local Business Taxes* results in some imprecision in calculating business property taxes per private sector employee; this imprecision is greatest for smaller states with relatively low total business property taxes. The amounts reported here for each state represent the midpoint of a range of possible values. For example, Minnesota's business property taxes per private sector employee could range from a low of $1,440 to a high of $1,520 and its rank relative to other states could range anywhere from 30th to 35th.



Interstate business property tax comparisons derived from data in the EY report are not without limitations. For example, EY business property tax data include taxes on income-producing residential rental properties[17]; while it is reasonable to regard such properties as businesses, in many states—including Minnesota—the rate of taxation applied to residential rental properties is significantly different from that applied to other types of businesses. Including residential rental property taxes in the business property tax total will make the resulting interstate comparisons a less accurate reflection of the relative level of commercial and industrial property taxes in the various states.

In addition, interstate business property tax comparisons and tax rankings based on EY data have one of the same limitations as the MCFE property tax rankings in that they might not be representative of the taxes paid by most subcategories of business property. As noted above, there is tremendous variation among the various subcategories of commercial and industrial property in the percentage of total value that is comprised of personal property; these variations cause significant variations in business property taxes among these subcategories, depending on state tax policy in regard to the taxation of personal property. Thus, tax rankings based on overall business property taxes per capita or per private sector employee (or rankings based on a single assumption regarding the percentage of total value that is personal) are likely not a meaningful reflection of relative tax levels for many of the subcategories of business property.

Policymakers and the public often have a keen interest in state rankings—including rankings of business property taxes. However, in order to serve as a useful basis for crafting public policy, such rankings need to be reasonably accurate reflections of business property taxes in each

[17] For taxes payable in 2017, property taxes on residential rental property comprises 27% of all business property taxes (including commercial, industrial, public utility, 1 to 3 unit non-homestead residential , and apartment properties) in Minnesota, based on House Research simulation #18A4.

state for a substantial portion of business property. Each of the business property tax comparison approaches examined above have significant limitations in this regard. Perhaps the beginning of wisdom on the issue of interstate comparison of business property taxes is to admit what we do not know, rather than pretend that we know more than we do.

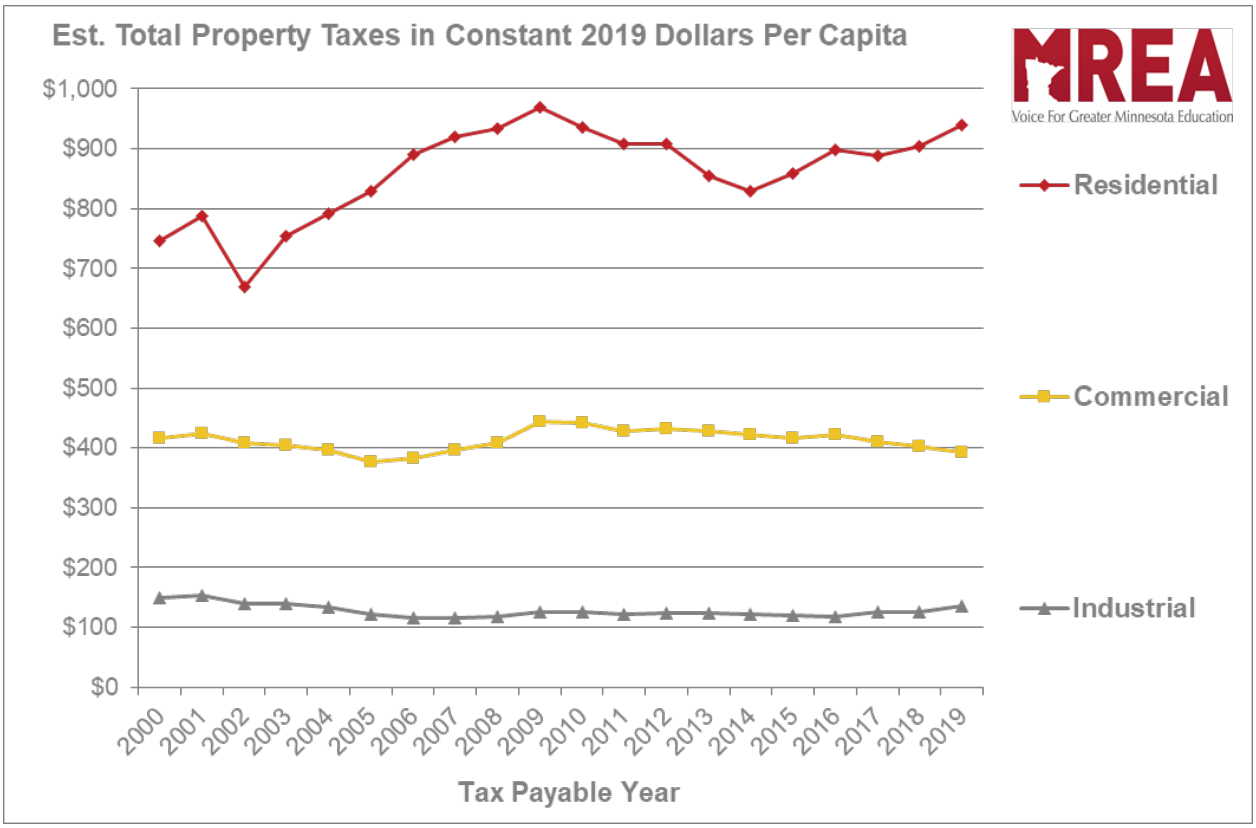
Part 2: How We Got There

For taxes payable in 2019, Minnesota business property taxes per dollar of value are significantly higher than those of residential property, as demonstrated in part 1. The first section of the second part of this paper will examine changes in business property taxes relative to residential property taxes over the course of the 21st century. The final three sections will examine forces that have contributed to changes in Minnesota property taxes since 2000 and that—in aggregate—have caused business property taxes to decline relative residential taxes; these include changes in state aid to school districts and other local governments, the 2001 tax act, and other miscellaneous changes.

Changes in Business Property Taxes Relative to Residential

The tax advantage that residential properties enjoy relative to business properties has eroded over the course of the 21st century. From 2000 to 2019,[18] property taxes on commercial and industrial properties increased by approximately 90%, while taxes on residential properties[19] increased by approximately 150%. A more meaningful comparison of property tax changes over time would take into account erosion in the purchasing power of the dollar due to inflation[20] and increased service demand and ability to pay due to population growth.

[18] Property tax amounts in this portion of the paper were calculated by the author using data from the Minnesota Department of Revenue. Data for years 2017 to 2019 are preliminary.
[19] During the housing crisis that began in 2008, many homestead properties converted to non-homestead residential (1-3 unit rental) properties; this trend accelerated the decline in homestead value and decelerated the decline in non-homestead residential value. To control for the valuation and tax effects caused by the conversion of homestead properties into rental properties, the longitudinal analysis in this section of the paper will focus on "residential" properties, which includes both homestead and non-homestead residential classes.
[20] Inflation adjustments in this paper are based on the Implicit Price Deflator for State & Local Government Purchases. All inflation-adjusted amounts will be expressed in constant 2019 dollars.



