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# What Would Minnesota Without an Individual Income Tax Look Like?

*A look at commonly shared revenue system features and spending characteristics of states without an individual income tax indicates that a phase-out of the tax would require a complete transformation of the state fiscal system – and the ideals underlying it – that has defined Minnesota government for more than half a century.*

With the massive surplus and a February economic forecast suggesting a possibility of even more to come, 2022 was a year of big tax cut and spending ideas. Even though divided government ultimately neutered everyone's plans, the ambition still lurks. This is perhaps best captured by Republican gubernatorial candidate Dr. Scott Jensen's expressed interest in phasing out the state's personal income tax. According to the Star Tribune, when asked whether it's realistic to eliminate the tax and how the state's budget could be balanced without that revenue, Jensen said: "I don't know how we could determine if it's realistic if we're not willing to have that big, bold, robust discussion."

There are many reasons why 41 states of every political hue tax individual income to support government operations. It's a revenue source that grows with the economy and exhibits the greatest reliability compared to other state revenue sources (the property tax is more reliable but is only occasionally used as a major state revenue source). It adds diversity to a revenue system portfolio. For states attentive to ability to pay matters, it can serve as a source of progressivity to mitigate the inherent regressivity arising from almost all other forms of taxation. And although some might not see this as a positive quality, it's a very productive tax with the ability to raise a lot of revenue. For all these reasons, state income taxation continues to serve as an indispensable foundation for government finance in the vast majority of states.

Yet nine states are able to fund state government without this tax. The idea of phasing it out here prompted us to take a closer look at just how these states are able to manage their fiscal affairs. How do these states pull off what might seem to be a "mission impossible" of public finance? What are the distinguishing characteristics and features of state revenue systems that forego what other states rely on? How and to what extent does forgoing individual income taxation impact the nature of government spending? We compared and benchmarked Minnesota's tax and fiscal system against several states without personal income taxes to explore these questions and offer some perspective on what a Minnesota without a personal income tax might look like.

Of the nine states without an individual income tax, our investigation focused primarily on the four closest "peers" in terms of economy or population – Florida, Tennessee, Texas, and Washington – plus our neighbor South Dakota (others are Alaska, Wyoming, Nevada and New Hampshire). Unless otherwise noted, our analysis is based on 2019 data from the Census Bureau's Annual Survey of State Government Finances (calculations by MCFE) to avoid tax and spending distortions resulting from the pandemic and federal responses to it.

## Revenues: How Do These States Make It Work?

Demographics and the make-up of state economies affect how states finance their governments. The ability of states to operate without an income tax can be influenced by these features. At the top of this list is the ability to export large amounts of taxation to non-residents. Such is the case with Florida and Nevada with their tourism – and gambling – industries; and Alaska, Wyoming, and Texas with oil and gas severance taxes, mining taxes, and related revenues. For example, in 2019, Florida had 145.4 million out-of-state visitors generating \$13 billion dollars in state and local taxes just from tourism, or 15% of all state and local own source tax revenue.<sup>1</sup> That's a greater share of own source revenue than Minnesota obtains from all its general sales tax collections. These are unique state characteristics that most states do not have and cannot replicate. Moreover, none of the nine states ever had an income tax,<sup>2</sup> thus no state has ever eliminated an income tax.

All of these states' tax systems have evolved in different ways in lieu of personal income taxation. However, four shared revenue system characteristics stand out – especially when juxtaposed against Minnesota's existing tax system structure and implementation.

**Much Less Revenue Raising Effort (with a notable exception)** – With one exception, the no income tax comparison states represent significantly smaller government – spending 15% or less per capita than the national average. As Table 1 shows, even if Minnesota had no income tax, Minnesota own source revenue collections per capita would still be greater than four of these states. The exception is Washington, whose above average spending in 2019 was enabled in part by \$3.36 billion in state property taxes on business and residential property owners on top of \$9.3 billion of local levies.

Table 1: Minnesota Own Source Revenues Collections vs. Comparison States

	State and Local General Own Source Revenue per Capita	% Above/Below MN	Without Income Tax	Without Income tax % Above/Below MN
<b>Minnesota</b>	\$9,246	NA	\$7,047	NA
<b>Florida</b>	\$6,481	-29.9%	\$6,481	-8.0%
<b>South Dakota</b>	\$6,283	-45.7%	\$6,283	-10.8%
<b>Tennessee</b>	\$5,632	-57.5%	\$5,632	-20.0%
<b>Texas</b>	\$7,029	-39.3%	\$7,029	-0.3%
<b>Washington</b>	\$9,172	-1.0%	\$9,172	30.2%

**Greater Reliance on General Sales Taxation** -- Money has to come from somewhere, so unsurprisingly states without a personal income tax rely heavily on general sales taxation, the other workhorse of state government finance. Minnesota's share of state government revenue coming from general sales taxes is about half that of the no income tax states which collect 18% to 99% more general sales state revenue per capita.

