MINNESOTA EXTENSION SERVICE

UNIVERSITY OF MINNESOTA

Department of Agricultural and Applied Economics
Classroom-Office Building
1994 Buford Avenue
St. Paul, Minnesota 55108

SPEAKING OF TAXES

Number 3
January 15, 1988

MINNESOTA'S PROPERTY TAX SYSTEM:
CLASSIFICATION, CREDITS, AND COMPLEXITY

by Arley D. Waldo
University of Minnesota

The 1987 legislature enacted major changes in Minnesota property tax laws under the banner of "tax reform." Some of these changes take effect for taxes payable in 1988, but most of the major property tax reform measures become effective for taxes levied in 1988 and payable in 1989. This means that the legislature will have an opportunity to reconsider property tax changes made in the 1987 session when state lawmakers convene in February 1988. Further modification of the property tax system is almost certain. Proposals for property tax reform seem always present.

PROPERTY TAX REFORM The slogan "property tax reform" is deceptive. The word reform means to improve, to change for the better, to correct a wrong. What's wrong with the Minnesota property tax system? Can we agree on what would make it better? The problem, of course, is that one person's idea of "better" might be someone else's notion of "worse".

I am often reminded of something written years ago: "The general property tax as actually administered is beyond all doubt one of the worst taxes in the civilized world." (Edwin R. A. Seligman, 1895) And that was before Minnesota first adopted its classified property tax system! I wonder what Mr. Seligman would think today?

Minnesota's property tax system is complicated. It is difficult to understand, hard to administer, and almost impossible to explain to anyone. Most taxpayers (and probably

many politicians) don't understand how property tax bills are determined, or who to blame if property taxes go up or who to thank if property taxes go down.

Would-be property tax reformers frequently list four main objectives:

1. Simplification of the property tax system.

2. Better targeting of property tax relief.

3. Avoiding large increases in local property tax levels.

4. Making local officials more accountable for local spending decisions.

Minnesota has a complex, classified property tax system. Different classes of property are assessed at different percentages of market value to arrive at the taxable valuation of property, and state-paid property tax credits reduce the tax imposed on certain classes of property.

Let's look first at the way the classification system works.

<u>CLASSIFICATION</u> Property tax assessors are responsible for both estimating the market value of all taxable property and determining its classification. Property is classified on the basis of how the property is used (e.g.; residential, farm, business, seasonal-recreational, etc.), specific characteristics of the property (e.g.; size of the parcel, number of rental units, etc.), and characteristics of the property owner (e.g.; blind, disabled, etc.). Both the estimated market value of a property and its classification will affect the net tax on a particular parcel.

In a period of rapidly changing market prices, the job of estimating market value can be difficult. The problem of valuing farmland in recent years is a familiar example. But the assessor must not only appraise property but also classify it. At times this can be as difficult as attempting to estimate market value.

Under a classified property tax system, the estimated market value of a property is multiplied by some percentage figure to arrive at assessed (taxable) value. For example, suppose the estimated market value of a particular home is $80,000 and the assessment ratio (sometimes called classification ratio) is 25 percent. The assessed value of the home would then be $20,000 ($80,000 times 25%). Now suppose the property tax rate is 50 mills (50 mills equals a tax rate of 5%). The tax on the home is

$1,000 ($20,000 times .050). In relation to the estimated market value of the home, the tax rate is 1.25 percent ($1,000 divided by $80,000). This is known as the "effective tax rate."

It is easy to see that if different kinds of property are assessed at different percentages of estimated market value, effective tax rates will vary even though all properties are taxed at the same mill rate. For example, suppose that the assessment ratio used in taxing business property is 75 percent. The assessed value of a business property with an estimated market value of $80,000 would be $60,000 ($80,000 times 75%). With a property tax rate of 50 mills, the tax on the business property is $3,000 ($60,000 times .050) -- three times the tax on a home that has the same estimated market value. The effective tax rate on the business property would be 3.75 percent ($3,000 divided by $80,000).

In practice, effective property tax rates in Minnesota vary both because of the classification of property and because certain classes of property are eligible for tax credits, such as the homestead credit, which reduce the tax bill on certain classes of property. For now, let's consider only the effect of classification.

Keep in mind two features of a classified property tax system:

<u>First, classification will affect the composition of the tax base.</u> This, in turn, will influence the distribution of property tax burdens <u>since different classes of property are taxed on the basis of different percentages of estimated market value</u>. What proportion of market value is taxed? Looking just at statewide figures for major types of property for taxes payable in 1987, total assessed (taxable) value as a percentage of market value for major types of property was:

Type of Property	Assessed Value as a Percent of Market Value
Farm	**16.9%**
Residential	**20.3**
Apartments	**31.1**
Commercial	**40.7**
Industrial	**42.1**

(Please note that each of these categories includes several different legal property classifications. These figures should not be confused with the assessment ratios used to calculate assessed values on individual parcels of property.)