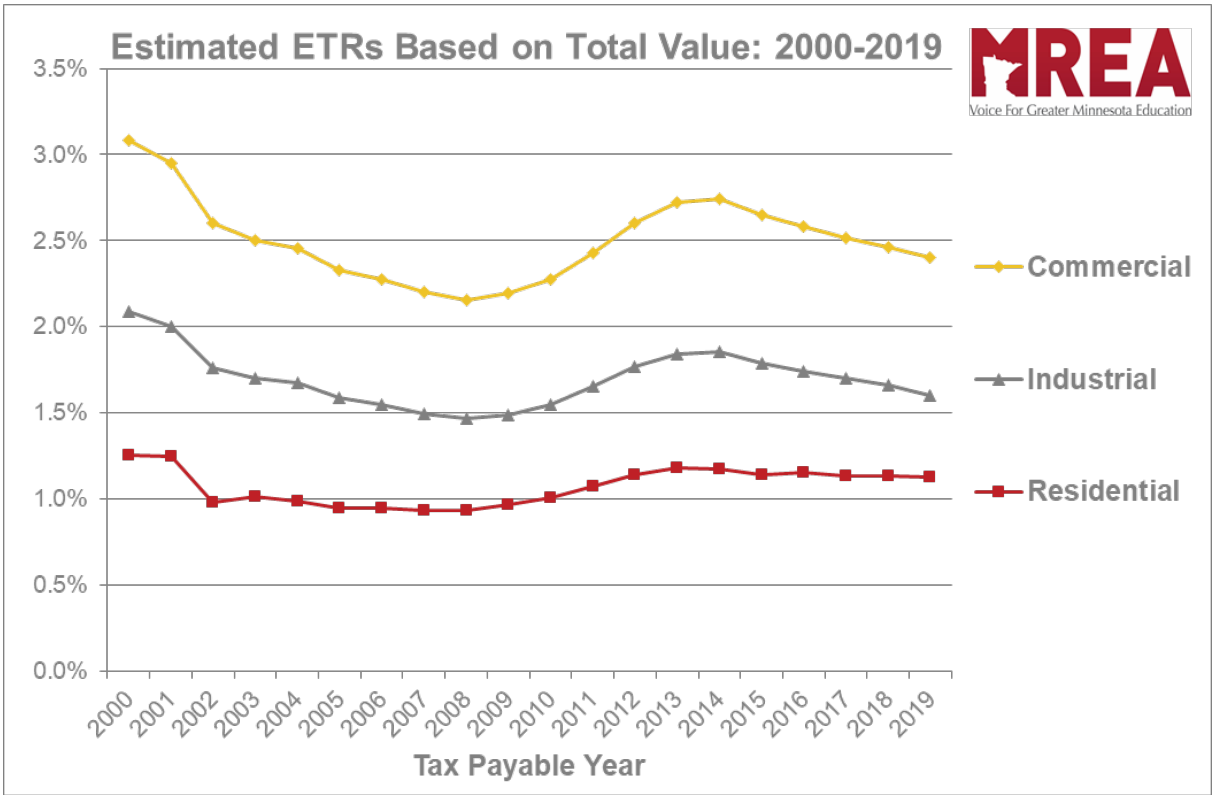
There has been significant variation in aggregate business and residential property taxes over the last twenty years. After adjusting for inflation and population growth, residential property taxes are significantly higher today than they were at the turn of the century, while commercial and industrial taxes are somewhat lower. In real (i.e., inflation-adjusted) dollars per capita, residential property taxes increased by 26% from 2000 to 2019, while commercial and industrial property taxes declined by 5% and 9% respectively.

Part of the reason for the sharp increase in real per capita residential property taxes and the decline in commercial and industrial taxes has to do with difference in the rate of value growth between these classes of property. Residential property values have increased by 182% (not inflation-adjusted) from 2000 to 2019, compared to just 143% growth in commercial and industrial values. The more rapid rate of growth in residential values contributed to a shift in property taxes away from commercial and industrial properties on to residential properties.

However, differences in the rate of value growth do not entirely explain the more rapid rate of tax growth among residential properties relative to commercial and industrial properties. Since 2000, property taxes as a percent of market value—a.k.a. the effective tax rate (ETR)[21]—for

[21] As in part 1 of this paper, the ETRs presented here will be based on total taxable value, including both real and personal property. The methodology for calculating total ETRs is described in footnote 2. A comparison of current MDOR estimates regarding the percentage of commercial and industrial value that is real versus the portion that is personal based on 2016 data is very close to those calculated based on 2004 data. For purposes of this analysis, it is assumed that the percentage of total value of property that is real versus the percentage that is personal has remained constant for all classes of property during the entire period since 2000.

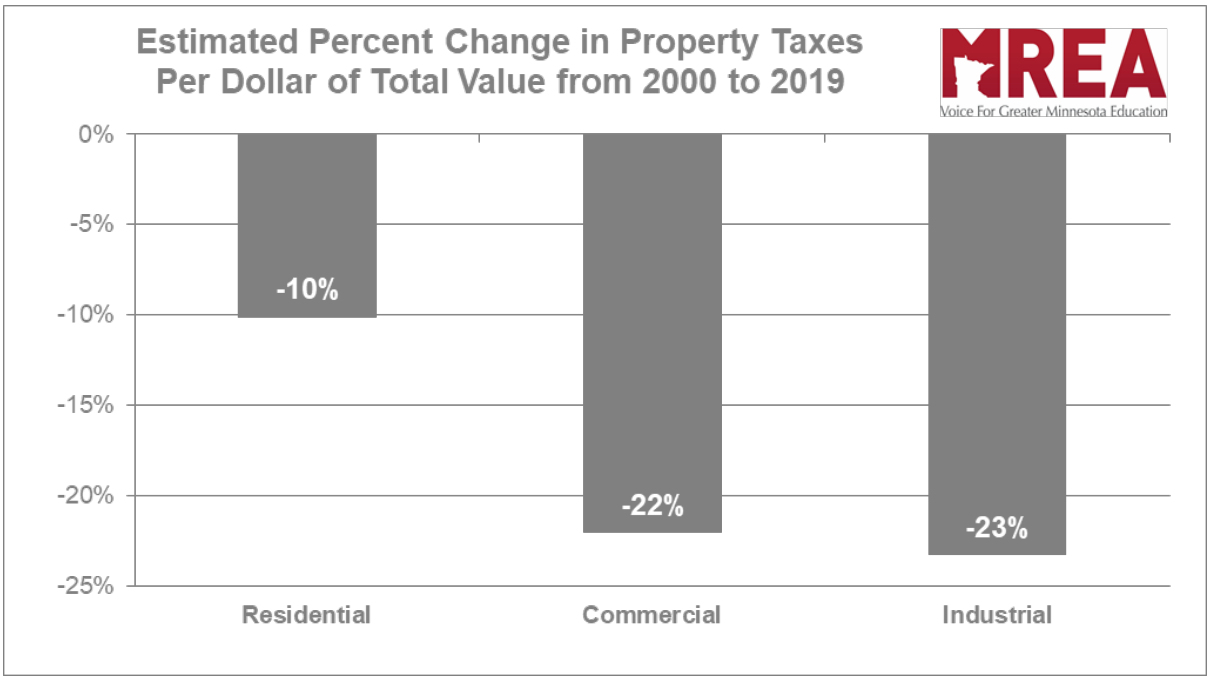
residential properties declined at a fraction of the rate of decline in commercial and industrial ETRs.



A rise in property values—led especially by soaring residential values—contributed to falling residential, commercial, and industrial ETRs during the period from 2000 to 2008. Declining values—driven primarily by falling residential values in the aftermath of the housing crisis—led to rising ETRs from 2008 to 2013.[22] Recovering values since approximately 2013/2014 have contributed to falling ETRs.[23]

However, trends in values do not explain differences between the various classes of property in terms of the rate of ETR change since the turn of the century. From 2000 to 2019, the statewide residential ETR fell from 1.25% to 1.12%—a 0.13% drop; in other words, the property tax per dollar of value declined by ten percent. Meanwhile, the commercial ETR declined from 3.08% to 2.40% (a 0.58% drop) and the industrial ETR fell from 2.09% to 1.60% (0.49% drop). Per dollar of market value, commercial and industrial property taxes fell by 22% and 23% respectively—more than double the rate of decline in residential property taxes.

[22] Strong growth in agricultural land values during this period partially offset the decline in total statewide property values and slowed the rate of growth in statewide ETRs.
[23] Here again, trends in agricultural land value functioned as a countervailing force. Declining agricultural land values slowed the rate of decline in statewide ETRs since tax payable year 2015.