The difference is rooted in the sales tax base on goods and services, not on state rates. As the Table 2 shows, Minnesota's 6.875% general sales tax rate is actually higher than all but one of the states without a personal income tax (three other no income tax states – Alaska, Wyoming and Nevada – have lower general sales tax rates as well, and New Hampshire has no sales tax.) A detailed comparison of what is and is not included in state sales tax bases is beyond the scope of this report, but taxation of big-ticket goods such as clothing, groceries, and gasoline (in addition to any excise taxes) – along with the use of gross receipts taxes and taxation of a higher number of services appear to be the sources of the differential. According to a 2017 Federation of Tax Administrators survey, Minnesota taxes 67 services whereas the total in the comparison states ranges from 69 to 167 services. The breadth of a state's sales tax base can be roughly measured by the share of total state personal income (a proxy for GDP) included in the sales tax base. In 2021, the breadth of Minnesota's general sales tax base was 29.53% -- almost exactly the 50-state mean, but 34% less than the average of the five comparison states.<sup>3</sup>

Table 2: Minnesota General Sales Tax Statistics vs. Comparison States

	State General Sales Tax Rate	Share of State General Revenue	State Revenue per Capita	Local Revenue per Capita
<b>Minnesota</b>	6.875%	13.6%	\$1,100	\$51
<b>Florida</b>	6.0%	30.7%	\$1,303	\$143
<b>South Dakota</b>	4.5%	25.8%	\$1,294	\$419
<b>Tennessee</b>	7.0%	29.0%	\$1,387	\$290
<b>Texas</b>	6.25%	26.2%	\$1,314	\$301
<b>Washington</b>	6.5%	32.2%	\$2,186	\$662

This relative level of sales tax reliance in the state is actually understated because it does not include sales tax support for financing local government. As the table also shows, states without a personal income tax collect 3 to 13 times more sales tax revenue per capita than Minnesota indicating more local option sales tax authority specifically and far greater local government fiscal "self-reliance" generally (an issue we'll return to later in a look at state spending). The five no income tax states all have local option sales taxes under state general law; in Minnesota only Minneapolis, St. Paul, and Duluth have been given such authority. For some perspective, the ratio of local own source revenue collections to state own source revenue collections in these five states averages 99 percent – meaning local governments together collect almost as much or more own source revenue than the state does. The ratio in Minnesota is only 54%.

**Reliance on dubious business tax policy** -- Even in embracing smaller government, states forgoing individual income taxation need to find alternative revenues to adequately fund operations. Business is a popular target, and states without a personal income tax often seek to compensate for the absence of taxable personal income with forms of business taxation that violate good tax policy principles.

The biggest problem is tax pyramiding – taxation imposed at multiple stages of a production and distribution process leading up to a final sale. South Dakota's ability to rely so heavily on sales taxation with a comparatively low rate is enabled by also including almost all intermediate business-to-business services like legal, accounting, and the production of advertising.

A similar problem arises in gross receipts taxation in which a low-rate tax is applied to a company's gross sales, without deductions for a firm's business expenses like costs of goods sold and compensation. In addition to pyramiding impacts, gross receipts taxes have long been criticized for their abundant efficiency, equity, and transparency problems, perhaps best summed up in the *Devil's Dictionary of Taxation* as "an increasingly popular form of business taxation created by people who weren't paying attention in their public finance classes."<sup>4</sup>

Only seven states employ broad gross receipts taxes at the state level. Four of these seven do not tax personal income. (WA, TX, TN as well as NV). Washington's Business and Operations (B&O) tax, the state's second largest source of revenue, is a gross receipts tax that has been jiggered countless times to address business complaints and headaches with an abundance of classifications and rate structures, exemptions, and exclusions that rival the complexity of Minnesota's property tax system. It's been described as, "one of the most burdensome and unpopular

taxes elected officials impose on the people of Washington,"<sup>5</sup> and "loathed with the intensity usually reserved for your college football team's archrival."<sup>6</sup>

Currently, as part of an investigation into state tax reform, the Washington Tax Structure Work Group is looking at replacing the B&O tax with a modified version of a gross receipts tax modeled after another state without a personal income tax. The Texas Margin Tax is also based on total revenue of the company with certain deductions. However, this modified gross receipts tax has been on the receiving end of the same criticisms regarding pyramiding, transparency, efficiency and equity. These characteristics and the tax's revenue performance led the Tax Foundation to conclude this tax "does not raise revenue in an equitable, simple, or transparent way" further noting that in an attempt to support K-12 education from a source other than property taxes, "they inadvertently created one of the worst business taxes in the country."<sup>7</sup>

**More Dedication and Earmarking** -- Constraining access to revenue sources increases internal government competition for revenues that are available. To ensure priority functions and activities of government have "competitive advantage," and receive adequate support, states may constitutionally or statutorily dedicate/earmark tax revenue streams.