Second, any attempt to provide tax relief by changing assessment ratios on certain classes will simply shift tax burdens to the owners of other property within a given taxing jurisdiction. At various times the state legislature has changed assessment ratios -- presumably to provide tax relief to certain groups of property owners. But a reduction in the assessment ratio for one class of property will mean a tax cut for some property owners at the expense of higher taxes for the owners of other properties.

Moreover, the effect of a change in assessment ratios will depend on the composition of the tax base in the local taxing district. For example, if the tax base of a local area is made up almost exclusively of a single class of property, say farmland in the case of an agricultural area, a reduction in the assessment ratio for farmland will have little effect on farm property taxes because there is very little nonfarm property to which the tax burden can be shifted.

Minnesota first adopted a classified property tax system in 1913 when four property classes were created. Through the years, additional classes have been established and several property classes have been divided into "tiers" in which a portion of the market value of a property is assessed at one percentage rate and part at a different rate. For example, for taxes payable in 1988 on nonagricultural residential property that qualifies as a homestead, the home will be assessed at a rate of 17 percent on the first $68,000 of estimated market value and at 27 percent on market value over $68,000. This is a "two-tier" classification.

Suppose you own a home valued at $80,000. The assessed value on your home would be 17 percent of the first $68,000 ($68,000 times 17% = $11,560) plus 27 percent of the value over $68,000 ($80,000 - $68,000 = $12,000 and $12,000 times 27% =$3,240). The total assessed value would be $14,800 ($11,560 plus $3,240).

According to the Minnesota Revenue Department, the classification system has been changed in every legislative session since 1941. Depending on how you count, for taxes payable this year there are around 70 different property classes for tax purposes.

The 1987 tax law provides for a substantial reduction in the number of property classifications beginning with property taxes payable in 1989. My own count is that there will be 20 classes, if each tier is assumed to be a separate class. Whatever the number, Minnesota will still have far more property classes than any other state. According to the Minnesota Taxpayers Association, 32 states do not classify property for tax purposes. They have only one class of taxable property. And those states that do provide for classification usually have only two or three classes.

Classification clearly adds complexity to Minnesota's property tax system, but this is not the whole story. Minnesota also has an elaborate set of property tax credits that reduce the tax bill for the owners of certain classes of property. These credits also influence effective tax rates.

<u>**TAX CREDITS**</u> Property tax credits are subtracted from the gross tax levied on qualifying property thereby reducing the tax that must be paid. Local governmental units are reimbursed by the state for allowable credits. The largest (and oldest) of the state-paid property tax credits is the homestead credit, which first took effect for taxes payable in 1968. An agricultural school credit (replacing another provision which reduced tax rates on farmland) was added beginning with taxes payable in 1977. These two credits account for nearly all of the $727 million in property tax credits paid by the state in 1987.

However, Minnesota's property tax system also includes credits, local government reimbursements, and special assessment provisions for certain other property classes. For taxes payable in 1987, the following property tax credits were in effect:

1. Regular homestead credit.
2. Taconite homestead credit.
3. Supplementary taconite homestead credit.
4. Disaster credit.
5. Wetlands credit.
6. Native prairie credit.
7. Power line credit.
8. Agricultural preserves credit.
9. Enterprise zone credit.
10. School agricultural credit.

For taxes payable in 1988, a one-time "small business transition credit" was added to the list. This provision is for a tax credit that will pay one-half of the amount by which the tax on commercial/industrial property exceeds an effective tax rate of 3 percent. The credit applies to only the tax on the first $120,000 of market value and to only one parcel per owner per county.

Under the 1987 tax law, the property tax credit system would be substantially altered for taxes payable in 1989, but it would not be much simpler. Only two credits -- for wetlands and for native prairie -- would be dropped.

Taxpayers are probably most familiar with the homestead credit. For property taxes homeowners paid in 1987, the gross property taxes levied were reduced by 54 percent of the tax on the first $68,000 of market value, up to a maximum credit of $700. In 1987, state-paid homestead credits amounted to a little over $609 million (which includes $11.2 million in special homestead property tax relief for homeowners in "taconite relief areas" in northeastern Minnesota).

Under the state school agricultural credit, owners of farmland were given a tax credit of $115.6 million in 1987 (in addition to the homestead credit given to homesteaded farm properties).

In addition to all of this, Minnesota also has special provisions for valuing agricultural ("Green Acres") and open space land for tax purposes, a property tax refund (circuit breaker) program for homeowners, and a renters credit.

<u>CLASSIFICATION & CREDITS</u> Both the assessment ratios applied to different classes of property and the property tax credits provided by the state affect the distribution of property tax burdens. Let me try to summarize the general tax provisions for the largest classes of taxable property in the state.

The property tax in Minnesota is almost exclusively a tax on real property. Most personal property is exempt from taxation. Real property makes up more than 98 percent of the tax base.

