Bill Blazar and Beth Kadoun, Minnesota Chamber of Commerce

Minnesota's spending and tax structure must reflect new economy and demographics

A Civic Caucus Focus on Competitiveness Interview

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Notes of the Discussion

Minnesota's spending and tax structure should reflect changes in the state's demographics and the impact of the world economy, say Bill Blazar and Beth Strinden Kadoun of the Minnesota Chamber of Commerce. The state has made some strategic changes in its tax structure in past years, but in general the tax system has not kept up with technological, global, economic and demographic changes. The state has not made enough progress on reforms on the spending side. They believe tax reform should be a revenue-neutral solution. Otherwise, the discussion turns quickly to how to raise more revenue, rather than how best to restructure the tax system. The ultimate goal of tax and spending reform, they say, should be to ensure a system that encourages economic change and growth, job creation and retention, and a high quality of life for all Minnesotans. Compared with other states, Minnesota ranks low on various business climate measures due to high overall business costs. They suggest the following changes the state could make to improve the tax structure: (1) Broaden the consumer base and lower the rate of the sales tax; (2) Treat online retailers the same as "main street" retailers in collecting sales taxes; (3) Get rid of the upfront capital equipment sales tax paid by businesses; (4) Don't let the individual income tax rate get too high compared with our border states; and (5) Further reduce the disparities between property taxes paid by businesses and those paid by other properties.

Background

Bill Blazar is Senior Vice President of Public Affairs and Business Development at the Minnesota Chamber of Commerce. He has been with the Chamber since 1992. He directs Grow Minnesota!, the Chamber's statewide business retention and expansion program. This year, Grow Minnesota! completed retention visits with over 800 Minnesota businesses and provided direct assistance to 125 of them.

Blazar represents the Minnesota business communities on several task forces and study groups, including the United States Chamber of Commerce's Labor Relations Policy Committee. He is a past member and chair of the board of the Minnesota Government Relations Council. He has also served in a leadership capacity for Minnesota's P16 Education Partnership, the Minnesota Health Data Institute, the Citizens League, the Lake Calhoun Sailing School and the City of Lakes Nordic Ski Foundation. He currently serves on the board of the Metropolitan Economic Development Association (MEDA).

Prior to joining the Chamber, Blazar was manager of government affairs for Target Corporation from 1987 to 1992. Before that, he was a freelance public policy analyst, specializing in state and local fiscal policy, economic development and telecommunications. He worked for the Citizens League from 1976 to 1980.

Blazar has a B.A. in political science from Northwestern University and an M.A. in public affairs from the Humphrey School of Public Affairs at the University of Minnesota.

Beth Strinden Kadoun is Director of Tax and Fiscal Policy at the Minnesota Chamber of Commerce. She joined the Chamber in October 2012. Prior to that, she was Committee Administrator for the Minnesota Senate Tax Committee during the 2011 and 2012 legislative sessions. Kadoun also served two years as Assistant Commissioner for Tax Policy with the Minnesota Department of Revenue and for three years as Senior Policy Advisor on tax, labor and economic development issues for Gov. Tim Pawlenty.

In the private sector, she lobbied the Minnesota and North Dakota legislatures on behalf of an energy services company. In addition, she was Finance Policy Director for the Minnesota Business Partnership from 1995 to 2000.

Kadoun graduated with honors from William Mitchell Law School and from the University of North Dakota, earning a Bachelor's degree in banking and finance.

Discussion

The rapidly aging population and the impact of the world economy make a very different environment today for considering tax and spending reform. Bill Blazar said he generally concurs with what Toby Madden from the Federal Reserve Bank (who spoke to the Civic Caucus on Dec. 7, 2012) observed about the nature of the current recovery.

"There are factors affecting the recovery in Minnesota and the entire Upper Midwest that I'm not sure we've wrestled with before in the context of tax reform," Blazar said.

1. The rapidly aging population today.

2. The world economy. He said Minnesota companies that have found a way to gain customers outside the U.S. generally have done much better than those dependent on the domestic economy.

For example, to tap the overseas market, Hormel bought Skippy to get access to Skippy's international distribution and customer list. Similarly, United Health Group bought a Brazilian hospital and health plan this fall.