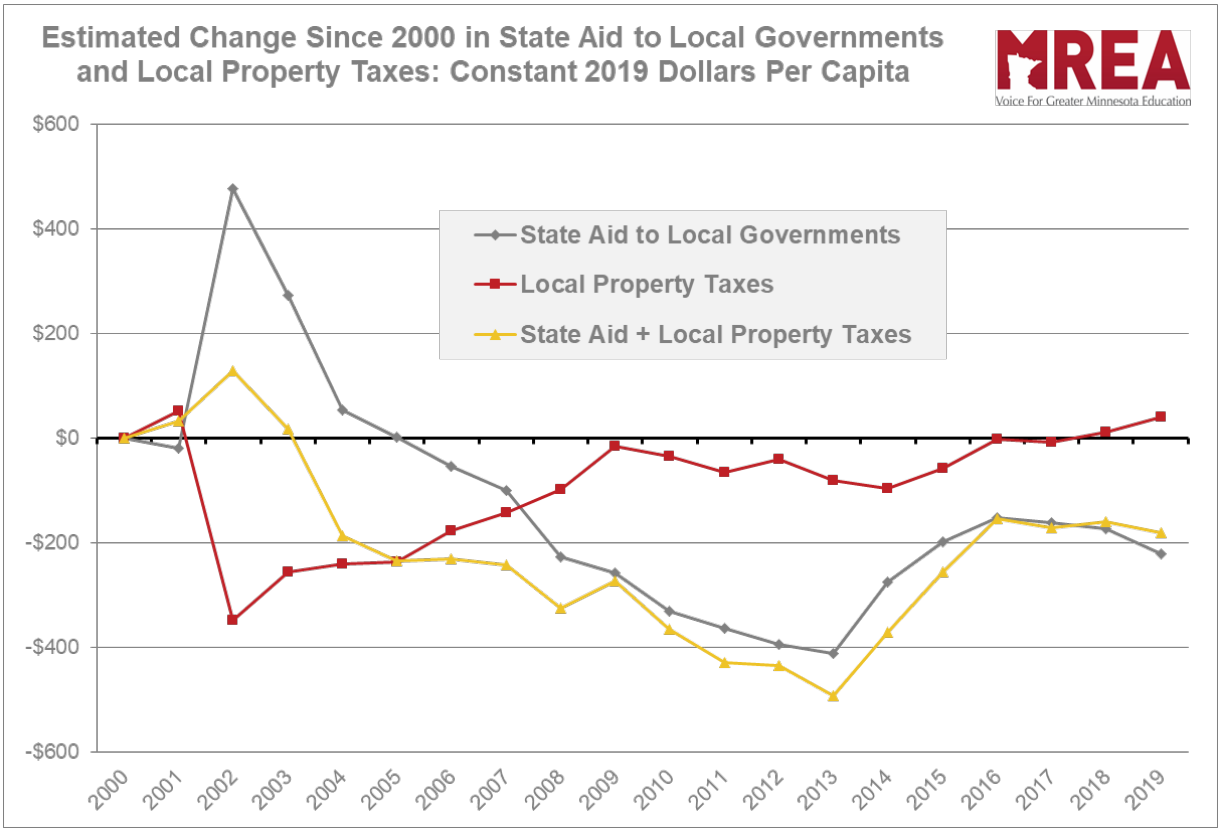
While changes in value played a role in changing property tax levels and changing ETRs, policy actions taken at the state and local levels were largely responsible for the change in total property taxes since 2000, while state level decisions were primarily responsible for differences between residential and business properties in terms of the rate of property tax change. The remainder of this paper focuses on three sets of policy changes since 2000; these include changes in state aid to school districts and other local governments, the 2001 tax act, and other miscellaneous changes.

Changes in State Aid

Changes in state aid to school districts and other local governments, combined with local decisions in response to these aid changes, obviously impact Minnesota property taxes for all types of property, including businesses. However, due to interactions with other features of the property tax system, changes in state aid can impact some classes of property differently than others.

State aid and property levels have fluctuated during the 21st century. As noted above, a useful comparison of changes over time in public revenues should take into account erosion in the purchasing power of the dollar due to inflation and increased service demand and ability to pay due to population growth. In constant 2019 dollars, per capita state aid in 2000 was $2,344, while local property taxes were $1,676. The chart below shows changes in real per capita state aid and local property taxes each year from 2000 to 2019.[24]

[24] The amounts here were derived from the November 2018 Price of Government (POG) report prepared by Minnesota Management & Budget and converted to constant 2019 dollars per capita using the Implicit Price Deflator for State & Local Government Purchases and population estimates and projections from the U.S. Census Bureau and the Minnesota State Demographer; amounts for 2017 through 2019 are preliminary. School data from the subsequent fiscal year are included with calendar year data for other local governments; for example, school aid and property tax information for FY 2001 (which began on



The most notable feature of this graph is the spike in state aid that occurred in 2002. In constant 2019 dollars, state aid to all levels of local government increase by $496 per capita or 20% from 2001 to 2002; 80% of the increased aid went toward reducing local property taxes, with the remainder providing an increase in local government revenues. From 2001 to 2002, real per capita local property taxes fell by 23% and real per capita local government revenues increased by 2.3%. The primary mechanism for the large net reduction in property taxes in 2002 was the replacement of nearly all general education property taxes with state aid dollars; in addition, a large portion of school referendum levies were also replaced with state aid dollars.[25] These two provisions of the 2001 tax act helped to produce the largest reduction in total property taxes in the last forty years.

July 1, 2000) is grouped with county, city, town, and special district information from 2000. Aid levels include all state aid (including various state-paid tax credits) to local governments listed in the POG report; it is assumed that all aid changes—including changes in categorical aids—impact the need of local governments to levy property taxes. Aid amounts include an approximate adjustment to reflect the partial state takeover of court administration costs; this adjustment results in a small reduction in state aid to local governments relative to the amounts reported in the POG report for years 2000 to 2004. The local government aid and combined aid and property tax revenue shown here do not include $500 million in federal stimulus dollars distributed to Minnesota school districts through the American Recovery & Reinvestment Act in FY 2010; these federal dollars were used to backfill a $500 million reduction in state aid to schools. Inclusion of this $500 million would increase state aid and combined revenue by approximately $120 per capita in constant 2019 dollars in tax payable year 2009.

[25] As a result of these changes, total school district certified levies declined by $1.33 billion (55%) in nominal dollars from tax payable year 2001 to tax payable year 2002, although the actual reduction in statewide school property taxes was less than this due to the elimination of the education homestead credit (described below).

With the onset of a recession, the state had difficulties maintaining the increased school funding obligations and other financial commitments[26] taken on during the 2001 session. With an aversion to a general state tax increase, policymakers were compelled to make budget reductions—including cuts in aid to local governments. These reductions are apparent in the preceding chart. From 2002 to 2013, state aid to all local governments fell by $890 per capita in constant 2019 dollars—a 30% reduction. After adjusting for inflation and population growth, the increase in state aid provided through the 2001 tax act had been wiped out by subsequent reductions; by 2013, real per capita state aid was $412 or 16% below the 2000 level.

The reduction in real per capita state aid corresponded with an increase in real per capita property taxes—at least during the period from 2002 to 2009. During this period, local property taxes increased by $332 per capita in constant 2019 dollars—a 25% increase. The property tax relief distributed in 2002 via the 2001 tax act had been eviscerated by 2009; in that year, real per capita local property taxes were nearly identical to the 2000 level. Real per capita local property taxes actually decline slightly from 2009 to 2013, even as real per capita state aid continued to fall. Local property tax increases from 2002 to 2013 were sufficient to replace only about one-third of the real per capita state aid loss over this period. By 2013, combined real per capita state aid and local property tax revenue was 14% less than it was in 2002 and 12% less than it was in 2000.

Real per capita state aid increased significantly in 2014, 2015, and 2016, funded largely with dollars from progressive state tax increases enacted in 2013. In constant 2019 dollars per capita, state aid to local government increased by $260 or 12% from 2013 to 2016—enough to replace 63% of the real per capita aid decline since 2000 and 29% of the decline from the high water mark year of 2002. On a statewide basis, state aid increases distributed from 2013 to 2016 went toward increased funding of local governments, not property tax relief. After declining slightly in 2014, real per capita property taxes increased slightly in 2015 and 2016.

The failure of the aid increases distributed from 2014 to 2016 to translate into property tax reductions have led some to argue that aid increases are unrelated to property tax relief. However, the context in which the 2014 to 2016 aid increases occurred should be considered. As noted above, from 2000 to 2013—and particularly from 2002 to 2013—the real per capita revenue that local governments received from both state aid and property taxes fell sharply. Under these conditions, it is not surprising that local governments used the aid increases received from 2014 to 2016 to replace revenue reductions experienced in preceding years and to restore real per capita funding cuts to local services and infrastructure. The decision to use the newly available state resources to increase local spending should also be considered in the context of increased service demands on local governments associated with an aging population, increased numbers of special need students in our schools, and the need to enhance infrastructure investments.[27]