Large, expensive, and high priority state spending programs, like K-12 education, can present a particular finance challenge for states without individual income taxes resulting in more dedication and earmarking of own-source revenues of all types. For example, in addition to dedicating a significant portion of the state's general sales tax collections to the state's Education Fund, Tennessee requires one-half the revenues derived from all county local sales taxes must be expended for education purposes.<sup>8</sup> Even though states without income taxes generally choose to rely more on local effort to fund K-12 education, school equity and adequacy issues and litigation has required states to figure out ways to step up their support.<sup>9</sup>

That has led to examples like these of revenue streams that are either dedicated/earmarked directly (wholly or in part) to education spending or indirectly by requiring local collections be used for this purpose or factored into equalization aids provided by the state.

- State lottery and other gambling proceeds
- Utility taxes
- Timber sales taxes
- Motor vehicle licensing fees
- Motor fuel taxes
- Mobile home licensing fees
- Bank franchise taxes
- Wind farm taxes
- Traffic fines
- Tobacco taxes
- Taxes on alcoholic beverage sales for on-premise consumption
- Litigation privilege tax (use of courts)
- Oil and gas severance taxes, land sales, and leases
- Retail and wholesale marijuana taxes
- Hotel room taxes

## The Role of Federal Funds

Do states without an income tax benefit from more help from the federal government? As the Table 3 illustrates, this is a complicated question. Minnesota's share of total state general revenue coming from the federal government is substantially lower than in other states (column 1). However, share will be influenced by state fiscal effort—greater state fiscal effort mathematically dictates the relative share of whatever federal revenue is received will be smaller. A better way is to compare revenue received per dollar of own source generated revenues (columns 2 and 3). Receiving 34 cents from the federal government for every dollar of own source revenue raised, Minnesota is still lowest among the 6 states. However, when factoring in local effort, differences among the states declines dramatically. Factoring in how financing responsibilities for government services are shared between state and local government illustrates how the perspective on reliance on the federal government changes.

Table 3: Minnesota Federal Funds Collections vs. Comparison States

	Federal Revenue as a percent of Total State General Revenue	Federal Revenue per \$ per \$ of Own Source General Revenue -- State Only	Federal Revenue per \$ per \$ of Own Source General Revenue -- State and Local	Federal Revenue per Capita
<b>Minnesota</b>	25.4%	\$0.34	\$0.24	\$2,050
<b>Florida</b>	31.2%	\$0.46	\$0.24	\$1,348
<b>South Dakota</b>	33.6%	\$0.51	\$0.31	\$1,687
<b>Tennessee</b>	36.2%	\$0.57	\$0.33	\$1,733
<b>Texas</b>	31.7%	\$0.48	\$0.25	\$1,592
<b>Washington</b>	36.3%	\$0.36	\$0.22	\$1,787

Column 4 offers a final curveball: Minnesota's federal revenue per capita is actually the largest of these six states – 15% greater second place Washington. This largely reflects Minnesota's relatively greater willingness to spend own source revenue to get various types of matching federal support. State Medicaid programs are the primary difference maker, accounting for over 60% of all federal grants to states.<sup>10</sup> Medicaid grants to states are a function of how much a state spends on the program and the state's matching rate and therefore has a unique role in state budgets as both an expenditure item and a source of federal revenue. (Of course, this unique role also makes any cuts to Medicaid spending less productive - federal money is lost with every cut.)

Minnesota's comparatively greater accessibility (higher levels of income eligibility) and program coverage (services provided) results in higher state spending but also more federal support. Minnesota's federal matching rate is among the lowest in the nation due to the state's high personal income, but our higher levels of program eligibility and service coverage still yields more federal income per capita. Notably, of the 12 states that have not expanded Medicaid coverage to cover more low-income citizens under the Affordable Care Act (which include FL, SD, TN and TX), six do not have an individual income tax.