Those two factors, Blazar maintained, make a very different environment for thinking of tax and spending reform. He questioned whether the governor and the Department of Revenue understand how the state is changing and how it's developing and whether or not they've factored that into their plan.

Minnesota has made some strategic changes in the tax structure in past years. Blazar said Minnesota eliminated its personal property tax long before other states. "That was a big deal in terms of building the computer industry in the state, because computers were considered personal property."

Minnesota's corporate income tax is structured by three factors. Multistate companies must apportion their income to the state based on percent of sales, percent of property and percent of payroll. The state put a higher weight on sales and lower weights on property and payroll. "The whole idea was to encourage businesses to have the property and the payroll here and to sell to the whole country," Blazar said. "It's a great example of seeing where the economy was heading and thinking strategically about the change."

The Taconite Amendment was another example, he said. The policymakers thought of a strategic change in the tax code to let that industry get going.

"We really do need to be thinking about how the economy is changing," Blazar said. "Any strategic changes we consider ought to be at no lower than an industry level. And thinking about the overall economy and then applying that knowledge to the tax code makes a lot of sense."

We haven't made enough progress on the spending reform agenda. For 10 years, the Chamber has had a series of recommendations on how to restructure and redesign the way we spend. Part of that motivation is the aging population and growing diversity of Minnesota.

Minnesota businesses use and expect public services just like everybody else, he said. Companies want education and good roads. Everybody wants that but without raising the price. "We all want more stuff and the price to go down even more," he commented.

We haven't made enough progress on the spending reform agenda, Blazar continued. "That's really hurting us. One of our fears is that we leap into this discussion of tax reform, since we haven't dealt with the issues of spending, and now we find ourselves trying to restructure a tax system in an environment where we not only need more money, but the more is forever."

It's easier to fix the tax system when you're not raising taxes or, better yet, when you can give people some relief, he said. Now we're positioned to have a discussion about tax reform in an environment where some would argue we need more money. "That's why the spending reform agenda is so much more important than tax reform. We need to make some significant progress on the spending side."

In 2008, the business community supported a $6 billion tax increase over 10 years for transportation by raising the fuel tax and instituting a metro sales tax for transit. Lots of people in business saw a problem in the transportation system - highways and transit - and they were willing to pay to fix it, Blazar said. It was going to be a good value. Now their constituents wonder, was the deal we made in 2008 worth it? Did the public sector deliver a high value for that fuel tax increase and metro sales tax that we supported?

Blazar said the Chamber is not ready to say right now that the state needs more general fund money, because we haven't really done the work to deliver value. "We'd like the Legislature to focus on spending reform and work through those issues." There are plenty of actionable ideas from outside groups.

We should talk about tax reform assuming it will be a revenue-neutral solution. Our fear is that when we talk about tax reform, the discussion will become about where to raise more money, Blazar commented. We've suggested that the governor propose a revenue-neutral set of reforms. We should get a new tax structure and then decide how much money we need to raise. "If we mix the discussion of the structure and the amount of money, issues of how much we raise will drive the discussion of reform. We won't have a discussion about the structure of a tax system for a 21st century economy."

The ultimate goal of tax and spending reform should be to ensure a system that encourages economic change and growth, job creation and retention, and a high quality of life for all Minnesotans. Beth Strinden Kadoun said both Gov. Mark Dayton and Commissioner of Revenue Myron Frans are saying their number one principle is to create jobs and improve competitiveness, the same thing the Chamber wants to see.

"We believe when state officials are looking at tax reform they have to keep in mind key tax-policy principles: competiveness, stability, transparency, simplicity and making sure Minnesota's economy is growing," she said. "It's a competitiveness issue."

Minnesota is a high-tax state. Minnesota ranks high on education, workforce, patents and volunteers, but we are a high-tax state, Kadoun continued. Minnesota ranks:

- Forty-fifth worst on the state business tax climate index.
- Fiftieth worst out of 51 on the business tax index for entrepreneurship and small business.
- Forty-third worst for the small business survival index.
- Third highest for corporate tax rate, at 9.8 percent. Other states and countries have lowered the corporate tax rate. "That's your billboard rate," Kadoun said. "Often people will not look further after they see that."
- Eighth highest, at 7.85 percent, on individual income tax rates. Ours is one of the most progressive income tax systems in the country. Minnesota is in the top three in structural progressivity, according to data from the Minnesota Taxpayers Association. Lower income

> taxpayers in Minnesota pay some of the lowest taxes in the nation and higher income taxpayers already pay some of the highest in the nation. This is due to our current income tax rates and our generous working-family income tax credit and other tax provisions benefiting lower-income households.

