Myron Frans, Minnesota Commissioner of Revenue

Governor's reforms will bring more stability, fairness to state tax system

A Civic Caucus Focus on Competitiveness Interview

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Present

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Introduction

Minnesota Commissioner of Revenue Myron Frans has nearly three decades of tax law expertise, as well as strong business and managerial experience. As commissioner, he supports Governor Mark Dayton's goal of a fair and equitable tax system.

Prior to his appointment in 2011, Frans served as president of Leeds Precision Instruments, a manufacturing and distributing company in Golden Valley, Minnesota. Under his leadership, Leeds Forensic Systems, a subsidiary of Leeds Precision, earned the Governor's International Trade Award in 2010 for success in building global markets.

Frans has been a tax attorney in private practice for 27 years, most recently as a senior tax partner at the law firm of Faegre & Benson in Minneapolis. Before joining Faegre & Benson, he was a tax partner at Gray Plant Mooty Mooty & Bennett, also in Minneapolis. He began his tax practice in 1983, with the firm of Miller & Chevalier in Washington, D.C. He has been active in the American Bar Association, the Minnesota Bar Association, where he served on the governing Tax Council for a number of years, and the Hennepin Bar Association, where he served on the ethics committee.

A graduate of the University of Kansas Law School, Frans has a bachelor's degree in criminal justice from Washburn University in Kansas.

Summary

Gov. Mark Dayton's recent budget proposal designing a new tax and spending structure had to deal first with the immediate problems of a looming $1.1 billion deficit in FY2014-2015 and with paying back the school funding shift of $1.1 billion, says Minnesota Commissioner of Revenue Myron Frans. Because of these problems, he does not believe the tax reforms in the governor's proposal could be done in a revenue-neutral way. He notes that in the last decade, the state has become more and more reliant on the property tax, instead of keeping the property tax, sales tax and income tax relatively equal as sources of revenue. The governor's tax reform proposals generally broaden the base of the sales and income tax, while lowering the rates. An exception to lowering the rate is the proposal to have the top two percent of income earners pay a higher income tax rate. The budget proposal attempts to reduce the growing reliance on the property tax by giving a $500 rebate to property tax payers. The governor's proposal will be re-evaluated after the February budget forecast is issued, Frans concludes.

Background

For a complete summary of Governor Mark Dayton's budget proposal, go to: **http://www.mbrecovered.org/doc/budget/bud-op/op14/presentation.pdf** .

Discussion

During his presentation, Minnesota Commissioner of Revenue Myron Frans outlined the revenue impact of the major tax changes included in Gov. Mark Dayton's recent budget proposal:

- The individual income tax will raise $1.1 billion of new revenue in the FY2014-2015 biennium from a new top income tax rate on the highest-income earners.
- There's a net $2.1 billion increase in sales tax revenue from the combination of broadening the sales tax base and lowering its rate.
- New cigarette and tobacco taxes will raise $370 million in new revenue.
- There will be $4 million in new corporate income tax revenue after broadening the base and lowering the rate.
- The new $500 property tax rebate to property tax payers will *reduce* new revenue from other tax changes by $1.46 billion.
- The total *net* new revenue for the biennium from these proposed tax changes (in addition to other more minor changes) will be $2.1 billion.

People are adamant that the state fix the problem of budget deficits. While working on Gov. Mark Dayton's tax reform and budget proposal, Frans traveled around the state, meeting with over 7,000 people in 50 different cities. "People we met with," he said, "wanted us to develop a revenue system that matched the budget we had. They believed that budgeting with all the deficits we've had in the last 10 years is not a way to manage the government. They were very adamant that we fix this problem."

In designing a new tax and spending structure, the state faces three problems:

1. How do we resolve the $1.1 billion deficit projected for the 2014-2015 biennium?

2. What investments should we make in this biennium? How do we save money and cut those costs where we can?

3. How do we position ourselves going forward so we have a revenue stream in the next biennium that not only gets us out of the red, but also pays back the $1.1 billion owed to the state's school districts due to the school funding shift. (The school shift is the delay in school payments the Legislature has approved in past years to balance the budget.)

"That's where we started," Frans said. "What kind of revenue system do we want to have that will generate the money to do that?"

In the last decade, we've become more and more reliant on the property tax. As we've cut funding at the state level and made cuts in local government aid and other areas, Frans said, we have forced local governments to raise property taxes or cut services or both. Schools have had to raise property taxes through referenda to increase their revenue.

"We've managed the crisis at the state level and we've pushed the crisis down to the local level," he said. As a consequence, in 2010, the property tax made up 40 percent of the three major state and local tax revenues.But traditionally, the sales tax, the income tax and the property tax have always more or less matched each other. "Not that a perfect match is essential, but they've been relatively in balance," Frans remarked. "We were concerned about that and we heard a lot about the overreliance on property taxes. One of the challenges right out of the chute is how do we effectively give people property tax relief, both businesses and individuals?"