The tax base of individual taxing districts varies widely. But, on a statewide basis (1986 valuations for taxes payable in 1987), the largest classes of taxable property are:

Property Class	Market Value (Bil. Dol.)
Residential/Nonfarm/Homestead	56.8
Residential/Nonfarm/Non-homestead	6.1
Farm/Homestead	17.6
Farm/Non-homestead	7.5
Apartments	6.0
Commercial/Industrial	18.2

These property classes account for about 92 percent of the state's local property tax base. There is no state property tax.

Now let's see how these classes of property are taxed. The following provisions apply for taxes to be paid in 1988.

RESIDENTIAL/NONFARM/HOMESTEAD. Nonfarm, owner-occupied residential property is assessed at a rate of 17 percent of the first $68,000 of estimated market value and 27 percent of market value in excess of $68,000. Lower assessments apply to the homes of disabled and blind persons. Residential homesteaded property also qualifies for the homestead credit. For taxes payable in 1988, this credit is calculated as 54 percent of the gross tax on the first $68,000 of market value. The credit cannot exceed $700.

RESIDENTIAL/NONFARM/NON-HOMESTEAD. Nonfarm residential property that does not qualify as a homestead is assessed at a rate of 28 percent of market value. Since the property, presumably rental property, is not occupied by the owner, it is not eligible for the homestead credit.

FARM/HOMESTEAD. Farm homesteads are assessed at 14 percent of the first $66,000 of market value and 18 percent of the excess over $66,000. Farm homesteads are also eligible for a homestead credit. In addition, farms qualify for the school agricultural credit. The credit for farm homesteads is 36 percent of the gross tax on the first 320 acres of farmland (excluding the house, garage, and one acre of land) and 26 percent of the tax on farmland in excess of 320 acres.

FARM/NON-HOMESTEAD. Farmland that does not qualify as a homestead is assessed at 18 percent of market value. There is no homestead credit, but the school agricultural credit does apply. For non-homesteaded agricultural property, the credit is 26 percent of the gross tax.

APARTMENTS. The assessment ratio for apartment houses varies. The rate depends on the number of rental units, whether the units are government-subsidized, and other factors. For apartments with four or more units and which do not fall into one of the special categories, the assessment ratio is 34 percent. There are no tax credits.

COMMERCIAL/INDUSTRIAL. Most commercial and industrial property is assessed at a rate of 28 percent of the first $60,000 of market value and 43 percent of market value in excess of $60,000. Special provisions apply to "employment property in enterprise zones." There is a business credit, mentioned above, that is effective only for taxes payable in 1988.

EFFECTIVE TAX RATES Because of differences in assessment ratios and property tax credits, different classes of property pay quite different effective tax rates. Residential homesteads and farms are taxed much less heavily than commercial, industrial, and rental property. The following estimates by the Minnesota Department of Revenue represent net taxes payable (after deduction of tax credits) as a percentage of estimated market value for taxes payable in 1988:

PROPERTY CLASS	EFFECTIVE TAX RATE
Farm	1.03%
Residential Homestead	1.28
Apartments	3.84
Commercial/Industrial	4.84
Total Real and Personal Property	2.23%

These are statewide average figures and will vary for individual taxing jurisdictions, but they do reflect the general disparity in tax rates on different types of property.

POLICY ISSUES If nothing else, this brief look at Minnesota's property classification and credit system suggests something of its complexity. Is it important to simplify our property tax system? A possible answer is that it is not. Some argue that simplification in and of itself is not very important as long as the end result (for example, the distribution of tax burdens) is what we want. How we get there doesn't matter.

I personally disagree with this view. I think taxpayers have more confidence in a tax system they can understand. Moreover, how can taxpayers -- and voters -- decide on the merits of proposed tax changes when the existing system is virtually incomprehensible?

How did our property tax system get so complicated? For the most part, because of legislative attempts to achieve goals thought to be desirable -- to provide tax relief for farmers and homeowners, to give special help to the blind and disabled, to encourage the construction of fire resistant apartment buildings, to provide incentives for the preservation of native prairie and wetlands, to provide tax relief for small businesses, etc. But are there ways to accomplish these objectives in a more understandable and better targeted way? Some would argue there are, and that tax simplification could be combined with a better targeting of tax relief to those taxpayers judged to be most in need of help.

Perhaps the most controversial outcome of our existing property tax system is the wide disparity in tax rates on different classes of property. Should commercial, industrial, and rental property be taxed at rates several times higher than rates on homes and farms? This question, along with concerns about cuts made in the property tax refund and renters credit program by the 1987 legislature, will be at the center of the property tax reform debate when the legislature convenes in February.

Arley D. Waldo is Professor, Public Finance and Tax Policy, Department of Agricultural and Applied Economics, and Extension Economist, Public Policy, Minnesota Extension Service, University of Minnesota.