Some changes that would improve the tax system. Kadoun pointed to three changes the Chamber believes would be valuable:

1. Treat main street retailers the same as e-commerce. Currently, online retailers without a physical presence in the state don't have to collect sales tax. "This is one idea we should be able to make progress on," she suggested.

2. Get rid of the upfront capital equipment sales tax, under which businesses get taxed on capital equipment and pay those taxes upfront, getting a refund later. "That's a problem, especially for small businesses," she said. "Changing that would be very helpful for our tax system."

3. Don't allow the individual income tax rate to get too high compared to our border states. There is a North Dakota proposal to reduce their tax rate for individuals from its current rate of four percent. Ours, at 7.85 percent, is the eighth highest in the country. The concern is that most businesses are pass-through entities, so they pay their business taxes through the individual income tax. The corporate income tax will raise $1.9 billion for the FY 2014-2015 biennium. But there are 10 times more companies where the corporate income tax is not a factor. "Their big deal is the individual income tax," Blazar said. Kadoun added that companies are very sensitive to a marginal tax increase. We must be concerned about the impact of an individual income tax rate increase on investment decisions and net business immigration.

The sales tax system does not reflect the change to people buying more services than goods. An interviewer pointed out that 60 years ago, two-thirds of what people bought were things; now two-thirds of what people buy are services.

"The tax system hasn't kept pace with the change from goods to services, leading to more instability in the sales tax," Kadoun responded. The Chamber favors expanding the base of the sales tax on consumer purchases and lowering the rate.

Kadoun and Blazar also said the sales tax should be imposed at the point of the final, or retail, sale. "Focus on consumer goods rather than taxing business inputs," Kadoun commented. Virtually all tax-policy experts and economists agree that sales tax expansion should be on consumer goods and not on business inputs and services, he noted.

Taxing business inputs can affect factors such as fairness among businesses, tax pyramiding, competitiveness and economic distortion in the marketplace. For example, larger businesses gain a competitive advantage over smaller businesses if smaller businesses have to hire accountants and pay sales taxes on the service, while larger businesses can afford to have in-house accounting departments, whose services would not be taxed. If Minnesota taxes business inputs, but other states don't, there is an uncompetitive burden on Minnesota businesses that compete with businesses elsewhere without these additional cost burdens.

Blazar noted that 40 percent (or $4 billion) of Minnesota's total sales tax revenue ($10 billion) comes from business-to-business transactions, such as one business buying furniture from another. The Chamber wants to eliminate the sales tax on business-to-business purchases and wants sales taxes paid at retail, the point of final consumption.

Taxing clothing purchases is a contentious issue. Kadoun reminded the group that Gov. Jessie Ventura got "beat up" trying to broaden the sales tax base. "Politically, it's very difficult."

An interviewer pointed out that Minnesota is one of only four states with no tax on clothing. Blazar responded that the Chamber likes a broader sales tax base and lower rates. He noted, though, that there is "lots of sensitivity among our members on taxing clothing." The Mall of America advertises that the state has no sales tax on clothing. Retailers on the South Dakota border also benefit from the same advantage.

Should we consider taxing food, not clothing? Blazar said that his personal opinion is that we should tax food and not clothing. There's some economic advantage to taxing food and people won't drive as far to buy food as to buy clothing. Food would provide a much broader base, which brings more predictability and stability in the tax. He commented that the state could adjust everybody's withholding table so that lower-income families get more in every paycheck to work against the impact of the sales tax. But, Blazar said, the Minnesota Chamber of Commerce Fiscal Policy Committee does not support the idea of taxing food.

Some tax system solutions might better come from the federal government. In response to a comment from an interviewer, Kadoun said there really needs to be a federal solution to the "e-fairness" issue. The affiliate nexus bill, which would require companies to collect sales taxes on online purchases if they have affiliates located in the state, is only a small piece to help even the playing field with remote online retailers. "If we extend the sales tax to clothing, that will exacerbate the current 'e-fairness' situation," she noted.

