

# Is the Minnesota Miracle Dead?

*Contrary to popular belief, the transformation of the state/local relationship and policy outcomes originating out of the Minnesota Miracle remain intact today. But to satisfy the continuing calls and insatiable expectations for lower property taxes, a new and different miracle is necessary.*

The moniker itself originated in a long-forgotten report from a now defunct federal agency, but has lived on to become an enduring part of Minnesota's fiscal and political history. Enacted after a marathon special session in 1971, the legislative package known as the "Minnesota Miracle" fundamentally transformed the state/local fiscal system. It helped propel the state to national attention on the cover of *Time* magazine while becoming a powerful political rallying theme for decades.

Forty-five years later the phrase is still routinely invoked in legislative hearings and on editorial pages, often with a wistful tone. The Miracle era coincides with the state's rise to economic prominence, and many believe that relationship is no accident. With property taxes on the rise again and the state/local relationship primed to be a focus for the shortened 2016 legislative session, it is worth looking at how "miraculous" we still are and whether the premises and promises linked to the Miracle can continue.

## Miracle 101

The Miracle centered on two high profile, interconnected, and very legitimate policy concerns – extraordinarily high levels of property taxation and inequity in school funding. Through the early and mid 1960's Minnesota local property tax collections were consistently 30%-40% above national averages. Public outcry prompted the creation of the state's first ever general sales tax (3%) in 1967 specifically to provide property tax relief. The effort delivered \$143.9 million in property tax relief, paid for by \$175.7 million in additional (mostly sales) taxes.<sup>1</sup> But this relief was short-lived. From 1969-1971 levies increased by an average of 17% per year, again triggering strident public demands for more, and lasting, property tax relief.

Meanwhile, major problems in school finance equity were evident.<sup>2</sup> In 1971, state aid for K-12 education constituted only 43% of school operating costs. School districts had to raise the rest through property taxes, resulting in significant disparities in school spending and property tax effort between poorer districts and their wealthier counterparts. Heading into the famed 1971 session, both political parties' platforms recommended a goal of 50% state support for schools.

In January 1971, Governor Wendell Anderson unveiled his Fair School Financing Plan calling for a massive increase in state taxes to boost school aid much higher than what the parties were calling for – to 70% of school operating costs. The \$762 million price tag of this proposal represented a whopping 37% increase in the state's general fund budget from the previous biennium. This set the stage for what turned out to be a 157-day special session, the longest in state history.

In the end, the final legislative compromise tackled both the school finance and property tax relief objectives in a way that completely altered Minnesota's fiscal landscape. As Table 1 summarizes, the Miracle's accomplishments were noteworthy but also came with a big price tag. The \$580 million in new "Miracle" taxes enacted in 1971 is equivalent to about \$3.4 billion in today's dollars. A 1972 report by the federal government's Advisory Commission on Intergovernmental Relations bestowed the description "miracle" to this monumental effort, but most legislators who participated in the process argued that the real miracle was getting reelected (which, in fact, most did).