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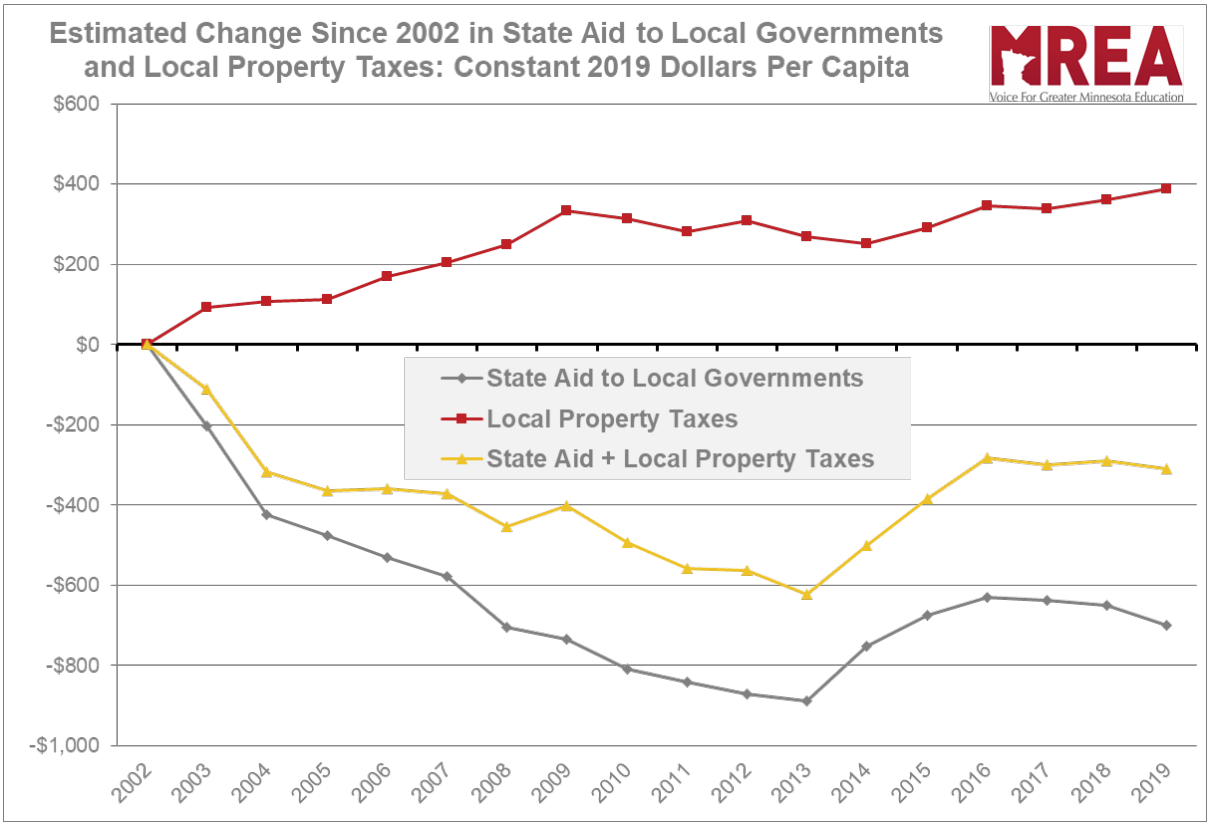
[26] In addition to the takeover of most general education costs, legislation passed during the 2001 session shifted operating transit funding responsibilities from local to state government. (2001 legislation also shifted court administration costs from counties to the state, but this was paid for through a reduction in state aid to counties.)

[27] An analysis of annual city financial data from the Office of the State Auditor shows that the vast majority of real per capita city spending reductions from 2002 to 2013 were focused on capital expenditures, which includes investments in infrastructure. Not surprisingly, the vast majority of city spending increases from 2013 to 2016 have gone toward restoring capital expenditures that were cut in preceding years.

This analysis does not seek to definitively answer the question of the relationship between changes in state aid versus changes in local property taxes. However, it should be noted that—based on the POG data used here—there is a strong negative correlation between changes in state aid and changes in local property taxes. In other words, from 2000 to 2019, there is a strong tendency for real per capita property taxes to increase when aid is cut and for property taxes to fall when aid is increased.[28]

Since 2016, real per capita state aid levels have decreased slightly, as aggregate state aid appropriations have not kept pace with the combined rate of inflation and population growth. Over the same period, real per capita property taxes have crept upward. In constant 2019 dollars, per capita property taxes are an estimated $41 (2.4%) greater in 2019 than in 2000, while state aid is $222 (8.8%) less and combined state aid and property tax revenue is $181 (4.3%) less.

The chart below more clearly illustrates the decline in state aid and the increase in local property taxes since 2002—the year that the state assumed near complete funding of all general education expenditures.[29] In constant 2019 dollars, per capita property taxes are $388 (29%) greater in 2019 than in 2002, while state aid is $699 (24%) less and combined state aid and property tax revenue is $311 (7.2%) less.



[28] The correlation coefficient (*r*) for the relationship between the annual change in real per capita property taxes and the annual change in real per capita state aid during the period from 2000 to 2019 is -0.829, which is statistically significant at the 0.01 level. During this period, 69% of the change in real per capita property taxes can be explained in terms of changes in real per capita state aid.

[29] See footnote 24 for technical notes regarding the information in this chart.

The preceding analysis of state aid is not without limitations.[30] However, one thing is apparent: the aggregate increase in local property taxes since 2000—and especially since 2002—has not been driven by expanding local budgets, since local government revenue today is less than it was in either 2000 and 2002, after adjusting for inflation and population growth. The primary driver of real per capita property tax increases in the 21st century has been reductions in state aid, not increases in local budgets. Local governments are responsible for property tax increases only insofar as they opted to replace a portion of the real per capita decline in state aid through increases in local levies.

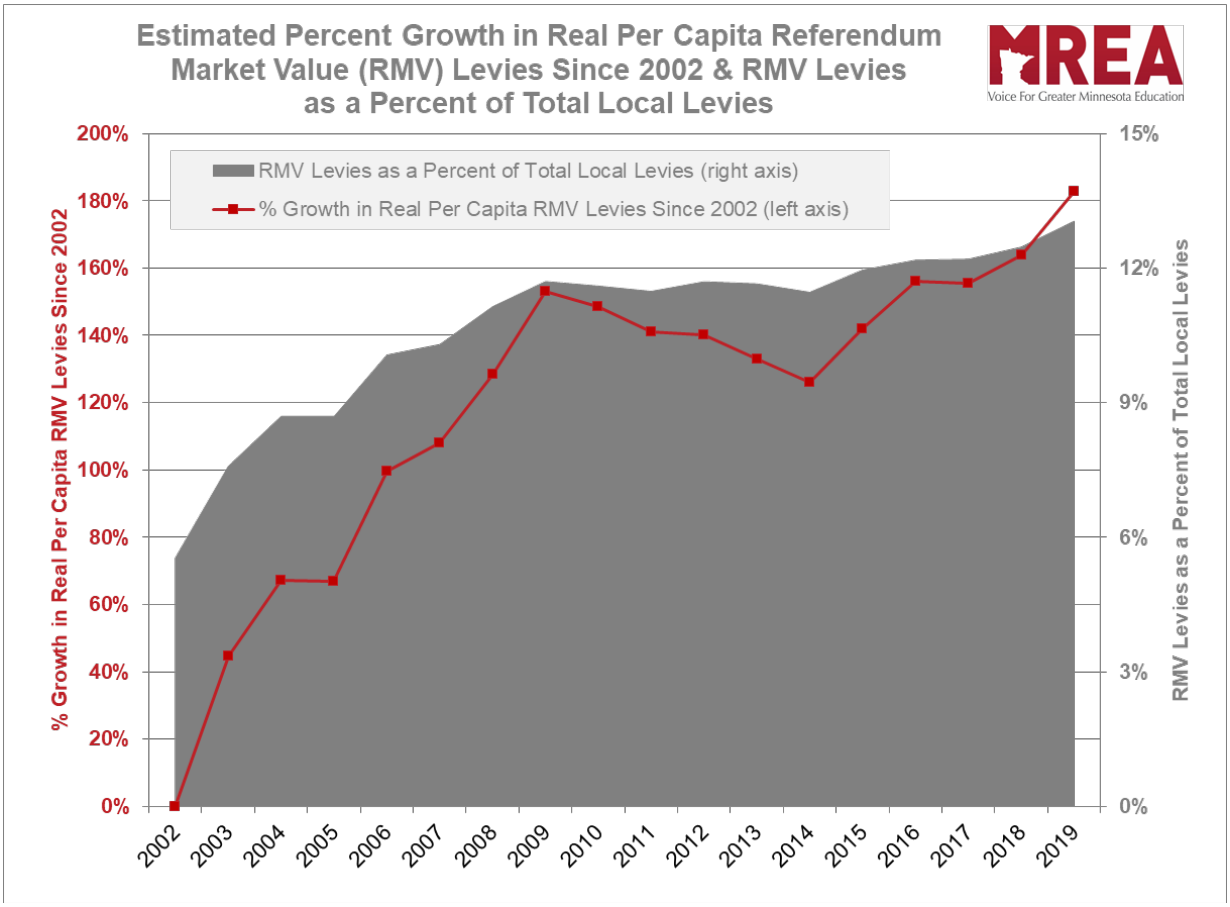
The aid reductions described above have contributed to an increase in property taxes for all classes of property, including businesses. However, the way in which aid reductions interacted with other features of Minnesota's property tax system caused the resulting property tax increases to fall more heavily on residential properties than on businesses. It is here that we need to go deeper into the weeds of Minnesota's complicated property tax system.

The decline in real per pupil state aid to school districts since 2002 (corresponding to school fiscal year 2003)[31] has compelled many school districts to rely more heavily on referendum market value levies.[32] As a result, referendum market value levies have increased dramatically. Real per capita referendum market value levies increased by 183% from 2002 to 2019, while tax capacity levies increased by only 10%. Referendum market value levies as a share of all local property taxes have increased from 5.5% in 2002 to 13.0% in 2019.

