



John James, former Commissioner, Minnesota Department Revenue

Civic Caucus, 8301 Creekside Circle #920, Bloomington, MN 55437

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Present: Verne Johnson (Chair); David Broden, Marianne Curry, Paul Gilje, Dan Loritz, Tim McDonald, Wayne Popham, Clarence Shallbetter, Bob White

Summary of James' comments : In this discussion former State Revenue Commissioner John James describes the importance of the right conditions for both state revenue and economic growth and proposes steps to set in place the best base for future fiscal stability.

The talk focuses on the two budgeting essentials: revenue and spending. James contends that to bolster revenue we must broaden the base of the sales tax in order to prepare for the increased spending that will result from the growth in Baby Boomer retirees. He believes that how broadly the taxable base is defined and how resulting tax revenue is spent are both more important than the tax rate applied.

On growth, James notes that there is no single button a state can push to expand the economy. Instead state leaders need to put in place the right tax structure to encourage growth. He proposes re-balancing the responsibilities for spending, giving the state a larger role in covering schools and health and human services, and leaving the rest to localities.

A. Context of the meeting -John James has visited with the Civic Caucus previously; he continues to contribute to policy debate by crafting proposals to solve difficult public challenges. His proposal to the group today is to improve the way the state works on both the revenue and the expenditure sides of the budget.

B. Welcome and introductions - John James is a lawyer and public policy consultant with significant background in taxation and public service.

A native of Iowa, James came to Minneapolis in 1974 from Harvard Law School and has lived and worked in the Twin Cities ever since. As James describes it, he got the public policy bug in the early 1980's when he became active in the Minnesota State Bar Association Tax Section. He joined the Minnesota Department of Revenue as Assistant Commissioner for Compliance under Commissioner Tom Triplett in early 1986. A two-year commitment turned into five years of service as he was named Commissioner of Revenue in late 1987 and stayed in state government until 1991.

In that year James co-founded the Public Strategies Group with Peter Hutchinson and Babak Armajani. He ran for Attorney General on Hutchinson's Team Minnesota ticket for the Independence Party in 2006. Over the years he has produced numerous governmental reform proposals, some of which have been enacted into law. His most recent success came in 2009 with passage of a bill that ended a gross unfairness in the Department of Revenue's approach to officer liability cases.

James has formed a new organization, Sensible Tax and Fiscal Systems (STAFS); its website can be found at www.SensibleTax.org . The notes of his January meeting with the caucus may be found here: <http://tinyurl.com/2bgxcqr> .

C. Comments and discussion -During James's visit today with the Civic Caucus, the following points were raised:

James thanked the Civic Caucus for providing the opportunity to come discuss his ideas for resolving the state's budget imbalance. "I'm so honored to be able to come here and say this," he opened. "I think Ted Kolderie really nailed it on the head when he says there are four things you can do-tax/cut /grow/redesign." James said his proposals tend to be heavier on the tax and the redesign angles, because of his background and expertise.

James presented a multi-point plan to the group (<http://tinyurl.com/22l6s2y>) describing how to resolve the problem right now, arguing that growth is not sufficient by itself. It is possible (necessary even) to cut state programs, James said, but he would not suggest what in particular should be cut. "What I want to give today is a sense of the more technical aspects, rather than philosophical or political issues."

He broke his remarks down to two components: The structure of how the state gets revenue, and redesign of spending processes.

REDESIGN ON THE REVENUE SIDE

Prepare for retiring Boomers by broadening the sales tax

James said that the most important thing the state can do to position itself for future stability is to broaden the consumer sales tax base, that is, the types of things that will be taxed. Policy makers may or may not cut the tax rate, depending upon how much they want the total tax burden to change.

He pointed out that the state has one of the narrowest sales tax bases in the country, and a high tax rate of 6 7/8 percent statewide with some additional rate increments levied by some local governments. The sales tax is a powerful revenue generating mechanism. Each year the Department of Revenue does a tax expenditure budget that shows how much expanding the base in various ways would increase revenue. Though he does not endorse it, James noted that state leaders could resolve the entire budget shortfall for the coming biennium by expanding the base without lowering the rate.

"The big faucet here is the sales tax," he said, though he admitted there are limits. "An area with big potential for increasing the tax base may be business-to-business services, but we don't want to go there."

The Budget Trends Study Commission in 2009 found that as the first of Minnesota's 1.4 million Baby Boomers reach retirement, the state's revenue will have reached an "inflection point." This milestone requires a complete reassessment of how Minnesota's economy is perceived. Long-ranging factors will weigh heavier on the tax base. "Policy makers have not prepared for the overwhelming effect this will have on the state tax base."

Retiring people buy less, pay less in sales taxes

James argued that this inflection point matters, because as people retire they buy fewer goods and so they pay less sales tax. They also have lower incomes, and their incomes tend to be more exempt from income taxes. "People will not be buying stuff. This is a major fiscal catastrophe hitting the state."

"I turned 64 a few weeks ago," James offered as an example, "and left a law firm in 2007 to work on my own." He listed some of his tax changes: No more 25-mile commute; no parking or meals; no more laundering or lawn services. In 2009 his business income dropped so he paid fewer taxes there. Some of his investments are coming tax free, and not until he is 70 does he need to begin drawing from IRA's. Also, there is home downsizing that many retirees do. The effect: "I'm on a tax holiday."