**TABLE 1** What the Miracle Wrought - The Highlights

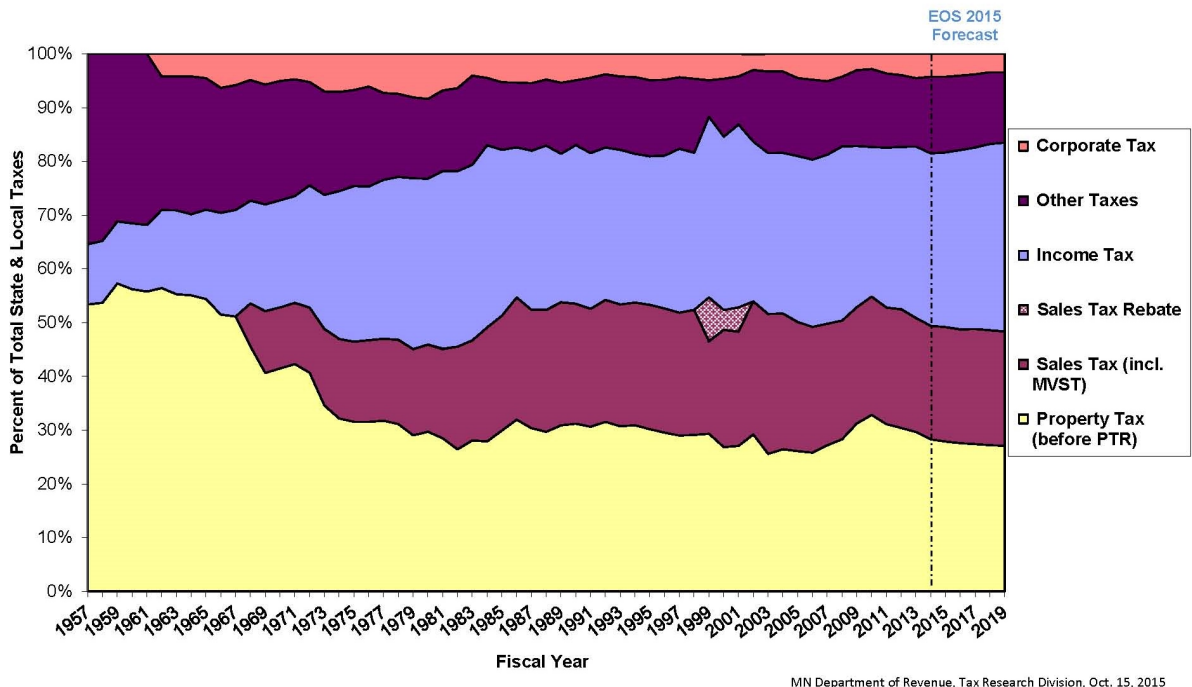
For Schools	For General Property Tax Relief	All Paid for By...
Increased state aid to 65% of school operating costs	Expanded homestead property tax credit and exemption of business inventories and machinery	Increase in income taxes by an average of 22%
Established a uniform and equalized local property tax levy for schools	Established Local Government Aid (LGA)	Increased corporate income, bank excise, and taconite taxes
Additional aid to districts based on disadvantaged students served	Increased categorical aid to counties for welfare costs	Increased liquor and beer taxes by 25% and cigarette taxes by 5 cents a pack
	Established levy limits	Increase in state sales tax rate from 3% to 4%
	Regional tax base sharing (Fiscal Disparities)	

## Checking for a Pulse

So has the Miracle been abandoned? A check of key measures indicates that contrary to public perception, the two primary goals of this legislation – property tax relief and improvements in school finance equity – remain very much intact. Several measures suggest Minnesota is actually more "miraculous" now than we were during the supposed Miracle heyday of the 70s, 80s and 90s.

To begin with, we are no more reliant on property taxation than we were following the adoption of the Miracle. As Figure 1 shows, the property tax relief efforts of 1967 and the subsequent Miracle legislation dramatically reduced property taxes' share of all taxes from over 50% to the low 30% range by around 1980. But over the years – including periods when the Miracle was being "abandoned" – property taxes' share of all state and local taxes stayed at about the same level. The exception is a brief spike during the Great Recession due to year-on-year declines in actual sales and income tax collections -- temporarily giving property taxes a greater relative tax share. But as the figure shows, property tax share was returning to normal historical patterns even before enactment of the 2013 income tax increase. Importantly, these shares are calculated before factoring in the property tax refunds the state annually delivers to homeowners and renters – which reduced property taxes by \$650 million in 2015.

### History of Minnesota's *State & Local Tax Shares* Actual FY 1957-2014 and Forecast to 2019



MN Department of Revenue, Tax Research Division, Oct. 15, 2015

A similar story emerges when looking at Minnesota property tax collections in a national context – significant decline immediately following the Miracle’s adoption with a leveling off thereafter. In some ways, the transformation of the state/local fiscal system culminated in 2001 with the state takeover of the general education levy, cutting local property taxes by \$1.3 billion. Even though other units of local government took advantage of this opportunity by backfilling some of this cut with sizable levy increases beyond their loss in state aid, this most recent major buy-down effort still propelled Minnesota property tax collections to all-time lows relative to national averages. (Perhaps unsurprisingly, this unique moment in time also conveniently became the benchmark moment for political assessments of property tax trends and changes going forward.) Although both national rankings and collections relative to the national average have increased since the Ventura Big Plan, we remain right where we have been through most of the Miracle’s lifespan. In fact, with aggregate property taxes only 0.6% above the national average in 2013, property tax burdens are lower relative to other states than at almost any other time since the enactment of the Miracle.