[30] For example, by grouping all levels of local government together, this analysis omits variations in state aid and property taxes unique to specific levels of local government and to specific jurisdictions. This information is intended to portray aggregate statewide trends in real per capita state aid and local property taxes; trends for individual jurisdictions often deviate from these aggregate trends. In addition, this analysis does not adjust for various local cost drivers outside of inflation and population growth; other factors not accounted for here—such the aging state population and increased number of special need students in schools—also drive local costs upward.

[31] According to a 2018 report, per pupil state operating aid to Minnesota school districts declined by $1,397 per pupil from FY 2003 to FY 2020 (corresponding to tax payable years 2002 to 2019) in constant FY 2019 dollars, while real per pupil school operating levies (i.e., property taxes) increased by $1,260. FY 2020 amounts cited here are based on Minnesota Department of Education projections from the end of the 2018 legislative session.

[32] Referendum market value levies are predominantly a funding source for school districts. For tax payable year 2019, 98% of all referendum market value levies are attributable to school districts; in addition, 98% of the growth in referendum market value levies from 2002 to 2019 is attributable to school districts.



Referendum market value levies provide preferential tax treatment to business properties relative to residential properties, insofar as referendum market value levies per dollar of *total* value are generally higher for residential properties than they are for businesses.[33] The far more rapid growth in referendum market value levies relative to tax capacity levies—driven largely by the decline in real per pupil state aid to Minnesota school districts—has contributed to (1) the real per capita growth in residential property taxes versus the real per capita decline in commercial and industrial property taxes and (2) the far more rapid decline in commercial and industrial ETRs relative to residential ETRs since 2002.

Reductions in real per pupil school operating aid and the subsequent burgeoning of referendum market value levies were not the only factors that contributed to the shift of aggregate property taxes away from businesses and on to residential properties. The restructuring of the property tax system enacted in 2001 also plays a major role in explaining this trend.

The 2001 Tax Act

The 2001 tax act was the single most influential piece of property tax legislation in Minnesota in the last forty years. Some features of that act—including the use of state aid to buy down local general education property taxes—were described in the preceding discussion of changes in

[33] This is due to the exemption of personal property, which—as noted in part 1—tends to shift property taxes away from business properties and on to residential properties.

state aid. Other major provisions of that bill, which took effect in tax payable year 2002 (corresponding to school fiscal year 2003), include the following: [34]

- A substantial reduction in the class rates[35] applied to some classes of property. The largest class rate reductions were received by commercial, industrial, and utility properties. The class rate for these properties was reduced from 2.0% to 1.5% on the first $150,000 of taxable value and from 3.4% to 2.0% on the portion of taxable value in excess of $150,000. This change resulted in a dramatic reduction in the share of local property taxes borne by businesses and an increase in the share borne by residential and other property classes.
- The creation of a new state business and seasonal recreational property tax, paid into the state general fund. The amount of the state levy in tax payable year 2002 was $592 million and was generated at a statewide rate of 57.933% applied to the tax capacity of all business and seasonal recreational property in the state, with some exceptions.[36] In 2002, 95% ($564 million) of the state levy was paid by businesses, with the remainder paid by seasonal recreational properties. The state levy was increased in each subsequent year by the rate of inflation as measured by the Implicit Price Deflator for State & Local Government Purchases.[37] The imposition of the state tax on business property was designed to partially offset the huge relief experienced by businesses as a result of the large class rate reductions in a way that would generate new revenue for state to help pay for increases in state aid to school districts and other state funding obligations.
- The education homestead credit was eliminated and replaced with the homestead market value credit. The education homestead credit was equal to a portion of general education property taxes levied against a homestead up to a maximum amount. The homestead market value credit was determined based on the taxable market value of the homestead.[38] The education homestead credit and the homestead market value credit that replaced it were both designed to provide equal property tax relief to homesteads of equal value, regardless of where in the state they were located.

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[34] Not included in this list of 2001 tax act provisions is the phase-out of the limited market value (LMV) program. The LMV program restricted the rate of growth in the taxable value of residential, agricultural, and seasonal recreational properties. In the short-term, the phase-out of this program contributed to a shift of taxes from classes not protected by LMV (including commercial and industrial) on to classes that were protected (including residential). However, even in the absence of the phase-out, the impact of the LMV program would have likely become negligible after 2008 as residential property values plunged during the housing crisis. For this reason, the phase-out of the LMV program probably was not a substantial contributor to the shift of property taxes from business properties to residential properties over the long term (i.e., from 2002 to 2019).

[35] See footnote 3 for an explanation of "class rates."

[36] For example, electrical generation machinery tax capacity and 60% of the first $760 of cabin tax capacity were exempted from the state levy.

[37] Since its implementation in 2002, the state property tax has undergone two major changes. In tax payable year 2006, the state levy was divided into two parts: a business levy (equal to 95% of the total state levy) and a seasonal/recreational levy (equal to 5% of the total state levy); the amounts of both levies continued to grow in subsequent years at the rate of inflation. In tax payable year 2018, the first $100,000 of business taxable value was exempted from the state levy, the amount of the levy was reduced (so that the tax rate would not increase due to the exemption of the first $100,000 of value), and the annual inflation adjustment was eliminated.

[38] Specifically, the homestead market value credit equaled 0.4% of the first $76,000 of homestead taxable value, so that a maximum credit of $304 was achieved for a home with a value of exactly $76,000. The credit was reduced at the rate 0.09% for each dollar of tax capacity in excess of $76,000, so that the credit was zero for homesteads with a taxable value of $413,778 or more.

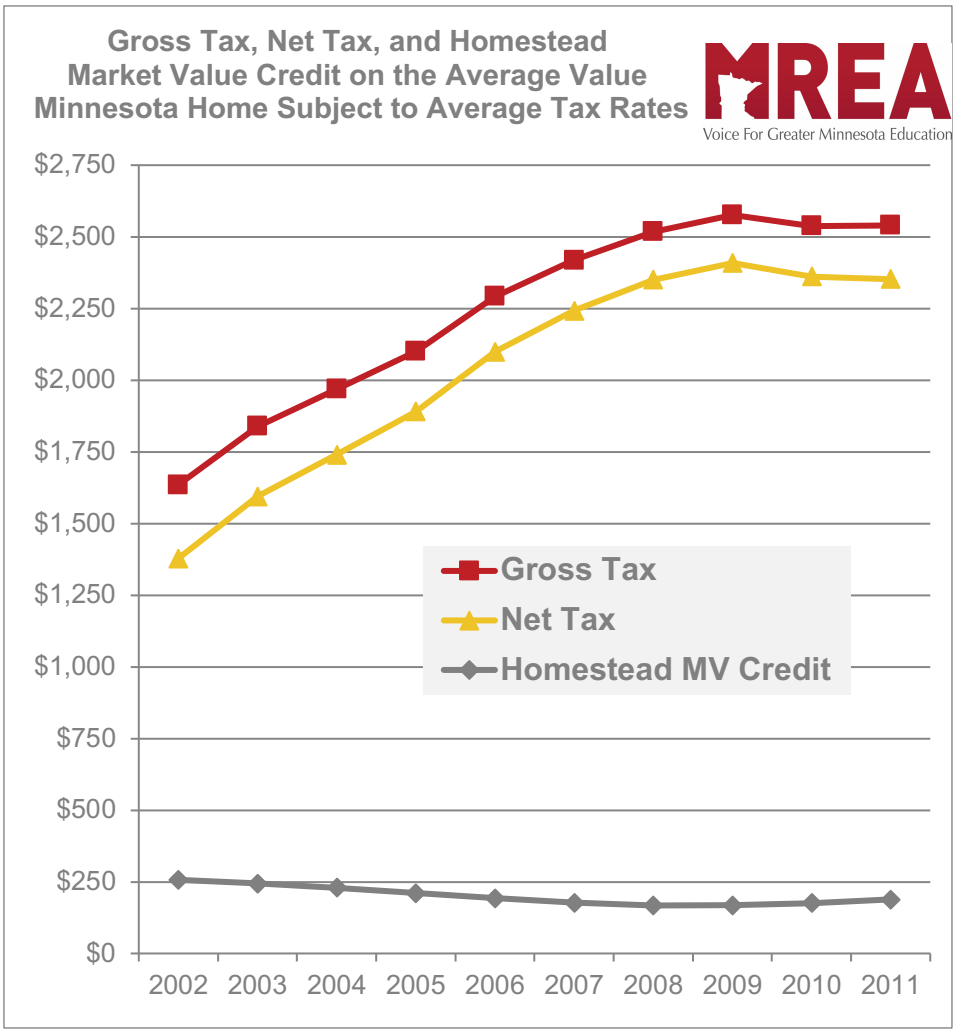
The various provision of 2001 tax act effected different classes of property in different ways, although every class experienced a substantial reduction in property taxes from tax payable year 2001 to 2002. As illustrated in the graph on page 12, residential properties enjoyed a 15% reduction in total real per capita property taxes from 2001 to 2002, substantially greater than that experienced by commercial property (4%) or industrial property (8%).