### Spending: Where Do the Differences Show Up?

States forgoing income taxation also exhibit different spending priorities. Demographics, geography, degree of urbanization, incomes of the citizenry, and how public services are organized are just some of the many factors affecting state spending priorities and decisions. In many cases states with no income tax may spend more on a specific government function than much higher tax states. For example, even though Florida's total state and local fiscal effort is substantially less than Minnesota's, its per capita spending on natural resources, transportation, police, and corrections is greater.

However, significantly lower levels of fiscal effort can be expected to show up somewhere on the expenditure side of the ledger. Two areas stood out in our overview.

**Less Local Government Support** -- "Intergovernmental expenditures" are amounts paid to local governments as fiscal aid in the form of shared revenues and grants-in-aid, as reimbursements for performance of general government activities and for specific services for the paying government, or in lieu of taxes. As Table 4 shows, spending on local governments makes up a substantially larger share of total state expenditures in Minnesota: often 2-3 times more on a dollar per capita basis and typically around twice as much per dollar of direct state spending (state spending on employees, suppliers, contractors, beneficiaries, and other final recipients of government payments excluding local governments).

Table 4: Minnesota Intergovernmental Expenditures vs. Comparison States

	Intergovernmental Expenditure as a % of Total State Expenditures	Intergovernmental Expenditure per \$ of Direct State General Expenditures*	Intergovernmental Expenditure per Capita
<b>Minnesota</b>	29.6%	\$0.42	\$2,653
<b>Florida</b>	18.6%	\$0.23	\$893
<b>South Dakota</b>	16.9%	\$0.20	\$1,023
<b>Tennessee</b>	22.1%	\$0.28	\$1,141
<b>Texas</b>	19.6%	\$0.24	\$1,106
<b>Washington</b>	28.0%	\$0.36	\$2,210

\*Total State Expenditures = Intergovernmental Expenditure + Direct Expenditures

Much of the difference can be linked to Minnesota's substantially higher levels of state responsibility for financing K-12 education. However, the exception -- Washington -- is even more reliant on the state for financing its education system (78.4% vs 76.2% of school general funds in 2020) yet still spends 17% less on local government support on a per capita than Minnesota. Adjusting Minnesota intergovernmental expenditure to reflect the per capita intergovernmental spending of these states translates into \$2.5 to \$9.9 billion less support for local governments annually.

**Significantly Lower Public Welfare Spending** – Public welfare spending provides support and assistance to needy persons contingent upon their need. It includes:

- cash assistance paid directly to needy persons under the categorical programs like Temporary Assistance for Needy Families (TANF) and other welfare programs;
- vendor payments made directly to private purveyors for medical care and other services;
- provision and operation by the government of welfare institutions and payments to other governments for welfare purposes, amounts for administration, support of private welfare agencies, and other public welfare services.

Table 5 provides a look at the public welfare spending differences. Since financial responsibilities for delivering these services are shared between state and local government, Table 6 combines both state and local effort. Minnesota's share of direct general state and local spending on public welfare is over 50% greater than the average of the five no-income tax states. On a per capita dollar basis spending is nearly twice the 5-state average.

**Table 5: Minnesota Public Welfare Spending vs. Comparison States**

	<b>Public Welfare Spending as a % of State and Local Direct General Expenditure</b>	<b>State &amp; Local Public Welfare Spending per Capita</b>
<b>Minnesota</b>	27.2%	\$3,017
<b>Florida</b>	16.7%	\$1,342
<b>South Dakota</b>	16.7%	\$1,363
<b>Tennessee</b>	24.5%	\$1,853
<b>Texas</b>	16.7%	\$1,450
<b>Washington</b>	15.5%	\$1,669

As highlighted in the federal revenue discussion, state Medicaid program designs are likely a major contributor to these results but are not the only factor (Washington has adopted ACA Medicaid expansion). A sense of the magnitude of difference in Medicaid eligibility between Minnesota and the other states is provided in Table 6. Adjusting Minnesota state spending to reflect the per capita public welfare spending of these states translates into \$6.5 to \$9.4 billion less support for health and human service programming annually.

**Table 6: Comparison of Selected Medicaid Eligibility Thresholds: Minnesota vs. Comparison States (% of Federal Poverty)**

<b>Medicaid Eligibility Thresholds for No Income Tax States</b>				
	Children Medicaid Ages 0-1	Children Medicaid Ages 1-5	Children Medicaid Ages 6-18	Pregnant Women Medicaid
Minnesota	283%	275%	275%	278%
Florida	206%	140%	133%	191%
South Dakota	182%	182%	182%	133%
Tennessee	195%	142%	133%	195%
Texas	198%	144%	133%	198%
Washington	210%	210%	210%	193%

Source: Centers for Medicare and Medicaid Services (July, 2021)

## What Would Minnesota Look Like?

Envisioning what Minnesota would look like in the absence of \$16 billion of state income tax collections is a thought experiment many might consider a hallucination given the state's fiscal history and current budget. Even states with exceptionally strong fiscally conservative histories still depend to some extent on income taxation. The few states that are able to manage their fiscal affairs without the tax typically have two fundamental prerequisites working in their favor: an ability to export significant amounts of tax burden to non-residents and, no less importantly, billions in spending that never existed in the first place.