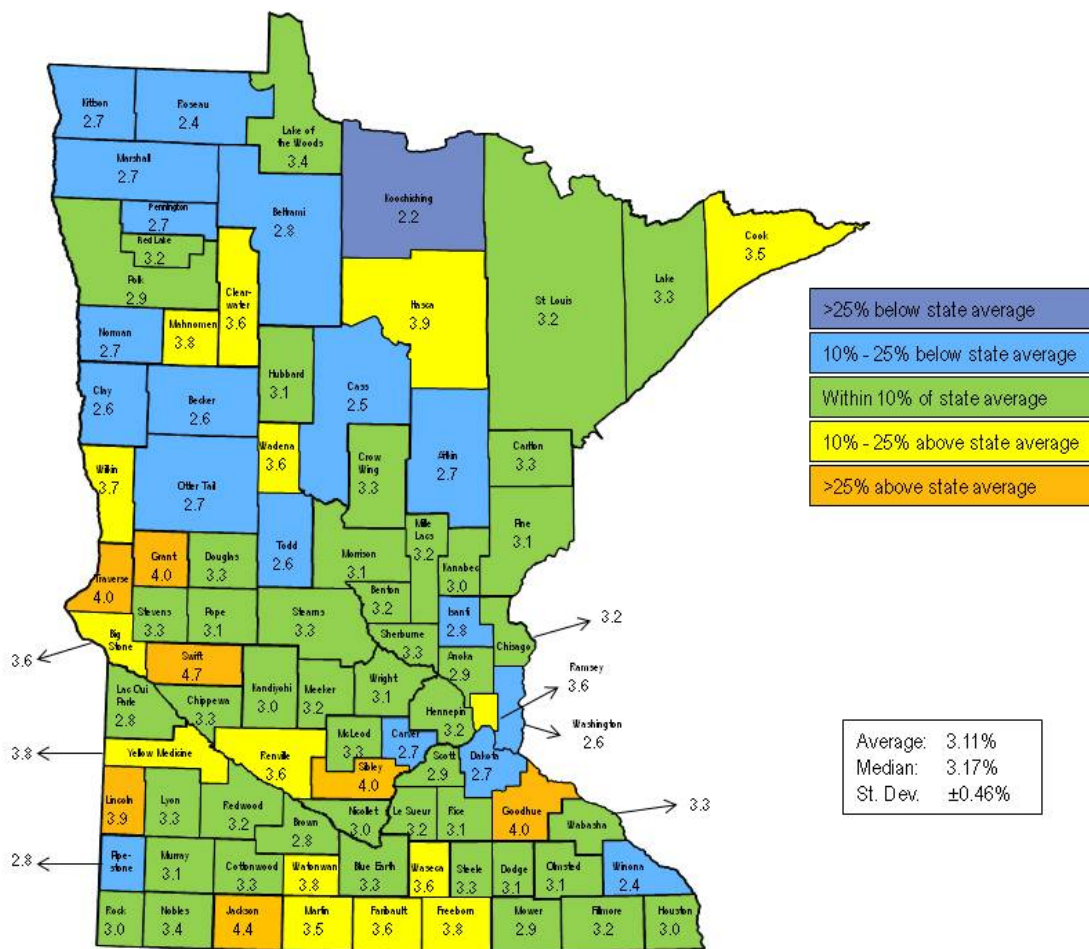
**TABLE 2** Minnesota Property Tax Collections per \$1,000 of Personal Income, Selected Fiscal Years

	1968	1971	1973	1983	1993	2004**	2013
Minnesota Property Tax Rank	9th	15th	19th	21st	19th	37th	19th
Above (Below) National Average	27.4%	18.4%	6.3%	6.8%	11.8%	(17.9%)	0.6%

\*\* Census Bureau did not publish state-specific data for FY 2003

Are geographic equity improvements intact? We eagerly await the Department of Revenue’s next Voss Report on effective homestead burdens across the state to see how things have (or haven’t) changed. In the meantime, the accompanying map (Figure 2) offers some perspective by examining total net local effort property taxes paid within a county<sup>3</sup> divided by all the cash income available to pay those property taxes within a county. As the map illustrates, the cause of property tax fairness seems rather well served. Sixty of Minnesota’s 87 counties are within 15% of the state average. Large swathes of average and below average tax burdens running border to border in any direction suggests that common concerns about equity are a lot more complicated than editorial pages generally communicate.

**FIGURE 2** Locally-Paid Property Taxes Relative to Cash Income, by County: 2013



With respect to school finance, the story is similar. Whether the state is providing adequate support is debatable, but no one can say that the Miracle’s goal of far greater reliance on the state for school funding hasn’t come to fruition. According to the Department of Education the state paid for 77% of district general operating costs in 2013 – higher than Governor Anderson’s original ambitious target.<sup>5</sup> To improve inter-district equity in school finance – another Miracle objective – over the years the state has added various compensatory aid programs to pay for geographic and other cost factors outside of a district’s control.