However, the tax relief enjoyed by residential property owners in 2002 began to unravel in subsequent years. Most of the tax relief enjoyed by residential properties in 2002 vanished in 2003 and residential ETRs once again began to increase. Meanwhile, real per capita property tax levels and ETRs for commercial and industrial properties continued decline. These divergent trends are due in part to the interaction in the business class rate reductions implemented in 2002 and the year lag in data used to make metropolitan and taconite tax base sharing (a.k.a. "fiscal disparities") calculations. As a result of this lag, the business tax relief resulting from business class rate reductions first implemented in 2002—and the corresponding shift in property taxes on to residential and other classes of property—were not fully realized until 2003.[39]

As noted above, the large business class rate reductions in the 2001 tax act effectively shifted a larger share of local property taxes away from businesses and on to other classes of property, including residential. As a result, a smaller share of the local property tax increases caused by the reductions in real per capita state aid beginning in 2003 (described above) was borne by businesses and a larger share was borne by residential and other property classes. Conversely, businesses benefited less in terms of property tax relief resulting from any local levy reductions attributable to state aid increases enacted in 2013 and other years. However, given that the overall trend in real per capita state aid has been downward from 2002 to present, the business class rate reductions in the 2001 tax act has reduced the share of corresponding local tax increases borne by businesses.

The structure of the homestead market value credit (HMVC) also contributed to an increase in residential property taxes. The HMVC was in effect from 2002 to 2011. From tax payable years 2002 to 2008 (corresponding to assessment years 2001 to 2007), home values in Minnesota increased rapidly, as the housing bubble inflated. For homes with a taxable value between $76,000 and $413,778 (which includes the vast majority of Minnesota homesteads during this period[40]), the amount of the HMVC declines as taxable value rises. Thus, the amount of the HMVC was falling during the period when gross homestead taxes were rising rapidly due to rising values and other factors, thus causing the net tax on these homesteads (i.e., gross tax minus the HMVC) to increase even more rapidly than the gross tax. The chart below shows the gross tax, HMVC, and net tax for an average value Minnesota homestead subject to average statewide tax rates during the period that the HMVC was in effect.[41]

[39] Approximately 23% of statewide business tax capacity was contributed to either the metropolitan or taconite tax base sharing pools in tax payable year 2003. This portion of the business property tax base did not benefit from the 2001 tax act business class rate reductions until 2003.
[40] During each year from 2002 to 2011, at least 70% of all residential homesteads in Minnesota had taxable values from $76,000 to $413,778.
[41] Amounts shown here are expressed in nominal dollars.



During the period from 2002 to 2008, the gross tax on this average value home increased from $1,635 to $2,517—an $882 or 54% hike. Just as value growth and other factors were pushing the gross tax upward, the HMVC on this home declined from $257 to $167—a 35% decrease. The decline in the credit caused the net tax to increase even more rapidly than the gross tax; from 2002 to 2008, the net tax increased by $972 or 70%.

The same trend observed in this examination of the average value home is also apparent in the aggregate numbers. Even prior to adjusting for inflation, the statewide HMVC fell from $325 million to $266 million from 2002 to 2008—an 18% decline.[42] This decline in the HMVC is entirely the product of growth in homestead taxable value and contributed to the growth in residential property taxes and ETRs documented above.

With the bursting of the housing bubble, homestead values began to decline and the HMVC began to increase. From tax payable year 2008 to 2011, the HMVC on the average value home subject to average tax rates increased from $167 to $188—a 12% increase. With a growing HMVC, the net tax on this average value home grew less rapidly than the gross tax; from 2008

[42] The HMVC amounts cited here are *prior to* regular cuts to the HMVC made in response to ongoing state budget problems. These cuts are discussed below.

to 2009, the gross tax on this home increased by $23 (1%), while the net tax increased by just $2 (0%), even prior to adjusting for inflation.

However, over the entire period that the HMVC was in effect, the amount of the credit declined (even prior to regular cuts to the program in response to budget problems), contributing to growth in homeowner property taxes. This was due to the counter-intuitive nature of the HMVC, whereby the amount of property tax relief provided through the credit declined at the same time that growing home values tended to push the gross tax upward. This feature of the HMVC did not contribute directly to growth in business property taxes, although it did contribute to reduction in the share of the total statewide property tax borne by businesses.

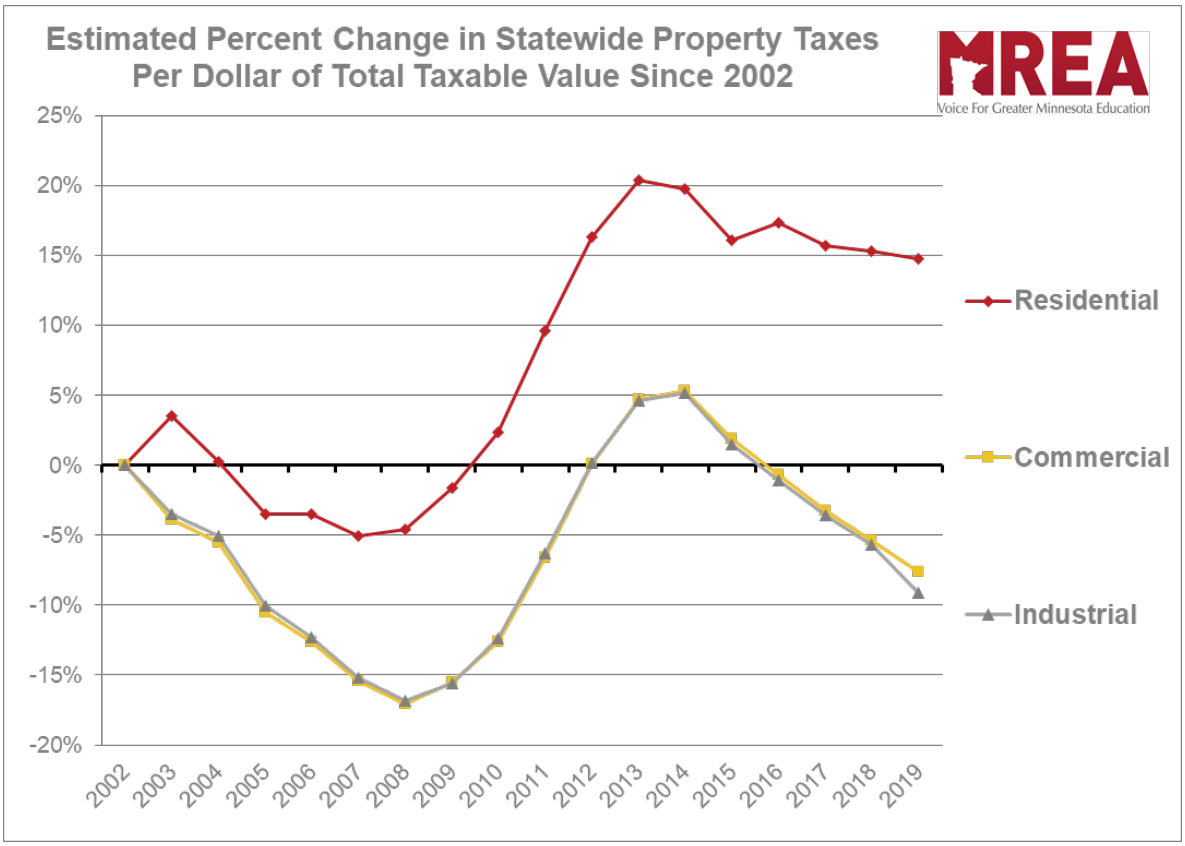
Another feature of the HMVC may have contributed to property tax increases for all classes of property, including businesses. In eight of the ten years that the HMVC was distributed, the amount of the credit was reduced in response to ongoing state budget problems. Homeowners were not directly affected by these cuts, since the amount of their property tax was still reduced by the full credit amount; however, the state reimbursement to local governments for this loss of property tax revenue was reduced. Cuts to the HMVC reimbursement became such a regular annual event that some local governments may have increased their levies in anticipation of the forthcoming loss of revenue. Such levy increases would have increased the taxes paid by all property owners.