Nevertheless, the type of transformation might be summarized as follows:

**A commitment to drastically smaller government** - This is self-evident, but as our comparison found, per capita state and local own source general revenue collections in all but one of the states we benchmarked without income taxes are *still lower* than what would exist if Minnesota

did not have an income tax. Whatever this may communicate about the current size of Minnesota government, it also suggests untapped revenue options helping to make up for the absence of income taxation can be extremely tough to find without adopting highly questionable tax policy that creates significant economic, budget, and political problems of their own.

**A dismantling of the historical state/local fiscal relationship** - A common theme among the comparison states is far greater fiscal self-reliance among all local governments. Minnesota has taken a different approach by being cautious in granting such fiscal autonomy such as general local sales tax authority and instead using general fund revenues to help support local services and schools. Phasing out income taxation would ensure the end of “Minnesota Miracle” -- the state’s 50-year approach to advancing geographic equity and providing local property tax relief through state aids -- and usher in a new era of local government fiscal self-reliance from property taxation, local sales taxation and related means. Due to demographic trends and general fund competition, this historical relationship is already under greater duress in finding enough money to pay for the persistent demands for low property taxes and high-quality local government services while addressing education equity requirements. In times of budget deficits, we have already witnessed how local aids are some of the first items to be cut as the state’s own spending responsibilities take priority. A phase-out of the income tax would be a nail the coffin of this fiscal relationship. It would also create some rather interesting political dynamics with DFL-oriented metro areas being generally the biggest winners of such fiscal self-determination due to their property tax capacity and local sales tax bases while predominantly rural areas being the biggest losers due to the loss of redistributed general tax revenues.

**Fiscal system culture shock** – Minnesota has a well-deserved reputation for having one of the most progressive fiscal systems in the nation. That’s partially because of the role Minnesota’s highly progressive income tax plays in offsetting regressive qualities of most all other taxation. A second and often overlooked reason resides on the spending side – state and local government services are generally progressive and highly dependent on this productive tax. Eliminating the income tax would be a one-two punch making Minnesota’s past budgets and fiscal governance essentially unrecognizable and propelling the state to the other end of the spectrum.

Functional and political impracticalities of a proposal like this do not mean the state’s income tax and its role in the tax system should be off-limits to change or reform. But such investigations are best undertaken in the context of broader system considerations and reform able to accommodate good tax policy principles and other essential tax system objectives.

In a political campaign, the messaging within policy proposals matters more than their implementation details, feasibility, or practicality. A call for phasing out the individual income tax sends a clear message that significant income tax cuts would be a top priority in any Jensen administration and is perhaps the primary objective behind the proposal. But if this idea reflects truly serious policy interest and gets attention among a new breed of lawmakers replacing over half a millennium of departing legislative experience, grab the popcorn because the 2023 session tax debate will be one for the history books.

#### Footnotes

<sup>1</sup> “Florida’s Tourism Economy Experiences Another Record Year in 2019 But Shifts Into a Lower Gear of Growth,” Rockport Analytics and BEA Annual Survey of State Government Finances

<sup>2</sup> Tennessee had a tax on investment income which was repealed in April, 2021

<sup>3</sup> “State Sales Tax Rate Breadth and Reliance, Fiscal Year 2021” Tax Foundation, May, 2022

<sup>4</sup> “The Devil’s Dictionary of Taxation”, Hamilton, *State Tax Notes*, October 13, 2008

<sup>5</sup> “Replacing the Business and Occupation Tax with a Single Business Tax” Washington Policy Center

<sup>6</sup> “The Infamous B&O Tax” *Seattle Business*, January 9, 2012 T.C.A. § 67-6-712

<sup>7</sup> The Texas Margin Tax: A Failed Experiment” Tax Foundation, January 14, 2015

<sup>8</sup> T.C.A. § 67-6-712

<sup>9</sup> The exception is Washington which levies a state property tax on all residential and business property to accompany local school levies. While not formally dedicated to a school fund, the roughly \$3.5 billion-plus state levy helps makes Washington one of the most state-supported K-12 systems in the nation.

<sup>10</sup> “Grants 101: An Introduction to Federal Grants for State and Local Governments” Federal Funds Information for States, Washington D.C.