### Major Headwinds

All this suggests the problem isn’t that we have dismantled the state/local fiscal relationship; rather, the problem is finding enough money to pay for the continuing twin demands of low property taxes and high quality local government services. That challenge has been emblematic of the Miracle’s 45-year history. (See this sidebar on Minnesota’s 45-year-long struggle to fuel the Miracle.) Going forward, Minnesota faces two major problems in delivering on such expectations.

The first problem is simply demographic. According to the House’s Fiscal Analysis Department, in FY 2000 health and human service spending comprised 22.1% of all spending out of the state’s general fund. By FY 2015 that share had climbed to 30.7%. To put this trend in another way, since FY 2000, the health and human service area has consumed 42% of all additional state general fund spending. Moreover, as the 2009 Budget Trends Study Commission pointed out, we are only at the cusp of the demographic changes that will increase pressure on health and human service spending going forward.

This budget reality translates into a mammoth uphill struggle for reliable, state-subsidized property tax restraint and relief over the long-term. The aforementioned change in health and human services’ share of the general fund budget represents \$1.75 billion of 2015 resources unavailable to support other spending priorities – including aids to local governments and funding for schools. As former state Finance commissioner Jay Kiedrowski has stated, “If I was a betting man I’d bet that there would be reduced local government aid for cities and counties into the future as human services costs go up.”<sup>6</sup>

The second problem is the absence today of any notion of “shared sacrifice” —a belief that was so essential to the ambitions of the original Miracle. In the rhapsodizing over how much better the state functioned when the local aid spigots were opened wide, one crucial element gets ignored – every citizen paid for it. Lower- and middle-income households clearly felt the increases in sales, excise, and income taxes that supported these new initiatives. As just one example, the effective state income tax rate for a household with income at 150% of the federal poverty guidelines immediately after the Miracle was adopted was 4.2% (compared to -2.3% today thanks to the state’s Working Family Credit). The \$272 income tax bill in 1973 for this filer would be equivalent to about \$1,450 in 2015 dollars. By the early 80’s recession, the effective rate for a filer at this income had risen to 4.9%, thanks in part to a surtax added to tax liability in 1981-1983 as policy makers frantically attempted to keep property tax relief going at the same time as the state budget was imploding.

With income and sales tax rates already among the nation’s highest, Minnesota tax policy doesn’t have the headroom it once had to allow policymakers to move further along this path. Base broadening might be an avenue for “revenue enhancement” but there appears to be zero public appetite or support today for such thinking. Ironically, part of that resistance is likely a function of the highly successful effort to portray Minnesota’s tax system as chronically and perpetually unfair. As a result, Minnesotans may still express strong support for egalitarian ideals like “One Minnesota” but are also adamant that a very tiny fraction of the state’s population pay for it.

### Miracle 2.0

There is no evidence of a return to anything resembling the reliance on property taxation that predated the Miracle nor the equity problems such reliance created. With respect to property taxation we essentially are where we always have been ever since adopting the Miracle.

None of this matters. Minnesotans want great services but expect low property taxes, making local governments reluctant to raise levies. Policy makers want to fulfill both wishes. The difference today is that our ammunition is spent, competition for general fund resources is more intense than ever, and the flawed tax policy which helped sustain it through challenging times (see sidebar) is unlikely to return.

Meeting this expectation without resorting to clumsy and heavy handed levy limits or a new miracle – only focused this time on the other side of the ledger. “Miracle 2.0” will need to be based on three building blocks:

### 1. Major Investment in the Scale Up of Local Government Service Redesign

For many years, and largely under the radar, local governments across the state have made significant strides in redesigning the ways they deliver services. This redesign comes in many forms. Despite the general recognition that the number and organization of local governments in Minnesota often reflects a bygone era, actual consolidation of local government entities – apart from schools – remains relatively rare. But shared service arrangements and other intergovernmental cooperative agreements are much more common and have yielded many success stories.

However, none of this happens without incurring real costs. Structural, administrative, and technical transition issues – such as the disposition of existing employees, professional service contracts and the need for coordinated technology platforms – have cost implications. According to a 2012 OLA report on local government consolidation, though there are opportunities to increase collaboration and consolidation, the path can be a “costly, controversial, and complicated undertaking with no guarantee of savings.”

But the state’s budgetary indifference to these pursuits doesn’t help. Consider that in 2015 the state distributed over \$720 million of general purpose aid to subsidize local government operations as they currently exist, but nothing to directly support cooperation, shared service, and consolidation efforts. One path forward would be to create a pool of resources to help pay for the costs associated with these opportunities for collaboration – including early retirement incentives to leverage the impending public sector retirement boom.