The feature of the 2001 tax act that contributed most mightily to the decline in the share of total statewide property taxes borne by businesses was the state general property tax. As noted above, the state general property tax levy increased at the rate of inflation; hence, this levy was insulated from all of the other forces that have pushed local property taxes upward, including population growth, the growing concentration of elderly people within the population, increasing numbers of special need students in public schools, and the impact of real per capita reductions in state aid to local government (described above). Beginning in tax payable year 2018, the annual inflation adjustment was removed, thereby insulating the state levy from all factors which push public costs upward. The exemption of the first $100,000 of taxable business value—also implemented in 2018—produced a one-time reduction in the state business levy.

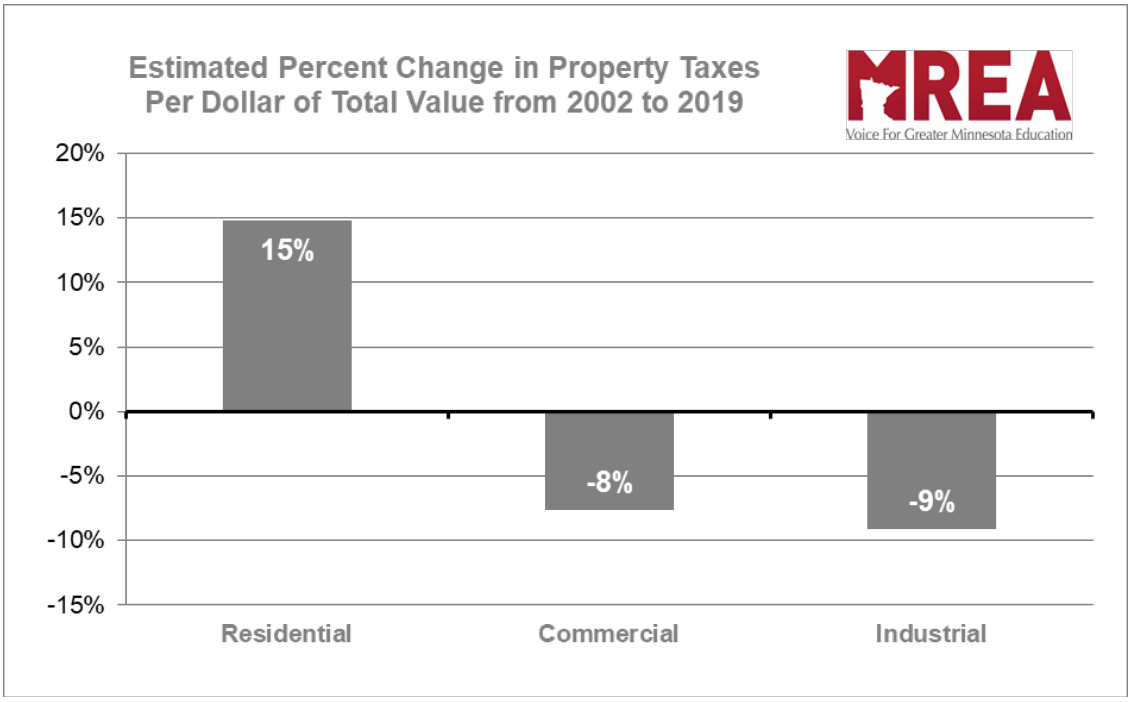
Largely because of this situation, real per capita business property taxes levied by the state declined over 20% from 2002 to 2019, while total real per capita local property taxes increased over 30%.[43] Thus, thanks to the state business property tax, a substantial portion[44] of property taxes paid by businesses were declining in real per capita dollars; meanwhile, local property taxes—which comprise 100% of the property taxes paid by residential properties—were increasing. This helps to explain the disparity in property tax growth between residential and commercial/industrial properties illustrated in several of the preceding charts. It also helps to explain the increase in residential property taxes per dollar of value since 2002, versus the decline for commercial and industrial properties, illustrated below.

[43] These estimates are based on statewide net tax amounts and state business levy amounts reported by MDOR and converted into real per capita dollars using the Implicit Price Deflator for State & Local Government Purchases and population estimates/projections. Statewide net tax amounts for 2017 to 2019 were calculated by the author using preliminary data.

[44] For tax payable year 2019, approximately 22% of all property taxes paid by Minnesota businesses were in the form of the state business property tax, with the remainder consisting of local property taxes. State levy as a percentage of all business property taxes has declined since 2002 because the state levy has declined in real per capita dollars, while local levies have increased.



From 2002 to 2019, residential property taxes per dollar of total value increased by 15%, while commercial property taxes fell by 8% and industrial property taxes fell by 9%.



It is difficult to separate the impact of the 2001 tax act from all of the other forces that impact annual changes in statewide business and residential property taxes. However, it is possible to examine what taxes would be like currently if principle features of the 2001 tax act were removed. A 2017 analysis examined what business property taxes would be in 2016 if (1) the business class rate reductions in the 2001 tax act were reversed (i.e., the rates were restored to the payable 2001 level of 2.0% and 3.4%), (2) the state business property tax was eliminated, and (3) a general education levy was reintroduced at the level of the foregone state business property tax. All other features of the 2016 property tax system—including local spending levels—were held constant.

If these provisions of the 2001 tax act were eliminated, aggregate statewide business property taxes in 2016 would have been an estimated 11.5% higher than they actually were. The increase in business property taxes under this scenario would have coincided with lower taxes for other classes of property, including residential. In short, the 2001 tax act was a significant contributor to many of the trends that have occurred since 2002, including the decline in commercial and industrial ETRs and the increase in residential ETRs.

Other Changes to the Property Tax System

There are at least two other events in the 21st century that impacted Minnesota property taxes and the distribution of those taxes among business, residential, and other classes of property. The first of these is the replacement of the homestead market value credit with the homestead market value exclusion. The second is the advent of the homestead credit state refund.

State budget deficits were a recurring problem during the first decade of the 21st century. These fiscal woes reached a new crescendo in 2011. Early in that year, the state confronted a $5 billion deficit in the upcoming biennium (FY 2012-13) and massive structural deficits beyond that. Legislative leaders continue to spurn the notion of a general state tax increase to deal with these recurring deficits. It was in this environment that policymakers opted to make a number of budget cuts, including the elimination of the homestead market value credit.

In the absence of any other action, the elimination of the HMVC would have produced large increases in homestead property taxes. To mitigate this effect, the HMVC was replaced with the homestead market value exclusion. Rather than providing direct state dollars to buy down homeowner property taxes, the new exclusion reduced the portion of homestead value subject to most local levies. Under the program, 40% of the first $76,000 of homestead value was exempted from local tax capacity levies;[45] a maximum exclusion of $30,400 was reached for a home with a value of exactly $76,000. The exclusion was reduced by 9% of each dollar of value in excess of $76,000, so that the exclusion was zero for homesteads with values in excess of $413,788. In this way, the new exclusion attempted to replicate the phase-out feature of the discontinued HMVC.

The exclusion did not fully protect homeowners from the impact of the HMVC elimination, but it did shift much of the resulting property tax increases to other classes of property, including businesses. In the first year of implementation (tax payable year 2012), the exclusion reduced the tax capacity of local governments, thereby causing an increase in local tax rates. The increase in tax rates caused a property tax hike for all classes of property, not just homesteads.

[45] The homestead market value exclusion applies only tax capacity levies. For taxes levied against referendum market value, homesteads continued to be taxed based on their full taxable value, prior to the exclusion.

In an environment of increasing home values—such as the one Minnesota has experienced over the last six years—the phase-out mechanism caused the share of homestead value excluded from taxation to decline. For example, in nominal dollars, the amount of value excluded from taxation due to the homestead market value exclusion has declined by $4.5 billion or 17% from tax payable year 2012 to 2019. The shrinking amount of the exclusion has accelerated growth in homestead taxes by accelerating growth in the share of homestead value subject to tax capacity levies.