So he says the state should begin taxing clothing, consumer services, food, and health care. "You could make it "revenue neutral" for today, bringing in no more in total tax revenue than we do right now- but setting in place the best tax base for the future." The state "needs to broaden the daylight out of the sales tax. I don't care if we don't raise another dime-cut the sales tax rate to 3 percent." The rate is less important now than the getting the foundation structured correctly. "That way as this tsunami comes through we're not in a permanent crisis."

REORGANIZE STATE/LOCAL RELATIONSHIP FOR WISE SPENDING AND GROWTH

A government cannot push a button and get growth, James noted. Instead state leaders need to create the conditions in which growth is most likely to occur.

Repeal property tax aids and credits

The state distributes \$2 billion per biennium in local property tax aids and credits. It is, as Perpich used to call it, a local tax from which the state derives no benefit. This is not good policy, James argued, because it erodes accountability and-importantly-decreases incentive for innovation at the local level. The state receives the tax revenue, then gives it right back-and to make matters worse the legislature tries to micromanage the process.

Instead: "Blow the whole thing up, and kill it off." This improves accountability, James said, and aligns incentives. Cities would rely much more on the property tax, and if citizens don't like it they can petition their city government do something different. "It's our choice as local citizens."

This does not necessitate a net increase in taxes, James noted-the state may use the property tax refund system to protect individuals. He outlined the 'circuit breaker' strategy in his visit with the caucus in January (<http://tinyurl.com/2bgxcqr>).

Have the state focus on education and human services; localities the rest

"If we basically change this framework there will be tradeoffs," James said. "But today what we've got is dysfunctional," with \$2 billion pouring out of the state in unaccountable property aids and credits.

"What I'm trying to do is move things around so the city doesn't come whining to the state every year on this-it needs to be more predictable."

James contends that there is enough room in the property tax that cities can do fine if the state pays more for schools and human services. This shifting around would be "eminently responsible with the goals we have in mind as a state," for the funding and sound function of services.

People need to be aware of what they're getting from taxes, so that they can push for improvements

"This is redesign, but it is also cutting in a sense-and raising in a sense, because our property taxes are not that high in this state." He argued Minneapolis is below average in property tax rates. Some localities will choose to raise more money, and some won't; that's not the question now, James said. This is about getting more accountable conditions in place and incentivizing innovation to improve services and cut costs. It is important to incentivize productivity. The closer spending decisions are made to the localities where the spending occurs, James said, the better.

A participant noted that one of the points made by mayors of large cities is that they have higher costs of services (police, fire for larger buildings, more challenging schools). Should they be entitled to higher aid?

James replied that this is a valid argument, but these cities also have a larger tax base. There may be needs to assist and subsidize, but he cautioned that when aid is sent from the state to localities there is a decrease in accountability if the funds are unrestricted and rigidity in its use if uses are prescribed.

Another member noted that the Minnesota Miracle was put in place to deal with these tax inequalities. How much has the miracle unraveled?

James responded that it hasn't unraveled, and said that this plan doesn't unravel it. Minnesota has been extra-ordinary in the percentage of its revenue that is raised at the state level but spent at the local level. The point: Fix the property tax so people are aware of what they're getting, there is clarity on what people are spending, and the state instead takes a role on equal funding for clearly disadvantaged areas.

Change business taxes so you tax market exploitation more than production

The goal of structuring taxes to encourage business growth is to arrange it so that Minnesota is a business center exporting to rest of the world.

James said he does not support eliminating the corporate income tax. He would replace the state business property tax, and eliminate sales tax on many business inputs, by enacting a business activities tax. He cautioned tough love for business: "I think everybody must pay their fair share, and business should be included in that."

A participant asked James how he proposes states could capture Internet sales tax? There is a federal commission now on that topic, he noted, and one possibility would be a 5 percent federal sales tax on all Internet commerce. This has actually been an issue that predated the Internet-television and catalogs raised it. There have been efforts among commissioners and representatives of industries to come to agreement but they never get there.

The governor will need to lead these changes

Making this sort of change in the character of the sales tax and the relationship between state and local spending will take a governor willing to lead. This is only possible if the governor is strongly involved, James believes. "It is very difficult even for the most brilliant legislator to move these sorts of shifts in the conditions of taxing and spending."

D. Closing

To close James reemphasized that the way the property tax operates now is the antithesis to how the government should work. "It is a black hole." Instead of pouring money down it the state should concentrate their resources on K-12 and health care and drive reform. He argued further that the state will need to find ways to protect schools because Health and Human Services is raiding the entire budget (8.5 percent annual growth, MMB forecasts).

Innovation is one route toward reform. James noted that over the years Minnesota has been very innovative in health care. The federal government has now stepped in with money, but it will take years to implement the plan fully. And, it does more expanding coverage and modifying regulation than actually reforming the system. There is opportunity now for the states. "If a governor were not to talk about repeal but instead took as much money as they could, got the waivers needed, and then redesigned the system, the Obama administration would be likely to bend over backwards to work with them. There is no state in the country with more potential to do health care right. We've got brilliant people in this state and we've got to get at it."

Thanks to James for a good session