Another challenge is to redesign the sales tax, so it is more robust and mirrors our service economy. He said two-thirds of the purchases now are for consumer services, not consumer goods. The sales tax was brought in in 1967, when it was just the reverse - two-thirds of the spending was for goods. Projections of sales tax revenue into the future, even with the economy recovering, remained fairly flat with no change in the current system.

"The income tax will bounce back as the economy improves," Frans pointed out. "In the projections, the sales tax really wasn't rebounding or getting to the point where we thought it would be adequate. We felt we needed to do the traditional tax reform, where you broaden the base and lower the rates."

One goal in both the individual and corporate income tax systems was to try to make the system fairer with base broadening and lower rates. He said that, on the individual income tax side, Gov. Dayton was committed to the top two percent of income earners' paying a higher income tax rate. That's been an important part of his conviction about the progressivity of the Minnesota tax system. "We feel we need that for the long-term generation of revenue from the income tax," Frans said.

In the corporate income tax area, a lot of companies don't pay the 9.8 percent statutory rate, Frans said. We eliminated some corporate deductions and credits, he said, so that the statutory rate would really be the effective rate. Also, the statutory rate was lowered to 8.4 percent. "We would actually have more companies paying the tax, but at a lower statutory rate and a higher effective rate," he said.

Ideas to improve on the governor's budget proposal must find spending cuts to match any revenue cuts. "We went through the budget in excruciating detail to try to find budget cuts to save money," Frans said. "We think we've done that. We want people to take the challenge to come up with ideas to improve upon our proposal to fund the government at the level that we have, with these investments, while solving the $1.1 billion deficit and the $1.1 billion payback to schools."

Some people believe that tax reform should only be done in a revenue-neutral environment. In response to a question, Frans said he doesn't understand how the state could propose a revenue-neutral system when there is a $1.1 billion deficit and a debt to the schools of $1.1 billion. "Right out of the box you have over $2 billion you've got to pay back and you've got to solve," he said. "How does a revenue-neutral system do that? And if people don't want to generate additional revenue, then what cuts are they willing to make? They haven't met that challenge yet."

An interviewer asked what the impact would be if we broaden the base for the sales and income tax as proposed, before adding in the higher spending. Frans responded that broadening the base of the sales tax allows lowering of the sales tax rate to 5.5 percent. If the sales tax rate change were revenue neutral, the rate would be something less than 5 percent.

Lower federal income tax rates correlate with income disparity, not economic activity or job growth. Frans referred to a September 2012 report by the Congressional Research Office, which studied federal income tax reductions since World War II. He said the report showed that federal income tax rates for everyone have come down, but they've come down more substantially for the upper tier of income. The report's conclusion was that lowering the income tax rates does not correlate with economic activity or job growth. The only thing lower income tax rates correlated with was income disparity.

Lowering state income tax rates in 2000 has cost the state $11 billion in lost revenue over the past decade. In 2000, the state lowered the top state income tax rate from 8.5 percent to 7.85 percent. Frans said we would have had about $11 billion in additional revenue during the last decade if we had not made those changes. "So we came into this thinking that the income tax rates needed to be adjusted in a progressive way," he said.

He noted that people pay the most income tax in their 30s, 40s and 50s. As they near or enter retirement, they tend to earn less and pay less income tax. The income tax stream is going to have challenges, he said, because of the aging of the state's population. The addition of the fourth tier of income tax rates is one way to help support long-term revenue strength.

Lowering the sales tax rate means the typical consumer won't pay more sales taxes, even with clothing and consumer services added to the sales tax base. An interviewer commented that the state debated the sales tax for about 10 years, before it passed in 1967. During the debate, there was a proposal to pair an offsetting income tax credit with the sales tax. Instead, we exempted food and clothing from the sales tax. He asked if we should go back to some type of credit now that we're looking at taxing clothing or, perhaps sometime, food.

"By lowering the sales tax rate from 6.875 to 5.5 percent, we find that the typical consumer won't pay more sales tax," Frans responded. "We think it holds true for people at the lower income level, as well, but we're studying that. If not, we might have to look at a credit system." He said the state's working-family income tax credit helps with progressivity if we broaden the sales tax base. "But we may have to have a credit if this turns out to be regressive at all."

He suggested that adding the fourth income tax tier, adding the $500 property tax rebates and lowering the rate of the sales tax are all very progressive, but the expansion of the sales tax base is the part that's regressive. "We think the rate reduction may solve that problem," he said. "If not, we'll have to design a credit." He noted that most of the $2.1 billion in new sales tax revenue would come from business sales taxes.

Adding the sales tax on clothing will generate less than $100 million in new revenue if, as proposed, the tax applies only to clothing items costing $100 or more. Limiting the tax to items costing $100 or more results in $200 million in lost sales tax revenue. But, he said, that limit is a progressive element.

"You won't buy a suit anymore," he joked. "You'll buy the jacket and then you'll buy the pants. You'll have a lot of $99 stores."

