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White Paper

How ‘bout dem taxes?

High state income taxes have been long been considered part of the Minnesota way of life, along with ice fishing and Ole and Lena jokes, but as the Minnesota Legislature considers moving our state income tax to the highest in the nation, let’s make sure that the joke isn’t on us.

Written by

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Scene: At the breakfast table in Minnesota in early April.

Ole: ‘Morning, Lena.

Lena: ’Morning, Ole. How are you feelin’ dis morning, dear?

Ole: Oh, pretty good. I got our tax forms from da tax guy yesterday. Ve got to pay more in. (sigh)

Lena: Vhat!?!? Ve paid in much more already than last year!

Ole: Ya, you’re right! But dats what da tax man says! Vhat’s vorse is dat the Minnesota Senate passed a bill to make dem even higher!

Lena: I heard dat but I thought dat’s only for rich folks. How will that affect regular folks? Ve’ve lived in da same house for 20 years. Ve don’t live in one of dem McMansion things. Ve employ folks and contribute to da community. I always thought Minnesota was taxed high enough already!

Ole: Me too, Lena. (sigh) Me too.

It’s the beginning of April and while thoughts of spring have been percolating in my mind, I’ve been obsessed with taxes as of late, specifically, Minnesota Income Taxes.

The news of the Minnesota Senate passing a bill to raise the state income tax to the highest in the nation caused me to get a little more “focused” on this topic than usual.

This bill was introduced and passed during a time when the state just finished with a $2 billion surplus! The total proposed tax increase is estimated to raise taxes by over $5 billion. The case for a tax increase is somewhat questionable since over the past five years state revenues have increased at a rate of 7.18% per year while inflation was 2.39%.

Revenues are also projected to increase at an annual rate of 4.96% per year, compounded going forward through the year 2009, also well in excess of expected inflation rates and that’s before the tax increase.

When I heard that the wealthy weren’t paying their share, I admit I was surprised, since I’m fairly familiar with the income tax situation in Minnesota and know that the upper income brackets pay a higher percentage than the lower brackets.

The proponents of this legislation point out that the wealthy pay a lower percentage of their income than the lower income groups. The source of their data is the 2007 Tax Incidence Report:

http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/07_incidence_report.pdf

This report shows a wealth of information, but if it is used only in part it doesn’t tell the whole story. For example, Table 2-3 on page 29 shows that the “total” state tax burden as a percentage of income tax is an arithmetic average of 11.6% for all taxpayers versus 9.6% for the top 1%. Does that tell the whole story?

This table leads me to ask three questions:

1. Who are the wealthy in Minnesota?

2. What is their burden relative to those with less income?

3. Is the current system unfair?

If you make more than $105,451 per year you are in the top ten percent of the wealthiest Minnesotans. In examining Table 2-2 on page 27, you find that the top 10% pay 54.4% of the total state income tax collected at an average rate of 6.8% of your income. The average for the top 10% is $13,664, compared to the overall average of $2,465, or a multiple of 5.5 times the average. These are 2004 numbers before the new legislation. If you make over $76,438 you are in the top 20% and pay over 75% of all the state income taxes collected. If you make over $354,738, you are in the top 1% and you pay over 25% all the income taxes collected, and an average tax of $59,792, or a multiple of 24.25 times more than the average Minnesotan paid. So…a small percentage is paying the majority of the tax. How do the proponents of this legislation assert that these percentages are accurate? Their position is that all taxes should be related to income, not just the income tax but also property taxes, business taxes and sales taxes. Where do the percentages get skewed?

It is broken down into four general categories on the State of Minnesota web site:

http://www.taxes.state.mn.us/taxes/legal_policy/other_supporting_content/tax_system_overview.pdf

The two factors bringing the percentages down for upper income tax payers are Local Taxes (property) and Business taxes. Since the income tax rate is a graduated schedule, the upper income taxpayers always pay more income tax by significant margins. Since the property tax has always been based on the property value, the issue of what it is as a percentage of income as a measure of fairness seems odd.

If Ole and Lena choose to purchase a home for less than their income would allow them to (a non-McMansion), is that bad? The services they receive for fire, police, and city are the same as their neighbors. It would logically make sense that this is lower and that people should be able to decide to live in a property of their choice and pay an appropriate tax to do so. This being said, the wealthier do pay more in these taxes for the same services because they have the ability to choose a more expensive home and some, but not all, do. For example, the top 10% pay 26.3% of all the residential property taxes in the state or 160% more than their pro rata share for equal services.