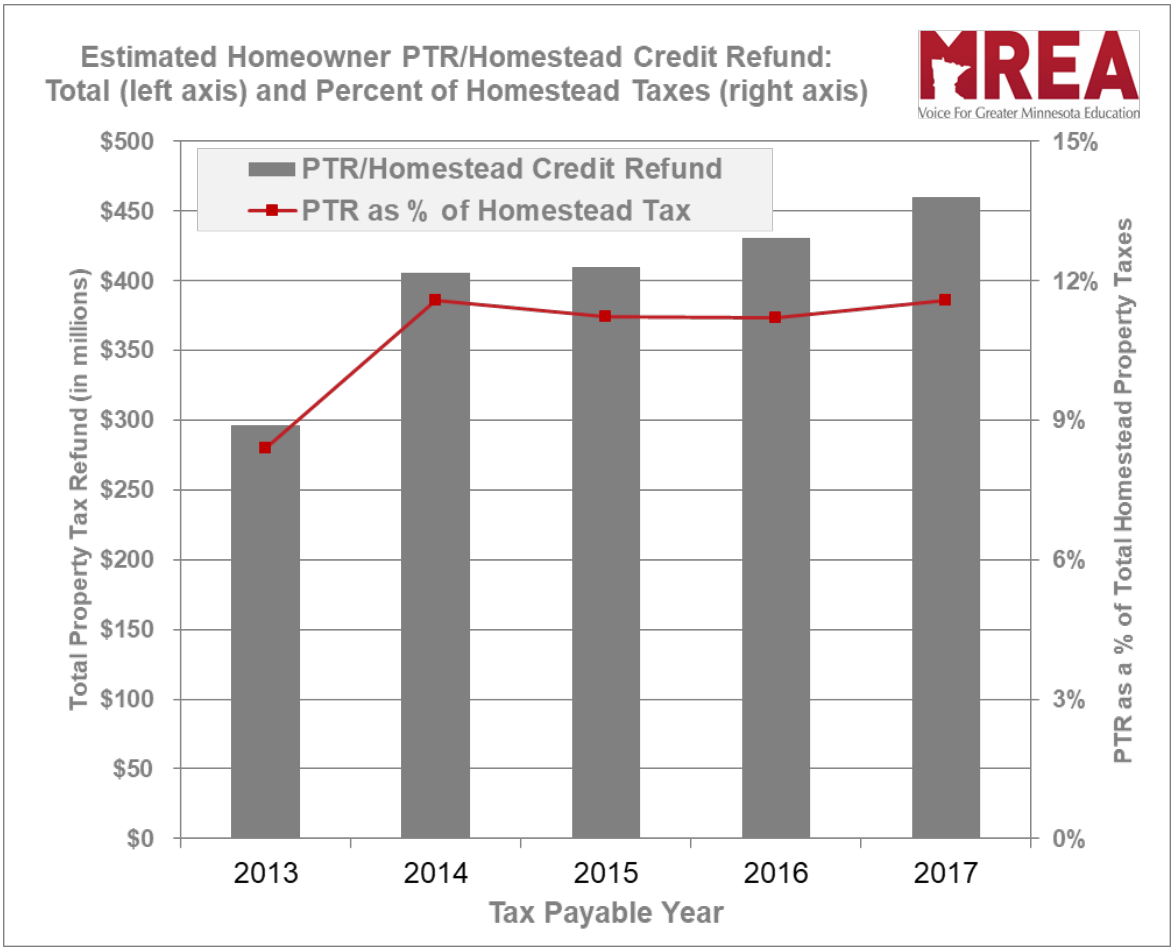
In a nutshell, the homestead market value exclusion successfully distributed the increase in property taxes resulting from the elimination of the HMVC in 2012 to all classes of property, not just homesteads. However, in the current environment of increasing home values, the phase-out feature of the exclusion causes the amount of excluded value to decline annually, thereby accelerating the rate of growth in homestead taxes relative to what would be the case in the absence of phase-out. Expressed another way, the homestead market value exclusion caused the ETRs of all property classes to increase in 2012; however, since 2012, the phase-out feature of the exclusion has caused homestead ETRs to increase more rapidly and the ETRs of business and other classes to increase less rapidly, all other things being equal.

The expansion in the homeowners and renters property tax refund (PTR) programs during the 2013 legislative session had no impact on business property taxes. However, insofar as this paper compares changes in residential property taxes to changes in business property taxes, it is appropriate to examine PTR increases that effectively reduced the ratio of final residential property taxes (i.e., taxes after refund) to business taxes.

The PTR provides tax relief to homeowners and renters whose property taxes exceed a specified percentage of their income, up to a specified maximum. During the 2013 session, the legislature decreased the income thresholds percentages used to determine the homeowners' and renters' PTR, effectively allowing more households to qualify for a refund and increasing the size of the refund for many households that had previously qualified.[46] In addition, the maximum refund for renters was increased and new initiatives were undertaken to notify homeowners of their potential eligibility for a PTR refund.[47] Finally, the homeowners' PTR program was renamed the "homestead credit refund." These changes were effective for homestead property taxes payable in 2014 and rents paid in 2013.

From tax payable year 2013 to 2014, the PTR payments to homeowners increased from $296 million to $406 million and the refund as a percentage of total homeowner taxes statewide (prior to the PTR) increased from 8.4% to 11.6%. Since 2014, PTR payments to homeowners have increased in nominal dollars, while the total PTR payment as a percent of total homeowner property taxes has remained fairly constant. The chart below shows the expansion in the homeowners PTR from 2013 to 2017—the last year for which final PTR payment amounts are available. A similar expansion occurred within the renters' PTR program.

[46] The changes to the homeowners' PTR benefited households with a household income over $19,530.
[47] In addition, the 2013 tax act excluded most voluntary contributions to retirement plans and included distributions from retirement plans in the definition of household income used to calculate the PTR.



After taking into account the effects of the PTR expansion in 2013, the rate of growth in residential property taxes declines relative to the amounts shown above (which did not factor in the effects of the PTR). For example, prior to factoring in PTR increases, homestead property taxes per dollar of total value increased by 15.8% from 2002 to 2017; after factoring in PTR increases, the increase was just 7.7%. If we factor the PTR into the calculation of the statewide homestead effective tax rate, the pay 2017 homeowner ETR would drop from 1.11% to 0.98% and the gap between homeowners and business ETRs would increase.

Conclusions

Per dollar of value, business property taxes in Minnesota are higher than residential property taxes. Residential properties have lower ETRs due Minnesota's class rate system, market value exclusion, and other factors. However, the gap between business and residential ETRs narrows if ETRs are calculated based on total property value, including real and personal property. When comparing business and residential ETRs, it is important to take into account personal value, since the exemption of personal property in Minnesota provides a tax advantage to business properties that partially offsets the advantage that residential properties enjoy due to other features of Minnesota's property tax system.

The total pay 2019 ETR of residential property in Minnesota is estimated to be 1.12%,[48] compared to 2.40% for commercial property and 1.60% for industrial properties. If we take into account the reduction in residential property taxes resulting from property tax refund programs, the residential ETR would drop by approximately 0.1%.[49]

It is more difficult to assess the level of business property taxes in Minnesota relative to other states. Based on the MCFE's *50-State Property Tax Comparison Study*, "urban" and "rural" business property taxes in Minnesota are high relative to other states. Based on an alternative approach which looks at business property taxes per capita and per private sector employee, Minnesota business property taxes are below the national average. Both approaches have limitations and neither should be viewed as the final word in terms of the level of Minnesota business property taxes relative to other states. In regard to business property tax rankings, the best approach may be to acknowledge what we do not know, rather than pretend we know more than we do.

Changes to the property tax system enacted since 2000 have caused the gap between residential and business ETRs to narrow. Reductions in real per capita state aid contributed to property tax increases for all types of property; however, the interaction between these aid cuts in the corresponding increase in referendum market value levies caused a disproportionately large share of these tax increases to fall on residential properties and a disproportionately small share to fall on businesses.

The 2001 tax act dramatically reduced business class rates, but also imposed a new state tax on business property. While the distribution of tax relief due to these changes initially favored residential properties, the long-term effect was to shift a larger share of statewide property taxes away from businesses and on to residential properties. This occurred because (1) interactions with Minnesota's tax base sharing programs caused the full impact the business class rate reductions and the corresponding shift on to residential properties to be delayed, (2) the new state property tax partially insulated businesses from many of the factors that were pushing public costs and local property taxes upward, and (3) the phase-out features of the homestead market value credit and—later—the homestead market value exclusion effectively shifted a larger share of local property taxes on to residential properties.

Other legislative efforts—most notably, the expansion of the homeowners and renters property tax refunds—mitigated the shift of property taxes on to residential properties. However, even after factoring in the impact of the expanded PTRs—residential property taxes per dollar of value have increased significantly since 2002, while business property taxes have declined.

The findings presented in this paper do not point toward any single goal or policy. However, this empirically based perspective regarding the current level of business property taxes and the examination of the forces behind trends in business property taxes relative to other classes of property will hopefully contribute to a more informed debate over proposed changes to Minnesota's property tax system.

[48] As noted above, the estimated pay 2019 ETR is 1.11% for residential homesteads and 1.24% for non-homestead residential properties; 1.12% is the weighted average for both of these residential classes.
[49] This approximation is based on homeowners' and renters' PTR amounts and total taxes amounts for tax payable year 2017. (2017 is the most current year for which final tax payable year PTR information is available.)