Some repurpose of state aid would also help correct for the disincentives existing state aid creates. The Legislative Auditor’s report also concluded local governments and citizens are in the best position to determine when and how service reform would make sense for them. But such determinations need more accurate local tax pricing of existing services to signal that investigations into service delivery reform and redesign are necessary. Hiding the true cost of local government from taxpayers through substantial state subsidies doesn’t do the cause of innovation in local government service delivery any favors.

### 2. Transformation of Local Government Cost Structures

Unfunded state mandates and maintenance of effort requirements have long been the bane of city and county governments – interfering with local decision-making and budget prioritization while increasing local property taxes. As a general rule, in a next generation Miracle environment, state government would resist temptations to micromanage local governments. Instead, it would identify measurable service performance expectations while giving local governments the freedom to organize and design processes to achieve those outcomes in whatever ways make sense for them. Towards this end, one “Miracle 2.0” initiative would be the creation of a mandate review and sunset commission to systematically and regularly evaluate the efficacy and cost of local government mandates, eliminate those that fail the benefits test, and ensure adequate state financial support for those that are retained.

Since local service delivery is a labor intensive process with compensation constituting the majority of local governments’ general operating budgets, compensation design and flexibility is no less a necessary focus for cost structure reform. As our recent education finance report concluded, moving away from the traditional collective bargaining constructs and towards alternative strategies can be challenging to design responsibly without creating other unintended consequences. But moving to an alternative compensation design that offers the opportunity to repurpose existing compensation resources for greater effect is rapidly evolving from a debatable policy discussion to an undebatable fiscal necessity.

### 3. Citizen Reengagement in Local Government Decision-Making and Budget Priorities

The next Miracle must focus on a different relationship – the relationship between local governments and citizens. Improving this relationship may be the greatest challenge of all. Empty seats at Truth in Taxation hearings may represent apathy and disengagement of citizens but they also likely reflect a belief that the average citizen has no way to meaningfully deconstruct and responsibly question the narrative of the budget that local officials are presenting.

Service performance measurement and benchmarking, which many local governments have pursued, should include cost information as well as outcome measures so citizens can evaluate government’s efficiency as well as its effectiveness. Transparency initiatives should be pursued to allow citizens to make informed judgments about the use of their tax dollars. Local governments should present their final levy in a “tax of last resort” format so citizens can clearly see how spending decisions and changes in other revenue sources resulted in the final determination of the levy.

Nothing is easy about any of the ideas behind Miracle 2.0. Reaching consensus on tax levels and state appropriations is child’s play compared to the challenges and obstacles embedded in this agenda. It collides head on with powerful and entrenched special interests of all types, inside and outside of government, while often requiring state policy makers to relinquish their most valued commodities: power and control. If any of this takes root, one thing can be said with certainty: the new Minnesota Miracle will be a lot more miraculous than the first.

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#### FOOTNOTES

<sup>1</sup> “Property Tax Relief Fund Ends Year With \$32,000,000 Balance”, Minnesota Taxpayers Association, July 25, 1968.

<sup>2</sup> Many of the details of the Miracle contained here are taken from Steve Dornfeld’s interview with its key legislative players in “Miracle: A Roundtable Discussion” which appeared in *Minnesota History*, Winter 2007-2008.

<sup>3</sup> Equal to all local property taxes levied in a county, less property taxes exported to non-county residents. Exported taxes assumed to equal 30% of local sales taxes, 80% of local cabin property taxes, 90% of local lodging taxes, and 100% of property tax refunds (which essentially exports the local property tax burden to the state).

<sup>4</sup> Cash income is equal to personal income less readily available non-cash components (employers’ FICA, pension, and insurance costs, one-half of the FICA taxes paid by the self-employed, imputed rental income, imputed interest income, the cash value of government medical benefits, SNAP benefits, education and training assistance benefits, and government transfer payments to nonprofit institutions) plus cash available for spending that is not included in personal income (employees’ FICA taxes, pension and annuity income, IRA distributions, and capital gains).

<sup>5</sup> Data from Consolidated Financial Report for all districts statewide for the 2012-13 school year. Data for 2013-14 is available, but the payback of certain accounting shifts distorts the results and so does not provide a representative measure.

<sup>6</sup> “Minnesota Scrutinizes 40-year-old ‘Miracle’ ”, Minnesota Public Radio, 12/23/2011.