The so called "business taxes" were a real eye opener for me. What are the "business taxes"? They represent the taxes collected and paid by businesses including liquor, cigarette, gasoline, sales taxes, property and income taxes. While the top 10% pay 28.9% (180%) of their equal share of the total, the percentage of their income is quite low. What is interesting is that businesses or their owners (see pages 32, 70, 75-79) get little if any credit for a significant share of their taxes since it is assumed that this is passed on to the consumer and therefore the consumer bears it and the cost allocated to them.
So the burden is shifted in an "accounting" manner and not by tracking real dollars per se and the business owner who makes it happen is not given credit for taxes paid. The wealthiest people in our state just can't drink, smoke and drive enough to get their percentage to an acceptable level for the proponents of this legislation. It should not be used in the way it has to assert that the upper income tax payers of this state do not pay their fair share.

It's also important to recognize that the justification for these taxes is often posited to reduce the incidence of the related activity. For example, tobacco, gasoline and liquor taxes are used to partially compensate society for the additional costs these activities incur for health care, infrastructure etc. These taxes also raise the cost of specific activities to discourage or encourage the certain behaviors (smoking, drinking, use of public transportation, etc.). Keep that thought and relate it to income.

Summary:

My purpose in this paper was to shed light on the other side of the story that I felt hadn't been heard. The upper income people in this state pay much more in State of Minnesota income taxes than the average both in nominal dollars (24.2 times!) and as a percentage of income. They also pay more than average for the other taxes but due to the nature and original purpose of the tax do pay a lower percentage of their income in these taxes. It does remains consistent with the nature and purpose of the tax.

Professionally, I've seen many people make the decision to leave Minnesota due to the tax structure. Our firm alone has seen $50,000,000+ in wealth leave this state in the past five years and the conversations about this topic are increasing in frequency. For the fabric of our community to be successful, we need all the threads in the cloth to continue our quality of life. This includes the threads of the fabric that make an above average income and have the resources to make a significant impact on our community. When wealthy people leave the state, it isn't just their tax money that we lose. Their charitable contributions, energy and intellectual capital go as well. The proponents of this legislation say there is little evidence to support that people move to avoid taxes. I suggest they spend some time in lower tax states such as Florida, Texas, South Dakota and Tennessee where many of our former neighbors and their capital now reside.

I would also suggest that the legislators talk to tax, legal and financial advisors about the conversations these advisors consistently have with clients on this topic. Some may say good riddance. I don't! Others may think that this group will not exercise prudent financial choices in their own best interest. My experience indicates this is not true.

This bill will provide more encouragement to those on the fence to cross over and make the move. No, there will not be a huge exodus of people but a portion of the 23,668 households that make up the 1% will have a huge impact on revenues (10% of the 25% of taxes paid equals 2.5% of all income taxes) and our quality of life. That alone would likely negate all the revenue the tax bill purports to raise and the trend of exodus will likely accelerate.

Scene continues:

Lena: Vhat choice do ve have, Ole?

Ole: Vell, we could move to one of dem der lower tax states. Sven and Tina moved down ta Florida.

Lena: What! Ole, ve lived here all our lives. Vhat about all our friends?

Ole: Well, Lena, most of dem are already downs dere. Sven and Tina are just two. I hear dat a tousand people a day are movin' ta Florida. Dey got no income tax dere. Dey like folks like us dere.

Lena: I do miss our friends, Ole.

Ole: Ya, so do I, so do I. (sigh)

The Punchline for Ole and Lena?

Minnesota ranked seventh in taxes collected per capita before this bill was passed. In every category the wealthiest taxpayers pay well in excess of their equal share. So what to do?

I've tried unsuccessfully to get this information in the media via letters to the editor, so I decided to write this paper. If you believe as I do that the whole story should be told, then pass this along in your personal network. Get familiar with the issues. Ask lots of questions. If you believe that more work and openness needs to happen before a new tax bill is put into law, call, write, and e-mail your legislator to let them know how you feel.

Legislators do pay attention to these communications. Re-election is just around the corner. Minnesota is a great state. Let's help keep it that way by keeping all the threads of the fabric of our society connected here. Selective tax increases will not serve that purpose. Let's not let the joke be on us.

You can find the contact information for your elected representatives at

http://www.house.leg.state.mn.us/

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