According to Kadoun, the state Department of Revenue will be issuing a report on the estate tax in February. Minnesota currently exempts the first $1 million of an estate from taxes, while the federal government now exempts the first $5 million. "Most other states currently don't have an estate tax," she said. "There might be more of a push now to get to some conformity with the federal policy."

Broadening the sales tax base can help offset the effects of an aging population. A questioner asked what changes we should make in the state's tax system to adjust for the aging of the population. Kadoun responded that as people age, they buy fewer goods and more services, which argues for a broader sales tax base. In addition, an aging population impacts individual income tax revenue, as seniors generally pay less in individual income taxes. Broadening the sales tax base on consumer purchases can help offset the coming reduction in the income tax base.

The Chamber is uncertain whether a change in the tax system like the Taconite Amendment

would be helpful to any industry in the state today. In response to a question, Blazar said he didn't know whether there is an industry segment where something like the Taconite Amendment would be appropriate. He said we didn't have pass-through businesses 30 to 40 years ago. "The changes in how businesses are structured might alone be a basis for making fundamental changes in the tax system."

He talked about the declining demand for paper and lumber from forest products industries and said Minnesota has lost five major producers in that area. "Many businesses haven't figured out what to do next, given the decline in demand for paper. I'm not sure if a Taconite Amendment-like change would have any effect. But that's the level of the conversation we ought to have."

Companies sense a recent decline in the quality of Minnesota's workforce. Responding to a question about the high quality of the workforce, Blazar said the Chamber, in talking to companies over the past year, has seen that the companies do place a value on that high quality. "Many businesses put up with higher taxes and a more complex, cumbersome regulatory environment in Minnesota because of the quality of the workforce," he noted. "But companies in the last few years have sensed a lowering in the quality of the workforce or have been unable to fill openings in Minnesota. As that happens more and more, they become a lot more sensitive on those other cost factors."

Changes in the property tax system in 2001 reduced the disparity among different property classes, but businesses still pay almost one-third of the state's property taxes. In response to a question about property taxes, Blazar commented that the structure of the local property tax system adopted in 2001 is the best we've had in years and that the disparity among property class rates is substantially less than it was before. But the changes that year didn't deal with property tax relief to homeowners. "We're no further toward a real system of residential property tax relief today than in 2001," he said.

Kadoun added that even though the changes in 2001 lowered the property tax class disparity between businesses and other property, they added a new statewide property tax on businesses, which now collects $800 million annually and makes up approximately 28 percent of the business property tax burden. So business properties pay their local property taxes, the statewide property taxes and voter-approved school levies for capital expenses. While businesses have 13 percent of the state's market value, they pay 30 percent of the property tax. "There still is a great disparity," she said. "For businesses, Minnesota property taxes are sixth highest in the nation for some business types, while for homeowners, they are 28th highest."

Getting more value in the public sector may require a whole new business model. An interviewer commented that if we're talking about value in the public sector, we must change the business model. He compared it to retailing: "We didn't get value in retailing by having department stores lowering prices; we went to a whole new business model."

"Working the current business model will only get you so much," Blazar responded. "The citizens have concluded it isn't enough. They want a lot of stuff at the same or a lower price."

The Chamber is different from the Itasca Project and Greater MSP. A questioner asked about the differences between the Chamber and other organizations, such as the Itasca Project and Greater MSP. Blazar said the Itasca Project is really a civic organization, whereas the Chamber is a business organization and sees itself as a voice of the business community.

Greater MSP, he said, is a regional economic development organization, created to present the Twin Cities region to the world; to convince companies to locate here; and to encourage more outside customers for the region's businesses. "That's hard work," Blazar pointed out. "Everyone should encourage Greater MSP to stick with its focus on business-attraction and recognize that it will take three to five years to come up with results."

The Chamber has an economic development program called Grow Minnesota!, Blazar continued. Last year the Chamber, in partnership with about 60 local chambers statewide, visited 800 businesses and helped 125 of them. "The program's focus is on working with businesses already in Minnesota to help them be more successful. Many of the companies we see are not Chamber members. We're focused on retention and growth of the businesses we have."