An interviewer asked why the governor's proposal doesn't include a tax on all clothing, paired with the income tax credit. Frans said they wanted to see whether the system could work alone without having to add a credit. "We're certainly willing to do that if that's the route we go," he said. "There are a lot of necessities under $100 that we thought it was nice to exempt."

Minnesota residential property tax rates rank in the middle of the pack in the country. "Part of the outcry over Minnesota property taxes is that there was a terrible phenomenon of values going down in the recession and property taxes going up," Frans said. "That's a prescription for people to be upset. There's been a big increase, even though we're still at the point where we're not an outlier."

We really explored what we could do to make the property tax more understandable to the average citizen, Frans continued. "It's complicated. That's one of the reasons we went with the direct property tax rebate. We wanted to let people know that we're trying to shift our emphasis off the property tax to income and sales taxes, so they're all relatively equal."

The state loses a total of $400 million per year in sales tax revenue from out-of-state Internet and catalog sales. An interviewer asked what the proposal does regarding the Internet sales tax fairness issue. Frans responded that the governor proposed that out-of-state companies, like Amazon, without brick-and-mortar stores in Minnesota, but with affiliates or sponsors in the state selling on their behalf, would have to collect state sales taxes. "It's a relatively small percentage of the out-of-state Internet problem," he said. "It captures about $5 million a year, but it is important. Best Buy and Target were really concerned about this as a fairness issue."

The bigger problem is at the federal level, Frans continued. The Marketplace Fairness Act currently being considered in Congress would require all sellers to collect sales taxes based on the destination of the product.

The proposal broadens the sales tax base to include business-to-business sales transactions, but does away with upfront sales taxes on capital equipment for use in a business. Frans said that currently, if a business buys capital equipment for use in the business, it has to pay the sales tax up front and then file to get a rebate later. "It's a problem for people," he said. "We're holding their money for a while." He said it costs $150 million in the FY2014-2015 biennium to eliminate the delay in the rebate. The governor's plan would, as of July 1, 2015, eliminate the delay and businesses wouldn't have to pay the sales tax up front and wait for a rebate.

One concern people have on the business-to-business service taxes is that there is a potential cascading effect if a company pays a tax on services while making a product and then sales tax is added again at the point of sale. "That is an issue we're going to have to address with the business-to-business transactions," Frans said. "We went through a lot of exercises of how to draw lines and make exceptions. Ultimately, we came to the conclusion that at the lowest possible rate, we had to levy the sales tax across the board."

The governor has been trying to instill in state agencies a culture of improvement and innovation. Responding to a question, Frans said Gov. Dayton asked state agencies to report what they're doing, how they're doing it and what they can get rid of that's outside their mission. "If you're managing an agency," Frans said, "it's so easy to let the agency just do its thing year after year. We've found ways to make some real savings."

The state is trying to stop the move toward more dedicated funds. In response to a question about dedicating tax revenue for specific programs or purposes rather than leaving the money in the general fund, Frans said, "It's been happening much too much. Everybody wants a dedicated fund and everybody wants out of the general fund. Part of that results from not having budgets this last decade that work. If you're concerned about the appropriations process, the best thing to do is have a dedicated fund. It's a huge problem and there's enormous pressure. We're trying to stop that. We feel the best way is to generate the revenue and then have it go through the appropriations process."

He did say that there could be a problem in areas like transit where the state needs to make long-term investments. "You can't always make commitments to those investments in a long-term project without a dedicated fund," he said.

The $500 property tax credit will not reduce the amount of money going into the existing property tax circuit breaker. (The "circuit breaker", a commonly used name for the state's regular property tax refund program, is a state-paid property tax refund to homeowners and renters whose property taxes are high relative to their incomes.) An interviewer asked why the Governor's budget proposal includes a property tax rebate instead of strengthening the circuit breaker. "We strongly support the circuit breaker, both for homeowners and renters," Frans responded, "so we're fully funding them in their current state." He said the governor was concerned that it's hard for people to understand that the circuit breaker refund is a reduction in property taxes, because the refund actually comes through the income tax system. The $500 rebate makes it clear that there's a reduction in property taxes. "We didn't limit it by income," Frans said. "While we might have to do that at some point, at least initially the goal is to give relief generally to homeowners and businesses."

The state could not afford to do more tax simplification right now. Responding to a question, Frans said that tax simplification costs a lot of money. "We came up against this in both the property tax and the individual income tax, two areas where we really wanted to do simplification. If we didn't have a $1.1 billion deficit and didn't owe the schools $1.1 billion, we would have done more simplification." He said the first step has been to add some stability to the revenue system. "Our next step, if we can get some surpluses, would be to do some more simplification. We wanted to do more; we simply felt we couldn't afford it."

The governor's proposal will be re-evaluated after the February budget forecast. Frans concluded by saying that when state economist Tom Stinson makes his February budget forecast, "we will re-evaluate this whole package based on his forecast and his growth assumptions. If the deficit is reduced, we will be able to make some changes."